11 July 2014

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Submitted online at LGPSReform@communities.gsi.gov.uk

Dear Victoria

Consultation on Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies

The IMA represents the asset management industry operating in the UK. Our members include independent asset managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of around £5 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles.

We welcome the opportunity to comment on the proposals and support Government efforts to improve efficiencies in the LGPS. Our answers to specific questions in the consultation paper are set out below.

We look forward to hearing from you if there is any clarification that you would find useful on the points we have raised. We would be very happy to meet to discuss our response.

Yours sincerely

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<u>Consultation on Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies</u>

The IMA recognises both the scale of the funding challenges facing Local Government Pension Schemes, and the need to assess whether cost savings can be achieved in the procurement processes of LGPS.

As our response of 27 September 2013 to the previous stage of this consultation identified, we also believe that a necessary (but not always sufficient) condition for addressing the issues facing UK pension schemes – public and private sector, defined benefit and defined contribution – is to put in place more robust governance mechanisms. Our response focussed on three areas of good governance:

1. *Appropriate targeting of cost-efficiency measures*
2. *Improved consistency of professional standards*
3. *Promotion of a long-term view*

Strong investment decision-making, implementation and review are features of well-governed pension schemes. If these features were demonstrably present throughout all LGPS, their advisers and managers, the outcome should be a cost saving through better overall value for money (i.e. better results for a given level of expenditure). It is this test – overall value for money and not lower upfront cost – which we think should guide Government in its thinking. We understand responses from our members will provide many examples of the how focussing upon overall performance and not mere headline cost has operated in the interests of their LGPS clients.

As with the previous consultation, we find it hard to respond helpfully within the constraints and embedded assumptions of the questions. We have therefore provided some opening comments with respect specifically to the use of active and passive mandates rather than taking it as axiomatic that active and passive strategies should be used as proposed and only then asking how best to achieve that.

1. It is clear that there will be client demand for both active and passive approaches to investment management, depending on a range of factors, such as client strategic asset allocation, the characteristics of the market being invested in, specific client preferences in terms of ESG factors and nature of the client itself. The IMA views the decision as to whether to use active or passive mandates, and the pricing of those mandates, as a commercial one for pension schemes themselves. We do not have a view as to what the overall balance within the market should be between active and passive. Again, this is something for a well-functioning market to determine. The growing set of recommendations and standards from the IMA on transparency of costs and charges are and will deliver improvements to the functioning of the market. It seems to us that a choice between active and passive must be classed as strategic and therefore something for the individual funds to decide in the context of their own governance and accountability framework. We believe that it would be inconsistent to assert that individual funds remain responsible for asset allocation (where to invest) decisions, but then to take from them the high level decision about how to invest.

We also note the comments of the Law Commission, in their recent report (Fiduciary Duties of Investment Intermediaries), regarding the possible application of the IORP Directive to the LGPS and that the impact of Article 18 of the Directive would be critical in this area.

2. To prescribe a specific investment structure for a whole client group is a blunt instrument, effectively asserting (on the basis of limited data – see point 4) that an average investment performance, measured as relevant benchmark (net of fees), should be the optimal approach for a range of pension schemes with different liability structures, funding positions and approaches to asset management. We would challenge the conclusion that because one part of a universe is not deemed to be accessing investment services on an optimal basis, the whole universe should adopt a harmonised approach. We believe that this risks missing two points. First, many LGPS schemes have a positive and extensive experience of active asset management. Secondly, and more fundamentally, the underlying issue here is governance process and behaviour, as outlined in our opening comments.

3. We would caution against the tendency to fall into simplistic comparisons of active and passive. There are a variety of more or less blended approaches which can be bought by LGPS. Even then, only considering active management in terms of relative performance to benchmark can miss the point. Asset managers also use strategies to help clients manage their liabilities and cash flow demands through the use of LDI strategies – these appear not to have been considered by Government.

