

The background of the slide features a large, light blue watermark of the Coat of Arms of the City of Edinburgh. The crest includes a crown with four thistles, a shield divided into four quarters (top-left: a saltire, top-right: a stag's head, bottom-left: a ship, bottom-right: a lion), and a motto scroll at the bottom with the text 'ANE FOR A'.

## **Agenda Item 4**

### **Local Government Pension Scheme - Consultation on Scheme Structure**

**Falkirk Council**

**Subject: Local Government Pension Scheme -  
Consultation on Scheme Structure**

**Meeting: Joint Meeting of Pensions Committee and Pension Board**

**Date: 23 August 2018**

**Submitted by: Director of Corporate and Housing Service**

**1. Purpose of Report**

- 1.1 The purpose of this report is to advise the Pensions Committee and Pension Board of a consultation exercise that is taking place on the structure of the Local Government Pension Scheme in Scotland.
- 1.2 The consultation has been launched by the national Scheme Advisory Board – the body responsible for advising Scottish Ministers on changes to the Scheme.
- 1.3 The consultation document is attached as an appendix to the report.
- 1.4 The report provides a summary of the consultation process and considers the high level advantages and disadvantages of the options proposed. The report also invites the Committee and Board to consider how they wish to take forward the response process.

**2. Recommendations**

**2.1 The Pensions Committee and Pension Board are asked:**

- (1) to note the contents of the report and invited to comment as appropriate;**
- (2) to consider how they wish the response process to be undertaken and, in particular, whether a sub-group (or sub-groups) of Committee and Board members should be established as outlined in Paragraph 5.4; and**
- (3) to request the Chief Finance Officer to formulate initial draft responses to the Consultation questions.**

**3. The Local Government Pension Scheme in Scotland**

- 3.1 The Local Government Pension Scheme in Scotland (SLGPS) is Scotland's largest pension scheme with around 400,000 members (employees, pensioners and deferred pensioners).

- 3.2 The Scheme covers local authorities, colleges of education, and a variety of other public bodies and charitable organisations. The Scheme is administered by 11 separate authorities whose Funds range in size as follows:

	<i>Largest Fund</i>	<i>Middle Sized Fund</i>	<i>Smallest Fund</i>
	Strathclyde	Falkirk	Orkney
No of Members	222,860	30,258	3,660
Assets	£19.7bn	£2.2bn	£335m

Statistics are as at 31 March 2017

- 3.3 The largest Funds are Strathclyde, Lothian and the North East of Scotland Pension Fund. The smallest Funds are Shetland Islands and Orkney Islands with Falkirk being a middle sized Fund alongside Tayside, Fife, Highland, Scottish Borders and Dumfries and Galloway.
- 3.4 At March 2017, the SLGPS had combined assets of £42bn and total liabilities of £55bn.

#### **4. Background to the Consultation**

- 4.1 The Heads of Agreement signed in 2013 between CoSLA and the Trade Unions contained a commitment that once the new Career Average Scheme had been set up there would be a review of the structure of the Scheme.
- 4.2 Following preparatory work by the Scheme Advisory Board, the Cabinet Secretary - Derek MacKay MSP – has now formally requested that the structural review be initiated.
- 4.3 A similar exercise (known as “the Pathfinder Project”) was conducted in 2011 to identify potential savings and efficiencies from Funds either merging or collaborating. At that time, the consultants, Deloitte, found that the savings from reduced investment fees were insufficient to justify the cost and disruption of merging Funds. They did however suggest that there would be benefits from increased collaboration.
- 4.4 Notwithstanding the long term commitment to undertake a review, the Scheme Advisory Board’s consultation document outlines “significant challenges” faced by the Scheme and cites these as further justification for the structural review. It lists challenges as:
- Investment management costs and their transparency
  - Investment performance
  - Volatile investment markets
  - Maturing scheme membership
  - Investment preferences, such as fossil fuels and infrastructure
- 4.5 The list is clearly not exhaustive and wider challenges such as meeting both customer demands in a digital age and the rising expectations of the Pensions Regulator need also to be factored into the review process.

- 4.6 In summary, the purpose of review is to determine whether the long term interests of scheme members and employers can be served better by changing the current structure.

## **5. The Options for Change and Consultation Process**

- 5.1 The consultation document identifies 4 options for consideration:

- Retain the current structure of 11 Scottish LGPS Funds
- Promote greater co-operation in administration and investing between the 11 Funds
- Pool investments between the 11 Funds
- Merge the 11 Funds into one or more new Funds

- 5.2 The consultation is open to LGPS employers and employee representative groups. Responses will be collated by the Pensions Institute who have been commissioned by the Advisory Board to carry out that work. The Advisory Board will then make a recommendation to the Minister with a final Government decision expected in mid to late 2019.

- 5.3 The consultation is in the form of a series of 60 questions with respondents asked to consider the 4 options against the following criteria:

- Cost of investing
- Governance
- Operating Risks
- Infrastructure Investment

A final section (Question 5) invites respondents to state their preferred structure for the future.

- 5.4 In order to manage the response process, one option would be to establish a sub group drawn from the Committee and Board - with Officer and Adviser support. The Chief Finance Officer could prepare initial responses to the consultation questions (excluding the final recommendation) which would be used as the basis for sub group discussion. If it was felt that there should be separate submissions from Committee and Board then separate sub-groups could be formed, albeit regard should be given to the capacity for officers to support two sub-groups.

- 5.5 An agreed sub-group response could be presented to the respective Committee and Board for approval where there would be the option to submit a joint or separate reports.

