

Pensions Committee

2.00pm, Wednesday, 27 March 2019

Pension Fund Cost Benchmarking

Item number	5.6
Executive/routine	
Wards	All
Council Commitments	Delivering a Council that works for all

1. Recommendations

The Pensions Committee (**Committee**) is requested to:

- 1.1 **note** the report; and
- 1.2 **note** that the CEM Investment Cost Effectiveness Analysis (to 31 March 2018) and the CIPFA Pensions Administration Benchmarking 2018 reports have been provided, on a confidential basis, to the Conveners of the Committee and Audit Sub-Committee and the Independent Professional Observer.

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Report

Pension Fund Cost Benchmarking

2. Executive Summary

- 2.1 The purpose of this report is to inform Committee about the benchmarking of investment costs for Lothian Pension Fund and of pension administration costs for Lothian Pension Fund, Lothian Buses Pension Fund (now merged with the main fund) and Scottish Homes Pension Fund (**the Funds**).
- 2.2 The analysis of investment costs was carried out by an independent provider, CEM Benchmarking Inc. Its database now includes 41 LGPS funds (with £206 billion of assets), and a wider global universe of 346 funds, including half of the world's top 300 funds (with £7.3 trillion of assets).
- 2.3 Actual investment cost of 0.43% of average assets was below the benchmark cost of 0.55%. The majority of the fund's investment cost relate to external management. The 0.12% difference with the benchmark is equivalent to a saving of approximately £8.0m per year. The main contributing factor to this difference is the fact that the fund manages a high percentage of assets on an internal basis compared to the benchmark peer group.
- 2.4 The analysis of pension administration costs was undertaken by the Chartered Institute of Public Finance & Accountancy (**CIPFA**). Pension administration cost per member of £23.38 for the three funds falls within a very wide range for local authority funds. It is slightly higher than the average of £21.71 and slightly higher than the average of £21.16 for a narrower range of funds of comparable scale to the combined three Funds.
- 2.5 The benchmarking information provides a useful snapshot of costs compared with funds that are prepared to share their data, but care should be taken in interpreting the information as the output relies on provider estimates and the accuracy of the data supplied to them.

3. Background

- 3.1 The funds' annual report for 2017/18 identifies £38.2 million of expenses, with investment costs representing by far the largest proportion of the total, as expected.
- 3.2 Benchmarking is undertaken to help identify areas where improvements can be made to deliver better value for money. The exercise should facilitate:
 - comparison between costs and performance;
 - the 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 peers; and
 - a review of performance trends over time.
- 3.3 The fund has contributed to CEM's database for the past five years to better understand its investment expense base and how it compares with other pension funds.
 - 3.3.1 The CEM 2018 global database comprises 346 funds representing £7.3 trillion in assets, including 244 North American funds with assets of £3.9 trillion and 89 European funds with assets of £2.4 trillion.
 - 3.3.2 The global database also includes 41 LGPS funds with total assets of £206bn.
 - 3.3.3 The funds range in size from £0.1 billion to £805 billion.
 - 3.3.4 The peer group for calculating the fund's benchmark cost contains 21 funds (including 10 LGPS funds). The peer group funds have been selected on the basis of fund size. The median fund size within the peer group is £7.8bn, with half the funds in the range of £6.6bn to £8.5bn. This compares with Lothian Pension Fund's assets of £6.6bn at 31 March 2018.
 - 3.3.5 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.
- 3.4 CIPFA's 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 Scottish Homes Pension Fund. The outputs and analyses have served to supplement internal performance management information.

