Centre for Policy Studies

Pointmaker

WHAT PRICE LOCALISM?

A CASE STUDY: THE LOCAL GOVERNMENT PENSION SCHEME

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SUMMARY

- Decades of ineffective governance have allowed the Local Government Pension Scheme to become a staggeringly inefficient, self-serving empire.
- Resistance to change is facilitating a fundamental misallocation of risk and return, with value leakage of well over £1 billion annually via performance fees (paid to third parties) and unnecessary operating costs, eroding capital.
- The LGPS was 21% underfunded at the 2013 valuations with over a third of the individual funds being cashflow negative in 2012-13. For a nation that is supposedly a leading provider of financial services, and given the scale of the LGPS, it is a national embarrassment.
- The Coalition has recognised the need for reform, but its proposals are compromised by political considerations masquerading under the banner of localism.
- The Treasury's proposed cost control mechanism is incomprehensibly complex. In addition, it excludes so many costs as to vaporise the prospect of any significant cost control being exerted on the LGPS.
- DCLG's proposal to add a new Pension Board for each individual fund, to what is already a complex, failing arrangement, risks a governance framework that would resemble a dysfunctional dystopian fantasy. There are already well over 1,000 people involved in LGPS governance.
- This paper makes nine proposals to improve the LGPS's efficiency and effectiveness, to ensure its long-term sustainability. The emphasis is on structural simplification, both in respect of day-to-day operations and governance. The proposed changes would pull together the individual LGPS funds into a single Local Government Investment Fund (LGIF), and socialise the liabilities across the LGPS.
- As a single fund, the LGIF would have assets of over £220 billion, the sixth largest pension fund in the world, capable of wielding huge influence. Given its size, the LGPS should take all asset management in-house, into four competing asset allocators. This would stop the huge leakage of value, as well as mitigating the operational disadvantages of a single, giant asset allocator.
- A single, politically independent, trust-based board should govern the LGIF, ending the pretence of "local accountability"; it is remarkable that no s151 officer has ever been held to account.
- Accountable to the LGPS membership, the board should exude an ethos of fiduciary duty. Its primary objective should be to ensure that the LGIF can meet its pensions obligations, thereby maintaining the self-sufficiency, and hence sustainability, of the LGPS. The board should have oversight of a cost control mechanism focused on cashflow rather than funding status, with pensioners participating in the risk sharing pool to preserve intergenerational equality.

NINE PROPOSALS

Proposal 1: The LGPS's 89 disparate funds should be restructured as a single fund, the Local Government Investment Fund (LGIF).

Proposal 2: The LGIF should comprise of four competing asset allocators. Each would receive 25% of contributions and be responsible for meeting 25% of pensions in payment. Interaction with the market would be via DCLG's two proposed Collective Investment Vehicles (CIVs).

Proposal 3: A single administrator should connect, and serve, the LGIF's four allocators, the two CIVs, the contributing employers and the whole membership, thereby substantially cutting costs.

Proposal 4: The LGPS should initiate plans to take all asset management in-house, starting with unlisted assets (notably private equity and hedge funds).

Proposal 5: Section 36 of Pensions Act 1995, requiring trustees, before investing, to obtain and consider proper advice, should be scrapped. The LGPS should then develop all the necessary skills within its two CIVs, doing without investment consultants, in particular.

Proposal 6: The LGPS should consider joining the Pension Protection Fund (which would require change to the LGPS's legal status). In any event, it should request a levy quotation.

Proposal 7: Responsibility for paying pensions should fall to a trust, secured on a beneficial interest in the LGIF's assets. The trust's beneficiaries would be the LGPS's membership.

Proposal 8: The trust should have a politically independent governing board of trustees, which would have oversight of the LGIF's cost control mechanism.

Proposal 9: The LGIF's cost control trigger should be cashflow-based. If total net cashflow were to fall below a £2 billion surplus, the governing board should adjust one or a combination of contribution rates, accrual rates and indexation of pensions in payment until annual cashflow returned to a £2.5 billion surplus.

A note concerning data

The Local Government Pension Scheme (LGPS) is a single occupational pension scheme comprising of 101 separate geographic funds (89 for England and Wales, 11 for Scotland, and one for Northern Ireland). There is no aggregated scheme data and, in addition, the triennial valuations of the Scottish funds are conducted on a different annual cycle, and the Northern Ireland fund reports separately. Consequently, this report pertains predominately to the 89 funds in England and Wales. Were it based on all 101 funds, the conclusions and proposals would be no different.

1. INTRODUCTION

In April 2014, a new benefits package came into effect for members of the Local Government Pension Scheme (LGPS); the "reformed scheme". Spawned from Lord Hutton's review of public service pensions, accruals are now based upon career average earnings (CARE), rather than final salary.[1] Surprisingly, the new LGPS was not accompanied by agreed frameworks for scheme governance (to protect members) and cost control (to protect taxpayers). This is akin to launching a new vehicle into the market before fitting the brakes.

The Government is well aware of the LGPS's shortcomings and has launched parallel initiatives via the Department for Communities and Local Government (DCLG, the scheme's sponsor), concerning procurement of asset management services and governance, and the Treasury (cost control mechanisms).

In June 2013, DCLG stated its intention that new governance regulations would be in place by April 2014, with the new national and local governance bodies becoming operational later in the year.[2] There is no prospect of this happening. Indeed, the first consultation document on draft new regulations was only published in June 2014, followed by another in October 2014.[3]

Meanwhile, the long-promised employer cost control mechanism has yet to be agreed. Lord Hutton's commission first identified the need for such a cap in March 2011, but it was not until late-2012 that the Treasury published its first, cursory, document.[4] Section 12 of the Public Service Pensions Act 2013 makes provision for an employer cost cap, and more details appeared in March 2014.[5] Since then, silence.

2. FINANCIAL CONDITION: WEAK, AND DETERIORATING

2.1 The 2013 triennial valuations

At end-March 2013, the 89 LGPS funds in England and Wales reported a £47 billion funding shortfall, an increase of £10 billion on 2010's valuations. Total assets of £178 billion and liabilities of £225 billion produced an overall funding ratio of 79%. This aggregated data belies the serious weakness of several individual funds, notably Brent (56% funded), Waltham Forest (60%), Havering (61%), Croydon (66%), Sutton (67%), Clwyd (68%) and Worcestershire (69%). Note that deficits are effectively liabilities ultimately underwritten by council tax payers (not the central government sponsor, DCLG).[6]

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1 *Independent Public Service Pensions Commission: Final Report*, 10 March 2011.

2 DCLG; *Local Government Pension Scheme (England and Wales) new governance arrangements; discussion paper*, paragraph 1.9, June 2013. Meanwhile, the existing governance arrangements, under Section 101 of the Local Government Act 1972, continue to apply.

3 DCLG; The LGPS *(Amendment) Regulations 2014; draft regulations on scheme governance. Consultation*, 23 June 2014, followed by *The LGPS (Amendment) (Governance) Regulations 2014; better governance and improved accountability in the LGPS. Consultation*, October 2014.

4 HM Treasury; *Establishing an employer cost cap in public service pension schemes*, November 2012.

5 HM Treasury; *Public service pensions: actuarial valuations and the employer cost cap mechanism*, March 2014.

6 The question of who has ultimate responsibility for ensuring that LGPS obligations are met is discussed in *The Local Government Pension Scheme: opportunity knocks*, MJ, CPS, November 2013.

As of end-March 2014, assets totalled £189 billion;[7] liability data for 2013-14 is not yet in the public domain.

