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London Borough of Barking & Dagenham Pension Fund

LGPS Update

A paper by the Independent Advisor
February 2019

Introduction

The purpose of this paper is to update the Pensions Committee on developments in respect of a range of important issues in the Local Government Pension Scheme (LGPS). This paper does not seek to address every significant issue relevant to the LGPS but rather those which appear to be the most relevant to the Barking and Dagenham Pensions Committee at this time.

The issues covered in this paper are:

- Scheme Advisory Board project – Good Governance in the LGPS Project
- Investment Pooling
- Investment Cost Transparency
- Section 13 Review of the 2016 LGPS Actuarial Valuation
- The Pensions Regulator and the LGPS

Scheme Advisory Board project – Good Governance in the LGPS

The LGPS in England and Wales is one Scheme administered by different local authorities (called Administering Authorities) who each operate a Fund within the overall Scheme. The operational structure of each Fund and its relation with the host authority will however be different.

For example, some Funds will have all LGPS Functions within one unit which ultimately reports to a single Chief Officer (usually, but not always, the Section 151 Officer) while some have Investment functions ultimately reporting to one Chief Officer (usually the Section 151 Officer) and Administration functions

reporting to another Chief Officer (usually the Director/Head of Human Resources). In some Funds Pension Officers deal exclusively with Pension issues while in others they also have non Pension roles such as responsibility for Council Treasury Management.

Conflicts of interest can occur as a result of a LGPS Fund sitting within the overall structure of a local authority. This could include where the host authority (Administering Authority) sought to exert pressure on the Section 151 Officer for example in relation to Employer Contribution rates, or where the Administering Authority did not effectively resource the Pensions function, or does not effectively manage recharges between the Pension Fund and wider Council.

In August 2018 the Scheme Advisory Board invited proposals from interested parties to assist it in developing options for change with regard to the relationship of LGPS Pension Funds to their existing host authorities for consideration prior to potentially making recommendations to the Secretary of State. Based on the documentation on the Scheme Advisory Board website it appears that the Board is considering two broad options:

- 1. Separation within existing structures** which would likely include some or all of – greater ring fencing of the Pensions function, completely separate Pension Fund Accounts and an accompanying Pension Fund specific annual governance statement, upfront funding of Pension budgets rather than internal recharging, clearer definition of duties and responsibilities of those charged with delivering the Pensions function, clearer/minimum training requirements for Officers and Members, minimum service standards. This option would involve greater ring-fencing of the Pensions function probably through the use of delegation to move some or all Pension related finance responsibilities from the Section 151 Officer to another officer whilst maintaining oversight, or requiring the host authority to create a dedicated senior officer position to take on all responsibilities for Pension Fund related issues as is already the case in a few (mainly very large) LGPS Funds. This option would likely also require that each host authority group all LGPS related activities within one discrete organisational unit.
- 2. Separation via new structures** – this would likely involve delegation of the Administering Authority function and all decision making to an alternative body that retains democratic accountability in some form. The employment of staff and contractual issues would be dealt with by this alternative body. Under this option consideration would be given, by the Scheme Advisory Board, to proposing legislation/regulation to require the creation of Combined Authorities with a number of Administering Authorities in each Combined Authority. This option while retaining some link between the existing Administering Authorities (such as Barking and Dagenham) and the LGPS would in effect transfer the responsibility for decisions relating to the management and administration of the Scheme to the new body (bodies).

Hymans Robertson have now been awarded the contract to work with the Scheme Advisory Board to develop possible options. It is anticipated that the Scheme Advisory Board will come forward with proposals on future structures for the LGPS during 2019.

Investment Pooling

On 3 January 2019 the Ministry for Housing Communities and Local Government (MHCLG) issued a consultation on new Statutory Guidance in respect of Asset Pooling. An item dedicated to this issue is contained elsewhere on the Agenda of the Pensions Committee and includes both a copy of the draft Statutory Guidance and a paper by the Independent Advisor providing observations and comments on the draft Statutory Guidance.