- 5.6 The closing date for responses is Friday, 7<sup>th</sup> December, 2018.

## 6. Pros and Cons of the Options

6.1 This Section of the report considers the high level advantages and disadvantages of the 4 options on the table:

### 6.2 Retaining the Current Structure

#### *Advantages*

- i) Risk mitigated by having Scheme delivered by 11 Funds
- ii) Continuance of local governance and local control
- iii) Service delivery close to employers and members
- iv) No new structure means no potential disruption to services
- v) Investment strategy can stay attuned to local Fund circumstances
- vi) Voluntary collaboration is still an option

#### *Disadvantages*

- i) Key person risk and long term resilience not addressed
- ii) Duplication of effort across 11 Funds
- iii) Limited scope to achieve investment efficiencies
- iv) Skills and knowledge require to be maintained by 11 Boards and Committees

### 6.3 Promote co-operation in administration and investing between the 11 Funds

The *Advantages* and *Disadvantages* of this option are essentially the same as in 6.1, except that Funds would be able to seek out efficiencies through collaborations and transition to these at their own pace.

### 6.4 Pool investments between the 11 Funds

This option is akin to the pooling initiative in England and Wales whereby Funds have been directed by Government to combine their assets into pools of around £25bn with the aim of reducing investment costs and increasing the scope for investment in larger scale infrastructure projects.

#### *Advantages*

- i) Strategic asset allocation decisions still made by local Fund
- ii) Specialist pool boards oversee the manager appointment/monitoring process
- iii) Prospect of lower investment costs
- iv) Scope to invest in large scale infrastructure projects
- v) Administration could still be delivered locally
- vi) Potential for greater focus on stewardship responsibilities

#### *Disadvantages*

- i) Risk increased by aggregating assets
- ii) Legislative, regulatory and governance issues to be overcome
- iii) Significant set up costs per England and Wales experience
- iv) Potential service disruption if Fund staff move away to posts with a pool
- v) Local Funds would continue to have challenges of long term resilience

- vi) Potential for conflict between local Funds and pool Board

## 6.5 Merge the 11 Funds into one or more new Funds

### *Advantages*

- i) Clarity - one entity (or several discrete entities) have responsibility for the pensions function
- ii) Opportunity to build hub(s) of LGPS expertise including internal investment
- iii) Allows for better management of key person risk
- iv) More likely to attract staff with necessary skills
- v) Administration could still be devolved for local delivery units
- vi) Prospect of lower investment costs
- vii) Scope to invest in large scale infrastructure projects
- viii) Potential for greater focus on stewardship responsibilities

### *Disadvantages*

- i) Risk increased by having fewer Funds
- ii) Requires legislative change
- iii) Governance arrangements to be worked out (Joint Committee or Other Vehicle)
- iv) Employers more remote from governance process
- v) Members potentially more remote from service delivery point
- vi) Staffing implications

n.b. Fund mergers have previously taken place previously - in 1975 – when County Council Funds and Burgh Funds were merged to form the present 11 Funds.

## **7. Infrastructure Investment**

7.1 The desire to channel Fund monies into national infrastructure projects is one of criteria against which respondents have been asked to assess the 4 options. In this regard, it is worth noting that:

- Whilst infrastructure is an attractive asset class for local authority funds, the Funds do not exist to facilitate infrastructure investment but to pay scheme benefits. Commitments to infrastructure must therefore meet a Fund's risk and return requirements so as to be in accordance with a Fund's fiduciary duty to invest in the best interest its stakeholders
- Lothian and Falkirk have been successful in accessing infrastructure assets even under the current structure
- Aggregating or pooling of assets will allow Funds to compete for an investment stake in larger infrastructure projects. However, such assets will not necessarily have the correct risk and return credentials to fit with Fund strategy. (Higher profile assets can be the target of a wide range of global investors (e.g. sovereign wealth funds) and may not be attractively priced).

## **8. Publicising the Consultation**

- 8.1 The following actions are being taken by the Fund to publicise the consultation:
- E-mailed all Falkirk Fund employers to alert them to the consultation exercise
  - Information about the consultation is included with this year's Benefit Statements
  - Pensioners will receive a message on their September advice slips referring them to the Advisory Board website
  - The Pensions manager will be happy to meet with employer management teams to brief them on the Consultation
- 8.2 Further information relating to the consultation is being posted on the website of the Scheme Advisory Board at <http://lgpsab.scot/>.

## **9. Implications**

### **Financial**

- 9.1 There are no immediate financial implications associated with this report. Depending on the outcome of the review, there may be scope for investment management fees to reduce, however savings could initially be offset by the costs of transitioning to any new structural arrangements.

### **Resources**

- 9.2 No additional resources are required at this time. Depending on the outcome of the review, there could be implications for staff employed in the Pensions function of the Council.

### **Legal**

- 9.3 If pooling or fund merger is sanctioned, it would be necessary for the Scottish Government to amend the Pension Scheme Regulations. With pooling there would also be regulatory processes to be undergone to establish the pool Boards.

### **Risk**

- 9.4 Key person risk and resilience are recognised as ongoing Fund risks under the current Fund structure. These risks are mitigated to a degree by the Fund's collaboration with the Lothian Pension Fund. Depending on the outcome of the review, these risks could be mitigated further in the event of a Fund mergers or with the pooling of assets.

Should a change in structure being authorised, Funds would have to guard against services to members being disrupted during any transitional period.

## **Equalities**

- 9.5 No equalities issues are raised by this report.