2.2 Comparison with private sector schemes

The Pension Protection Fund (PPF) publishes the estimated funding position of all company defined benefit (DB) schemes in its eligible universe. The aggregate deficit of the 6,057 schemes in the PPF 7800 index was estimated to be £164.9 billion at the end of October 2014, an increase of 230% since October 2013 (£49.9 billion). Total assets were £1,198.5 billion and total liabilities were £1,363.5 billion, for a funding ratio of 87.9%.

More than 75% of schemes are in deficit, a substantial increase over the last year. In many cases, the primary driver of deficits has been falling discount rates, to reflect the low interest rate environment. It should be noted that the average discount rate used last year by the 89 DB scheme sponsors in the FTSE 100 was 0.5% *lower*[8] than that used by the LGPS funds.[9] Consequently, compared to the standards adopted by corporate Britain, the LGPS's liabilities are understated… which should raise a number of questions.

Meanwhile, over the last five years, FTSE 100 companies have pumped over £100 billion into their pension schemes yet, as of the end of December 2013, only 21 of the 89 that sponsor DB schemes reported a surplus. This does not bode well for the LGPS.

2.3 Permanent deficits

Most pension schemes lack inherent financial equilibrium, primarily care of their ageing populations. From inception, many are Ponzi schemes in the making and, ironically, cost-saving measures taken within a sponsor's business, such as reducing the size of the workforce or freezing wages, serve to *weaken* schemes' financial health (through reduced contributions). The LGPS has experience of both.

Table 1 shows that six years ago the LGPS had three employees supporting every four dependents (pensioners and deferred members): now they have to support 5.3 dependents, a 33% increase.

Demographic change apart, the biggest cause of the LGPS's ill-health is decades of insufficient contributions, relative to the future cost of meeting its pension promises. Contributions have typically been around 20%

7 DCLG; *Local Government Finance Statistical Release*, 29 October 2014.

8 Lane Clark & Peacock; *Accounting for pensions 2014, Appendix 1,* August 2014.

9 The LGPS funds in England and Wales used discount rates ranging from 4.5% to 6.1%, averaging 5.03% on a weighted liability basis.

Table 1: LGPS MEMBERSHIP

Thousands	**2008-09**	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**
Employees	1,813	1,811	1,179	1,691	1,713	1,804
Pensioners	1,159	1,203	1,261	1,332	1,370	1,429
Deferred	1,210	1,316	1,408	1,508	1,602	1,711
TOTAL	4,182	4,330	4,428	4,531	4,685	4,944
Dependency Ratio*	76.5%	71.9%	65.9%	59.5%	57.6%	57.5%

Source: SF3 returns. "Deferred" members include former members to whom Regulation 18 applies
** Measured as employees/ (pensioners plus deferred members)*

of pensionable pay,[10] whereas the pre-reform final salary-based pension promise has been valued at 33% to 36%. Consequently, it is no surprise that the LGPS has become seriously underfunded, a situation that has been legitimised, in part, by perennial under-projections of life expectancy.

Notwithstanding the recent benefit reforms, contributions are likely to continue to fall short of the value of the pension promises being made (and certainly not exceed them, necessary for deficit reduction). Thus, unless a robust control mechanism is installed (discussed below), or barring an investment performance miracle, significant deficits are now a permanent feature of many LGPS funds.

2.4 LGPS fund valuations: pointless from here on?

Periodic valuations only serve a purpose if they aid decision-making. They can, for example, provide insights to the governance committees of private sector schemes, perhaps prompting de-risking of a fully funded scheme if the quality of the sponsor's covenant (i.e. credit risk) were weak. But this is irrelevant in respect of the LGPS. Public sector bodies are effectively corporations without end. It is unclear how a local authority could go bankrupt, and there appears to be no mechanism for Parliament to dissolve one; a new Order of Parliament would probably be required. In addition, particularly given the prospect of permanent LGPS fund deficits, they exert little, if any, pressure for change (political or otherwise). A deficit is, after all, merely a nebulous concept that does not manifest itself in day-to-day life, a point-in-time measurement, which can be very volatile.[11] Valuations in the context of the LGPS are a distraction from what really matters: cashflow.

2.5 Cashflow: crucial

The principal risk facing LGPS funds is running out of cash to meet pensions in payment. To be clear, funding deficits do not *automatically* produce cashflow shortfalls, but they make them more likely, leading to a perpetration of

10 From employers (England and Wales): 14.3% for pre-2008 members and 11.9% for subsequent entrants; plus, from employees, 5.5% to 7.5% (since April 2008. Prior to that, a standard 6%).

11 The total deficit of FTSE 350 DB pension schemes, for example, surged 52% over the first two weeks of October 2014, as gilt yields and equity markets fell sharply, driving the aggregate deficit from £63 billion to £96 billion.

Table 2: CASHFLOW, LGPS ENGLAND AND WALES

£ million	**2008-09**	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**
Total expenditure on benefits	-£5,981	-£6,733	-£7,190	-£8,026	-£8,005	-£8,388
Employee contributions	£2,054	£2,106	£2,099	£1,970	£1,917	£1,962
Employer contributions	£5,809	£6,180	£6,378	£6,349	£6,181	£6,485
Core net cashflow	£1,882	£1,553	£1,287	£293	£93	£59
Investment income (gross)	£2,999	£2,690	£2,827	£3,191	£3,142	£3,338
Net transfers and other	-£288	-£412	-£404	-£309	-£444	-£463
Total net cashflow	£4,593	£3,831	£3,710	£3,175	£2,791	£2,934
Market value of funds, eoy	£103,418	£140,502	£152,012	£157,340	£178,193	£189,409
Total net cashflow/ market value	4.4%	2.7%	2.4%	2.0%	1.6%	1.5%

Source: DCLG; LGPS Funds England, Wales, 2013-14, Statistical Release, 29 October 2014 inter-generational injustice as funds demand ever more cash from today's workers to meet pension payments.

In 2012-2013, 30 of England and Wales' 89 funds experienced negative core cashflow (i.e. contributions less pensions in payment). They are generally the smaller funds (median assets of £867 million, versus £1,486 million for the cashflow positive funds): another endorsement of the virtues of scale.[12] Core cashflow is dwindling rapidly, primarily because of falling membership, and the funds are increasingly reliant upon investment income to make up cashflow shortfalls; Table 2.

Over the last six years, the total net cashflow surplus has fallen by 36%, and as a percentage of asset market value, it is down 66%: the direction of travel is clear. It is no surprise that investment sub-committee agendas and meeting minutes are increasingly flagging pending cashflow crises.

Some funds are responding by increasing their asset allocation to higher yielding, but less liquid, alternative assets, which incur much higher charges and dealing costs than conventional assets. There is no independent evidence to suggest that these funds will benefit over the long term; the only sure "winners" are the legions of intermediaries, including investment consultants, who thrive on asset churn.

Unfortunately, the LGPS funds do not publish cashflow projections, but Table 3 provides a hint as to the future: the net aggregated cashflow of all of the public sector's unfunded schemes.

Eight years ago, pensions in payment were almost entirely met by contributions (from employers and employees), but a £10.4 billion shortfall is expected this year, rising to nearly £15 billion in four years' time. This cashflow gap has to be plugged by the Treasury, i.e. taxpayers.

As for LGPS funds with cashflow issues, asset sales could initially plug the gap, but deficits would then increase, exacerbating the cashflow problem. As discussed in previous papers, a death spiral would then ensue, leading to fund collapse.[13] Indeed, some funds (Brent, Havering, Waltham Forest) may already be beyond the point of no return. This is partly the result of dismally incompetent governance.

3. LGPS GOVERNANCE

3.1 The current arrangement: complex and ineffective

The LGPS's financial health is currently in the hands of a disparate tripartite of decision makers: central government, which sets the

12 *Performance analysis of LPS funds, 2001-2013*; Patrick Moran, Department of Economics, University of Oxford.