Investment Cost Transparency

The fee quoted by an Investment Manager for their services has always to be deducted from the gross return achieved by the Investment Manager to calculate the net return received by the Investor (in this case the Barking and Dagenham Pension Fund). However, there are also other costs, necessarily incurred by the Investment Managers (which depending on the asset class might, for example, include transaction taxes, broker commissions, entry/exit charges, custody charges, audit fees) that reduce the return received by the investor. Traditionally there was no standard means by which investors could seek information on these charges to allow investors to scrutinise and challenge costs.

During 2019 it is intended to launch, with the active participation of both institutional investors and the investment management industry, a scheme to facilitate the consistent reporting by investment managers of their management charges and costs to institutional investors in the United Kingdom. This very positive and welcome initiative has been facilitated by the work of the LGPS Scheme Advisory Board for England and Wales (SAB).

To improve the reporting and understanding of investment management charges and costs by LGPS Funds the Scheme Advisory Board for England and Wales (SAB) working with major stakeholders including CIPFA, some LGPS Funds and most crucially the Investment Association (the main trade body representing UK Investment Managers) developed the LGPS Investment Code of Transparency which was initially issued in May 2017. Under this voluntary Code participating Investment Managers will report their fees, costs and any relevant income (for example from stock lending) using standard templates issued by the SAB.

The approved templates cover only listed assets but where an asset class is not covered by the existing templates Investment Managers can still sign up to the Code and submit data agreed with each client that is “substantially *similar...to that covered by existing templates.*” It was intended to expand the Code to cover unlisted assets but this was subsequently passed to the Institutional Disclosure

Working Group (IDWG) established by the Financial Conduct Authority (FCA) which is discussed further later in this paper.

To sign up to the Code an Investment Manager must write to the SAB in a prescribed way and put in place, within a period of 12 months, systems to enable the completion and automatic submission of Templates to each relevant LGPS Fund. In September 2018 the SAB launched a tender for a process to validate the templates received from Investment Managers. As at early 8 February 2019 ninety five Investment Managers including four LGPS Asset Pools (Border to Coast, Brunel, Central, and the Local Pensions Partnership) had signed up to the Code.

The FCA Asset Management Market Study Final Report of June 2017 (Chapter 13) welcomed the use of the LGPS templates and proposed *that “both industry and investor representatives agree a standardised template of costs and charges”* and to *“ask an independent person to convene a group of relevant stakeholders to develop this further, for both mainstream and alternative asset classes”*. This resulted in the establishment of the Institutional Disclosure Working Group (IDWG) to gain agreement on disclosure templates for asset management services to institutional investors.

The IDWG membership was approximately 40% Institutional Investors, 40% investment Managers and 20% Independent experts. The IDWG reported back to the FCA in June 2018 and the FCA publicly welcomed their recommendations in July 2018. The IDWG made recommendations to the FCA which may be summarised as follows:

1. Proposed the use of five templates – User, Main Account-Level (for most product types), Private Equity, Physical Assets, Ancillary Services (Custody).
2. The use of the templates should be voluntary but encouraged through other means such as pressure from institutional investors applied to providers. Typically, this would be by non-compliance resulting in de-selection from Requests for Proposal and the non-renewal of contracts. Investment consultants and other market participants (such as platforms) should adopt a similar selection approach. Industry representative organisations and trade bodies should be prepared to adopt the templates as their disclosure codes and to support the use of the templates by their members.
3. Institutional investor education on the matter of cost disclosure and its benefits should be improved.
4. A new body or group should be created and convened by autumn 2018 to curate and update the framework. It should be representative of a wide range of stakeholders.

5. The IDWG recommended that no FCA rule should be written at this time that either mandated submission of data by providers using the templates or mandated the collection of data from providers by institutional investors. The IDWG recommended that the FCA should consider writing rules if: there is poor adoption of the templates by institutional investors or their providers; or institutional investors report difficulties in obtaining cost data to the level proposed in the templates from their providers; or providers are found to have misrepresented data via the templates to clients.