## **Sustainability/Environmental Impact**

- 9.6 No direct sustainability/environmental issues are raised by this report, although depending on the outcome of the review, the environmental, social and governance activities in which the Fund currently engages may become the responsibility of another body (e.g. a Pool Board or a New Fund).

## **10. Conclusion**

- 10.1 The Scheme Advisory Board has launched a consultation into the structure of the LGPS in Scotland. This is an opportunity for Funds, Employers and Unions to consider how best the Scheme should be configured in order to ensure its ongoing sustainability and resilience.
- 10.2 The review has the potential to change the manner in which the Scheme delivers administration and investment functions to its stakeholders. Around 7% of the Scottish population have a financial interest in SLGPS and, as such, the review can be considered to be of material significance.

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## **Appendices**

Consultation - Review of the Structure of the Scottish Local Government Pension Fund

## **List of Background Papers:**

None





## **Consultation on the**

*Review of the Structure of the Scottish Local Government Pension Fund*

## **Carried out by the Pensions Institute**

*on behalf of the Scottish Local Government Pension Scheme Advisory Board*

June 2018

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### About the Pensions Institute

Hosted by Cass Business School at the University of London, the Pensions Institute ([www.pensions-institute.org](http://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 data and research, with particular emphasis on the UK system.

### 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.

## **Cabinet Secretary's foreword**

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I am delighted to support the launch of the Scottish Local Government Pension Scheme Advisory Board's consultation on a structural review of the Local Government Pension Scheme (LGPS) pension funds in Scotland.

LGPS fund authorities invest in a wide variety of projects including local housing and infrastructure, however investment in Scotland's infrastructure is only a small part of the investment strategy of the Scottish fund authorities. The Scottish Government is ambitious for greater investment by local government funds in Scotland's infrastructure.

There are currently excellent examples of fund authorities collaborating on infrastructure projects in Scotland. We look to LGPS fund authorities to improve their already positive impact on the economy thereby contributing further to sustainable economic growth, creating more jobs and supporting the delivery of key capital infrastructure needs in Scotland, such as transport projects and housing.

A key part of the Scheme Advisory Board's role is to provide advice about the effective and efficient administration and management of the Scheme. So I asked the board to investigate the collaboration between fund authorities to invest in Scottish infrastructure, whilst maintaining overall investment performance to ensure that the interests of LGPS members' are protected.

The Scheme Advisory Board commissioned reports from pension consultants Mercers and Iain Clacher of the University of Leeds on possible future structures for the funds. The reports highlight that the new governance arrangements require a greater focus on cost transparency and performance. The academic evidence on costs and fees also seems to support the premise that there are cost savings available with economies of scale for both the administration and investment of pension funds.

I welcome the Scheme Advisory Board's consultation, which provides four clear options for the future structure of pension funds in Scotland. I encourage you to participate fully in this important debate which could have a wide-ranging impact on the people of Scotland.

Derek Mackay MSP

**Cabinet Secretary for Finance and the Constitution**

## Executive summary

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This consultation seeks to establish the views of employers and employee representative groups on whether outcomes for the members and sponsors of the Scottish Local Government Pension Scheme (SLGPS) can be improved by altering the structure of the scheme.

The consultation asks these stakeholders to compare the advantages and disadvantages of the current scheme structure against three options that, by differing degrees, consolidate the functions of the scheme's 11 constituent funds by collaboration, pooling and merger.

The main question is whether the sustainability of the scheme, and thus members interests, can be improved by reducing the investment management costs of the system with the trade-off of potentially diminishing local governance and oversight.

Investment management costs are the single biggest line item of expenditure in the system and small reductions in fees can lead to significantly improved net investment performance for funds over the long run. But how do these quantitative gains compare to the qualitative losses of local control?

This central question also gives rise to subsidiary questions. Consolidation has the potential to improve the ability of funds to invest. Larger scale in funds could improve governance, the range of investments available to funds and the management of operating risks – each with the potential to enhance performance.

But at the same time, the roles of people working locally in funds could be diminished, with their responsibilities concentrated in a smaller set of larger funds. Changes to the current structure would generate set up costs and require careful implementation to ensure accountability was maintained.

The purpose of the consultation is to get feedback on four possible options, ranging from maintaining the *status quo* to full consolidation into one or more larger funds. Responses gathered in this consultation will be evaluated and presented to Scottish Government Ministers in 2019 for a decision on a future course of action.

Although this consultation asks questions about a potential future structure for the SLGPS, these questions were also relevant when designing the current system. This consultation asks whether the trade-off – between scaling up to reduce investment costs or retaining governance locally – inherent in the current system of 11 funds is the best interest of members and sponsors or should be revisited.

## Introduction

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This consultation invites employers and employee representative groups to give their views on how the Scottish Local Government Pension Scheme (SLGPS) should best be structured to serve its members and sponsors.

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.<sup>1</sup> 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.<sup>2</sup>

Research by the Scheme Advisory Board, a statutory organisation set up to advise SLGPS and the Scottish Government, shows that the scheme faces a number of significant challenges and, as a result, the current structure of the scheme with its 11 funds should be reviewed.

A selection of these challenges include: the deficit; investment management costs and their transparency; investment performance; volatile investment markets; low interest rates; a maturing scheme membership; and the consequences of implementing investment preferences in respect of certain assets, such as fossil fuels and infrastructure.

Based on this research, the Scheme Advisory Board has identified four options that 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.