13 See *The Local Government Pension Scheme: opportunity knocks*, Michael Johnson, CPS, 2013.

Table 3: PUBLIC SERVICE UNFUNDED PENSION SCHEMES: CASHFLOW DEFICIT

£ billion	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Outturn	£0.2	£1.1	£2.2	£3.1	£4.7	£5.6	£8.0	£10.2

	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
OBR forecast	£10.5	£10.4	£11.7	£12.7	£13.8	£14.9

Source: HMT Budget documents and OBR; Economic and Fiscal Outlook, Table 4.24, March 2014.

rules governing the funds, and the level of benefits; local government Administering Authorities, via their s101 Pension Committees (often lacking the necessary skills and experience), responsible for the funding strategy and investment performance; and employers, who set wages. Consequently, there are three different parties involved in managing the three key drivers of pension fund cost (benefits, asset performance and wages). Today's arrangement bears all the hallmarks of the now-defunct pre-crisis oversight of the banks by the Bank of England, FSA and Treasury. It is perhaps no surprise that the LGPS is in such trouble.

3.2 Responsibility without accountability

Operation of the LGPS is characterised by a marked absence of clear accountability. Given the parlous state of some of the LGPS funds, it is remarkable that no Section 151 officer has been held to account. Are they not complicit in accepting years of overpromising and underfunding, facilitated by consultants' unrealistic assumptions for expected investment returns and longevity, and excessively accommodating (i.e. high) discount rates? Local accountability would appear to be non-existent, undermining the case for "localism", which remains a source of ideological confusion. Harnessing economies of scale to improve operational efficiency, for example, requires centralisation, which is at odds with a localism agenda.

3.3 Pension Committees: ridiculous excess

The LGPS's Pension Committees have approximately 1,000 members between them.[14] And this is before the creation of a new Pensions Board for each LGPS fund (see section 3.8). In addition, today's Shadow Advisory Board and its sub-committees have a total of some 95 members. All this for what is, ultimately, just one, albeit large, public service pensions scheme.

New York City's public service pension arrangements share some similarities with the LGPS. The city sponsors five separate schemes rather than one, resulting in five separate boards, 15 consultants, 58 trustees, and over 360 asset managers. As the first deputy comptroller once observed, *it is tough to tell who has accountability and authority*. Quite so.

In stark contrast, the Universities Superannuation Scheme (USS), another large DB, multi-employer scheme, has a single governance committee with eight members. Internationally, there are many examples of funded DB public service schemes. Canada, for example, has three large schemes (HOOPP, OMERS and OTPP, with combined assets of C$258 billion, £147 billion).[15] Their governance committees comprise of 18, five and nine members, respectively.

3.4 Opacity due to a reporting blizzard

The USS' latest annual report has 120 pages, and the three big Canadian schemes' average 122 pages. Between them, the 2013 annual reports of the 89 LGPS funds in England & Wales have 8,186 pages. In addition, their Communications Policy, Funding Strategy and Governance Compliance Statements, plus their Statement of Investment Principles, come to

[14] The 2013 annual report for the combined 89 England and Wales funds states that an average governance committee membership of "about 10"; then add the 11 Scottish funds plus Northern Ireland.

[15] Ontario Teachers' Pension Plan (OTPP), Healthcare of Ontario Pension Plan (HOOPP) and Ontario Municipal Employees Retirement System (OMERS). Assets as of end-2103.

another 4,670 pages,[16] and their 2013 valuation reports total another 3,769 pages.[17] A total of 16,625 pages. All for one occupational pension scheme (and this *excludes* the 12 funds in Scotland and Northern Ireland). This is bureaucratic madness, at a substantial cost. And perhaps worst of all, the reporting avalanche does not provide transparency. A simple example: one fund's 2013 annual report shows a single investment of £250 million (17% of total assets) yet, within its 102 pages, there is no clue as to what the asset is.

3.5 Dismal data quality[18]

What gets measured gets managed. Much of the annual reports' data is sourced from the SF3 returns provided by each fund to the DCLG, but some of it is of such dubious quality as to be nigh useless for the purpose of informing rational debate. Meanwhile, the Pension Committees continue to blandly accept data of appalling quality, a problem which has persisted for decades. Such insouciance suggests a lack of curiosity, determination, financial acumen and understanding of their governance role, which is to safeguard the interests of members and taxpayers.

For 2012-13, the 89 funds reported a total fund management cost of £409 million, i.e. 23 basis points when measured against total assets of £178 billion (and, for 2013-14, £494 million, 26 basis points and £189 billion, respectively). This is a ludicrously low figure given the complexity of many of their investments. An analysis by Hymans Robertson, actuarial consultants, put the asset management cost at 44 basis points for 2012-13, while also pointing out that their figure *excluded* performance fees on alternative assets and turnover costs.[19] In an earlier report, Hymans put the total figure at 63.5 bps.[20] In addition, the lack of standardisation, both in funds' reporting format and in their actuarial valuations (methodology and underlying assumptions), only serve to confuse. Once all the implicit costs are taken into account (such as the trading costs, currently unreported), the true figure may well be over 100 basis points (1%). This would be consistent with a recent observation from Railway Pension Investments ("Railpen", a £20 billion pension fund), that the headline fees they were given by their asset managers with around one fifth of the true total cost.

3.6 Uncontrolled costs

Table 4 shows the recent evolution of LGPS costs, as reported by the individual funds to DCLG. The 46% increase in fund management

16 Scaled up, based upon the 31 funds that link these documents to the LGPS Advisory Board website.

17 Scaled up, based upon the 86 funds (out of 89) that make their valuation reports publicly available. The three funds that have not done so are Bromley, Croydon and Swansea.

18 For more detail, see *The Local Government Pension Scheme (LGPS): opportunity knocks*; Michael Johnson, CPS, 2013.

19 Hymans Robertson; *LGPS structure analysis*, December 2013.

20 *Investment management costs in the LGPS: global benchmarking study*, Hymans Robertson, September 2013.

Table 4: LGPS COSTS PER SCHEME MEMBER (ENGLAND AND WALES)

	2009-10	2010-11	2011-12	2012-13	2013-14	5 year change
Administration	£28.3	£30.2	£28.0	£27.2	£26.8	-5.3%
Fund management	£68.4	£76.9	£84.1	£87.2	£99.9	46.1%
Total costs, psm	**£96.3**	**£107.1**	**£112.1**	**£114.4**	**£126.7**	**31.5%**

costs, over the last five years, evidences a marked absence of effective governance. It also reinforces the case for the DCLG's May 2014 proposals to centralise asset procurement, embrace passive management for all listed assets, and to exit all funds of funds (discussed in section 5).[21]

This aggregated data masks some dramatic recent changes in the costs of individual funds, driven by asset management, rather than administration, costs; see Table 5.

The dramatic variety in individual funds' costs could partly reflect differences in how they are reported, but the funds' annual reports are largely silent on the underlying causes of the year to year change. The huge cost increases need explanation, and it would also be useful to know how the large cost reductions were achieved, not least so that funds could learn from one another. The Appendix contains the administration, investment and total costs for each of the LGPS funds, ranked by cost per member.

[21] DCLG; *Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies*, May 2014.

3.7 Governance today: conclusion

Decades of lax governance has facilitated high operating costs to continue to compound, stealthily and iniquitously eroding capital. For a nation that is supposedly a leading provider of financial services, and given the scale of the LGPS, it is a national embarrassment.

3.8 DCLG's proposed framework

DCLG has recognised the need to reform the governance of the LGPS, and has proposed the framework illustrated in Figure 1.

