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AN EVALUATION OF INVESTMENT GOVERNANCE IN LONDON LOCAL GOVERNMENT PENSION SCHEMES

A Discussion Paper for Stakeholders to the London Funds

David Blake

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November 2012

An Evaluation of Investment Governance in London Local Government Pension Schemes: A Discussion Paper for Stakeholders to the London Funds

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The Pensions Institute (www.pensions-institute.org) is the first and only UK academic research centre focused on pensions issues. The views expressed in this report are those of the authors and not the Pensions Institute which takes no policy positions.

Preface

In March 2011 the Independent Public Service Pensions Commission (IPSPC), chaired by Lord Hutton, published a landmark report on local government pension schemes. It found that key data concerning assumptions were incomplete and inconsistent, which makes it impossible to analyse their true current financial position or their future prospects.¹ It also found that there was no clear and consistent standard for investment governance in the schemes. In the light of these findings, Hutton called for a clear definition of investment governance to be established and for a full benchmarking study to be carried out in order to identify and clarify the perceived problems, and to recommend improvements that would help schemes reduce their costs and, therefore, the current and future burden on the taxpayer.

Hutton's proposals coincided with the growing interest in – and also opposition to – the idea of a central collective or mutual fund for the London schemes, which, in aggregate, are in a significantly worse funding position than defined benefit (DB) schemes in the private sector. London borough funds each have assets under management of less than £1bn, with 50% of funds holding less than £0.5bn and 50% in the £0.5-1bn category. (The London Pension Fund Authority is an exception with £4.3bn of assets in 2012). The concept of the central fund emerged from concerns over the inefficiencies associated with small funds and was based largely on a quantitative analysis of the cost savings that might be achieved through the reduced fees and improved asset management strategies conferred by greater scale.²

While Hutton's recommendations and the central fund proposal appear to form part of the same debate, it is not a given that the latter would address the problems identified by the former. We suggest, therefore, that a full and open debate on the need for reform, and what the reform options might be, should not be considered without first conducting further analysis that is qualitative as well as quantitative.

Such analysis would interrogate the data in close detail. Despite the statements about the lack of data in previous reports, such as those published publicly by Hutton and privately by PwC, the Pensions Institute has found that almost all of the data are available and that a close analysis can complete the missing pieces in the jigsaw. However, to retrieve and evaluate all data across all schemes will require a major investigative and forensic study that includes the examination of a range of documents – some of which appear to be under-researched or not researched at all at present – plus a robust quantitative modelling exercise so that it is possible to compare like with like.

The analysis would also consider very carefully the governance frameworks, decision-making processes, the strategies, and – importantly – the behavioural issues that help to explain the schemes' current funding positions and future plans to address deficits. To date, this essential qualitative analysis has been missing from the debate.

¹ http://cdn.hm-treasury.gov.uk/hutton_final_100311.pdf. Hereafter referred to in the text as 'the Hutton report' or 'Hutton'.

² The analysis by PricewaterhouseCoopers (PwC) was not published in the public domain.

The focus of this present report, therefore, is the administering authority's pension committees, which run the local government schemes. This focus provides a better understanding how and why key pension fund administration decisions are reached and diverse actuarial and investment assumptions are adopted.

The purpose of the research exercise that we conducted was to identify areas that might be considered in a full benchmarking study of the investment governance of the 34 London Local Government Pension Schemes (LGPSs).

The preliminary results of this research, set out in this present report, indicated that in certain cases the decision-makers are influenced as much – and possibly more – by behavioural and political factors than by the current investment governance framework, which our research indicates can be poor. One possible conclusion from our research, therefore, is that there might be a connection between poor investment governance and the increasing trend for schemes to defer the costs of their liabilities into the future ('kicking the can down the road', as it were) – a concern that was also raised by Hutton and the Centre for Policy Studies.³

Our analysis was based on information publicly available on the schemes' websites, from which we were able to derive the core data on funds' key financial and actuarial assumptions and the context in which these are determined. This enabled us to consider, among other aspects, the nominal discount rates relative to the funding position and the recovery period.

We also examined the minutes of the pension committee meetings, a close scrutiny of which reveals how decisions are made in practice, for example, through an assessment of the quality of debate between decision-makers and their advisers and asset managers, and the apparent ability (or otherwise) of decision-makers to challenge the information with which they are presented.

This research was supplemented by a wide range of interviews with councillor-members of the pension committee and with the administering authorities' (the individual council's) officers involved in running the scheme – the senior treasury and investment staff. The interviews represent a broad cross-section of London funds, notwithstanding the fact that certain funds were unwilling to discuss their governance framework and procedures with us. We also interviewed independent experts in the private sector with experience of local government schemes. These interviews are anonymised for confidentiality reasons.

As the evidence in our report reveals, it is not an exaggeration to suggest that the London LGPSs in aggregate represent a ticking time-bomb – however well managed some of the individual schemes might be. The extent to which the liabilities in the schemes are being understated and the recovery periods continually extended into the future will sooner or later become transparent. While individual schemes could improve their governance, ultimately the responsibility for introducing a robust governance framework for all of the funds lies with the regulator – the Department for Communities and Local Government (DCLG). There is time to diffuse the time-bomb – but time is running out and action is required urgently.

3 Centre for Policy Studies, August 2012: <http://www.cps.org.uk/files/reports/original/111027141410-20110211EconomySelfSufficiencyIsTheKey.pdf>

Based on the research, we make three proposals for future research. First, we set out recommendations that would improve the clarity and comparability of key data; second, we recommend the London schemes establish a clear definition of investment governance; and third, we put forward a proposal for a full qualitative and quantitative benchmarking survey of the 34 schemes. Importantly, this further research, should it be undertaken, would not be dependent on the cooperation and active participation of all 34 schemes. Our investigations to date indicate that this would not be a realistic prospect, since many schemes are sensitive to what might be perceived as an invasive level of scrutiny.

Many people helped with this research. We would like to thank in particular: Chris Wagstaff, Visiting Fellow of the Pensions Institute, Trustee Director and Investment Committee Member, Aviva Staff Pension Scheme, and Independent Trustee Director and Investment Committee Chair, Merchant Navy Ratings Pension Fund; Luke Webster, Treasury Manager, Greater London Authority and a former borough pension fund officer.

The idea for this report followed a debate entitled 'Merging London's Pension Funds: The Pros and Cons' organised by Centre for London and held at City Hall on 2 July 2012. The Pensions Institute participated in the debate which was also attended by the London Pension Fund Authority (LPFA). We suggested to the LPFA that it might broaden the debate if there was an independent review of the current state of investment governance in London LGPSs. The LPFA agreed such a review would be worthwhile and funded the research. This report is the outcome. The LPFA did not seek to influence our research in any way. The views expressed here are those of the authors not the Pensions Institute which takes no policy positions.

David Blake and Debbie Harrison, November 2012

Executive Summary

The purpose of this discussion paper is to establish whether there is a fundamental problem in respect of the investment governance of London Local Government Pension Schemes (LGPSs). Our evidence indicates that, in aggregate across the schemes as a whole, this is indeed the case. The paper suggests further research is required before appropriate recommendations can be made.

We stress that our research found examples of strong investment governance and excellent administration. However, it also identified serious weaknesses in the case of a large number of schemes. It is on the latter that we focus – with reference to the former, and also with reference to best practice in the private sector, in order to identify areas for improvement.

Above all, the paper indicates that the LGPSs have suffered from the lack of a strong overarching governance framework and supervision, which is the responsibility of the regulator – the Department for Communities and Local Government (DCLG).

We highlight the following problems in particular.

1. Poor and inconsistent data

- a. The reporting of key data by schemes – the nominal discount rate, investment performance assumption, and recovery periods, for example – is often poor and inconsistent.
- b. In many cases there is no published assumption for the scheme's overall investment performance target. In these cases the focus appears to be on the performance of individual asset managers, rather than on an overarching investment strategy.
- c. The data, if provided, often are not explained clearly or thoroughly.
- d. The data are frequently buried towards the end of lengthy reports that are largely devoted to generic descriptions of the economic and financial environment, manager performance and accounting audits.
- e. There is a marked difference between the level of scrutiny applied to accounting and to actuarial factors: the former is extensive and specific, while the latter frequently is generic and vague.

2 Schemes do not make relevant connections between investment governance, poor performance and the deferment of liabilities

- a. Councillors dominate pension committee decisions. While evidently highly diligent in exercising their responsibilities, their ability to develop experience and expertise appears to be limited because their tenure is predicated on four-yearly elections. We found examples where the entire pension committee membership had changed at the last election.

