Complete Agenda

Democratic Service
Swyddfa'r Cyngor
CAERNARFON
Gwynedd
LL55 1SH

Meeting

PENSIONS COMMITTEE

Date and Time

2.00 pm, THURSDAY, 11TH FEBRUARY, 2016

Location

Ystafell Gwyrfai, Council Offices, Caernarfon, Gwynedd. LL55 1SH

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(DISTRIBUTED 03/02/16)

PENSIONS COMMITTEE

MEMBERSHIP (7)

Plaid Cymru (4)

Councillors

Peredur Jenkins
Simon Glyn
W. Tudor Owen
Vacant seat

Independent (2)

Councillors

Trevor Edwards
John Pughe Roberts

Liberal Democrats (1)

Councillor Stephen W. Churchman

Co-opted Members

Hywel Eifion Jones	Anglesey County Council
Margaret Lyon	Conwy County Borough Council

Aelodau Ex-officio / Ex-officio Members

Chairman and Vice-Chairman of the Council

A G E N D A

1.	**APOLOGIES**	
	To receive any apologies for absence	
2.	**DECLARATION OF PERSONAL INTEREST**	
	To receive any declaration of personal interest	
3.	**URGENT ITEMS**	
	To note any items which are urgent business in the opinion of the Chairman so that they may be considered	
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	To submit a report by the Investment Manager	
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	To submit a report by the Pensions Manager	

PENSIONS COMMITTEE TUESDAY, 10 NOVEMBER 2015

Present: W. Tudor Owen (Chair)
Stephen W. Churchman (Vice-Chair)

Councillors: Trevor Edwards, Seimon Glyn, Peredur Jenkins, Margaret Lyon and Glyn Thomas

Also present: Dafydd L. Edwards (Head of Finance), Caroline Lesley Roberts (Investment Manager), Gareth Jones (Pensions Manager), Nicholas Hopkins (Deputy Pensions Manager) and Lowri Haf Evans (Members and Scrutiny Support Officer),

1. APOLOGIES

Apologies were received from Councillors H. Eifion Jones (Isle of Anglesey County Council Representative) and John P. Roberts

2. DECLARATION OF PERSONAL INTEREST

Declarations of personal interest were received from the Investment Manager and the Deputy Investment Manager for item 11. The officers left the room during the discussion

3. URGENT ITEMS

The Members were reminded of the discussion that had been held at the September 2015 meeting on the Welsh Pensions Collaboration Project together with a report formed by *Mercer* business consultants who had been investigating the possibility of merging the assets of the eight Welsh funds. It was explained that only unofficial statements had been published up to now, but it appeared that a response to the consultation may be necessary before the next meeting of the Pensions Committee (26.01.16). In order to secure a response from Gwynedd on the benefits, it was suggested for the Head of Finance Department and the Investment Manager to review the benefits, while consulting with the Chair of the Pensions Committee.

RESOLVED TO ACCEPT THE RECOMMENDATION

4. MINUTES

The Chairman signed the minutes of the previous meeting of this committee, held on 8 September 2015, as a true record.

5. STATEMENT OF INVESTMENT PRINCIPLES

Submitted - the report of the Investment Manager highlighting the need to review the Pension Fund's Statement of Investment Principles (SIP) together with agreeing on a full consultation process with interested parties by March 2016. Members were reminded of the decision that had been made at the Pensions Committee 23.03.2012 to increase some of the limits to the maximum amounts as permitted under the regulations as follows:

- Increase the sum that could be invested in any single insurance contract to 35%.
- Increase the limit for all contributions to any single partnership to 5%.
- Increase the total of all contributions to partnerships to 15%.

and that these decisions would be reviewed within three years.

As the three year period was nearing its end, the need to review the decisions that had been made was highlighted, as well as considering whether they remained suitable for the Pension Fund. When deciding on the progress it would be necessary to comply with appropriate requirements and as a response to that, advice was sought from Paul Potter, the Fund's advisor.

It was noted that an initial review of the Statement of Investment Principles would be produced by the officers, with a draft to be circulated to interested parties during November and December 2015. The intention was to submit a final version, following the consultation, to the Pensions Committee in March 2016 for discussion and approval.

RESOLVED TO APPROVE THE REPORT AND SUPPORT THE LIMITS (35% / 5% / 15%) IN LINE WITH THE RECOMMENDATIONS, TOGETHER WITH THE CONSULTATION ARRANGEMENTS

6. TREASURY MANAGEMENT FOR 2014/15

The Head of Finance submitted the report’s background for information, and it was explained that it was mandatory under the CIPFA Code of Conduct to report on the results of the Council's actual Treasury Management on behalf of the Pension Fund in the last financial year against the expectations. A summary of where the pooled money had been invested during the year 2014-2015 was highlighted, and in line with amended Welsh Assembly Government guidance on Investments, the security and liquidity aspects had been prioritised rather than yields. It was also explained that interest rates had been very low, but that there was no recommendation to consider changing the decision to pool the fund's money with the Council's general cashflow.

In response to a question regarding who provided an overview of CIPFA principles, it was noted that Wales Audit Office checked this and the importance of prioritising security over yields was reiterated.

RESOLVED TO ACCEPT THE REPORT FOR INFORMATION

7. TREASURY MANAGEMENT 2015/16 - MID YEAR REVIEW

The Head of Finance Department provided the introduction and background of the report for information, explaining that it was required under the CIPFA Code of Conduct for councils to report on the performance of the treasury management function at least twice a year. The report highlighted the treasury’s activities together with the risk monitor and associated risk control.

In the context of Heritable Bank investments, it was noted that the authority had now reclaimed 98% of Heritable Bank investments with the probability of further distributions.

RESOLVED TO ACCEPT THE REPORT FOR INFORMATION

8. KNOWLEDGE AND SKILLS

The Investment Manager submitted a report notifying Members of training arrangements. Members were reminded that the Pension Fund had adopted a Skills and Information statement to ensure that all staff and members who were responsible for financial administration and for making decisions in relation to the pension scheme, had all the information and skills to undertake the responsibilities and duties allocated to them.

As a result, the establishment would provide appropriate training for those individuals so that they maintained a suitable level of expertise, information and skills.

It was highlighted that the Council would undertake a training needs assessment. The intention was to present members of the Pensions Committee and the Pension Board with a self-assessment questionnaire for them to note their training needs. The results of the questionnaire would highlight the training needs and the information they would require. The information would secure appropriate training for individuals through current meetings, specific sessions or external courses. The intention was to distribute the questionnaire after Christmas and members were encouraged to co-operate.

RESOLVED TO ACCEPT THE INFORMATION AND COMPLY WITH THE REQUIREMENTS OF THE INFORMATION AND SKILLS POLICY

9. PROPOSAL TO IMPLEMENT AN INTEGRAL DOCUMENT IMAGING SYSTEM WITH ALTAIR

The Pensions Manager submitted a proposal for the Committee's approval to fund the purchase of an integrated document management system to store documents and to respond to the retrieval requirements of a modern pension administration office. The original solution had been the use of the corporate EDRMS management system, but it had been highlighted that EDRMS would not accomplish the full requirements of the Pensions Unit as projected. In order to adapt and work efficiently to the individual records retrieval requirements for each current and former member of the pension scheme, it was proposed to move towards the use of Heywood's 'Altair Image' system, which was a completely integrated system with an associated workflow system.

In line with the membership of the entire fund (which was more than 38,000 at present), the following costs were proposed to implement and run this specialist software. Costs for initial licence - £58,525 together with an implementation and consultancy fee of £20,560. Total of £79,085. It was noted that the amount was significant, but the need for an investment in a system was recommended so that the Pensions Unit could progress and work in a more effective manner.

In response to a question, it was noted that the funding would be released from the administrative costs of the Pension Fund. It was difficult to cost efficiency savings, but a saving of half a post was projected. It was also noted that it would be necessary to become familiar with the system prior to seeing yields and therefore it was recommended to re-assess the situation in two years' time.

In response to a question regarding whether the Pensions Unit could cope without the software or not, it was noted that the service would exacerbate without it.

RESOLVED TO APPROVE THE PROPOSAL TO FUND THE PURCHASE OF 'ALTAIR IMAGE' SOFTWARE AND THE ANNUAL LICENSING FEES.

The Chair took the opportunity to thank Mr Gareth Jones, Pensions Manager, on behalf of the Committee for his service to the Pensions Unit, and expressed well wishes to him on his retirement following 42 years of service to the Council. The Head of Finance Department added that Mr Gareth Jones had been a very reliable manager and a key member of the Department and the Pension Fund

10. ADMINISTRATION AUTHORITY DISCRETIONS

The Pensions Manager submitted a report requesting to review and update policies in the context of the Local Government Pension Scheme Regulations 2014. The information was highlighted, which listed the discretions available under the main Pension Scheme regulations together with a list of the discretions available under the transitional and savings provisions. It was also highlighted that the information formalised the procedure.

RESOLVED TO AGREE ON THE ADMINISTERING AUTHORITY'S POLICIES IN LINE WITH THE RECOMMENDATION

11. ADMINISTRATION UNIT STAFFING FROM JANUARY 2016

(Mr Gareth Jones and Mr Nicholas Hopkins left the room)

Submitted - the report of the Head of Finance Department to approve funding for resourcing a team to reconcile the Guaranteed Minimum Pensions (GMP) and to accept a new administration unit structure - projected cost of £53,573 in the first 12 months. At the June 2015 Pensions Committee meeting, it had been reported that there was a need for Gwynedd's Pension Fund to reconcile the GMP of individual members against that held by HMRC. At that meeting, it had been agreed to fund £8,300 per annum for appropriate software so as to start on preliminary work of comparing HMRC's figures with the fund's data. In response to a request by the Local Government Pensions Committee, the estimated cost of the exercise would be £200,000 based on basic research work undertaken by other funds which had already commenced the exercise, and the number of records that needed to be reconciled by Gwynedd.

In response to these challenging requirements of reconciling the GMP and the 2016 valuation, a request was made to the Pensions Manager (who would retire in December), to return for two days per week to establish and supervise a team to undertake the reconciliation work and to share his experience and expertise with his successor. In addition, the need for two other staff members to join the team was noted. It was reported that the task would take at least two years to complete, with the 'Supervisor' role ending 12 months after establishing the procedures.

It was highlighted that the timetable was tight and that there was an open opportunity here for external consultants to take advantage of the situation as inadequate resources were in place within authorities to complete the work. It was noted that the Pensions Manager was willing to continue for a year and it was added that this was a great opportunity to take advantage of individuals' experience rather than paying more for a consultative company to undertake the work.

In response to the report, it was noted that the internal resources should be taken advantage of, and that using expensive external consultants should be avoided. The recommendation was accepted as a good option and it was noted that the situation should be reviewed in six months’ time.

RESOLVED TO APPROVE THE EXPENDITURE TO FUND STAFF RESOURCES TO RECONCILE THE GUARANTEED MINIMUM PENSION

The meeting commenced at 2.00 pm and concluded at 2.45 pm

CHAIRMAN

MEETING	**PENSIONS COMMITTEE**
DATE	**11 FEBRUARY 2016**
TITLE	**WESTMINSTER GOVERNMENT (DCLG) CONSULTATION ON REVOKING AND REPLACING THE LOCAL GOVERNMENT PENSION SCHEME (MANAGEMENT AND INVESTMENT OF FUNDS) REGULATIONS 2009**
AUTHOR	**CAROLINE ROBERTS, INVESTMENT MANAGER**

1. INTRODUCTION

1.1 Members of the Committee will be aware that the Pension Fund has a Statement of Investment Principles which provides a framework for the investments. It includes any increases to the standard limits in the legislation for specific types of investments.

1.2 The current consultation proposes revoking the regulations and the restrictions would then no longer apply. The reason for this change is to enable funds to participate in pooling investments without breaching the current limits.

1.3 The consultation is aimed at all parties with an interest in the LGPS and the closing date for responses is 19 February 2016. The responses will be analysed and a Government response published within three months, and subject to the outcome of the consultation, the resulting regulations will be laid in Parliament.

2. PROPOSAL 1: ADOPTING A LOCAL APPROACH TO INVESTMENT

2.1 The consultation paper sets out the following matters under proposal 1:

- Deregulating and adopting a local approach to investment by simplifying the regulations that govern the management and investment of funds.
- Removing the existing schedule of limitations on investments. Instead authorities will be expected to take a prudential approach, demonstrating that they have given consideration to the suitability of different types of investment, have ensured an appropriately divers portfolio of assets and ensured an appropriate approach to managing risk. This would allow us to invest 15% in the Insight fund without the current UK overlay required to conform to the regulations. It would give more flexibility for BlackRock investing in passive funds during any transition period. It would also facilitate pooling on a larger scales as required by the Government.
- Instead of the current Statement of Investment Principles, there will be a requirement for an Investment Strategy which authorities will be required to prepare, having taken proper advice, and publish. Transitional

arrangements would require authorities to publish an investment strategy statement no later than six months after the regulations come into force.

- The draft replacement Regulations include provision for administering authorities to publish their policies on the extent to which environmental, social and corporate governance matters are taken into account in the selections, retention and realisation of investments.
- Keeping asset allocation with the local fund authorities, and making available more transparent and comparable data to identify the true cost of investment and drive further efficiencies in the Scheme.
- A proposal not to pursue fund mergers at this time.

3. CONSULTATION QUESTIONS

3.1 The consultation questions on the changes to the regulations are as follows:

Q1. Does the proposed deregulation achieve the intended policy aim of removing any unnecessary regulation while still ensuring that authorities' investments are made prudently and having taken advice?

Q2. Are there any specific issues that should be reinstated? Please explain why.

Q3. Is six months the appropriate period for the transitional arrangements to remain in place?

Q4. Should the regulation be explicit that derivatives should only be used as a risk management tool? Are there any other circumstances in which the use of derivatives would be appropriate?

4. PROPOSAL 2: INTRODUCING A SAFEGUARD – SECRETARY OF STATE POWER OF INTERVENTION

4.1 The consultation paper sets out the following matters under proposal 2:

- Power to intervene if the Secretary of State believes that an administering authority has not had regard to guidance and regulations.
- In reaching that conclusion the Secretary of State will consider the available evidence including;
    - Evidence that an administering authority is ignoring information on best practice
    - Evidence that an administering authority is not following the investment regulations or has not had regard to guidance published by the Secretary of State, for example, this might include failing to participate in one of the large asset pools or proposing a pooling arrangement that does not adhere to the criteria and guidance.

- Evidence that an administering authority is carrying out another pension-related function poorly.

- If the Secretary of State is satisfied that an intervention is required, he will write to the authority outlining the proposed intervention and the evidence used to reach a determination.
- The authority will then be given time to consider the proposal and present its argument for any changes that it thinks should be made.
- If, at the end of that period an intervention is issued, any resulting costs, charges and expenses incurred would be met by pension fund assets.
- The intervention will have a formal review date but could be ended before that if sufficient improvement is made.

4. CONSULTATION QUESTIONS

4.1 The consultation questions on the changes to the regulations are as follows:

Q5. Are there any other sources of evidence that the Secretary of State might draw on to establish whether an intervention is required?

Q6. Does the intervention allow authorities sufficient scope and time to present evidence in favour of their existing arrangements when either determining an intervention in the first place, or reviewing whether one should remain in place?

Q7. Does the proposed approach allow the Secretary of State sufficient flexibility to ensure that he is able to introduce a proportionate intervention?

Q8. Do the proposals meet the objectives of the policy, which are to allow the Secretary of State to make a proportionate intervention in the investment function of an administering authority if it has not had regard to best practice, guidance or regulation?

5. RESPONSE TO CONSULTATION

5.1 A full copy of the consultation document is available at https://www.gov.uk/government/consultations/revoking-and-replacing-the-local-government-pension-scheme

5.2 The Committee is asked to consider any views or issues that they wish to include in the response from Gwynedd Council.

Agenda Item 6

MEETING	PENSIONS COMMITTEE
DATE	11 FEBRUARY 2016
TITLE	WESTMINSTER GOVERNMENT (DCLG) CONSULTATION ON LOCAL GOVERNMENT PENSION SCHEME: INVESTMENT REFORM CRITERIA AND GUIDANCE
AUTHOR	DAFYDD EDWARDS, HEAD OF FINANCE

1. INTRODUCTION

1.1 Members of the Committee are aware of the project undertaken by the Pensions Subgroup of the Society of Welsh Treasurers and agreed to support further work to:

- Investigate opportunities for reduced fees for passive investments
- Jointly assess the detailed business case for pooling frameworks for other investments

1.2 The work in these two areas has continued and has reached the stage where consultants have been appointed to progress them on behalf of the eight welsh funds.

2. CONSULTATION

2.1 The consultation issued by the Government in November 2015 invites authorities to submit proposals for pooling which the Government will assess against the criteria in the consultation document. The Chancellor has announced that the pools should take the form of up to six British Wealth Funds, each with assets of at least £25bn, which are able to invest in infrastructure and drive local growth. The proposals should have regard to four criteria as follows:

A. Asset pools that achieve benefits of scale
B. Strong governance and decision making
C. Reduced costs and excellent value for money
D. An improved capacity to invest in infrastructure

Initial proposals are to be submitted to the Government by 19 February 2016.

A copy of the consultation document is available on https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance

2.2 Part of the brief for the consultants who will be assessing the detailed business case for pooling frameworks is to produce a response to this consultation on behalf of the eight welsh funds. Hymans Robertson has been appointed to undertake this work and in conjunction with the Society of Welsh Treasurers Pensions Group is preparing a response to this consultation and it will be sent to members of this committee by 5th February 2016.

3. RESPONSE TO CONSULTATION

3.1 The response will be submitted by each of the eight funds as their joint proposals.

3.2 The Pensions Committee is asked to support the joint proposal.

WELSH LOCAL GOVERNMENT PENSION FUNDS

WORKING TOGETHER

(INTERIM REPORT)

MARCH 2013

(Version 6.1.1)

Society of Welsh Treasurers Pension Sub Group

CONTENTS

EXECUTIVE SUMMARY

Background

The Local Government Pension Scheme in Wales has over 280,000 members and has assets valued in excess of £9bn. In March 2010, the Pensions Sub Group of the Society of Welsh Treasurers representing the 8 LGPS funds in Wales commissioned a study by Price Waterhouse Coopers (PwC). The aim was to build on the existing collaboration already undertaken in Wales and identify the potential for collaboration/partnership working across the Welsh Local Government Pension Schemes.

The PwC study provided a base upon which some broad assumptions could be made i.e. that the whole issue was worthy of further consideration. The work has been taken forward by the SWT Pensions Sub Group with appropriate support. They believed **the PwC report was important in that it established a "prima facie" case to look further at the organisational structure of the Welsh LGPS with the potential to improve efficiency and service standards**. It was recognised and important from the outset that any further work was objective and positive in working toward the production of an evidence backed outline business case. Due regard would be given to work undertaken elsewhere, which could helpfully assist in this process, but conclusions drawn elsewhere would not drive the conclusions of this report.

Objectives and Methodology

The purpose of this report is to set out the findings of the outline business case which has considered the optimal number of LGPS funds in Wales and the most appropriate organisational structure. This should also include proposals for enhanced collaboration, including, joint procurement opportunities and other efficiency measures.

In undertaking the work, and in order to keep the task to manageable proportions, the Project Board determined that analysis should be focussed around four options;

1. An "as is" option based on the current structure with 8 Funds which provides a benchmark position.

2. An "as is" but with enhanced collaboration (Joint procurement, shared working efficiencies etc.)

3. A mid range option based on a number of grouped Funds. The requirement is to provide the solution that works best and so at the outset, the project was not prescriptive regarding numbers and groupings which could be seen as limiting the options for consideration.

4. An option based on one all Wales LGPS Fund.

There was no presumption that the optimum solution for one work stream (e.g. administration) would also be the best for another (e.g. investments). The approach was therefore to be totally objective and open minded and ensure analysis was objective and robust to withstand scrutiny and challenge.

The Board adopted a collaborative approach utilising the resources across all 8 Funds and the expertise of the in-house teams. Work stream groups were established covering Administration, Investments and Funding, and Financial Modelling. The latter also covered the subject of governance. Research was undertaken in all areas commissioning a number of external reports in respect of investment performance, legal issues, funding and investments and transition costs. There was a need to co-ordinate the research work produced by the work streams. To this end, it was considered appropriate to provide a non prescriptive outline of what could be included within each work stream's plans. The research work of each work stream therefore included but was not be restricted to:

- A review of the PWC Report and use of that report as the starting point, subject to appropriate validation if, and where required;
- Updating and validation of core data
- Consideration of the 4 options, including implications relating to governance and transition, and objective justification for those discarded and those worthy of consideration.
- Consideration of the service delivery options
- Consideration of key components -e.g. service delivery and standards, people, IT, accommodation etc...
- Pros and Cons of different options
- Barriers to change or implementation
- Assessment of options against agreed design principles
- Conclusions
- Recommendations

Although originally included, the following have been held back in this interim report but will be incorporated in the final version.

- Views of wider stakeholders
- Views on timing of any proposed changes

The design principles adopted below were generic rather than specific to Pensions but the principles were sound and formed a backcloth to the work to be undertaken by each work stream. These principles also acted as a "litmus test" of the appropriateness of the proposals put forward.

- Reducing costs and sustaining service
- Improving front line service delivery
- Delivering a timely and responsive service
- Improving back office administrative consistency and efficiency of process
- Achieving the most by appropriate collaboration
- Improving the employee/pensioner experience
- Comply with sound governance arrangements and stewardship controls.
- Better information for better decisions

Findings of Investment Work

1. **There is evidence that there are potentially significant financial benefits of scale to be found** from either merger or working collectively through a common investment approach. The results of analysis demonstrate a general statistical trend of higher investment returns when a larger amount of investment assets is grouped together and invested. There are however no

guarantees of improved returns and **it does not appear to require organisational change to benefit since enhanced collaboration would achieve the same goal in a quicker and less disruptive way**.

2. **The potential benefits are not a direct relationship with the size of a fund but rather the result of economies of scale that together with size allow improved governance and the potential for increased return with a combination of attributes that larger funds tend to have** such as
    - More internal / specialist resources;
    - More internal / hands on management;
    - Better diversification – asset classes, managers;
    - More bargaining power on fees;
    - Better, more responsive governance structures and processes in place enabling speedy decision making.
3. Changes introduced as a result of the findings of this paper would not impact on employer contribution rates until the Actuarial Valuation after any changes were implemented (i.e. **earliest impact could be 2017/18**).
4. It is impossible to predict future investment returns with any degree of certainty.
5. The variety of valid funding assumptions and approaches adopted across Welsh LGPS funds makes comparison difficult and has the potential to significantly cloud the interpretation of a Funds funding position.
6. Given other influencing factors at this time such as changing (increasing) liabilities, changing membership profile, improving longevity and benefit design changes, **the impact of any investment benefits are more likely to be a dampening effect on future upward contribution pressures resulting in slower growth in the employer contribution rates rather than a reduction.**
7. There are inherent difficulties in adopting a common investment/funding strategy across all Funds whilst they remain independent legal entities. **The more appropriate option would be a common approach to the implementation of a Funds strategy rather than the Strategy itself being common.**
8. Funding changes are the most complex and lengthy areas for change but also have the greatest potential for cost saving.
9. Investment manager fees amount to some £22.3m per year across LGPS funds in Wales. A common investment approach could provide some modest savings which even if a low level of only 10% saving were achieved would amount to a £2m saving across Wales; equivalent to 0.1% on employer contribution levels. It is important to note however that to deliver such savings would potentially incur significant transition costs at the outset.
10. On the basis of the evidence, there is, from an investment standpoint, **a prima facie case for change and an appropriate programme of works should be put in place** to maximise the benefit which can be realised through greater collaboration, including specifically managing Pension Fund Investment assets on a collective basis.

Findings of Governance Work

11. **There is much that can be done using a collaborative approach within existing legal, organisational and governance arrangements.**

12. Merger cannot be undertaken without a change in secondary legislation at UK level. This would be the most challenging option with the longest lead in time, requiring engagement with both Wales Government and the DCLG.
13. Merger would distance Funds from local accountability and control unless additional layers of governance were introduced.
14. A common investment proposition is feasible within the existing investment regulation framework but clarification on aspects of the Regulations from DCLG would be helpful.
15. A Governance structure to develop and control future collaboration across Wales needs to be established with agreed standards.

Findings of Administration Work

16. **Building on existing collaboration and the additional impetus provided by this Collaboration project, can achieve improvements in front line pensions service delivery**, consistency and efficiency whilst ensuring compliance with sound governance arrangements and stewardship controls and regulations.
17. A local presence is important for responsive service delivery.
18. The absence of agreed service standards within the LGPS does not help meaningful comparison either within Wales or across UK funds.
19. Administration costs across the LGPS Funds in Wales amount to some £8m per year. **Financial benefits identified through the administration work are thus far more modest than those identified elsewhere but should nevertheless be pursued.**

Findings of Costs and Transition Work

20. **Both fund management fees and transition costs are significant factors** but not the fundamental drivers when considering investment strategy.
21. Merger to one Fund or the mechanism of a collective investment vehicle would facilitate potentially lower management fees, but the overall reduction in fees (if indeed achieved) as a percentage of market value across Wales would be dependent on the new investment strategy and the method of implementation.
22. **There would be very significant 'one off' costs of transitioning the assets to a new organisational structure.**
23. An attempt has been made to quantify the fee reduction and cost of transition but these should be used for illustrative purposes only as the assumptions are many. In isolation, and prior to factoring in any improved investment return due to size and associated attributes, it is reasonable to conclude that transition costs will be significantly higher than any potential reduction in management fees and thus it could several years to 'pay back' the cost of transition before any lower fund management fee benefits accrued.

Conclusions

It is clear that there is no simple and quick solution that answers the question; what is the optimal number of LGPS funds in Wales and the most appropriate organisational structure. Given the existing organisational picture, and the funding complexities, any change will require careful planning and will take time to implement/achieve. The work undertaken however clearly indicates that despite collaboration already being part of the Welsh fabric for pensions, the "no change" option is not supported since a more pro-active approach to consistency and service efficiency is required.

Enhanced collaboration is seen as the area where medium term savings can be optimised. This is the option where the balance of service delivery and efficiency, cost of change, time and resource can be blended in the most effective way and should be pursued further. This should include proposals for enhanced collaboration, including, joint procurement opportunities and other efficiency measures.

Analysis demonstrates that the potential financial benefit through any change varies considerably with the smallest benefit in the administration area and increasing in size through joint procurement, combining investments to benefit the level of fund manager fees and larger investment mandates (via merger or a collective investment vehicle) potentially achieving better investment returns. This latter option could however be achieved in a less disruptive manner through a collective investment vehicle across existing structures as opposed to new and larger structures.

The prospect of merger to regional funds or a single Welsh Fund is both complex and the transition would be costly with a long lead in time and a loss of local autonomy. Changing funding strategies could also have a destabilizing effect with a loss of local accountability. Following any merger of funds a common set of actuarial assumptions would also be needed for future valuations of the merged fund. This would have an impact on employer contributions. Whilst this may merit additional investigation in the right environment, it is not recommended for further work at this time.

Key Recommendations

1. **The "as is" or no change option is not supported.** The pension's environment requires a more pro-active approach to managing service standards and costs within the LGPS within Wales.
2. **Enhanced collaboration is seen as the area where medium term savings can be optimised. This is the option where the balance of service delivery and efficiency, cost of change, time and resource can be blended in the most effective way and should be pursued further**.
3. **To create a Full Business Case for a common investment approach** to encompass the common attributes that appear to benefit larger funds with the aim of implementation thereafter.
4. **To create an appropriate and responsive governance structure to drive and manage future collaboration initiatives within Wales** which will:
    a. explore the potential in the longer term for consistent Valuation and funding assumptions and standards.
    b. develop minimum administrative service standards for Wales and an agreed measurement framework.
    c. take advantage of joint procurement initiatives to help consistency and efficiencies
5. The prospect of **merger to regional funds or a single Welsh Fund is both complex and the transition would be costly with a long lead- in time and a**

loss of local autonomy. Changing funding strategies could also have a destabilizing effect with a loss of local accountability. Whilst **this may merit additional investigation in the future, it is not recommended for further work at this time, especially where it is believed that the most significant gains can be realised through greater collaboration and, specifically a common investment approach.**

Background and Context

Background

In March 2010, the Pensions Sub Group of the Society of Welsh Treasurers representing the 8 LGPS funds in Wales commissioned a study by Price Waterhouse Coopers (PwC)[1]. The aim was to build on the existing collaboration already undertaken in Wales and identify the potential for collaboration/partnership working across the Welsh Local Government Pension Schemes.

The initial study concluded that there was scope to generate further efficiency savings along with achieving greater consistency in service standards across both the administration and investment arms of fund management, suggesting that such benefits would be optimised through either further collaboration or a reduction in the number of funds. The savings provisionally identified could well be seen as small in the context of the combined assets of the 8 pensions funds (£8.5bn plus at that time) but they were considered large enough to merit further investigative work. The study also recognised that all Funds had very different approaches and changes, whether at an organisational level or restricted to either Investments or Administration would be complex and would take time to achieve. Transition would also be complex and would incur costs with payback periods varying according to the degree of change. In addition, because contribution costs for employers in the respective funds are generally only amended every three years (at the triennial valuation), the earliest financial year when such savings might be identified, from even very prompt actions, would be linked to the actuarial valuation cycle.

Governance arrangements were also identified as a significant issue in the context of any further work to be carried out.

The PwC study however provided a base upon which some broad assumptions could be made i.e. that the whole issue was worthy of further consideration. The Pensions Sub Group of the Society of Welsh Treasurers acting as a Project Board agreed for more detailed work to be undertaken to produce an outline business case around proposals for a possible reduction in the number of Welsh Pension Funds, and/or the possibility of further collaboration including joint procurement opportunities and other efficiency measures. The Project Board commitment was evidenced by the fact that the Project pre-dated but was then endorsed by its inclusion in the Compact between the Welsh Government and Local Government (signed off at Partnership Council on 5 December 2011).

The work has been taken forward by the SWT Pensions Sub Group with appropriate support. They believed the PwC report was important in that it established a "prima facie" case to look further at the organisational structure of the Welsh LGPS with the potential to improve efficiency and service standards. It was recognised and important from the outset that any further work would be objective and positive in working toward the production of an evidence backed outline business case. Due regard would be given to work undertaken elsewhere, which could helpfully assist in this process, but conclusions drawn elsewhere would not drive the conclusions drawn here.

The purpose of this report is to determine via an outline business case, the optimal

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[1] **Price Waterhouse Coopers; Consultancy review of Welsh Local Government Pension Funds October 2010**

number of LGPS funds in Wales and the most appropriate organisational structure. This should also include proposals for enhanced collaboration, including: joint procurement opportunities and other efficiency measures.

Scope

The initial study by PwC provided a level of confidence that proceeding to an outline business case was appropriate. Some concerns had been raised about the results produced and there had been some feedback that the initial work had not been sufficiently clear on the impact of any possible change on each pension fund. There were also reservations expressed with regard to the validity of some of the data comparisons. The ability to address these concerns and ensure a high level of engagement during the next stage was therefore of key importance.

In undertaking the next stage of work, and in order to keep the task to manageable proportions, the Project Board determined that analysis should be focussed around four options; two polar views and two mid range options with one based on enhanced collaboration and one based on a reduced number of funds. These options are:

1. An "as is" option based on the current structure with 8 Funds which provides a benchmark position
2. An "as is" but with enhanced collaboration (Joint procurement, shared working efficiencies etc.)
3. A mid range option based on a number of grouped Funds. The requirement is to provide the solution that works best and so the Project Initiation Document (PID) was not prescriptive regarding numbers and groupings which could be seen as limiting the options for consideration.
4. An option based on one all Wales LGPS Fund.

There was no presumption that what was optimum for one work stream (e.g. administration) would also be the best solution for another (e.g. investments). The approach was therefore a "blank piece of paper" approach aiming to be totally objective and open minded and ensure analysis was objective and robust to withstand scrutiny and challenge. The PWC report was used as an aid in formulating ideas and options. Whilst the PwC report suggested that a reduction in the number of funds would optimise the benefits, this project stage required consideration of all possible outcomes including the status quo.

The Project Board at its meeting on 2nd December 2011 also set out additional factors regarding the scope of the project. It was agreed that the project should be contained within a Wales public sector model only (no outsourcing and third party options) and that the potential for collaboration with English Pensions Funds should be noted but is not considered part of this particular "Welsh" project.

Anticipated Benefits

A key deliverable for the project was the development of a clear vision for the future. Although the underlying requirement to consider service standards, efficiency and improvement, together with cost reduction was already clear, it was important to consider whether any new approach was required and if so, the key outcomes that would be delivered by any new approach. The establishment of a clear set of design principles was therefore seen as important in ensuring a focus on an optimum service solution.

It is accepted that the design principles adopted below are generic rather than specific to Pensions but the principles remain sound and formed an important backcloth to the work undertaken. These principles also helped test the appropriateness of the proposals:

- Reducing costs and sustaining service
- Improving front line service delivery
- Delivering a timely and responsive service
- Improving back office administrative consistency and efficiency of process
- Achieving the most by appropriate collaboration
- Improving the employee/pensioner experience
- Complying with sound governance arrangements and stewardship controls.
- Better information for better decisions.

It is important to note that this review is not just about reducing cost, although that is an important component but it is very much about improving value. Pension Scheme member requirements should drive service standards and delivery, and the way Funds collectively and consistently meet those requirements is at the heart of this report. The goal was therefore to optimise the current arrangements blending both cost and service requirements in the best way. There was also recognition at the outset that cost benefits could take the form of either an absolute reduction in cost or a dampening of future cost growth that may prove less easy to quantify.

Objectives and Methodology

The objective of this report was to set out the findings of the outline business case which has considered the optimal number of LGPS funds in Wales and the most appropriate organisational structure. This should also include proposals for enhanced collaboration, including, joint procurement opportunities and other efficiency measures.

In order to progress the work, three work stream groups with representation from each LGPS Fund in Wales were established to undertake the following areas of work:

- Investments and Funding
- Financial Modelling (to include Governance and Transition)
- Pension Administration

A project team acted as a co-ordination point across the three groups and provided the conduit through to the Project Board. Within this context, it was considered appropriate to provide a non prescriptive outline of what could be included within each work stream's plans. Knowledge of this is helpful in providing readers with appropriate context. The outline included but was not restricted to:

1. Review of the PWC Report and use of that report as a possible starting point, subject to appropriate validation if, and where required.
2. Updating and validation of core data.
3. Consideration of the 4 options, including implications relating to governance and transition, and objective justification for those discarded and those worthy of further consideration.
4. Consideration of the service delivery issues:
    - Service components such as standards of service, people, IT, accommodation etc...
    - Pros and Cons of different options

- Barriers to implementation/change
- Assessment of options against the design principles

5. Views of wider stakeholders or research undertaken.
6. Views on timing of any agreed change proposed.
7. Conclusions and Recommendations.

Overview of Current Position

The governance and management arrangements for the LGPS in Wales are a legacy of the Local Government Superannuation Regulations 1974 made under the Superannuation Act 1972. This prescribed that there should be separate LGPS funds for each of the 8 newly created County Councils covering all local authority employees and other eligible employees in Wales. The 8 Funds and their administering authorities are as follows:

- Cardiff and Vale of Glamorgan Pension Fund(Cardiff)
- Clwyd Pension Fund (Flintshire)
- Dyfed Pension Fund (Carmarthenshire)
- Greater Gwent Pension Fund (Torfaen)
- Gwynedd Pension Fund
- Powys Pension Fund
- Rhondda Cynon Taff Pension Fund
- Swansea Pension Fund

Following the further re-organisation of local government in Wales in 1996, this situation remained with the designation of administering authorities set out in the Local Government Re-organisation in Wales Regulations 1995.

At the last Valuation in 2010 there were approximately 280 participating employers across the 8 funds with 160 scheduled bodies (councils, police and fire authorities, universities and colleges) and 120 'other smaller employers' such as Community Admission bodies (local charities, community councils) and Transferee Admission Bodies (typically short term contractors). In addition there are also nominal assets and liabilities from previous employers such as the pre 1996 County Councils and District Councils.

There is no single model of governance in operation across the 8 funds and in some cases delegation has been made to a Pensions Committee, an Investment Panel or directly to the Chief Financial Officer. In addition, representation also varies within each structure. Some funds have other employers and member representation on their main committee/panel. Others have established consultative panels/representative forums comprising elected members from the administering authority, representatives from other unitary authorities and participating employers, fund members and Trade unions. The 8 funds also have different independent advisors, investment consultants and actuaries.

The LGPS in Wales as at 31st March 2011 had 288,882 members (**282,615** as at 31st March 2012) (source: DCLG SF3[2]) as follows:

[2] **Department of Communities and Local Government SF3 Pension Fund Returns**

125,596 (43.5%) Active contributors
75,758 (26.2%) Pensioners
87,528 (30.3%) Deferred members

The Funds have assets of **£9.289 bn** as at 31st March 2011 (SF3) with Fund size ranging from £0.348bn to £1.661bn. Asset allocations and funding strategies vary considerably. Investment management costs amounted to £29.158m in 2010/11 with a further £8.880m spent on administration. Total staff numbers amount to over 140 including 131 administration staff. The full time equivalent is 128.

Investments and Funding

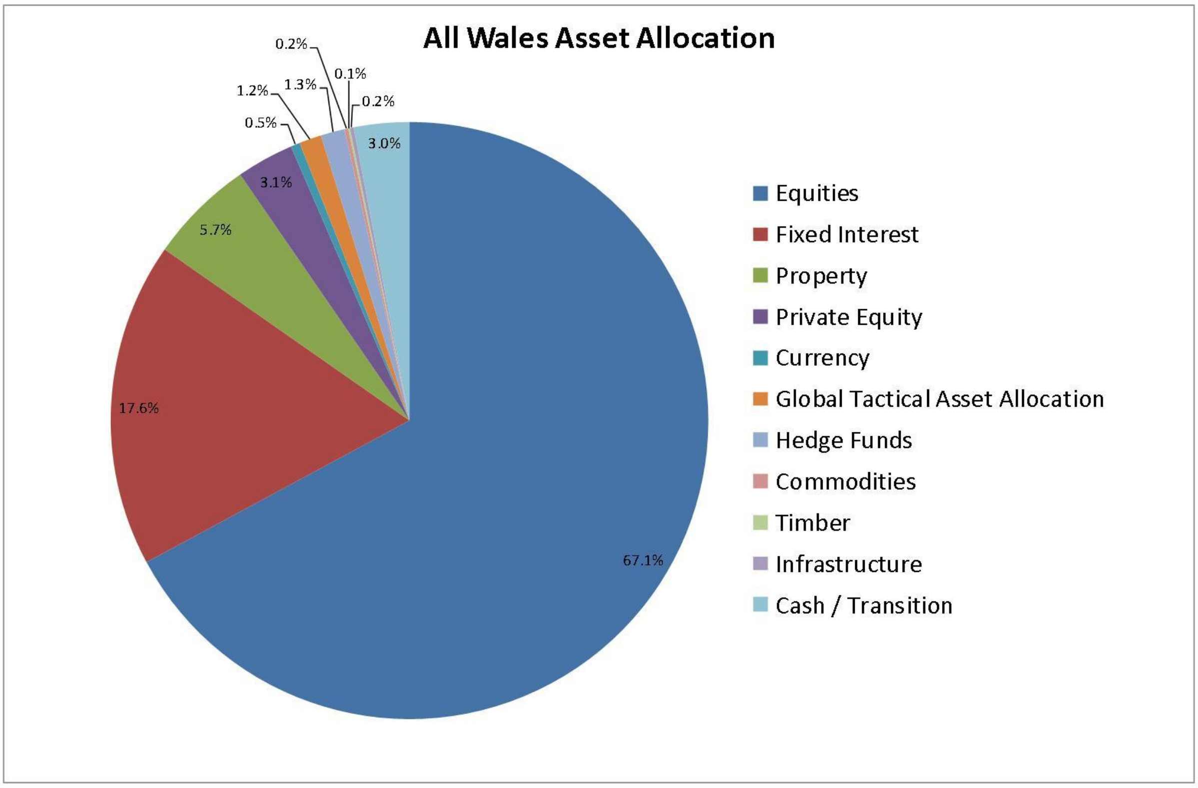
Background

The current 8 individual funds in Wales have Assets amounting to £9.289bn (value as at 31st March 2011), which if combined would place it in the top 5 by market value amongst LGPS funds. The respective total market value by fund and the Investment Valuations (excluding year end adjustments such as creditors/debtors etc...) are shown in the following tables.