On 7 November 2018 a new body (as proposed by the IDWG) was launched which is known as the **Cost Transparency Initiative** (CTI). This is an independent group working to improve cost transparency and to progress the work of the IDWG. The CTI is supported by the Investment Association, LGPS Scheme Advisory Board and the Pensions and Lifetime Savings Association which is providing website services for the CTI. The CTI has the support of the FCA - Christopher Woolard, Director of Strategy and Competition at the FCA has commented: *“We welcome the launch of the Cost Transparency Initiative and have passed on the IDWG’s report and draft templates in full.... The FCA has been asked to join the Cost Transparency Initiative as an observer and we look forward to our continuing involvement in this area.”*

It should be noted that the Investment Management industry has been closely involved in both the development of the LGPS and IDWG templates and is involved in and supportive of the work of the CTI. At the Launch of the CTI Chris Cummings, Chief Executive of the Investment Association, stated that *“We welcome the launch of the Cost Transparency Initiative. Our industry is fully committed to transparency of costs and charges for all investors. We look forward to working closely with the PLSA and Local Government Pension Scheme Advisory Board to build on the progress of the IDWG, to.... enable costs and charges to be reported in a clear and comparable manner for institutional investors.”*

Mel Duffield from the Universities Superannuation Scheme which is a major UK institutional investor (with assets of around £60 billion) has been appointed Chair of the CTI. The CTI will run a pilot to test the templates developed by the IDWG and issue supporting technical and communications material during early 2019. Following the pilot, the CTI will roll out templates to the Investment Management and Pension Industries to encourage fully transparent and standardised cost and charge information for UK institutional investors.

Clearly, therefore, Cost Transparency is already becoming embedded within the LGPS and will begin to be embedded across UK institutional investors from this year. This is very positive in terms of openness, facilitating comparisons and scrutinising /constructively challenging Investment Managers charges.

Additionally, four LGPS Asset Pools have so far signed up to the LGPS Code of Cost Transparency. Furthermore (as highlighted in the Independent Advisor's paper elsewhere on this Agenda on the draft Statutory Guidance on Asset Pooling) this clearly and explicitly indicates the importance that the Ministry for Housing Communities and Local Government (MHCLG) attaches to investment cost transparency as Section 8.7 states *"Pool members should ensure that pool companies report in line with the SAB Code of Cost Transparency. They should also ensure that pool companies require their internal and external investment managers to do so."*

Section 13 Review of the 2016 LGPS Actuarial Valuation

The Government Actuary Department (GAD) was appointed by the MHCLG to report under Section 13 of the Public Service Pensions Act 2013 in respect of the 2016 Actuarial Valuations of the Funds in the Local Government Pension Scheme in England and Wales (LGPS). Section 13 requires GAD to report on whether the following aims were achieved:

- **Compliance:** whether a Fund's Valuation is in accordance with the Scheme Regulations
- **Consistency:** whether the Fund's Valuation has been carried out in a way which is not inconsistent with other Fund Valuations within the LGPS
- **Solvency:** whether the rate of Employer Contributions is set at an appropriate level to ensure the solvency of the Fund
- **Long term cost efficiency:** whether the rate of Employer Contributions is set at an appropriate level to ensure the long-term cost efficiency of the Scheme, as measured on an individual Fund basis

The first two issues are concerned primarily with the methods of the four Actuarial firms (Aon, Barnett Waddingham, Hymans Robertson and Mercer) who undertake Actuarial Valuations for LGPS Funds. The issues of Solvency and Long Term Cost Efficiency are Fund specific.

GAD undertook a "Dry Run" using the 2013 Actuarial Valuations but the report on the 2016 Valuations, which was issued on 27 September 2018, was the first official Section 13 Report. In reviewing the 2016 LGPS Actuarial Valuations GAD looked at a range of metrics to identify issues of Solvency and Long Term Cost Efficiency. Each Fund's score under each measure was colour coded: Green (no material issue), Amber (potential issue), Red (material issue).