- b. The combination of the use of favourable discount rates and investment assumptions, together with repeated extensions of funding recovery plans, indicate that a number of schemes would appear to be deferring the cost of liabilities into the future.
- c. There appears to be evidence that some schemes – through their choice of actuarial or investment consultant – ‘shop around’ for discount rates and investment performance assumptions to improve the funding level.
- d. Schemes’ reports and, in particular, the minutes of quarterly pension committee meetings, indicate the actuarial and investment consultant (frequently the same firm) drive the decision-making process and that their advice is not challenged effectively. This suggests a possible over-reliance on these consultants.
- e. Investment strategy can be poor. There is a disproportionate focus on micro issues, such as asset manager selection, at the expense of the key macro focus, which is the overarching investment objective and strategy. This results in frequent changes of manager, which leads to substantial additional costs in terms of selection procedures, transition management and investment performance. There is also a strong preference for active managers over passive and for significant allocations to alternative asset classes that appear to be excessive relative to the scheme’s size, both of which features add to the administration costs, but without any evident corresponding reward.

Proposals For Further Research

We hope that this report will stimulate debate and suggest that after a period of consultation with stakeholders, further research is undertaken. We propose the following areas for consideration.

1. To establish a blueprint for the calculation and explicit presentation of clear and consistent data

This would be in the form of a simple tabulated summary at the beginning of each annual report which might include the following data for the current and previous two valuations:

- The size of the fund and the size of the deficit
- The funding position
- The recovery period
- The actuarial assumptions
 - Nominal discount rate
 - Investment performance target (contingent on the deficit recovery period and the expected growth of liabilities)
 - Inflation (earnings and price)
 - Mortality
- The employer contribution
- The proportion of council tax receipts used for scheme funding purposes

Each data item should be expressed on an agreed single standardised basis, so that comparisons can be made across the London schemes and also with non-London LGPSs and with private sector DB schemes.

2. To establish a clear definition of investment governance for the London schemes

3. Based on the data blueprint and the definition of investment governance, to conduct a full benchmarking study of the 34 funds to produce a 'map' of governance standards across all the schemes

Section 1: Objective Of The Study And Information Sources Used

Transparency and effective oversight of public service schemes is required for public service workers and taxpayers to have confidence in the system and improve the quality of debate about the future of public service pensions. Currently there is inconsistency in what scheme data and assessments, such as valuations, are published and such information is often difficult to access. This lack of transparency prevents comparisons and hinders analysis. Hutton 9

The objective of the study was to assess the quality of investment governance in London Local Government Pension Schemes. This, in turn, required us to assess the quality of the information available to those engaged in the investment governance process.

To do this, we analysed available documentation and conducted a series of interviews that together help explain how schemes are run. The key documents we used are those publicly available on each local authority's website.

We accessed the following specific documents:

- Core documents:
 - The Annual Report and Accounts
 - The Triennial Valuation (31 March 2010)
 - Statement of Investment Principles (SIP)
 - The Funding Strategy Statement (FSS)⁴
 - The Statement of Accounts
- Additional documents, where available:
 - The Governance Report
 - The Business Plan
 - Committee Meeting Reports

Some funds publish the core documents separately, while others combine them in a single annual report and accounts document, which includes the SIP, FSS and Statement of Accounts at the end. The quality and number of documents varies across different local authorities. Only certain reports and certain information are legally required to be made public and it is not clear what minimum standards are required for the extent of disclosure and the depth of analysis and explanation required for scheme-specific data. Future research would clarify this point.

We found that the pension committee meeting reports, which several funds publish on a quarterly basis, provide a very useful insight into the way that these

⁴ This document follows CIPFA guidelines set out in 'Guidance on Preparing and Maintaining a Funding Strategy Statement and to the Fund's Statement of Investment Principles'. For a comparison with private sector guidelines, see <http://www.thepensionsregulator.gov.uk/doc-library/scheme-funding-recovery-plans-of-uk-defined-benefit-and-hybrid-schemes.aspx>

meetings work and how decisions are reached. Future research would undertake a more thorough analysis of these sources of information.

A note on the availability and quality of data

The biggest challenge facing researchers is the absence of a central, publicly available, depository of information to enable comparisons between the London schemes – a service for which there is a pressing need, as recommended in the Hutton report:

Recommendation 21: Centrally collated comprehensive data, covering all LGPS Funds, should be published including Fund comparisons, which, for example, clarify and compare key assumptions about investment growth and differences in deficit recovery plans. Hutton 17

At present, it is necessary to access 34 different websites. Some have a specific home page for the pension fund, but others scatter information across the local authority's general website.

Overall, the ease of access to information in the core documents varied considerably, with actuarial descriptions and data frequently relegated to the final third of a very lengthy document. Compared with the extensive coverage of accounting, the investment conditions, and the performance of asset managers – the actuarial information provided was very limited and often quite vague. The most difficult data to identify were the actuarial assumptions (in particular the nominal discount rate (NDR) for the valuation as at 31 March 2010 and the corresponding rate for the previous valuation period (2007)) and the investment performance assumption which, in most cases, was missing.

The NDR used can under- or over-state the funding position, as the Audit Commission (2010)⁵ pointed out and which also stated that the use of inappropriately favourable assumptions would not solve the underlying issues but merely defer the liabilities into the future. We examined the NDRs set out in the 2010 valuations and also examined the 2007 figures (where available): the 2010 NDRs, as expected, were generally lower than the 2007 NDRs as a consequence of the government's 'quantitative easing' exercise following the Global Financial Crisis in 2008 which lowered the yields on bonds upon which the NDRs are based. Future researchers would have access to the March 2013 valuations,⁶ which would enable them to establish clearly the trend in NDRs since the GFC and to evaluate the extent to which what Hutton described as 'an established or developing trend to defer unfunded liabilities into the future' is an embedded feature of the London LGPSs.

The Audit Commission made an initial examination of the sustainability of the LGPS in its July 2010 information paper, 'Local government pensions in England' and took the view that the current approach, with unfunded liabilities being deferred into the future, could not continue indefinitely. Following the planned abolition of the Audit Commission, it will be necessary for another body to follow up this conclusion. Hutton 136

⁵ <http://www.audit-commission.gov.uk/nationalstudies/localgov/localgovpensions/Pages/Default.aspx>

⁶ Although we understand that these reports might not be published until 2014.

The analysis of three valuation periods in the post-2000 economic and financial environment would also facilitate a more detailed analysis of the cost implications of recovering deficits over a period longer than a standard valuation interval. Certainly, there is clear evidence from our research that this is already happening, with several funds resetting their recovery plan periods in 2010 to 25 years, which was the maximum permitted (we understand this has been reduced to 24 years, although one fund appears to be using a 30 year period). Hutton stressed this 'would be a measure of how far future generations are facing greater burdens because of decisions to trade off the short term against the long term' (139).

There is no information in the fund documents about the proportion of council tax used to fund any scheme deficit, which we suggest should be made available as this is in the public's interest. A report published in January 2006 suggested that for all LGPSs the figure at the time was about 26%.⁷

⁷ www.telegraph.co.uk/finance/2930601/Whose-pension-are-you-paying.html. This report was also covered in 'Whose Pension are you Paying?' shown on Channel 4, 27 January 2006.

Section 2: Qualitative Analysis

We began our qualitative analysis with a brief consideration of the overarching regulatory framework for Local Government Pension Schemes (LGPSs) and then focussed on how governance works in practice through a close examination of the composition, collective experience, expertise, knowledge and resources of the local authority's pension committee, the body responsible for investment decisions. This approach provided a practical and, we hope, fresh insight into the potential weaknesses of investment governance.

*2.1 The regulatory framework for Local Government Pension Schemes*⁸

LGPSs were established on a statutory basis, rather than on the trust basis used in the private sector for defined benefit (DB) pension schemes. We understand that this implies that their fiduciary duty, in relation to the assets, is to council taxpayers, rather than to the scheme members and other beneficiaries, which is the model that applies in the private sector. There is no employer covenant in the public sector, as there is in the private sector: ultimately the taxpayer underwrites the scheme.

The Regulator is the Department for Communities and Local Government (DCLG). The Secretary of State for the DCLG is the supervisor and is responsible for setting out the responsibilities of the administering authorities and also for approving the appointment of pension committee members, with the exception of the LPFA, which has its own procedure for appointments. The Policy Review Group for England and Wales, run by the DCLG, is responsible for considering changes to rules.