The purpose of this consultation – requested by the Scottish Government Cabinet Secretary for Finance and Constitution, Derek Mackay MSP – is to ask employers and employee representative groups for their views on each of these options.

Responses gathered in this consultation will be evaluated by the Scheme Advisory Board and presented to Scottish Government Ministers in 2019 to inform any future course of action. As well as this consultation, Ministers will also take into consideration a

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<sup>1</sup> The SLGPS also includes five additional funds including transport funds and the Scottish Homes Pension Fund which are managed by the 11 administering authorities.

<sup>2</sup> All figures dated 31 March 2017.

governance review of public sector pensions being undertaken by the Scottish Public Service Pensions Agency.

This consultation report contains detailed background on how the options were developed including web links to the original research reports; presents arguments for each option; and provides questions that LGPS employers and employee representative bodies should answer to present their views.

The consultation is being managed by Pensions Institute, an academic research organisation hosted by the University of London, on behalf of the Scheme Advisory Board.

## **How to participate**

This consultation is open to LGPS employers and employee representative groups only. To have their views heard, these organisations should respond to the questions in the form accompanying this report and return it via email to the Pensions Institute at [consultation@pensions-institute.org](mailto:consultation@pensions-institute.org) no later than Friday, 7 December 2018.

As it is not practical to engage with scheme members directly, respondents who are employee representative bodies are encouraged to canvass the views of their members in order to present their views to this consultation.

Employers who are also administering authorities are additionally invited to give their views from their perspective as authorities. The consultation will attempt to contact all employer members of the SLGPS but the 11 administering authorities should also encourage their admitted bodies to take part in the consultation.

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](mailto:matthew.roy@pensions-institute.org).

## Background to the consultation

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1. A review of the structure of the SLGPS was agreed with stakeholders and the Scottish Government Ministers when the changes to the scheme and the new Scheme Advisory Board were introduced in 2015. The Scheme Advisory Board (SAB) proposed carrying out this review beginning in 2016.
2. SAB's proposal was approved by the Scottish Government Cabinet Secretary for Finance and Constitution.
3. Several studies were used to inform this review and make up the background to this consultation. These are summarised in Appendix 1.
4. In February 2017, SAB produced its own review report. This report is informed by the findings of research in Appendix 1 as well as a working party set up by the board comprising employers, trades unions and fund advisers. It also includes two new pieces of research commissioned by SAB from Mercer in 2016 and Iain Clacher at Leeds University Business School in 2017 and these are included as annexes to SAB's review report.

*The report can be found at SAB's website [lgpsab.scot/consultation2018](https://lgpsab.scot/consultation2018).*

5. In summary, the report sets out four options for the future structure of the local government pension scheme in Scotland:
  - 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
6. The four options were presented to Scottish Government Ministers in May 2017. In January 2018, SAB received a letter from Derek Mackay MSP, Cabinet Secretary for Finance and the Constitution seeking a consultation with SLGPS employers and employee membership bodies on the four options.
7. The next section presents a summary of the arguments detailed in SAB's review report.

## **Summary arguments for and against the four options**

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8. The Scheme Advisory Board's 2017 report sets out four main options for the local government pension scheme and this consultation focuses on four criteria in relation to each option:
  - Cost of investing: This is the biggest outlay by each fund in SLGPS and research suggest even small reductions in investing costs and, in particular, investment manager fees could have a significant impact on fund performance.
  - 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.
  - 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.
  - 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.
9. Below are summarised the advantages and disadvantages of each option in relation to these criteria and the questions asked in the consultation. The full arguments across a wider range of criteria can be found in SAB's review report. Detailed summaries of the arguments for each option are also presented in Appendix 2 of this report.

### **Option 1: Retain the current structure with 11 funds**

10. The first option for the SLGPS is to do nothing and to maintain the status quo by retaining the current structure with 11 funds.

#### **Cost of investing**

11. Evaluating the costs of investing in the 11 funds is currently hindered by the funds' different approaches to reporting and a lack of transparency in investment fees. But from an investment perspective, maintaining the current structure is likely to mean that inefficiencies will remain across the SLGPS as most of the funds will not achieve the benefits of scale that have been documented across a number of countries including the UK. These benefits include improved bargaining power and reduced duplication of efforts in administration, governance, spending on advisors and fund management.
12. The consequence of this is that the scheme will continue to cost more per member for some employers than others. Over the long-run, such cost inefficiencies could be considerable and hence require higher contribution rates putting further pressure on local government and employer budgets.



## **Governance**

13. The current structure of the SLGPS is complex and funds have responded by adopting a variety of different processes for managing investment mandates, investment fund performance and investment costs. As a whole, larger funds have greater resources and capacity to establish and manage these processes than smaller funds.
14. However, a potential advantage in maintaining the current structure would be to retain local oversight and strategy. This local connection may be more difficult to retain if centralised asset pools or merged funds were to be created, as are explored in the options below.

## **Operating risks**

15. There is significant variation in the resources funds have to manage governance processes under the current structure. Smaller funds tend to have less executive support than larger funds. Funds run by only a few individuals may face 'key-person' risk where the incapacity or absence of a single individual hampers the operation of the fund.

## **Infrastructure**

16. Funds have different capacities to invest in infrastructure under the current structure. Larger funds are better able to make investments in infrastructure projects, while small funds acting on their own may not have the resources or expertise to invest in these assets.

### **Question 1:**

*Please use the attached form when answering these questions and explain your responses.*

#### **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?
- How well does the current system manage investment costs?
- How would you improve the measurement and management of investment costs in the current system?