Overall the GAD Section 13 report was clearly positive in respect of both the Scheme as a whole and individual LGPS Funds. In the Executive Summary to the report GAD commented that *“In aggregate the LGPS is in a strong financial position and funds have made significant progress since the 2013 valuation.....”* and that *“The Scheme ...has made significant progress since the dry run”* in terms of potential issues in respect of Solvency and Long Term Cost Efficiency with 70 out of 89 Funds with all green flags compared to 52 out of 90 in the dry run. There were 20 amber and 2 red flags compared to 58 amber and 5 red flags in the dry run. These results are, overall, very reassuring for the LGPS as a whole.

It should be noted that the two red flags related to the closed West Midlands Integrated Transport Authority Pension Fund and that no open LGPS Fund received a red flag. It is pleasing to note that the London Borough of Barking and Dagenham Fund received all green flags. Although, as already stated, the GAD report of September 2018 was clearly positive in relation to the Scheme as a whole and individual LGPS Funds it appears clear that GAD likely understated the strength of the Scheme as a whole and potentially the strength of individual LGPS Funds.

In October 2018 the four Actuarial Firms who provide Actuarial Services to the LGPS issued a (unprecedented joint) letter to the LGPS Scheme Advisory Board in England and Wales regarding the GAD Section 13 Report on the 2016 LGPS Actuarial Valuation. The letter included the statement *“We recognise that the initial headline messages in the report are positive about the overall progress being made by the LGPS..... Clearly this is something which we are pleased to see. However, on reading the detail of the report we have some material concerns over its content. We believe that it is important to highlight these,.....”*

The letter from the Actuarial firms includes concerns that GAD has failed to acknowledge improvements in funding that occurred between March 2016 and the 18 months until GAD issued their report. This letter was also clearly critical of the metrics used by GAD to determine the allocation of green, amber and red flags stating that *“the report is largely focussed on highlighting perceived failures by Funds against a series of arguably rather arbitrary actuarial metrics, many of which focus on a single point when in fact there are a number of interrelated issues at play.”* The letter also stated *“The metrics are in our view too simplistic and could lead to incorrect/invalid conclusions....in our view, there hasn't been sufficient detailed engagement with the administering authority and Fund Actuary to understand local circumstances or the risk management measures already in place..... Readers of the report will see the metrics used as a valid test (especially with the Red/Amber/Green classification used). This could influence funding behaviours in an effort to avoid a future red or amber flag and lead to lay readers drawing incorrect conclusions about the performance of a fund and its officers and committee. Ultimately this could result in actions being taken which are not in the best interests of the LGPS and/or individual funds.”*

Indeed, examination of the GAD report clearly demonstrates that GAD appear to have concentrated on very narrow metrics rather than taking a broad based or more holistic view. For example, ten Funds received an amber flag simply because they were in the lowest decile in terms of funding level based on the Scheme Advisory Board (SAB) standard basis funding level which was an attempt by the SAB to produce a measure to compare LGPS Funding levels using one particular set of assumptions. Using this approach ten Funds were in effect bound to receive an amber flag simply because of their position in a league table! The position in a league table in itself provides no objective information about the actual solvency (or long term cost efficiency) of an LGPS Fund. This metric which alone accounted for 10 of the 20 amber flags (in the whole report) is clearly at best a weak metric and arguably a misleading metric when considering the overall issue of solvency taking into account such issues as employer contribution levels, investment strategy and member profile.

As previously indicated the first two issues of **Compliance** and **Consistency** are concerned primarily with the methods of the four Actuarial firms who undertake Actuarial Valuations for LGPS Funds. At Section 2.2 (page 9) of their main report GAD state *“We found no concerns over compliance.”* GAD however expressed significant concerns over Consistency. For example at Section 1.12 (page 2) of the Executive Summary GAD expressed concern in respect of variations in approach between the 4 Actuarial firms stating *“in some areas, it appears that the choice of assumptions is more dependent on the house view of the....firm of actuaries....than on the local circumstances of the fund”* In the “Key consistency findings” section (page 11) of their main report GAD state *“The following assumptions showed a marked difference for funds advised by the different firms of actuarial advisors that are not apparently due to local differences”* - discount rate, mortality improvements, salary increases, commutation. *“We recommend the SAB consider what steps should be taken to achieve greater clarity and consistency in actuarial assumptions except where differences are justified by material local variations....”* This Recommendation is Recommendation 2 of the GAD report.

