Pensions Committee

2.00pm, Monday, 26 March 2018

Pension Fund Cost Benchmarking

Item number	5.10
Report number	
Executive/routine	
Wards	All
Council Commitments	Delivering a Council that works for all

Executive Summary

The purpose of this report is to inform Committee of conclusions of the benchmarking of investment costs for Lothian Pension Fund and pensions administration costs for Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund ("the Funds").

The report on investment costs relies on data and analysis provided by CEM Benchmarking Inc. Its database comprises 33 LGPS funds (£168 billion), and a wider global universe of 331 funds (£6.2 trillion including half of the world's top 300 funds). Actual cost of 0.41% was below the benchmark cost of 0.48%. The majority of actual costs relate to external management. The 0.07% difference amounts to approximately £4.3m per year. The main contributing factor to these cost savings is the fact that the Fund manages a relatively high percentage of assets on an internal basis, compared to the benchmark peer group.

Pension administration cost per member of £24.37 for the three Funds is within the wide range of cost of local authority funds, c£13 to £33, albeit higher than the total average of £20.18. CIPFA Benchmarking Club also allows for a narrower range of "comparator" funds to be selected on the basis of fund size. The average cost per member of funds of comparable scale to the combined three Funds is £21.12.

However informative, care should be taken not to derive definitive conclusions on the basis of benchmarking information due to potential flaws and/or assumptions included in the underlying data.

Report

Pension Fund Cost Benchmarking

1. Recommendations

Committee is requested to:

1.1 Note the report; and

1.2 Note that the CEM Investment Cost Effectiveness Analysis (to 31 March 2017) and the CIPFA Pensions Administration Benchmarking 2017 reports (both the "Final Report" and the "Comparator Report") have been provided, on a confidential basis, to the Convener of the Pensions Committee and Convener of the Pensions Audit Sub-Committee.

2. Background

2.1 The annual report 2016/17 identifies £31.9 million of expenses for the Funds, with investment costs representing the largest proportion of the total, as expected.

2.2 Benchmarking can be a helpful tool to identify areas for review to deliver improved value for money. It is intended that participation in the benchmarking of service provision should facilitate:

- Comparison between the costs and performance;
- Provision of evidence to support decisions on budget relating to the sustainability and capability of the investment and administrative teams to enhance customer satisfaction;
- Sharing of information and ideas with peer(s);
- Review of performance trends over time.

2.3 In an effort to better understand its investment expense base, Lothian Pension Fund has contributed to CEM's database for the past five years.

2.3.1 The CEM 2017 global database comprises 331 funds representing £6.2 trillion in assets, including 248 North American funds with assets of £3.4 trillion and 74 European funds with assets of £2.1 trillion.

2.3.2 The global database also includes 33 LGPS funds with total assets of £168bn.

2.3.3 The funds range in size from £0.1 billion to £736 billion.

2.3.4 The peer group for calculating the Fund's benchmark costs contains 21 funds (including 11 LGPS funds). The peer group funds have been selected on the basis of fund size. The median fund size within the peer group is

£6.8bn, with half the funds in the range of £6.5bn to £7.8bn. This compares with Lothian Pension Fund's assets of £6.6bn at 31 March 2017.

2.3.5 Care should be taken in deriving conclusions from the headline data. CEM itself states that "being high or low cost is neither good nor bad". What matters is whether a pension fund is receiving sufficient value for the costs incurred. This is reflected in the long term returns of pension funds, net of costs.

2.4 Chartered Institute of Public Finance and Accountancy (CIPFA) pensions administration benchmarking club has been used for a number of years to assess the costs of administration of the Lothian Pension Fund, Lothian Buses Pension Fund and the Scottish Homes Pension Fund. The outputs and analyses have served to supplement internal performance management information.

3. Main report

Investment Cost Benchmarking Analysis

3.1 The benchmarking provided by CEM aims to provide comparable data, but they are unable to capture all investment costs from all funds. Private asset performance fees (excluded in previous years) are now included, although transaction costs remain excluded. The total actual costs reported by CEM therefore differ from those reported in Lothian Pension Fund's annual report.

3.2 CEM calculates a benchmark cost for Lothian Pension Fund, which reflects the Fund's asset class mix, based on the asset class costs of the peer group funds.