FUND	**Value By Fund**	
	£M 2011	**£M 2012**
Cardiff	1,111	1,166
Clwyd	1,052	1,061
Dyfed	1,348	1,401
Gwynedd	1,024	1,050
Powys	348	372
RCT	1,639	1,712
Swansea	1,106	1,120
Torfaen	1,661	1,666
Total	**9,289**	**9,548**

Investment Valuations (by Asset Class)	**2011 £M**	**%**
Equities	6,182	67.1
Fixed Interest	1,617	17.6
Property	520	5.7
Private Equity	285	3.1
Currency	45	0.5
Global Tactical Asset Allocation	106	1.2
Hedge Funds	116	1.3
Commodities	19	0.2
Timber	12	0.1
Infrastructure	21	0.2
Cash / Transition	277	3.0
Total	**9,199**	

Investments within each fund include different asset classes. The combined asset class analysis of the 8 Welsh funds is shown in the following table.



Each fund has its own Funding Strategy currently based on the 2010 Actuarial Valuation results as shown in the following table. These funding rates are based on each fund's individual actuarial assumptions agreed by each fund and its actuary but which differ across the 8 Welsh funds.

	Funding level %	**Employer Rate %**	**Actuary**	**Deficit recovery years**
Cardiff	71	23.2	Aon	25
Clwyd	72	20.7	Mercer	20
Dyfed	91	15.2	Mercer	17
Gwynedd	84	22.1	Hymans	20
Powys	71	21.8	Aon	25
RCT	70	20.4	Aon	25
Swansea	71	20.5	Aon	25
Torfaen	74	19.0	Mercer	20

Practitioner discussion, knowledge sharing and joint research in this area examined the four options and concluded the following:

1. <u>"As Is"</u>

- Existing arrangements provide a localised solution, which facilitates effective communication and stakeholder engagement.

- Risk is inherently diversified by the very nature of having 8 separate funds.

- Maintaining the status quo provides consistency and continuity, for example all funds are currently in the process of implementing and seeking to deliver their own investment strategies which have been duly and professionally considered.

- The do nothing option should not be viewed as such insofar as **increasingly greater collaboration is already happening,** albeit mainly in the administration area. **There thus remain further opportunities to expand the existing collaboration** which might for example include fully exploiting procurement opportunities through joint arrangements, particularly through those areas such as fund management arrangements which are less well developed

- There are no change management issues to deal with, such as staffing, relocation, impact upon employment opportunities across Wales.

- Corporate Impact – Pension Funds are already currently benefiting from economies (and efficiencies) of scale, for example from Administering Authority existing / embedded facilities, IT systems and services.

2. Enhanced Collaboration

- There is a lack of collaborative examples in the Investment and related areas (advisors) and there is thus the opportunity for increased and more specialised procurement and development of Framework Agreements, with

    - Potential savings in staff time
    - Facilitation of change options in aspects such as training, legal support and actuarial advice

- The potential to consider beyond Wales
- More suitable for legal, custodial, actuarial services
- Enhanced Fund Management arrangements
- Longer term partnership working with third party service providers

- An oversight model where the 8 funds were retained but managed centrally appears to have the disadvantages of one fund without any of the potential advantages from mandate consolidation etc.

- There is undoubted an opportunity to enhance (more formally) the sharing of existing expertise and resources across the 8 Funds. This could be developed specifically around systems, procurement and an expansion of the communications work already undertaken

- **A Common Investment vehicle or Fund would provide an opportunity to achieve the benefits referred to** above. Such a mechanism could be applied to specific assets types ranging from mainstream equities to alternatives such as infrastructure. A development in this direction might increase the ability of LGPS Funds to consider investments in a range of investments that have wider economic benefits within Wales, or beyond.

- The potential to enable the movement of investments between Funds to maximise the utilisation of existing mandates does provide an opportunity to reduce appointment costs, timescales and maximise existing arrangements.

- All of the advantages of the "do nothing"/"as is" option.

- Greater collaboration could also be viewed as part of a route-map toward more formal merger at a future stage (if it is deemed viable to do so and upon the satisfying of stipulated criteria – aka "state of readiness"). The counterweight to this is that collaboration requires increased co-ordination and administration and hence any gain must be justifiable and worth the additional effort.

3. Grouped Funds

- The basis of determining the optimal number of funds needs to be clearly set out, for example, is it based on:

  - Asset Allocation
  - Geographical
  - Funding Strategies (recovery rate)
  - Funding Level
  - Contribution Rates
  - Different employer type

- If Funding Level, Employer Rate and Recovery Period are accepted as key drivers, then there are clearly well correlated Funds where merger could be considered viable. Further work is needed however, to understand whether there are other significant differences in factors such as life expectancy, age profiles, risk profiles etc.

- Many of the issues of merger which need to be considered will apply equally for a regionalised model as for the one fund model. The cost benefit of a number of mergers needs to be carefully examined against the cost benefit of a merger to one fund for Wales.

- **Subject to the extent of change, transition costs (investment related) are most likely to be significant**. The extent to which these would be the same for any merger (be it regionalised or one Wales) would clearly be dependent upon the basis of the "from" and "to".

- **Existing arrangements have a variety of different risk appetites**.

- The extent to which closure valuations may be triggered needs to be carefully considered.

- Investment expertise is currently attached to each of the 8 Funds, any regionalised merger would need to consider retention / recruitment issues and in particular continuity. Physical location is clearly a factor to consider in this regard.

4. Merger to One Fund

- Notwithstanding the complexity of change – legislative etc., one Fund for Wales would have a "status" which could be helpful in attracting staff (such as "specialists") and in having a voice at a national level. The Fund size would make it one of the largest LGPS funds in the country.

- There could be a removal of some small scale duplication, and increased conformity and consistency.

- While equities form the majority of assets for 6 out of the 8 Funds, a range of asset allocations and investment strategies has been adopted. Organisational change would mean a reduction of diversification of risk at a manager level which is inherent in the current arrangements.

- Organisational change would also incur some significant transition costs – investment, change management (staff etc.), together with a potential corporate impact upon current administering authorities back office structures. These aspects are dealt with in more detail within the Costs and Transition chapter of this report.

- Perhaps the key questions in order to justify this proposal Is whether there is evidence to support larger mandates having lower level of fees and whether there is evidence to support improved investment performance of bigger funds? These matters are dealt with later in the report.

- From a purely Investment standpoint, issues of localism are not considered to be a barrier and are less of an issue that what the group perceive might be the case for fund administration.

The results of this practitioner discussion, knowledge sharing and joint research identified the importance of a number of key funding and investment questions encapsulated within the requirement to provide a high level estimate of the impact on contribution rates and funding levels of using revised or common assumptions under the various collaboration options. A piece of work was thus commissioned to address via specialist actuarial advice the questions (Appendix 1) which were deemed as critical to the assessment of the optimum way forward. Hymans Robertson produced a report in response to this brief which rebased comparisons between the 8 Welsh funds using a common set of financial assumptions. In response to the questions raised, they concluded that:

- **A common funding and investment strategy could, but need not be applied across all of the Welsh funds since it is not seen as a necessity to gain financial benefits.** There are other options referred to in this report that achieve the benefits in a less disruptive way without having to reach a common funding or investment strategy. A move to such a strategy would be a long term target and the transition to a common strategy could take place over a period of time with different paces of funding and different levels of risk for any Fund making a change.
- If the number of Funds were to be reduced, then the two most likely criteria for grouping funds to minimise impact on long-term funding arrangements would be grouping to optimise operational capabilities or grouping by funding level.
- **Differences in approach to setting financial assumptions are likely to have the most impact on the funding level but it is understood why there are local differences** (e.g. attitude to risk and historical local differences). Thus standardisation of actuarial assumptions and funding strategies would have an impact on employer's contributions.
- **To reduce employer contributions by 0.1% of pay would require savings of circa £2m per annum.**
- **Ten year historic investment returns for LGPS funds in England and Wales show evidence of some correlation between size of investment funds under management and net of fees performance. Research suggests however that larger funds have better governance and alignment with objectives and it is not merely to do with scale.**

This latter aspect was endorsed via statistical analysis and commentary that was obtained from State Street Investment Analytics (WM Company) which corroborated the trend that larger funds tend to produce higher investment returns (net of fees) over the longer term.

The evidence collected appears to show that from an investment management standpoint; there are no insurmountable barriers to merger, although a collective investment vehicle could provide most of the same benefits over a shorter period with less risk than full merger. Key considerations include:

- impact on contribution rates for employers
- cross subsidy issues arising from pre merger positions

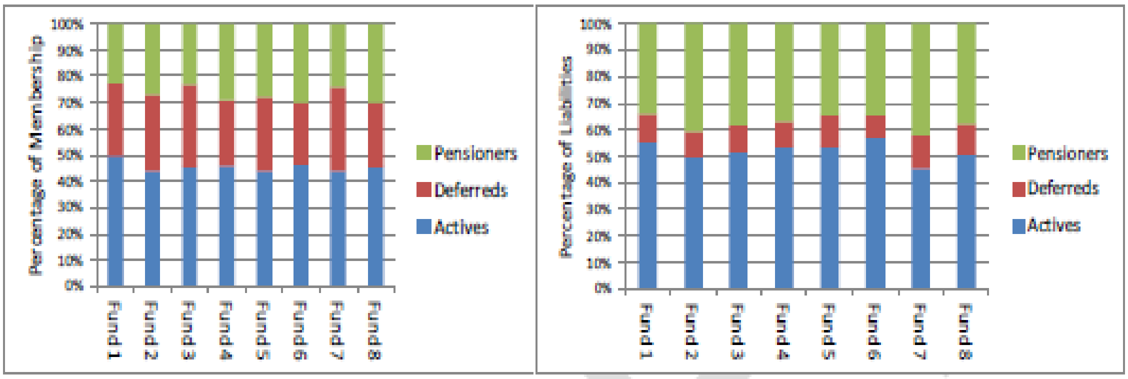
Closer examination of the results, together with the external advice provided, enabled further comment to be made on the funding and investment issues. These are outlined in the following paragraphs grouped around the areas of strategy(S), investment return (IR) and cost(C).

Investment Strategy(S)

In order to undertake the modelling within this report it is necessary to note that an indicative investment strategy was used which seeks to achieve a required level of return at an appropriate level of risk. This is illustrative only but is set out as in the Costs and transition section of the report.

Standardising Actuarial Assumptions(S)

There are no significant differences in the membership or liability profiles of the individual Welsh Funds.



All eight funds have broadly similar profiles, whether measured by numbers of members in each category, or liabilities. In terms of numbers, around 45% of members are actives, with the remaining 55% split broadly equally between deferred and pensioners.

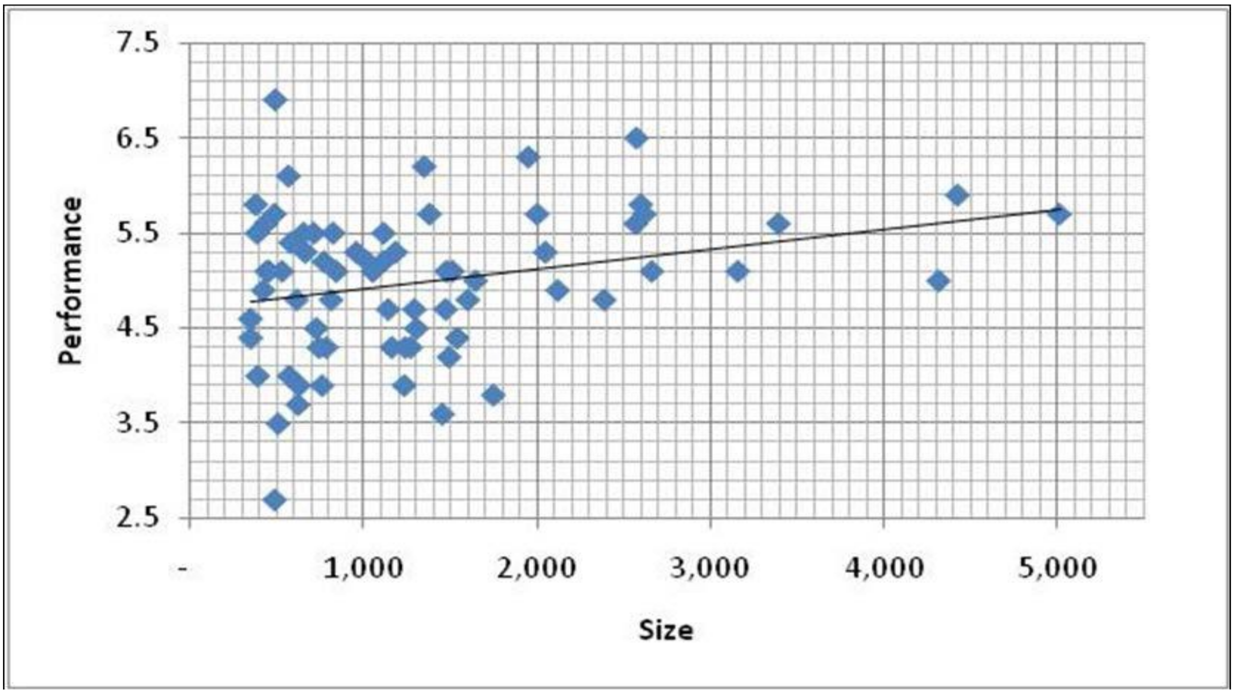
However, there are a range of different sets of actuarial assumptions used which reflect local circumstances such as appetite for risk. Re-basing to a common set of actuarial assumptions shows a greater disparity between funds, in relative terms, albeit this does not mean that merger would prompt an immediate increase in contribution rates.

In practice, a move to a single funding strategy, using a common funding target on the same assumptions, could still permit retention of the current contribution rate strategies in the short term.

Following any merger of funds a common set of actuarial assumptions would be needed for future valuations of the merged fund. This would have an impact on employer contributions.

Benefits of Size (IR)

From the advice commissioned, it is apparent that there are benefits of size in large funds, although better returns cannot be guaranteed. Hymans' analysis over the 10 years to 31st March 2011 suggests that benefits of size accrue incrementally in funds greater than £5 billion in value. These **benefits come from wider characteristics rather than simply the quantum of funds invested.**



The table shown excludes the 3 largest funds, partly because the x-axis scale would be dragged to the right and partly to ensure that the chart was not overly influenced by these three Funds. Including the three funds would not however have changed the picture. There is significant dispersion of returns around the line of best fit. **It is believed that it is the economies of scale that can result, together with size which can lead to improved investment return**. Any improved return is likely to be a function of improved governance, as larger Funds are likely to have greater resource applied to aligning the interest of managers with the Fund objectives.

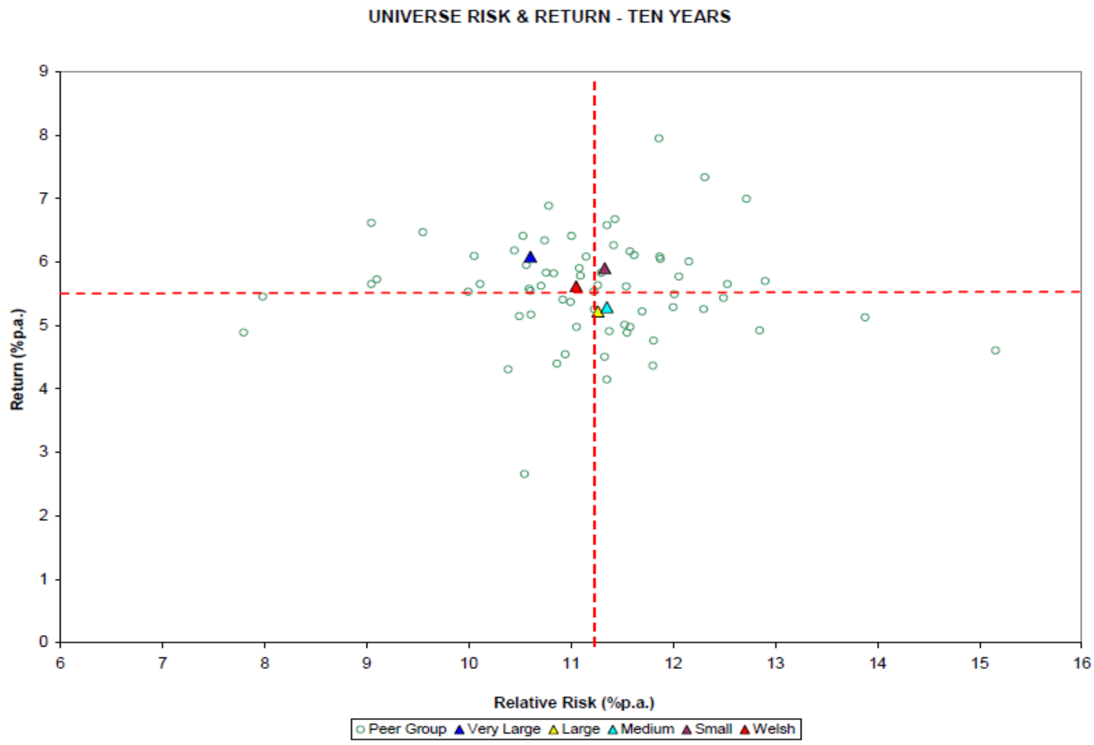
The wider characteristics include governance structures which enable more timely decision making, more internal specialist resources, hands-on management and in-house management of investments.

It is also important however to understand the extent to which benefits of size and scale can be achieved through greater collaboration more quickly than might be the case through a full merger. It is possible to achieve some of these benefits through pooling investment resources and managing investment funds collectively across Wales as an alternative to a full merger into one fund.

Maximising Investment Returns at Lower Risk (IR)

There are clearly significant risks associated with forecasting future Investment return. However there is a statistical correlation between size of fund and investment return, whereby larger funds appear to be able to achieve higher returns at lower risk. This has been analysed over a 10 year period (see above) and appears likely to be the result of economies of scale that together with size allow improved governance and the potential for increased return.

Further analysis and comparison of the average of a group of "very large" funds against the "all Wales" average undertaken by State Street (WM) (see chart below) showed outperformance in the region of 0.6% with lower levels of relative risk for very large funds as illustrated in the chart below. If simply replicated in practice, a theoretical outperformance of 0.6% on £9 billion would amount to an additional £54 million of investment assets being generated.



This chart shows the ten year risk and return for the peer group this time overlaying the median outcomes by size band. What this shows is that the very largest funds have delivered the best return at considerably lower risk. (Source WM Company)

Hymans also analysed all fund performance and size and plotted the linear, again demonstrating a general statistical trend of higher investment returns when a larger amount of investment assets is grouped together and invested.

Whilst additional investment return cannot be guaranteed, any improved performance, however marginal, is likely to result in significant benefits in monetary terms given the aggregate value of Welsh Funds. For example, improved investment performance of around 0.22% - about one third of the outperformance observed above equates to 1% of employer contribution rates across Wales and given the uncertainty of investment returns and organisational change requirements, it is not unreasonable to moderate expectation. This is particularly true given the lead in time to progress any changes, the wider changes in the pensions industry and the fact that some of the benefits of size might not be realised in the short term if there is a need to create a new investment organisation. The result via enhanced collaboration or a merger could be gradual improvement over a number of years but this would only be reflected from perhaps 2017 (after the next Actuarial valuation). It is also important to emphasise that the **evidence supports higher investment returns when a larger amount of investment assets is grouped together and invested. This does not require organisational change and can be achieved with existing organisational structures through enhanced collaboration**. This is an important area that requires a more in depth examination in order to produce a detailed business case.

Transition (C)

Transition costs will be incurred when funds move from one investments allocation to another. These costs should not be underestimated and can form a significant cost component affecting any change proposals. The illustrative costs of moving from different types of current investment structures to the above model are shown in the Financial (Costs and Transition) section of this report. This illustrates the short term impact of merging current investments into one investment strategy.

In practice the transition could be undertaken over a short period or extended over a longer period to spread the impact of these costs. Details of potential transition costs are included in the Costs and Transitions section of this report.

Fund Management Cost (C)

Fund manager fees are inherently complex with some performance related drag and some elements of fees not being transparent (e.g. pooled funds). They are also not the key determinant in fund manager and asset allocation decisions, typically attracting a small weighting (20-30%) in manager appointment processes.

Details of the potential savings on Fund Management Costs are included in the Costs and Transitions section of this report.

In House Investment Management Costs (C)

These are currently minimal at around £0.6 million.

One of the characteristics of larger funds appears to be the extent to which investments are managed in-house. Larger fund size appears to attract increased levels of in-house management, with appropriately skilled and experienced in house staff. Welsh funds do not generally invest in this way and do not have the necessary skills currently in place to do so.

Realising Cost Savings at an Employer Level (C)

The prospect of employers being able to realise the impact of any "savings" (from say increased investment return or from cost savings) is one step removed due to the funded nature of the LGPS which involves the triennial valuation process and the associated setting of contribution rates. The issue of materiality of savings relative to £9 billion of investments and the many other continuously moving assumptions and asset valuations is also of relevance.

In order to be able to get a measure of impact, the question was addressed with Hymans that assuming everything else stayed the same what level of savings within funds would be required to achieve a 0.1% reduction in employer contribution rates. It is recognised that this is wholly hypothetical in terms of many things having changed significantly since the 2010 valuation and indeed any savings within pension funds might actually be more about cost avoidance than cost savings – but for the purpose of the report it is helpful in terms of any positive impact upon employers, and their pension contributions.

The pensionable pay bill for those in the LGPS across Wales amounts to circa £2 billion, and to achieve a 0.1% saving on contribution rates (which would save employers £2 million) would require a corresponding saving in pension funds, either through reduced cost or increased income. Thus, for every £1 improvement in the finances of pension funds, this can be seen to pass through into contribution rates, so employers will see the benefit of reductions in pension fund costs / improved investment returns.

It needs to be stressed that the current outlook and reality is a potential worsening funding position across all funds (not just Welsh funds) and that any cost benefit which might be achieved is likely to be more about future cost avoidance or dampening future cost increases

At this juncture it is important to recognise that for any merger proposition, the lead time to benefit realisation is protracted and a number of steps removed. The legislative framework would require changes to legislation which are within Central Government control (not Welsh Government) and may well be complex and involve lobbying of central government. This aspect is covered in more detail in the Governance section of the report.

Conclusion

Each pension fund is seeking to achieve a return on its investments in line with its own investment strategy (funding strategy statement). It does not necessarily follow that each fund is attempting to solely maximise return, since any investment return achieved must be within appropriate levels of risk.

At its basic level however, if large funds are able to deliver increased returns at the same or lower levels of risk than the existing 8 Welsh Funds then this is something which needs further consideration.

Fund manager fees, whilst relatively minor in comparison with assets under management (£22.3 million fees on AUM of £9.2 billion), are nonetheless a significant monetary value. The results of analysis demonstrate a general statistical trend of higher investment returns when a larger amount of investment assets is grouped together and invested. This is in part due to the potential for larger funds to be able to access lower fund manager fees which whilst not material to the value of assets under management are nonetheless significant in monetary terms and the potential cannot be discounted.

Whilst additional investment return cannot be guaranteed from combining funds any improved performance, however marginal, is likely to result in significant benefits in monetary terms given the aggregate value of Welsh Funds. Improved investment performance of only around 0.22% equates to 1% of employer contribution rates across Wales and appears a more realistic target or aspiration. This is because of the uncertainty of investment returns and organisational change requirements, the lead in time to progress any changes, the wider changes in the pensions industry and the fact that some of the benefits of size might not be realised in the short term if there is a need to create a new investment organisation.

The results brought about by any enhanced collaboration or merger would only be reflected from perhaps 2017 (after the next Actuarial valuation). It is also important to emphasise that the evidence supports higher investment returns when a larger amount of investment assets is grouped together and invested. This does not require organisational change and can be achieved within existing organisational structures through enhanced collaboration. This is an important area that requires a more in depth examination in order to produce a detailed business case.

It does not necessarily follow that full merger is the way forward. Enhanced collaboration is a vehicle through which many of the benefits of scale might be achieved, whilst retaining an element of local control within existing governance structures, and with realisation of benefit being possible over a shorter timeframe. This would also allow individual funds to continue with their existing actuarial assumptions based on local decision making removing the risk of adverse impact on employers' contributions following change of assumptions on a merger.

On the basis of the evidence we have seen however, there is, from an investment standpoint, a prima facie case for change and an appropriate programme of works should be put in place to maximise the benefit which can be realised through greater collaboration, including specifically managing Pension Fund Investment assets on a collective basis.

Governance

Background to LGPS Governance

The LGPS is a common scheme throughout England and Wales. As a statutory public service scheme, the LGPS has a different legal status compared with trust based schemes in the private sector. Matters of governance in the LGPS therefore need to be considered with proper regard to the legal status of the scheme. This includes how and where it fits in the local democratic process through local government law and locally elected councillors who have final responsibility for its stewardship and management and have a clear fiduciary duty in the performance of their functions.

Eighty nine local authorities have been given statutory powers by UK Government to administer the scheme. Under legislation a local authority can delegate their functions through their own constitution to the council, committees, sub-committees or officers. However, the statutory decisions are not the responsibility of the Executive arrangements of the council.

The appointing council decides upon the number of members of a committee and their terms of office. They may include committee members who are not members of the appointing council. The formal committee structures operated by individual pension fund authorities reflect local circumstances and priorities and it has not been the aim of Government to prescribe a 'one size fits all' approach. The evidence collected by the CLG in 2006, and included as part of CLG's Statutory Guidance on Governance Compliance Statements issued on 3rd December 2008 indicated that the overwhelming majority of these committees operate efficiently and effectively despite their variations in constitution, composition and working practices.

Over recent years, CLG, Lord Hutton and CIPFA have published guidance on governance; CLG's being statutory guidance on Governance, where each authority is required to publish a Governance Compliance Statement on a 'comply or explain' basis. The intention as explained by the CLG was not to 'level out these differences' but instead to ensure that different structures reflect best practice principles. More detail on these publications is set out in Appendix 1.

The Public Service Pension Bill will also include consideration of LGPS Governance and overall scheme cost management, which is known as work stream 2 of LGPS 2014. The LGA and trade unions alongside Government have released a joint statement with 12 proposals and those relevant to governance are set out in Appendix 2a.

It appears that changes to Regulation will be forthcoming which will reduce the level of discretion in local governance structures, retaining local democracy but with greater scrutiny. This will question different approaches, working practices and the knowledge and skills of those making and advising on the decisions. These proposals on the whole simply underline and possibly impose earlier best practice from the CLG.

There are specific governance issues to consider within the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. Throughout these Regulations reference is made to the requirement for an administrating authority to take 'proper advice' when considering investment policy, investment manager appointments and monitoring. It is usual practice for an administering authority to appoint an investment consultant to provide this 'proper advice' and an independent advisor to consider the quality of this advice.

Officers of the administering authority should as a minimum have sufficient knowledge to advise on any conflict of interests with advice received. Some larger LGPS funds employ investment specialists who manage some of the fund internally (instead of through external fund managers) and hence they should have the knowledge and skills to provide 'proper advice', but these funds are in the minority.

As required by the above Regulation an administering authority must publish a Statement of Investment Principles (SIP) which must include the extent to which it complies with guidance given by the Government. This guidance includes CIPFAs Investment Decision Making and Disclosure, which is a guide on the application of the six Myner's Principles (Appendix 2b).

To complete the governance picture as well as the Governance Compliance Statement and SIP discussed above, LGPS Regulations require an administering authority to publish a funding strategy (after taking advice from an Actuary) and a Communication Policy. In addition Regulations allow administering authorities to establish a Pensions Administration Strategy which includes the power to introduce local performance targets and to measure performance against them. All these measures are designed to make the administration and stewardship of the scheme transparent and accountable to its stakeholders. The best practice guidance assists administering authorities with managing LGPS risk areas (Appendix 2c)

LGPS Governance in Wales

In Wales, as with England, **there is no single model in operation across the 8 funds** and in some cases delegation has been made to a Pensions Committee, an Investment Panel or directly to the Chief Financial Officer. In addition, representation also varies within each structure. Some funds have other employers and member representation on their main committee/panel. Others have established consultative panels/representative forums comprising elected members from the administering authority, representatives from other unitary authorities and participating employers, fund members and Trade unions.

The 8 funds have different independent advisors, investment consultants and actuaries. In addition the roles and responsibilities of the officer support for pension fund finance varies across the funds and most officers also have none pension fund duties and responsibilities. Working practices vary but none of the funds employ investment specialists to manage investments in house. The funds have a range of 3 to 5 individuals involved with accounting, investment and governance but this equates to only 1 to 3 FTE's (about 18 FTE across Wales) which reflects the differing working practices and fund size.

Each Administering Authority has a section which administers LGPS benefits. These vary in size from 8 to 26 individuals dependent in the main on fund size. However, organisation structures, operational models and working practices vary across these sections.

Hence in Wales, as across the whole LGPS, local decision making, based on advice from different advisors, has lead to different outcomes especially in terms of investment structures, funding positions, employer contributions and consistency of the administration (benefit) service provided to members. This should not alarm or surprise stakeholders as the governance structure explained above is designed to provide for local decision making and accountability and differences are an inevitable and acceptable consequence. As noted earlier it appears that the LGPS will still be managed locally in England but with more collaboration between Funds and greater scrutiny on the need for differing approaches to the risks outlined above.

The various governance options for the management of the Scheme in Wales are now considered.

As Is

The current governance arrangements in Wales have been in place since 1996 and there are differences in strategy, organisation, working practices and outcomes across the funds. If there is a desire to have a more consistent approach, as the benefit of these local differences comes under closer scrutiny, those charged with current governance must be satisfied that the benefits from collaboration can be implemented on a piecemeal basis without a change in the governance structure.

CIPFA has led on initiatives and advice for practitioners through the CIPFA Pensions Panel and CIPFA Pensions Network and there are many opportunities available for elected members and officers to network and share ideas. The CIPFA Knowledge and Skills Framework and Code of Practice should also improve governance. A number of framework agreements for efficient procurement of third party services are also now available.

There are already good examples of collaboration within the current structures especially joint initiatives in pension administration and on responsible investing through the Local Authority Pension Fund Forum. These tend to come about as a result of external drivers providing opportunities for change and collaboration rather than through a programme of collectively planned collaboration.

It should be noted that in terms of governance it is unlikely that 'as is' will be an option because of changes driven from LGPS 2014 as detailed in the Background section. It could be argued that this change alone will be a driver for improvement in the governance of the Scheme.

Enhanced Collaboration

In this scenario each of the 8 Council's would maintain their administering authority status and each would have a Committee (or Board) which satisfies the requirements of LGPS 2014 in terms of structure and representation. These 'Boards' would continue to determine and implement strategy locally.

The key question is **what sort of governance mechanism would drive such collaboration,** especially if it were for example focussed on investment related matters. One approach is a Joint Sub Committee (JSC) that could be formed with the principle aim of driving and implementing collaboration

There is more than one option within this approach that could be considered, together with various issues for discussion and resolution:

i. A Joint Sub Committee could either be elected members advised by officers or a more autonomous group of elected members who appoint a third party or specific officer(s) who would report and be accountable to them. In effect, it could be a specialist unit advising and delivering investment related procurement solutions on behalf of any of the 8 pension Funds who wished to participate.
ii. A further option might be create a JSC of the current Chief Finance officers of the 8 administering authorities (with other senior pension officers as substitute members). This JSC and its delegated powers would be recorded in each of the administering authorities' constitutions.

iii. Another model could simply be that each pensions committee has to agree to a proposed investment and that decision is actioned by the collaborative body.

Whichever option was favoured, much detail would need to be worked through. Regardless of the option, these would include matters such as:

- **The level of delegation from the 8 main committees (it would need to be decided and documented)**
- the level of consistency across the whole of the eight funds.(or is it simply a Fund chooses to be in the collaboration or not)
- Given that Strategic decisions would remain with the main committees, does the JSC only have the power to recommend, depending on how it was set up and constituted.
- Other, operational decisions would need to be determined. Dependent on the structure, this could be perceived as a loss of control by the administering authority and there will be some debate on what is strategic and what is operational but the concept requires more detailed examination through the production of a detailed business case.
- The JSC may also wish to consider the use of a single investment consultant and/or independent adviser. As stated earlier these organisations or individuals are key in the decision making process and if all eight administering authorities (via the JSC) receive consistent advice then over time logic would suggest that strategy should become more consistent, where appropriate. This could be extended with the joint procurement over time of other third parties such as actuaries, fund managers, custodians, legal advisors, tax advisors etc. As well as the advantages of consistency, joint procurement may result in lower overall cost and a reduction of the operational burden on finance sections.
- In addition there could be two pension practitioner groups' who would research and recommend collaborative opportunities to the JSC, overcome barriers and implement. Groups might include an Administration Group (current Pension Officer Group) and a Finance Group (covering governance, investments, funding and accounting), both with practitioners from the eight administering authorities.

For this governance structure to work the principle of collaboration must be agreed across the 8 funds. Those Funds which choose not to participate in certain collaborative projects will be accountable locally to their stakeholders for this. In simple terms the starting point when considering a collaborative project would be 'why are we not collaborating' rather than 'why should we change current practices'.

The legal advice received considered collaboration and concluded that **'existing legislation provides the Authorities with broad powers to discharge their functions through joint committees for procurement, administration and investment'**. This provides some flexibility in terms of how these governance arrangements could be structured.

The legal advice received did however express **a note of caution in any merging of investments**. Under the Local Government Pension Scheme (Administration) Regulations 2008 there is a requirement to 'maintain' the fund and it must be possible to identify the individual funds investment assets. This can be achieved by creating a separate section for each Authority within a 'common investment fund' or by unitising the assets. However due to the perceived "vagueness" of the wording, there is a concern that such an approach could be interpreted as an over-allocation to a particular asset class within the Investment Regulations. Consultation with CLG would be recommended here to clarify the intent and interpretation within the existing Investment Regulations. For the implementation of a common investment fund there may be a need to amend secondary legislation. In the current spirit of collaboration across the LGPS it appears unlikely that barriers would be put in place by the CLG, but if change is required, it may not be a quick change due to the existing LGPS legislative workload.

For completeness, although the scope of the above was to consider governance as a whole a JSC could be set up just for specific areas of work such a JSC for passive equity investment or JSC for administration. The options are wide ranging and require further investigation.

Merger – (2 - 7 Funds)

Independent, external legal[3] advice was received on the merger of the 8 pension funds. This concluded that only the UK Government (Secretary of State) has the power to amalgamate funds as a change to secondary legislation is required. The Secretary of State would consider whether it is in the interests of members' and ratepayers'. The legal advice suggests that the Secretary of State may consider a full merger may not be in members' and ratepayers' best interest if the eight Funds funding levels are different. The logic used to support this contention is that such a move may not be seen as being in the interests of the better funded schemes to merge with a less well funded scheme, which could effectively dilute their fund.

Separately, actuarial advice considered the funding levels of the eight Funds using common assumptions identified that there are differences; hence, there is a risk that the Secretary of State could reject a full merger on these grounds.

The legal advice recommended that if the merger option was to be pursued the 8 Councils with responsibility for administering the Pension Funds would need to lobby the Secretary of State. Although they do not have a direct responsibility for the administration of the Scheme, it would be sensible to approach DCLG with the support of Welsh Government but given the heavy legislative workload of the DCLG at present, it may add considerably to the timing of any proposed change in order to implement the required changes in secondary legislation.

Although legal and actuarial advice from one source can always be challenged this approach to change does seem consistent with the democratic governance arrangements for the LGPS explained earlier in the Background section.

The legal advice above applies equally to a merger involving two Pensions Funds as all eight. In essence however, the message here in a legal sense is clear. Collaboration is achievable in a timely manner within the existing legislative framework whereas any proposal for merger will take considerably more time to achieve due to the secondary legislative requirements.

There would be a number of options for structuring the governance arrangements for merged funds including:

- A new corporate body (The Northern Ireland Model)
- One Lead Authority (a current Council would take responsibility for the LGPS for the whole of Wales)

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3 SACKERS; All Wales Pension Funds collaboration Study-Overview Paper On Legal Issues

- A Mutual Model (The civil service pension scheme model)

These are equally applicable to a single merged fund, but logic suggests that in the interests of time and cost the larger the number of remaining funds the more likely the lead authority option would be the most appropriate.

In terms of governance specific issues of compliance with statutory guidance etc. logic also suggests that complexity and size will be more easily managed and the risks and costs of change lower than with a full merger to a single fund.

This option does raise a new dynamic in terms of how these funds could be grouped, other than the obvious various geographical splits. Hymans Robertson considered two options 'worthy of further consideration':

- Grouping funds with similar funding levels
- Operational capabilities (identify strengths of individual authorities)

However, they do then comment that whichever option is chosen the governance challenges of retaining local accountability and input into decision making should not be under-estimated. Another consideration of non-geographical options is that this may result in an anomaly in the future if there was another re-organisation of local government in Wales. The other dynamic to consider within this aspect is the perceived or real loss of local accountability from any reduction of Funds and how this could be managed across the 280 or so employers if any change process was initiated.

Full Merger – One Local Government Pension Fund in Wales

As stated above, the legal advice received applies equally to a merger of two funds as to all eight

Similarly, the options for structuring the governance arrangements remain the same as with any merged funds.

The Administration and Investment sections of this report consider to what extent the advantages of merging organisations applies to LGPS funds but there are some specific governance issues to be considered.

However any new structure would need to satisfy the principles of good governance, the current statutory guidance and/or the changes under consideration through LGPS 2014. There is a clear challenge here to develop a governance structure that allows for the representation of stakeholders across the whole of Wales (with the potential to be a structure of great complexity and size) which still allows for effective and timely decision making.

In addition, there will be a period of transition which will incur costs (especially asset transfer costs) and risks. A full assessment would be required on the impact on all the risks which were listed earlier from the lead in period post the formal decision of merger, the transitional period and post the merger.

The whole process from gaining agreement of the 8 Councils, Secretary of State approval and the setting up of the new governance arrangements will take time and cost which are both difficult to estimate. The timing of such a major change, given the implementation of a new scheme from April 2014, the 2013 Actuarial Valuation and current financial market risks needs due care and attention by those currently charged with governance.

Governance Conclusion

Although any changed governance arrangements in Wales will be largely dictated by the results of detailed consideration of change across administration, investments and broader financial considerations, there remain some specific governance considerations which should not be underestimated.

In terms of merger, following legal advice this can only be achieved with the agreement of the Secretary of State and a change in secondary legislation. There are also other risks and costs to consider. Specifically, determining a governance structure to satisfy statutory guidance or the future LGPS 2014 principles (or regulation) would be challenging, but not impossible. The timing of any change given LGPS 2014 and the impact on other risks must not be overlooked by those currently charged with governance.

Due to both the development of LGPS 2014 and the current focus on collaboration it seems unlikely that the 'as is' will be a viable option. However setting this aside, those currently charged with governance, would need to be satisfied that, if there are benefits from collaboration, then this could be managed in a transparent way, and indeed that the end results will justify the change process.

A governance structure to develop and enable enhanced collaboration was considered which included a joint sub committee. There are few legal barriers with this option and there are advantages of relative speed of implementation, simplicity and low cost. This governance structure would drive collaborative projects in a collectively strategic and planned manner over time. In the short to medium term this could enable a more consistent and cost effective approach to managing the scheme across Wales, without losing the local accountability which underpins the statutory governance guidance. In the longer term the increased consistency may allow for more logical mergers, either from choice or driven by any future re-organisation of the 22 unitary authorities in Wales.

Administration

Background to LGPS Administration

With 4.6 million members, the Local Government Pension Scheme is one of the largest public sector pension schemes in the UK. The LGPS is a nationwide scheme and is a valuable part of the pay and reward package for employees working in local government or working for other employers participating in the Scheme and for councillors. The scheme regulations are made under the Superannuation Act 1972. Changes to the Scheme are discussed at national level by employee (trade union) and employer (LGA) representatives but can only be amended with the approval of Parliament.

The LGPS has a diverse workforce contributing to the scheme, which requires varying degrees of support and communication.