4. Decisions of this magnitude need to be taken with care and analytical rigour. We are not persuaded that the evidence set presented on investment management performance and the associated cost savings of the proposed move to passive is sufficiently robust. We would give four immediate examples:

    a. The Government's own statistics suggest that asset management fees are significantly lower across the LGPS universe than the Hymans Robertson report suggests (Local Government Pension Scheme Funds summary data: 2011 to 2012). In detail, according to the Government statistics, for the period 2011-2012, the 89 LGPS funds in England and Wales had a total administration cost of £505m of which £381m were fund management costs. Given an average fund market value of £155bn (based on a fund market value of £153bn at the beginning and £157bn at the end of the period), this implies that the entire LGPS sample in England and Wales faced 33 basis points for total administration and 25 basis points for fund management. These numbers are considerably different to the amounts in the Hymans

Robertson report which for the end of 2012 quotes £790m for total costs and £745m for investment management costs, accounting for 44 and 41 basis points respectively[1].

b. The Hymans report claims significant savings from a reduction in transaction costs achieved by moving to passive mandates, but this cannot not be true (by definition) where there is gross outperformance of a benchmark. Transaction costs clearly matter significantly to overall return, but are accounted for within it. For example, in UK equities, the gross outperformance within the Hymans sample (albeit small at 0.1% in the selected mandates) is net of any transaction costs. The starting point, therefore, will be a loss of 0.1% (or the relevant out-performance for specific mandates at individual scheme level), and no savings. Where a mandate has under-performed, the amount saved/gained is the difference between the benchmark (net of fees) and the actual performance (net of fees). Moreover, there is a lack of consistency in the periods covered for each part of the report. The basis for the estimations is a total market value of £180bn as at 31 December 2012 (page 10). However, the transaction costs are reported for the period 2012-2013 (page 14).

c. It is not clear to us how performance fees for equity and fixed income mandates have been incorporated into the cost savings calculations. Performance fees will only have been paid if relevant performance metrics have been met, which means that those fees should be assessed relative to the relevant mandate, not at an aggregate level. This implies that the quoted cost savings of £230m achieved by moving equities and fixed income into passive strategies is overestimated as it accounts for performance fees paid by outperforming funds and these funds won't be outperforming when they become passive and so won't be paying any performance fees.

d. It could also be added that there is not enough clarity on the estimation of the total transition costs (pages 24-25). Although it is clearly stated that the cost of transitioning equities and bonds to passive management is estimated at £215m and that the other costs are relatively insignificant, it would be beneficial for transparency to clearly state how much each of the items listed under "Costs" on page 24 is estimated to cost. Moreover, moving equities and bonds from active to passive management would sacrifice value for the funds that are reported to have consistently outperformed over long periods

[1] A similar discrepancy could be observed with the Government statistics for the period 2012-2013. LGPS funds in England and Wales had a total market value of £157bn at the start of the period and £178bn at the end. Total administration costs amounted to £536m (32 basis points of the average market value at the beginning and the end of the period) of which £409m (24 basis points of the average market value at the beginning and the end of the period) were fund management costs.

(page 20). The authorities and contributors to the funds concerned should be aware of the added value that would be lost from this move.

5. For the Government effectively to take the view that passive rather than active management is a preferred direction fails to acknowledge the importance of active asset management for the wider economy. The reality is that markets, both primary and secondary, and whether for equities, fixed income or other asset classes such as property, function because decisions are taken both about capital allocation and about price levels. This combination results in trading which determines from moment to moment a price level. Critically, without such activity there would be no index to track, as it would no longer be sufficiently underpinned by active decisions. Furthermore, both UK and European public policy expectations of filling the funding gap left by capital-constrained Governments and banks depend upon successful intermediation of capital flows by other parties, notably asset managers. It would be contradictory for Government to signal on the one hand that asset management is a critical component of long-term investment, while on the other implying it has limited value because of a consistent focus on benchmark performance.

Having made these points, and having re-iterated our concern that the policy proposals should be focussed on improving outcomes in terms of overall performance whilst still addressing cost, we address further aspects of the consultation questions not fully addressed above.

Q1: Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments? Please explain and evidence your view.