In their joint letter of October 2018, the four Actuarial firms expressed serious concerns regarding GAD’s approach to Consistency. The letter included the statement *“We fundamentally disagree with how GAD has approached what they call “evidential consistency”: the wording in the Public Service Pensions Act is “not inconsistent” implying a focus on identifying outliers which is entirely logical for a review analysing and comparing local LGPS valuations. GAD has instead interpreted their role as requiring a comparison of individual assumptions..... and commenting on whether or not they are identical. Our concern is that readers will be given a completely false impression of what we understood to be the intentions of Section 13.”*

The letter from the Actuarial firms went on to state *“In putting forward Recommendation 2, GAD has neither outlined what the benefits for the LGPS and its stakeholders would be, nor has it considered the potential downsides in terms of the reduced input from the administering authority into the funding*

process and the fundamental change in governance arrangements which would be involved. A change of this nature needs to be considered from a policy point of view with consultation with all stakeholders, rather than being introduced by the back door. We therefore do not agree with Recommendation 2 and believe that the Scheme Advisory Board should consider the feedback we provide to GAD before taking this recommendation forward.”

With regard to the issue of Consistency the relevant test is whether the Fund's Valuation has been carried out in a way which is “*not inconsistent*” with other Fund Valuations within the LGPS rather than whether the Fund Valuation is “*consistent*” with other Fund Valuations. Because the test is concerned with “*not inconsistent*” rather than “*consistent*” the test is surely of a lower level and therefore, supports the argument in the letter from the Actuarial firms that GAD has approached the issue of Consistency inappropriately in its review and report.

The four Actuarial firms all carried out their 2016 Valuations in accordance the Standards of the Institute and Faculty of Actuaries. Consequently, they applied professionally acceptable approaches to their Valuations of each individual LGPS Fund. Furthermore, if the four Actuarial firms did everything the same way this would eliminate both judgement and innovation. At present individual LGPS Funds have a choice of four Actuarial firms each with differing approaches but all of which are compatible with the requirements of Institute and Faculty of Actuaries. This provides choice to LGPS Funds in respect of their Actuary. If GAD's Recommendation 2 is enacted this will, in effect, reduce the choice of individual LGPS Funds and be a significant move towards a centralised and rigid approach to actuarial and funding issues in the LGPS.

The Scheme Advisory Board have not yet formally responded to GAD's Recommendation 2. Given that the 2019 Actuarial Valuations of LGPS Funds will formally commence at the end of March 2019 it is, therefore, highly unlikely that this recommendation will impact the approach of the four Actuarial firms to the 2019 LGPS Actuarial Valuation.

The Pensions Regulator and the LGPS

Section 17 and Schedule 4 of the Public Service Pensions Act 2013 extended the role of the Pensions Regulator (tPR) to include public sector pension schemes including the Local Government Pension Scheme (LGPS) from 1 April 2015.

With regard to the LGPS the Pensions Regulator (tPR) now has responsibilities in relation to governance and particularly administration. However, the Pensions Regulator's role **has not been extended to funding and investment issues within the LGPS** which remain wholly the responsibility of the Secretary of State for Housing, Communities and Local Government.

Schedule 4 of the Public Service Pensions Act 2013 requires the Pensions Regulator (tPR) to issue a Code of Practice or Codes of Practice in respect of certain specified matters. In response to this requirement the Pensions Regulator issued Code of Practice No 14 "Governance and administration of public service pension schemes" which came into effect from 1 April 2015. This Code of Practice is applicable both to the Barking and Dagenham Pension Fund and the individual Employers within the Fund. The Code provides practical guidance and sets expected standards of practice in relation to legal requirements in relation to a number of important issues including: knowledge and understanding required by pension board members, internal controls, Scheme record-keeping, maintaining contributions, providing information to members, Internal dispute resolution, reporting breaches of the law.