Benefits Administration teams provide a range of services for current and former employees of local government and other employers participating in the scheme. Their core activities are calculating and paying pension benefits to scheme members but their role extends far beyond this, providing support and guidance to scheme members, often at times of personal change or upset for the member, keeping them informed of the latest developments in the scheme and also ensuring that payments are correct, which means working closely with scheme employers to ensure that information is accurate.

In order to ensure that the scheme is reactive to the extending longevity trends and the subsequent cost implications, the LGPS was subject to regulatory change in April 2008. These changes afforded members specific protections, the result of which increased scheme complexity. Future challenges for the Funds in Wales will, in conjunction with Employers, ensure the implementation of auto enrolment and following consultation and regulation being laid before Parliament (intended to be by 31st March 2013) the 'New LGPS 2014'. The 2014 New Scheme is designed to help address the immediate affordability concerns; however, it will introduce yet another layer of complexity to the existing LGPS administration and as a direct consequence increased membership contact.

LGPS Administration in Wales

The 8 regional Welsh pension funds are responsible for administering the Pensions for the 22 local authorities in addition to the town, community and other bodies admitted under separate admission agreements. 131 staff are employed across 8 local authority areas providing services for a total of 296 Employers and some 289,000 scheme members. All funds hold local surgeries with their Employers and the availability of face to face support for scheme members.

In terms of the financial context, the existing Funds' Administration charges within Wales compares favourably with Private Sector Administration charges i.e. less than 0.12% of total Funds' assets (Source: Mercer HR).

As part of this review, an Administration Workstream, represented by each of the 8 Funds was identified, with the objective of establishing the current baseline data and level of service delivery at each Fund. The Administration Workstream would use this information to objectively challenge the 'status quo', and identify opportunities to improve efficiency and service to the Welsh LGPS membership, in context of the four service models defined by the Project Board.

All options were tested as part of the work stream's analysis and **the Administration work stream concluded the most beneficial option to the delivery of the LGPS Pensions Administration throughout Wales would be through expansion and development of collaborative work.** In this context it was felt that the alignment of Pensions Administration and Pension Funds should continue; as a single or grouped Administration Service operating a multiple number of Funds would present significant inherent risks. The work of the team is presented in tabular format at Appendix 4 but in essence the conclusion drawn was due to the following key points:

- Whilst the Collaborative model is unlikely to generate significant financial savings, there are tangible improvements to service delivery that can be achieved with minimal risk and disruption to stakeholders, within existing organisational structures.

- The Welsh Pensions Officer Group has been in place for several years, and has proactively sought to collaborate on a number of initiatives. This has successfully delivered and ensured a consistent interpretation and application of Regulations across Wales, whilst also enabling all participants to benefit from cost efficiencies.

- The Pensions Officer Group has already identified that the development of a set of All Wales Service Standards along with the implementation of the 2014 LGPS Scheme is a key juncture for future collaboration and anticipates joint communication, presentations and training for the latter.

- This option would ensure that risks such as provision of varying support and 'face to face' communication needs to the diverse membership is maintained and also continues to address the necessity to provide the service in the medium of Welsh locally.

- There is no real evidence to support groupings or a single entity to be more cost effective or efficient than the current operational arrangements

Comparison with other LGPS Funds was possible utilising data from the DCLG's "SF3" return (below) although there was no data that allowed the workstream to identify in a justifiable way an optimum size of fund.

Table: Fund Membership Size 2010/11[4]

Bandings of Member numbers	Less than 12.5k	12.5k - 16k	16k - 18k	18k - 20k	20k - 40k	40k - 50k	50k - 65k	65k - 90k	More than 90k
Total Funds in Banding	10	9	9	9	9	11	9	11	12
Wales Fund Banding Profile		1			5	1	1		

[4] Source: SF3 return data for 2010-11

As Is

While there are some broad similarities between the funds, the current administration arrangements have developed since local government reorganisation in 1996. For a number of years, the implementation of significant changes to scheme administration have been discussed and developed collaboratively through the Pension Officers Group enabling the sharing of experience and skills.

The current arrangements allow service delivery to be alert to scheme member and employer requirements based on agreed local measures; however number, variation in, and consistency of local measures hinder wider benchmarking and setting of service standards. This appears a current weakness that could be addressed via merger or more efficiently and quicker via enhanced collaboration

Comparison with CIPFA benchmarking data for ratios of administration staff to scheme members showed that there were only marginal opportunities to reduce the number of staff currently employed in administration (maximum of 6.82 FTEs).In total, this might generate savings of up to £120,000 per year but this may not materialise as Regulatory complexity increases with the introduction of auto enrolment in 2013 and the new LGPS in 2014. The sum is also small in the context of the 8 Funds (£15,000 per Fund) and secondary to anything that could be achieved around investments.

The ability to provide a local face-to-face service appears to be appreciated by scheme members where available. Whilst difficult to quantify, letters of appreciation from scheme members are not uncommon.

Each fund use the same base IT system but there are some significant differences in the versions used and the way in which the system is configured and utilised that have resulted from local system development.

While there is some scope for further collaboration and potentially some cost avoidance, this can be limited by local resource availability and experience.

Enhanced Collaboration

The option of Enhanced Collaboration would build on existing collaborative networks but with the addition of greater governance allowing collaboration to be driven in a planned and strategic way. This would allow greater cost avoidance and improved consistency of service while minimising transition costs and the risk to current service delivery. It would allow local face to face service delivery to continue and maintain the local responsiveness of the existing arrangements.

The implementation of the LGPS 2014 scheme would be delivered collaboratively and greater consistency in the use of IT would be possible. Sharing experiences of system development and implementation would allow for the maximisation of technological advances. Other collaborative changes may be possible during the implementation of LGPS 2014.

One of the greatest limitations found in the undertaking of this project was the inherent difficulties in collating any meaningful comparable Service Standards and subsequently the inability to identify a potential 'Best in Class' Fund for LGPS Administration across the UK. The following observations were drawn from the project review:

- There are no nationally agreed Pension Administration Service Standards that can be used for performance measurement
- Individual funds set a range of locally determined targets and measures

- IT capabilities to record and report on measures are not fully implemented across all funds in Wales
- Calculation of measures varies considerably (for example: some funds publish percentage completed on target, others the actual number completed, or the average number of days taken to complete; different start and end points are used to capture performance measures making comparison meaningless)
- Publication of targets and measures varies considerably (for example: some publish their target standards but no results)
- CIPFA Pensions Benchmarking Club does not compare Service Standards (in order for this to be successful and a meaningful comparison Service Standards need to be set the same. The current omission by CIPFA is a reflection of the existing inconsistency)

This issue would be addressed through enhanced collaboration and the development of common service standards.

Merger (2-7 funds)

As discussed above, there are marginal opportunities for reducing costs based on staff-member ratios, but there may be the opportunity to develop specialist roles (e.g. systems or communications officers).

The scope for making savings through merging the use of a single IT system are limited, in part because all the Funds already use the same IT provider and as costs are based on the number of scheme members which would not change on merger.

There is a risk that the current levels of local access may no longer be possible, with a further risk that the service may become less responsive to local issues and be seen as increasingly remote.

There is also a timing issue since the implementation of LGPS 2014 would through necessity have to take precedence over the implementation of fund merger. The current level of resources would mean that it would not be possible to implement both concurrently.

Greater consistency and some cost avoidance would be possible through the merger of funds, although this would not necessarily be across the whole of Wales and would depend on the groupings to be merged. Savings, if realised would be extremely small in the context of the service and it is questionable whether the costs of change would justify the level of savings potential.

Common service standards would be developed within the newly merged funds and potentially across Wales.

Existing service delivery is considered to be at greatest risk given the degree of complexity involved in merging and local accountability would be diluted.

Full Merger

Many of the conclusions reached under the consideration of grouped mergers also apply to a full All Wales merger.

Common service standards, procedures and documentation would apply across Wales but local responsiveness and accountability would be severely diluted.

Again, the implementation of LGPS 2014 would need to take precedence over the implementation of fund merger, and it is questionable whether the quantum of any possible saving would justified through the upheaval of change. The other important facet here is the legislative and governance issues to be addressed which is dealt with elsewhere in this report.

Administration Conclusions

The following overall conclusion has been drawn together by the Administration Workstream based on the evidence gathered for each of the four options.

Whilst the Collaborative model is unlikely to generate significant financial savings, there are tangible improvements to service delivery that can be achieved with minimal risk and disruption to stakeholders, within existing organisational structures. This is therefore the option that is recommended.

There is **no real and supported evidence that demonstrates that groupings or a single merged fund would be significantly more cost effective or efficient than the current operational arrangements**. The overall quantum of cost in respect of administration also results in this area being less attractive as an area to achieve meaningful financial benefit.

There is a serious risk that **any major relocation or change from the current Fund deployment would result in a loss of key personnel and ensuing recruitment difficulties, due to the geographical nature and infrastructure within Wales.**

All eight Funds use the same software supplier (who is the market leader in LGPS Pension Software). Evaluation of the systems costs identified that reduction in the number of Funds would not generate material savings. Whilst it is conceivable that some non-direct central recharges may be reduced through economies of scale, any such contrast between the support service requirements of a much larger entity would need to be determined.

Furthermore, the review identified that whilst all Funds use the same administration software, utilisation of the system and processes are configured differently to meet funds individual service requirements. This has created difficulties, particularly in respect of data records in the past where organisations previously regionalised in Wales have been merged into a single body.

Recommendations

Having given due consideration to the four options and associated risks, the Administration Workstream concluded that the most beneficial option to the delivery of the LGPS Pensions Administration throughout Wales would be through expansion and development of collaborative work, as further identified during this project.

This option would ensure that risks such as provision of varying support and 'face to face' communication needs to the diverse membership is maintained and also continues to address the necessity to provide the service in the medium of Welsh locally.

The Pensions Officer Group has already identified that the development of a set of All Wales Service Standards along with the implementation of the 2014 LGPS Scheme is a key juncture for future collaboration and anticipates joint communication, presentations and training for the latter.

Costs and Transition

Background

The costs incurred by pension funds include investment management fees, custodian fees, specialist advisors fees and in-house administration, investment management, accounting and management. The **investment management fees are the single largest regular costs incurred by each fund** and are therefore most relevant for consideration when looking for improvements and efficiencies.

In addition to these annual costs, **any decisions which involve the fund moving from one investment allocation to another, or from one investment manager to another, will result in transition costs. These costs can be significant and therefore need to be considered as part of the assessment of a move to collaboration on investment management**. The potential gain however within this context is a possible improvement in investment returns.

Investment Strategy

In order to undertake the modelling within this report, an indicative investment strategy was used which sought to achieve a required level of return at an appropriate level of risk. This is purely illustrative only but is set out as follows:

Asset Category	Weight	Approach to Management
UK Equities	18	Largely Passive
Regional Equities	20	Largely Passive
Global Equities	25	Themed active (e.g. income or value)
Private Equity	5	Existing fund of funds for now
Property	7	Pooled UK Property funds
Credit	10	Emerging market passive and high yield active – no UK investment grade
Nominal gilt	15	Short duration (less than 5 years)
Index linked gilts		Long dated I-L (over 15 years)

In practice it would be difficult to agree a common investment strategy due to the diverse investment strategies in the Welsh funds which provide different starting points, and the local circumstances for each fund both currently and brought about over time and the appetite for risk of each Fund which is influenced by these various factors.

Fund Managers Fees

Each Fund sets its own investment strategy relative to its own liabilities. Fee levels will therefore differ for Fund specific reasons. For example, a more mature fund aiming to minimise volatility will have a different asset allocation to one targeting higher returns; hence each Fund will invest in different asset classes, with different amounts in active versus passive approaches.

Investment strategies consider returns net of fees, and also the additional return which may be possible from performance fees. All large investors pay the same low fee within most tracker funds and then consider the relative value of paying additional fees for some active management with the aim of increasing returns. However, fees are usually of limited importance when deciding whether to adopt active management compared to the excess returns and risk-return characteristics of the active strategy. Many investment manager contracts have performance related fees which can vary significantly according to the returns achieved against the relevant benchmark.

Thus it is difficult to make comparisons between the fees in different funds when there are many variables affecting their calculation.

At an all Wales level, Fund Manager Costs (excluding custodians, specialist advice etc...) amount to over £22 million. **A study carried out by WM of their LGPS Funds over a 10 year period identified fund manager fee ranges that did appear dependent upon size of fund.** This concluded that funds over £5 billion do have lower levels of fees than funds of between £1 billion and £2 billion. The differential within those funds which are externally managed is circa 0.07%. On assets under management of £9 billion, this statistical trend, if actually realised, amounts to a potential financial differential of £6.3 million.

Many larger funds also undertake more investment activity in-house which further reduces their costs. The differential in fees at an all fund level increased to circa 0.20%. On assets under management of £9 billion, this amounts to a potential financial differential of £18 million.

Hymans have similarly commented on fund manager fees and imply a potential cost saving being achievable from having bigger mandates. Part of these savings could be realised due to the higher bargaining power of larger investors **but larger funds do appear to have certain economies of scale that may influence investment returns in a positive way.**

The extent to which lower fee levels might be associated with older mandates is a key observation here, and one which through greater collaboration might be exploited within existing fund structures. This is due to some mandates being in place over many years and negotiated at times of historically low management fees.

To further explore possible fee savings, the investment strategy provided by Hyman's was used as a base case and independent third party advice was sought on the range of fees currently in the market for these larger mandates. Many assumptions as to the number of fund managers and types of mandates have been made to enable any such comparison to take place so results should be interpreted with care. The market value used for the eight Funds was the mid point of the March 2010 and March 2011 market value to enable some comparison with the £22.3m (total fees for 2010/11). The results are summarised in the table below:

	Assumed Fund Value	Low Fee Range	Mid Fee Range	High Fee Range
Fund Management Fee	£8.9bn	£17.2m	£19.4m	£24.8m

Therefore, these results broadly further support the hypothesis and some survey findings that larger pension funds can achieve lower fees, of between £3-7m per annum in this example. Albeit should be noted that using all the higher range of assumptions, current fee levels in total are lower. This may reflect current low fees paid for some older mandates or simply the range of assumptions made to enable the comparison.

Asset Transition Cost

Theoretically, if the current assets of the individual eight funds were being employed using the same investment strategy and implemented through the same fund managers then a merger or some kind of pooling or grouping of these assets would result in no change or cost.

However, in practice, for reasons outlined in the Governance section of this report the eight fund have different investment strategies implemented through many different fund managers. Hence, to achieve any potential benefits from merger or collaboration there will inevitably be some transitional cost and risk.

Transition management (i.e. the moving of monies from one asset class to another or from one manager to another) is a specialist area and it is usual for any institutional investor to employ a transition manager to manage costs and risks where a major change in investment strategy is to be implemented. As part of this report, three Transition Managers were approached both to provide some further understanding on the components of the costs and quantify these costs.

The costs are briefly outlined below:

- Commission fee charged by a broker to execute a buy or sell.
- Taxes and fees levies charged by some countries for equity trades e.g. UK stamp duty.
- The 'spread' which is the difference between the purchase and sell price of an investment.
- The market reaction to a buy or sell order and the resulting impact on the price.
- Specific high asset costs in some fixed income securities due to the limited number of counterparties.
- Alternative assets where transactions may be difficult to achieve or at a high cost or discount to market value.

In addition there is also the 'Opportunity Cost or Risk' which is the market movement during the transaction while the investor is 'out of the market'. This can be a positive impact on performance if the market falls during the transaction or negative if the market rises. In times of volatile markets, this can be a significant positive or negative effect.

As referred to earlier in this section, Hymans provided an indicative optimum investment asset allocation structure for a consolidated investment structure at an all Wales level.

Whilst for the reasons provided above, transition costs can vary considerably due to timing decisions, it is nonetheless important to understand the scale of costs which might arise. This is shown in the table below and suggests transition costs of £11m.

Transition from	Transition to	Amount to be traded £'000	Estimated cost £'000	Estimated cost Basis points
Existing	Hymans Report Allocation	5,815,030	10,979	12

A number of other "transition to" scenarios were also modelled, in order to further understand the range of potential costs. These additional scenarios were identified as representing the two ends of the current spectrum of investment strategies currently used by the Welsh funds. **The transition cost estimates** for these movements were £21M and £46M, as compared to the £11M cost of moving to the Hymans indicative allocation. These costs **are substantial and would have to be factored into any proposals for organisational change.**

The transition managers stress the large number of assumptions made in arriving at the indicative costs and that in reality costs may be significantly different from those above but the important conclusion is that under all scenarios, transition costs are significant monetary sums.

Clearly it is difficult to be precise about the cost of a transition but it is important to recognise there is a 'one off' cost and risk, the quantum of which need to be considered relative to potential cost savings.

Investment Returns

The Investment and Funding Chapter of this report has already dealt with the issue of size of Fund and the attributes of larger funds that may help improve investment returns. Whilst additional investment return cannot be guaranteed from combining funds through merger or enhanced collaboration, any improved performance, however marginal, is, as previously stated, likely to result in significant benefits in monetary terms given the aggregate value of Welsh Funds. **Improved investment performance of only around 0.22% equates to 1% of employer contribution rates across Wales and this is a goal worth pursuing.**

Conclusion

Whilst fund management fees and transition costs are significant in terms of value they are not the fundamental drivers of an investment strategy or of changing a strategy.

If the eight Welsh Funds were to merge, the buying power of one new Fund would enable the Fund to purchase mandates at a lower management fee, but the overall reduction in fees (if indeed achieved) as a percentage of market value across Wales will be determined by the new investment strategy and the method of implementation. Equally the evidence would suggest that it is the grouping of assets which is important, not necessarily changing organisational structures. A collective investment approach by Funds would appear to have the same potential to achieve improved investment returns

There would be a significant 'one off cost' of transitioning the assets to these larger mandates under any of the scenarios modelled within the report.

An attempt has been made to quantify the fee reduction and cost of transition but these should be used for illustrative purposes only due to the extent of assumptions made. However, it is not unreasonable to conclude that it could take several years to 'pay back' the cost of transition before any lower fund management fee benefits may accrue.

Whilst additional investment return cannot be guaranteed from combining funds through merger or enhanced collaboration, any improved performance, however marginal, is, as previously stated, likely to result in significant benefits in monetary terms given the aggregate value of Welsh Funds. It is therefore a goal worth pursuing, particularly if it is attainable without significant organisational upheaval.

Overall Conclusions and Recommendations

Findings of Investment Work

1. There is evidence that there are potentially significant financial benefits of scale to be found from either merger or working collectively through a common investment approach. The results of analysis demonstrate a general statistical trend of higher investment returns when a larger amount of investment assets is grouped together and invested. There are however no guarantees of improved returns and it does not appear to require organisational change to benefit since enhanced collaboration would achieve the same goal in a quicker and less disruptive way.
2. The potential benefits are not a direct relationship with the size of a fund but **rather the** result of economies of scale that together with size allow improved governance and the potential for increased return **with** a combination of attributes that larger funds tend to have such as
    - More internal / specialist resources;
    - More internal / hands on management;
    - Better diversification – asset classes, managers;
    - More bargaining power on fees;
    - Better, more responsive governance structures and processes in place enabling speedy decision making.
3. Changes introduced as a result of the findings of this paper would not impact on employer contribution rates until the Actuarial Valuation after any changes were implemented (i.e. earliest impact could be 2017/18.
4. It is impossible to predict future investment returns with any degree of certainty.
5. The variety of valid funding assumptions and approaches adopted across Welsh LGPS funds makes comparison difficult and has the potential to significantly cloud the interpretation of a Funds funding position.
6. Given other influencing factors at this time such as changing (increasing) liabilities, changing membership profile, improving longevity and benefit design changes, the impact of any investment benefits are more likely to be a dampening effect on future upward contribution pressures resulting in slower growth in the employer contribution rates rather than a reduction.
7. There are inherent difficulties in adopting a common investment/funding strategy across all Funds whilst they remain independent legal entities. The more appropriate option would be a common approach to the implementation of a Funds strategy rather than the Strategy itself being common.
8. Funding changes are the most complex and lengthy areas for change but also have the greatest potential for cost saving.
9. Investment manager fees amount to some £22.3m per year across LGPS funds in Wales. A common investment approach could provide some modest savings which even if a low level of only 10% saving were achieved would amount to a £2m saving across Wales; equivalent to 0.1% on employer contribution levels. It is important to note however that to deliver such savings would potentially incur significant transition costs at the outset.
10. On the basis of the evidence, there is, from an investment standpoint, a prima facie case for change and an appropriate programme of works should be put in place to

maximise the benefit which can be realised through greater collaboration, including specifically managing Pension Fund Investment assets on a collective basis.

Findings of Governance Work

11. There is much that can be done using a collaborative approach within existing legal, organisational and governance arrangements.
12. Merger cannot be undertaken without a change in secondary legislation at UK level. This would be the most challenging option with the longest lead in time, requiring engagement with both Wales Government and the DCLG.
13. Merger would distance Funds from local accountability and control unless additional layers of governance were introduced.
14. A common investment proposition is feasible within the existing investment regulation framework but clarification on aspects of the Regulations from DCLG would be helpful.
15. A Governance structure to develop and control future collaboration across Wales needs to be established with agreed standards.

Findings of Administration Work

16. Building on existing collaboration and the additional impetus provided by this Collaboration project, can achieve improvements in front line pensions service delivery, consistency and efficiency whilst ensuring compliance with sound governance arrangements and stewardship controls and regulations.
17. A local presence is important for responsive service delivery.
18. The absence of agreed service standards within the LGPS does not help meaningful comparison either within Wales or across UK funds.
19. Administration costs across the LGPS Funds in Wales amount to some £8m per year. Financial benefits identified through the administration work are thus far more modest than those identified elsewhere but should nevertheless be pursued.

Findings of Costs and Transition Work

20. Both fund management fees and transition costs are significant factors but not the fundamental drivers when considering investment strategy.
21. Merger to one Fund or the mechanism of a collective investment vehicle would facilitate potentially lower management fees, but the overall reduction in fees (if indeed achieved) as a percentage of market value across Wales would be dependent on the new investment strategy and the method of implementation.
22. There would be very significant 'one off' costs of transitioning the assets.
23. An attempt has been made to quantify the fee reduction and cost of transition but these should be used for illustrative purposes only as the assumptions are many. In isolation, and prior to factoring in any improved investment return due to size and associated attributes, it is reasonable to conclude that transition costs will be significantly higher than any potential reduction in management fees and thus it could several years to 'pay back'

Key Recommendations

1. The "as is" or no change option is not supported. The pension's environment requires a more pro-active approach to managing service standards and costs within the LGPS within Wales.
2. Enhanced collaboration is seen as the area where medium term savings can be optimised. This is the option where the balance of service delivery and efficiency, cost of change, time and resource can be blended in the most effective way and should be pursued further.
3. To create a Full Business Case for a common investment approach to encompass the common attributes that benefit larger funds with the aim of implementation thereafter.
4. To create an appropriate and responsive governance structure to drive and manage future collaboration initiatives within Wales which will:
    a. explore the potential in the longer term for consistent Valuation and funding assumptions and standards.
    b. develop minimum administrative service standards for Wales and an agreed measurement framework.
    c. take advantage of joint procurement initiatives to help consistency and efficiencies
5. The prospect of merger to regional funds or a single Welsh Fund is both complex and the transition would be costly with a long lead- in time and a loss of local autonomy. Changing funding strategies could also have a destabilizing effect with a loss of local accountability. Whilst this may merit additional investigation in the future, it is not recommended for further work at this time, especially where it is believed that the most significant gains can be realised through greater collaboration and, specifically a common investment approach.

Acknowledgements

This interim report is in itself a true collaborative effort produced by local government officers from all eight Pensions Fund administering authorities in Wales.

The Project Board established a structure of working groups covering administration, investments and funding and financial modelling and governance. Each group had membership from each Welsh Pension Fund and the work produced represented a collective input from many individuals across all Funds with an interest in shaping the future direction of local government pensions in Wales for the benefit of its current and future stakeholders. A project team acted as a co-ordination body to bring the separate work strands together into a single document.

The Project Board wishes to formally place on record its thanks and appreciation to all those officers involved in the project who have spent considerable time and effort, in addition to their existing roles, to produce this report. The work has been considerable and the challenge of achieving sufficient consensus of views and ideas across 8 organisations has been considerable but rewarding. The Board would also like to record its thanks to those third parties who have contributed in a professional manner to the work undertaken.

The Project Board hope that this report stimulates debate about the future direction of the LGPS in Wales and enables an increased confidence that there is a way that the LGPS in Wales can be provided in an increasingly efficient way and operated in both an affordable and sustainable way for all its stakeholders, now and in the future.

Appendices

1 Key Funding and Investment Questions

2 Guidance on Governance

3 Extract from Joint Statement relating to Governance

4 Summary of key Points re Administration

APPENDIX 1

KEY FUNDING AND INVESTMENT QUESTIONS

1. Based on the current funding strategies and membership structures across existing Funds, is it possible to model, in outline terms, a funding strategy to balance existing funding objectives across a single Wales Pension Fund? Following on from that, is it then possible to suggest a basic investment strategy (asset allocation, risk and return targets) to meet that funding scenario? This is for illustrative purposes only (we are not seeking to undertake a wholesale asset / liability study/review) but could be something which might be used for modelling purposes to demonstrate what a potential strategy might look like, and how we can model the transition costs with our transition managers.

2. Are there any basic funding rules, or a template or checklist, which might be appropriate to determine any best fit for a regionalised model across Wales? Based on existing funding assumptions, membership structures etc., have you any views upon which, if any, Funds might be more aligned so as to minimise the impact on long-term funding arrangements? Could we then carry out the same analysis as in point 1 above for the suggested regional groupings?

3. For enhanced collaboration as well as the status quo option, are there particular actuarial assumptions or aspects of funding strategies which could usefully be standardised? Is it possible to quantify the impact of this on employer contributions?

4. Based upon any cost savings being identified as achievable, is there a calculation which could be carried out to demonstrate the absolute or relative level of administrative cost savings would be required to have a positive impact upon employer contribution rates of 0.10% (ie 10bps). That is, if everything else stayed the same, then at the 2010 valuation what level of long-term cost savings would have been required to have reduced employer contribution rates by 10bps?

5. The question of Fund size also needs to be explored if possible. Are there any factors from a funding or investment perspective which you feel are generally linked to Fund size? Is it possible to value any such factors, whether positive or negative, and to provide estimates of the potential impact on employer contributions under different scenarios?

APPENDIX 2

Guidance on Governance

There are nine principles to the CLG statutory guidance but underlying these principles is the democratisation of LGPS committees and governance arrangements. The principles are on structure, representation, selection and role of lay members, voting, training/facility time/expenses, meetings (frequency and quorum), access (to reports), scope (to include investment and administration) and publicity (of governance arrangements).

Although compliance with all the above principles is relevant to any changes proposed in this project the first two principles are shown in more detail as they will require particular attention.

1. Structure

a. The management of the administration of benefits and strategic management of fund assets clearly rests with the main committee established by the appointing council.
b. That representatives of participating LGPS employers, admitted bodies and scheme members (including pensioner and deferred members) are members of either the main or secondary committee established to underpin the work of the main committee.
c. That where a secondary committee or panel has been established, the structure ensures effective communication across both levels.

2. Representation

a. That all key stakeholders are afforded the opportunity to be represented within the main or secondary committee structure. These include:-

    (i) employing authorities (e.g. admitted bodies)
    (ii) scheme members (including deferred and pensioner scheme members)
    (iii) independent professional observers, and
    (iv) expert advisors (on an ad hoc basis)

More recently **Lord Hutton** considered LGPS governance as part of his report on Public Sector Pensions. His recommendation did not change the local approach to the management of the LGPS when there was an opportunity to do so. However, amongst other recommendations on properly constituted, trained and competent Pension Boards, greater consistency, transparency and scrutiny, there was also mention of central and local government closely monitoring the current co-operative projects within the LGPS, with a view to encouraging the extension of this approach.

In light of this **CIPFA** published a document ‘Buying Time’ which described a number of co-operative projects which are on-going across the LGPS and published a Code of Practice on Knowledge and Skills in Public Sector Pension Finance for elected members and officers.

APPENDIX 3

a. Extract from Joint Statement relating to Governance

1. Both governance and cost management are equally essential to the future sustainability of the scheme and should not be considered in isolation
2. A national LGPS Board would be set up to include representatives of scheme employers, scheme members, the government and professional bodies. The remit of the board would be to extend best practice, increase transparency, co-ordinate technical and standards issues and provide an effective liaison with the scheme regulator.
3. At a local level we propose that boards provide a greater degree of segregation between funds and administering authorities and that the potential for conflict of interest at both member and officer level is reduced.
4. Membership of local boards is proposed to require a minimum recognised level of skills and knowledge and to include representation for fund employers and trade unions.
5. We also propose that best practice with regard to transparency and accountability is extended across all funds.

b. Myner's Principles

- Effective Decision Making
- Setting Clear Investment Objectives
- Managing liability risks
- Measurement and reporting on investment and governance
- Responsible ownership
- Communication and transparency to stakeholders.

c. LGPS Risk Areas

- Investment risk
- Liability risk
- Employer risk
- Resource and skill risk
- Administrative Risk
- Regulatory and compliance risk
- Reputational risk

Summary of Key Points re Administration				**APPENDIX 4**
	Option 1 **As is**	**Option 2** **Greater collaboration**	**Option 3** **Merger of grouped funds**	**Option 4** **Single merged all Wales LGPS Fund**
Opportunity for reducing costs	None	Minimal	Minimal	Minimal
Risks to sustaining current service	None	None / Minimal	Medium / High	High
Opportunity to improve front line delivery	Limited – subject to local resource availability	Medium / High – shared resources – develop minimum standards – some specialisation	Limited – some specialisation – reduced local access – medium risk of loss of experienced staff	Low / Medium – specialisation – reduced local access – high risk of loss of experienced staff
Delivering a timely and responsive service	Medium / High – alert to local member and employer needs – based on agreed local measures	High – alert to local member and employer needs – agree consistent service standards	Medium – less responsive to local member and employer needs – agree consistent service standards within groups	Medium / High – less responsive to local member and employer needs – single set of service standards for Wales
Improve back office administrative consistency	None – currently based on local resource	Medium / High – develop standard processing practices	Medium – develop standard processing practices	Medium – standard processing

	availability and experience	– develop standard documentation	– develop standard documentation – risk of difficulties in data collection due to remoteness from employers	practices – standard documentation – risk of difficulties in data collection due to remoteness from employers
Achieving the most by appropriate collaboration	Medium – some already achieved through Pensions Officer Group (POG) and Pensions communication forums – collaborative opportunities across UK	High – enhanced governance – LGPS 2014 further opportunity to collaborate – maximise utilisation of specialists eg systems officers – maximise utilisation and development of IT systems – collaborative opportunities across UK	High – further collaboration between merged funds – collaborative opportunities across UK	High – collaborative opportunities across UK
Improve employee / pensioner experience	High – local access maintained, including face-to-face service	High – local access maintained, including face-to-face service – shared communications events	Medium – dilution of local access – shared communication events	Medium – dilution of local access shared communication events

Comply with sound governance arrangements and stewardship controls	Medium – Currently dependent on each Funds interpretation and application of governance arrangements. – Local accountability is maintained	High – Shared resources for governance, interpretation and further opportunity to expand the existing collaboration arrangements in respect of 'Internal Dispute Resolution Procedure' and Discretions Panel. – Local accountability is maintained	High – More consistent approach to Governance – Local accountability diluted	High – More consistent approach to Governance – Local accountability diluted
Better information for better decisions	Network of information already available, LGA, CLG, etc. Collaboration with other pension officers through All Wales POG and other user groups	Network of information already available, LGA, CLG, etc. Collaboration with other pension officers through All Wales POG and other user groups	Network of information already available, LGA, CLG, etc. Collaboration may be required with English Funds due to the reduction in the number of Welsh Funds to interpret pension legislation.	Network of information already available, LGA, CLG, etc. A single welsh Fund will be required to collaborate with English Funds to interpret pension legislation.

Proposed Next Steps

This report is regarded as being "Interim"

One of the most important perspectives still to be factored into the narrative, findings and initial conclusions are the views of our wider stakeholders. This element was always regarded as being essential in any final proposals. It is however easier to provide constructive comment upon a set of definite propositions and so this report in its current guise provides that opportunity. This report is therefore now being circulated for wider consultation and to invite comments on the findings. The following sets out the broad approach.

Why is information being communicated?

This is critical. The report as drafted provides interim conclusions and recommendations. The consultation invites views on the conclusions reached and includes specific questions based on the direction of the report. We are inviting specific responses, together with the opportunity to make more general comment. This gives more focus for consultation rather than a wide ranging general discussion.

What is being communicated?

4 separate documents have been prepared:

i) The Full Report (excluding background research papers and analysis)

ii) An executive summary

iii) A short briefing or context note that may be used for wider communication purposes

iv) An invitation to provide comments and views on the findings of the report together with a set of specific questions on which we are seeking consultation responses.

The production and completion of the draft Report is the end of one phase but also the start of another. This next phase is important in giving the conclusions ultimately reached wider credibility and so it is important that the consultation involves an approach that is clear and consistent and that the mechanisms to be used for wider engagement and consultation are effective in allowing all stakeholders the opportunity to comment.

How and When?

The consultation process and how to respond

Scope of the consultation **Topic of this consultation:**	Proposals relating to the optimal number of LGPS funds in Wales and the most appropriate organisational structure
Scope of this consultation:	This consultation seeks responses from interested parties, including officers and councillors and their representative bodies, together with any wider interests
Geographical scope:	Wales
Body responsible for the consultation:	The Society of Welsh Treasurers (Pensions Sub Group) is responsible for the draft report and the consultation exercise.

Duration:	One calendar month. (From 1st March 2013 to 31st March 2013).
Consultation Bodies :	This consultation is seeking views from the following parties with an interest in the Local Government Pension Scheme in Wales: LGPS Administering Authorities in Wales and those charged with Governance of those Funds The Chief Executives of County and County Borough Councils in Wales Fire and Rescue Authorities in Wales Police and Crime Commissioners in Wales National Probation Service in Wales Other scheduled and admitted bodies to the LGPS Funds in Wales GMB UNISON Unite Welsh Government Department of Communities and Local Government Welsh Local Government Association (WLGA) CIPFA in Wales Association of Consulting Actuaries
How to respond	You should respond to this consultation by 31st March 2013. You can respond by going to the hyperlink included in the covering correspondence associated with this report. This link will open from 1st March 2013. Alternately you can write to: WELSH LOCAL GOVERNMENT PENSION FUNDS-WORKING TOGETHER c/o WLGA Data Unit 3-7 Columbus Walk Cardiff, CF10 4SD When responding, please state whether you are responding as an individual or representing the views of an organisation.

Archwilydd Cyffredinol Cymru
Auditor General for Wales

WALES AUDIT OFFICE
SWYDDFA ARCHWILIO CYMRU

Review of the Local Government Pension Scheme Funds in Wales: Costs, Structure and Management

Welsh Government

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Status of report

This document has been prepared for the internal use of the Welsh Government.

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The team who delivered the work comprised Anthony Barrett from the Wales Audit Office and Mark Packham and Justine Davies, from PwC.

Contents

Executive summary

Introduction

1. At the request of the Minister for Public Services, the Auditor General has carried out a review of the costs, structure and management of Local Government Pension Scheme Funds (LGPS) in Wales.

Background and context

2. The LGPS is under intense scrutiny to ensure it remains sustainable for the future, whilst at the same time ensuring that it is both efficiently run and cost effective and clearly accountable to all its members and stakeholders.

3. The Department for Communities and Local Government (DCLG) currently has overall responsibility for regulatory oversight of the 89 LGPS funds in England and Wales. The DCLG identified a couple of years ago that improvements in managing the investments of the LGPS were likely to generate efficiencies several times (ie, six to 10 times) greater than improvements in member administration. The DCLG commissioned research on various options, comparing the use of Collective Investment Vehicles (CIVs) and LGPS fund mergers. Hymans Robertson reported on these options in March 2014, concluding that CIVs were likely to be somewhat more effective than LGPS fund mergers in delivering substantial investment cost efficiencies. A high level of CIV take up, whether by mandation or encouragement of voluntary participation, was recognised as essential.

4. The DCLG then initiated a consultation on efficiency indicating that it did not intend to impose mergers on the 89 LGPS schemes in England and Wales. The consultation, entitled 'opportunities for collaboration, cost savings and efficiencies' primarily considered the case for CIVs and possible structures for them. However, the consultation gave no steer on whether their use would be voluntary or with some mandation imposed on funds.

5. Consultation closed in July 2014 and the DCLG's response is expected in June 2015 or later.

6. Under the Public Service Pensions Act 2013, advice on the LGPS is provided to the DCLG by the LGPS Scheme Advisory Board (SAB) from April 2015. Before that, the Shadow Scheme Advisory Board (SSAB) started work on the SAB remit: its Investment and Engagement Sub-Committee has, for example, a work programme on management fees, charges and transactions costs across the 89 funds. Another of its sub-committees, Governance and Standards, decided in February 2015 to consider three options by which the scheme manager function might best be separated from the employer functions of the relevant administering authority. One of these governance options would involve the establishment, by groups of funds, of joint committees under Section 102(5) of the Local Government Act 1972. An option such as this would potentially generate new ways of delivering investment efficiency via increased asset scale.

7. The Westminster Coalition Government (2010-2015) did not seek to dissuade the London boroughs from continuing to make progress on setting up their own CIV with voluntary participation by London LGPS funds. The London CIV is expected to be authorised by the Financial Conduct Authority (FCA) and launched later in 2015. Thirty out of 33 boroughs expect to participate in the London CIV, but it is not clear what proportion of their assets each will commit to the London CIV.

8. Given these developments, we have considered two main options for the eight LGPS funds in Wales. Our review has included the benefits, risks and issues of using CIVs and of merging the Welsh LGPS funds from an investment perspective. The possibilities of more complex governance options (as at paragraph 6 above) have not been considered as part of this report, but we do not exclude them at this stage. We have also considered certain funding, administration, governance and operational issues.

9. Throughout, we have been cognisant of the possibilities for the reorganisation of local government in Wales and of the legal constraints that may be encountered if it were desired to pursue certain options for the LGPS funds. We have sought to identify areas (regarding LGPS management and structure) in which it might be helpful to seek either legal competence for the Welsh Government or a decision from DCLG in line with Welsh Government advice.

Specific structures reviewed

10. There is now a body of research on the LGPS across the UK that demonstrates that increased scale in investment should lead to improved investment performance. Accordingly, we have identified and reviewed the most plausible structures for delivering this scale in Wales. Specifically, we have examined merger of the eight LGPS funds – either to three larger LGPS funds or a single LGPS fund for all of Wales – and the use of a CIV – either to establish a single CIV for Wales or to participate in CIVs that might be established across England and Wales in response to a clear DCLG decision on these. The Society of Welsh Treasurers has already started feasibility work on setting up a CIV in Wales.

11. Wider local government changes in Wales provide an opportunity to also consider the approach taken to local government pensions in Wales. Under the existing arrangements, 22 separate unitary authorities participate in the eight LGPS funds and each has its own funding level determined by notionally tracking its asset share and the liabilities of its members. Current proposals are that the number of unitary authorities would reduce significantly, by merger within four or five years. We have examined possible positions on the hypotheses that there might be nine or 12 unitary authorities. Other revised numbers of unitary authorities are of course also possible: we chose these numbers simply to facilitate credible analysis.

12. We have modelled the impact on the funding positions of hypothetical newly created authorities. These revised funding positions of the new authorities will depend directly on the funding positions of the merging entities which, although within the same LGPS fund in most cases, may or may not be at similar funding levels at the time of merger. In so doing, we have not considered the impacts on LGPS financing from associated reductions in staff levels. These impacts could themselves be significant (either detrimental or positive) but will depend on the age and service profile of staff leaving.

Conclusions

13. There is now a broad consensus that investment scale delivers real investment performance improvements which would tend to reduce deficits. Across Wales, based on £11.8 billion of assets, an improvement in net of fee investment performance of £45 million a year is a reasonable target to work towards. Achieving an improvement of this type is financially more important than rearranging administration arrangements. New investment arrangements could be established within 24 months.