No, not necessarily, and if they do it could be better achieved by other means. The important question is not so much how the pension funds' investments are structured as how collective bargaining power can be harnessed to achieve economies of scale and market access for smaller funds. A CIV structure may be one way of achieving this, but it is not the only way. This depends upon how the governance arrangements of the CIV are structured. Increased co-operation and the use of framework agreements for procurement across groups of funds can have a similar effect and these arrangements have been developing in recent years. Government should consider the extent to which a national framework agreement for asset management would operate in the public benefit.

Q2: Do you agree with the proposal to keep decisions about asset allocation with the local authorities?

Yes, but the competing objectives of local control and the establishment of effective, specialised governance arrangements need to be addressed. While many existing local authority funds represent good examples of well-functioning, appropriately governed pension arrangements, the problem of the diversity of skillsets that, by some accounts, characterises the LGPS landscape needs to be addressed. This can be done in a number of ways.

Governance within LGPS would be significantly improved through greater consistency of professional standards among local authority funds, helping to address the challenges created as mandates become more specialised and more diversified into alternative asset classes. Whatever else, such mandates increase the need for highly specialised skills.

Our members' experience and findings from independent reports link effective internal management to stronger performance and a positive impact for scheme members and taxpayers. A greater focus on risk is another important factor. A well-resourced, qualified and specialist team of investment professionals at LGPS would engender an environment in which there is greater challenge of ideas and expectation of service. This could be accomplished within a framework where local authorities retain decision making at asset allocation level, but with access to greater resources to help them make increasingly complex choices.

We would welcome a discussion on the possibility of greater collaboration in the area of professional standards, including the potential for a cross-industry initiative in conjunction with consultants, advisors and the local authorities themselves. This could include an expansion of existing educational and training initiatives as well as the potential for establishing industry 'best practice', so as to enable comparison, self-evaluation and tools for improvement among the funds themselves.

Q3: How many common investment vehicles should be established and which asset classes do you think should be separately represented in each of the listed asset and alternative asset common investment vehicles?

Assuming CIVs are the best solution, there would have to be sufficient asset classes to accommodate the different objectives of different funds. This number may change over time as objectives and asset allocations change. With umbrella structures, a very small number of CIVs could include as many sub-funds as are needed, with the ability to add new asset classes as demand dictates. The alternative reading of this question might be that some central body would determine how many classes and sub-classes of asset-types could be comprised in any one mandate which could be awarded to an asset manager. In the absence of a sufficient number of different asset sets, the choice of asset allocation would be commensurately removed from local authorities. So the answer should be that the number of sub-funds in any umbrella arrangement should be as large as is needed to allow each local authority client to access the asset allocation it chooses.

The question also reminds us of the problems which arise with trying to operate under the existing investment regulations. It has been a long-standing request of our members' LGPS clients, their advisers and our members themselves to restructure the investment rules so as to allow for more efficient and effective investment approaches to be taken. We are pleased the Government has indicated its commitment to a consultation on this subject, which we trust will proceed notwithstanding the present consultation.

Q4: What type of common investment vehicle do you believe would offer the most beneficial structure? What governance arrangements should be established?

Assuming CIVs are the best solution, the authorised contractual scheme, with its look-through tax structure, could represent an effective option. In which case, the governance arrangements for the scheme itself would be governed by the rules in the FCA's Collective Investment Schemes Sourcebook (COLL), in particular COLL 6, "Operating duties and responsibilities". We expect the biggest issue will not be the vehicle type, but how best to reflect the legitimate interests of a more or less diverse group of LGPS funds with the need for clear lines of governance and accountability under FCA regulation. For example, a Board with a representative of each LGPS might be unwieldy, and even challenging in terms of regulatory approvals, whilst a Board consisting of only a sub-set will leave some LGPS funds needing to consider how to secure the level of accountability and control necessary to match the local authority's own democratic accountability.

Q5: In the light of the evidence on the relative costs and benefits of active and passive management, including Hymans Robertson's evidence on aggregate performance, which of the options set out above offers best value for taxpayers, Scheme members and employers?

The fourth option is preferred on the basis that this question and the options presented ignore other factors which deserve consideration. Funds need access to asset management solutions which achieve a range of outcomes. They will have different levels of liability and different requirements in terms of liability management. Our opening comments provide more detail in relation to the Hymans Robertson work.