The key components are, at national level:

(i) a new Scheme Advisory Board (SAB) to advise DCLG's Secretary of State on any desirable changes to the scheme, including cost management initiatives. Consequently, once established, the SAB will have oversight of the whole LGPS. The current Shadow Advisory Board has an interim chair, 12 representatives, 5 advisors and 3 observers;

(ii) five SAB sub-committees: Administration and Communications (16 members), Cost Management and Contributions (17), Governance and Standards (14); Investment and Engagement (15) and

Table 5: TOTAL LGPS FUND COSTS PER MEMBER

Rank	LGPS fund	Total costs per member 2012-13	Total costs per member 2013-14	Change in cost
1	Lincolnshire	£103.4	£71.1	-31.2%
2	Northamptonshire	£147.2	£102.5	-30.4%
3	Lewisham	£139.8	£104.6	-25.2%
4	Sutton	£187.6	£140.8	-24.9%
5	Cornwall	£103.5	£83.9	-18.9%
85	Gloucestershire	£95.2	£139.9	47.0%
86	Croydon	£115.1	£172.1	49.5%
87	Isle of Wight UA	£121.7	£189.9	56.0%
88	Swansea UA	221.9	£348.3	57.0%
89	Hammersmith & Fulham	240.7	£389.7	61.9%

Value for Money and Collaboration (13), a total of 75 members; and, at local fund level, replicated 89 times (in England and Wales):

(iii) Scheme Managers (the Administering Authorities);

(iv) s101 Pension Committees and their Investment Sub-Committees, long-established by the Local Government Act 1972 (Section 101 concerns local authorities' powers of delegation to discharge their responsibilities);

(v) new advisory Pension Boards, spawned by the Public Service Pensions Act 2013, tasked with "assisting" the Scheme Manager to comply with regulations and guidance; and

(vi) s151 officers, responsible for the proper administration of the local authority's financial affairs (so called after Section 151 of the Local Government Act 1972).

In parallel, in future the LGPS will have to comply with The Pensions Regulator's (TPR) codes of practice on governance and administration, currently in consultation.

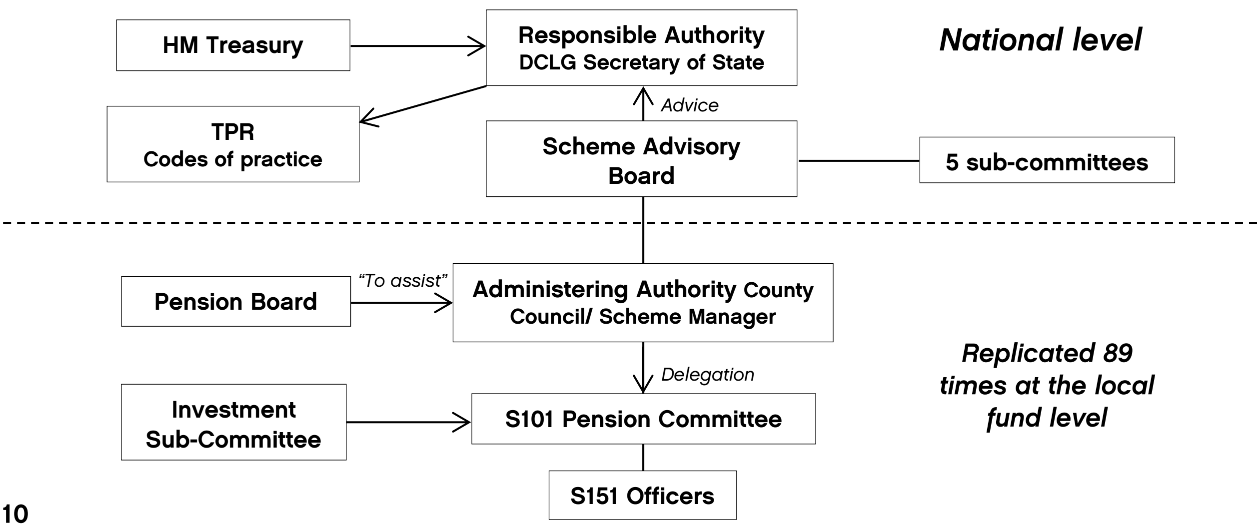
3.9 What price localism?

The introduction of 89 new Pension Boards to an already complex, failing, arrangement risks a governance framework that resembles a dysfunctional dystopian fantasy. This is the consequence of political considerations masquerading under the banner of "localism". Why is local accountability deemed so important, when only some 15% of an LGPS fund's income comes from local taxation, and s151 officers are never held to account?[22]

Many people have questioned the Pension Boards' purpose: what could they deliver that up-graded (i.e. more professional) s101 Pension Committees could not? The result will be an even more complex, multi-layered, unjustifiable nonsense, lacking in role definition and clear accountability. To be fair to DCLG, they may have anticipated this, and Section 5 of the Public Service Pensions Act 2013 does permit Board and Committee mergers, notwithstanding the potential for conflict in

[22] Roughly 66% of LGPS income comes from contributions, and only 22% of councils' income comes from local taxation. 66% x 22% = 15%. *DCLG; Local Authority Revenue Expenditure and Financing: 2014-15 Budget, England (revised)*, ONS, 22 October 2014.

Figure 1: GOVERNANCE: DCLG'S PROPOSED FRAMEWORK



primary legislation that pitches Section 102 (appointment of committees) of the Local Government Act 1972 against the Public Service Pensions Act 2013. That aside, Pension Boards are unlikely to help the Government meet its three objectives: to improve the LGPS's efficiency and effectiveness, and sustainability. In addition, it is unclear how Administering Authorities will ensure that they hold the balance of power over the Pension Boards. DCLG's proposed Pension Boards are an extravagant nonsense.

4. THE SPONSOR'S COVENANT

4.1 Looking ahead

The LGPS's ageing population ensures that, one day, someone will have to rescue one or more of the individual LGPS funds. The question is who? Ostensibly, the ultimate responsibility for meeting pensions in payment resides with the Administering Authorities, but they are hampered by council tax freezes and adverse public opinion. The latter is fuelled by the observation that LGPS employees will continue to enjoy certainty of income in retirement until they die, largely paid for by private sector workers who enjoy no such certainty. Consequently, requiring council taxpayers to plug the forthcoming cashflow deficits, at the expense of local services, is unlikely to be politically implementable.

In practice, the Treasury is the ultimate underwriter of the LGPS's liabilities, although there is no legal requirement for it to be so. Consequently, from the Treasury's perspective, it is exposed to the liabilities of each individual LGPS fund, albeit that today they are reported separately at huge operational cost. It is ridiculous to fragment the LGPS's membership necessitating, for example, actuarial assessments of the longevity profile of each individual fund's membership, rather than the LGPS as a whole. It is time to socialise the liabilities across the *whole* of the LGPS's membership, but how?

4.2 Crown guarantee?

Perhaps the most simple approach would be for the Treasury to provide a Crown guarantee in respect of LGPS liabilities. There would then be no further need to ring-fence each fund's liabilities, which would be centralised within the Treasury, i.e. away from Administering Authorities. This would certainly put an end to any last vestige of justification for "localism", and DCLG would then be in a position to pursue a radical simplification of the LGPS's structure, and with that, value for money for taxpayers.

The Treasury, however, would most likely baulk at assuming, so explicitly, the allied risks (notwithstanding the substance), and there would also be adverse implications for the National Accounts (which would have to incorporate the LGPS's liabilities). In addition, we should avoid providing the Treasury with an opportunity to move the LGPS onto a pay-as-you-basis (as most public service pensions are), taking the LGPS's assets in-house (perhaps to kick-start a sovereign wealth fund?). An alternative approach is required.