Each scheme is run locally by the administering authority through the pension committee (or panel), which must comply with national law, but which also has certain discretions in relation to investment governance. In line with DCLG guidance, each scheme should have an investment strategy that is based on the deficit recovery period and the expected growth of liabilities and how these liabilities are to be met, in terms of investments selected and 'reasonable risk parameters'. This is balanced against other aims, such as seeking to keep employer contribution levels stable and affordable, and taking account of the impact on local council tax payers.

Participating employers to the schemes include a very variable range of non-local-government private sector employers, a feature that adds a further layer of complexity.

2.2 Potential weaknesses in the regulatory framework

While schemes are required to report certain information to the DCLG, it is not clear the extent to which the Department operates as a regulator, in the sense that is understood in the private sector, where several government departments are involved (in particular the Department for Work and Pensions and the Treasury), and where the day-to-day job of independent regulation and scrutiny is undertaken by the Pensions Regulator (tPR).

⁸ <http://www.audit-commission.gov.uk/nationalstudies/localgov/localgovpensions/Pages/Default.aspx>

The Hutton report commented on this issue as follows:

There is a case for scrutiny of public service pension schemes that is independent of stakeholders with a direct interest, such as employers, local councillors and ministers ... While some local authorities consider the DCLG as their pension regulator, this does not seem appropriate given that best practice advocates the separation of powers ... as they have no oversight of pension administration or the management of pension funds in the administering authorities. Hutton 134

As noted above, the DCLG guidance requires schemes to publish an investment strategy that sets out how its pension liabilities are to be met, but in practice we found this area of reporting to be poor in most cases, with schemes providing only a very generic overview of investment issues.

The DCLG guidance requires the investment strategy in LGPSs to take account of the need to keep employer contributions 'stable and affordable'. The sponsoring employers of private sector DB schemes also desire 'stable and affordable' contributions. But there is a fundamental difference in the position of the two groups of employers. In the public sector, the council taxpayer provides the ultimate covenant, and the sponsoring employer of a LGPS can pass the burden for underfunding onto the council tax payer. In the private sector, the covenant is underwritten by the employer which must provide any additional funding to the pension scheme to enable it to meet its recovery plan. Although this obligation could force the private sector company into liquidation and the scheme into the Pension Protection Fund, this escape route is not open to council taxpayers.

The Hutton report commented on these points as follows:

The LGPS Funds are given far more scope to exercise flexibility over their approach to funding than trust-based schemes, where the regulatory regime accepts that funding should be scheme-specific, but triggers firm criteria for funding adequacy and ensures that schemes take appropriate action. Hutton 138

As we explain below, there is an additional behavioural factor at work in the public sector, since understandably councillor members of the pension committee might be keen to avoid resources being directed to the fund that might otherwise be spent on the local projects to which they committed themselves when they were elected.

Finally, although scheme assets are ring-fenced, with the exception of fees to external professionals, many of the overheads are 'implicit' costs and are not explicitly accounted for. We understand that this is because the scheme is not a separate legal entity and therefore it shares common resources with the local authority. These overheads appear to include the authority's IT resources and the time allocated to running the fund by its officers, such as the chief finance officer and treasurer.⁹ Further investigation might determine the extent to which cross-subsidies apply.

⁹ See Treasury 'Scrutiny Unit Briefing Note: Public Sector Pensions', May 2007.
<http://www.parliament.uk/documents/upload/publicsectorpensions.pdf>

2.3 The pension committee and supporting resources

In the private sector, the governance of the pension scheme is established by a trustee board that comprises employers, lay members, and, possibly, a union representative. Increasingly, especially in the larger schemes, there is an independent trustee and a CIO.¹⁰

The equivalent of the trustee board in local authority schemes is the pension committee. While there are similarities between the private sector trustee board and the local authority pension committee, there are important differences too. To explore these differences, we drew on the documentation publicly available on the authorities' websites and gained further insight from a series of confidential interviews with councillor members of the committee, the authorities' financial executives who are involved in the running of the pension scheme, and also with several independent experts who had direct experience of advising the London schemes.

Number and type of members and their voting rights

Most committees had between four and 12 members, with an average of about six or seven. In some cases, in particular in the smaller schemes, the committee comprised only of councillors. In others, the committee included a union representative, a member representative and a representative from a participating employer. However, we did not see any examples within this second group where the member had voting rights.

Several committees had more extensive committee memberships – more than 20 members in a minority of cases – and these included the financial advisers to the fund and also the authority's professional senior financial officers, such as the director of finance, the head of the treasury function and the chief accountant. (As previously noted, in most cases the officers attend meetings but are not formal members.) In addition, some schemes have appointed an independent adviser, but this individual does not appear to have voting rights.

The chair

This is always a councillor.

The chief finance officer¹¹

The CFO is referred to as the S151 Officer, with reference to Section 1:51 of the Local Government and Housing Act 1979. We use this description here.

We understand that the S151 Officer is considered to be the most important individual in relation to investment governance and has the ultimate power of

¹⁰ There has also been a marked trend, particular among smaller and medium-sized schemes that cannot afford a full-time CIO, towards appointing some type of fiduciary manager to undertake the more regular hands-on investment strategy and asset management functions. Aon Hewitt, *Delegated Investment Survey 2012*, http://www.aon.com/unitedkingdom/fiduciary-management/delegated_investment_survey.jsp

¹¹ The CFO is also known as the Executive Director of Resources or, less usually these days, the Borough Treasurer.

approval or veto for the authority's financial decisions, including those of the pension fund in relation to the manager appointments and the fees, for example. He or she, therefore, is the most powerful figure involved in the administration of the fund and also is legally responsible for the prudent management of the authority's financial affairs.

Moreover, this is a professional appointment, so the individual is not a councillor. Therefore the S151 Officer theoretically is politically neutral. However, interviewees said that the individual operates within a political environment and ultimately is hired – and can be fired – by the councillors.

In practice, the extent to which the S151 Officer is involved directly in the committee's work varies considerably. Some are very 'hands-on' and retain direct responsibility for a range of functions. Others might delegate these to, for example:

- The CIO or investment director
- The pension scheme accountant
- The authority's treasury manager

The treasury manager

This is likely to be a senior employee of the authority, who is often responsible for the scheme's accounting and who might also undertake some of the functions of the chief finance officer, as noted above.

The chief investment officer (CIO)

A very small minority of the larger schemes have appointed a professional CIO. This is considered an important role, as he or she can address governance issues swiftly, rather than wait for the next quarterly meeting. However, as in the private sector, a full-time CIO is not an economic option for smaller schemes, which would be unable to afford and to justify such an appointment. The fact that each of the London LGPSs have assets under management of less than £1bn – and in 50% of cases less than £0.5bn – is clearly very relevant to the debate.

The independent adviser

This appointment is optional, but is increasingly a feature of the larger scheme committees. The independent adviser is hired to attend a certain number of meetings per annum and to contribute to and/or write certain reports. The individual might also undertake the role of investment performance monitoring.

As with the role of the independent trustee on private sector trust boards, this can be a very influential appointment, but clearly this depends on the adviser's expertise. We were told that it also depends on the extent to which the adviser is (or feels) able to challenge the committee and the investment consultant, since the committee has made the appointment, usually from a shortlist determined by the officers. We were also told that the most effective advisers are assertive and challenging, but that this could lead to the individual being fired if councillors and/or officers felt undermined due to their lack of knowledge and expertise – or

if they felt the independent adviser's recommendations were not compatible with their own objectives as councillors and officers, for example (see 2.4 below).

The performance monitor

This role is undertaken by a range of third parties, which might or might not be directly involved with the committee. It might be the custodian, the independent adviser, the investment consultant, or it could be a specialist firm. The investment performance measurement service WM,¹² for example, is widely used for macro-level analysis and benchmarking, through its WM LGPS universe indices.

Non-councillor members

In many cases, a scheme member (usually a pensioner), a union representative, and a representative from one of the participating (non-local government) schemes are on the committee, but they do not appear to have voting rights.

Shared roles

The shared role varies from scheme to scheme. Examples include where the pensions manager is also responsible for the administration of contributions and benefits, and where the scheme accountant, who might run the authority's treasury function, reports to the committee on performance and also takes part in the manager selection.

The investment sub-committee

It is common practice in the private sector for the trust board of a large scheme to establish a sub-committee for investment, which comprises those members with the most experience and expertise, together with the professional advisers. Such sub-committees are not common among the London schemes, largely, we understand, due to time and resource issues.