14. In Wales, investment scale can be delivered using different options. We have considered either merging the eight existing LGPS funds in Wales to form one LGPS fund for Wales or by establishing or using a CIV. Such a CIV could be established for Wales, or the eight existing LGPS funds in Wales could participate in CIV(s) for England and Wales if the DCLG either endorses or directly facilitates such arrangements. In practice, it would be prudent to keep DCLG informed on intentions and progress towards a CIV for Wales.

15. The option of merging to form an intermediate number of LGPS funds for Wales should be disregarded from an efficiency perspective. A case exists for continuing with the existing eight LGPS funds; a case exists for merging them all to form a single LGPS fund for Wales. From our analysis, there is no case predicated on investment efficiency (the largest source of efficiency) for an intermediate number, such as three LGPS funds or, should it be possible, across three joint committees.

16. A high level of participation is vital if a CIV is to deliver the £45 million annual performance improvement envisaged. This requires either mandation or a high level of voluntary participation to achieve investment scale. In practice, it would be expected that voluntary participation would be higher if the funds have access to good-quality information to support a business case for their individual decisions, for example information on anticipated CIV transition and ongoing costs. In the absence of a sufficient level of CIV participation, perhaps after a pre-determined time period has elapsed, only merger into a single fund will deliver the expected improvement in investment performance. Lower levels of participation would generate lesser savings. Transition and operational costs, substantially independent of participation levels, would arise if a CIV is set up in Wales. These should be a modest proportion of the full annual saving but to ensure that money is well spent, there would need to be a strong drive to achieve high participation if this option is taken forward rather than fund merger.

17. There is a legal issue associated with mandation to use a CIV. In essence, there is a European directive that can be interpreted as prohibiting government from directing authorities on investment decisions (including participation in a CIV). Some legal opinions would, however, indicate a more flexible interpretation. We have not sought our own legal opinion on this issue.

18. There is also a legal issue associated with merging LGPS funds. In essence, merger would require either DCLG-sponsored secondary legislation or the transfer of legal competence in this area to the Welsh Government. The Governance and Standards Sub-Committee of the SAB will need to consider legal implications of establishing joint committees across funds, if this option were to be recommended for DCLG consideration.

19. One sequence of events might be to establish a CIV for Wales, with voluntary participation. This may be sufficient to achieve the scale envisaged if participation was at, or close to, 100 per cent. In the event that participation was lower after a pre-determined time period has elapsed, mandation (of CIV use) could be sought or merger (of LGPS funds) actioned, subject in each case to resolving the relevant legal issues and administration issues in the case of merger.

20. Reorganisation of the LGPS in Wales can be pursued before, at the same time as, or after reorganisation of the unitary authorities. They are substantially independent decisions.

21. The key impact of reorganising the unitary authorities is to amalgamate current funding positions created over a long period of time in the sense that each new unitary authority would inherit both the assets and liabilities of the relevant predecessor unitary authorities. A process of averaging would take place. In most, but not all, scenarios researched the averaging has a modest impact.

22. Mergers between LGPS funds would not have this type of averaging impact. The assets and liabilities of each unitary authority would carry over into a single LGPS fund for Wales, and they could continue to be separately identified and measured to derive a funding level for each unitary authority. Coherent actuarial assumptions would, however, be expected if there were to be a single LGPS fund. The definition of the actuarial approach would require care, not least to maintain acceptable contribution stability between the results of the 2016 and 2019 actuarial valuations (assuming the merger was concluded by 2019-20). This checking of the overall actuarial approach would not affect the ‘notional ownership’ of the assets and liabilities by each unitary authority.

23. These conclusions are reached ahead of the 31 March 2016 actuarial valuations of the LGPS funds, which will derive new employer contributions payable from April 2017. Given recent market conditions, there is an underlying concern that the contributions, measured either as a proportion of unitary authority budget, or of council tax receipts, will tend to increase. Actions consistent with these conclusions can help to contain such increases, but care would be needed to mitigate against possible local adverse effects, even if they would be modest.

Recommendations

24. In our view, there is a strong case for the Welsh Government and the Welsh Local Government Association to support the establishment of a CIV for all eight funds in Wales. This approach would incur start-up costs, and the Society of Welsh Treasurers should be asked to provide analysis of those costs.

25. A Wales CIV could be established over the next two years, in advance of local government reorganisation (although, as noted above, the timing is independent) on the assumption of appropriate commitment by relevant stakeholders including the funds themselves/existing administering authorities.

26. Following local government reorganisation, participation in the CIV, by the eight administering authorities responsible for the funds, should be reviewed. If participation in a CIV was not at an optimal level to secure the maximum investment returns after a pre-determined time period, then the Welsh Government should consider merging the existing eight funds into a single LGPS fund for Wales using an appropriate legal channel. The two channels available for this to happen are through DCLG passing secondary legislation (regulations for mergers) or the transfer of such legal competence to the Welsh Government to pass regulations.

27. There is also a strong case for considering further either an earlier merger of the eight funds in Wales or, if available, a joint committee approach. These possibilities might create more investment efficiency than a Wales CIV but are not within the sole control of the Welsh Government. The latter would depend on recommendations by the SAB and both would depend on decisions by DCLG.

28. These recommendations have to be considered in the light of the wider considerations taking place. For example, DCLG's forthcoming response to the consultation, which may result in optional or mandatory participation in CIV(s) that might be established across England and Wales and advice given by the Governance and Standards Sub-Committee of the SAB, which may open up a joint committee route for the eight funds in Wales. Accordingly, given the state of flux shortly after the General Election, these recommendations are highly time sensitive and actions should be taken only after further consideration.

Part 1

Scope, issues and initiatives

Scope

29. This review concerns the structure and costs of the LGPS in Wales and how these may be improved. The overall approach of the review is broadly as follows:

- Establish a baseline by considering the main issues affecting the efficiency and cost effectiveness of the LGPS across England and Wales. The issues can be categorised under four headings: deficit measurement and management; investment performance; governance arrangements; and the administration of and operations of the LGPS funds.
- Identify the initiatives and actions taken to address these issues over the last five years. The position over England and Wales is relevant since the LGPS as a whole, and the individual 89 LGPS funds in England and Wales, are presently regulated by the DCLG. Summarise research into the identified issues and consider its relevance to decisions affecting the LGPS in Wales.
- Given that research points to investment performance being the largest source of potential efficiency gain, focus on this aspect, in particular presenting and reviewing analysis on the relationship between investment performance and the scale at which assets are managed.
- Quantify the potential financial benefits likely to be achieved by efficiency initiatives in Wales, using recent actuarial funding information, administration cost and investment cost data for the eight Welsh LGPS funds. Initiatives such as fund mergers and the collective management of assets without fund mergers have been examined. Outline the actions, including where applicable any legislative change to provide legal competence to the Welsh Government, needed to implement such initiatives.
- Consider how conclusions may be affected by any proposals to merge the 22 unitary authorities in Wales.

30. The benefit structure of the LGPS and rates of member contributions, two primary drivers of its affordability to employers, are out of scope. Benefits and member contributions will in future be connected to new cost-capping regulations intended to maintain the long-term affordability of the LGPS.

31. The benefit structure of the LGPS was altered recently, in April 2014, in line with the 2011 recommendations of the Independent Public Service Pensions Commission (the Hutton Commission). This new benefit structure was implemented one year before other public service schemes implemented their new structures. Now that this complex transition has been completed, increased focus across England and Wales is being directed to efficiency and cost-effectiveness issues.

32. The review has included consultation with a range of stakeholders to seek their views. Stakeholders consulted have included the Welsh LGPS fund pension managers, the Welsh Local Government Association, the Society of Welsh Treasurers, and trade unions.

Issues affecting efficiency and cost effectiveness

33. The major issues affecting the efficiency and cost effectiveness of the LGPS across England and Wales fall under four main headings. We provide an overview of each of these below.

Deficit measurement and management

34. Deficit measurement and management is about how funding valuations are conducted and how LGPS funds agree appropriate contribution levels with their employers. To date, there has been limited guidance from DCLG on best practice, but the SAB for the LGPS in England and Wales has identified the issue as a workstream to be pursued in 2015.

35. Specific issues have emerged in relation to wide divergence of actuarial assumptions used by the four actuarial firms that advise the LGPS funds: the challenge of comparing LGPS funds on a like-for-like basis, the use of long recovery periods, a lack of transparency of how contributions agreed with employers are ultimately determined and of funding positions at employer level.

36. There has also been considerable variation in the approach taken by funds to consider employer covenant risk. Given their taxpayer backing, the unitary authorities can be seen as ultimately having a very sound covenant, despite severe budgetary constraints. Other employers in the LGPS, such as housing associations, colleges and charities, have varied and sometimes more questionable ability to maintain contributions.

37. Deficit management is particularly closely linked to investment performance in the LGPS, given that the benefit structure cannot easily be varied and that the LGPS funds are open to new members and continuing accrual of benefits. This is not the situation with most private sector occupational pension funds. It places an extra premium on good long-term investment decisions.

Investment performance and efficiency

38. Investment performance and efficiency concerns a range of issues. These include the appropriateness of existing investment strategies of LGPS funds as long-term investors, the choice and complexity of investment management structures, investment performance and its measurement, risk metrics and measurement and investment costs and their transparency.

39. Questions have arisen over the cost effectiveness of balanced management in terms of investment returns achieved net of costs. Evidence has also emerged in relation to scale. For example, smaller funds can be charged higher investment fees than larger funds, and other funds with internal management deliver better performance.

40. Some of the research concerns how assets of different funds could be managed collectively for both listed asset classes and alternatives such as infrastructure. Collective management can be consistent with individual funds retaining asset allocation decisions.

41. Some funds – not specifically in Wales – have been criticised for having an inappropriate short-term outlook in terms of measuring performance and rotating managers. This is an example of investment management linking with governance issues.

42. Investment management provides the greatest potential for improved efficiency and cost effectiveness. Assets under management in the eight LGPS funds total £11.8 billion. Thus an overall performance improvement of 0.4 per cent per annum, if it could be achieved each year, would equate to an annual £45 million approximately. (Such a level of improvement is consistent with the potential savings modelled under different revised investment structures of between 0.36 per cent and 0.42 per cent in Part 3 of this report.) As another example of the importance of investment management savings, total investment management fees paid by the Welsh funds in the year to 31 March 2014 were £45 million (by coincidence the same figure as for the performance improvement above).

Governance

43. Many LGPS costs are affected by governance structures. Good structures can increase the likelihood of efficient working practices being operated and better decision making for individual LGPS funds.

44. A range of governance issues were highlighted by the Hutton Commission in 2010-11. A consequence was the Public Service Pension Schemes Act 2013 which has led to a new regulatory regime commencing from April 2015. Compliance with the regime will have its own costs although it has the potential to produce efficiencies elsewhere.

45. Issues have arisen around the knowledge and length of tenure of councillors serving on pension committees, which are the decision-making bodies of the LGPS funds. These, and a tendency to over-rely on, and lack of challenge to, advisers (actuaries and investment consultants in particular) by pension committees, are highly relevant to investment efficiencies.

46. Other issues are the management of conflicts of interest, and sometimes lack of scrutiny of adherence to regulations laid down by the DCLG.

Administration and operations

47. There has been increasing scrutiny over the last five years as to why different funds have different administration costs and expenditure on advisers and the scope of services performed by individual funds' pension teams. Each fund generally has its own administration team although there have been examples of collaboration to share team resources across neighbouring funds (eg, Devon and Somerset).

48. Individual LGPS funds have had to cope with expanding legislation, including the introduction of auto-enrolment requirements which commenced in 2012, and the new LGPS Career Average Revalued Earnings (CARE) design implemented from April 2014. The necessary changes to IT systems and processes have been achieved, a significant challenge met generally with little additional resource.

49. Emerging issues which have had, or will have, an adverse impact on management of administration costs include:
    - the growing number of employers, recently reaching 10,000 in England and Wales (but more prevalent in England than Wales due to establishment of academy schools);
    - increased complexity of benefit design and disclosure with the introduction of the CARE design;
    - increased complexity of transfers rules and operation of Freedom and Choice legislation from April 2015;
    - new standards of record keeping under the Code of Practice from the Pensions Regulator from April 2015; and
    - increased annual data submissions to the SAB and triennial submission to the Government Actuary's Department.

50. A beneficial development in recent years has been funds addressing the high costs of procuring advisers by setting up framework agreements for various services with other funds, including the national frameworks.

51. Total administration costs of the eight LGPS funds in Wales in the year to 31 March 2014 were £10 million. Although a substantial total, this relates to 312,000 members, and so is modest on a per capita basis. It demonstrates that the potential for efficiency and cost effectiveness on administration is less than for investment change: if a substantial percentage saving of say 20 per cent were to be achieved on administration costs, this would be £2 million a year.

LGPS initiatives and actions since 2011

52. Exhibit 1 summarises the key initiatives and actions taken to address efficiency in the LGPS over the last five years. These included central (DCLG or SAB led) and local fund actions.

Exhibit 1

Initiative/action	Timing	Affected issues
English South West Funds Framework and National Framework for consultancy services commenced.	2011 and 2012	Deficits/ investment/ administration
Work commences to establish London funds CIV for 32 borough funds with potential assets of £24 billion. This is to be established as an authorised collective scheme, an EU-compliant structure, recently formulated under UK legislation.	2013	Investment
LGPS investment regulations amended to increase maximum permitted percentage holdings in contributions to partnerships, and thus widening access to infrastructure investments.	February 2013	Investment
'Call for Evidence' on the future structure of the LGPS published by DCLG and the Local Government Association.	June 2013	All
SSAB established in response to Public Service Schemes Pensions Act 2013.	July 2013	All
DCLG consultation closed on opportunities for collaboration, cost savings and efficiencies for LGPS. This consultation excluded the possibility that DCLG would press for mandatory mergers. The response to consultation is not expected until June 2015 or later.	July 2014	All
Launch announcement for £0.5 billion infrastructure fund partnership (West Midlands LGPS fund and LPFA).	January 2015	Investment
Pensions Regulator publishes Draft Code of Practice on governance and administration.	January 2015	Administration, governance
Shadow Board guidance on operation of local pension boards.	January 2015	Governance
Shadow Board letter to funds confirming deficit management work programme, including standardised basis publication proposals, ahead of recommendations to DCLG.	January 2015	Deficit management

Initiative/action	Timing	Affected issues
Shadow Board publication of whole of scheme data and work to develop scheme metrics to identify failing funds.	Work ongoing at April 2015	All
Shadow Board Investment Sub-committee resolution to follow two-part work programme on investment fee transparency, looking at information availability under existing legislation and how legislation might be changed.	March 2015 onwards	Investment
SAB established, funded by levies, and takes over the work of the SSAB.	April 2015	All
Local pension boards in the process of being set up.	April 2015 – June 2015	Governance
The Pensions Regulator starts to have responsibility for aspects of public service schemes governance.	April 2015	Administration, governance
London funds CIV expected commencement date.	Late 2015	Investment

Part 2

Review of actions and papers

Analysis of effect of recent and current LGPS initiatives and papers

53. In this section, we comment on both the list of actions and initiatives previously summarised in Part 1 and the research documents considered for this review. The latter are listed in Appendix 1 which also contains one-page summaries of each.

Deficit management

54. More consistency and transparency of approaches to setting contributions for the 2016 valuation is generally anticipated. These expectations anticipate publication of best practice guidance by DCLG, advised by the SAB.

Investment

55. The overall impact of the investment regulations appears to have been increased activity on the collaborative establishment of infrastructure funds.

56. The impact of the DCLG announcement that it is not intending to impose mandatory mergers has been, perhaps as intended, to increase the significance of other collaboration and of CIV options in particular.

57. However, the context within which these would be operating will only be clear once the DCLG responds to its consultation on efficiency, which closed in July 2014. Major unknown aspects of the response are as to:

- whether a top-down CIV model will be imposed over England and Wales, or whether local initiatives to establish CIVs will be encouraged;
- the degree of compulsion or encouragement applied to the 89 funds to use CIVs; and
- the emphasis on the use of passive investment techniques and infrastructure investment.

58. DCLG has consistently maintained that its response will be made in due course. It is now expected at some point after June 2015. Ministers then in place could be expected to influence the timing and content. The interim uncertainty may have delayed some voluntary collaborations at a local level. Despite this, the London Councils has proceeded to make tangible progress to establish a CIV, now expected to commence in late 2015. Their and other work on the best structure to establish CIVs may enable further LGPS funds to set up CIVs more quickly and at lower cost once the context is clearer.

59. Finally, there appears to have been some re-consideration of active management given the publicity in the Hymans Robertson report preceding the DCLG consultation. The Hymans Robertson emphasis on passive management drew a range of comment, including observations from active managers.

Administration and other non-investment costs

60. Some funds are pressing on with their own collaborations on sharing administration teams and setting up framework agreements for procurement of actuarial, benefit, governance and legal services.

Governance

61. It is too early to analyse how effective new pension boards and training requirements imposed by the Pensions Regulator may be in raising governance standards and promoting effective decision making.

Quantification of potential performance enhancements supported by papers on the LGPS

Analysis of net investment performance

62. An important part of the scope of this report is to review past literature on the relationship between investment performance and the scale at which assets are managed. PwC carried out such a review encompassing different published papers, data sets and analysis techniques which should help establish a consensus and evidence-based view. The key findings of the papers considered of most relevance to the Welsh LGPS funds report are summarised in Appendix 1. The investment performance findings were collated and are summarised in the Exhibit 2.

63. Inevitably, different papers commented on different aspects, but the overall consensus was that, on average, larger pension funds including LGPS funds specifically have performed better than smaller funds, and that the factors causing this will have persistence.

Exhibit 2: Sources of net investment performance enhancements

Reference	Report	Overall commentary on improved gross performance resulting from greater scale	Lower fees from increased scale	Benefits from internal management	Lower fees from passive	Lower cost alternatives approach	Lower asset turnover	Better governance premium	Better access to alternatives	Better diversification of asset class and manager
1	Scottish Pathfinder	Little evidence presented.	0.08%							
2	PwC Wales 2010	Higher and more consistent performance noted.	0.02% to 0.04%							
3	Scottish Pathfinder II	Concluded no hard evidence looking at eight-year period – other analysts differed from same data published by Audit Commission.	0.08%							
4	PwC London 2012	0.35 per cent pa is achievable after comparing average London fund (less than £1 billion) with large funds (£5 billion plus) over different length periods 2001 to 2011.	0.15%							
5	CASS Lon Governance				Yes	Yes	Yes	Yes	Yes	
6	UNISON	1.0 per cent pa for 2008-09 comparing Wales actual with large funds (£8 billion plus).	0.2%					Yes		Yes

Reference	Report	Overall commentary on improved gross performance resulting from greater scale	Lower fees from increased scale	Benefits from internal management	Lower fees from passive	Lower cost alternatives approach	Lower asset turnover	Better governance premium	Better access to alternatives	Better diversification of asset class and manager
6	APG	APG: 1.20 per cent pa outperformance of largest UK funds over 2002 to 2009 compared to average UK fund.	Up to 0.3%					Yes		Yes
6	Stonefish		0.2%							
7	SWT 2013	Hymans Robertson evidence: 0.9 per cent pa over 10 years to 2011 comparing £1 billion fund to £5 billion fund.	Yes	Yes				Yes		Yes
7	SWT 2013	State Street (WM): 0.6 per cent pa outperformance of largest UK funds compared to average UK fund over 10 years to 2013.								
8	State Street	0.6 per cent pa over 10 years to 2013 – and 0.22 per cent pa suggested as realistic future target.	0.15%	0.30%	0.15%	Yes	Yes	Yes	Yes	Yes

Reference	Report	Overall commentary on improved gross performance resulting from greater scale	Lower fees from increased scale	Benefits from internal management	Lower fees from passive	Lower cost alternatives approach	Lower asset turnover	Better governance premium	Better access to alternatives	Better diversification of asset class and manager
9	Hymans Robertson 2013	Evidence not presented on scale. Potential savings from other investment management restructuring (see later columns) noted to be achievable without significant reform/merger.			0.12%	0.13%	0.11%	Yes	Yes	Yes
10	London Councils	0.5 per cent pa comparing average London with large funds (£5 billion plus).		Yes		Yes		Yes	Yes	

64. Some of the factors were behavioural: larger funds tend to have better governance structures and more efficient and responsive decision-making procedures. This is the ‘governance premium’ which leads to better informed decision makers with wider and longer-term investment expertise and experience. In turn, this enables them to challenge investment consultants more readily, and to appreciate the benefit of longer-term strategies and lower turnover – buying and selling – of individual stocks.

65. Another major factor was the possibility of internal management by larger funds and wider, lower-cost access to alternative asset classes.

66. Many of the papers cited evidence of the bargaining power of larger funds to achieve lower external investment management fees. These were typically reported as historically being around 0.2 per cent lower when comparing funds up to £1 billion with substantially larger funds.

67. Several of the papers quoted the results of extensive numerical analysis which looked at the historical performance of either the smallest LGPS funds (of up to £1 billion) or of the average LGPS fund in comparison with the largest LGPS funds in the UK of £8 billion plus (such as Strathclyde, West Midlands, Greater Manchester and West Yorkshire). These typically indicated outperformance of an £8 billion fund compared to a sub £1 billion fund of between 0.6 per cent and 1.2 per cent per annum over different periods of several years to 2013. Some papers suggested that around one-third of this outperformance would represent a credible and achievable estimate for the future.

68. Passive investment management is often mentioned and the Hymans December 2013 paper stresses its benefits for listed assets. It explicitly suggests a saving of 0.12 per cent resulting from fees being lower than for active management, and it also identifies 0.11 per cent resulting from lower asset turnover, which passive management almost automatically achieves.

69. In summary, PwC’s observation was that a net of fees investment performance enhancement of between 0.4 per cent and 0.5 per cent a year is a credible target estimate for a UK pension fund of £1 billion switching to being managed collectively as part of a £10 billion fund, based on the evidence reviewed. The broad split would be 0.2 per cent to 0.3 per cent from better gross returns and another 0.2 per cent from reduced investment expenses.

70. This observation has been used in the modelling by PwC of potential savings that might be realised by the Welsh funds should they pursue alternative investment structures and taking into account their existing sizes, which range from less than £1 billion to just over £2 billion. These structures are considered in Part 3 of this report using the modelling results set out in Appendix 2.

71. Percentages in each row normally add up to indicate an overall suggested improvement in a given report (references 8 and 9). All percentages are annual, applicable to assets under management.

72. Looking at columns, however, one report might put one label on a certain effect, whereas another report uses a different description of a similar effect. An example would be lower fees from increased scale and lower fees from passive management. It is not always possible to add a saving from one report to a differently labelled saving in another report.

CIV cost offsets

73. PwC provided a high-level review of the costs expected to be associated with achieving enhanced investment performance by using a CIV.

74. The only paper in the public domain on the costs of establishing and running a CIV is the London Councils update. Exhibit 3 summarises its estimates. These are based on building an operator for the CIV, rather than renting an operator (see Appendix 5).

75. A range is given depending on whether the monies transferred to the CIV are closer to £5 billion or £24 billion from a maximum potential sum of £24 billion.

76. The costs quoted are relatively modest as offsets by comparison with the enhancement to net investment performance to be sought via the use of a CIV.

Exhibit 3

Type of cost	London Councils
Establishment costs	0.007 per cent to 0.028 per cent or £1.4 million to £1.7 million
Annual ongoing costs	0.055 per cent to 0.025 per cent or £2.7 million to £6.1 million
Assumed fund size under management	£5 billion to £24 billion

Part 3

Analysis of different structures

Introduction

77. In this section, we examine some plausible structures for delivering increased scale in investment, to achieve enhanced net investment returns. Specifically, we examine:

- merger of the eight LGPS funds – either to three larger LGPS funds or a single LGPS fund for all of Wales; and
- the use of a CIV – either to establish a single CIV for Wales or to participate in CIVs that might be established across England and Wales in response to a clear DCLG decision on these.

78. We make estimates of the annual investment improvement arising under these specific structures. The modelling of these estimates is set out in detail in Appendix 2 of this report and is based on relevant research papers reviewed individually in Appendix 1 and commented on collectively in Part 2. The key parameter for the modelling is the estimated improvement in the net of fee investment performance as assets are managed at a greater scale. These are summarised in Exhibit 4:

Exhibit 4

Starting individual fund asset size	Move to £10 billion – £25 billion collective asset size: estimated net investment saving*	Move to over £25 billion collective asset size: estimated net investment saving*
Under £1 billion	0.5 per cent	0.55 per cent
£1 billion to £2 billion	0.4 per cent	0.45 per cent
£2 billion to £5 billion	0.3 per cent	0.35 per cent

* 'Net' means net of investment management expenses/fees. Any transition costs or ongoing costs associated with collective asset management would serve to offset these savings.

A majority (five of the existing eight) of the Welsh LGPS funds are in the middle asset size group above, one is in the smallest group and two are in the largest asset size group.

Maintaining the status quo

Potential savings

79. Clearly there are no potential scale driven investment performance savings to be realised by continuing with the existing eight LGPS funds and their investment management structures.

80. There are some potential savings that do not necessarily require scale. In particular, the Hymans review and the State Street review provide evidence in relation to enhanced net of fees performance from switching active management to passive management of 0.12 per cent to 0.15 per cent. Recent SWT work has also identified potential savings from joint procurement.

Costs and risks

81. The risks of taking no action for the Welsh funds in the short-term include potentially more difficult deficit management negotiations for LGPS employers in Wales and criticism from representatives of local and central government taxpayers for not seeking out efficiencies.

82. Future risks would come from the UK government or DCLG, supported by its SAB, potentially intervening to impose a new structure which could otherwise have been avoided by earlier action.

Mergers in Wales

83. There have been no voluntary mergers between LGPS funds to date and DCLG has ruled out mandatory mergers of funds under the recent UK Coalition Government.

84. In this section, we consider the possibility of either voluntary mergers or a merger mandated by the Welsh Government in the event that it obtained legal competence in the area.

Potential savings

85. The modelling in Appendix 2 indicates that merging down from eight funds to three funds would produce a net investment saving but only a relatively modest annual estimate of £14 million (being approximately 0.12 per cent of total assets).

86. However, the estimated annual net investment saving for a full merger to establish a single fund for Wales is much higher at £43 million (or circa 0.36 per cent of fund assets). There would be no need to establish a Wales-only CIV under this structure. Unlike the savings considered via use of CIVs on a voluntary basis (see below), there is no dependency for this savings estimate on a participation or 'take up' rate by the funds.

87. So the option of merging to an intermediary number of funds (eg, three) is not supported by a case for efficiency given that investment savings are the biggest source of efficiency savings.

88. At the end of Part 4 we note how a coherent single actuarial approach to funding would require development in the event of there being a single fund.

Costs and risks

89. There is a legal issue associated with merging LGPS funds. In essence, merger would require either DCLG-sponsored legislation in Westminster or the transfer of legal competence in the area to the Welsh Government. One or the other can be requested but, even if agreed, there is a clear time implication.

90. The process of mergers is anticipated to take at least one year longer than CIV establishment and perhaps considerably longer. The overall process would be dependent on how quickly the necessary legal changes took to be implemented.

91. There is more transition cost uncertainty on mergers since there is no precedent (whereas London Councils has published full information on their transition costs for CIV establishment).

Establishing a CIV for Wales

92. Given DCLG's stance on collaboration to date, the possibility of mandatory participation in CIVs which are yet to be established remains open.

93. In this section, we consider the possibility of the establishment of a CIV in Wales which would initially be available on a voluntary basis to Welsh funds only. This is similar to the approach being implemented for London LGPS funds. A high level of participation by London LGPS borough funds (30 of 33) is anticipated, but there is less clarity as to the proportion of assets that will be invested.

Potential savings

94. The modelling in Appendix 2 shows that the estimated annual net investment saving is £43 million ie, the same figure as under full merger in the previous sub-section. However, this is conditional on full take up of the CIV by all the LGPS funds (whether the original eight or a lower number after any fund mergers).

95. A high level of participation is vital if a CIV is to deliver the estimated saving. This requires either mandation or a high level of voluntary participation to achieve investment scale (or participation from outside Wales). In the absence of a sufficient level of participation only merger into a single fund will deliver the expected improvement in investment performance. Lower levels of participation would generate lesser savings.

Costs and risks

96. There is a legal issue associated with mandation to use a CIV. In essence, there is a European directive that can be interpreted as prohibiting government from directing authorities on investment decisions (including participation in a CIV). Some legal opinions would, however, indicate a more flexible interpretation. We have not sought our own legal opinion on this issue.

97. Transition and operational costs, substantially independent of participation levels, would arise if a CIV is set up in Wales. These should be a modest proportion of the full annual saving. Looking at the London CIV estimates quoted in Part 2 and Appendix 1 (Part 10), the transition costs might be of the order £1.5 million and ongoing costs of the order £3 million. These are broad estimates only which would depend on how exactly the CIV is established. Transition costs and timings may also depend on exit clauses of existing investments held by the Welsh funds since the transition process would need to seek to avoid exit penalties.

98. The process of CIV establishment is anticipated to take up to two years.

99. There is more transition cost and operation cost certainty on CIVs through the London precedent.

Potential CIV structure

100. In Appendix 5 of this report, PwC has provided a diagrammatic of how a CIV might be structured for the Welsh funds. The overall structure shown is an Authorised Contractual Scheme or 'ACS' for short. The participating LGPS funds would hold units in the ACS under co-ownership. Please refer to the explanatory text in the appendix for more detail.

Using pre-established CIV(s) for England and Wales when available

Potential savings

101. The modelling in Appendix 2 indicated that the estimated annual net investment saving is £49 million (or circa 0.42 per cent of fund assets). This is £6 million higher than the estimated saving achievable from mergers into a single fund or via 100 per cent take up of a Wales CIV. The reason for the increase is the assumption that the Welsh LGPS fund could get further economies of scale by joining a CIV operating across England and Wales which had collective assets under management which were 'ultra-large' ie, £25 billion or more for whom some evidence has been presented as earning higher net investment performance than even 'large' funds classified for LGPS purposes as being of a lower scale ie, circa £10 billion.

102. However, there is no short-term prospect for this option becoming available since DCLG's intentions are not yet known and nothing is expected to be announced until after June 2015 at the earliest with a new UK Government in place.

Costs and risks

103. The legal issues here will be dealt with by DCLG in respect of all English and Welsh funds. There is no need for the Welsh Government to consider specific legal issues for Welsh funds.

104. There would be no transition costs unless one or more Welsh funds were somehow involved in the establishment of an across-England-and-Wales CIV. Ongoing costs would be expected to arise for participation in a pre-established CIV.

105. Both the costs and terms of membership (eg, ability to vote on the overseeing investment joint committee) are likely to differ between founding CIV members and ordinary participating CIV members. This could be seen as a drawback of this type of CIV since there would be less or no Welsh control over CIV management in comparison with the Wales CIV governance model with representation for all Welsh administering authorities illustrated in Appendix 5 of this report. However, all types of CIV should allow continuation of control over investment strategy by administering authorities.

Use of CIV then subsequent potential merger

106. One sequence of events might be to establish a CIV for Wales, with voluntary participation. This may be sufficient to achieve the scale envisaged if participation was at, or close to, 100 per cent. In the event that participation was lower, mandation (of CIV use) could be sought or merger (of LGPS funds) actioned, subject in each case to resolving the relevant legal issues.

107. If merger was identified as the preferred medium-term goal, then there would be little long-term point in establishing a CIV for Wales (with the associated costs). However, if merger were difficult to achieve in the short to medium term for any reason, a CIV might be a precursor.

108. Decision making around this requires a view to be taken on how soon CIVs may be made available across England and Wales. More information on DCLG's intentions in this area are expected in June 2015 or later with a new UK Government in place.

Administration savings

109. In previous sub-sections above, our modelling suggests that achieving an improvement in net investment performance of at least £43 million before relatively modest costs is a reasonable target. Achieving this is financially more important than rearranging administration arrangements as another possible source of efficiency.

Administration and investment: staffing models in Wales

110. Administration and investment management are distinct functions which could be streamlined separately in due course and have different recruitment/retention issues.

111. This report has noted that obtaining savings via investment restructuring is financially more significant than from rearranging administration. In terms of investment management roles, the vast majority of Welsh LGPS assets are currently externally managed by firms outside Wales. If a Wales CIV were established, with an operator that was built rather than rented (see Appendix 5), it would be realistic to base its staff in a single location subject to being able to attract the required investment expertise to that location. In contrast, the administration of the eight funds is carried out internally across different sites. Further work could be conducted to determine which administration roles would be more easily brought into a streamlined central administrative team and which others might be left to provide a 'local' service. Some degree of streamlining could be carried out under a move to a CIV as well as under a move to full merger.

112. There is no compelling case for any central administrative function to be located in the same geographical location as the investment management function. Accordingly, there may be flexibility on locating any central team or teams if the question arises in due course.

Part 4

Local government changes in Wales

113. In January 2014, the Commission on Public Service Governance and Delivery (known as the Williams Commission) published its recommendations. These were for the Welsh Government to implement a comprehensive programme of change to public service delivery requiring a three-to-five-year time period. This included the recommendation that the current 22 unitary authorities in Wales should be merged into larger units, no more than 12 in number.

114. We understand that the actual number of authorities is still being debated between eight and 12, that the decision is not expected until later this year ahead of Welsh Assembly elections in 2016 and that new arrangements may not be fully implemented until 2020.

115. We understand that the Welsh Government has determined that these forthcoming local government changes provide an opportunity to also consider the delivery of the LGPS in Wales.

116. There are currently eight LGPS funds in which the 22 unitary authorities participate in Wales. These are listed in Exhibit 15 in Appendix 3. The administration and management of each fund is effectively the responsibility of one designated unitary authority known as the 'administering authority' of the particular fund. As such, these authorities have a dual relationship with their fund: to manage the fund and also as a participating employer.

117. The 14 other authorities are simply participating employers: one of the funds, Powys, has no other participating authorities, but Torfaen has four other participating authorities; most funds have an intermediate number. Individual deficit numbers and contribution rates are calculated by each fund for each authority. This requires each fund to maintain a notional segmentation of assets and liabilities for each authority – as also happens for other employers in each fund, but this is not relevant to the main point here – and thus different authorities can build up different actuarial funding positions as a result of historic decisions.

Impact of merger of unitary authorities

118. The merger of unitary authorities would not directly have much impact on three of the four identified areas (investment, administration and governance) but it will have an impact on deficit measurement and management. This would be through current funding positions being averaged between merging authorities and the possibilities of moving authorities between funds. We consider each of the four issues in turn before finally commenting in this section on the interaction between this type of merger and LGPS fund mergers.

Deficit measurement and management

119. The unitary authorities would be impacted in relation to their actuarial funding position and hence associated deficit recovery contributions. There may also be some impact on their contributions in respect of ongoing benefit accrual (known as the future service rate) if, for example, the average age of employees of the merging authorities were significantly different.

120. Our illustrative analysis of the impact on contributions from the merger of unitary authorities is limited in this report to the effect on deficits, since we expect this to be greater than the effect on the future service rates.

121. A change to the funding level arises because the authorities will end up with a weighted average of the funding levels created over a long period of time of all ie, the two or three authorities which are part of each merger. For example, if authority A and authority B participate in the same fund and have pre authority merger funding levels of 75 per cent and 85 per cent, then after the authority merger the new entity will inherit both the assets and liabilities of its predecessors and so end up with a funding level between 75 per cent and 85 per cent. The new level would, for example, be 80 per cent if the authorities had liabilities of very similar size or else be closer to the previous funding level of the larger authority if unequal in size. To this extent, historic performance on managing funding deficits would be crystallised and combined. But the deficit of the new merged entity would overall simply be the sum of the previous deficits. Thus, there would be no change in the overall deficit to be managed, in the absence of any change in actuarial method.

122. In order to look at possible effects in more detail, Appendix 3 contains detailed modelling for each of the 22 current unitary authorities based on estimated funding positions at 31 March 2014. This has been derived from accounting IAS19 data published at that date for each authority. The modelling covers two purely illustrative possibilities for a reduction to nine authorities and a reduction to 12 authorities. Other scenarios are of course possible. The impact on the authorities is summarised in Exhibit 5.

Exhibit 5

Scenario	Largest deficit worsening across original authorities	Largest deficit improvement across original authorities	Total deficit impact all funds, all new authorities	Number of impacts in excess of £15 million
Reduction to nine unitary authorities (see Exhibit 17 in Appendix 3)	£20 million	£23 million	Nil in total	7
Reduction to 12 unitary authorities (see Exhibit 16 in Appendix 3)	£50 million	£50 million	Nil in total	4

123. Overall, the modelling suggests that the averaging has a modest impact on most, but not all, of the existing authorities under either scenario. It also illustrates which authorities might be expected to see an improvement or worsening in terms of the funding of their LGPS liabilities. Important points to bear in mind regarding the modelling are:

- Relative funding positions could change between the illustrative date of March 2014 and the actual merger date to form the new unitary authorities.
- The modelling is presented on a common or standardised set of assumptions. This is a notional basis rather than the basis which would actually be used by each fund actuary. Its purpose is to allow like-for-like comparisons across funds. The key assumption is the discount rate used to value liabilities.
  This is taken to be CPI inflation plus 3.0 per cent ie, the real discount rate is 3.0 per cent.
- The modelling does not allow for any changes to LGPS liabilities arising from authority staff leaving voluntarily or via redundancy as part of the authority mergers process. These changes could themselves be significant (either detrimental or positive) but will depend on the age and service profile of staff leaving.

Investment

124. There would be no direct impact from merger to form new unitary authorities since the investment management structures of the underlying funds would be unchanged.

125. The allocations of assets to each LGPS employer are notional, conducted by the actuaries allocating whole of fund investment returns. In rare situations where an authority moved between funds as part of a merger, transfer amounts would have to be agreed and paid.

Administration

126. Merger into new unitary authorities would have a minimal impact on administration costs. In most situations, the same administration team would be likely to continue the same roles as previously. Teams would interact with a smaller number of large LGPS employers for data collection, contribution collection and funding valuation discussions. There would also be some transitional issues to be managed.

Governance

127. There could be a slight impact on personnel elected to pension committees and boards but these are likely to be minimal.

128. There would be fewer large employers to manage within each fund, although much of the administrative complexity relates to smaller non-authority employers in any event.

Interaction with fund mergers or other collaborations

129. The forthcoming plan to merge local authorities would neither enhance nor create obstacles in relation to possible proposals to reorganise the LGPS in Wales. Reorganisation of the LGPS in Wales can be pursued before, at the same time as, or after reorganisation of the unitary authorities. They are substantially independent decisions.

130. Mergers between the LGPS funds themselves, rather than between authorities, would not have this type of averaging impact. The assets and liabilities of each unitary authority would carry over into a single LGPS fund for Wales, and they could continue to be separately identified and measured to derive a funding level for each unitary authority. A coherent single actuarial approach would, however, be expected if there were to be a single LGPS fund. The definition of the approach would require care, not least to maintain acceptable contribution stability between the results of the 2016 and 2019 actuarial valuations (assuming the merger was concluded by 2019-20).

Appendix 1

Literature review

We have selected the following key papers (Exhibit 6) on the development of the LGPS. Selection is a subjective process but, as a group, the papers reflect the breadth of the debate and trace the progress over the last six years of the major LGPS initiatives, in Scotland (the Pathfinder Project), in Wales, in London (leading to the current establishment of a CIV for London) and by the DCLG.

For each paper, we have considered the paper in its own terms, providing a summary of its approach and its conclusions. Themes around administration, deficit management and governance have been identified but the major theme is around enhancing investment performance, since achieving this is essential to long-term affordability and deficit management.

Implications for Wales have been drawn out and projected savings scaled to the Welsh context.