In June 2015 the tPR issued its "Compliance and enforcement policy for public service pension schemes." This set out the Regulator's proposed approach to compliance and enforcement in relation to public service pension schemes. In this document the Regulator stated that its primary focus would be on educating and enabling Schemes to improve standards and comply with legal requirements. This was in effect an educate, enable, enforce approach.

The Pensions Regulator (tPR) has shown an increasing interest, attention, and focus in relation to the LGPS. It has a clear focus on record keeping and data quality, also on cyber security, internal control, and Governance in practice. In 2017 the tPR levied a fine on the London Borough of Barnet LGPS Fund and has now moved from its educate, enable, enforce approach, to a quicker, clearer and tougher approach.

In September 2018 the Pensions Regulator tPR unveiled a "*new approach*" in its publication "***Making workplace pensions work***" This operating model covers both the public and private sector and is a new regulatory approach "*to drive up standards and tackle risk.....taking a much more proactive approach....and tackling problems and being tougher when we need to be.*" tPR will focus on 4 key themes – Setting clear expectations; identifying risk early; driving compliance through supervision and enforcement; working with others. This approach (yet) again emphasises that both LGPS Pension Funds and individual Employers need to pay close attention to Pensions Administration issues.

The approach of the Pensions Regulator to the LGPS in particular has however caused the Chair of the LGPS Scheme Advisory Board in England and Wales (SAB) to write (on 28 November 2018) to the Chief Executive of the Pensions Regulator. The SAB website states that the letter expressed “concerns raised at the last board meeting in October about the burdens being imposed by the Regulator on individual administering authorities”. This letter included the following “...the Board is clear that the overwhelming majority of administering authorities have been taking steps to improve the quality of their data and record keeping and are making significant progress towards achieving the prescribed standards..... I would therefore hope that you would agree to work jointly with us in communicating any lessons learnt from your engagement with a selected number of LGPS administering authorities to the scheme as a whole. We see this as an alternative to enforcement action against any of the selected funds that you consider to be non-compliant with your codes of practice. The Board is clear that the threat of enforcement action would not be helpful in creating an environment where administering authorities can be fully open and willing to resolve any shortcomings identified by your casework teams.

Outside of the current one-to-one programme, it has been reported that progress within the LGPS is lagging behind other cohorts. But such conclusions do not in the Board’s view reflect the unique position of the LGPS as a locally administered, multiemployer, funded pension scheme. To borrow the fruit analogy, we take the view that apples are not being compared with apples in this case.

Against the good progress that we believe is being made, the Board is disappointed to learn of cases where formal action is being considered against individual LGPS scheme managers with the imposition of fines being a real possibility. The Board fully accepts that the Pensions Regulator has a clear responsibility to apply the enforcement powers conferred by the various Pensions Acts in appropriate cases and we are certainly not questioning the right for these powers to be exercised where warranted. However, having identified the LGPS as the most at risk public service pension scheme, the timing of individual enforcement action would appear to sit uncomfortably with the wider one-to-one engagement you are presently undertaking with a number of LGPS scheme managers where positive engagement is being encouraged.”

The fact that the Scheme Advisory Board (SAB) felt that it needed to issue such a robust letter to the Pensions Regulator indicates the genuine concern of the SAB as to the practical approach and attitude to the LGPS of the tPR. The Chief Executive of the tPR has now confirmed that a senior member of her team will be available to attend the April 2018 meeting of the Scheme Advisory Board. It is to be hoped that through the SAB more positive relations between the tPR and the LGPS can be established to the benefit all stakeholders.

Conclusion

This paper has sought to inform and update the Pensions Committee on a number of important issues affecting the LGPS and with which it is desirable that the Members of the Committee are appropriately conversant.

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8 February 2019

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