4. Main report

Investment Cost Benchmarking Analysis

- 4.1 The benchmarking analysis undertaken by CEM aims to provide comprehensive, like-for-like comparisons with similar funds, but they are unable to capture all investment costs from all funds. Improved transparency has been achieved with the inclusion of private asset performance fees, but investment transaction costs, including property operational costs, are excluded. In addition, the Fund undertakes more detailed cost analysis than CEM for its listed private market funds as these cannot be compared with other funds in the database. Thus, the total actual costs reported by CEM differ from those reported in Lothian Pension Fund's annual report.
- 4.2 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.
- 4.3 The fund's actual cost figure to 31 March 2018 of approximately 0.43% of average assets was below the benchmark cost of 0.55%. The 0.12% difference is equivalent to a saving of approximately £8.0m for the year to 31 March 2018. Previous CEM cost analyses are shown below (analyses prior to 31 March 2017 were calculated on a calendar year basis):
- 31 March 2017: 0.31% versus the benchmark cost of 0.48%
 - 31 December 2015: 0.36% versus the benchmark cost of 0.45%
 - 31 December 2014: 0.39% versus the benchmark cost of 0.50%
- 4.4 CEM concludes that the primary reason for cost 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.
- 4.5 CEM analysis also shows that the Lothian Pension Fund cost of 0.43% is significantly lower than the median cost of the global peer group (0.63%) and CEM's LGPS dataset of 41 funds (0.55%).
- 4.6 The annual report 2017/18 for the pension fund identifies £33.3m of investment management expenses (2016/17: £27.7m), £28.5 million (86%) of which are external management fees (2016/17: £23.4m (84%)). All other expenses, the largest of which are internal asset management costs, transaction costs, property operational costs and custody fees, amounted to £4.8m (2016/17: £4.3m). External management fees represent 0.43% of average assets, while all other expenses represent 0.11% of average assets.

CIPFA Pensions Administration Benchmarking Club

- 4.7 The CIPFA Pensions Administration Benchmarking Club aims to collect the transactional volumes and processing costs for administering members' LGPS benefits (i.e. excluding costs associated with administration and management of

investments) using standard definitions. "Employing authority work" and any work associated with the administration of non-LGPS pensions are excluded.

- 4.8 Local authority pension funds subscribe to the CIPFA Benchmarking Club on a voluntary basis. The relative value to be gained from benchmarking analyses is obviously dependent on the scale of take-up of the service.
- 4.9 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 Conveners of the Committee and Audit Sub-Committee and the Independent Professional Observer.
- 4.10 The fund is, however, able to report restricted summary findings and other relevant observations that affect the cost as follows:
 - LPF cost per member of £23.38 falls within the very wide range of local authority funds of c£11 to £61. However, the cost is higher than the average of all funds of £21.71. The average of funds of comparable scale is £21.16.
 - The composition of a fund's membership impacts costs. Active members represent 39.3% of LPF membership compared with an average of 34.2%, and pensioners represent 30.8% compared with 24.1%, with the consequence that deferred members represent a lower proportion of membership (22.2%) than the typical fund (29.9%). 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 the proportion of LPF staff holding relevant pension administration qualifications is significantly higher than the average (more than double).
 - Moreover, LPF's administration performance is above average for 7 of the 9 industry standard indicators, in certain instances by a considerable margin.
- 4.11 It is important to emphasise that care should be taken in interpreting the data purely on the basis of apportioned costs. This is of particular relevance 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.
- 4.12 Also, there appears to be potential inconsistency between the presentation of the benchmarking data and the allocation of costs in LGPS funds' financial statements (using CIPFA Guidance) to 'Administration' and 'Oversight and Governance' expenses.

Performance Benchmarking

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

- 4.14 CEM have compared Lothian Pension Fund's net value added (investment performance in excess of a fund's benchmark) over the medium-term (five years) with the net value added by CEM's global universe and its LGPS universe.
- 4.15 The analysis indicates Lothian Pension Fund's net value added performance has been very strong - 13th percentile for the global universe and 6th percentile for the LGPS universe (94% of LGPS funds in the dataset have lower net value added).
- 4.16 CEM has also conducted analysis on net total returns across its database. Over five years, Lothian Pension Fund's net total return is 6th percentile for the global universe, and 3rd percentile for the LGPS universe.
- 4.17 The fund's strong performance relative to peers is attributable to the strong performance of the Lothian Pension 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 – which was the case during that period.
- 4.18 Pension administration performance appears to be generally in line with industry standards.

5. Next Steps

- 5.1 The fund will use the benchmarking information to identify areas for improvement to ensure best value for money across its operations in investment administration and management and in pensions administration.

6. Financial impact

- 6.1 There are no financial implications arising directly from this report. Out of the funds' total costs of £38.2 million for 2017/18, investment costs amounted to £35.9 million and pension administration costs amounted to £2.1 million. Continuous improvement initiatives will be met from the approved budget 2019/20.

7. Stakeholder/Community Impact

- 7.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Funds and they are invited to comment on the relevant matters at Committee meetings.
- 7.2 There are no adverse health and safety, governance, compliance or regulatory implications as a result of this report.
- 7.3 There are no adverse sustainability impacts arising from this report.

8. Background reading/external references

- 8.1 None.

9. Appendices

9.1 None.