Exhibit 6

	Title/subject	Author	Date
1	Local Government Pension Scheme Pathfinder Project Options Appraisal	Hymans Robertson	November 2009
2	Consultancy review of Welsh Local Government Pension Funds	PwC	October 2010
3	Pensions Pathfinder Project Phase II Interim Report	Deloitte	April 2011
4	Reconfiguring the London LGPS Funds: Evaluation of options	PwC	October 2012
5	An Evaluation of Investment Governance in London Local Government Pension Schemes	The Pensions Institute, CASS Business School	November 2012
6	LGPS cost studies commissioned by UNISON	UNISON, APG, Stonefish	2010 to 2013
7	Welsh Local Government Pensions Funds Working Together (Interim Report)	Society Welsh Treasurers, Hymans Robertson	March 2013
8	Do Larger Funds Perform Better?	State Street Investment Analytics	September 2013
9	LGPS Structure Analysis	Hymans Robertson	December 2013
10	Progress report on implementing London LGPS CIV	London Councils' Pensions Working Group	February 2014
11	Deficit management in the LGPS – draft report to the SSAB	PwC	October 2014

1. LGPS Scotland pathfinder project options appraisal report – Hymans Robertson – November 2009

Background

This paper was commissioned as part of the Pathfinder Project initiated in 2007 to identify opportunities for cost savings and operational efficiencies through the adoption of shared services within the LGPS in Scotland. The objective of this report was to establish if there were any opportunities to rationalise and improve with the pathfinder organisations the management of the LGPS in Scotland including identifying potential broader benefits for the LGPS in Scotland. Three broad options were considered:

- separate funds with shared administration;
- separate funds with shared investment management; and
- rationalisation of funds.

Conclusions

Investment management

Strong arguments exist for creating larger pools of assets, achieved either through a merger of funds or by creating a common investment fund structure based on either a one-host or a two-host structure. Further work would be needed before a recommendation could be made – see April 2011 report.

Data for investment performance against fund size was for the 11 Scottish LGPS funds only, and as such had limited statistical reliability, with Strathclyde (for Glasgow) the only fund at £10 billion.

Analysis of investment management fees showed that larger funds would produce savings eg, investment management fees for three funds of £1 billion would be £9.47 million compared with fees of £7.10 million for a single £3 billion fund. This fee difference is equivalent to just 0.08 per cent. Transition costs of the order of 0.6 to 0.8 per cent of the value of the assets being moved were identified, indicating a three-to-five-year payback period.

Administration

Recommendation for a detailed investigation of cost and service levels to inform a decision on the cost/service level balance; identification of areas where consolidation of services is possible and desirable; implementation of standardised benchmarking of quality and cost of administration to allow like-for-like comparison going forward.

Key main risk identified in the four smallest funds where between two and four staff carried out the whole of the administration of the funds.

Administration costs – smaller funds were most expensive (£58 per member for Orkney), but beyond that larger funds offered more services and so were not the lowest cost. Strathclyde was £19 per member.

Implications for Wales

There is little evidence from this early review of larger funds producing significantly better returns net of fees. There is some consistency in the administration data for this review with Welsh data in that both show variation of administration costs according to type of region covered by a fund.

2. Consultancy review of Welsh Local Government Pension Funds – PwC – October 2010

Background

The report was commissioned by the Pensions Sub Group of the Society of Welsh Treasurers to identify ways in which the eight LGPS funds in Wales could operate more effectively together, particularly in their investment and administration arrangements.

Conclusions

Investment management

Analysis of data underlying the July 2010 Audit Commission report on English LGPSs suggested that funds under £1 billion had delivered mixed results, whereas funds above £1 billion had typically achieved a higher and more consistent performance over the eight years to 31 March 2009.

Looking specifically at fees, four alternative investment models were identified and cost-saving estimates made (Exhibit 7). Savings were quoted after deducting annual ongoing costs and an estimate of transition costs:

Exhibit 7

Model	Estimated annual savings (in first year)
Shared procurement	£2 to £3.2 million
Shared procurement with oversight	£1.6 to £2.8 million
Collective investment funds	£3.2 to £4.4 million
Merger of fund assets	£2.7 to £3.9 million

Administration

Three alternative operating models were identified and cost-saving estimates made. The largest possible saving was suggested to be £2.1 million if there was a single merged administration entity, in one or more locations, which might be implemented with or without merging the funds themselves.

Deficit management

The eight funds were examined on a common actuarial basis to strip out the effect of differing assumptions on funding, to enable a consistent comparison. On a common basis, funding levels and deficits varied significantly, but it was more challenging to understand the effect on contributions of merger, given that the actuaries aimed to achieve stability in contribution rates in different ways.

Governance

The governance arrangements and levels of input from different groups of stakeholder varied from fund to fund. Members had no direct representation on the main governance panels or committees, and participating employer representation was varied.

Governance after any merger should address these points, and a possible model is that used by the Northern Ireland Government Officers' Superannuation Committee (NILGOSC), which administers the single LGPS for Northern Ireland.

Next steps after this paper

The Pensions Sub-Group of the SWT believed that the PwC report was important in that it established a 'prima facie' case to look further at the organisational structure of the Welsh LGPS, with the potential to improve efficiency and service standards. The SWT followed up with further work towards an evidence-backed outline business case in the 2013 report on Working Together and the associated consultation.

3. Scotland Pensions Pathfinder Project Phase II Interim Report – Deloitte – April 2011

Background

Deloitte was appointed to carry out the research required under Phase II of the Pathfinder Project and to identify appropriate recommendations to improve the administration, investment and governance of the LGPS in Scotland. The options defined for consideration were retaining the current 11-fund structure or merger of the current 11 funds into one, two or three future funds, split broadly by geographical area.

Conclusions

Merger of the current 11 funds into one, two or three future funds should not be progressed due to the absence of a clear business case for merging funds. There were a number of improvements which should be progressed.

Investment management

There would be limited savings from moving from the current structure to one, two or three larger funds: less than £2 million pa, being less than 0.1 per cent of total assets in Scotland of £25 billion.

The report considered whether investment scale improves performance, and concluded that there was no hard and fast evidence to this effect. In support of this, it quoted an Audit Commission 2010 report which concluded that 'there is little evidence to suggest a relationship between fund size and investment performance over the last eight years, either in higher investment returns or lower volatility'. Data underlying this conclusion has been interpreted very differently by other analysts.

Administration

Variation in administration costs was modest and the average cost per member was £21, comparing favourably with the average for LGPS funds in England and Wales. Four options were considered:

- **Maintain current arrangements:** not recommended.
- **Maintain current arrangements with a revised approach to delivery:** recommendations to develop and implement standard services and service levels to improve service delivery and consistency; establish which non-core services should be offered, to be charged for separately at an agreed schedule of costs; and explore further opportunities for cost savings later.
- **Merge administration services to one, two or three centres:** rejected, since no consensus on potential host authorities, the cost of developing new operating models and the uncertainty of cost savings. However, small fund administration mergers should be considered to mitigate key main risk.
- **Use an external provider:** recommendation to transfer all administration to the Scottish Public Pensions Agency (SPPA) to be considered further in due course.

Governance

Recommendations were that model terms of reference for LGPS pensions committees in Scotland should be developed to consistently define the role and responsibilities of pensions committees. Once developed, they should be adopted and implemented by all pensions committees, and membership of pensions committees should be extended to include representatives of other employers, members and external professional representatives.

Implications for Wales

Implications for Wales seem limited. This 2011 report confirmed a growing consensus in Scotland to hold back from fundamental reform of LGPS operations, instead taking forward incremental change.

The case for cost savings by merging administration functions in Wales may be somewhat stronger for Wales than for Scotland, if this is looked at in future, given that the Welsh average lies somewhat above that for England and Wales overall in both 2010 and 2014. The Scottish average lay below (at least in 2010).

4. Reconfiguring the London LGPS Funds: Evaluation of options – PwC – October 2012

Background

This paper evaluated evidence that the individual London LGPS funds could make efficiencies by working more closely together. With the exception of the LPFA, the 34 funds are individually small, typically having assets in the range £0.5 to £0.8 billion, organised at a borough level. In aggregate, £24 billion of assets were under management.

Four types of structure with the potential to deliver financial benefits were examined, against five challenges identified by the Society of London Treasurers, relating to:

- investment governance;
- investment asset allocation;
- the linkage between local accountability and local taxation;
- statutory responsibilities; and
- the political and managerial ownership of decisions.

Conclusions

The paper presented evidence that larger funds (eg, Strathclyde, Manchester) had historically outperformed smaller LGPS funds (such as many but by no means all of the London borough funds) and identified potential savings of £120 million a year, based on performance and fee improvements combined of 0.5 per cent per annum, applied to the £24 billion asset base.

The two recommended structures were:

- A CIV for London. The paper left open the question as to whether use of the CIV would be mandatory or encouraged in order to achieve the high participation required to make the maximum savings. It was clear that asset allocations would continue to be chosen by boroughs.

- The other structure thought to meet the SLT challenges, but not taken forward, was a London framework fund. This would have gone further than a CIV by creating a single legal framework for all London LGPS funds, handling many operational matters on a collective basis, effectively a merged fund. Boroughs would have retained the power to choose asset allocations, and their separate funding levels and contribution rates/ negotiations would have been preserved, subject to a coherent overall actuarial approach.

The two structures not recommended as they did not meet the SLT challenges were variants of the London framework fund:

- one variant would have been a common investments merger, which would have removed borough autonomy on asset allocation decisions; and
- the other, a full merger, would have gone further with standardised contributions by all boroughs.

Next steps after this paper

The London boroughs have taken forward one of the four structures: a CIV to centralise much of the boroughs' investment responsibility into a central entity, charged with delivering a range of well-defined, best-in-class, pooled investment funds in a range of asset types.

Scaling to Wales

With almost £12 billion assets in the eight Welsh funds, the corresponding investment improvement of 0.5 per cent would be £60 million each year. However, since most of the eight Welsh funds start from a somewhat greater scale, investment savings would be correspondingly less.

5. An Evaluation of Investment Governance in London Local Government Pension Schemes – The Pensions Institute, CASS Business School – November 2012

Background and research

The paper aimed to establish whether there was a fundamental problem in respect of investment governance of London LGPS funds. It also sought to identify areas that might be considered in a full benchmarking study of this issue as originally recommended by Lord Hutton in 2011.

Research utilised publicly available information on funding and investment, using pension committee minutes. Interviews were held with various fund stakeholders (councillors on pension committees, pension and s151 officers, treasury and investment staff). The interviews preserved anonymity.

Conclusions

The paper concluded that overall London LGPS funds have suffered from a lack of a strong overarching governance framework. The authors stated that their research identified serious weaknesses in many of the 34 funds. To recap, these are small funds, almost all with assets in the £0.5 to £0.8 billion range.

Deficit management

Problems identified included poor or inconsistent reporting of key aspects of funding and investment strategies. These included the discount rate used to value the liabilities, the investment performance assumption for a valuation deficit recovery plan and the length of the recovery plan.

The paper claimed evidence of poor deficit management via 'shopping around' for favourable assumptions and use of repeated extension of recovery plan lengths, both likely to reduce short-term contributions, so that larger contributions would be more likely in the future. The paper describes this forcefully as 'a ticking time-bomb for London council tax payers and very likely for national tax payers too' requiring urgent action.

Investment governance

Decision making via pension committees dominated by councillors is cited as an issue. It is suggested that decisions are influenced as much by behavioural and political factors as by adherence to the current investment governance framework. Short tenure on committees can be a barrier to acquiring experience and expertise. Committee minutes suggest over-reliance on consultants who drive the decision-making process with insufficient challenge.

Investment strategy

The paper says there is a disproportionate focus on micro issues such as asset manager selection with frequent changes of manager leading to additional costs, with insufficient focus on overarching investment objectives and strategy. Strong preferences for active management and significant allocations to alternative asset classes lead to higher costs but without evidence of corresponding additional award.

Next steps after this paper

Although the anonymous interviewing approach was criticised by some at the time, the CASS paper built pressure towards the establishment of London CIVs.

The paper also fed into DCLG consultation, leading to alternative governance arrangements specified under regulations which came into force on 1 April 2015, including the establishment of pension boards for LGPS funds.

The Pensions Regulator has also published a Code of Practice setting out best practice on governance including training of Pension Board members and management of conflicts of interest.

6. Performance Analysis of LGPS Funds – reports by APG Groep NV and UNISON – February 2010; The Total Cost of Ownership LGPS – Stonefish Consulting – March 2013

Background

These three reports were commissioned by UNISON to provide analysis of LGPS cost and investment performance differences between funds. A summary of their findings was included in UNISON's response to the Welsh Funds Working Together Consultation in 2013. Although the reports also covered the potential for administrative savings, we summarise below only the much larger investment related savings.

Overall conclusions

The overall conclusion was that significant savings in investment performance would have been made historically by moving from smaller funds of between around £1 billion (similar to the existing average size of Welsh funds) to a fund of at least £8 billion in size which is broadly commensurate with the largest three funds in England and Wales (or of the Welsh funds combined). The analysis was for two individual years and also for approximately 10-year periods. The reported annual savings were up to approximately 0.2 per cent to 0.3 per cent in respect of investment management expenses and up to approximately 1.00 per cent to 1.20 per cent in respect of investment performance.

1. UNISON report

This was based on LGPS data analysis (89 funds in England and Wales) for the years to March 2008 and March 2009. A comparison with the three largest English funds (West Yorkshire, Greater Manchester and West Midlands) was justified on the grounds that they had asset values in 2009 of £6 billion to £8 billion which was similar to the total value of Welsh LGPS funds at that date. The total annual saving arising was circa 1.2 per cent in both years: see details in Exhibit 8.

The report also quotes several studies produced in relation to US, Canadian and European pension funds suggesting a strong trend for better performance by larger funds. It quotes research as having indicated that fund size offers advantages in relation to improved governance and control, better research and diversification and reduced management expenses from greater scale.

Exhibit 8

Larger fund potential benefit	Comment	Annual saving (2008)	Annual saving (2009)
Reduced investment management expenses	Comparison of Welsh funds with three largest English funds	0.19%	0.17%
Enhanced investment performance	Comparison of Welsh funds with three largest English funds	1.00%	1.06%

Retrospective implication for Wales: potential investment-related savings of £89 million for 2008 and £92 million for 2009.

2. APG report

This was based on LGPS data analysis (101 funds in UK) for years ending March 2002 to March 2009. As part of the analysis, a benchmark performance was constructed using market index returns by asset class. Whilst there was considerable variation between the performances of the smaller LGPS funds relative to the benchmark return over the period, the largest funds all performed better than the benchmark.

The report does not comment on why larger funds may perform better but notes that the £8 billion fund size it was asked to consider is 'not necessarily the optimum size for a pension fund. Evidence from the Netherland shows that the sophistication of investment policies increases and the risk/return profile improves with fund size.' Exhibit 9 summarises the key results.

Exhibit 9

Larger fund potential benefit	Comment	Annual saving (eight-year analysis)
Reduced investment management expenses	Focus on moving from £1 billion fund to £8 billion fund.	Up to 0.3 per cent.
Enhanced investment performance	Focus on all funds performing in line with four largest funds in LGPS over the period of analysis.	At least 1.20 per cent on average for UK funds.

Retrospective implication for Wales: the total savings over eight years for the net investment performance of the Welsh funds were calculated with a simulation running from March 2001 to March 2009 such that their performance was modelled to be in line with that of the four largest funds. The total savings were quoted to be £200 million.

The average annual savings were £5 million for investment expenses and £20 million for investment outperformance or £25 million in total or 0.5 per cent of assets. This annual saving would be expected to be higher now all else being equal given that the total value of Welsh fund assets is higher than for the midpoint of the data analysis period which was March 2005.

3. Stonefish Consulting report

This was based on LGPS analysis for 2001 to 2012 and did not consider investment performance but did consider investment expenses. Exhibit 10 summarises the key finding.

Exhibit 10

Larger fund potential benefit	Comment	Annual saving % (11-year analysis)
Reduced investment management expenses	Focus on moving to funds with lowest charges (broadly £8 billion plus funds).	0.25 per cent for Wales. C. 0.20 per cent for England and Wales combined.

Implications for Wales: applying a 0.25 per cent saving to a current asset base in Wales of £11.8 billion gives a £30 million saving just for expenses (the report quotes a saving of £24 million on assets of £9.6 billion).

7. Welsh Local Government Pensions Funds Working Together (Interim Report) – SWT, Hymans Robertson and Sackers – March 2013

Background and options considered

The Pensions Sub Group of the Society of Welsh Treasurers used four workstreams to analyse four options, without presuming that the best solution for any one workstream would be best for another:

- an ‘as is’ option based on the current structure of eight funds;
- ‘as is’ but with enhanced collaboration (joint procurement, shared working efficiencies etc);
- mid-range approaches based on merging to an intermediate number (two to seven) of funds; and
- an option based on merging to one all-Wales fund.

Findings from the four workstreams

Investment

There was evidence of potentially significant benefits of scale to be found from either merger or working collectively through a common investment approach. The potential benefits were not a direct relationship with the size but rather the result of economies of scale that together with size allow improved governance and the potential for increased return. Evidence/analysis included:

- Larger funds tending to have a combination of attributes, such as more internal and specialist resources, more internal and hands-on management, better diversification of asset class and manager, more bargaining power on fees and more responsive governance enabling speedy decision making.
- Hymans evidenced the benefit of size over the 10 years to 31 March 2011: there was significant dispersion of results around the line of best fit, but the line suggested that a £5 billion fund had outperformed a £1 billion fund by 0.9 per cent per annum over the 10 years.
- State Street (WM) compared very large LGPS funds (circa £10 billion) with the ‘all-Wales’ fund average, and identified outperformance in the region of 0.6 per cent per annum, with lower levels of relative risk. A more realistic target of around a third of this outperformance (0.22 per cent) would equal a one per cent of payroll reduction in employer contribution rates across Wales.
- Fees for investment totalled £22.3 million, so just a 10 per cent saving here was worth £2 million.

Governance

There is much that can be done using a collaborative approach within existing legal, organisational and governance arrangements. In contrast, merger would require a change in secondary legislation and thus engagement with both the Welsh Government and the DCLG.

Administration

Building on existing collaboration could achieve improvements in front-line service delivery, consistency and efficiency. With total administrative costs of £8 million, financial benefits identified through the administration workstream were modest but should nevertheless be pursued.

Transition costs

Both fund management fees and transition costs are significant factors but not the fundamental drivers when considering investment strategy. There would be very significant ‘one-off’ costs of transitioning the assets to a new organisational structure.

Key recommendations and next steps after the paper and consultation

The ‘no change’ option was not supported: a more proactive approach was required. At the other end of the option spectrum, the merger to a mid-range number of funds or to a single all-Wales fund were costly prospects with a long lead-in time, a loss of local autonomy and a need to change funding strategies.

Enhanced collaboration was thus seen as the area where medium-term savings could be optimised, specifically using a common investment approach. A full business case would be created to encompass the common attributes that appear to benefit larger funds with the aim of implementation thereafter.

8. Do Larger Funds Perform Better? – State Street Investment Analytics – September 2013

Section 1: do larger funds perform better?

This paper addressed the question in its title by comparing the four largest LGPS funds (Strathclyde, Greater Manchester, West Midlands and West Yorkshire, ranging in value from £9.8 billion to £13.0 billion) with the other 97 LGPS funds over the 10 years to March 2013, thus updating the SWT paper by two years. All four had higher than median return (by approximately 0.6 per cent per annum) and lower than median risk (lower volatility). So, ‘at first sight, there certainly does seem to be some weight behind the size argument’.

But size is not in itself the whole answer. Nine less-complex funds (with five portfolios or less) and five internally managed funds had also performed well. Of these 14 funds, two were big four funds. Hence size in itself is unlikely to guarantee success if the structure that is in place cannot deliver the expected benefits. Key factors are strong governance and advisors advocating a slower rate of change (eg, low stock turnover).

Section 2: can anything be learned from large corporate funds?

Large corporate funds are more often managed on an internal basis. Of the 10 corporate funds above £10.8 billion that SSIA measure, eight are managed on an internal basis, a higher proportion than observed in the LGPS, even for large LGPS funds. The corporate funds had delivered superior performance at reduced risk.

Section 3: objectives for structural reform of the LGPS

There are straightforward ways to improve investment returns. First, all returns are eroded by fees, transaction costs, taxes and commissions: **long-term investment strategies** reduce the impact of three of these – transaction costs, taxes and commissions. Second, **passive management** offers the largest opportunity to reduce fund management fees paid.

SSIA states that size, of itself, will not improve performance, but it believes that larger fund size may confer a number of benefits in terms of improving returns. Primary objectives would be to realise:

- **Potential to reduce investment management costs**: larger funds can access external management at lower costs. SSIA research indicated that larger funds (above £5 billion) had costs of 0.23 per cent as opposed to smaller funds (up to £1 billion) with costs of 0.38 per cent – a difference of 0.15 per cent. Passively managed portfolios can reduce fees down to 0.07 per cent.
- **Potential to consider internal management**: this provides, first, the opportunity for active management at passive management fee levels. And, second, stronger underlying performance, which seems to average 0.3 per cent a year and arises from lower turnover. This cuts transaction costs and avoids the short termism that external managers are prone to so as to avoid their mandates being terminated: instead, underperforming stocks can be retained where value remains.
- **Potential for better governance**: size can open up asset classes, such as private equity, direct property and infrastructure opportunities. But the paper also strikes a note of caution: more responsive governance can destroy value if it focuses on manager selection – which only guarantees more spend with investment consultancies. Better governance has more to do with changing behaviours to have a greater focus on strategy relative to liabilities and a true long-term approach.

Secondary objectives would be to achieve:

- **reduced behavioural biases**, such as short-term focus and manager measurement, LGPS fund herding, excessive deference to professional investment consultants;
- **more flexible investment strategies**, with more specialist resource in house; and
- **greater infrastructure investment**, where there are strategic benefits to be gained.

Implications for Wales

Wales can achieve a £10 billion scale, but only if a high level of participation is achieved.

If internal management were pursued, there would be issues on attracting and locating investment staff.

9. LGPS Structure Analysis – Hymans Robertson – December 2013

Background

This paper was commissioned by DCLG to compare three options for structural reform of the LGPS across England and Wales. The options were to create a single CIV, to create five to 10 CIVs, in either case with mandatory use by the 89 LGPS funds being likely, or to merge the 89 LGPS funds into between five and 10 large funds, which would have implied each large fund being between £10 billion and £40 billion in size.

Conclusions

Investment management

Ultimate improvements in net investment performance totalling £660 million each year were identified. These were thought to be achievable with or without significant structural reform/merger.

In more detail, the savings for England and Wales are shown in Exhibit 11:

Exhibit 11

Investment approach item	Annual saving £m (England and Wales)	Annual saving %
More passive investment	£230 million	0.12%
Lower cost alternative assets	£240 million	0.13%
Lower asset turnover	£190 million	0.11%
Total	**£660 million**	**0.36%**

Legal

The paper contained a section on the legal impediments to establishing CIVs and merging LGPS funds, provided by Squire Sanders (now Squire Patton Boggs).

Scaling to Wales

An annual improvement of 0.36 per cent, if applied to an asset base in Wales of £11.8 billion, would be £42 million.

Next steps after the paper

The Hymans paper fed into a process that has now made clear that there will not be mergers of the 89 funds imposed across England and Wales. Another consequence was to activate a debate about the merits and demerits of passive management of listed assets that is not yet settled for the LGPS.

A consultation by DCLG, that closed in July 2014, still awaits a response from DCLG, which is now expected in June 2015 at the earliest with a new UK Government in place.

The paper also estimated timeframes and costs for establishing CIVs and for fund merger. Timeframes varied from 18 months to establish a CIV to three years to merge LGPS funds and transition their assets to larger LGPS funds.

10. Progress report on implementing London LGPS CIV – London Councils' Pensions Working Group – February 2014

Background

The purpose of the report was to update the local authorities in London on progress on the design of a CIV for the London funds in the form of an ACS, to present a business case and outline the next steps including finance for authorities wishing to participate.

Proposals

The report proposed that a private limited company be incorporated to become the operator of the ACS with each participating authority becoming a shareholder. It also proposed that a representative body of the participating authorities be established in the form of a Pensions CIV Joint Committee. The proposed structure would follow a few key principles for participation, oversight and control:

- Participation is voluntary and withdrawal is possible.
- A participating authority will be able to make asset allocation decisions.
- The authorities should have sufficient control over the operator to be assured it will be acting in their best interests. It will be able to influence its activities by owning all its share capital.
- The Joint Committee will have the power to identify and appoint key directors to the operator.
- The operator would provide regular information to authorities relevant to making investment decisions and provide regular information to the Joint Committee.

The operator would require capital over and above the assets to be invested and an amount of two to three basis points ie, 0.02 per cent to 0.03 per cent of invested assets was suggested. This can be regarded as an investment not an expense since these monies would be retained and effectively remain under fund ownership.

The business case for participation is that the savings created far outweigh the costs incurred. This is set out in Exhibit 12 which shows the maximum potential assets from London funds under management in the CIV of £24 billion and the minimum target assets of £5 billion.

Exhibit 12

Investment item	Assets under management of £24 billion	Assets under management of £5 billion
Expected savings from enhanced net of fee investment performance (annual)	£120 million or 0.5 per cent	£25 million or 0.5 per cent
Ongoing costs (annual)	(£6.1 million) or (0.025 per cent)	(£2.7 million) or (0.055 per cent)
Establishment costs including professional fees (one off)	(£1.7 million) or (0.007 per cent)	(£1.4 million) or (0.028 per cent)

The estimates are noted to take into account existing investments held by LGPS funds and that initially the majority of investment mandates are likely to be passive.

The annex to the report indicated an expected timeline of 10 months to the launch of the ACS (in February 2015) from the decisions on whether to participate (requested April 2014).

Current actions and scaling to Wales

The Joint Committee for London was established and its progress report for December 2014 indicates that 30 London authorities had agreed to participate and three had declined. The timeline for launch was extended to summer 2015 and the establishment costs were still projected to be £1.7 million with the 30 authorities expected to pay £75,000 each in costs to April 2016.

The savings for a Welsh CIV may be less than the 0.5 per cent quoted (equivalent to £60 million per annum) due to the larger average existing fund size in Wales compared to London. In terms of costs, the assets under management would potentially be up to £12 billion which is in the range considered. Costs for Wales could be lower than for London in absolute terms by re-using a proportion of the professional advisers' work done for London.

11. Deficit management in the LGPS – Draft report to the Shadow Scheme Advisory Board – PwC – October 2014

Background and research

The review was commissioned by the SSAB to inform its future policy recommendations to DCLG on better deficit management. The importance of this objective was referred to by the Board in its response to the Call for Evidence on structural reform in January 2014.

The review considered the approach taken by LGPS funds in England and Wales to deficit measurement and management at both fund and employer level. Deficits are locally managed by the 89 individual LGPS funds. The purpose of the review was to consider the development of good practices, to promote more holistic thinking and consistency of approach between funds.

As part of the research for the review, PwC interviewed actuarial and investment consultants of the four actuarial firms to the funds, and two LGPS pension managers who are members of the Deficits Working Group, which reported to the Shadow Board.

Conclusions

Deficit and covenant management

A key conclusion of the review was that using standardised assumptions to disclose and compare the deficits of individual funds would create a clear overall picture of the total deficit in the LGPS. It would show where the total resides on a granular basis and provide a foundation for actions to reduce it. Standardised assumptions would be used for comparison: individual funds would still decide their individual funding approaches in conjunction with their individual actuaries.

The review recommended that more work be carried out on the desirability of a contribution stability objective.

The review suggested a need for central guidance and direction on best practice to incentivise the active management of employer risk, since current practice was diverse. The process should be carried on a proportionate basis to keep costs manageable and cover covenant monitoring and a role for additional securities.

Guidance should be given to promoting the early recognition of exit bases for exiting employers. In addition, regulations might be amended to allow more flexible exit arrangements to be undertaken and to require a maximum level of prudence in the assumptions used.

Investment and risk management

The review considered some specific investment ideas to mitigate risk. It recommended that liability-driven investment, that can manage risk and deliver contribution stability, should be more widely understood, since it has both advantages and disadvantages.

Governance

The review noted that disclosure of funding positions on standardised bases would assist the Board with its objective of publishing balanced scorecards covering both financial and governance metrics to help identify failing LGPS funds and arrange appropriate intervention if necessary.

Next steps and implications for Wales

The Shadow Board established a new work programme for 2015 based on the review's recommendations in the run up to 2016 valuations. This was shared with funds in January 2015.

The Welsh funds should expect more scrutiny from the Board of its 2016 valuation results on a like-for-like basis with all funds in England and Wales and of their contribution setting approach for different employer groups taking into account individual employer covenant.

Appendix 2

Estimated investment gains through fund merger or the introduction of a collective investment vehicle

Background

Several of the research papers reviewed conclude that a different approach to investment, seeking the benefits associated with greater scale, would lead to higher long-term net investment returns. Scale across the LGPS in England and Wales ranges between relatively small LGPS funds, some with assets in the order of £500 million to £1 billion, up to a small number of large LPGS funds significantly above £10 billion. Even larger scale is possible: a London CIV could reach £25 billion and a national CIV £200 billion.

The papers vary in their attribution of exactly how scale would deliver higher net investment returns. This is considered in Part 2. However, many of the papers reviewed are consistent with the proposition that increased scale (ie, moving from assets under management in line with the smallest LGPS fund up to the largest LGPS fund) would improve net investment returns by around 0.4 per cent to 0.5 per cent per annum.

In this appendix, we consider net investment returns. The concept is intended to include savings from lower investment fees and operational/turnover costs as well as higher investment returns from smarter investment decisions within asset classes. We are not considering change in overall asset allocation, which we assume would not be substantially changed. A substantial change in asset allocation would clearly have wide implications.

Analysis for this appendix

In principle, there are two possible options for increasing scale within the eight Welsh LGPS funds:

- The eight funds could be merged into a smaller number of funds. For illustration, we have considered merger to form either three funds or a single LGPS fund across Wales. A single LGPS fund for Wales would have assets of approximately £12 billion.
- The eight funds could invest their assets collectively, which would probably be achieved using a CIV. In Appendix 5, we outline the mechanics of such a CIV if one were to be established specifically for Wales.

The CIV option does not exclude the possibility of merger, but there would be duplication of effort. Three funds could, for example, operate with a CIV.

If there were to be a single LGPS fund across Wales, there would be little long-term point in establishing a CIV for Wales. But if merger were difficult to achieve, a CIV might be a precursor.

The effect of reducing the number of unitary authorities can be considered separately from investment efficiency resulting from fund merger or CIV use. This is because merged funds can preserve notional segments for each unitary authority, as is already the practice.

The options are evaluated in Exhibit 13.

Exhibit 13

Number of Welsh funds	CIV participation	Net investment returns: potential for annual enhancement, based on assets of £11.8 billion	Timescale
8	None	Nil	Not applicable
8	England and Wales	£49 million for ultra-large CIV	Dependent on DCLG timing for England and Wales CIV
8	Wales only	£43 million for full take up of CIV	Two years
3	None	£14 million	Two to four years
3	England and Wales	£49 million for ultra-large CIV	Dependent on DCLG timing for England and Wales CIV
3	Wales only	£14 million (as result of merger) or up to £43 million for full take up of CIV	Two to four years
1	None	£43 million	Two to four years
1	England and Wales	£49 million for ultra-large CIV	Dependent on DCLG timing for England and Wales CIV

For this modelling, the key parameter is the impact on net investment performance as the quantum of assets under collective management is increased. We have taken a best estimate of the difference between net investment performance for small funds (classed for the purpose of this analysis as less than £1 billion) and large funds (classed as exceeding £10 billion) to be 0.5 per cent. We have then made incremental allowance for intermediate size as indicated in Exhibit 14.

Note that the estimated annual return enhancement is before an offset from transition costs (ie, costs associated with mergers or with establishing a Wales-only CIV). It is also before associated ongoing costs (eg, cost of running a CIV in Wales or joining an existing CIV in England and Wales).

These parameters are summarised in the final column of the below. For example, a fund of £5 billion to £10 billion is expected to achieve a net investment return of 0.2 per cent per annum lower on average than a 'large' fund given its lower scale. The table also shows the distribution of existing fund sizes of the Welsh funds. There are currently two funds in the £2 billion to £5 billion range, five in the £1 billion to £2 billion range and one fund below £1 billion. We have allowed for a modest 0.05 per cent as being achievable if 'ultra-large' CIV arrangements, spanning England and Wales, were to be established.

Exhibit 14

Fund asset range	Current number of Welsh funds	Size of assets under management within existing structures (£ billion)	Net of fee investment performance (impact as % of assets)
Greater than £25 billion ('ultra-large')			Max + 0.05%
£10 billion to £25 billion ('large')			Maximum
£5 billion to £10 billion	0		Max – 0.2%
£2 billion to £5 billion	2	4.3	Max – 0.3%
£1 billion to £2 billion	5	7.0	Max – 0.4%
Less than £1 billion ('small')	1	0.4	Max – 0.5%
Total	**8**	**11.8**	

Appendix 3

Estimated funding levels by council

This appendix contains the results of some detailed modelling looking at the possible effects on funding levels of the 22 unitary authorities should the number of authorities be reduced via mergers. It looks only at funding levels which drive deficit recovery contributions payable by LGPS employers. It does not present any illustrative impacts on contributions in respect of ongoing benefit accrual (known as the future service rate).

1. Illustrative scenario: funding levels pre unitary authority mergers (existing eight funds)

As a starting point, we consider a recent valuation position if there was no structural change, either to the number of funds (eight) or to the number of unitary authorities (22). The published funding levels of the LGPS fund (on differing actuarial funding bases) are shown in the third column of Exhibit 15, but funds do not publish funding levels for individual unitary authorities. However, it is possible to estimate the funding levels for each of the existing unitary authorities on a common standardised actuarial basis by manipulating data from their published IAS19 results in their 2013-14 accounts.

Estimates are shown in the fifth column of Exhibit 15, as at 31 March 2014, using a standardised basis with a discount rate of CPI plus three per cent. To be clear, this is not an IAS19 discount rate; the IAS19 results are used only to obtain data for each existing unitary authority. The discount rate used of CPI plus three per cent is used in other LGPS calculations, such as for cost cap purposes. The key point is not the rate itself, but the ability to make comparisons on a common basis and it is put forward solely for that reason. Other bases that provide a valid comparison could also have been used equally effectively with minimal difference in the relative positions described in this analysis.

The discount rate results in somewhat higher funding levels for several of the funds, but the important point at this stage of the analysis is to have comparability between funds.

The funding level estimates range from 65 per cent to 103 per cent.

Exhibit 15

		Funding bases		Common basis		
Fund actuary	**LGPS fund**	**2013 funding level (published)**	**Participating unitary authorities**	**2014 Pre unitary authority merger funding level (estimated) (%)**	**2014 Post unitary authority merger funding level (estimated) (%)**	**Impact on funding deficit (£m)**
Hymans Robertson	Gwynedd	85%	Gwynedd	99%	99%	1
			Conwy	103%	99%	12
			Isle of Anglesey	93%	99%	-12
Mercer	Clwyd	68%	Flintshire	72%	75%	-16
			Wrexham	80%	75%	20
			Denbighshire	74%	75%	-4
Aon Hewitt	Powys	79%	Powys	80%	80%	0
Mercer	Dyfed	89%	Carmarthenshire	94%	97%	-23
			Pembrokeshire	100%	97%	13
			Ceredigion	101%	97%	10
Mercer	Torfaen	71%	Torfaen	79%	79%	-1
			Newport	80%	79%	6
			Caerphilly	80%	79%	6
			Monmouthshire	77%	79%	-6
			Blaenau Gwent	78%	79%	-5
Aon Hewitt	RCT	78%	RCT	70%	71%	-9
			Bridgend	76%	71%	25
			Merthyr Tydfil	65%	71%	-16
Aon Hewitt	Swansea	81%	Swansea	82%	80%	20
			Neath Port Talbot	76%	80%	-20
Aon Hewitt	Cardiff	82%	Cardiff	82%	83%	-2
			Vale of Glamorgan	83%	83%	2

2. Illustrative scenario: funding levels after reduction to eight unitary authorities (existing eight funds)

Simply for illustration, we then consider eight funds remaining and 22 unitary authorities reduced in number to eight, in line with the funds they are now in.

The funding levels as at 31 March 2013, still using standardised assumptions, would then have been as shown in the last-but-one column in Exhibit 15 and now range from 71 per cent to 99 per cent. An averaging takes place between the former unitary authorities, so that the new, larger unitary authorities would have funding levels that were weighted averages of the former unitary authorities in each fund.

The notional gains or loss made by each of the former unitary authorities can then be estimated in terms of changes to the funding deficit corresponding to the employees and former employees of the former unitary authority. These are shown in the final column of Exhibit 15. Changes are generally modest, since there would be histories in common, but it is possible to identify the former unitary authorities making and taking the largest contributions:

- biggest gain: £23 million improvement to funding deficit: the former Carmarthenshire; and
- biggest loss: £25 million worsening of funding deficit: the former Bridgend.

3. Illustrative scenario: funding levels after reduction to nine unitary authorities (existing eight funds)

Under this scenario, all existing unitary authorities participating in each LGPS fund merge with each other, except that Bridgend (RCT Fund) merges with Vale of Glamorgan (Cardiff Fund) to become a unitary authority. The merged entity would then be one of two unitary authorities within one of the funds, for example the RCT Fund.

The updated results for this scenario are shown in Exhibit 16. For 17 of the former 22 unitary authorities, the results are unchanged from Exhibit 1.

Exhibit 16

Fund actuary	LGPS fund	Participating unitary authorities	Post merger unitary authority	Common basis: 2014 Pre unitary authority merger funding level (%)	Common basis: 2014 Post unitary authority merger funding level (%)	Common basis: Impact on deficit (£m)
Hymans Robertson	Gwynedd	Gwynedd	1	99%	99%	1
		Conwy		103%	99%	12
		Isle of Anglesey		93%	99%	-12
Mercer	Clwyd	Flintshire	2	72%	75%	-16
		Wrexham		80%	75%	20
		Denbighshire		74%	75%	-4
Aon Hewitt	Powys	Powys	3	80%	80%	0
Mercer	Dyfed	Carmarthenshire	4	94%	97%	-23
		Pembrokeshire		100%	97%	13
		Ceredigion		101%	97%	10
Mercer	Torfaen	Torfaen	5	79%	79%	-1
		Newport		80%	79%	6
		Caerphilly		80%	79%	6
		Monmouthshire		77%	79%	-6
		Blaenau Gwent		78%	79%	-5
Aon Hewitt	RCT	RCT	6	70%	69%	11
		Merthyr Tydfil		65%	69%	-11
		Bridgend	7	76%	79%	-15
		Vale of Glamorgan		83%	79%	15
Aon Hewitt	Swansea	City and Council of Swansea	8	82%	80%	20
		Neath Port Talbot		76%	80%	-20
Aon Hewitt	Cardiff	City and Council of Cardiff	9	82%	82%	0

For the remaining five former unitary authorities (Rhondda Cynon Taf, Merthyr Tydfil, Bridgend, Vale of Glamorgan and Cardiff), the results change to different degrees. The impact on Rhondda Cynon Taf and Merthyr Tydfil is now worse since they no longer benefit from the relatively higher funding level associated with Bridgend pre unitary authority merger. However, the impact on Bridgend is now dramatically better (a £15 million improvement compared to a £25 million worsening) because it benefits from the relatively higher funding level associated with Vale of Glamorgan pre unitary authority merger. An opposite effect is seen for the Vale of Glamorgan which moves from a modest worsening of £2 million to a larger worsening of £15 million.

Overall, the biggest impacts would be:

- biggest gain: £23 million improvement to funding deficit: the former Carmarthenshire (as previously); and
- biggest loss: £20 million worsening of funding deficit: each of the former Wrexham, Swansea and Neath Port Talbot (replacing Bridgend).

4. Illustrative scenario: funding levels after reduction to 12 unitary authorities (existing eight funds)

Under this scenario, three unitary authorities continue (Carmarthenshire, Powys and Swansea). Sixteen of the unitary authorities merge with one other unitary authority to become a new unitary authority and finally three unitary authorities merge with two other unitary authorities to become a new unitary authority.

The updated results for this scenario are shown in Exhibit 17. Not surprisingly, there is no impact on the deficit position for Carmarthenshire, Powys and Swansea. In contrast, Carmarthenshire was previously noted to benefit from a merger with unitary authorities with better funding levels. There is also now no impact on the former Bridgend and the former Neath Port Talbot because they have the same pre unitary authority merger funding level (measured on a common basis) and therefore this will continue post unitary authority merger.