The purpose of the sub-committee is to make decisions on a range of issues, including asset allocation strategy at a macro level, tactical asset allocation, and de-risking, subject to the objectives set by the main committee. It also helps to establish clear benchmarks for the evaluation of asset manager performance through the analysis of, for example, risk-adjusted returns and tracking error, so that the main committee can understand better the reasons for under- and out-performance. Without this type of strategic analysis and support, arguably there is no proper basis for the decision to hire and fire particular managers.

The sub-committee also focuses on the more technical aspects of investment strategy, such as rebalancing the portfolio and currency hedging.

Pensions' management and administration

The administration of contributions and benefits usually is overseen by the pensions manager.

¹² Owned by State Street

Professional advisers to the committee

The number of professional advisers to the scheme varies, but the most important roles, in terms of investment governance, include:

- The actuary, who is responsible for setting the key assumptions (the nominal discount rate, the overall target investment return, and mortality assumptions, for example) on which the assets and liabilities are calculated and the funding level established
- The investment consultant, who provides advice on investment strategy and the selection and appointment of the asset managers
 - Note: In all of the cases we have examined to date, the same organisation provides both actuarial and investment consultancy. However, further analysis might reveal exceptions to this arrangement.
- The custodian, who plays an important role in reconciling reports from accountants and asset managers in relation to valuations
- The engagement and voting consultant, who advises the scheme on shareholder activism, which can be a significant feature of scheme governance
- Legal advice tends to be provided by the authority's lawyers, although independent firms are used for specific issues.

Training

In the private sector, tPR requires a minimum level of training for all trustees through its Trustee Knowledge and Understanding (TKU) code of practice. Many boards, particularly of the larger schemes, provide further training and require trustees to study for formal qualifications, for example, those offered by the Pensions Management Institute. It is relevant that tPR has raised concerns about the experience and expertise of trustees of smaller schemes and has recommended trustees should study for formal qualifications, such as the Pensions Management Institute's Award in Pension Trusteeship.¹³

2.4 Potential weaknesses in the operation of the pension committee in practice

Good sustainable investment governance structures and processes are essential if schemes are to rise to the difficult challenges they face, which include:

- The sheer number and complexity of scheme risks, and the need to identify and to manage or to mitigate these risks in a transparent manner. This information is summarised in the private sector in a 'risk register'.¹⁴

¹³ <http://www.pensions-pmi.org.uk/qualifications-and-learning/award-in-pension-trusteeship-overview>

¹⁴ A risk register lists the key risks that could influence the outcome of running a pension scheme (or any other activity). For each risk, the register attempts to quantify the likelihood of the risk occurring and its likely impact if it does occur. The register also identifies who is responsible for each risk (the 'risk owner') and how it should be managed or mitigated.

- The extent of deficits
- The challenges of deficit recovery plans and periods
- The increasing complexity of the newer (so-called 'alternative') asset classes, which can only be evaluated within the framework of a clear investment strategy that includes an explicit assumption for future investment returns
- The negotiation of transparent fees for service providers, including the actuary, investment consultant and asset managers

We found that some of the scheme pension committees appeared to be run in a very professional manner, comparable to the highest standards of DB trusteeship in the private sector. The best run committees generally have the following features:

- An investment sub-committee that focuses on investment strategy and provides strategic direction to the main committee, which ensures a more robust basis for decision-making
- In a minority of cases, a full-time chief investment officer, whose role is to respond rapidly to market conditions and asset manager problems, and certainly much more promptly than is possible via the quarterly committee meetings.
- An independent adviser.
- Training delivered in a structured format and using independent organisations.

However, certain pension committees appear to have weak governance structures, which make them particularly vulnerable to both behavioural influences and the democratic nature of councillors' tenure. In some cases, we found evidence of frequent and wholesale changes in the committee memberships – for example, in one case the entire councillor membership changed at the last election.

At the risk of over-simplification, smaller schemes tend to have fewer pension committee members and, for these schemes, there tends to be a considerable amount of 'multi-tasking', whereby one individual covers several functions. A typical example is where the authority's accountant is the scheme accountant, runs the treasury function, reports on investment performance to the committee and is also involved with the manager selection. Moreover, we were told that smaller authorities are less able to provide the committee with secretariat support, which means that the members have to spend more time on this themselves.

Beyond these generic points, which are very much a symptom of scale, we identified certain specific issues that appear to affect the decisions committees make.

The local authority's senior financial officers involved in running the fund appear to have conflicts of interest

In section 2.2 above, we said that the costs of running the fund are not fully transparent because significant overheads are shared by the fund and the authority, for example, in relation to the time spent on the fund by the chief finance officer and treasurer, among others. Two issues emerged from the interviews that gave rise to concerns.

The first is that the pension fund might be used to cross-subsidise the authority's other expenses, although interviewees varied in their estimates of the extent of this issue:

'One reason authorities don't want to lose control over the fund – as might happen if a central fund for London schemes was established – is that they lose their ability to cross-subsidise council and scheme expenses.' Councillor

'Of course, it is not the case that the authorities are drawing directly on the fund itself; it's the fact that the overheads between the authority and the scheme are so blurred, it makes it easy to share costs in ways that cannot be scrutinised and which might not be appropriate.' Councillor

'Overheads could be charged to the fund, rather than the employer, in an inequitable manner.' Treasurer

The second and possibly more significant concern relates to a potential conflict of interest faced by the authority's professional financial officers. We report the following comments (which are just two examples of many we received along similar lines) and would stress that we did not have access to information about the typical remuneration arrangements for financial officers.¹⁵

'It's usually the case that the remuneration of the authority's top financial officers is linked to the size of the fund and their responsibilities for running it. This is why they are not going to hand their funds over to a central fund without a big fight.' Treasurer

'I can see how senior finance officers' salaries being linked to managing the pension fund would provide them with a very big incentive to prevent the schemes being managed centrally, especially at a time of public sector pay freezes.' Independent expert

Committees comprise of councillors on 'temporary contracts' and with conflicting priorities

Councillors are elected every four years. This means that the councillor members of the committee might change on a regular basis, which undermines the continuity of the governance focus and the retention of collective expertise and knowledge. It also raises the concern that councillor members might have a political agenda that creates conflicts of interest in relation to running the scheme.

'No successful business is steered by a series of temporary managers.' Independent expert

'Scheme governance is a hostage to political fortune. It's left to councillors, who might only serve for four years and who are aware that nobody really cares [about the funding position] because the liabilities are underwritten by the taxpayer.' Councillor

One interviewee identified what he called committee 'member risk' as the biggest concern for long-term governance:

¹⁵ In other words, we do not know whether finance officers in general receive an explicit bonus for taking on responsibility for the pension fund or whether they do this as part of their basic remuneration package.

‘Councillor turn-over can lead to periods of inactivity, undermining the continuity of focus on investment issues. So there is a significant key member risk here.’ **Treasurer**

Several interviewees said that councillors might lack interest in the scheme, as this was not a priority in relation to the purpose for which they felt they were elected:

‘Many councillors are reluctant pension committee members. It’s not what they were elected for and it’s not what they want to spend their time doing. You get votes for improving local services; there are no votes in running the pension scheme well.’
Councillor

Lack of time, resources and expertise were also cited as major concerns:

‘For our scheme, the lack of resources is a real issue. Time is the first problem – the councillor members typically spend just 20 hours a year on the scheme and there might only be one or two officers [financial executives from the authority] involved. Also the budgets are tight for external advisors. Most of all, the knowledge and expertise of members and officers is the greatest challenge’. **Treasurer**

Training will not solve the governance problems

Interviewees said that the perceived weaknesses of the pension committee might be improved to an extent through better training, but that the very real limitations of training must be recognised:

‘In my experience it can be difficult training councillors. Some are reluctant to spend the time on this; others find it overloads them and makes them feel that they look ignorant’. **Independent expert**

‘I’ve run training sessions where it looks like the councillors have turned up under duress. I don’t blame them – this was the last thing they thought they’d be doing when they were elected.’ **Independent expert**

‘The training I’ve seen is borderline useless. It’s often left to the asset managers, who attend the quarterly meetings. This is a far from impartial source.’ **Independent expert**

‘Even if the training is good, the councillors might change after the next election, so there’s no chance to build up real expertise. So, no, the committee can’t be fixed with more training. All you’ll end up with is better trained people facing the same conflicts of interest and the same short-term contracts. It needs root and branch reform to embed a robust and permanent governance structure.’ **Treasurer**

Generic reporting where scheme-specific detail is needed

The reporting of two of the most important features of the scheme – the investment strategy and the actuarial assumptions – tends to be poor and/or generic, suggesting this material might possibly be derived largely from CIPFA and DCLG guidance notes. The same is true of funds’ coverage of the Myners Principles and socially responsible investment (SRI). In some cases, there is little or no correlation between the stated (generic) strategy and objectives, and the actual decisions made.

