Pensions Committee

2.00pm, Monday, 26 March 2018

Merger of Lothian Buses Pension Fund and Lothian Pension Fund

Item number	5.7
Report number	
Executive/routine	
Wards	All
Council Commitments	Delivering a Council that works for all

Executive Summary

The report seeks approval to the transfer of the assets and liabilities of the Lothian Buses Pension Fund into the Lothian Pension Fund, subject to the satisfactory completion of a revised admission agreement and shareholder guarantee (as referred to in the separate report "2017 Actuarial Valuation for Lothian Buses Pension Fund"). The merger would then proceed at the earliest suitable date, this to be determined by the Executive Director of Resources.

Prior consultation has taken place with the respective stakeholder interests of both the Lothian Buses Pension Fund and Lothian Pension Fund.

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Report

Merger of Lothian Buses Pension Fund and Lothian Pension Fund

1. Recommendations

Committee is requested to:

1.1 Note the consultation which has taken place with the respective stakeholder interests of both the Lothian Buses Pension Fund and Lothian Pension Fund;

1.2 Note the significant advantages to be derived from consolidation of the two Funds, including investment diversification opportunity and economies of scale;

1.3 Note that the assurance that the interests of members of the Lothian Buses Pension Fund (employees and former employees of Lothian Buses Limited and its predecessor, Lothian Transport plc), would be unaffected;

1.4 Note the separate report on “2017 Actuarial Valuation for Lothian Buses Pension Fund”, specifically:

1.4.1 Lothian Buses Limited, as employer, will continue to retain a bespoke investment strategy which will be reviewed over the coming months. This review will recognise the increasing maturity profile of the membership and ensure that the risks inherent in the investment strategy are deemed appropriate.

1.4.2 An updated admission agreement for Lothian Buses Limited to the Local Government Pension Scheme (LGPS) is currently being progressed. This will reflect both regulatory requirements of and affirm the guarantor obligations of the company’s shareholders in respect of pension liabilities. It is anticipated that this will be formally concluded very shortly. In the event of any employer default, which is emphasised is not anticipated, then pension liabilities will be met by the four Lothian Councils in proportion to their respective company shareholding; and

1.5 Approve the merger of the assets and liabilities of the Lothian Buses Pension Fund into the Lothian Pension Fund at the earliest suitable date (to be determined by the Executive Director of Resources) subject to the satisfactory completion of a revised admission agreement and shareholder guarantee.

2. Background

2.1 The investment strategy review completed in 2016 highlighted that Lothian Buses Pension Fund was defined in regulations as a sub-fund of Lothian Pension Fund and there was an option for the Fund to be subsumed into Lothian Pension Fund.

2.2 The Pensions Committee agreed in March 2016 that the option for Lothian Buses Pension Fund to be merged into Lothian Pension Fund should be explored in consultation with stakeholders.

2.3 A merger was seen to provide a potential solution to the issue of achieving the different target allocations to unlisted assets (infrastructure and private debt) for Lothian Buses Pension Fund and Lothian Pension Fund. Currently any unlisted investments made for both funds are split in a fixed proportion of 7/93. "Lothian Buses Pension Fund would benefit from increased diversification and additional efficiencies would be expected in accounting, actuarial valuations and investment manager arrangements".

3. Main report

Employer asset tracking and retention of bespoke investment strategy for Lothian Buses Limited

3.1 The revised Funding Strategy Statement (reported separately on this agenda) states "Lothian Pension Fund is a multi-employer fund. Previously, individual employer asset shares have been calculated triennially at formal valuations by the Fund's Actuary using an analysis of surplus technique and tracked between valuations using a cash flow or roll forward approach. However, in order to enhance the transparency, accuracy and auditability of individual employer asset allocations and reduce any cross-subsidy between participating employers, from 1 April 2014 the Fund introduced an employer asset tracking system based on cash flows. This is a form of unitisation of investments, where each investment or disinvestment of monies involves the purchase or selling of units in the fund. By sub-dividing the assets into units, the fund can more easily and accurately track each individual employer's assets. Changes in the value of the underlying assets are reflected by changes in unit prices.

3.2 Such unitisation therefore provides an efficient way of accurately apportioning assets to individual employers by allowing for employer cash flows and investment returns achieved by the Fund. In addition, this provides a mechanism for facilitating and managing a range of investment strategies within the single Fund to meet the needs of employers with different maturity profiles, funding levels or investment objectives."

3.3 Importantly, therefore, Lothian Buses, as a potential employer within Lothian Pension Fund, could retain its own bespoke investment strategy, distinct from that of other employers.