Exhibit 17

Fund actuary	LGPS fund	Participating unitary authorities	Post merger unitary authority	Common basis: 2014 Pre unitary authority merger funding level (%)	Common basis: 2014 Post unitary authority merger funding level (%)	Common basis: Impact on deficit (£m)
Hymans Robertson	Gwynedd	Gwynedd	1	99%	97%	9
		Isle of Anglesey		93%	97%	-9
		Conwy	2	103%	88%	50
	(Clwyd)*	Denbighshire		74%	88%	-50
Mercer	Clwyd	Flintshire	3	72%	76%	-18
		Wrexham		80%	76%	18
Aon Hewitt	Powys	Powys	4	80%	80%	0
Mercer	Dyfed	Carmarthenshire	5	94%	94%	0
		Pembrokeshire	6	100%	100%	-1
		Ceredigion		101%	100%	1
Mercer	Torfaen	Torfaen	7	79%	79%	-1
		Caerphilly		80%	79%	6
		Blaenau Gwent		78%	79%	-5
		Newport	8	80%	79%	6
		Monmouthshire		77%	79%	-6
Aon Hewitt	RCT	RCT	9	70%	69%	11
		Merthyr Tydfil		65%	69%	-11
		Bridgend	10	76%	76%	0
	(Swansea)*	Neath Port Talbot		76%	76%	0
Aon Hewitt	Swansea	Swansea	11	82%	82%	0
Aon Hewitt	Cardiff	Cardiff	12	82%	83%	-2
		Vale of Glamorgan		83%	83%	2

* Indicates former fund before change of fund arising from unitary authority merger.

Overall, the biggest positive and negative impacts are different from the previous scenarios and their impacts are much greater (twice the size). Note that they arise under this scenario purely because two unitary authorities with very different LGPS funding levels (on common basis) are earmarked for merger:

- biggest gain: £50 million improvement to funding deficit: the former Denbighshire; and
- biggest loss: £50 million worsening of funding deficit: the former Conwy.

Although these largest impacts are much greater than for the previous Exhibit 16, there are fewer significant impacts across the former unitary authorities as a whole. For example, for a reduction to 12 unitary authorities (Exhibit 3), the impacts are £15 million or more in four cases, whereas for a reduction to nine unitary authorities (Exhibit 3), the impacts are £15 million or more in seven cases.

5. Illustrative scenario: number of funds were reduced to three (north, west and mid, and south) and reduction to nine or 12 unitary authorities

There would be no further impact on deficit results measured on a common basis for each of the new larger unitary authorities. This is because the three funds would each have several (between two and four) of the new unitary authorities.

6. Illustrative scenario: number of funds were reduced to one and reduction to nine or 12 unitary authorities

There would be no further impact on deficit results measured on a common basis for each of the new larger unitary authorities. The single fund would have notionally segmented assets, liabilities and funding levels for each of the new unitary authorities.

7. Comment on results under actual rather than standardised/common actuarial bases

Considerations will include:

- lower funding levels, if more prudent assumptions, essentially moving back towards the published funding levels for funds in 2013;
- development in funding levels between 2013 and 2016; and
- appointments of actuaries if fund numbers reduce from eight, to three or one.

Appendix 4

Data on current administration and investment costs

Exhibit 18

Region	Fund	Total assets (£m)	Total members	Total admin and other costs (£m)	Total investment management cost (£m)	Total cost (£m)	Average admin cost per member (£)	Investment cost (% of asset values)
North	Gwynedd	1,310	32,274	1.3	6.9	8.1	39	0.5%
	Clwyd	1,215	34,675	1.0	6.4	7.4	28	0.5%
Middle	Powys	445	15,934	0.9	2.2	3.1	58	0.5%
	Dyfed	1,667	42,573	0.9	2.1	3.0	22	0.1%
	Swansea	1,376	36,072	1.0	11.6	12.6	28	0.8%
South	Torfaen	2,073	51,256	2.0	5.6	7.6	40	0.3%
	Rhondda Cynon Taf	2,237	64,870	1.7	5.9	7.7	27	0.3%
	Cardiff	1,466	34,722	1.0	4.1	5.0	27	0.3%
Total		**11,789**	**312,376**	**10**	**45**	**55**		

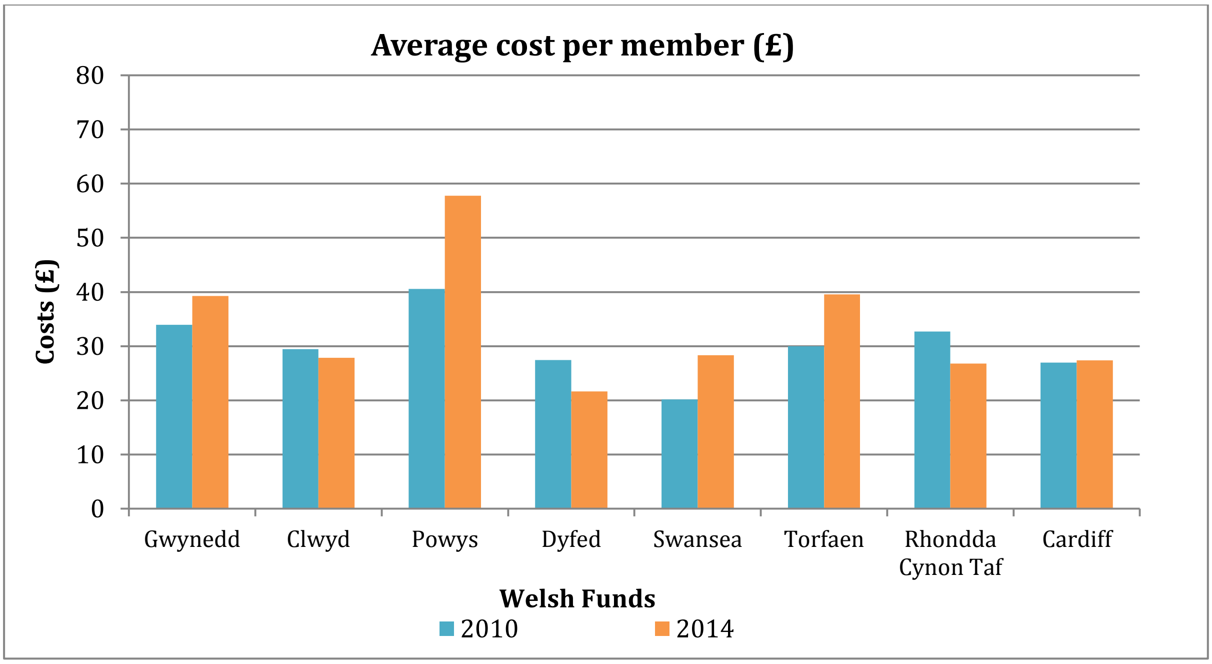
Source: SF3 data published by DCLG for 2013-14

Administration and other (non-investment) cost data

The total cost across eight funds for 2013-14 was £10 million.

The data is shown graphically below, with comparisons back to SF3 data for 2009-10. The smallest fund, Powys, continues to have the highest per member administration costs with the differential from other funds increasing between 2010 and 2014. For three funds, the average cost per member has reduced over the period. However, the scope of the administration service provided by different LGPS funds varies, and within individual funds the scope of service may also change over time.

Exhibit 19



Meaningful comparisons of administration costs between funds, and within funds over time, are inevitably difficult.

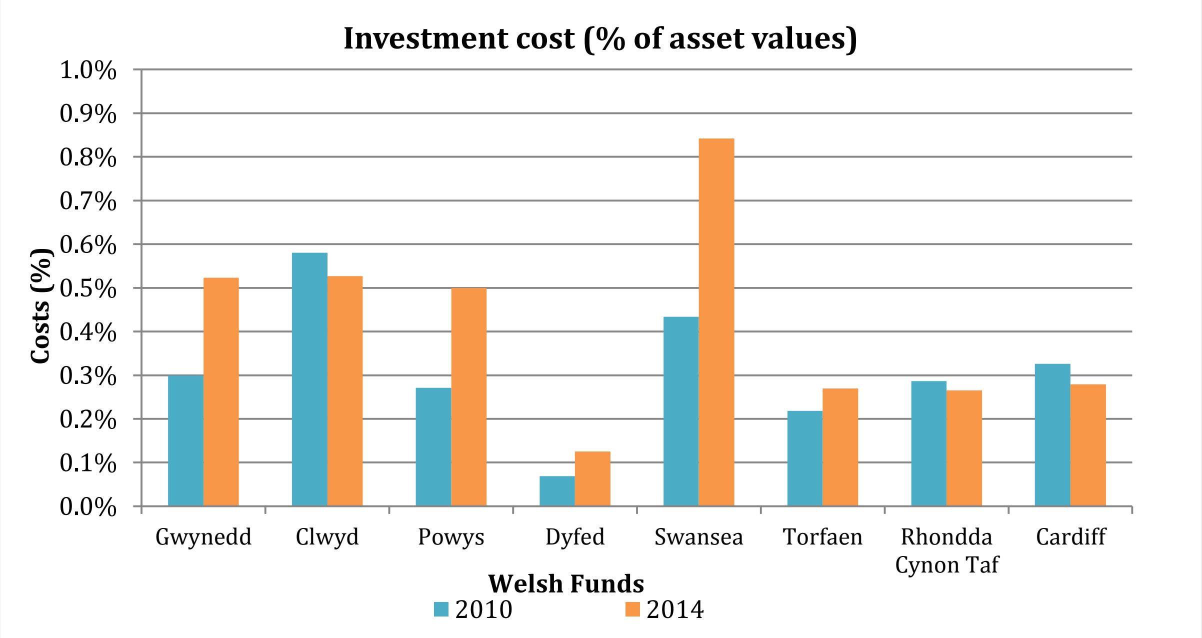
The scope of the administration service provided by different LGPS funds varies, and within individual funds, the scope of service may also change over time.

DCLG's own analysis of the SF3 data for England and Wales for 2013-14 does show a broad relationship between fund size (both in terms of assets under management and number of members) and administration costs per member. Generally, the larger the fund, the lower the administration cost per member, and this is borne out in Wales data.

Investment cost data

The total investment fees charged to the funds across the eight funds for 2013-14 was £45 million. This is 4.5 times greater than costs on administration and other non-investment related costs.

Exhibit 20



Source: SF3 data published by DCLG for 2009-10 and 2013-14

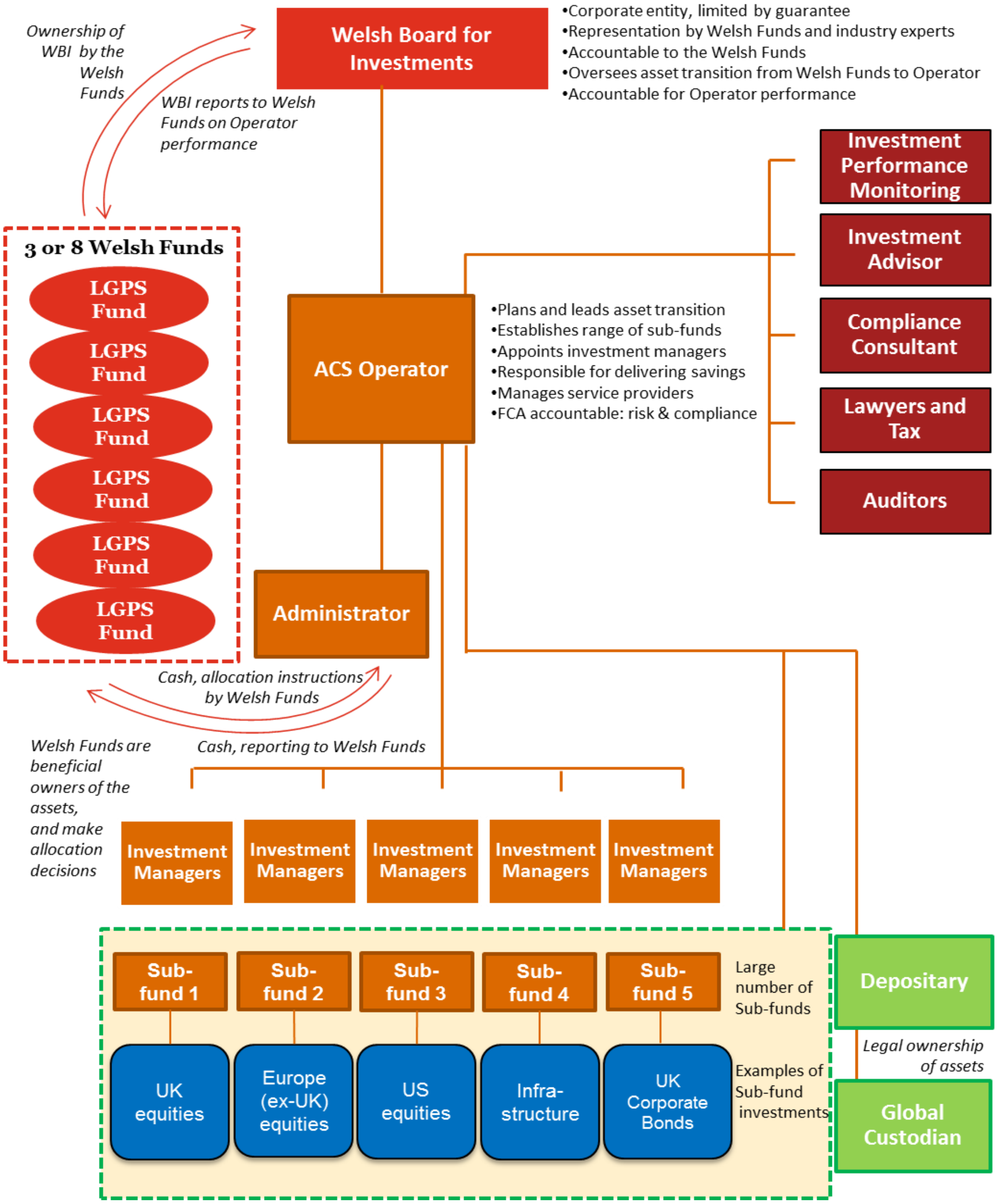
As the chart above shows, investment costs vary greatly between funds in Wales, and over time. There are many factors which affect investment costs and make meaningful comparison difficult, such as:

- Asset allocation – different asset classes have different investment costs.
- Investment management style – passive management (as used extensively by Dyfed) is lower cost than active management.
- Performance-related fee structures – each one will be structured differently, and as the amount payable is variable each year, they can cause large fluctuations in investment costs year on year. For example, a large proportion of the investment costs for the Swansea Fund in 2013-14 are due to a large performance-related fee being payable during the year, but which related also to cumulative performance from prior years.
- Changes to investment strategy or investment managers – transition costs can be significant when implementing a change to the investment strategy or transitioning from one investment manager to another.

Appendix 5

A possible collective investment vehicle for Wales

Exhibit 21



Potential CIV structure: the ACS

Exhibit 21 illustrates one possible model for the pooling of certain assets of the Welsh LGPS funds into a central CIV or CIVs. It uses an ACS. The ACS is a tax-effective structure introduced into the UK funds landscape in 2013. The participating LGPS funds would hold units in the ACS under co-ownership and the model permits the operation of a number of sub-funds under the one vehicle resulting in greater efficiency in terms of both establishment and ongoing costs than other alternatives.

ACSs are not themselves subject to UK corporation tax, income tax or capital gains tax and are tax transparent for income. Pension funds typically favour tax-transparent vehicles so that they do not suffer 'tax drag' on their overseas investment returns. Management services supplied to an ACS should be exempt from VAT under the management of 'special investment funds' exemption.

An ACS and its operator would require authorisation by the FCA and would be subject to its ongoing supervision. Each sub-fund of the ACS may have its own investment objectives and different investment managers may be appointed for each, thereby allowing the ACS to benefit from the full range of cost efficiency, expertise and market performance available in the market.

Operator models

The ACS structure for a CIV requires there to be an operator, to be authorised by the FCA. Day-to-day interactions involving cash flows and asset allocation instructions would be through the Administrator appointed by the operator. The investment performance of each LGPS fund would depend on its choice of asset allocation, with reliance on the operator to deliver effective performance from each sub-fund.

There are two main delivery models for an operator: build or rent:

- Building an operator would create a Welsh LGPS funds/Welsh Government asset. It could be located locally, and could generate some internal management efficiencies on asset management. Establishment and authorisation would take longer, and have significant costs. Risks would have to be managed. 'Build' is the option that London CIVs have chosen to implement.
- Renting an operator is the faster and lower initial cost route to setting up a CIV. Procurement processes under OJEU would be required. Interest from a number of possible providers might be expected. It is likely to be the lower-risk route, particularly if levels of take up are modest. 'Rent' is the option that the SWT is currently understood to be considering.

Delivery models involving private sector partners have lower initial set-up costs for government.

However, these costs would ultimately be passed back to government as operating costs over the life of commercial agreements.

Governance

A practical way to separate the operational and oversight functions would be needed. The operator would be responsible for delivering the envisaged savings. Its key functions may be to establish investment sub-funds, and to appoint, manage and dismiss investment managers to operate them. Oversight could then be by a separate body, an Investment Board which would be accountable to the Welsh LGPS funds and to the Welsh Government for the performance of the operator. The primary benefits of the separation of the operator and oversight functions are:

- As it would not require FCA regulation, the Investment Board could bring a range of perspectives to the oversight role. The Welsh LGPS funds would be fully represented, channelling their voices through the board.
- The board viewpoint could be wide, including economic and infrastructure issues.
- The operator could focus solely on meeting investment challenges, to deliver investment savings and performance, at scale, in each asset class that it offered.

The Board could be the forum for aggregation of portfolio information and analysis, enabling a single consolidated view of performance.

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FINAL REPORT

MAY 2015

MARSH & McLENNAN COMPANIES

CONTENTS

1

Executive Summary

This paper outlines the background and relevant details to support the eight Welsh LGPS Funds ("the Welsh Funds") in their considerations in establishing a collaborative governance and investment framework. The paper recommends that the Welsh Funds:

- Spend time to develop a shared set of principles for collaboration.
- Pursue a more collaborative approach in order to avail of key benefits that include economies of scale and lower costs, increased consistencies, enhanced governance and operational management across the Welsh Funds.
- Select a single passive provider for passive global equities to obtain immediate cost savings. A pooling structure would not be required to achieve these gains.
- Establish a pooling framework to extend on collaboration beyond passive global equities
- Adopt a regulated (pooling) vehicle along with a model that supports leveraging the infrastructure of a third party provider (rather than building such infrastructure internally). In addition, the paper suggests that the Welsh Funds should look to appoint a provider with appropriate experience who can provide an optimal level of governance and operational support, reducing both the risk and cost of developing internal resources and capabilities to operate the new framework.
- Consider framing the new collaborative framework as optional for each Welsh Fund but target mandates that are common to all to ensure strong uptake and an engaged and simple approach.
- Consider both active global equity and UK equity as the two immediate mandates to commence with the new collaborative framework. The analysis outlined in the paper highlights that these two mandates are consistent across the vast majority of funds and offer the greatest potential for cost savings.
- Agree a set of next steps to take forward the project, including a workshop / training session and development of a project plan, including the potential tender process to assess suitable partners/providers to support the new collaborative framework.

2

Background and aims of this report

Background

We begin at the point at which the eight LGPS Funds in Wales have decided that there is merit in exploring whether investing collectively is worthwhile and how it might be achieved.

The previous report on this issue, compiled by PwC, suggested that there would likely be savings (or improvements in net return) if assets were pooled. We agree with this concept, although clearly there are many variables here; not least of which is the issue of the degree of take up within any collective arrangement.

The previous report suggested that savings of between £1.6m and £4.4m could potentially be made (depending upon the investment model adopted). The obvious starting point therefore is to consider whether any quantum of those savings could be made by keeping things simple and leveraging existing arrangements. We do this in Section 5.

We have not looked to repeat any of the work carried out previously (although we do provide an analysis of the current situation in Section 5 for context). It is a matter of fact that the majority of investment managers will levy lower fees if dealing with a single large pool of assets relative to a larger number of smaller mandates.

Investing collectively will also likely allow the Welsh Funds to access asset classes and build strategies (cost effectively) that can make more sense with scale. Alternative assets are the obvious example.

Nonetheless, we are also cognisant of the fact that numbers showing cost savings can be open to interpretation and are heavily assumption dependent. It has to be accepted that there are also qualitative arguments that come into play too. For example, we would argue that a more focused, nimble / market aware approach could be taken under a collective, professionalised structure that would not be possible under a single Fund approach operating under a typical “Four Committee meetings per year” arrangement.

Investing collectively can take many forms, and we have assumed that a regulated entity of some description is the most sensible route; however this is discussed further in Section 7.

With a regulated entity however comes a plethora of operational and compliance related issues, which leads to the question of whether to “build” that entity or to “rent” the associated infrastructure. Regardless of either building the capabilities to manage an investment vehicle in-house or appointing a partner with existing infrastructure, it is critical that the Welsh Funds establish an appropriate governance and investment framework to support the decision-making process (both taking and implementing decisions) to ensure that the collaborative framework operates efficiently.

This report

This report develops a business case for the **establishment of a governance structure and investment framework** that will allow the eight Welsh LGPS funds to invest collaboratively. We have approached this project on the assumption that participation will be optional and that asset allocation will remain a local decision; in short we have looked at options that are flexible enough to cope with the many or the few.

The vision, as we see it, is to create a vehicle, which forms part of a collaborative investment framework across the Welsh Funds, whereby efficiencies are maximised (both in investment fees, investment returns and operational efficiency) by having participants' investment needs optimised through such a vehicle. Creating a flexible vehicle will, we believe, maximise participation.

The business case will:

- set out governance requirements in establishing a collaborative investment framework;
- highlight possible options for the structure of a collective investment vehicle, within the new framework;
- identify how in practice such a vehicle can be implemented and managed on an ongoing basis;
- consider financial savings and costs that could be anticipated;
- identify any practical difficulties which would need to be overcome;
- set out next steps and project plan to set up the new framework.

In addition we will:

- consider any legislative implications;
- identify a clear Governance model.

Integral to this whole project is the issue of "building" versus "renting" the chosen structure and both will be considered. However, no degree of asset pooling can occur without first considering governance structures and so we consider this early in the report.

3

Are the benefits of collaboration proven?

In order for collaboration to be proven to be effective, the overall ‘result’ needs to lead to improved investment returns net of fees.

Fee savings are tangible, but arriving at improved investment returns may require a different approach to decision making and a long term outlook, and the impact of these factors are less simple to calculate, particularly over short term periods.

In short, we suggest that by delegating the implementation of investment manager decisions to a collective vehicle (in which each Fund will have representation and control across decision-making), individual Committees will be free to spend more time on the issues that really impact the bottom line; namely investment and funding policies. Of course the impact here is virtually impossible to quantify except over the long term, but various academic research suggests that if governance is improved (often by focusing on the big picture items) then there is a significant return premium to be earned. (This is discussed further in Section 4).

LGPS funds are long term investors and we do believe there is a premium therein. We have carried out analysis that supports the theme of investing for the long term through engaged ownership and its financial benefits are well supported. Putting in place a structure which looks to deal with leakages arising from a short term outlook can increase asset values by as much as 25% over a 20 year accumulation period (Ambachtsheer, 2013). We would argue that a collective vehicle funded by a number of committed, long term investors could have the potential to reap the rewards if the right principles are established at outset.

The opportunity to collaborate has the potential to allow the Funds (in aggregate) to achieve things that perhaps weren’t possible in isolation and in turn provide greater flexibility and choice. Let’s take Alternatives and specifically “Real Assets” as an example. This is an increasing area of focus for LGPS funds with their inflation linked liabilities, but one that can present difficulties for individual funds to properly access the best of the market without the appropriate scale. A carefully considered collective vehicle, tailored for the needs of the LGPS, would have distinct merits – managed by the LGPS for the LGPS.

Collaboration also allows operational efficiencies to be realised. Currently eight Funds are independently diverting internal resources and paying fees to external providers. Where there is commonality in services required, whether it investment related (e.g. a manager selection requirement for a particular asset class) or operational (e.g. use of a custodian) collaboration can drive operational efficiencies of a significant magnitude.

There will always be a tipping point in terms of economies of scale becoming diseconomies, but unfortunately there is no definitive evidence that quantifies a particular level. For example, significant scale may mean that smaller boutique managers do not have capacity to come on board. At current asset levels, we would not envisage this to be an issue for the Welsh Funds, but it will be one to watch over time.

In practical terms, there are an increasing number of pension schemes both exploring and adopting collaborative governance and investment frameworks. A number of our clients, with similar challenges to the Welsh Funds have implemented such solutions and are achieving the benefits of collaboration (economies of scale and lower costs, enhanced governance and increased speed of decision making, efficient implementation and improved performance) on an ongoing basis.

Summary:

- The key benefits to collaboration are:
  - Increased scale to reduce cost and improve diversification potential;
  - Improve consistent and simplification of investment arrangements;
  - Co-ordinated governance to improve operational management of Welsh Funds, including speed and implementation of decision-making.

4

Governance issues and a shared vision?

Key to any potential collaborative project is whether each individual Fund is on board and willing to commit to a shared set of principles. With this in place, a sensible governance structure will be easier to achieve.

It is worth noting that we are not recommending any degree of compulsion for any individual Welsh Fund to invest in a collaborative entity. However, regardless of whether a structure is built or rented, each Fund (and its associated Committees), if deciding to use the structure, will need to be on board with the concept of delegation to a collective entity of some description in terms of manager selection, monitoring and implementation. With this in mind, we would suggest that it is crucial that a joint vision or set of principles is established at outset that local Committees can buy into and reference at future points.

We would strongly recommend that after consideration of this report, the eight Funds prioritise the establishment of a shared set of principles. Issues to resolve will include:

- What is the primary aim of collaboration?
    - Cost savings
    - Pursuit of excellence – governance and investments
    - Defence against merger
    - Implementation of a long term investment philosophy
- How will success be measured?
- Will decisions require a majority or full consent?
- Will all Funds approach engagement with Committees collectively or individually (at outset and on an ongoing basis)?
- How will operational issues such as procurement be dealt with?
- How often and where will the group meet, and with the difficulties presented by geography and travel, will sub groups for potentially separate work streams be established?
- What asset classes / mandates to include in the initial collaboration framework?

Governance

Good governance is crucial.

There is academic research that suggests the existence of a good governance premium; ranging from 0.05% p.a. (Clarke, 2007) to 1-3% p.a. (Ambachtsheer 2007, Watson Wyatt 2006)

“Pension Fund Governance can make a positive difference to financial performance, cost efficiency, and the trust of stakeholders in the institution” (Clark, 2007)

There are several reasons as to the relevance of a governance premium in this case. In the first instance, by delegating investment manager issues to a collective entity, the more important considerations of funding and investment policies can be given more time by Committees (locally) at each Welsh Fund. Of course this assumes that all Funds do use the collective entity to a significant degree. Second, the governance structure of the collective entity itself is of utmost importance in terms of the role it plays in efficient decision making and implementation.

Any collective entity will have an Investment Committee of some description that will need a Terms of Reference to determine its precise make up and roles / responsibilities and this will become more tangible once a collective model is established. In the meantime, we would make the following initial suggestions:

- All Funds participating will require representation, but on the grounds that it is our opinion (and experience) that smaller groups tend to operate more efficiently, we would recommend that each Fund has just one representative;

- Depending on the structure chosen, it may be that an independent chair and a secretary are considered. Otherwise, it may be worth considering having a rotating chair with perhaps each Fund’s representative serving as chair for six months;

- To maximise the professionalism of decision making, we would suggest that the Fund representatives are Officers with investment experience / expertise rather than elected officials;

- It may be worth considering having an elected official from each local Pensions Committee form a Consultative Committee that could receive periodic reports from the Investment Committee.

Summary:

- Key to any potential collaborative project is whether each individual Fund is on board and willing to commit to a shared set of principles.

- We would suggest that these principles are formalised at outset and are focused around:

    - Aims of collaboration
    - Measures of success
    - Decision making process
    - Engagement at a local level
    - Operational considerations

- In putting in place an appropriate governance structure, a balance needs to be struck between retention of issues at a local level (where appropriate); but the need to delegate aspects where it “makes sense” to do so.

5

Increasing efficiency within the existing arrangements

It would seem sensible before embarking on a project requiring change, to consider whether there are efficiencies that can be easily exploited within the existing arrangements.

We have considered the following areas:

- Investment manager fees (based on commonalities across current assets / manager structure);
- Other expenses (e.g. custodian and consulting costs).

Investment manager fees

An obvious place to start is to review the aggregate investment manager fees currently in place across the eight Funds. We set out below a summary of asset allocation and the manager fees paid at an aggregate level.

	Assets (£bn)	% of assets	Total fee (£m)	Average fee
UK Equity	**2.5**	**20.7**	**11.7**	**0.47%**
Active	1.3	10.8	10.9	0.82%
Passive	1.2	9.9	0.6	0.05%
Global Equity	**4.4**	**36.0**	**15.6**	**0.35%**
Active	3.3	27.3	14.6	0.44%
Passive	1.1	8.8	1.0	0.09%
Emerging Market Equity	**0.4**	**3.2**	**1.9**	**0.47%**
Active	0.2	2.0	1.7	0.69%
Passive	0.2	1.2	0.2	0.13%
Property	**0.8**	**6.5**	**3.8**	**0.35%**
Diversified Growth / Balanced funds	**0.7**	**5.6**	**1.6**	**0.24%**
Alternatives	**1.2**	**10.0**	**11.1**	**0.91%**[1]
Bonds	**2.2**	**17.9**	**4.0**	**0.18%**
Corporate bonds	1.6	13.0	3.5	0.22%
Government bonds	0.6	4.9	0.6	0.10%
Total	**12.2**	**100.0**	**49.7**	**0.40%**

Source: All Wales. May not sum due to rounding. Based on data as at 30 September 2014.

[1] Approximate – based upon the data provided. Where fees were not provided an estimate has been made. Underlying manager fees have been excluded unless explicitly provided.

In establishing any potential cost efficiencies within the existing asset structure we reviewed the following areas:

- Aggregate fees – how do fees of the eight Funds in aggregate compare to other large mandates?
- Commonalities within active UK and global equity strategies
- Potential for savings within passive mandates
- Initial thoughts on alternatives
- Implications for bond portfolio

A summary of our findings is below. Further detail on each aspect is outlined in the appendix.

	Comment
Aggregate fees	Current fees are generally competitive across the board compared to our Global Fee Survey (used to benchmark fees relative to the industry). However, the Fee Survey does not provide information on mandates of the scale possible across the eight Welsh funds collectively.
Commonalities within active UK and global equity strategies	There is limited commonality between the Funds' manager line-up, and even where there are consistencies at a manager level, due to the client specific requirements in the majority of cases there is little scope to enable Funds to leverage any economies of scale under the current structure. Given the allocations and consistency of UK and global equity across the schemes, these mandates offer the greatest scope for initial collaboration.
Potential for savings within passive mandates	Fees are relatively good value compared to other passive mandates globally. However, specific to the LGPS we are aware of the leading passive managers becoming increasingly commercial to win (or retain business). We believe there is potential for fee savings in Wales as a collective seeking to negotiate with the leading passive managers. Based on halving the existing fees (based on our experience this would not be unsurprising), this could lead to savings of £800,000 p.a. We would caution however that other factors (such as profits on stock lending and costs of trading) would also need consideration.
Initial thoughts on alternatives	It is very difficult to quantify any potential for immediate cost savings through leveraging any commonalities due to complex structures in place. There is also little point in attempting to renegotiate fees with private markets managers given the Funds are "locked in" to these investments. There is potential for significant savings should Funds collaborate on alternatives under a revised model – but the "model" will need to be in place first.

	Comment
Implications for bond portfolios	The make-up of the individual Funds' bond portfolios are wide ranging, and can broadly be categorised into UK Government, UK Corporate and Global bonds. There is little commonality between mandates and so little scope to harvest significant fee savings. We do however note that from a strategic perspective the case for holding bonds in the current environment is changing. Therefore to the extent to which these mandates are up for review there may be more potential for collaboration going forward.
Other expenses	The Funds incur other expenses of c£1.6m p.a., with the largest expenses relating to custodian and consulting costs. We would view custody as an area where fee savings could be made. From the data provided, there are at least 3 named custodians (HSBC, BNY Mellon and Northern Trust) and by looking to procure a single custodian we would expect significant savings to be made as a result of incredibly aggressive pricing in the market. We would suggest any wins here are considered as part of the wider collective investment model for Wales as opposed to a stand-alone custodian decision being made.

Summary:

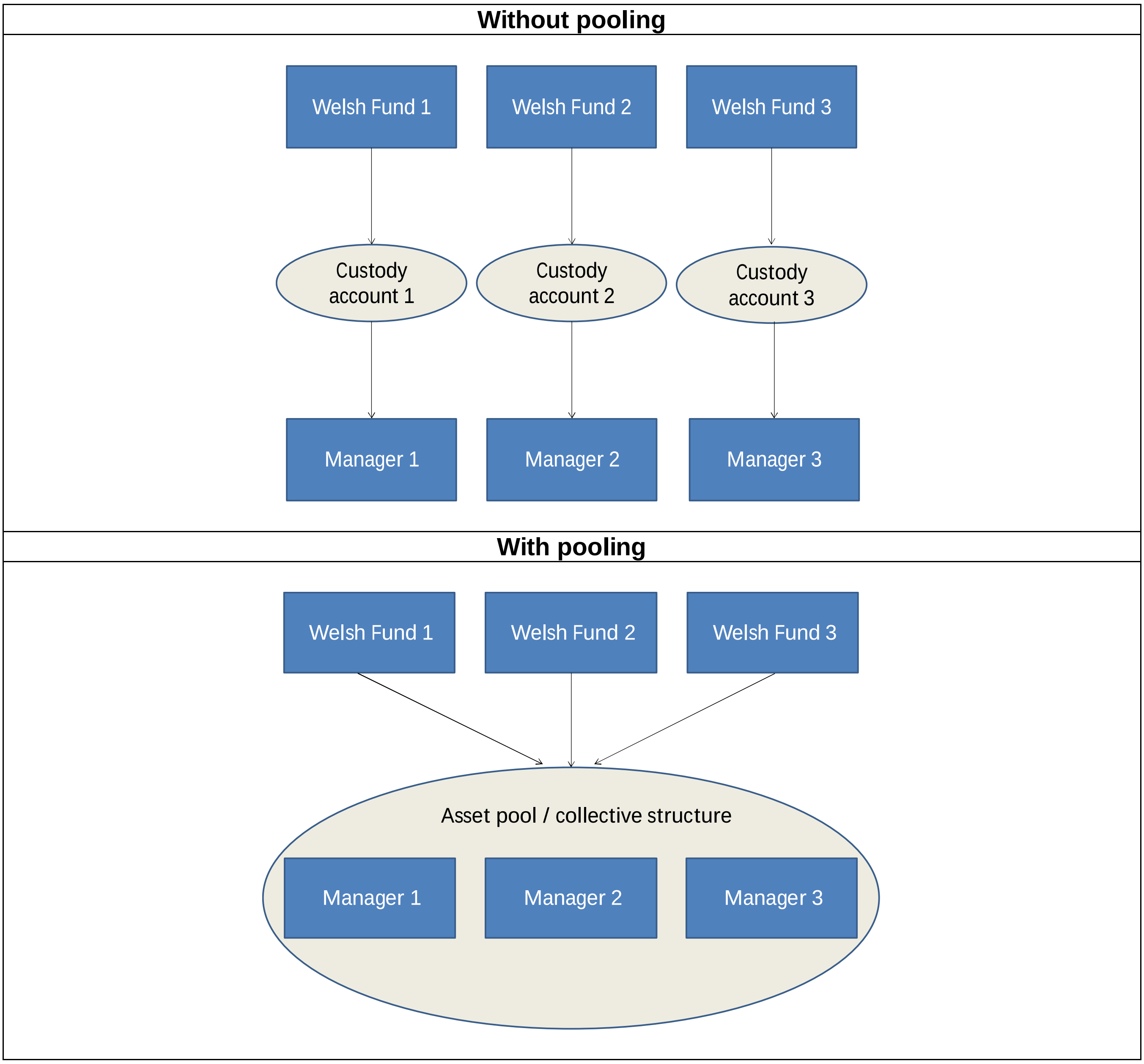
- We have investigated the potential for cost efficiencies in respect of investment manager fees and other expenses under the existing arrangements. Given the allocations and consistency of UK and global equity across the funds, these mandates offer the greatest scope for initial collaboration.
- The diversity across mandates suggests that there are limited initial savings to be made without aggregating assets in some way. The exception would be the passively managed funds, which could achieve savings of c£800,000 p.a. should the funds appoint a common manager.
- There is also potential fee savings to be made in respect of appointing a common custodian. We would however suggest that this is considered as part of the wider collective investment model being considered for Wales under the buy or rent structure.

6

Asset Pooling

In technical terms, asset pooling is the commingling of assets from multiple investors into one vehicle. Investment managers and pension schemes tend use the following five structures to commingled assets:

- Corporations
- Trusts
- Insurance companies
- Partnerships
- Contractual arrangements



Main Challenges in Asset Pooling

A significant challenge in successfully pooling assets is achieving scale to cover set-up costs, ongoing operating expenses and governance costs. Scale is also required to make the structures efficient and have a reasonable expense ratio on an ongoing basis. Another large challenge is collaborating with local fiduciaries and internal stakeholders to obtain approvals and support for the asset solution. A smaller challenge is to align the investments and asset classes to the right vehicle to ensure smooth operations and quality accounting; however, if scale cannot be achieved running multiple funds and structures become expensive.

Potential Benefits in Asset Pooling

In our experience, schemes pool assets to realise the following benefits:

- Ability to leverage larger plan scale to smaller plans reducing fees and operating costs
- Better diversifications and investment opportunity set for smaller plans
- Investment decisions taken by people with experience and expertise
- Greater control over investment decisions
- Better risk management over investments and liabilities
- Faster investment decision-making and greater ability to respond to dynamic markets across all investor plans in a short time frame
- Improved transparency and governance
- Reduced governance resource demands at a local level
- Reduced administrative, legal and transition costs associated with changing managers or portfolio construction

It is important to highlight that achieving the benefits above depends on the operational management and implementation efficiency of the new structure.

7

Available structures

In establishing a collaborative investment framework, the assets of the plan will be required to be "pooled" in some form. This pooling aspect can be achieved through an unregulated or regulated structure.

Unregulated Structures

An unregulated structure is not subject to the same level of oversight and governance as the regulated vehicle. Options include:

- Increase efficiency of existing arrangements i.e. selecting common managers and negotiating lower fees (as discussed in section 5) ;
- Common Investment Funds.

At first glance, a common investment fund may feel like a more simple solution. However, it doesn't solve any governance issues for the eight Welsh Funds. There would need to be a lead authority or a joint body of some description that would take responsibility for manager selections, reporting and monitoring, transitions, and unitisation.

From a risk perspective, a regulated structure with proper operational controls and expertise will provide a more robust solution and establish a professional framework that would stand up to best practice and ensure the Welsh Funds are meeting appropriate standards.

Regulated Structures

Some of the key factors / drivers to be considered in determining the most suitable regulatory regime include:

- Investor type – retail or institutional
- The investment strategy to be adopted within the Fund i.e. asset classes and investment approach
- Required degree of flexibility and control
- Future proofing

Options available include:

- UCITS, or;
- Qualifying Investor Alternative Investment Fund ("QIAIF") (replacing the Non-UCITS QIF effective 22 July 2013)

UCITS

UCITS (Undertakings for Collective Investment in Transferable Securities) are defined under a European Union directive which covers the coordination of national laws, regulations and administrative provisions in relation to collective investment in securities.

In general, UCITs operate on the basis of their availability to the "man in the street" and their investment & borrowing powers are not negotiable. However, they are also used by institutional investors for whom the drawbacks noted below are not significant.

- Restrictions on the investment and borrowing powers of the UCITS and on the use by the UCITS of leverage and financial instruments.

- Where financial derivative instruments are utilised by a UCITS, the UCITS must establish an extensive risk management process ("RMP") which must be approved by the Regulator.

- Higher cost of legal & regulatory compliance e.g. RMP, UCITS IV Business Plan and the production of Key Investor Information Document (KIID).

- UCITs can be sold without any material restriction to any retail investors in the EU. This is subject to compliance with local regulatory rules.

A UCITS fund may be established through any one of the following vehicles:

- An investment company;
- A unit trust; and
- A tax transparent fund.

QIAIF ("Non-UCITS")

Non-UCITS are generally intended for institutional investors and have few investment restrictions.