#### **b) Governance:**

- 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?

c) 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?
- 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?

d) Infrastructure:

- 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?

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

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

17. The second option 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.

### **Cost of investing**

18. Cooperation between funds when hiring investing managers could lead to efficiency gains. One example of this is the investment collaboration between the Lothian and Falkirk funds. This agreement allowed Falkirk to leverage expertise and scale by jointly investing with the larger Lothian fund.
19. The Lothian-Falkirk example suggests that groups of funds could collaborate to lower costs by clubbing together when appointing managers to invest in particular asset classes. In this model, funds would invest in UK equities or other asset classes as one large block rather than as separate mandates across a number of funds.
20. But coordinating such joint procurement decisions in an informal environment may be challenging. Since any party is free to leave the arrangement, any cost savings may not be long lasting.

### **Governance**

21. Under the cooperation option, the current structure of governance would continue. Investment mandates would be directed by the Pension Committee of each fund and each fund would retain local oversight and strategy. As such, cooperation between the funds would be limited in scope by the rules for investing followed by each Pension Committee.
22. Each collaboration arrangement would then require a new subordinate governance process. In the example of Lothian and Falkirk, the Pension Committees of each fund must agree to coordinate when they delegate investment mandates.
23. Although cooperation would require some sharing of control, and more complex governance, it would still retain some local oversight and strategy.

### **Operating risks**

24. Promoting cooperation arrangements would not resolve issues that smaller funds may have with executive support. They would add new layers of complexity which must be managed. The need for funds to coordinate activities has the potential to reduce the effectiveness and responsiveness of the individual investment decisions of each fund, particularly if this slows down the investing process.

### **Infrastructure**

25. In the Lothian-Falkirk example, both funds have been able to jointly invest substantial in infrastructure projects. But it is unclear how well collaboration agreements would scale to include more joint fund investors. Several funds may wish to club together to invest in large scale projects as each fund individually is likely to have only a small

allocation available to infrastructure as an asset class. It is unclear if funds could bear the transaction costs and resources this 'clubbing together' process would require or if it could be concluded swiftly enough.

Question 2:

*Please use the attached form when answering these questions and explain your responses.*

a) Cost of investing:

- 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?

b) Governance:

- 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?

c) Operating risks:

- 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?

d) Infrastructure:

- 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?

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

### **Option 3: Pool investments between the 11 funds**

26. The third option 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.
27. Asset pooling would be a significant shift to the way in which the SLGPS manages its investments. From an investment perspective, if there were to be a single aggregated pool, it would have circa £42bn of assets under management more than double the size of the largest fund currently, Strathclyde at £19.7bn in assets.
28. Although funds would be pooled, assets and liabilities would still be allocated by the employer in the same way as the current arrangements. This ensures that employers would still be liable for the pension obligations that they have accrued, for any deficit that they are liable for currently, and for any new benefits that are promised.

#### **Cost of investing**

29. Asset pooling has the potential to generate significant cost savings from scale over the long-term. For instance, the larger scale of asset pools could enable the majority of the investment activities of funds participating in each pool to be brought in house, which is likely to create significant cost efficiencies over time as well as allowing for a more sophisticated and dynamic investment strategy.
30. A significant challenge in successfully pooling assets is achieving scale to cover set-up costs, ongoing operating expenses and governance costs. 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.

#### **Governance**

31. From a governance perspective, under asset pooling each fund's Pensions Committee would likely retain responsibility for determining the asset allocation for their investments, making funding decisions and ensuring funds were managed in accordance with applicable laws and regulations. However, the day-to-day management of the investments would be delegated to the pool.
32. Each fund would also retain its Pension Board as stipulated in The Public Service Pensions Act 2013, with its existing employer and employee representation, as well as its role to provide advice on the administration and management of the pool.

#### **Operating risks**

33. Pooling assets would significantly boost the executive resources available to manage governance process related to day-to-day investing. But investment management risks would become concentrated in the new asset pools. It would be critical to establish clear lines of responsibility to ensure there is accountability for decisions made when managing the pool and to retain local oversight and strategy.

## Infrastructure

34. By grouping investments together under single mandates, pooling is expected to significantly boost the capability of the SLGPS to invest in infrastructure. Combined in pools, the buying power of each individual fund's allocation to infrastructure could be exercised collectively, in a coordinated way.

### Question 3

*Please use the attached form when answering these questions and explain your responses.*

a) Cost of investing:

- 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?

b) Governance:

- 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?

c) Operating risks:

- 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?

d) Infrastructure:

- 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?

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

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

- 35. The fourth scenario is for funds in the SLGPS to merge, with assets, liabilities and administrative functions being managed by one or more larger funds.
- 36. Merging pension funds poses a number of challenges. Although funds merge, their assets and liabilities still have to be allocated by the employer, as employers would remain liable for the pension obligations that they have accrued, for any deficit that they are liable for currently, and for any new benefits that are promised.

### **Cost of investing**

- 37. Fund mergers have the potential to generate significant cost savings from scale over the long-term in the same way that asset pooling does. For instance, the larger scale of funds could enable the majority of the investment activities of merged funds to be brought in-house, which could create significant cost efficiencies over time as well as allowing for a more sophisticated and dynamic investment strategy.
- 38. Fund mergers may provide additional improvements to the cost of investing over and above pooling. As well as day-to-day investment management, other back office functions would also be combined to lower costs. Larger scale asset pools may also make available additional investment risk management strategies, such as interest rate hedging.
- 39. In the short-term, merging would generate large initial transitional and set-up costs.