5. STRUCTURAL SIMPLIFICATION

5.1 Recent proposals for procurement

In May 2014, DCLG published a consultation document outlining proposals to make substantial cost savings by simplifying, through centralisation, the procurement of investment management services for the LGPS funds.[23] This exhibition of leadership very sensibly

[23] See DCLG; *Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies*, May 2014, and Hymans Robertson; *LGPS structure analysis*, December 2013.

proposes to move all listed assets onto a passive basis of fund management, and to end the use of "fund of funds" arrangements for unlisted (i.e. alternative) assets, including hedge funds, infrastructure and private equity. DCLG has proposed that two collective investment vehicles (CIVs) be established for this purpose.

The outcome of the consultation is yet to be made public but, irrespective of the feedback, the proposals lack ambition for the LGPS, its members and taxpayers: the focus is much too narrow.

5.2 A single fund

(a) Scale matters

The DCLG's proposal to establish two CIVs is an important *first step* towards structural simplification of the LGPS, but to then leave asset allocation decisions with today's disparate shoal of 89 predominately sub-scale funds, with all of the allied operational replication and expense, does not advance the interests of members, nor taxpayers. The merits of a single fund for the LGPS have been widely discussed elsewhere, notably improved returns for a given risk appetite, and an ability to harness economies of scale.[24] There is incontrovertible evidence that scale matters to pension funds, and while increased scale may not guarantee improved investment performance, it would help squeeze out the industry's profitable inefficiencies, reducing unit costs per member.

(b) An exemplar with global clout

Today's structure also represents a missed opportunity for the UK to project some soft power. As currently configured, the LGPS is nigh invisible in the global ranking of pension funds, care of its disassembled local fund structure. Combined, the 101 LGPS funds (including Scotland's 11 funds and one for Northern Ireland) comprise the UK's largest pool of assets, some £220 billion. A single (asset allocating) fund, called the Local Government Investment Fund (LGIF), say, could wield global influence. By size, it would rank sixth amongst pension funds, well ahead of the California Public Employees' Retirement System (CalPERS), nearly double the size of Singapore's Central Provident Fund and more than three times the size of the three Canadian funds.[25] It would also appear amongst the largest eight sovereign wealth funds, ahead of globally recognised funds such as the Government of Singapore Investment Corporation (GSIC), the Qatar Investment Authority and the Abu Dhabi Investment Council.

Proposal 1: The LGPS's 89 disparate funds should be restructured as a single fund, the Local Government Investment Fund (LGIF).

The LGIF should aspire to being an expert client of the market, rather than merely a customer of the financial services industry, pressurising the industry to address its high charges and commissions, and lack of transparency. It should act as an exemplar to the UK's private sector pension funds, almost all of which are sub-scale and inefficient, and could become a global influence on how capital markets function (as CalPERS, Australia's Future Fund, Ontario Teachers, Temasek, and others, are today).

24 See, for example, *The Local Government Pension Scheme: opportunity knocks*, section 4.4, *Scale matters*, Michael Johnson, CPS, November 2013.

25 Towers Watson; *Pensions & Investments / Towers Watson 300 analysis, year-end 2013*, September 2104.

(c) Practical considerations

There are, however, some practical issues to running a single (giant) fund, including:

(i) portfolio inflexibility. A 1% asset reallocation, for example, would require the sale and purchase of over £2 billion of assets which, outside of the major equity and government bond markets, is difficult to execute quickly, quietly and efficiently, i.e. without an adverse market impact. It would also have a *de minimis* impact on total fund returns;

(ii) a reduction in the range of investible funds. Small funds and mid-cap stocks, for example, may not warrant the necessary due diligence, because even a modest investment, for a super-fund, could represent too large a slice of the recipient fund. In addition, mandate sizes could be so large as to swamp an investment strategy;

(iii) a lack of competition from service providers: a single super-fund could prompt some providers to drop away;

(iv) cultural issues within a super-fund. Individuals could become too powerful (key man risk), and the fund itself could become an overly-dominant market participant, harbouring an unchallenged closed culture; and

(v) the risk of government intervention, perhaps in respect of asset allocation.

Consequently, perhaps the ideal would be to be able to portray the LGIF as a single giant fund, but for it to be internally structured so as to overcome the aforementioned operational drawbacks.

5.3 Four competing asset allocators

The LGIF could be structured as four competing asset allocators, each receiving 25% of all LGPS contributions, and each being responsible for meeting 25% of pension payments. Any excess of contributions over payments would be retained by the allocator, and any shortfall would be a loss to the allocator. A multi-allocator approach would not be unique: it has, for example, been well tested within Sweden's national (state) pension system.[26]

The benefits of installing four allocators within the LGIF, rather than one, include:

(i) fostering competition between the allocators, to spur them to reduce costs and improve performance, ideally resulting in better risk-adjusted returns than a single giant fund;

(ii) providing diversification, of management (i.e. people) risks, investment approach and asset allocation;

(iii) allaying fears that one giant fund would become too dominant an investor, with adverse consequences for the market (and the fund itself); and, crucially

(iv) reducing the scope for political interference, in what would otherwise be a single asset-allocating fund.

The four LGIF allocators, each with more than £50 billion in assets, would be large enough to afford significant internal investment

[26] Sweden's AP Funds currently comprise four competing funds (AP1, 2, 3, and 4, with combined assets of some £99 billion, end-2013), plus a much smaller fifth fund (AP6), for domestic private equity. There are proposals to consolidate the five funds into three (although the review board recommended consolidation into a single fund, an option which the government has rejected).

management and research capabilities, compensated at private sector rates. Ideally, the allocators would not all be located in London.

The allocators would select their assets from DCLG's two CIVs, which would transact with the markets on a "net" basis. Thus, if any two allocators wanted to execute opposite trades (i.e. one a buyer, the other a seller of the same asset), the asset would merely be reallocated: no market transactions would be required (saving costs).

> **Proposal 2:** The LGIF should comprise of four competing asset allocators. Each would receive 25% of contributions and be responsible for meeting 25% of pensions in payment. Interaction with the market would be via DCLG's two proposed Collective Investment Vehicles.

A single administrator should connect, and serve, the LGIF's four allocators, the two CIVs, the contributing employers and the whole membership, thereby substantially cutting costs; see Figure 2. Today, the individual LGPS funds report administration costs per member that are far higher than those paid by other (non-UK) large funded public service pension schemes.

> **Proposal 3:** A single administrator should connect, and serve, the LGIF's four allocators, the two CIVs, the contributing employers and the whole membership, thereby substantially cutting costs.

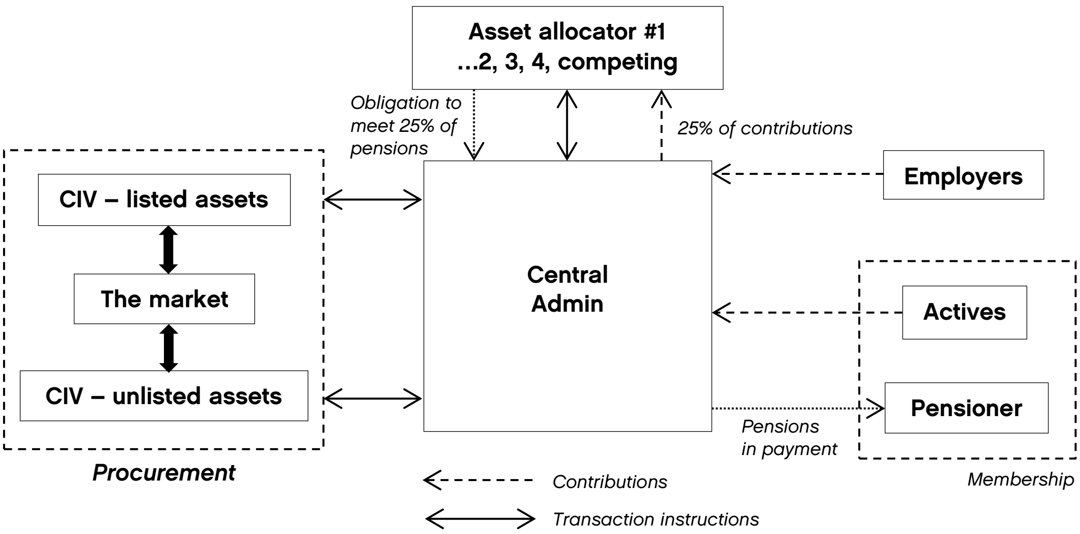
5.4 Take all asset management in-house

(a) End the leakage of value

Fund size in itself is not the only recipe for good performance. There is mounting evidence that structure matters too and that, over the long term, internal (i.e. in-house) management is the most successful structure.[27] Establishing the two CIVs as market-interfacing procurement vehicles should be viewed by DCLG as merely an interim step. Eventually, the LGPS should aspire to conducting all asset management in-house, thereby minimising the scope for value leakage away from members and taxpayers, notably in respect of alternative assets' performance fees.