'If you look at the reports, you can see that they all say pretty much the same thing about the investment strategy and the actuarial assumptions. This doesn't make any sense, given the very different funding positions of the schemes.' **Treasurer**

Relationship with the actuarial and investment consultants and the asset managers

From our study of the minutes of meetings, it is evident that committees frequently focus on investment performance, rather than on investment strategy, and rely on the regular attendance of their asset managers for their 'training', which means that their understanding of investment issues is derived from a source that is not obviously impartial. Moreover, the quality of debate indicated in these minutes is very mixed, with members at times merely noting the content of the asset manager's (often very complex) presentation and not challenging underperforming managers in a robust manner.

The underlying problem here is that in many cases there appears to be no clear focus on the investment objectives of the fund as a whole, which is a primary function of good investment governance. As we have already mentioned, many schemes do not even publish an assumption for the overall investment return target. Instead, both the committee meeting reports and the fund reports focus on the asset managers' generic narratives of the economic climate and their performance relative to individual targets.

A significant number of committees do not have an investment sub-committee, which means that the councillors are directly responsible for all key investment decisions, often without appropriate resources to support them in their duties. From the committee meeting minutes, it appears that in many cases councillors, who might have little or no financial experience, expertise or training, are strongly influenced by their actuary and investment consultant and are less able to question investment strategy.

This conclusion from our analysis of the minutes was strongly endorsed by our interviewees:

'Due to the asymmetrical relationship in knowledge and expertise between the councillor members and their advisers, this leads to an over-reliance on the small number of investment consultants that dominate the sector.' **Treasurer**

Commenting on the knowledge and expertise of committee members in relation to investment governance, one interviewee was surprisingly critical:

'There are two types of councillor member. The first has no financial background, which is bad. The second has some sort of financial background, which is worse. The latter tend to think they know all about money and exhibit an inappropriate level of confidence when they suddenly find themselves in charge of a multi-million pound fund.' **Councillor**

But this interviewee was not the only one to suggest that councillors might unintentionally appear to behave in a naïve manner when placed in the position of being able to hire and fire asset managers:

'There's no doubt about it – councillors are much more interested in meeting active asset managers and hearing them talk about their world. By comparison, passive

managers can appear to be dull with their emphasis on a system that knocks a few basis points off the annual charge.’ Councillor

Of course, this problem also arises in the private sector. A recent Towers Watson report noted the cost of ‘trigger happy’ fiduciaries, which builds on the earlier landmark study by Busse, Goyle and Wahal in 2010 in relation to asset manager turnover, which can result in high transition costs and lower performance, due to the tendency to fire underperforming active managers at the bottom of their performance cycle.¹⁶ With reference to the London schemes, an interviewee said:

‘If you look at some of the schemes that are very under-funded, you can see that they are trying to invest their way out: they are taking on increasing levels of risk and paying through the nose for specialist active asset managers, and then they keep changing them when they don’t like the performance.’ Councillor

Apart from the transition costs, high manager turnover adds to the cost of updating the SIP:

‘Every time you change a manager you have to update the SIP – or at least you should do. This can be an expensive exercise in its own right, as it involves the lawyers and investment consultants.’ Independent expert

Several interviewees questioned the advice of the investment consultants, who in theory should steer the committee away from the practices described above and towards better investment governance:

‘Councillors might not have an appropriate background in investment governance and do not have the time to undergo extensive training. This means that they pay inadequate attention to investment strategy and tend instead to focus on something that they think is more important – the hiring and firing of managers. If you look at how common this pattern is, it makes you wonder what the consultants are up to. If I were a cynic, I’d say the consultants were trying to justify their fees by encouraging manager turnover, so they can charge for the new manager selections and beauty parades.’ Treasurer

‘Who reviews the consultants?’ Independent expert

‘What governance process prompts smaller schemes to invest £50m in hedge funds, and the same amount in private equity and high-yield bonds? These are very specialist, research-intensive strategies that are high-risk and also very high-cost – plus the smaller the scheme the more you pay.’ Councillor

‘The odd thing is that funds use sophisticated strategies in the wrong areas. They might invest in hedge funds and high-yield bonds, but then use index-linked gilts to hedge inflation risk, and conventional gilts to hedge interest-rate risk. Swaps would be a more efficient strategy, and they could also use infrastructure to deliver secure longer-term inflation-linked cash flows with the potential for a bit of capital return too.’ Independent expert

¹⁶ www.towerswatson.com/assets/pdf/7259/TW-EU-2012-26094-The-cost-of-trigger-happy-investing.pdf and Jeffrey A. Busse, Amit Goyal, Sunil Wahal (2010) ‘Performance and Persistence in Institutional Investment Management’, *Journal of Finance*, 65(2): 765–790 (www.afajof.org/afa/forthcoming/5143.pdf).

‘The truth is, as a group of short-term financial fiduciaries, we are semi-illiterate and very easy to sell to.’ Councillor

This last point was raised obliquely in the Hutton report, which suggested that there might be a lack of competition among consultants to the LGPS, which might lead to a degree of complacency:

‘At present there appears to be a concentration of knowledge of public service pensions, their legal basis and their management in a few specialists.’ [Hutton 150]

Dependence on actuarial advisers

Interviewees expressed concern about the apparent ease with which decision-makers can exploit what they called ‘actuarial arbitrage’, although they acknowledged that the implications of such practices might not be obvious to councillors:

‘The councillors’ priority is to keep the employer contribution down and to direct as many resources as possible to visible local causes. They might not appreciate the long-term cost implications of using optimistic actuarial assumptions – their priority is to avoid having to go to the leader of the council to ask for more money for the pension fund at the expense of spending on local projects. That’s political suicide.’

Councillor

From our preliminary examination of the scheme documents, there does appear to be some evidence that actuaries choose assumptions that help the councillors keep down short-term funding costs. However, these assumptions do not necessarily fit in with the long-term funding requirements of the scheme. This suggests that actuaries might be supporting a trend whereby schemes postpone the recognition of liabilities and costs into the future.

‘It’s hard to understand how two actuaries can recommend two different sets of assumptions for the same fund, but this is what happens in practice and it encourages committees to shop around for the best deal. They think they’ve got a bargain – but like a lot of bargains, it costs more in the long run.’ Independent expert

There is also clear evidence that some schemes are not sticking to their recovery plan, with several recovery periods extended to the maximum permitted in the 2010 valuation. This simply transfers costs into the future.

‘Some of these schemes are like doctors’ patients: they need to take strong medicine to get well. What’s the point of a recovery plan, if you keep on postponing the treatment? The prognosis can only get worse.’ Independent expert

Section 3: Preliminary Quantitative Analysis

Building on the qualitative analysis of the previous section, in this section we briefly summarise the findings of our preliminary quantitative analysis of London LGPSs derived from the scheme valuations for 31 March 2010 (which in some cases include changes since 2007) and from external data sources, such as WM. We also provide comparisons with private sector defined benefit schemes.

Our summary findings from the scheme valuations are as follows:

- Funding levels in London LGPSs: 60% to 91% with an average of 75%.
 - Private sector average: 79.1%¹⁷
- Employer contributions in London LGPSs: 15.8% to 31.1% with an average of 22.3%.
 - Private sector: 13.7% to 19% with an average of 14.2%¹⁸
- Recovery periods in London LGPSs: 12 to 30 years with an average of 20.1 years.
 - Private sector average: 9.4 years¹⁹ However, the current stance adopted by tPR indicates a more flexible approach, due to the post-2008 economic environment, which is expected to lead to longer recovery plans of 11 years on aggregate.²⁰
- Nominal discount rate in London LGPSs: 5.6% to 7.5% with an average of 6.44%.
 - Private sector: 4.6% to 5.0% with an average of 4.8%.²¹

There were two key factors that were either not reported at all or were not reported on a systematic basis in the London LGPS documents:

- The assumptions for future investment returns, which are provided only in a minority of cases. The most common practice is to provide target investment returns for specific asset classes in relation to the managers appointed. This indicates poor governance in relation to investment strategy.