### **Governance**

- 40. The full merger of SLGPS funds would likely have the most far-reaching consequences for governance. Governance would likely no longer be a local government function and could be the responsibility of one or more central government bodies. Although there would be local government representation on the Pensions Boards of the merged funds, the treasury function of the local authority is no longer likely to have direct involvement in any pension fund matters.
- 41. The dual board-committee structure could persist or be replaced by different arrangements such as a lead authority or a joint board.

### **Risk management**

- 42. Mergers, like the asset pooling option, would significantly boost the executive resources available to manage governance process related to day-to-day investing, but additionally bring more executive support to bear in merged back office and administrative support functions.
- 43. As in asset pooling, it would be critical to establish clear lines of responsibility to ensure there is accountability for decisions made when managing merged funds.

### **Infrastructure**

- 44. By grouping investments together under single mandates, mergers, like pooling are expected to significantly boost the capability of the SLGPS to invest in infrastructure.

Combined in merged funds, the buying power of each individual fund's allocation to infrastructure could be exercised collectively, in a coordinated way.

#### **Question 4**

*Please use the attached form when answering these questions and explain your responses.*

a) Cost of investing:

- 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?

b) Governance:

- What impact do you think mergers between funds would have on governance?
- What would be the positive impacts?
- What would be the negative impacts?

c) Operating risks:

- 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?

d) Infrastructure:

- 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?

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



### **Question 5**

*Please use the attached form when answering these questions and explain your responses.*

- a) Which option does your organisation prefer? Please explain your preference.
- b) What other options should be considered for the future structure of the LGPS?
- 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?
- d) Are there any other comments you would like to make?

## **Appendix 1: Reports of previous pension scheme reviews**

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### **Deloitte report**

*A copy of the Deloitte report can be found SAB's website [lqpsab.scot/consultation2018](https://lqpsab.scot/consultation2018).*

In 2011, Deloitte presented research on the merits of combining the investment and administration functions of the SLGPS. This research was conducted as part of a Pathfinder Project to identify potential cost savings and operational efficiencies in SLGPS by adopting shared services. Participants in the research included the Improvement Service, Scottish Government, Convention of Scottish Local Authorities (COSLA), the 11 funds and the Scottish Public Pensions Agency.

The 2011 report considered a number of models including retaining the current structure and merging into one, two or three larger host funds. While Deloitte identified a number of key risks in the current structure, they concluded that the savings in investment management fees would not be significant enough to justify, in cost terms alone, merging funds. They reached a similar conclusion in relation to an improvement in investment performance. They did recommend less active investment management and pointed to the benefits, particularly for small and medium sized schemes, of shared technical advice.

In relation to administrative costs, the report found that costs per member in Scotland compared favourably with funds in England and Wales. However, based on the experience of shared services between Cumbria and Lancashire, Deloitte recommended further consideration of a single operating model and a common administration system – rather than formal administrative mergers.

### **APG report**

*A copy of the APG review can be found at SAB's website [lqpsab.scot/consultation2018](https://lqpsab.scot/consultation2018).*

In light of increasing awareness about investment fees and performance, UNISON commissioned the Dutch pension group, APG, to undertake a similar review of LGPS pension funds across the UK, including Scotland. APG evaluated data on 101 funds over 2001–09 and modelled the impact of fund mergers.

APG concluded that investment expenses and administration costs decline when the size of fund increases and that larger funds consistently achieved higher investment returns. They also drew upon international studies that show substantial positive economies of scale in asset management.

APG's simulation for one fund in Scotland indicated average annual savings in investment management costs of £7m. They also concluded that improved investment performance could have led to £772m of additional assets for Scottish funds.

## **Audit Scotland report**

*A copy of the Audit Scotland report can be found at SAB's website:*

[lgpsab.scot/consultation2018](https://lgpsab.scot/consultation2018)

*or the Audit Scotland website:*

[www.audit-scotland.gov.uk/report/the-cost-of-public-sector-pensions-in-scotland](https://www.audit-scotland.gov.uk/report/the-cost-of-public-sector-pensions-in-scotland)

In 2011, Audit Scotland reported on the cost of public sector pensions in Scotland. The focus of this review was on the costs of benefits and associated contributions. Audit Scotland summarised the advantages and disadvantages, which essentially come down to economies of scale and expertise as against transition costs and the impact on local governance.

## **Cost transparency code and FCA market study**

*Information about the cost transparency code for the local government pension scheme in England and Wales can be found on the scheme's website:*

[lgpsboard.org/index.php/structure-reform/cost-transparency](https://lgpsboard.org/index.php/structure-reform/cost-transparency)

*Information about the FCA's market study into asset management can be found at the authority's website:*

[www.fca.org.uk/publications/market-studies/asset-management-market-study%20](https://www.fca.org.uk/publications/market-studies/asset-management-market-study%20)

In 2015, the Financial Conduct Authority (FCA) launched an asset management market study to understand how asset managers compete to deliver value to both retail and institutional investors. The FCA found weak price competition with evidence of sustained, high profits over a number of years.

The local government pension scheme in England and Wales launched a Code of Transparency to improve investment fee transparency and consistency. The voluntary code sets standards for reporting on fees paid to asset managers and was adopted by SLGPS in 2016.