[27] See, for example, *Do larger funds perform better?;* State Street Investment Analytics, September 2013.

Figure 2: FOUR ALLOCATORS SERVED BY TWO CIVS AND ONE ADMINISTRATOR



Such a move would be very much in step with pension schemes globally. More than 80% of schemes plan to bring more asset management responsibilities in-house, a trend that is being driven by cost concerns: in 2012, the world's largest pension funds spent an average 0.46% on external managers, compared to 0.08% on internal investment capabilities.[28] In addition, there is a growing concern that it is actually very difficult to ensure that a pension scheme's interests are aligned with those of the external managers.[29]

(b) The benefits of in-house management

Given the LGPS's overall size, there are several significant advantages to in-house management, in addition to retaining performance fees, including:

(i) opportunities to harness economies of scale, leading to reduced running costs, and hence improved performance for a given risk appetite;

(ii) an ability to afford *top quality* in-house expertise, to become a centre of excellence (for investment in housing and infrastructure, for example), as well as external advice; and

(iii) improved access to both co-investment opportunities and a wider range of asset classes, geographies and asset maturities.

(c) Start with the unlisted assets

The initial focus should be on the unlisted "alternative" asset classes. The LGPS's exposure to private equity, for example, is relatively small as a percentage of total assets (5%), but it leaks to external managers at least £250 million every year in charges and performance fees ("carried interest"). The experience of other public sector pension funds is similar; the Dutch PFZW, for example, paid more than €400 million (£330 million) to private-equity firms in 2013. This is some 50% of all fees paid, yet private equity accounted for only 6% of the assets.

The LGPS's hedge fund investments are likely to be similarly unrewarding, when compared to the risk. PMT, the Dutch pension fund with €56 billion under management, has recently decided to liquidate its entire (externally managed) €1 billion hedge fund portfolio. While only some 2% of assets, the portfolio accounted for 32% of all investment fees: the logic is clear. Costs are controllable whereas, broadly, investment performance is not.

> **Proposal 4:** The LGPS should initiate plans to take all asset management in-house, starting with unlisted assets (notably private equity and hedge funds).

Over time, the role of the two CIVs should evolve from pure procurement of third party asset management services (on behalf of the allocators) to being highly skilled asset managers. Models for in-house management of alternative assets include Canada's public sector OTPP scheme, which has a freestanding private equity operation, Teachers' Private Capital. Now one of the world's largest pools of private equity capital, it is also considered to be one of the most sophisticated.

5.5 No more consultants

Given its scale, the LGPS should have no need for consultants. They emasculate full time employees, create on-going reliance because knowledge is not fully transferred, they are

[28] CEM Benchmarking.

[29] Joint survey of DB and DC schemes by the Economist Intelligence Unit and State Street Corporation; *Pensions Funds DIY: A Hands-On Future for Asset Owners*, November 2014.

expensive, and are rarely, if ever, held to account. Certainly, to the extent that consultants are ever needed, their fees should be linked to post-project cost savings. Sometimes the use of consultants is, in reality, an admission of failure by management, perhaps in respect of managing employee relations (it is easier to command a consultant than one's own employees). They can also be used to abdicate managerial responsibility or as a mechanism to find a way round an internal blockage: the use of consultants raises questions about the leadership and hints at a culture of fear that may hinder taking responsibility for making decisions.

More specifically, concerning investment consultants, Section 36 of Pensions Act 1995 requires trustees, before investing, *to obtain and consider proper advice on the question of whether the investment is satisfactory*. Consequently, the UK is the only country where use of an investment consultant is compulsory: this is ridiculous, and hardly encourages trustees to assume responsibility: blame the consultant!

The Government is currently considering the regulation of pension consultants, as part of its update on the Kay Review, which aims to tackle short-termism in UK equity markets. But the LGPS should side-step the high cost of consultants (and their potential conflicts of interest) by becoming self-reliant.

Proposal 5: Section 36 of Pensions Act 1995, requiring trustees, before investing, to obtain and consider proper advice, should be scrapped. The LGPS should then develop all the necessary skills within its two CIVs, doing without investment consultants, in particular.

6. RISK MITIGATION

6.1 Socialisation of the liabilities

Replacing today's 89 individual funds with a single fund, the LGIF, would significantly reduce the risks to which scheme members, employers and tax payers are currently exposed. The LGIF would be responsible for meeting all pensions in payment: a full socialisation of the liabilities across the *whole* of the LGPS, secured on all of the assets.

Thus, the actuarial (i.e. valuation), cashflow and investment risks faced today by individual LGPS funds would be smoothed across all employers and employees, akin to volatility dampening (volatility being a proxy for risk). Consider cashflow: 30 of the 89 funds in England and Wales experienced negative cashflow in 2012-13, but aggregate total cashflow was a positive £271 million that year. And if pensioners were included in risk sharing (discussed in section 8), the risks would be even more dissipated, across the whole LGPS membership.

6.2 The allocators: cashflow buffering

The LGPS is essentially a pay-as-you-go (PAYG) pension scheme. Last year, expenditure on benefits (£8.39 billion) almost equally contributions received (£8.45 billion). Thus, *in aggregate*, the £2.9 billion cashflow from investments (less net transfers) was not needed, although some *individual* funds are already dependent upon it to help meet pensions in payment. Ultimately, this is likely to send some of those funds into a death spiral, as they consume assets simply to pay pensions. In addition, the LGPS's aggregate cashflow is deteriorating rapidly (Table 2).

The four allocators within the LGIF would act as cashflow buffers, their investment incomes netting out one another's cashflow surpluses and deficits which arise whenever their contributions deviated from pensions in payment. The four allocators *are*, collectively, the LGIF, each acting as a demographic and economic risk buffer, available to assist the others when necessary.[30] This structure would, at the very least, long delay the day that additional contributions may be required, either from employees and employers, or directly from taxpayers (either locally or nationally, via the Treasury).

6.3 A second line of defence: the PPF

The quality of private sector occupational schemes' sponsors is underpinned by their membership of the Pension Protection Fund (PPF). Given the ambiguity as to where, *in practice*, ultimate responsibility for meeting LGPS liabilities rests (the quality of an individual Administration Authority's covenant is unclear, section 4), perhaps the LGPS should join the PPF?

Unfortunately, as the LGPS is a public sector scheme made under statute, pursuant to legislation, it is ineligible to join the PPF: regulatory change would be required. Putting that challenge to one side, the LGPS could be moved onto a "last employer standing" basis (akin to the USS). It would only become eligible to enter the PPF in the extremely unlikely event that the majority of the scheme's employers were to become insolvent. At the very least, the PPF could be asked to price up the levy it would charge for LGPS membership, and also to make suggestions as to how best the LGPS could be structured to minimise the levy.