Benefits of Merger

3.4 These are summarised as follows:

a. **Increased investment diversification**

Merger would create opportunities across asset classes to obtain greater diversification for Lothian Buses Pension Fund than it has had as a relatively small, standalone Fund. The Fund's listed equity exposure, currently provided by two portfolios, is quite concentrated compared to the nine portfolios in Lothian Pension Fund.

b. **Consistency of investment approach**

Both Funds currently invest in a number of portfolios that are not common across both, including Baillie Gifford Global Alpha, Baillie Gifford Investment Grade Fund, Standard Life Pooled Property Fund, Harris, Nordea and several internal equity portfolios. Further, currency hedging is used by Lothian Pension Fund and not Lothian Buses Pension Fund. A merger provides the opportunity for greater consistency within asset classes, together with the benefits of greater scale.

c. **Reduced number of investment portfolios**

Merger would reduce the number of portfolios to be managed and monitored by the investment team and Investment Strategy Panel leading to better allocation and focus of resources.

d. **Cash management**

Greater efficiency in cash management can be expected. Instead of maintenance of two cash balances for each portfolio for each Fund, a single cash balance would reduce frictional balances and save on administration.

e. **Investment administration and accounting**

Cost and time efficiencies have been identified in the areas of financial reporting, transaction fees and the global custodian's current unitisation system and its reporting. A merger would lead to a single set of financial statements and reduce external audit and actuarial fees.

Implications of "No Change"

3.5 It is also worth considering the negative implications of maintaining the status quo as Lothian Buses Pension Fund implements its investment strategy. Without merger, a bespoke investment implementation would be required, which would potentially result in a greater number of relatively small portfolios. For example:

a. duplication of internally managed global portfolios for Lothian Buses Pension Fund. (Its equity allocation will reduce over time which may limit the diversification which can be achieved);

b. creation of additional account(s) for unlisted assets (infrastructure and debt) with a higher allocation of investments to Lothian Buses Pension Fund compared to the fixed 93/7 apportionment currently used. Subsequent changes to strategy could mean the need for further accounts;

c. associated custodian and internal resource costs.

Employer covenant

3.6 A revised Admission Agreement for Lothian Buses Limited, formally clarifying the position of the four Councils as guarantors in proportion to their respective shareholdings, will be sought prior to the transfer of assets and liabilities.

Stakeholder consultation

3.7 Consultation has taken place with the respective stakeholder interests of both the Lothian Buses Pension Fund and Lothian Pension Fund has taken place over recent months. These include:

a. Lothian Buses Limited;
b. The Pensions Board, including the employer and employee (Trades Unions) representatives of the two Funds;
c. The four Lothian Councils as company shareholders and as employers within Lothian Pension Fund; and
d. All other employers within Lothian Pension Fund.

3.8 Assurance is provided that the proposed merger is purely an administrative change and will not affect members (employees and former employees) of either Fund.

3.9 A stakeholder consultation document was issued in February 2018. This is shown in full at Appendix 1. It is not anticipated that there should be any potential significant concerns raised. An oral update on the feedback from the stakeholder consultation will be provided to Committee.

4. Measures of success

4.1 The financial advantages secured through the transfer of assets and liabilities from Lothian Buses Pension Fund to Lothian Pension Fund will be reflected in future investment performance and actuarial valuations of Lothian Pension Fund and be reported to Committee in due course.

5. Financial impact

5.1 Investment efficiencies and administrative savings would result from the transfer of assets and liabilities from Lothian Buses Pension Fund to Lothian Pension Fund. Investment opportunities would also be enhanced. To a large extent, however, the scale of such benefits will be dependent upon future financial market conditions and asset allocation. It is likely that the savings will be at least £0.75m - £1.0m per annum, although these would not be realised immediately but over time.

6. Risk, policy, compliance and governance impact

6.1 A revised Admission Agreement for Lothian Buses Limited, formally clarifying the position of the four Councils as guarantors of the pension liabilities in proportion to their respective shareholdings, will be put in place prior to the transfer of assets and liabilities. This will serve to strengthen governance and affirm the employer covenant.

7. Equalities impact

7.1 There are no equalities implications arising from 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.

9.2 Consultation with Lothian Buses Limited and union representatives for Lothian Buses members has been undertaken.

10. Background reading/external references

10.1 None

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Executive Director of Resources

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11. Appendices

Appendix 1 - Stakeholder Consultation – Proposed merger (consolidation) of Lothian Buses Pension Fund into Lothian Pension Fund - Frequently Asked Questions (FAQs)

Lothian Pension Fund –Stakeholder Consultation
Proposed merger (consolidation) of Lothian Buses Pension Fund into Lothian Pension Fund

The Pensions Committee of the City of Edinburgh Council agreed that the option for Lothian Buses Pension Fund to be merged into Lothian Pension Fund should be explored in consultation with stakeholders. A report will be put to the Committee in March to consider the issues raised during the consultation. This Frequently Asked Questions (FAQ) document sets out common questions and answers for stakeholders.

FAQs

Q What is being proposed?
A. It is proposed to transfer the assets and liabilities of the Lothian Buses Pension Fund into the Lothian Pension Fund. Lothian Buses Pension Fund owns assets valued at approximately £0.5bn, while Lothian Pension Fund's assets are valued at approximately £6.8bn (January 2018).

Q. Will the members of Lothian Buses Pension Fund (employees and former employees of Lothian Buses Limit and its predecessor, Lothian Region Transport) be affected?
A. No, this change will not affect members, it is purely an administrative change. All Local Government Pension Scheme (LGPS) members' benefits will remain unchanged. Active members will remain in the Scheme.