3.3 The Fund's actual cost figure to 31 March 2017 of approximately 0.41% was below the benchmark cost of 0.48%. The 0.07% difference amounts to approximately £4.3m per year. Previous year CEM cost analyses were calculated on a calendar year basis and are shown below:

- 31 December 2015: 0.36% versus the benchmark cost of 0.45%
- 31 December 2014: 0.39% versus the benchmark cost of 0.50%

3.4 CEM concludes that the primary reason for costs being low compared with the benchmark is 'implementation style' – a relatively high percentage of assets are internally managed. External active management fees are significantly more expensive than internal management.

3.5 CEM analysis also shows that Lothian Pension Fund costs of 0.41%, are significantly lower than the median costs of the global peer group (0.64%) and CEM's LGPS dataset of 33 funds (0.54%).

3.6 The annual report 2016/17 for the pension fund identifies £27.7m of investment management expenses (2015/16: £34.5m), £23.4 million (84%) of which are external management fees (2015/16: £29.5m). All other expenses, the largest of which are internal asset management costs, transaction costs, property operational costs and custody fees, amounted to £4.3m (2015/16: £5m). External management fees represent 0.39% of average assets, while all other expenses represent 0.07%

of average assets. The direct costs attributable to internal asset management are approximately 0.02% of average assets.

CIPFA Pensions Administration Benchmarking Club

3.7 The CIPFA Pensions Administration Benchmarking Club aims to collect the transactional volumes and processing costs for administering members' LGPS benefits (i.e. excluding investment) using standard definitions. "Employing authority work" and any work associated with the administration of non-LGPS pensions are excluded.

3.8 Local authority pension funds subscribe to the CIPFA Benchmarking Club on a voluntary basis. The relative value to be gained from benchmarking analyses is therefore dependant on the scale of take-up of the service.

3.9 CIPFA has stated that, in order to protect its commercial interests, its benchmarking reports "cannot be put in the public domain. It is for internal uses only within the authority....and for contacting and communicating with other members of the club". Accordingly, the full report and also the comparator report, the latter being a selected subset of Funds of comparable scale, have been provided, on a confidential basis, to the Convener of the Pensions Committee and Convener of the Pensions Audit Sub-Committee.

3.10 Recognising this important proviso, restricted summary findings on costs and other observations on differences in the make-up of the Fund are as follows:

- LPF cost per member of £24.37 is within the range of the local authority funds, c£13 to £33. However, the cost is higher than the average of all funds of £20.18. The average of funds of comparable scale is £21.12.
- Active members represent a higher percentage of overall membership for LPF (40.3%) than the group average (33.9%). The proportion of Pensioners to total membership (29.5%) is again higher (than group of 24.1%), with the consequence being that the proportion of deferred members (22.6%) is lower than that of the typical fund (31.7%). As deferred members are less demanding on administration services, these factors would tend to increase pension administration and payroll workload and therefore cost.
- Also of note is that in terms of the proportion of staff holding relevant pension administration qualifications, LPF is significantly in excess (more than double) that of the average.

3.11 It is emphasised that it would be incorrect to derive definitive conclusions on the basis of apportioned costs. This is an inherent issue given the scale of central support costs which are typically apportioned to the pension fund by the host Councils, the extent of co-provision of employer services and also the bases of overhead apportionment to the pension administration function, as distinct from other activities within the Fund Accounts.

Performance Benchmarking

3.12 CEM highlights that investment costs should be taken in the context of a fund's long-term net returns.

3.13 CEM have compared Lothian Pension Fund's net value added (investment performance in excess of a fund's benchmark) over three-, four- and five-year time horizons against the net value added performance of CEM's global universe and LGPS universe.

3.14 The analysis indicates Lothian Pension Fund's net value added performance has been very strong over these periods - in the top 5%-10% percentile for the global universe and in the top 5% percentile for the LGPS universe.

3.15 The Fund's strong performance relative to peers is attributable to the strong performance of the Fund relative to its benchmark in the years to 31 March 2015 and 2016. This was driven by the performance of the Fund's internally managed equity portfolios, which aim to deliver stronger returns when equity markets are weaker/ less buoyant.