17 <http://www.pensionprotectionfund.org.uk/Pages/PPF7800Index.aspx>

18 ONS, Occupational Pension Schemes Survey Annual Report 2011, Chapter 4, Table 4.2, p.4: http://www.ons.gov.uk/ons/dcp171766_276117.pdf. Full report: <http://www.ons.gov.uk/ons/rel/pensions/occupational-pension-scheme-survey-annual-report/2011-annual-report/index.html>

19 <http://www.thepensionsregulator.gov.uk/docs/recovery-plans-assumptions-triggers-2010.pdf>

20 See <http://www.thepensionsregulator.gov.uk/docs/the-defined-benefit-regime-evidence-and-analysis.pdf> and <http://www.thepensionsregulator.gov.uk/docs/pension-scheme-funding-in-the-current-environment-statement-april-2012.pdf>

21 Hyman Robertson, IAS 19 Assumptions Report, June 2012. The data are for 31 December 2011. http://www.hyman.co.uk/media/110665/ias19_assumptions_report_final.pdf

- The extent of funding derived from council tax is not covered in the publicly-available documentation.

Funding levels

Based on the 2010 valuations, we estimate that the average funding level for the London schemes is 75% with a range of 60% to 91%. This compares with the private sector, which had an average funding level of 79% in 2010 on a Pension Protection Fund (PPF) basis.²²

Funding levels for the private sector, on average, therefore, are higher than in the public sector. Moreover, the implications of the local government scheme funding positions are quite different from those in the private sector for several reasons:

- As mentioned above, the costs of overheads – with the exception of fees to external professionals – are implicit because the scheme is not separate from the authority, so certain costs are shared between the authority and scheme
- Private sector sponsoring employers can default, in which case the scheme enters the PPF. This means that a key factor that determines a scheme's risk rating and the recovery period is the strength of the employer covenant, the technical provisions basis used, the asset allocation, and the hedging strategy, among other factors. There is no employer covenant underlying the local government schemes: the burden of additional funding falls on the council tax payer.
- Most DB schemes in the private sector are closed to new members and, increasingly, to future accrual. This has a major impact on the cash flows. Since the local government schemes are open, they benefit from a generally positive cash flow.

In relation to the last point, the Audit Commission stated in its 2010 report, 'Local government pensions in England', schemes cannot assume this positive cash flow will continue unchanged, due to the likelihood that there will be fewer employees contributing in future.²³ Investment strategies, therefore, are vulnerable to a significant reduction in the proportion of active members, which could result in a negative cash flow. 'That would mean that pensions could not be paid without cashing in investments, which could reduce investment in long-term growth assets.' The research for the present report found that such risks were not well-addressed in the fund documents.

²² www.pensionprotectionfund.org.uk/Pages/PPF7800Index.aspx. The figure for 2012 is 82.3%. Note: a private sector scheme's s179 liabilities represent, broadly speaking, the premium that would have to be paid to an insurance company to take on the payment of PPF levels of compensation. This compensation may be lower than full scheme benefits. For comparable data with the 2010 London scheme valuations see http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/PPF_7800_October_10.pdf. tPR announced in 2012 that it would permit certain schemes to extend their recovery periods, among other options, to avoid employers becoming insolvent in the current economic climate. See <http://www.thepensionsregulator.gov.uk/docs/the-defined-benefit-regime-evidence-and-analysis.pdf> and <http://www.thepensionsregulator.gov.uk/docs/pension-scheme-funding-in-the-current-environment-statement-april-2012.pdf>

²³ Audit Commission (2010), 'Local government pensions in England' paragraph 43, www.audit-commission.gov.uk/localgov/nationalstudies/localgovpensions/Pages/Default_copy.aspx

The Audit Commission also said that in addition to the impact of increasing longevity and falling investment returns – factors that affect private sector schemes too – the funding position of local government schemes would worsen because ‘unfunded liabilities are being deferred into the future, to make the scheme more affordable to employers in the short term’, and because of ‘the action needed to recover funding deficits’. In other words, there is a very real danger that some schemes will build up ever larger deficits, in effect accepting higher long-term costs in order to secure short-term affordability. Finally, the report notes that the significance of the scheme funding position is relevant to councils’ ability to fund local services and has an impact on council tax. Hutton raised similar concerns:

It is the funding valuations, not accounting data, which affect LGPS contribution rates and council tax. This means that, at present there is no independent and publicly available assessment of the likelihood of the LGPS in England and Wales eliminating its overall deficit over the long term and the consequences of not doing so. That overall deficit is in effect an unfunded liability. Hutton 136

Employer contributions and recovery periods

There are two surprising differences between the London LGPSs and private sector schemes when it comes to employer contributions and recovery periods, and it is difficult to account for these in relation to the different legal frameworks. Employer contributions in the public sector are, on average, almost 50% higher than in the private sector schemes (22.3% vs 14.2%). However, recovery periods in the public sector schemes are more than double those in the private sector schemes (20.1 years v 9.4 years).

This begs the question: if private sector schemes can eliminate their deficits over an average of 9 years (albeit likely to rise to 11 years from 2012) with an average employer contribution of 14%, why will it take the London schemes an average of 20 years with an average employer contribution of 22%, given that the ratio of deficits to assets are not vastly different?

We also found clear evidence that some London schemes are simply extending their recovery period to the maximum at each valuation (so there is never any actual ‘recovery’). This is puzzling, unless the true liabilities in the public sector schemes are much higher than the reported liabilities.

This brings us to the crucial question of the nominal discount rate used to determine the size of pension liabilities.

Nominal discount rate

The single most important variable that influences the current size of pension liabilities is the nominal discount rate that is applied to estimated future pension payments to give a current or present value to these future payments. The higher the rate at which these future payments are discounted, the lower is the present value of these liabilities. In other words, a higher discount rate ‘lowers’ the pension liability and this effect is magnified as the discounting period increases.

The implications of changing the discount rate can be shown using a simple model for calculating pension fund liabilities. Assume a typical UK male joins a defined benefit (DB) pension plan at age 25 and retires at 65. Suppose his life

expectancy (LE) at age 65 is 19.74 years (which equals the LE of a typical UK male at age 65 in 2012).

Let:

- L65 = present value of the pension liabilities for a scheme member who is currently aged 65 and has just retired (for each £1 payable per annum from age 65 for however long the pensioner lives)
- L25 = present value of the pension liabilities for a scheme member who is currently aged 25 (and expects to receive a full pension from the scheme when he is 65)
- LE = 19.74 = Life expectancy of a typical UK male at age 65 in 2012
- R = discount rate
- $(1 + R)^{-40} = 1 \div (1 + R)^{40}$ = 40-year discount factor when the discount rate is R. By multiplying the present value of the liability at age 65 by this discount factor, we get the present value of the liability at age 25 (40 years earlier)

Given the above, the present value of the pension liabilities for the 65-year old is equal to the present value of an annuity paying £1 per annum for LE years using a discount rate of R:²⁴

$$L65 = [1 - (1 + R)^{-LE}] \div R$$

and the present value of the pension liabilities for the 25-year old is the present value of the pension liabilities for the 65-year old discounted for 40 years:

$$L25 = L65 \times (1 + R)^{-40}$$

LGPS assumptions for the discount rate vary between 2.6% and 4.5% above the assumed inflation rate (which we take to be 3%) implying that the nominal discount rate varies between 5.6% and 7.5%. Table 1 below shows the impact on the value of pension liabilities at age 65 and 25 of varying the discount rate within this range.

Table 1: The impact of the discount rate on the value of pension liabilities: A comparison between the highest and lowest discount rate used in the London LGPSs (£ per £1p.a. pension from age 65 for life)

Liabilities	Discount rate	
	5.6% (lowest London LGPS)	7.5% (highest London LGPS)
Liabilities at 65 (L65)	11.77	10.13
% reduction at 7.5% cf 5.6%	-	-13.86%
Liabilities at 25 (L25)	1.33	0.56
% reduction at 7.5% cf 5.6%	-	-57.79%

²⁴ See Equation (3.26) on p. 97 of David Blake (2000) 'Financial Market Analysis' published by Wiley.

A discount rate of 7.5% is 34% higher than a discount rate of 5.6%. At age 65, a discount rate of 7.5% 'reduces' the present value of pension liabilities (payable from age 65) by nearly 14% compared with a discount rate of 5.6%. However, the real impact of the discount rate lies in discounting from age 65 to the current age of 25. The impact of the higher discount rate is to 'reduce' liabilities at age 25 by 58%. So for a 40-year discounting period, the magnification effect is almost twice the size of the change in the discount rate.