Proposal 6: The LGPS should consider joining the Pension Protection Fund (which would require change to the LGPS's legal status). In any event, it should request a levy quotation.

There are two other important strands to risk mitigation: good governance and an effective cost control mechanism.

7. GOVERNANCE

Today's convoluted and fragmented governance framework should be demised and, with the advent of single fund, the LGIF, there would be no need for DCLG's proposed Pension Boards to materialise.

7.1 A trust to own the assets

The LGPS is one pension scheme for one group of workers, but today it has 89 funds all attempting to perform the same task: to pay pensions. Responsibility for meeting this one task should fall to one principal, a trust, which would be the ultimate asset owner through a sole beneficial interest in the LGIF.[31] The trust's beneficiaries would be the LGPS membership.

Proposal 7: Responsibility for paying pensions should fall to a trust, secured on a beneficial interest in the LGIF's assets. The trust's beneficiaries would be the LGPS's membership.

7.2 A governing board of trustees

The trust should be overseen by a governing board of trustees, accountable to the LGPS membership. Trustees should be subject to duties connected to the exercise of power, duties of care and fiduciary duties (detailed in the trust deed). The board should be

[30] If, for example, one allocator were unable to meet its 25% share of pensions in payment, perhaps due to asset underperformance, a mechanism would be required to ensure that the gap were plugged by the other three allocators.

[31] Today, the legal owner of each LGPS fund's assets is its Administering Authority: the LGPS's regulations would have to be rewritten.

autonomous from DCLG and the Treasury, albeit that the Secretary of State (or an appointed deputy) should have a seat on the board. The board's objectives should be clear and easily verifiable, notably to ensure that the LGIF can meet its pensions obligations, thereby maintaining the self-sufficiency, and hence sustainability, of the LGPS.

All board members would be required to evidence competence and impartiality (ideally, none should be members of the LGPS). The appointments process should be free of political interference, and board members should embrace:

(i) the seven Nolan Principles (the basis of the ethical standards expected of public office holders);[32] and

(ii) the Myners' Principles, to improve trustees' decision-making in respect of investment and governance.[33]

The board, acting on behalf of the trust, would sub-contract asset management to the four allocators (collectively, the LGIF) and be tasked with ensuring that they operated independently of any political constraints. It should be free to establish a reference portfolio to be used as a benchmark for performance, and perhaps provide some nudges in respect of investment time horizon, risk appetite and maybe some guidelines in respect of infrastructure investments (including housing).

Crucially, the board's responsibilities should include oversight of the cost control mechanism. Consequently, it would need the support of a technical team that produced regular reports on the LGIF's cashflow.

Proposal 8: The trust should have a politically independent governing board of trustees, which would have oversight of the LGIF's cost control mechanism.

7.3 Transparency

The board's meetings should be held publicly (and webcast), with all minutes put into the public domain (barring issues of confidentiality), a practice adopted by CalPERS, amongst others. The LGIF's annual report should comply with the principles of integrated reporting (and perhaps be subject to National Audit Office inspection) and include an assessment of past performance, a forward looking report on strategy and the management of key risks, and a cashflow analysis, including a forecast. At the AGM, employer, member and Treasury representatives should have an opportunity to quiz the board.

8. COST CONTROL

8.1 The Treasury's proposals: complexity to the fore

The Treasury's proposals for an employer cost control mechanism (to protect taxpayers) have yet to be finalised. Outline proposals have been circulating for years: they are extremely complex, which is an early warning flag as to their likely effectiveness.[34] This complexity is

32 The Nolan Principles: selflessness, integrity, objectivity, accountability, openness, honesty and leadership.

33 The six Myners' Principles concern effective decision-making, clear objectives, risk and liabilities, performance assessment, responsible ownership and transparency and reporting.

34 The first HM Treasury document discussing the cost cap is *Public Service Pensions: good pensions that last*, November 2011. Section 12 of the Public Service Pensions Act 2013 requires schemes to set a rate, expressed as a percentage of pensionable earnings, to be used for the purposes of measuring changes in the cost of the scheme: the employer cost cap.

evidenced by the (ongoing) chain of correspondence between the Treasury's Director of Public Spending and the Government Actuary, concerning the need for technical changes to the Directions.[35]

Cost control is intended to operate at both a national and a local level.[36] The former has its origins in the Treasury's cost control proposals for the public service's unfunded schemes, but these do not readily lend themselves to the LGPS's peculiarity, its funded status. The local layer is intended to take this into account, operating in parallel with the national controls.

(a) Cost control at national level

The Treasury has proposed a statutory target employer cost cap to control the future costs of the benefits being accrued, not the cost of paying today's pensions. It will be set as a percentage of pensionable pay (as yet unspecified for the LGPS), based upon the valuation of a model fund. A valuation-based change of 2% or more from the target (above or below, i.e. a cost corridor) is intended to trigger adjustments to future benefit accruals or member contributions, affecting *all* LGPS employees. If agreement could not be reached, a default adjustment (likely to be a change in the accrual rate) would be applied. But there are, as yet, no published details for this.

(b) Local cost control

At local fund level, a mechanism is being put in place that is intended to provide greater control over the contribution rates paid by employers (i.e. taxpayers, ultimately). Run by the Scheme Advisory Board (SAB), it will target an employer contribution rate of 13% of pensionable pay, measured against valuations provided by a second model fund that may use different assumptions to those used in the national cost cap's model. Consequently, this second layer of cost control could result in changes being made to benefits or employee contributions that are incompatible with the national mechanism. The latter, however, will take precedence, although should the 2% corridor not be breached, the SAB can still propose scheme amendments to DCLG (based upon their own cost control process).

(c) Inconsistent policy intentions

The Treasury intends that the LGPS's cost cap will operate in the same way for all public service schemes. Consequently, the national level valuation model for the LGPS will use the same discount rate as that being used in respect of the unfunded schemes. Notwithstanding the question as to whether this (technical detail) is appropriate, the mere existence of a local cost control mechanism for the LGPS is inconsistent with the Treasury's intention. The resulting additional complexity is another part of the price of localism. It also potentially pitches the Government Actuary, who will have oversight of the national mechanism, against the SAB which controls the local mechanism. That aside, there are some readily apparent, fundamental flaws in what is staggeringly complicated procedure.

8.2 The proposed mechanism: impotent for at least a decade

From a taxpayer's perspective, the combined national and local cost cap mechanism is totally unsatisfactory because it leaves huge scope for cost leakage. The mechanism excludes:

[35] See https://www.gov.uk/government/publications/public-service-pensions-actuarial-valuations-and-the-employer-cost-cap-mechanism-supplementary-documents

[36] The author is grateful to staff at HM Treasury for their assistance in helping him understand the proposed cost cap mechanism.

(i) the future service pension costs associated with all employees who enjoy transitional protection, i.e. all those who were within ten years of Normal Pension Age (NPA) on 1st April 2012 (plus some within 14 years). They will not experience any change in their (pre-reform) pension expectations. Thus, a significant cohort of active members (roughly 18%) will continue to accrue benefits on a final salary-basis, and retire earlier than their younger colleagues.[37] In addition, this fortunate group is likely to be amongst the LGPS's highest paid employees. Although some are now paying higher contributions (post-Hutton), these are substantially below the value of the on-going final salary-based accruals;

(ii) any additional costs arising in respect of deferred and pensioner members' past service liabilities in the pre-reform scheme.[38] Thus, the cap excludes costs resulting from improvements in life expectancy, for example, of some 63% of the total membership of the pre-reform scheme;[39]

(iii) the additional costs of paying down any scheme deficits which have arisen since the previous valuations. The initial level of the cap will be based on only the future service costs of the CARE schemes;

(iv) the additional State Pension rights that public service employees will accrue following the introduction of the new single-tier State Pension in 2016;[40] and

(v) additional costs arising from technical or financial changes (such as a fund valuation discount rate or actuarial methodology). Thus, only member-related, costs are included in the cap, such as revisions to life expectancy and future salary growth (and only in respect of the revised scheme). Given that fund valuations influence employer (i.e. taxpayer-funded) contributions, this leaves further scope for cost leakage.