## Appendix 2: Overview of advantages and disadvantages for the four options

Criteria	OPTION 1 Retain the current structure with 11 funds	OPTION 2: Promote cooperation in investing & administration between the 11 funds	OPTION 3: Pool investments between the 11 funds	OPTION 4: Merge the funds into one or more new funds
GOVERNANCE	<p><b>PROS</b></p> <p>Maintains local decision making and connection with respect to oversight and strategy.</p>	<p><b>PROS</b></p> <p>→</p>	<p><b>PROS</b></p> <p>There is not, at least at a high level, an issue of localism vs centralisation that emerges from merging/pooling; it is simply a question of investing in the most cost effective way to secure member benefits.</p> <p>Professionalise decision making and governance.</p> <p>Some representation of local authorities on a Pensions Committee, which would set broad asset allocation, risk budgets, and risk-adjusted performance criteria for the investment of the assets.</p> <p>Funds may be more focused on the performance and accountability of an investment pool and it is likely that they would exert a high degree of scrutiny on the performance of the pooled assets.</p> <p>Additional gains from better risk-management functions under the ethos that good governance should drive outcomes and not just wrap round a predetermined solution or structure.</p> <p>More arms-length from administering and reduced conflicts of interest.</p>	<p><b>PROS</b></p> <p>→</p> <p>→</p> <p>Reduces number of Pension Boards.</p> <p>A fund as large as a pooled Scottish LGPS would be able to attract and recruit the best people.</p> <p>→</p> <p>→</p>

Criteria	<b>OPTION 1 Retain the current structure with 11 funds</b>	<b>OPTION 2: Promote cooperation in investing &amp; administration between the 11 funds</b>	<b>OPTION 3: Pool investments between the 11 funds</b>	<b>OPTION 4: Merge the funds into one or more new funds</b>
	<p><b>CONS</b></p> <p>Potential conflicts between Fund and Administering Authority e.g. in multi-employer fund, setting contribution rates.</p> <p>Duplication across funds in terms of administrative, governance, advisory, and fund management costs, and lack of scale in most of the Scottish LGPS funds.</p> <p>Large number of stakeholders and decision makers including committees and pension boards.</p> <p>Specialist staff recruitment (especially for investment) can be difficult due to terms and conditions of councils and/or for more rural funds.</p> <p>Lack of internal resource and staff in smaller funds have other duties to perform that can be impacted by broader council developments.</p>	<p><b>CONS</b></p> <p>→</p> <p>→</p> <p>→</p> <p>→</p>	<p><b>CONS</b></p> <p>Increase in consolidation of governance thus reducing local governance.</p> <p>A significant shift towards a more central structure such as asset pooling could remove existing functions such as trustees etc.</p> <p>Such change will take time and cost money, both of these factors have to be accepted and the costs and benefits of the envisaged structure would have to be clear and accepted by a wide range of stakeholders. Moreover, the gains to any long-term strategic shift in the operation of the Scottish LGPS are likely to emerge over a number of years rather than immediately or in the short-term.</p>	<p><b>CONS</b></p> <p>Governance would no longer be a local government function and would be the responsibility of a quango.</p> <p>Potential disconnect between the employer and the scheme leading to lower local engagement.</p> <p>→</p> <p>→</p>

Criteria	<b>OPTION 1 Retain the current structure with 11 funds</b>	<b>OPTION 2: Promote cooperation in investing &amp; administration between the 11 funds</b>	<b>OPTION 3: Pool investments between the 11 funds</b>	<b>OPTION 4: Merge the funds into one or more new funds</b>
<b>INVESTMENT</b>	<p><b>PROS</b> Bespoke investment strategy and implementation for each fund.</p> <p>Potential to collectively negotiate with existing managers to reduce fees.</p>	<p><b>PROS</b> Joint procurement of investment managers or other services could lead to some efficiency gains.</p> <p>Potential to leverage some of the internal expertise and scale within the larger funds.</p> <p>Some cost efficiencies could be gained if broad mandates e.g. UK passive equities were to be invested as one large block rather than as separate mandates across a number of funds</p>	<p><b>PROS</b> Significant cost savings resulting from scale.</p> <p>Ability to move towards greater internal management.</p> <p>Professionalisation of investment – FCA authorisation likely to be required.</p> <p>Resolves MIFID II issues.</p> <p>Enable the in-housing of the majority of the investment activities of the fund, which is likely to create significant cost efficiencies as well as allowing for a more dynamic investment strategy. -Increased employment as a result.</p> <p>Ability to invest in new asset classes/opportunities.</p> <p>A more transparent and uniform governance model with potential to improve returns.</p> <p>Collective proactive stewardship opportunities to capture the ‘engagement premium’ which could add up to 2 to 4% in the first year to returns.</p> <p>Smaller funds gain access to new investment opportunities.</p>	<p><b>PROS</b> Likely that significant cost savings could be generated if there was to be a significant scaling up of pension fund assets as this increases the bargaining power of the SLGPS.</p> <p>Increased sustainability of SLGPS</p>