3.16 Pension administration performance appears to be generally in line with industry standards.

CIPFA Pension Panel – Letter to Chief Finance Officers, all Local Authority Funds, September 2017

3.17 Mike Ellsmore, Chair, CIPFA Pension Panel, wrote to the Chief Finance Officers of all UK administering authorities in September 2017. He expressed the opinion that "During this period of prolonged austerity there is continuous pressure to drive down costs and local government pension schemes have not been able to avoid this pressure. The CIPFA Pension Panel has become increasingly concerned that in some instances this may now be impacting on the effective administration of the scheme". This letter is shown in full at Appendix 1.

4. Measures of success

4.1 Benchmarking of costs provides management information, which serves to inform the service planning and budgetary process of the three pension funds.

5. Financial impact

5.1 There are no financial implications arising directly from this report. Out of the Funds' total costs of £31.9 million for 2016/17, investment costs amounted to £29.7 million and pension administration costs amounted to £2.1 million. Continuous improvement initiatives will be met from the approved budget 2017/18.

6. Risk, policy, compliance and governance impact

6.1 The provision of summarised conclusions of benchmarking is intended to enhance the governance of the three Lothian Pension Funds.

7. Equalities impact

7.1 There are no equalities implications as a result of this report.

8. Sustainability impact

8.1 There are no adverse sustainability impacts arising from this report.

9. Consultation and engagement

9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Fund and they are invited to comment on the relevant matters at Committee meetings.

10. Background reading/external references

10.1 None

Stephen S. Moir

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11. Appendices

Appendix 1 – Letter from Chair of CIPFA Pensions Panel

Dear Colleague,

LGPS Resource Requirements

During this period of prolonged austerity there is continuous pressure to drive down costs and local government pension schemes have not been able to avoid this pressure. The CIPFA Pension Panel has become increasingly concerned that in some instances this may now be impacting on the effective administration of the scheme. The Panel acknowledges that a number of Funds and Pools have worked hard to protect schemes during this difficult period.

I am therefore taking the opportunity to write on behalf of the CIPFA Pensions Panel to remind all Section 151 Officers of their responsibilities regarding the resourcing requirement for Local Government Pension Scheme (LGPS) Funds. The pension liability is the biggest single risk on the balance sheet of most local authorities, and the responsibility for this risk lies with individual employers in respect of both the historic and current costs.

You will no doubt be aware of the current asset pooling initiatives which are placing significant demands on existing pension staff and the Panel is concerned that this is having a negative impact on the level of resources available to deliver the statutory functions of pension funds. The LGPS is already facing a number of challenges including managing an ever increasing number of employing bodies in the scheme and also the ongoing implementation of the 2014 CARE Scheme. Following the 2016 Triennial Valuation the four actuarial firms identified major concerns with the quality of data being submitted by funds and this has been followed up recently by The Pensions Regulator who has noted the issues around data quality and will be focusing upon this area in the coming year.

We are all aware of the challenges around resources during this period of austerity and pension funds as with all other services should be as efficient as possible. However, the current pressures and increased complexity facing the LGPS require an increase in resources to ensure that the huge challenge of establishing asset pools as well as the increasing administrative requirements do not create an unmanageable risk.

In 2014 CIPFA issued a supplement to its Role of the CFO Publication covering the Role of the CFO in the Local Government Pension Scheme setting out the requirements and standards expected of the CFO. CIPFA also collaborated with AON Hewitt to produce **Guidance on Investment Pooling Governance Principles for Administering Authorities.** The fiduciary responsibility for a pension fund will not change following asset pooling and all stakeholders should ensure that in addition to the work going on to establish asset pools it is equally important that the funds put in place sound governance arrangements to manage the relationship with these pools.

The level of scrutiny on LGPS Funds has never been higher both from internal sources such as Local Pension Boards but particularly from external sources such as The Pensions Regulator, Pensions Ombudsmen and the national press. It is therefore essential that funds have the necessary capacity to meet these challenges otherwise there is a significant risk of censure and the subsequent reputational damage at local and national level. CIPFA would expect funds to be taking the necessary advice and comparing its costs and service delivery (through benchmarking and other analysis) to ensure they are in line with the rest of the LGPS and achieving the standards expected by their members.

CIPFA's Pension Panel aims to support all those involved in delivery of the LGPS and has produced a range of Guidance to assist practitioners and will continue to do so. The Panel is always keen to hear the views of its members with regard to pensions and works closely with Treasurer Societies as required.

Kind Regards,

Mike Ellsmore

Mike Ellsmore
Chair CIPFA Pensions Panel

CIPFA
The Chartered Institute of Public Finance & Accountancy