The Welsh Funds could self-impose any investment restrictions through the fund's investment guidelines rather than having to adhere to strict regulatory imposed guidelines. Non-UCITS offer:

- Greater flexibility with respect to investment styles and restrictions;

- Extensive risk management process not required;

- Quicker upfront and ongoing change approval process with Central Bank;

- Compliance with domestic legislation.

It is likely that the QIAIF is the most suitable regulatory regime to meet the Welsh Funds' requirements.

Recommendation

The decision as to which fund vehicle, regulatory framework or structure is most appropriate for the Welsh Funds will be dependent upon a variety of considerations including:

- Investment Strategy (now and in the future);
- Foreign Tax Considerations;

- Whether the fund would be offered to new investors over time;
- Speed of Authorisation.

The key factor for the Welsh Funds is investment strategy; and in particular the likelihood of investment in alternative asset classes. The non-UCITS regulatory structure would provide necessary advantages of investment flexibility and future-proofing.

However, the decision to choose an appropriate vehicle will depend on the "build" v "rent question. If the Welsh Funds choose the "rent" model i.e. to leverage the existing infrastructure of a third party, then the vehicle chosen would be made in conjunction with, and the input and support of, the appointed partner.

Vehicle Domicile

Within Europe, the leading (and proven) fund domiciles are Ireland and Luxembourg; although we note the recently available option of a UK Authorised Contractual Scheme. The choice of vehicle between Ireland and Luxembourg is finely balanced and we would suggest that this issue is investigated further as and when the Welsh Funds move towards asset pooling.

Summary:

The main decisions in respect of a chosen collaboration structure are as follows:

- ***Regulated or unregulated:*** We would suggest that a regulated structure with proper operational controls and expertise will provide a more robust solution.

- ***Type of regulated vehicle:*** If a regulated vehicle is agreed upon, the options relate to whether a UCITS or QIAIF ("non-UCITS") structure is adopted. We would recommend a QIAIF as this provides fewer investment restrictions and provides the Welsh Funds with flexibility to self-impose their own investment restrictions as opposed to having to adhere to regulatory imposed guidelines.

- ***Vehicle Domicile***: We would suggest that this issue is investigated further as and when the Welsh Funds move towards asset pooling – but the leading fund domiciles are currently Ireland and Luxembourg based.

8

Build or rent?

Management Company and Governance

In order to establish a Welsh fund / vehicle, a Management Company will be required.

The Management Company is responsible for the running of the fund but generally delegates its main day-to-day functions (fund management, custody and fund administration). The Management Company has a fiduciary responsibility for the fund and must exercise oversight and appoint all delegates. The Regulator needs to be satisfied as to the suitability of the management company, its directors, shareholders and share capital.

The main duties of the Management Company are to:

- Issue the Prospectus (which contains details of the underlying investments and certain required disclosures). This is approved by the Regulator and must be kept up to date;
- Appoint appropriate advisors;
- Monitor investment performance
- Administer the subscriptions and redemption of units;*
- Value the assets, calculate the net asset value per unit and keep books of account;*
- Prepare the annual report and accounts;*
- Make necessary filings and ensure compliance with applicable regulatory and legal requirements.

In practice, the items marked with an asterisk (*) are often delegated to an Administrator.

The options for the Management Company are:

1. Establish your own Management Company;
2. Use the Management Company of a third party custodian;
3. Access the Management Company of third party provider to tailor a Welsh solution.

Option 1 – Establish a Management Company (the "build" option)

We outline here the requirements, timelines, costs and ongoing obligations associated with the establishment of a management company and related regulated fund structure (the "**Fund**"). The management company could be located in any of the main jurisdictions for fund domiciles (Ireland, Luxembourg, for example and most recently the UK). The principles, cost and timelines are broadly similar regardless of the choice of fund domicile.

In summary, the following practical elements should be considered when deciding whether to establish a fund:

1. Initial set–up of a regulated Fund, to include the Management Company being authorised in accordance with AIFMD (Alternative Investment Fund Managers Directive).

The essential elements of the authorisation process which would need to be undertaken are outlined below:

1. Choose an appropriate legal structure for the Fund
2. Choose regulatory framework for the Fund
3. Establish Management Company
4. Put in place required governance structure
5. Appoint Directors
6. Alternative Investment Fund Manager entity selection and authorisation * *for prudence we have assumed AIFM license is applicable*
7. Appoint all 3rd Party Service Providers
   a. Investment Manager appointment and authorisation
   b. Administrator / TA
   c. Depository
   d. External Legal Counsel
   e. External Tax advisors
   f. External Auditor
8. Appoint External Directors
9. Fund Approval (Regulatory)
10. Fund Set up and launch (Operational)

Timing

As a guide, we estimate that the minimum timeframe involved to establish a fund and related entities is **12-18 months**. This timeframe, however, would be prolonged considerably if the appointment of any external service provider, such as the investment manager or administrator to the Fund, were to trigger the OJEU Process (and it is more than likely that this would be the case). The timeframe is also contingent on a dedicated team of internal and external resources working on this project on a full-time basis and all aspects of the project going to plan.

The timing will be dependent on the level of complexity. Whilst the regulatory authorisation timeframes are not extensive, the level of preparation in terms of making key decisions, drafting and negotiating contractual documentation, and establishing all of the required structures in place requires the majority of resources, in terms of time, cost and key personnel.

Costs

In addition to the external tax and legal costs that we expect will be incurred (estimated to be in the region of £0.5m to £0.8m) considerable resources, both internal and external (in the form of consultants) in terms of time and costs need to be considered.

We estimate total resource related costs (internal and external) to be in the region of £2.7 to £3.1 m bringing the total initial cost estimate to between £3.2m and £3.9m.

This estimate is based on Mercer's own experience and cannot be relied upon as a definitive figure and is also contingent on no OJEU processes being triggered.

Capital Requirements

Under AIFMD, the initial capital requirement for the Management Company is estimated to be between £3 - £6 million. This amount is subject to regulatory change and ongoing monitoring by the Welsh Funds.

2. On-going considerations

Having established a Management Company and related Fund, the Welsh Funds have ultimate fiduciary responsibility.

While certain functions may be outsourced, there is a requirement that the Fund is not a "letter box" entity. The Management Company will need to satisfy the Regulator on an ongoing basis that it has adequate management resources to conduct its activities effectively and employs personnel with the skills, knowledge necessary for the discharge of the responsibilities allocated to them.

There are considerable ongoing governance, oversight and reporting requirements to be undertaken by the Welsh Funds as a result of the establishment of regulated entities and funds. Examples include:

- Board representation and quarterly Board meetings
- Required governance structure and committees, internal policies and procedures to mitigate risk
- Oversight of all service providers
- Regulatory reporting and filings

The Welsh Funds will be subject to the Regulator's supervision, which is carried out as follows:

- Analysis of returns submitted to the Regulator
- Risk-rating of companies
- Themed and general inspections
- Review meetings
- Regular correspondence and engagement with companies under Central Bank supervision

The Welsh Funds will need to ensure sufficient ongoing internal resources are available to accommodate all of the ongoing requirements.

The Regulator has the power to impose sanctions on regulated entities for breaches of regulatory requirements ranging from substantial fines to, ultimately, the loss of authorisation. It is therefore crucial that any regulated entity has access to an adequately resourced and experienced team of compliance professionals. As is common with regulators around the world, the Central Bank is increasingly focused on supervision and enforcement.

We have provided an overview of the steps and costs only. If more detail is required we would be happy to provide additional information.

Option 2 – Access the Management Company of a third party provider (the "rent" option)

The second option would be to use the standalone, pre-existing Management Company of a Custodian or an Investment Manager (for example).

As the Management Company is legally responsible for appointing the custodian, administrator and investment managers, it would be important to ensure that a suitable governance framework was established which would ensure that the Welsh Funds' preferences for investment managers could be satisfactorily accommodated without compromising the Management Companies' legal obligations. In addition, there is the potential for conflict as the Management Company would effectively be overseeing themselves in the role of custodian and fund administrator.

This approach would provide the benefits of avoiding to "build" an internal management company and therefore avoid the associated cost and complexity outlined in Option 1.

However, it should also be noted, that while a Custodian and/or Investment Manager may be able to provide a Management Company and infrastructure, the needs to support a collaboration framework are typically wider. The Welsh Funds would still require internal resources to support the governance and operations layer outside the Management Company to cover project management, manager appointments and implementation and asset transition.

A custodian would not typically have the internal investment expertise or capabilities to provide this wider support. In addition, the appointment of an investment manager in this role may create challenges with other investment managers managing the assets of the Welsh Funds in that they would need to provide their stock holdings and undertake fee negotiations (typically confidential information) with a competitor.

Notwithstanding this, Option 2 would be a viable option where the Welsh Funds would like to establish an internal team (significantly less than would be required under Option 1) to co-ordinate their investment arrangements.

The costs of Option 2, along with those of Option 3 for comparison are covered below, and we have also provided a comparison of included "services" between the two options.

Option 3 – Access the Management Company of third party provider to tailor a Welsh solution (a further "rent" option)

The third option is for a third party provider to tailor a solution for Wales using their existing infrastructure and in addition, to support the operational co-ordination of the new framework on a day to day basis. Ideally a provider would be found who has experience of this role with other UK pension schemes and has established a number of different umbrella fund structures. This means that the Welsh Funds would not need to go through the full legal process of establishing a fund - the provider could simply launch a bespoke fund via an umbrella structure.

In addition, Option 3 would not require the development of internal Wales' resources as the appointed provider would provide the expertise, project management and operational governance to set up and operate the new arrangement on behalf of the Welsh Fund.

Some thoughts on the differences between Options 2 and 3

The difference between Option 2 and Option 3 is that the latter allows for an integrated investment advisory support to the Welsh Investment Committee decision-making process, along with implementation in terms of set up, execution of manager appointments / replacements, transitions and rebalancing etc. Depending on the specification requirements of the provider, it would also allow for operational due diligence of the underlying investment managers and real time risk / portfolio reporting of manager's portfolios. Depending on the chosen provider, Option 3 would also allow for additional scale in terms of securing lower manager fees.

Specifically, Option 2 would **not** allow for the following:

- manager fee reductions (no access to global buying power)
- manager selection and implementation
- portfolio construction, analysis, (manager allocations, manager styles)
- expertise to connect holistically with each Fund's liabilities
- the support of decision-making that needs to be integrated with implementation

It is also unlikely that Option 2 would provide support in terms of co-ordinating and execution between managers, transition managers, custodians, pension advisors, legal advisors. It is therefore likely to require specialist / specific Officer support; perhaps in the form of a dedicated project manager.

We suggest a more framework based approach with a single provider that can support the full remit to the Welsh Funds to ensure all of these parties are co-ordinated and ensure an efficient set up and **effective ongoing investment governance around the collaborative framework.**

Further, we believe there to be a number of advantages to Option 3:

1. It is arguably the most efficient option in terms of timing and cost;
2. The provider will have a dedicated team of professionals across investments, operations, legal, compliance and risk management;
3. Specialist transition management services;
4. Independent oversight of the Administrator/Custodian;
5. Because the Management Company and fund are not public bodies, we understand (and have taken advice to the effect) that there would be no requirement to procure third party providers via the OJEU process;
6. Depending on the provider chosen and the investment managers that are ultimately used, there is the potential for even greater fee savings than the collective Welsh assets would bring. (For example, the Welsh Funds would likely also leverage the provider's scale of assets under management with many managers);
7. Lower operating, administrative, legal and governance costs at inception and on-going;
8. No set-up costs for the Welsh Funds to cover;
9. Lower internal resource requirements to manage and monitor the vehicles and underlying managers;
10. Limited operational risk;
11. Limited regulatory risk;
12. Flexibility – there will be minimum asset sizes required to make this option viable (and also attractive to providers) but it may mean that individual Funds do not need to sign up at outset.

Under this option, the Welsh Funds should have flexibility to determine the make-up and the Terms of Reference of the Investment Committee of the Management Company. There will be some stipulations / parameters from the provider on the basis of the regulatory requirements of the structure itself. The key point here however is that the Welsh Funds would have majority representation on the Investment Committee and would therefore be predominantly responsible for investment manager appointments and portfolio structure (for example the asset allocation within an equity fund).

Because the set up costs of this option are absorbed by the provider (and probably recouped by way of a minimum ongoing fee once assets are invested) there are no cost implications for Funds who decide not to participate from the outset. This does however assume that a minimum scale is achieved via those Funds who do invest.

It is also worth raising the issue of ongoing advice in terms of manager selection and implementation, and monitoring. Under Option 3, all these items are covered and there would be no requirement for individual Funds who are committed to engage these services at a Fund level. Of course, it may be the case that existing Fund consultants and advisors are engaged to provide advice on the recommendations of the Investment Committee to the collective structure, but that would be an individual Fund choice.

Nonetheless, we understand that, in order to fully assess the differences between Options 2 and 3, the Welsh Funds may wish to seek proposals from interested parties along with associated cost estimates.

Costs of rental (Options 2 and 3) versus current approach

We outline below the indicative costs associated with the existing approach compared with either of the two rental options.

As a starting point, and for simplicity, we have taken the eight Funds' **active global equity** allocation and assessed the potential costs of a collaborative approach according to various levels of take up. (We consider equities in totality later in the report).

There are several reasons for starting with one asset class only:

- It is more tangible in the sense that the simpler we make it, the fewer assumptions that are needed;
- We think that by starting with one asset class and getting a structure in place, it is more likely that any collaboration project will actually get off the ground;
- Global equity is arguably far less controversial (and easier for a collective to agree on) than a wider ranging project such as "alternatives";
- Once a robust governance structure is in place, more complex decisions such as the structure of an alternatives portfolio have a proper forum for discussion.

Take up by Welsh Funds	100%		50%		25%	
Current Approach	(%)	(£m)	(%)	(£m)	(%)	(£m)
Manager Fees	0.44%	14.6	0.44%	7.3	0.44%	3.7
Option 2 - Custodian Approach	(%)	(£m)	(%)	(£m)	(%)	(£m)
Manager Fees	0.37%	12.5	0.41%	6.8	0.42%	3.5
Structural Fee	0.04%	1.4	0.06%	1.0	0.10%	0.8
Implementation Fee	Not included as part of the service and potentially difficult to quantify. Items for inclusion include investment advice (for manager selection), transition fees, advice on terms of reference for Committees, monitoring of custodian / third party provider. For illustrative purposes 0.01% = £0.33m which may be useful when considering the associated advisory and procurement services still required under this model.					
Total		13.8		7.8		4.4
Potential saving per annum		**0.8**		**-0.5**		**-0.7**
Option 3 – Tailored Approach	(%)	(£m)	(%)	(£m)	(%)	(£m)
Manager Fees	0.31%	10.4	0.31%	5.2	0.31%	2.6
Structural Fee	0.08%	2.7	0.12%	2.0	0.15%	1.3
Implementation Fee	Nil	-	Nil	-	Nil	-
Total		13.1		7.2		3.9
Potential saving per annum		**1.5**		**0.1**		**-0.2**

Numbers may not sum due to rounding

To note:

Additional savings / benefits

The savings quoted are in relation to manager fees only and for one asset class only.

Alternative assets are the area where anecdotally the largest savings could be made but this would be a longer term project first in terms of running off existing commitments and second building a long term collective strategy.

Over time, for a Fund committing a significant proportion of assets, there would be associated reductions in fees for:

- Custody
- Reporting
- Procurement / manager selections

Based on each Fund committing to the collective arrangement, we estimate an additional £0.1m of savings per annum per Fund (or £0.8m collectively).

In addition, the additional premia discussed earlier in terms of ***long term investment philosophy*** and the ***governance premium*** should also be considered.

Additional costs

There would also be transaction costs in migrating to the new arrangement. However, in practice, we would expect the fund to be built around existing high quality managers where appropriate.

There would also be the costs of procurement and internal resource to be incorporated.

The implementation fee

Options 2 and 3 have an "implementation fee" row within the above table. Option 3 includes all associated services in relation to the final product i.e. in this case a global equity fund for Wales.

Option 2 would need the Welsh Funds to undertake, or outsource, the following tasks:

- Advice in relation to manager selection and portfolio construction
- Procurement of managers
- Transition services

Assumptions

The key assumptions outlined in the analysis are as follows:

- Current approach:

  We have assumed the current manager fees (including performance fees) represent the cost of the typical manager fees under the existing arrangements. Where take up is reduced, we have assumed the basis points fee remains the same.

- Option 2 – Custodian approach:

  We have assumed that, based on the size of assets in place (£3.3bn), should manager appointments be made as a collective the costs could reduce, in basis point terms to 0.37% p.a. should all global equities be moved into this structure. The fees secured under the 50% and 25% take up options are higher to reflect the discounts being secured with managers reducing.

  The structural fee in adopting this approach with a custodian increases (in basis point terms) as take up rates fall.

- Option 3 – Tailored approach:

  We have assumed that using a third party provider, the fees secured with managers would be the same regardless of the take up. This is owing to the buying power already being in place from a global organisation with extensive assets under management

  In line with Option 2, the structural fee in adopting this approach with a custodian increases (in basis point terms) as take up rates fall.

The numbers outlined here are indicative and would be dependent upon the managers and structural platform used.

Clearly the above relates solely to actual monetary cost savings and does not allow for any potential for improved decision making and the extent to which this translates to improved investment returns.

In order to provide clarification of the potential savings that could be made across ***all*** active equities, we set out below similar analysis which includes UK and emerging markets actively managed equity strategies, in addition to solely considering the global equity analysis provided in the draft report.

Take up by Welsh Funds	100%		50%		25%	
Current Approach	(%)	(£m)	(%)	(£m)	(%)	(£m)
Manager Fees*	0.47	22.9	0.47	11.5	0.47	5.7

Option 2 - Custodian Approach	(%)	(£m)	(%)	(£m)	(%)	(£m)
Manager Fees*	0.41	20.0	0.44	10.7	0.45	5.5
Structural Fee	0.03	1.3	0.04	1.0	0.06	0.8
Implementation Fee	Not included as part of the service and potentially difficult to quantify. Items for inclusion include investment advice (for manager selection), transition fees, advice on terms of reference for Committees, monitoring of custodian / third party provider. For illustrative purposes 0.01% = £0.49m which may be useful when considering the associated advisory and procurement services still required under this model.					
Total	0.43	21.3	0.48	11.7	0.51	6.3
Potential saving per annum	-	**1.6**	-	**-0.3**	-	**-0.5**

Option 3 – Tailored Approach	(%)	(£m)	(%)	(£m)	(%)	(£m)
Manager Fees*	0.35	17.0	0.35	8.5	0.35	4.3
Structural Fee	0.06	3.2	0.08	2.0	0.11	1.3
Implementation Fee	Nil	-	Nil	-	Nil	-
Total	0.41	20.2	0.43	10.5	0.46	5.6
Potential saving per annum	-	**2.7**	-	**1.0**	-	**0.1**

Numbers may not sum due to rounding

* Note that the actual UK manager fees for the Welsh Funds over recent history is 0.82% p.a. inclusive of performance fees. We recognise that this fee is higher than would be expected over the longer term and have assumed 0.5% p.a. would be a more appropriate figure. This provides a degree of prudence in the above cost savings.

Recommendation

In short we would discount the build option on the grounds of timings and resource constraints and would recommend that consideration is given to Option 2 or 3. The differences between Option 2 and 3 relate to the desire for the Welsh Funds to establish an internal team to co-ordinate and manage day to day the various components of the new collaborative arrangements. This is the key question that should be considered (along with the cost) between Option 2 and 3.

Given our knowledge of the Welsh Funds, we would see Option 3 as the best fit with the existing and desired governance arrangements of the Funds. From our experience and the growing trend across the market place, this would be optimal to support the key objective of cost efficiency, consistency and ongoing governance and operational efficiencies in both setting up and operating the new framework.

We would **further recommend** that the Welsh Funds consider the following question:

Is there a need for a “big bang” solution (i.e. having a collaborative approach that covers all asset classes from day 1) or should a solution be phased or incremental?

We would strongly recommend that consideration is given to the latter, on the following grounds:

- Although the costs savings associated with a single asset class are clearly lower than the entire asset allocation, starting singularly means that a platform and governance structure can be built that will allow more complex decisions to be given proper consideration.

- We would predict that by starting with an asset class such as equity and allowing others to follow, the project will have a much shorter timescale to fruition.

The above two bullet points also reflect the view that Option 3 would support the best fit for the Welsh Funds at this time.

Summary:

- In order to establish a Welsh fund / vehicle, a Management Company will be required – this can be **"built"** or the structure could be **"rented"** from an existing provider.

- The estimated costs of build would be c£4million and it would take at least 12-18 months to establish, plus any procurement time in addition. The internal resource required to build would also be significant. On this basis, **we have discounted "build" as a viable option for Wales.**

- There are two main ways in which the Funds could "rent" a Management Company – either solely purchasing the infrastructure (option 2) or by using a tailored third party approach, which would also incorporate governance and operational oversight (option 3). **The upfront costs, internal team requirements, and timescales are significantly reduced under the rental option and is therefore our favoured approach.**

- There are **expected to be cost savings associated with collaboration** and we have provided information using active global equities as a starting point. The costs do however vary depending upon take up and the solution sought (from an increase in fees of £0.7m p.a. to a reduction of fees of £1.5m p.a.). The savings would increase as more asset classes are incorporated. In addition, the additional benefits in terms of long term investment philosophy and the governance premium should also be considered.

- The **key question to decide between Options 2 and 3 relates to the desire to develop internal resources and priority for cost-efficiency** across the Welsh Funds. Both internal resourcing and cost would be higher under Option 2. Given our understanding of the key objectives of the Welsh Funds we would view Option 3 as the best fit at this time. This would also align with market trends and best practice.

- **Costs savings are expected to be increased further if other asset classes are adopted over time** – most notably from alternatives, albeit noting that this is likely to be a longer term project first in terms of running off existing commitments and second building a long term collective strategy.

- In setting up an appropriate course of action, we would **strongly advocate a phased / incremental approach to collaboration** (e.g. using global equities as a starting point); as opposed to a "big bang" solution (which might cover all asset classes from day 1). This would reduce the timescales for implementation and the level of complexity in the shorter term.

- We would suggest that the **next step for the Welsh Funds would be to invite non-binding proposals from potential "rental" providers** in order that a comparison of services and costs can be made.

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Legal issues

The advice in this section of the report has been provided by Sackers

Advice from Sackers

Background and summary

The purpose of this section is to identify the high level legal considerations raised by the proposals outlined in the rest of this paper (for the purpose of this section, the "Proposals"). In particular, the Proposals include the possibility of establishing a bespoke Welsh investment vehicle (the "Welsh Fund") and either creating or appointing a management company to manage that vehicle.

The principal questions are:

- do the Councils have power to implement the Proposals;
- how do the proposals interact with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 ("Investment Regulations"); and
- what procurement obligations apply?

In summary, we have not identified any legal show stoppers which would prevent the Councils proceeding. However, we do identify a number of points which we should draw to the Councils' attention. These points do not affect our overall conclusions, but do raise some issues which will need to be addressed should the Councils decide to continue.

Power to implement proposals

Outline of proposals

From the legal perspective, the Councils must each be satisfied that they have the necessary statutory powers to proceed with the Proposals.

The Proposals could involve:

- the establishment of a Welsh Fund;
- appointing a third party management company and potentially "building" that company under one of the options;
- active engagement in the governance of the Welsh Fund and/or the management company, most likely via a joint committee operating through a formal delegation; and
- the investment of all or part of the pension fund assets into the newly created Welsh Fund.

Exercise of powers and proper delegations

Subject to our comments relating to the Investment Regulations, we are satisfied that the Councils have power to take each of the steps outlined above provided they are satisfied that the proposals are in the best interests of each sections' members and their respective rate payers.

Care should, however, be taken to ensure that the appropriate decision maker within each Council is engaged and that proper delegations are put in place. These activities (particularly the establishment of a Welsh Fund and/or management company) go well beyond ordinary investment decision making.

Each Council will need to consult its own constitution and delegation arrangements to ensure that a decision to engage with these proposals is made at the appropriate level (i.e. we imagine this would be a full Council decision rather than an investment sub-committee decision unless very clear delegations have already been put in place).

Governance arrangements will need further thought depending on the preferred structure. However the Councils may ultimately need to establish a joint committee to discharge their duties in relation to the Welsh Fund and management company. This delegation will need to follow the relevant statutory and Council procedures.

Strategic management and ongoing monitoring

The Councils cannot, in our view, divest themselves of ongoing responsibility for:

- strategic management; and
- on-going monitoring.

The proposals do not envisage either scenario, but the Councils will want to ensure that they can demonstrate their ongoing governance role in both respects and structure any ongoing (joint) investment committee documentation with these high-level principles in mind.

LGPS investment limits

The Proposals could involve the use of a Welsh Fund and each Council's commitment to that vehicle would, in our view, be treated as an investment. The Investment Regulations limit the amount that any one LGPS section may invest by reference to the legal structure of the underlying investment. For example, investment in any single partnership is limited to 2% or 5% of the section's assets.

The Welsh Fund will need to be structured through a vehicle which gives the participating Councils as much flexibility as possible in the context of the Investment Regulations. In theory, we envisage that the Councils will want the option of investing up to 100% of their scheme assets through the Welsh Fund. The Investment Regulations do not contemplate a joint investment structure and there is therefore no specific exception or easement designed to assist Councils who wish to collaborate in this way.

There are a limited number of options for achieving the desired outcome. One such option involves structuring the Welsh Fund as a contractual vehicle such as an English authorised contractual fund or an Irish or Luxembourg common contractual fund (as distinct from shares in a company, units in a unit trust or a limited partnership interest).

The Investment Regulations state that the Schedule 1 limits "shall have effect for the purpose of limiting the making of investments of the types described in the table"[1]. The Investment Regulations do not refer in any way to contractual schemes which are therefore not investments "of the type described in the table". The effect of this appears to be that there is no applicable limit to the amount an administering authority can invest in this type of vehicle, provided the authority is satisfied that the investment is otherwise reasonable for the scheme.

While we are not aware of any alternative reading of these provisions, our interpretation does have the effect of apparently circumventing the intended limits set out in the Investment Regulations. It is therefore possible that the legislation could be amended to address this or that, if the investment were challenged in court, a judge might be disposed to favour another interpretation of the Investment Regulations.

As the Councils are no doubt aware, prior to the recent election DCLG, confirmed their intention to review the Investment Regulations. We do not yet know if they will make any changes or what those changes might be.

The Councils will also want to be mindful of potential reputational risks though, in this instance, there has been considerable public/political pressure on Councils to work collaboratively.

Management Company

A key consideration for the Councils will be establishing the parameters of their control over the management company of any new investment vehicle. Much of the work around the London Council's proposed common investment fund has focused on this aspect.

The Proposals suggest:

> **Option 1 – the "build" option**. This is the option being pursued by the London Councils, who will be shareholders to the management company of the common contractual vehicle. In addition to the employment, contractual and operational issues which would flow from establishing the company, the new management company would need to go through the (onerous) process of becoming FCA authorised.
>
> **Option 2 and 3 – the "rent options".** Both options involve establishing a joint governance structure to supervise the activities of a third party manager with control of the investment company. The management company will be appointed by the Welsh Fund. We envisage that this relationship would need to be supplemented by an investment management agreement between the management company and the Councils (either individually or through a properly constituted joint committee).
>
> The Councils should appreciate that their relationship with the management company will be different depending on whether the management company is a company established and owned by the Councils (as with option 1) or whether they have selected a third party provider and contractually agreed the services to be provided by a third party, as with options 2 or 3. Option 1 is likely to be more onerous in terms of establishment and (possibly) ongoing operation, but it will potentially allow much greater control of the manager from the legal perspective. The Councils should form a clear view of how actively they wish to be involved in the running of the management company, or whether they would prefer to accept a greater degree of reliance on a third party.

[1] Regulation 14(1) of the Investment Regulations.

As noted above, in either scenario, the Councils will want to be very clear that they are retaining ultimately responsibility of the management company's activities and will need to retain strategic control over the activities of the management company.

Procurement

Procurement considerations for the Councils

The Councils will also wish to take into account is obligations under the Public Contracts Regulations 2015 (the "**Procurement Regulations**"). Again, the obligations under the Procurement Regulations will flow from the plans ultimately adopted by the Councils and we deal with different possibilities below.

Activity	Comments	OJEU applies?
Establishment of the Welsh Fund	To the extent that the establishment of the Welsh Fund is carried on in-house, there no actual outsourcing and therefore no procurement obligation. In practice, the Council is likely to engage the assistance of its professional advisors. To the extent to which this involves additional/extended appointments, the usual procurement rules will apply.	✗ ✓
Creating and/or appointing a third party management company.	The establishment of a management company should be regarded the same way as establishing the Welsh Fund (see above). The <u>appointment</u> of a management company by the Councils may depend on how the management company is established. It is possible that the management company may fall within the *Teckel* exception if it is created by the Councils (and assuming the Welsh Fund is not offered to other investors). The alternative option is that the appointment is under the exception in Regulation 10(e) which excludes*: "financial services in connection with the issue, purchase, sale or a transfer of securities or other instruments in particular transactions by the contracting authorities to raise money or capital".*	✗ ✗

The investment of (potentially all of) the pension fund assets into the newly created regulated or unregulated structure.	In our opinion, it is not necessary to follow a statutory procurement process. There are two possible arguments to support this conclusion: It could be argued that an investment decision should not be characterised as a contract for the supply of services or goods and therefore falls completely outside the scope of the Regulations; or If the Regulations do apply, then an investment decision of this sort also falls into the exemption for "financial services in connection with the issue, purchase, sale or transfer of securities" under Regulation 10(e).	×

We are aware that other local authorities choose to go through procurement processes in relation to their investment decisions even where there may be no strict legal obligation to do so under the Regulations. They do this either for reputational reasons or because they regard doing so as consistent with their broader duties to ratepayers. Given the likely profile of this decision, the Councils may wish to procure some aspects of the services for these reasons even in the absence of a legal obligation to do so.

Procurement considerations for the Welsh Fund and management company

A further consideration is that the management company and the Welsh Fund are each likely to outsource some of their service (e.g. custody) and make further investments in third party products. This may require further consideration, particularly if the "build" option is pursued. The procurement Regulations cover *"bodies governed by public law"*, which has a broader definition than might be expected in that it includes:

> *"bodies that have all of the following characteristics: (a) they are established for the specific purpose of meeting needs in the general interest, not having an industrial or commercial character; (b) they have legal personality; and (c) they have any of the following characteristics: (i) they are financed, for the most part, by the State, regional or local authorities, or by other bodies governed by public law; (ii) they are subject to management supervision by those authorities or bodies; or (iii) they have an administrative, managerial or supervisory board, more than half of whose members are appointed by the State, regional or local authorities, or by other bodies governed by public law".*

The Councils will want to keep these requirements in mind in establishing the structure of the Welsh Fund and management company and it may be appropriate to seek counsel's opinion depending on the likely impact of this point.

Statement of Investment Principles

Each Council's statement of investment principles would need to be amended to reflect these proposals.

Pensions Boards

The Councils will be aware of the new Local Pensions Board roles and may wish to take steps to establish the boards' buy-in and parameters for their involvement in any joint structure. Local Pensions Boards can now be established jointly between a number of administering authorities. If the Councils are considering a joint investment structure, it might make sense to also establish a joint Local Pensions Board.

Tax

Please note that we are not providing tax advice as to the efficiency of the proposed Welsh Fund. The Councils will want to ensure that the proposed Welsh Fund is appropriate from this perspective.

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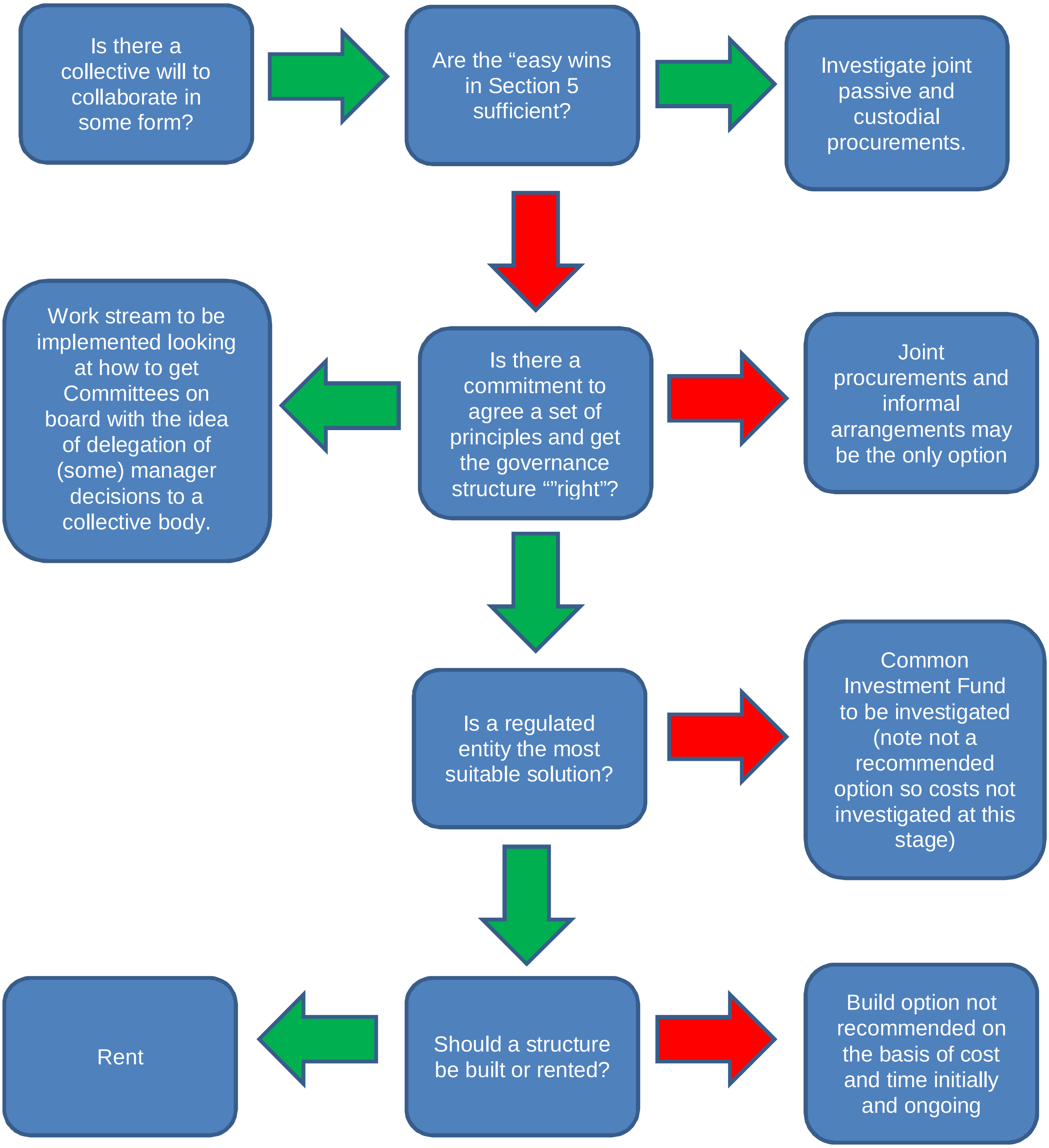
Where to start?

We would suggest the following series of questions are worked through as a starting point:



For the purposes of this report, we have assumed that the "rent" option is preferred and in which case, the first step will be to define a set of principles and to consider how the governance structure would work. This was covered in Section 4.

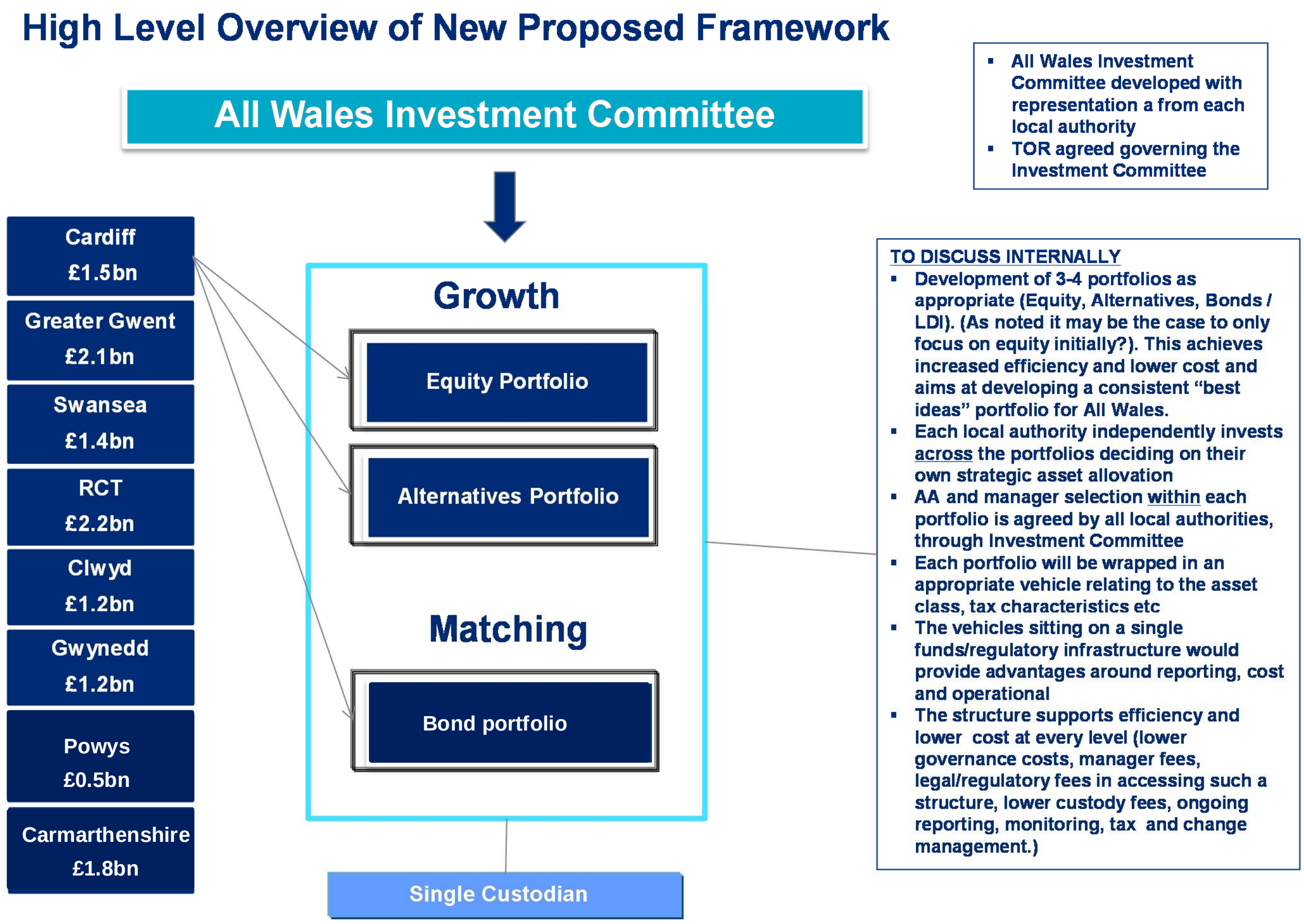
The next consideration is whether there are any legal barriers to implementation (Covered in Section 9).

Next is whether the structure be Option 2 or 3 (as detailed in Section 8).

Once this decision is made, we would suggest that proposed specifications and costings are sought from potential providers. We would expect that an OJEU process will be required to ultimately appoint a provider; although this will of course take time so it is crucial that the general specification of services required is clear at outset to avoid unnecessary analysis of unsuitable tenders.

In order to do this however, thought would need to be given as to the asset classes that would be available through the collective structure and the level of participation that would be likely. However, initially, it may be worthwhile considering the selection of a singular asset class (one that has scale and would have an impact on cost) such as global equity to get the project up and running. Once a platform is established, then more asset classes can be added.

The graphic below illustrates the resultant structure.



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Summary and Recommendations

There are significant savings to be made; both direct and indirect, some more quantifiable than others, through pooling assets and investing collectively.

Governance and delegation

For the Welsh Funds to use a collective structure there must be a shared vision and we would suggest that a set of principles are established at outset.

We believe that there is a premium to be achieved through good governance and sufficient time should be spent in establishing the correct construct of an investment committee of a collective investment structure.