Table 2: The impact of the discount rate on the value of pension liabilities: A comparison between the average discount rate used in the private sector and in the London LGPSs (£ per £1p.a. pension from age 65 for life)

Liabilities	Discount rate	
	4.8% (average in private sector)	6.44% (average in London LGPS)
Liabilities at 65 (L65)	12.58	11.00
% reduction at 6.44% cf 4.8%	-	-12.55%
Liabilities at 25 (L25)	1.93	0.91
% reduction at 6.44% cf 4.8%	-	-53.01%

Table 2 shows the comparison between the average private sector discount rate (of 4.8%) and the average London LGPS discount rate (of 6.44%). There are similar sized differences between the present values of the pension liabilities between the two sectors as there was between the London LGPSs that had the lowest and highest discount rates (see Table 1). The liabilities of the average London LGPS would be substantially higher if it used the average private sector discount rate. This might go some way to explain the puzzle discussed earlier. The liabilities of the average London LGPS are probably much higher than the reported figures suggest.

Investment risk exposure

Figure 1 shows that local government (LG) and private sector (PS) funds had similar weightings in risk assets (i.e., equities) prior to 2005, at around 70%. After 2005, a very significant gap has emerged. PS funds have de-risked steadily: by the start of 2012, total risk assets had fallen to 35%. By contrast, LG funds were still holding more than 60% of their investments in risk assets.²⁵ This would appear to support the view of the councillor who informed us that schemes were taking on 'increasing levels of risk' in an attempt to remove their deficit. Figure 2 shows that LG funds have a (slightly) higher percentage of assets that are actively managed than PS funds.

²⁵ We understand that CIPFA data indicate that the average equity weighting for all local government funds is 65%. Our initial analysis confirms this figure although it is not always apparent whether 'other' asset classes listed by funds relate to equity-like assets or bond-like assets, therefore further analysis is required to provide more accurate scheme-specific weightings.

Figure 3 shows that this additional risk taking by LG funds has not been rewarded. The total cumulative return generated by LG funds of 55% between 2005 and 2012 lags behind the 64% generated by PS funds.

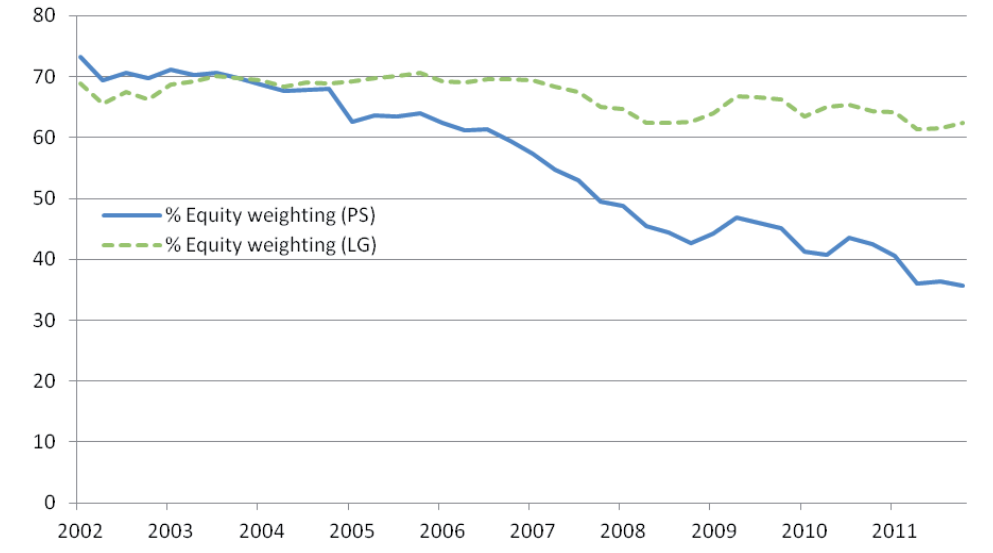


Figure 1: Equity weighting (%) in local government and private sector pension schemes 2002-12 Source: State Street Investment Analytics

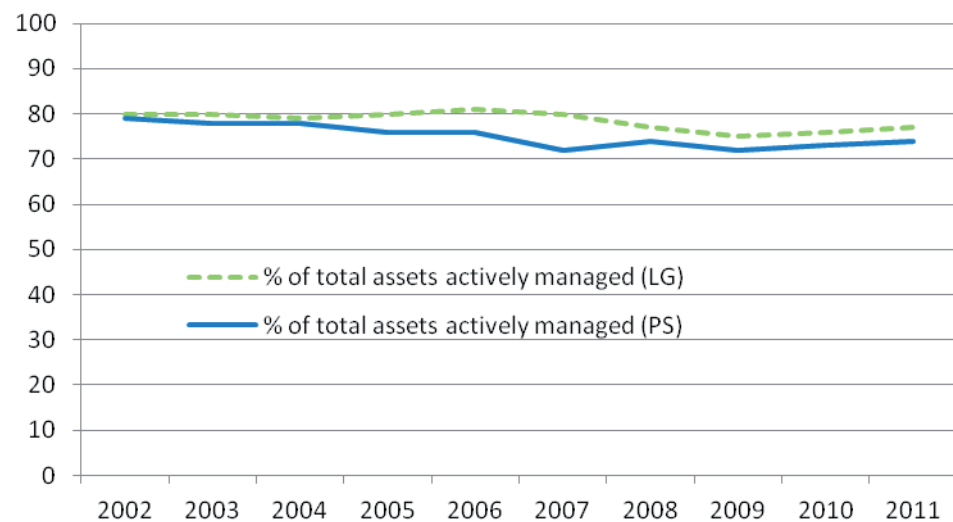


Figure 2: Active management (% of total assets) in local government and private sector pension schemes 2002-12 Source: State Street Investment Analytics

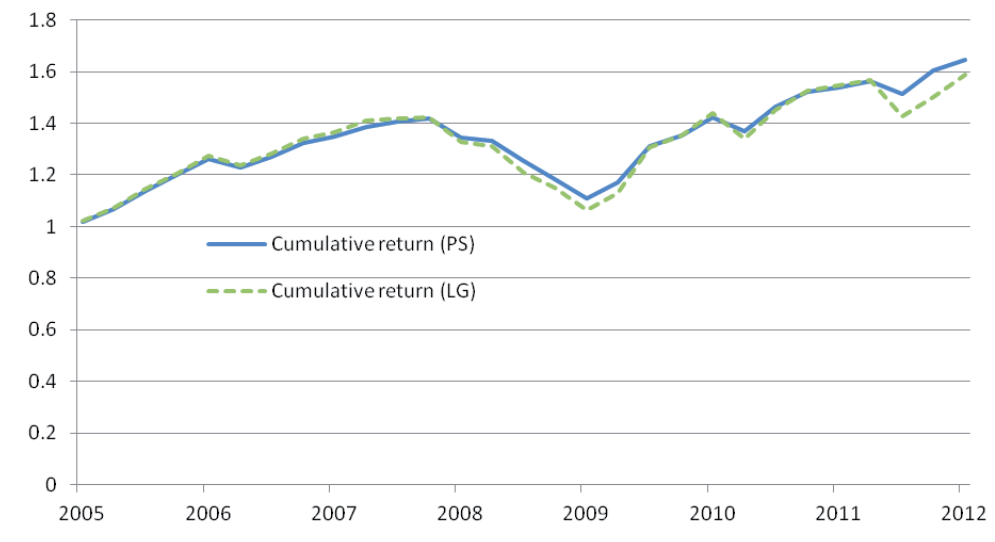


Figure 3: Cumulative return in local government and private sector pension schemes 2002-12 Source: State Street Investment Analytics

Section 4: Proposals For Further Research

Hutton recommended a two-stage approach, with which we agree, but we suggest the addition of a requirement for transparent comparable data should be the first priority. Our recommendations for further research, therefore, are:

1. To establish a blueprint for the calculation and explicit presentation of clear and consistent data.
2. To establish a clear definition of investment governance for the London schemes
3. Based on the data blueprint and the definition of investment governance, to conduct a full benchmarking study of the 34 funds to produce a 'map' of governance standards across all the schemes.

We offer the following observations as a basis for debate on these three proposals.

4.1 Data requirements

For the funded LGPS, it is arguably easier to assess whether the pension benefits promised are sustainable by considering whether the liabilities built up to date are being fully covered by the assets held by the Funds and any deficit recovery plans approved by the Fund. Relevant information on assets, liabilities and deficits for individual LGPS Funds is generated by triennial actuarial funding valuations. However, this information is not available at an aggregate national level. Hutton 17

To facilitate closer scrutiny and comparisons, therefore, there needs to be an agreed set of data requirements and the data should be calculated in a consistent manner that is set out explicitly in all documentation. We wonder if a single standard for disclosure might be derived from the requirements stipulated by tPR and the Pension Protection fund (PPF) for private sector schemes.