Q. Will the members of Lothian Pension Fund be affected?
A. No, as above, this change will not affect members.

Q Why is the merger being proposed?
A. Lothian Buses Pension Fund was established in 1986 by agreement between Lothian Regional Council and Lothian Region Transport. It was set up as a 'further fund' within the meaning of the Local Government Superannuation Funds (Scotland) Regulations 1986 (i.e. a sub-fund of Lothian Pension Fund).

Currently, Lothian Buses Pension Fund is considered to be a 'stand-alone' Fund - it has its own investments, actuarial valuation and accounts.

However, there is the option for the Buses Fund to be subsumed into the main Lothian Pension Fund. The Investment Strategy Panel have agreed that, from an investment perspective, a merger would be sensible.

Benefits of merger are summarised as follows:

- Benefits of scale associated with greater consistency of investments across the two Funds, whilst retaining a bespoke investment strategy for Lothian Buses
- Improved efficiency due to unnecessary duplication of various fees
- An increased opportunity set of investments.

Q. What would happen in the event of Lothian Buses defaulting on its liabilities?
A. Lothian Buses is owned by four councils (the City of Edinburgh, West Lothian, East Lothian and Midlothian). A revised Admission Agreement formally clarifying the position of the four Councils as guarantors will be sought prior to the transfer of assets and liabilities. Therefore, these Councils will act as guarantors in the event of the Lothian Buses defaulting on its liabilities.

Q. Is a revised Admission Agreement required in terms of the Actuarial Valuation 2017, which has to be approved by Pensions Committee prior to 31 March 2018?
A. Yes, the Actuary has stated that such explicit guarantee is required to permit "Lothian Buses to continue to pay contributions to the Fund after the last active member leaves" and so that "there would be no need to target a 100% gilts strategy at the cessation date if the funding time horizon extends beyond that point". This increased flexibility is likely to be very much in the mutual interests of the company and its shareholders.

Q. How will the assets of the Lothian Buses Pension Fund be protected?
A. Lothian Pension Fund uses a dedicated employer asset tracking software system that allows for flexible allocation of investments (unitisation) for all employers within the same Fund. As such, Lothian Buses, as an employer, can retain its own unique investment strategy, distinct from that of other employers in Lothian Pension Fund.

Q. Will the proposal impact upon the funding of other employers within Lothian Pension Fund?
A. No, as discussed above, a revised Admission Agreement would be sought which would confirm that the Councils are the guarantors.

Q. Why are employers within Lothian Pension Fund being consulted?
A. Although this is not a statutory requirement, it is considered best practice to provide requisite assurance that no such employer should be disadvantaged and also to accord the opportunity to every employer to feedback any concerns prior to any final decision.

Q. Will Lothian Buses continue to be an employer member of the LGPS?
A. Yes, the company's admission to the LPGS is not being terminated.

Q. Will Lothian Buses be exposed to additional risk of an employer in Lothian Pension Fund defaulting?
A. At present, with "ringfencing" as a "sub Fund", Lothian Buses has been viewed as being isolated from the risk of other employers in the Lothian Pension Fund defaulting. The Funding Strategy Statement has established the policy of "alignment" whereby liabilities on default of one employer, with no guarantor, are assigned or apportioned to another employer(s) where a clear linkage exists, e.g. geographical or funding relationship. This provision ensures that smaller, stand-alone employers within the Fund are protected, with the burden typically being borne by the Councils. Lothian Buses would not be "aligned" to any other employer, so it will not be exposed to additional risk of an employer in Lothian Pension Fund defaulting.

Q. Has legal opinion been sought in relation to the merger?
A. Yes. The specialist external legal advice emphasised that consultation with stakeholders should be undertaken.

Q. Have other Scottish LGPS funds merged funds?
A. Yes, both Strathclyde and Tayside have merged their transport funds with their main funds.

Q How will the Regulatory detail be concluded?
A. Scottish Ministers, through the Scottish Public Pensions Agency, the Pensions Regulator and HMRC will all be informed of the change.

Q. Is the proposed merger supported by Lothian Buses?
A. Yes, discussions with company representatives support the proposal being submitted for this wider consultation. Formal approval of the revised Admission Agreement will, however, be required by the company's Board.

Q. Who is being consulted?
A. The main stakeholders, which are:

- Lothian Buses Limited;
- The Pensions Board, including the employer and employee (Trades Unions) representatives of the two Funds;
- The four Lothian Councils as company shareholders and as employers within Lothian Pension Fund;
- All other employers within Lothian Pension Fund.

Q. Who has authority to approve the merger?
A. City of Edinburgh Council, in its role as administering authority of the LGPS for the Lothian area, will be required to approve the merger. Its Pensions Committee has delegated authority to approve the merger.

Q. What are the next steps
A. The steps are:

- A report will be submitted to the Pensions Committee of the City of Edinburgh Council in March detailing the responses to the consultation.
- If the merger is approved, the merger is expected to take place during the 2018/19 financial year.

Responses to this consultation are requested by 16 March 2018.
Please respond to employer.pensions@edinburgh.gov.uk

February 2018