Criteria	OPTION 1 Retain the current structure with 11 funds	OPTION 2: Promote cooperation in investing & administration between the 11 funds	OPTION 3: Pool investments between the 11 funds	OPTION 4: Merge the funds into one or more new funds
	<p><b>CONS</b></p> <p>Inefficiencies will persist and not allowing benefits of scale thus risking future sustainability.</p> <p>Investment mandates, performance targets, and an understanding of costs and fees are unlikely to be optimal.</p> <p>While likely that improved disclosure via better data collection (now underway) will help improve this situation in the coming years, it does not necessarily shift the dynamic between funds and fund managers, as there is only a small increase in bargaining power.</p> <p>Pension funds, in all likelihood, would remain price takers.</p> <p>Limited options for bespoke employer investment strategies.</p> <p>Smaller funds lack influence unable to take an active role as a shareholder.</p> <p>Smaller schemes face key-person risks. MIFID II, and FCA classification of local authorities, could have major impact on investment options available.</p>	<p><b>CONS</b></p> <p>Relies on Pension Committees and officers being more coordinated / or compromising. Potentially a slow process.</p> <p>Sustainability risk e.g. if one fund decides to terminate agreement.</p> <p>Potential issues relating to unauthorised investment advice due to lack of FCA authorisation.</p> <p>Opportunity of gains limited by virtue of extant governance structures.</p> <p>Does not resolve MIFID II issues.</p> <p>Potential for smaller funds gaining access to new opportunities.</p>	<p><b>CONS</b></p> <p>Complexity and costs of establishing FCA authorised pool.</p> <p>Could be time consuming to establish. →</p> <p>Lose local connection with funds. →</p> <p>E&amp;W models untested as yet so there is no track record to assess benefits. →</p>	<p><b>CONS</b></p>

Criteria	<b>OPTION 1</b> <b>Retain the current structure with 11 funds</b>	<b>OPTION 2:</b> <b>Promote cooperation in investing &amp; administration between the 11 funds</b>	<b>OPTION 3:</b> <b>Pool investments between the 11 funds</b>	<b>OPTION 4:</b> <b>Merge the funds into one or more new funds</b>
<b>FUNDING</b>	<p><b>PROS</b></p>	<p><b>PROS</b></p> <p>Greater consistencies of funding approach, depending on service to be shared.</p> <p>Potential for consistent approach to employer covenant and offering different funding options including offering different investment strategies.</p>	<p><b>PROS</b></p> <p>Funds retain funding decisions.</p> <p>May provide wider range of options for different investment/funding strategies.</p>	<p><b>PROS</b></p> <p>Employer liabilities remain identifiable thus avoiding concerns with regard to cross-subsidy or netting of gain/losses at the time of merging funds.</p> <p>May provide wider range of options for different investment/funding strategies.</p> <p>Consistent funding approach within each new fund. (See funding challenges section in Annex 5). This could include the approach to employer covenants and the potential to offer different investment/funding options.</p> <p>Resolves the funding inconsistencies and the issue of risk of cessation faced by employers who are admitted to more than one fund.</p> <p>May be an opportunity to separate the liabilities of certain employers from others and put in place different funding arrangements, potentially reducing the exposure of the other employers in the funds. For example, certain groups of employers could be grouped for funding purposes and bespoke admission agreements/guarantees put in place e.g. third sector/charities or colleges.</p> <p>Improves long term sustainability of the SSLGPS.</p>



Criteria	<b>OPTION 1 Retain the current structure with 11 funds</b>	<b>OPTION 2: Promote cooperation in investing &amp; administration between the 11 funds</b>	<b>OPTION 3: Pool investments between the 11 funds</b>	<b>OPTION 4: Merge the funds into one or more new funds</b>
<b>FUNDING</b>	<p><b>CONS</b> Difficult to see the funding position of the Scottish LGPS as a whole.</p> <p>Employers who are admitted to more than one fund have inconsistent funding approaches and risk of triggering cessations.</p> <p>Duplication/inconsistent approach to employer covenant.</p> <p>Limited options for bespoke employer funding strategies.</p>	<p><b>CONS</b> Limited opportunity for improvement and the cons associated with the status quo option would remain.</p>	<p><b>CONS</b> Funds retain funding decisions and inconsistencies persist.</p>	<p><b>CONS</b> Potential lack of customisation of assumptions for different employers.</p>
<b>PENSION ADMINISTRATION</b>	<p><b>PROS</b> More local/ bespoke service.</p>	<p><b>PROS</b> (As per merging funds, depending on the collaboration).</p>	<p><b>PROS</b></p>	<p><b>PROS</b> Improved economies of scale. Consistent service for all members and employers. Removes duplication. IT system rationalisation and standardisation.</p>

Criteria	<b>OPTION 1</b> <b>Retain the current structure with 11 funds</b>	<b>OPTION 2:</b> <b>Promote cooperation in investing &amp; administration between the 11 funds</b>	<b>OPTION 3:</b> <b>Pool investments between the 11 funds</b>	<b>OPTION 4:</b> <b>Merge the funds into one or more new funds</b>
	<b>CONS</b> Costs in some schemes will remain higher than they need to be.  Inefficiencies in data submission for employers admitted to more than one fund.  Inconsistent service for members, particularly evident where employers are admitted to more than one fund.  Duplication of effort.  Key-person risks.	<b>CONS</b> (As per merging funds, depending on the collaboration).	<b>CONS</b> As per status quo.	<b>CONS</b> Potential loss of local service / local jobs.
<b>INFRASTRUCTURE</b>  (note that Investment comments above generally apply)	<b>PROS</b> Local funds retain decision making on the type of infrastructure investment.	<b>PROS</b> Potential to leverage expertise within existing funds.	<b>PROS</b> Scale facilitates direct and co-investments in large infrastructure projects and at lower cost.	<b>PROS</b>
	<b>CONS</b> Smaller funds don't have expertise to implement.  Safeguards need to be put in place to prevent governmental or local issues driving investment to projects where there is no financial return to the pension fund.	<b>CONS</b> Safeguards need to be put in place to prevent governmental or local issues driving investment to projects where there is no financial return to the pension fund.	<b>CONS</b>	