A simple tabulated summary at the beginning of each annual report might include the following data for the current and previous two valuations:

- Assets and liabilities and how these are measured
- The size of the fund and deficit
- The funding position
- The recovery period
- The actuarial assumptions
 - Nominal discount rate
 - Future investment performance
 - Inflation (earnings and price)

- Mortality
- Asset manager turnover, fees and transition costs
- The employer contribution
- The proportion of council tax receipts used for scheme funding purposes

This summary could be submitted to a central body, so that it can be consolidated in a single document and made available on a central website.

4.2 Definition of good investment governance

There is a powerful case for more independent oversight and much stronger governance of all the public service pension schemes. This should keep government, taxpayers and scheme members better informed about the financial health of these schemes. Hutton 4

This section explores the crucial issue of what is meant by good investment governance for the London schemes (see below for full details).

The objective of this stage of the proposed research is to construct a clear benchmark against which the pension schemes can be measured and evaluated, individually and in aggregate.

For investment governance to be effective, it must be embedded in the pension committee's decision-making processes. It is also very important to preserve the collective long-term experience, expertise and knowledge of committee members, insofar as this is possible, as the tenure of councillor members is vulnerable and subject to change every four years when local elections are held.

Recommendation 17: Every public service pension scheme (and individual LGPS Fund) should have a properly constituted, trained and competent Pension Board, with member nominees, responsible for meeting good standards of governance including effective and efficient administration. There should also be a pension policy group for each scheme at national level for considering major changes to scheme rules.

Hutton 126

The role of national pensions boards in respect of the locally administered schemes would be facilitative. While not taking on a regulatory or oversight role national pensions boards might help analyse and recommend on comparative performance of governance and administration. They might point to the scope for efficiencies in those areas that raise standards across the piece. In the case of the LGPS, their national pensions board could also look at overall funding and the comparative performance of individual Funds, fostering links between different individual LGPS Funds and perhaps making recommendations on opportunities to capture efficiencies and to improve investment performance. The boards could include nominees of individual scheme members and employers as well as those responsible for national scheme rules and local financing. Hutton 131

Factors that shape the model for investment governance include:

1. Common standards for reporting key data
2. Regulation (comparison of the London schemes' statutory framework with private sector DB regulation, which is overseen by tPR)
3. Investment governance objectives, including:
 - a. Fiduciary responsibilities
 - b. Accountability
 - c. Transparency
 - d. Risk management and the introduction of risk registers, which are used in private sector DB schemes to summarise the key risks for the scheme and the controls put in place to manage and mitigate these risks.
 - e. Variations between schemes: why these might exist and the need to impose quantitative limits
4. The composition of the governance committee
 - a. Representation of stakeholders and experts
 - b. Continuity /turnover / succession planning
 - c. Levels of experience and expertise
 - d. Relevant qualifications and requirement as condition of membership (e.g., the equivalent of TKU for local government schemes).
 - e. Type of external professionals used
 - f. Frequency of meetings; time allocation to investment issues
 - g. Identification of and processes to deal with potential conflicts of interest
5. Investment strategy
 - a. Role of the investment sub-committee
 - b. How to achieve consistency in structure and processes across all schemes
6. Asset management
 - a. Frequency of strategy review and process
 - b. Cost base / control
 - c. Fee structures: explicit and implicit
 - d. Risk management

- e. Role of the investment consultant
- f. Asset management procurement methodologies
- g. Performance measurement
- h. ESG

Independent regulation and oversight

Schemes are not subject to external independent regulation in the way that private sector schemes are. Hutton 16

By comparison with the private sector, the London schemes present very detailed accounting information, but very limited auditing of investment governance.

The Hutton report acknowledged the unusual status of LGPSs, which, unlike private sector schemes, are connected with the local democratic process. The report said that ‘where schemes with nationally determined rules are administered locally, as is the case for the LGPS ... there is a case for supplementing local pension boards with a national pension board ... separate from the individual local authorities and employers’. [130]

Recommendation 19: Governance and the availability and transparency of information would be improved by government establishing a framework that ensures independent oversight of the governance, administration and data transparency of public service pension schemes. Government should consider which body or bodies, including, for example, The Pensions Regulator, is most suitable to undertake this role. Hutton 16

We suggest that while the Pensions Regulator might be the obvious choice for an independent regulator for the local government schemes, tPR would require considerable additional resources to undertake this role. This is particularly relevant as tPR is required to oversee the defined contribution (DC) schemes of private sector employers used for auto-enrolment, which is being phased in between 2012 and 2018.

4.3 The benchmarking survey

Recommendation 17: Every public service pension scheme (and individual LGPS Fund) should have a properly constituted, trained and competent Pension Board, with member nominees, responsible for meeting good standards of governance including effective and efficient administration. There should also be a pension policy group for each scheme at national level for considering major changes to scheme rules. Hutton 16

Our research indicates that investment governance in the public sector is more lightly monitored or audited than is the case in the private sector, where such governance is considered a high priority by tPR. Many local government schemes appear just to ‘tick the box’ when it comes to publishing their (rather generic) Statement of Investment Principles. By contrast, the reverse is true in relation to pension fund accounting, which is rigorously audited in the public sector – more so, we were told, than in the private sector.

We recommend the following data should be collected for the last three valuation periods, updated with further information from other documents, such as the annual report and accounts and the custodian's report. This would provide a data set that facilitates the analysis of aggregate and scheme-specific trends in relation, for example to increased contributions, improvements in investment performance, reduction in costs, significant changes in the membership number and profile.

Data to be collected

1. AUM
2. Liabilities
 - a. In aggregate
 - b. Relative to active, deferred and pensioner member sections
3. The funding level
4. The recovery plan period
5. Actuarial assumptions
 - a. Nominal discount rate
 - b. Future investment performance
 - c. Inflation (earnings and prices)
 - d. Mortality
- e. Early retirement strain assumptions
6. Investment strategy
 - a. Asset allocation and rationale
 - b. Use of active and passive managers
 - c. Performance relative to an objective benchmark
 - d. Number of managers used
 - e. Turnover of both portfolio and managers
7. Fees paid to:
 - a. The investment consultant
 - b. The actuary
 - c. The asset managers, including transition fees when the managers change

8. The employer contribution
9. The proportion of council tax receipts used for scheme funding purposes
10. The composition of the pension committee
 - a. Number of councillor members
 - b. Average number of years of service on the committee
 - c. Turnover and reasons
 - d. Total hours per annum members spent on
 - i. Scheme meetings
 - ii. Other fund-related duties
 - e. Structure of the investment sub-committee
 - f. Analysis of the role of the S151 officer
 - g. Analysis of the role of the CIO and the independent adviser, where application

Conclusion

This report sheds a new light on the London Local Government Pension Schemes in relation to their published data and to their investment governance framework and processes. We hope that it helps all stakeholders in the London schemes to understand better the very real difficulties those tasked with running these schemes face, and also to appreciate the complexity of the potential conflicts of interest that appear to exist, which, although understandable, might influence key decisions made about the deferment of liabilities into the future and the responses to reform.

As we note in the Preface, the London LGPSs in aggregate represent a ticking time-bomb for London council tax payers and very likely for national tax payers too. But, we believe it is possible for this time bomb to be diffused if the relevant stakeholders act now. The lessons learned from the governance failings in private sector DB schemes in the 1990s, which led to their widespread closure at the turn of the century, must not be lost. Ultimately, governance is a matter for the Department for Communities and Local Government (DCLG), but the cooperation of all stakeholders is a prerequisite for successful reform.

We recognise the sensitivity of the debate about reform, which is why we suggest that a full benchmarking study based on an agreed definition of investment governance – as recommended by the Hutton report – is required. This study must be impartial and must accommodate the views of all stakeholders willing to engage with the research.

We welcome responses to this report.

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The London Local Government Pension Schemes Examined

Barking and Dagenham
Barnet
Bexley
Brent
Bromley
Camden
City of London
Croydon
Ealing
Enfield
Greenwich
Hackney
Hammersmith and Fulham
Haringey
Harrow
Havering
Hillingdon
Hounslow
Islington
Kensington and Chelsea
Kingston upon Thames
Lambeth
Lewisham
Merton
Newham
Redbridge
Richmond upon Thames
Southwark
Sutton
Tower Hamlets
Waltham Forest
Wandsworth
Westminster
LPFA

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Pension accounting, taxation and administration

The operational aspects of running pension schemes.

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