Taken in aggregate, there are so many exclusions from the cost cap mechanism that they vaporise the prospect, for at least the next decade, of exerting any significant control on the LGPS's burgeoning costs.[41] Thereafter, there will be material savings, principally powered by Lord Hutton's proposal to link the retirement age to the retreating State Pension Age. The risk is that these savings will come far too late to assuage pressure for further reform, the public's opprobrium being fuelled as much by unfairness as unaffordability.

Meanwhile, in particular, the ten year transitional protection concession to the unions ("grandfathering") will prove very expensive, part of the price of closing the (post-Hutton review) deal. At the very least, the price will be paid by

37 Based upon 2013 data, this is some 303,000 of the 1.71 million active members.

38 Such reformed scheme costs are included in the cap.

39 The employer cost cap for the LGPS in England and Wales will be set with reference to the 2013 model fund valuation, to be based on data from the 2013 fund valuations. LGPS membership at end-March 2013 comprised of 1.71 million contributors, 1.60 million deferred and 1.37 million pensioners: a total of 4.68 million (*source*: SF3 data).

40 This is more fully explained in *A toxic tangle: the Public Service Pensions Bill and the DWP's White Paper*, Michael Johnson, CPS, 2013.

41 Danny Alexander MP, Chief Secretary to the Treasury, made a statement to the House of Commons concerning Lord Hutton's reforms. "*Anyone ten years or less from retirement age on 1 April 2012 are assured that there will be no detriment to their retirement income*" (2nd November 2011).

those who were not at the negotiating table, notably younger workers (extending the on-going perpetration of inter-generational injustice) and taxpayers.

The full operational details of both the national and local cost controls (including the sequencing between the two) have yet to be published. Until they are, the Treasury's claim that the mechanism will *provide backstop protection to the taxpayer* cannot be substantiated.[42] An ineffective cost control mechanism could threaten the long-term viability of the LGPS. In this light, by pushing too hard, the unions may have committed a strategic error of Scargillian proportions.

8.3 Cost control and the LGIF

(a) Guiding principles

The ultimate purpose of the LGIF's cost control mechanism should be to connect pensions in payment to the LGIF's ability to meet them: in short, to ensure that the LGPS remains both sustainable and self-sufficient. There should never be a need to fall back on taxpayers (unlike the unfunded public service schemes which are now tapping the Treasury for £ billions, annually, Table 3). In addition, intergenerational equality should be preserved amongst all LGPS members (i.e. employees, including deferred members, and pensioners).

There are two components to consider when designing an effective mechanism: a simple and readily quantifiable trigger, and the subsequent corrective action.

(b) The trigger: focus on cashflow

The traditional measure of a scheme's financial health is the market value of its assets net of the present value of its liabilities (determined by an actuarial valuation). One well established example of a funding-based trigger is the Dutch central bank's requirement that pension fund assets are at least 105% of liabilities: below that, and benefits have to be cut. On this basis, the LGPS is, arguably, already doomed given that at end-March 2013, its aggregate funding ratio was only 79%. However, let us assume the going concern, and focus on the primary risk to which all stakeholders are exposed: a cashflow deficit. Note that funding deficits can flag trouble ahead, but they can be misleading in respect of cashflow. A scheme in surplus could have negative cashflow, and vice versa.

Last year, the LGPS's total net cashflow was £2.9 billion (Table 2). Why not set a total net cashflow trigger at £2 billion? A combination of short range and long range (i.e. forward looking) triggers could be deployed (the latter would reduce the scope for surprises), but this may come at the price of complexity.

An alternative trigger to consider could be a demographic dependency ratio (employees as a percentage of pensioners).

(c) Subsequent action

Once a trigger is hit, the ensuing process of deciding which cost control levers to pull should, ideally, be prescriptive and simple. The Dutch experience of controlling the cost of their CDC schemes is salutary. A triggered alert leads to stakeholder gatherings to discuss a menu of options, which has led to extensive wrangling, sometimes stalling the necessary corrective action. A complex process can also prompt a subsequent communications nightmare (as the Swedes have learnt to their cost with their Balance Notional DC scheme, for example).

[42] HM Treasury; *Public service pensions: actuarial valuations and the employer cost cap mechanism*, paragraph 2.14, March 2014.

The cost control levers should be aligned with the principal cost drivers. Today's LGPS includes several examples of misalignment: pensions in payment, for example, continue to be indexed even if pay (and therefore contributions) are frozen, inevitably squeezing cashflow. Consequently, the board should have access to a variety of cost control levers, including contribution rates, accrual rates (with future implications for cashflow) and indexation of pensions in payment. In addition, it should be properly empowered to deploy them to meet the fundamental objective: LGPS sustainability on a self-sufficient basis.

(d) Crossing the Rubicon

The LGPS's demographic shape and financial state is such that the scheme's pensioners should be included within the cost control mechanism. Intergenerational equality is a principle enshrined in the Dutch pension system: in 2013, 81 of the 454 Dutch funds cut benefits by 1.9%, on a weighted average basis. While politically unpalatable, the theme is catching on elsewhere in the developed world. The UK should follow suit, thereby removing the risk of cross-subsidy across the generations.

Previous British governments have not refrained from removing past accrued rights, including increasing the State Pension Age (SPA) and making retrospective changes to SERPS and Additional State Pension accruals.

> **Proposal 9:** The LGIF's cost control trigger should be cashflow-based. If total net cashflow were to fall below a £2 billion surplus, the governing board should adjust one or a combination of contribution rates, accrual rates and indexation of pensions in payment until annual cashflow returned to a £2.5 billion surplus.

9. THE NATIONAL INTEREST SHOULD COME FIRST

There would be considerable resistance to simplifying the LGPS's structure, but it would not emanate from the membership. Indeed, some of the union submissions to Lord Hutton's commission proposed a single fund. Decades of ineffective governance has allowed the LGPS to become a staggeringly inefficient, self-serving empire that would appear to place the interests of those who work within it, or provides services to it, ahead of those of its members, employers and taxpayers. To be clear, vested interests should not be allowed to ride roughshod over clear-cut economic rationale, particularly in these straitened times.

10. CONCLUSION

Notwithstanding Lord Hutton's recent reforms, there is a serious risk that the LGPS's financial condition will continue to deteriorate. Structural simplification, to boost operational efficiency and retain the assets' full performance within the scheme, would significantly mitigate this risk.

In October 2014, Jean Tirole was awarded the Nobel prize for economics, partly as recognition for identifying a four-pronged strategy to improve the efficiency of the French state: restructuring, competition, independent evaluation and accountability.[43] This approach lends itself equally well to ensuring that the LGPS remains sustainable, restructured as a single fund (comprising four competing allocators) overseen by a strong, trust-based, governing board accountable to

[43] `Professor Tirole is Director of the Toulouse School of Economics and of the Jean-Jacques Laffont Foundation. The prize was for his work on market power and regulation, and taming powerful firms.

the LGPS's membership. This would be consistent with the NAPF's call for "super trusts", and would also resonate with the direction of travel of a number of initiatives from Steve Webb, the pensions minister (notably the collectivisation of risk). In addition, the LGPS should set an example to the private sector.

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