We further believe that there is a real opportunity here to establish a collective with long term principles of investment at its heart; a philosophy that in itself has been show to add real value.

Steps that could be taken without the need for a collective structure

In the particular circumstances that the Welsh Funds find themselves (most notably little cross-over of existing mandates), we conclude that there are few "easy wins" in terms of leveraging existing mandates. We do however recommend that a joint procurement is effected for passive management and possibly custodial arrangements (once decisions have been made on a collective structure).

We would suggest that a single passive manager for Wales would not need to operate under a collective structure and that savings of around £800,000 p.a. could be made if all Funds participated at current levels of assets under passive management. It is likely that this would need to be procured under OJEU due to the additional services deployed by passive managers, such as swing management / rebalancing roles. We have not allowed for transition costs in this instance, on the grounds that passive mandates ought to be transferred between managers on an in-specie basis.

In addition, we note that a joint custodian procurement, presumably utilising the National LGPS Custodian Framework, could harvest further savings. ***However, this is not a step we would suggest considering until decisions are made on collective investing***.

A collective structure

We have recommended, for reasons of future proofing and efficiency, that ***a regulated vehicle is the optimal solution*** for any collective vehicle.

We would further recommend that ***a structure is "rented"*** (i.e. leveraging the existing infrastructure of a third party) ***as opposed to "built"*** (on the grounds of cost, resource and time). An increasing number of sophisticated institutional investors across Europe are moving in this direction.

The attraction of a rental model lies in its ***flexibility***; there will be minimum asset sizes that need to be committed in order to make it a viable proposition for the provider, but by no means do all eight Funds need to commit all of their assets to make it work. We suggest that a rental model using active global equity as a starting point will offer tangible savings; more so if UK equity is included.

This feels like an “easy win”; a starting point to try out a collective arrangement whilst a longer term plan on more complex assets is determined.

There are reduced or no set up costs to be incurred under Options 2 and 3, other than procuring the provider, by the Funds. These are bourne by the provider who will likely charge a minimum ongoing fee for an initial period in order to cover this; just an ongoing operating cost, which means that Funds need only commit (and pay) when they are ready to invest. Of course the cost savings would be greater the more Funds that invest, but we would suggest that the idea of a platform being available to rent / use when needed may be more attractive than compulsion to use a model that has been expensive to build independently.

Under the right model / provider, there would be no “give up” in innovation; the Funds would be free to consider a range of options and perhaps these are more plentiful in the alternative assets space. Indeed, there is the future option here of the Welsh funds running solutions for LGPS funds e.g. an LGPS real assets fund may have real appeal to funds outside of Wales. However, we would contend that Option 3 lends itself more readily to this idea on the grounds that providers in this mould will have relevant experience in creating bespoke strategies for similar clients (whereas Option 2 providers will simply provide the operational infrastructure once All Wales have developed ideas, taken advice, chosen managers etc).

The next step will be to assess the options that are available from the various providers under this model and we can help formulate a template for discussion if required.

Critical Mass

Under the rental model, critical mass will be determined by the minimum fee set down by the chosen provider, but it will also depend on the time period over which savings need to be demonstrated.

For example, if half of the Funds (by asset value) commit to looking at global equities first under a rental model, then the immediate fee savings may be net neutral and a commitment would be needed towards a longer term aim of adding additional asset classes.

Legal Issues

Sackers’ high level advice confirms that the use of a contractual vehicle (such as a CCF or UK ACS) should not, in their view, be subject to any limits under Schedule 1 of the LGPS Investment Regulations. They have not identified any show-stopper legal issues with the use of a manager, either rented or built.

Sackers have also confirmed their view that there is no legal obligation to go through a formal Procurement Regulations 2015 (or “OJEU”) procedure in respect of the initial investment into a bespoke pooled vehicle or in respect of the appointment of a “rented” manager. However, they note that some Councils choose to go through a procurement obligation for policy and/or reputational reasons even where the Regulations do not require this.

Recommendations

- To consider the appointment of a single passive manager across the eight Welsh Funds (regardless of any decision to proceed with a collective structure; although noting that this could just as easily fall under the collective structure for ease).

For actively managed assets:

- To avoid compulsion; a collection of the willing with a shared set of principles is likely to result in a more robust, focused arrangement;

- To be clear on guiding principles;

- To consider the governance structure;

- To consider the set-up of a regulated vehicle;

- To consider leveraging the infrastructure of a third party provider to tailor a Welsh solution. Given our knowledge of the Welsh Funds we would suggest Option 3 provides the most suitable fit to meet existing needs.

- To start with a single asset class, with a view to adding more complex propositions once the structure and its governance arrangements are up and running. Given our analysis, both UK and global equity would offer a strong starting point to fit into the new collaborative framework given the allocation and consistency of these mandates across the schemes and the potential to leverage material cost savings.

- We would suggest a training workshop to discuss the details and workings of the new framework to be set up for the summer period. A separate session would be required for Officers and key Committee members. (Mercer would be able to provide these workshops under the terms of the contract i.e. there would be no additional fee).

- After the workshops, the next step for the Welsh Funds would be to invite non-binding proposals from potential providers in order that a comparison of services and costs can be made. Appendix B contains suggested areas for questioning.

Next steps

We would see the next steps of the project being as follows:

Stage	Time scale
Development of guiding principles	Q2 2015
Training for Key Councillors of each Fund's Committee on principles and options (Mercer would be able to provide this at no additional fee)	Summer 2015
Workshop / training for Officers on the operational aspects of the "rent" option. (Mercer would be able to provide this at no additional fee)	Summer 2015
Draft of specification for providers (Suggestions found in Appendix B)	Q2 2015
Draft Terms of Reference for All Wales Investment Committee	Q2 / Q3 2015
Each Fund to work through constitutional issues in terms of delegation to All Wales Investment Committee	Q2 / Q3 2015
Initial due diligence meetings with providers	Q3 2015
OJEU Process to begin (if required)	Q3 2015

Jo Holden
May 2015

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Important Notices

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Appendix A

Increasing efficiency within the existing arrangements

As summarised in section 5, we set out below further detail on the current arrangements in place.

Aggregate fees

Putting aside any differences in manager line up between Funds, and any implications of regional equity structures (compared to global mandates), we outline below a broad comparison of the aggregated Funds' assets and fees compared to what we might typically expect based on our Global Fee Survey in 2014, which benchmarked our experience of clients fees' globally.

The intention of the comparison is to stop any "glaring" disparities or areas to explore further. There will likely be a number of differences in the specifics of the Welsh Funds mandates relative to those included in the survey and the analysis is intended as a guide, but it may point out whether there are any obvious issues relative to peers.

Note we have excluded alternatives (including property) due to the wide variation in mandates which make it difficult to do a like for like comparison. We have however included performance fees in order to compare like with like.

	Assets (£bn)	ALL WALES Total fee (£m)	ALL WALES Average fee	MERCER FEE SURVEY Total fee (£m)	MERCER FEE SURVEY Average fee
UK Equity	**2.5**	**11.7**	**0.47%**	-	-
Active	1.3	10.9	0.82%	6.1	0.45%
Passive	1.2	0.6	0.05%	1.2	0.10%
Global Equity	**4.4**	**15.6**	**0.35%**	-	-
Active	3.3	14.6	0.44%	18.6	0.56%
Passive	1.1	1.0	0.09%	1.4	0.13%
Emerging Market Equity	**0.4**	**1.9**	**0.47%**	-	-
Active	0.2	1.7	0.69%	1.9	0.77%
Passive	0.2	0.2	0.13%	0.2	0.16%
Bonds	**2.2**	**4.0**	**0.18%**	-	-
Corporate bonds	1.6	3.5	0.22%	3.6	0.23%
Government bonds	0.6	0.6	0.10%	0.9	0.15%

Key: Green – Paying less than expected fees, Red – Paying more than expected fees

The key findings from this comparison are as follows:

- Fees are generally competitive across the board compared to the fee survey; although UK equities do look high (albeit there is a large performance related element). This is not unsurprising given our experience of fee negotiations with managers within the LGPS.

- Please note we have included performance related fees which impact both the UK and Global equity strategies shown. Clearly, the nature of performance fees can be volatile and therefore a meaningful comparison may differ from year to year.

- Whilst not captured within the Mercer fee survey itself we are aware of developments within passive managers over recent years in providing significant reductions to LGPS clients (both before and following the London CIV discussions). We cover this later in this section.

- Whilst fees are generally competitive, it is worth noting that the fee survey generally stops at asset sizes of £250m. It supports the argument that there would be further savings to make with large enough mandate; although we recognise that this may be seen as an anecdotal argument.

Active UK and global equity strategies

We do believe that consolidation of mandates across the eight Funds could reduce fees. Further, where there are already similar mandates in place with a particular investment manager this *could* (manager permitting) lead to some fee savings without having to change the structure. The area where this has the most potential is actively managed equity strategies.

Based on the data provided, c40% of the eight Funds' assets are managed in active UK, global or regional equity funds. However, whilst a significant proportion of the assets across all Funds held in actively managed equities, there is a limited commonality in their underlying structures.

The table below highlights the detail of the underlying structures in order to demonstrate the commonality between Funds. This shows that there are limited similarities in manager line-up, and even when there are consistencies at a manager level, due to client specific requirements in the majority of cases there is little commonality to enable Funds to leverage any economies of scale.

	Total number of mandates	**Total number of managers**	**Difference**
UK active equity strategies	8	7	1 common manager
Regional (ex UK) active equity strategies	US: 1 European: 3 Asia-Pac: 2 Japan: 3 Emerging markets*: 7	US: 1 European: 2 Asia-Pac: 2 Japan: 3 Emerging markets*: 3	US: 0 European: 1 Asia-Pac: 0 Japan: 0 Emerging markets*: 4 common managers
Global active equity strategies	13	10	2 common managers (one manager used within 3 Funds)

** includes Frontier markets*

- In the event that Funds are invested in the same asset class with a common manager, there is potential for fee savings should Funds join together to request fee reductions. To the extent that there are common mandates (in a pooled fund) there could be potential savings if a manager has a tiered fee scale and is willing to view common mandates as one (e.g. for reporting purposes).

However, as outlined above, there is limited commonality at a mandate level. When "looking through" the underlying structures, even where there is some commonality by manager, due to the use of segregated accounts with specific Fund objectives, there is likely to be little to no efficiencies in reporting as each account will be treated separately. We therefore believe it is unlikely to harvest any meaningful saving in approaching managers in this way.

- Should Funds be willing to lose some flexibility, either by moving away from segregated accounts to a pooled fund structure (where there is already existing commonality at a manager level); or by reviewing their manager appointment in place (perhaps by looking to run a joint procurement process), this has the potential for fee savings. However, there would be transition costs associated with any change in mandate; and the upfront costs of running any procurement exercise. Practically, this approach is not "future proofed" as it may store up problems for later as and when individual Funds wish to make local decisions – for example, if one Fund looks to terminate a manager whilst another wishes to retain an appointment.

Overall, we believe there are limited savings to be made under the existing structure for actively managed equity mandates under the current individual Fund structure. We have spoken to managers where there is a high degree of commonality with mixed results. Aberdeen would be unlikely to reduce fees for a joint entity as their fees are already well below their standard fee scales. BlackRock would look at fees if reporting to a single entity. Baillie Gifford's tiered fee structure would result in reduced fees should there be efficiencies in reporting.

As noted earlier, fees at a local level are already relatively competitive based on each individual Fund size and there is limited commonality to improve fees further without making additional structural change.

Passive mandates

Around 20% of the Fund's assets (predominately equities) are passively managed. Unlike actively managed strategies, passive mandates can arguably be viewed more as a "commodity" and we would therefore expect local Funds to be more comfortable in moving away from an existing provider if this led to meaningful cost efficiencies.

When reviewing the Fund's assets compared to other passive mandates globally (as outlined earlier), fees appear to offer relatively good value.

However, specific to the LGPS, we are aware of the leading passive managers becoming increasingly commercial to win (or retain) business. We therefore believe there is potential for fee savings in Wales as a collective seeking to negotiate with the leading passive managers in aggregate.

Where managers are willing to view the eight Funds as an informal collective, this would likely lead to extremely competitive pricing (even further than those already well negotiated fees).

For example, should the existing fees be halved (based on our experience of a selection of similar sized mandates this would not be unsurprising), this would lead to savings of £800,000 p.a. As this would not require a huge amount of resource to investigate, this may be something which the Funds are willing to pursue further.

It should however be noted that investment manager fees are not the only costs associated with passive management. There are other factors to consider in reviewing any appointments – including:

- Profits on stock lending – to what extent does the manager take a proportion of these?

- Bid/offer spreads – as the passive mandates are the most common 'holding ground' for mandates during any asset allocation re-structure, ensuring any move in and out of passive assets is carried out with minimal transaction costs should also be considered.

We would suggest that a cost benchmarking exercise is carried out as part of any next steps resulting from this report before any procurement is undertaken.

Initial thoughts on alternatives

The collective Funds' alternative asset portfolios was the area that was most difficult to quantity any potential for cost savings through leveraging any commonalities.

In particular, there were extreme disparities within the structures in place, fee structures are complex (owing to underlying manager fees which are not always typically accounted for) and the approach to alternatives was inconsistent, which is not entirely unexpected. However, from experience, there is little point in attempting to renegotiate fee arrangements with the private asset managers given the Funds are "locked in" to these investments.

Whilst we would not expect much merit from pursuing fee reductions based on the current structure, there is a potential for reviewing how Funds can collaborate on alternatives under a revised model. This is considered later within the report.

The majority of the Funds' property allocation are UK based, but there is little commonality at a manager level to pursue fee negotiations. Property is also too illiquid to be a first port of call for any immediate change in structure – particularly given the majority of the mandates in place are pooled arrangements where the individual Fund has little to no control. DGFs are yet to form a significant allocation (c1% of total assets) with already competitive fees; and the balanced funds (c5% of total assets) relate to two long standing mandates which would unlikely be a starting point for any further collaboration activity.

Active bond strategies

The make-up of individual Funds' bond portfolios are wide ranging. Broadly, we can categorise the eight Funds' aggregate allocation as follows:

UK Government Bonds:	27% (including Liability Driven Investment – LDI) 3 mandates.
UK Corporate Bonds:	49% (including absolute return mandates) 6 mandates.
Global Bonds:	24% (two global bonds and a Multi-Asset Credit mandate).
Total:	*100%*

UK Government bonds consist of a mix of 2 government bond mandates with one provider, but very different objectives (one is passive index linked gilts, the other an actively managed Core Plus strategy). The remaining LDI mandate is not an area we would collaboration to be best utilised - as portfolios are driven by a Fund's own liability profile; of which there will be different challenges at a local level.

The UK corporate bond holdings relate to 6 mandates with 3 managers. There is however no commonality at the underlying fund level to leverage any efficiencies in their current form. We do note that from a strategic perspective the case for holding UK corporate bonds is changing. Therefore to the extent to which these mandates are up for review may provide potential for collaboration – for example, within a joint procurement, if this was to be considered an appropriate approach.

There are no consistencies to leverage within global bonds.

Other expenses

Investment manager fees aren't the only way to levy cost efficiencies under the current arrangements. Over £1.6m of other expenses were disclosed across the eight funds over the last year and a summary of these are outlined below.

Custody (£000)	Reporting (£000)	Consulting advice (£000)	Audit and legal (£000)	Other expenses (£000)	Total (£000)
647	99	648	105	115	1614

The remainder of this section provides comment on any potential cost efficiencies that we believe could realistically be achieved.

Custody

An area where the LGPS is already benefiting from improved collaboration is in respect of custodian services.

A summary of the custodian fees currently incurred are outlined below:

	Fund A (£000)	Fund B (£000)	Fund C (£000)	Fund D (£000)	Fund E (£000)	Fund F (£000)	Fund G (£000)	Fund H (£000)	Total (£000)
Custody Fees	51	N/A – pooled funds only	50	None disclosed	157	134	138	117	647

From the data provided, there are at least 3 named custodians (HSBC, BNY Mellon and Northern Trust) between the Funds who disclosed custodian fee information.

By looking to procure a single custodian we would expect there to be significant fee savings to be made, and are aware of incredibly aggressive pricing in recent custodian reviews.

To give an idea of the order of magnitude; when Norfolk, Hackney and Suffolk went through a joint process under the National Custodian Services Framework; the three funds, with combined assets of £5.2bn, disclosed that they are expecting to save a total of £1.25m over the lifetime of the contracts. A reported £250,000 was also saved in procurement costs by using the framework.

There are clearly fee savings to be achieved here; but should a decision be made to build or rent a collective model for Wales we would suggest this forms part of those considerations as opposed to being considered as a standalone decision.

Other expenses

Other significant expenses relate to consulting, reporting and audit and legal costs.

However, the nature of the costs being incurred are specific to work carried out at a particular Fund level, and we have therefore not considered the cost savings any further.

Appendix B

Outline questionnaire for providers

At this stage we have simply provided headline suggestions of areas for initial questioning. If required, we would be pleased to forward a draft RFP.

Background

The eight Welsh LGSP Funds have assets under management of £X and collectively have Y investment manager mandates.

The Welsh Funds are keen to explore collaborative solutions for investing and have the following goals:

- Improved governance
- Best in class investments
- Cost reduction and transparency
- Robust risk management

Specifically, in the first instance we are looking for a provider who can aggregate our equity assets under a single structure, whilst fulfilling our 4 stated goals set out above.

Current Mandates

[To add a description of mandates at the time of tender]

Requirements

The investment services provider must be able to document experience in the management of the above or similar solutions.

(IF THE WELSH FUNDS DECIDE TO OPT FOR OPTION 3, WE WOULD SUGGEST THE FOLLOWING IS ADDED)

The provider must be able to meet the following minimum criteria at the time of submission:

- Independent Investment Research – Global investment manager research team which advises clients of a similar size to Client
- No in-house management of individual securities
- Independent Operational Research Team – A dedicated global operational research team which advises client of a similar size to Client
- On-line access to investment manager research and operational risk reviews
- Global operational infrastructure with portfolios that have been implemented
- Demonstrable experience in implementing multi-manager multi asset portfolios
- UK presence with a minimum of two investment relationships with institutional

investors

- Currently running a fully integrated solution including manager research, advice, operational risk review, portfolio risk management (based on security level data), implementation and oversight of all third parties and integration with in-house risk systems
- Proven success in reducing explicit costs from third service provider (including but not limited to asset managers, custodians etc)

Further information can be obtained from: [TO INSERT}

SUGGESTED HEADINGS FOR QUESTIONS

- BACKGROUND INFORMATION ON YOUR ORGANISATION
- MANAGER RESEARCH AND ADVICE
- RISK MANAGEMENT SERVICES
- IMPLEMENTATION AND TRANSITION SERVICES
- OPERATIONAL AND COMPLIANCE DUE DILIGENCE
- THIRD PARTY RELATIONSHIPS
- COMPLIANCE & CONFLICTS OF INTEREST
- COSTS, FEES & COMPENSATION
- ADDITIONAL INFORMATION

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Draft wording for letter of support from Committee chairs

Dear XXX

We are fully committed to ensuring that the administration and management of the [*name of Pension Fund*] is carried out as efficiently and cost-effectively as possible.

In this context, we have been working with our partner funds in Wales to identify ways of achieving efficiencies in administration and communication over a number of years and more recently, specifically through collaboration on investing the funds' assets. A substantial amount of work has been carried out in this regard and in September 2015, alongside the other 7 LGPS Pension Funds in Wales, we gave formal approval for the implementation of a number of recommendations regarding changes to our investment arrangements.

We have noted the recent publication of the Local Government Pension Scheme: Investment Reform Criteria and Guidance.

We believe that establishing a Welsh pool for Welsh LGPS funds is the most effective way to deliver pooling arrangements that meet government objectives in terms of cost savings and collective governance and, at the same time, meet the needs of all LGPS stakeholders in Wales including members and employers, recognising their specific characteristics, circumstances and needs.

At our meeting on [*date*], the [*name of committee / panel*] confirmed their support for the establishment of the Wales Pool as the best way to maintain momentum towards capturing efficiencies within the management of the Fund's assets. We are also confident that this approach is consistent with the Government's objectives published in its recent guidance.

Signed

XXXXXX

Chair …………………….

On behalf of ………………

Submission to the Department for Communities and Local Government from the Wales Pool

February 2016

Our commitment to asset pooling

The proposed pooling arrangement within Wales (“the Wales Pool”) will comprise the following funds:-

- Cardiff and Vale of Glamorgan Pension Fund
- City and County of Swansea Pension Fund
- Clwyd Pension Fund
- Dyfed Pension Fund
- Greater Gwent (Torfaen) Pension Fund
- Gwynedd Pension Fund
- Powys Pension Fund
- Rhondda Cynon Taff Pension Fund

Collaboration across the eight LGPS pension funds in Wales is not new. Opportunities for improved efficiency have been pursued for a number of years within the areas of administration and communications – for example, through the production of the bi-lingual All Wales Annual Benefit Statement, Newsletters and Factsheets.

More recently, there has been strong support from elected members across all eight funds to explore the opportunities for achieving efficiencies within the areas of funding and investment by considering issues such as scheme mergers and collaboration on investments. In fact, the Welsh Funds have already developed and agreed a detailed business plan which includes joint procurement of passive management and establishment of a pooling vehicle which will be up and running early in 2017, significantly ahead of the government’s timetable to transfer liquid assets to a pool by 2018.

We have enclosed in the appendices letters of support from the Chairs of each of the respective Pensions Committees / Panels (of elected members) for the current asset pooling proposals.

In the next section, we have set out the substantial work which has taken place in recent years. The clear desire within Wales is to continue the direction of travel we have adopted to date which we believe accords with Central Government expectations whilst recognising the economic, social, environmental, cultural, regulatory and political context within Wales, as well as the physical geography.

We believe that the Wales Pool proposal meets all of the criteria set by Government except for that of scale.

Progress to date

With the universal support from all eight Funds' Pension Committees / Panels (of elected members), the Society of Welsh Treasurers (Pensions Sub Group) commissioned a report from Price Waterhouse Coopers (published in October 2010) to identify if there was a case for closer collaboration or even merger across functions or funds to support the longer term affordability and sustainability of the Welsh Funds.

Following the final publication of the Hutton Review and consultation on the new LGPS scheme, the Pensions Sub Group published a substantial report ('Welsh Local Government Pension Funds: Working Together') in March 2013, which included a formal consultation process.

The report cited evidence that there were potentially significant financial benefits of scale to be found from working collectively through a common investment approach. The potential benefits for the funds were not directly related purely to the aggregate size of assets but rather the result of economies of scale that, together with size, allow improved governance and the potential for increased return through a combination of attributes that larger funds tend to have such as:

- More internal / specialist resources;
- More internal / hands on management;
- Better diversification – asset classes, managers;
- More bargaining power on fees;
- Better, more responsive governance structures and processes in place enabling speedy decision making.

In 2014, the results of the wider DCLG Consultation on Cost savings and Efficiency were awaited for some guidance or clarity on how best to proceed.

In early 2015, the Pensions Sub Group commissioned a further report on the development of a detailed business plan for the establishment of a common investment fund. The recommendations from this report have been fully endorsed and agreed by all eight Welsh funds and **are now being implemented by the Pensions Sub Group,** namely:-

- To pursue a collaborative approach to achieve reduced costs, enhanced governance and operational management across funds, and to be based on shared principles of governance and collaboration.
- To select a single provider for all of the Funds' passive assets (equities and bonds).
- To establish a pooling framework to extend collaboration into active management across a range of assets.
- To adopt a regulated pooled vehicle based on the infrastructure of a third party provider.

Formal decisions were taken in September 2015 by all 8 Funds' Pensions Committees / Panels (of elected members) to:-

- Begin a procurement process for a single passive management provider. This exercise is well advanced and it is anticipated that a provider will have been appointed by the end of March 2016.
- Appoint an external advisor to advise the funds on procuring a provider of an appropriate collective investment vehicle (CIV). An advisor is now in place and it is anticipated that a CIV will be available for use in early 2017.

In parallel to these developments during 2015, the Wales Audit Office initiated at the request of Welsh Government a value for money review of the Welsh LGPS, under the auspices of the Welsh Government's Workforce Partnership Council. There was wide consultation of relevant stakeholders including trade unions. The report concluded that there was a strong case for the Welsh Government and the Welsh Local Government Association to support the establishment of a CIV for all eight funds in Wales.

The extent of the detailed work which has already been undertaken in Wales and the widespread support which it has received is evidenced by the substantial reports already produced which have been included as appendices to this submission.

There is a clear intent and momentum in developing a Welsh solution capable of achieving efficiency and cost savings in respect of pension investments. The funds are committed to continuing to implement pooling arrangements which build on the substantial work which has been done to date and which will also satisfy the criteria issued most recently by DCLG. The work done to date should allow implementation ahead of the Westminster Government's intended timetable.

Characteristics of the Welsh funds

The group believes strongly that there is a balance to be struck between ensuring strong effective governance and the level of assets within the pool. A structure which can demonstrate strong cohesive governance will produce more tangible cost and performance benefits - and more quickly - than an arrangement which might have more assets but where there is less cohesion amongst participants and therefore weaker governance.

Effective governance will be assured by the common characteristics shared by the current participants.

- The administering authorities already have substantial experience of collaborating on other areas of policy across Wales.
- All participating funds have been involved in discussions on collaboration from the outset.
- No single fund dominates the pool in terms of asset size. Funds range in size between £0.5bn and £2.2bn, with an average fund size of £1.5bn.
- All funds are required to conform to standards on the use of the Welsh language in terms of their proceedings and communications.
- There is a requirement to respond to Wales specific legislation such as the over-arching “Well Being of Future Generations Act 2015” which places certain duties on public bodies in Wales to carry out sustainable development in a social, environmental, economic and cultural sense.
- There are similarities in investment approach across funds – in terms of the asset classes used and investment managers employed. (More detail is provided in the Appendix.)
- All funds use an external manager model (minimal internal management functions).
- The funds are reasonably close geographically which will be helpful for joint working and governance.
- The funds are subject to a different audit regime than funds in England.
- There are 22 different unitary authorities across the eight funds which are subject to a different funding regime than in England.
- There is full engagement with elected members.

Establishing a Welsh pool for Welsh LGPS funds is the most effective way to deliver pooling arrangements that meet government objectives in terms of cost savings and collective governance and, at the same time, meet the needs of LGPS stakeholders in Wales including members and employers, recognising their specific characteristics, circumstances and needs.

Meeting the criteria issued in November 2015

The Government's expectations are clearly understood in Wales and have been echoed and emphasised by the Wales Audit Office report commissioned by Welsh Government.

The group has appointed a third party advisor to assist them with developing the detailed proposal for the asset pooling arrangements for Wales and to support implementation.

The group is confident that each of the specific objectives set out below will be achieved through the Wales Pool.

Asset pools that achieve the benefits of scale

The total value of assets within the Wales Pool at March 2015 was £12.3bn.

Although this falls short of the £25bn mentioned specifically by Government, the group believes strongly that the level of savings achievable will be very similar to those from forming a larger pool, i.e. that a sufficient scale of assets has been reached in order to deliver substantial benefits of size.

It is extremely difficult to estimate potential future fee savings with any degree of confidence. However, based on data provided by investment managers to Project POOL, there is some evidence that the economies of scale on individual equity mandates, for example, cease at around £500m / £1bn. Larger asset pools will face capacity constraints within the manager universe and may be obliged to appoint a larger number of managers to cope with their larger equity pools. Their individual mandates therefore may not be larger. With an active equity pot of £5.8bn, the group is confident that it can benefit from similar economies of scale from its active equity managers, which manage 47% of total assets.

In addition, 20% of total assets are managed on a passive basis. The experience of the Midlands Counties project in 2015 suggests that the economies of scale from passive management can be fully captured by a relatively small number of funds and assets coming together. A manager selection exercise for a single passive provider will be concluded shortly.

Importantly, these cost benefits will flow through to the Wales Pool more quickly due to the progress made already towards setting up a collective vehicle and the strong cohesion between funds which have already been working together on pooling their investments for some time.

Due to the significant amount of work which has already been carried out by the group, it is proposed that a collective vehicle will be available for use and to receive assets by early 2017, comfortably ahead of the Government's proposed timetable.

Transfers in of listed assets – bonds and equities – could be achieved in H1 2017. The group has yet to decide on the specific arrangements for more illiquid assets such as property, private equity and infrastructure. Project POOL showed that there are potentially dis-economies of scale on some asset types such as property and private equity. The group would also welcome the opportunity to invest in national pools for other asset classes, such as infrastructure, where regional pools may not deliver the greatest level of savings.

The group will aim to offer an appropriate range of sub-funds across all asset classes within the pool to allow individual administering authorities to implement their preferred asset allocation.

Strong governance and decision-making

The group has already commissioned a detailed study on the potential approaches to implementation and it is their intention to appoint a provider who will make available a Collective Investment Vehicle (CIV). It is expected that 'renting' a CIV from an existing provider will allow for speedier implementation and be more cost effective given the size of the pool.

A Governance Committee will be formed to make decisions such as manager selection at pool level and liaise with the regulated operator of the CIV. The detailed composition of the Committee is still under consideration.

The number of funds participating in the pool (eight) will allow true engagement in investment decision-making by all participants. All eight funds have been participating in discussions on collaboration for a number of years already.

Reduced costs and excellent value for money

Analysis of the potential for cost savings on a fund-by-fund basis has yet to be carried out. This will be provided in our July submission.

Some of the funds are currently engaged with CEM Benchmarking and consideration is being given to using that firm to monitor the level of cost savings achieved by the group in future years.

As discussed above, it is not possible to estimate fee savings with any degree of confidence as few investment managers provide even indicative fee scales for much larger mandates. However, at this stage, **based purely on the broad assumptions underlying the Project POOL methodology**, aggregate savings for the pool in the region of £15-20m p.a. might ultimately be achieved once all asset classes have been moved fully into a pooled arrangement.

The group recognise that transition costs will be a significant feature of implementing new arrangements. It is anticipated that current mandates will be moved into the pool initially with any restructuring then taking place over a period of time in order to manage costs and the level of disruption. The group will also seek to liaise with other asset pools in order to reduce transaction costs as far as possible.

An improved capacity and capability to invest in infrastructure

The group recognises that infrastructure can potentially represent an attractive investment for local government pension funds.

The current allocation across the funds in aggregate is less than 0.5% of total assets (£40m), though some funds have commitments in place which will increase that level of investment.

With the increased scale of assets within the pool, it should be possible to consider investing directly into infrastructure funds and obtain a diversified portfolio without making use of a 'fund-of-funds' arrangement. As a result, the pool is likely to provide a lower cost way of accessing the asset class - which may therefore make it more attractive from a risk/return perspective. This will lead to individual funds considering a higher allocation to the asset class than at present.

The group would also welcome the opportunity to use a national infrastructure pool within which investment management costs might be even lower and which is designed to give access to investment in projects that meet the risk / return needs of LGPS investors.

Next steps

The Welsh Treasurers have in place a professional, external project management team which is starting work on a detailed implementation plan to support our proposals for the July deadline and manage the short term implementation steps which include:

1) Completing the joint procurement of passive management to deliver quick win savings for all of the funds that will participate in the Wales Pool;

2) Following through the plans agreed to procure a third party operator to provide a pooling vehicle and make this operational to allow transfer of liquid assets to the pool by H1 2017.

Appendices

The following information has also been included.

- Asset breakdown of participating funds
- Copy of ‘Welsh Local Government Pension Funds: Working Together’ – Interim Report (March 2013) – published by the Pensions Sub Group
- Copy of ‘All Wales Collaboration’ (May 2015) – published by Mercer
- Copy of ‘Review of the Local Government Pension Scheme Funds in Wales: Costs, Structure and Management’ (May 2015) – published by the Wales Audit Office
- Letters of support from Chairs of Pensions Committees / Panels (of elected members) from each of the eight participating funds.

Asset breakdown

Fund	AUM (£m)	Allocation
Cardiff	1,549	12.6%
Dyfed	1,771	14.5%
Clwyd	1,339	10.9%
Gwynedd	1,396	11.4%
Powys	481	3.9%
Rhondda Cynon Taff	2,228	18.2%
Swansea	1,395	11.4%
Torfaen	2,095	17.1%
Total	**12,253**	**100.0%**

Asset Class	AUM (£m)	Allocation
Active UK equity	1,336	10.9%
Active global equity	4,230	34.5%
Active emerging market equity	236	1.9%
Active equity	**5,802**	47.4%
Passive UK equity	1,079	8.8%
Passive overseas equity	732	6.0%
Passive emerging market equity	136	1.1%
Fundamental indexation	87	0.7%
Passive equity	**2,034**	16.6%
Active UK corporate bonds	467	3.8%
Active gilts	171	1.4%
Active fixed income composite	511	4.2%
Active overseas bonds	125	1.0%
Active emerging market debt	23	0.2%
Absolute return bonds	512	4.2%
Private debt	10	0.1%
LDI	298	2.4%
Active fixed income	**2,117**	17.3%
Passive UK corporate bonds	8	0.1%
Passive gilts	63	0.5%
Passive index-linked gilts	270	2.2%
Passive overseas bonds	16	0.1%
Passive fixed income	**358**	2.9%
Diversified growth fund	284	2.3%
Property	929	7.6%
Private equity	339	2.8%
Hedge fund	136	1.1%
Infrastructure	40	0.3%
Timberland/agricultural	25	0.2%
Special opportunities	10	0.1%
Alternatives	**1,762**	14.4%
Cash	179	1.5%
Cash	**179**	1.5%
Total	**12,252**	**100.0%**

Degree of manager concentration

Five managers	**52% of total assets**
Ten managers	**70% of total assets**
Fifteen managers	**81% of total assets**

This level of concentration will increase once the single passive manager has been appointed and funded.

MEETING:	**PENSIONS COMMITTEE**
DATE:	**11 February 2016**
TITLE:	**PRIVATE EQUITY AND INFRASTRUCTURE INVESTMENTS**
PURPOSE:	**To ask the pensions committee to decide on two investments**
RECOMMENDATION:	**ACCEPT THE RECOMMENDATION**
AUTHOR:	**CAROLINE ROBERTS, INVESTMENT MANAGER**

1. INTRODUCTION

1.1 A meeting of the investment panel was held in London on 19 November 2015.

2. PRIVATE EQUITY INVESTMENT

2.1 A report from Hymans Robertson on the options for a further commitment to private equity investments was discussed. The Panel's opinion was that an investment of €20 million (£15 million) should be made in a private equity fund of funds with Partners Group. As this is a direct investment it is not necessary to go through a procurement process.

3. INFRASTRUCTURE INVESTMENT

3.1 A report from Hymans Robertson on the options for a further commitment to private equity investments was discussed. The Panel's opinion was that an investment of $43.6 million (£30 million) should be made in a infrastructure fund of funds with Partners Group. As this is a direct investment it is not necessary to go through a procurement process.

4. RECOMMENDATION

4.1 The Committee is requested to confirm the direct investments in

Partners Group Direct Equity 2016 Fund
Partners Group Direct Infrastructure 2015 Fund

in accordance with the Panel's opinion.

Agenda Item 8

Meeting:	Pensions Committee
Date:	11/02/16
Title:	Pension Administration Unit Staffing
Purpose of Report:	Minor change to staffing structure from 1/3/16
Author:	Nicholas Hopkins – Pensions Manager
Recommendation:	To accept the new staffing structure

1 Background

1.1 Following recent appointments within the Section, in order to assist in the office's checking work, it is suggested that one post's grade is upgraded from an S2 Communications Officer to a scale S3 Senior Communications Officer. The additional cost will be £3500.00 per annum including employer National Insurance and pension contribution.

2 Review of staffing of the Pensions Unit from 1/3/16

2.1 To improve the efficiency of the Pensions Administration Unit, it is proposed that a minor structural adjustment is made to widen the supervisory responsibility within the Section. The proposed structure is shown in Appendix 2 (for information the current structure is shown in Appendix 1)

2.2 It is proposed to change the job description of the current grade S2 post of Communications Officer (5EE014) to a grade S3 Senior Communications Officer to lead on communications matters. The revised structure (Appendix 2) would be more flexible in respect of supervising and managing the Section's procedures

Details of post	Proposed scale	Full time annual pay	Additional cost
Senior Communications Officer	S3	£34,892	£3500
		Annual total	£3500

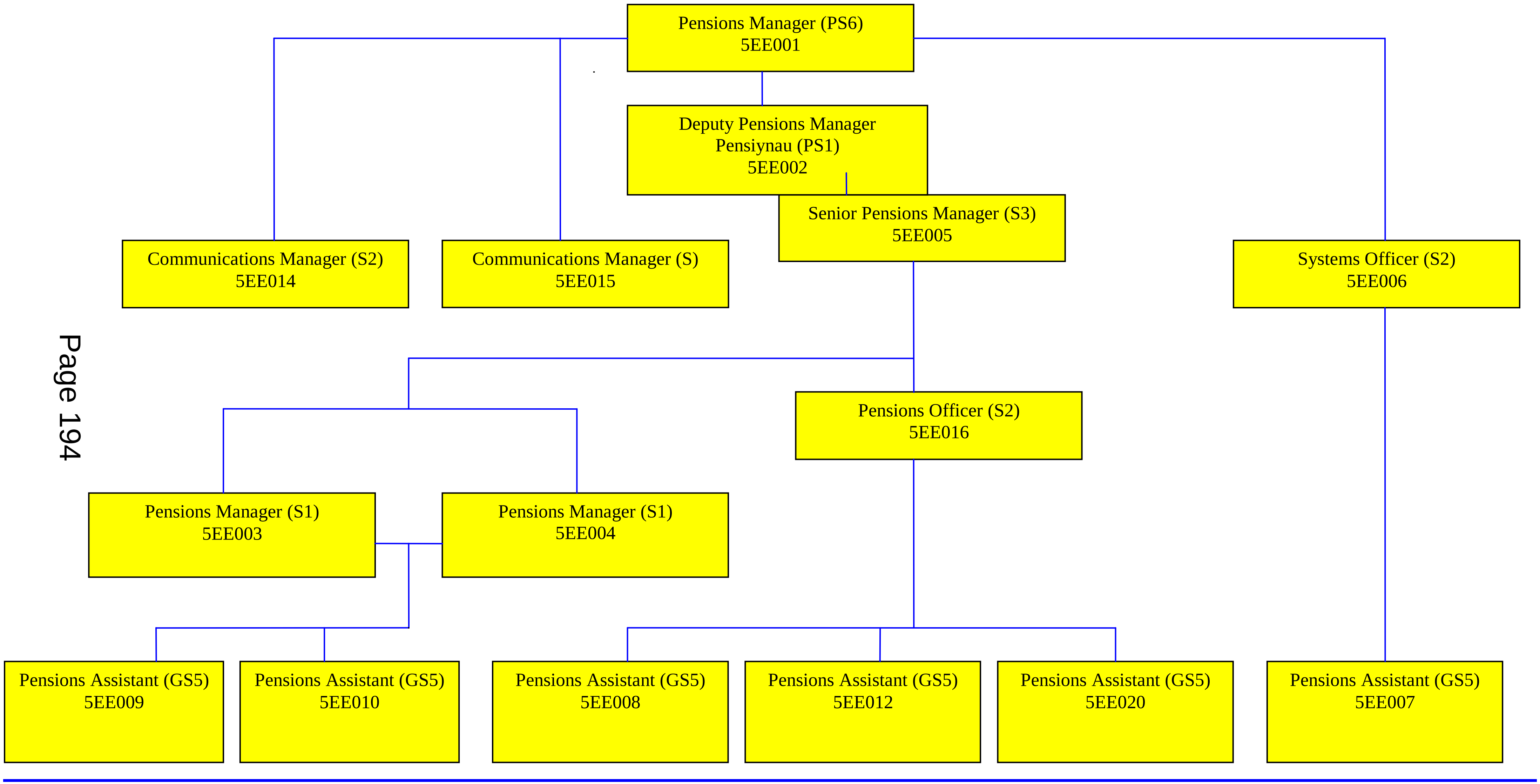
3 **Recommendation**

3.1 Members are requested to approve the increase in expenditure to change the staffing structure at a cost of £3500.

3.2 To agree the revised staffing structure for the Pensions Unit in accordance with Appendix 2 effective from 1/3/16.

Appendix 1

Current Structure



Appendix2

Proposed Pensions Administration Structure with effect from 1/3/2016