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Securing the future of pensions

Local Government Pension Scheme 2013:

investing in a changing world

May 2013

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Executive Summary

Although the Local Government Pension Scheme (LGPS) has its roots back in the 1850s, it has been in existence in its current form since 1972. During that time it has gone through significant periods of change, most recently in 2008 when the Government was focused on putting public sector pensions on a more sustainable footing.

The challenges the LGPS now faces have arguably never been greater. The introduction of the new scheme in 2014, the roll out of auto-enrolment, and the abolition of contracting out in 2016 will all have significant implications for scheme funding, design and administration going forward. Wider societal and economic factors will continue to have a major impact with Local Authority (LA) funds struggling to navigate their way through an environment of low returns and historically low gilt yields. This is expected to cause significant increases to scheme deficits in the 2013 round of valuations, at a time when LA budgets are already under pressure and against a backdrop of rising longevity and ever increasing liabilities.

LGPS funds are rapidly maturing. Our projections suggest that positive cash flows will quickly turn into negative cash flows over the next few years. Meanwhile scheme members' affordability concerns are increasing scheme opt outs, putting further cash flow pressure on the scheme.

It is clear that the LGPS is at a critical juncture. This will impact on how the scheme is administered and governed, but, crucially, will affect the investment strategies and decisions of the individual funds. This has wider implications for the UK economy as well as funds' ability to invest within the current regulatory framework. This report explores LA fund investment behaviour and the impact the changing economic and policy environment may have on the way funds invest in the future.

LA funds manage around £150bn of assets in total for the payment of benefits over a 70-year time horizon. Whilst LA funds' investment strategies have not seen a radical shift over the last decade, our analysis of investment trends suggests an on-going trend towards greater diversification:

- Equity allocation still dominates LA funds' asset allocations even though there has been a gradual decline in their holdings of equities over the last decade. Like private sector defined benefit schemes, LA funds have been gradually moving away from equities, albeit at a slower rate than in the private sector.
- Fixed income allocations have remained broadly stable over the last decade. The relative immaturity of LA funds, the strength of the employer covenant, and the differing regulatory framework from that of private sector schemes means funds are under less pressure to hedge away movements in the value of their liabilities and de-risk.
- The allocation to 'other' assets has risen in line with the decline in equities as LA funds have turned to alternative forms of return seeking assets whilst seeking to diversify risk.

NAPF polling suggests that, over the next 3-5 years, LA funds are expecting a continuation of the trend away from equities towards 'other' assets such as property and infrastructure. Assuming this trend applied uniformly across all LGPS participating funds, we could expect an additional move away from equities in the region of £5.7 billion and an extra £7.7 billion being invested in 'other' assets – a 25% increase on current allocations over this period. These shifts are small within the overall context of the £150 billion total assets in the LGPS. However, as an indication of a long-term trend these movements will have potential implications for the current investment regulations that may hinder the new investments LA funds may increasingly want to make.

The legislative and regulatory landscape

If LA funds are to continue to deliver pension benefits in an affordable way for taxpayers the right regulatory architecture and flexibilities need to be in place. There is already an active debate about how greater efficiencies can be driven as a result of schemes working together and the form that collaboration could take.

The right structures and processes should allow LA funds to collaborate, for mutual benefit, to benefit from efficiencies and to drive better value for money. A key area of focus should be on continuing to drive down costs and improving scheme performance. **So the Government needs to facilitate an open debate on the case for schemes working together to drive efficiency.** This should build on the productive joint working that is already going on between some LA funds.

The governance and administration standards in LA funds need to continue to be strong, in particular given the introduction of the new scheme from 2014. Oversight by the Pensions Regulator (TPR) could be a key driver in cementing the already strong features of governance found in many LA funds. However, there is a concern about mission creep and TPR's role extending beyond governance and administration to cover investment strategies and recovery plans. This runs the risk of duplicating of regulatory oversight. Given that TPR will have responsibility for governance and administration of all public service pension schemes **TPR will need to ensure that it works with LA funds to understand their unique nature. The regulatory architecture also needs to be clear so that there is no duplication of regulatory activity by TPR and the Department for Communities and Local Government (DCLG).**

In addition, LA funds need the flexibility to invest, for the good of the scheme, the members and taxpayers. The outdated LA investment regulations hamper innovation and stifle funds' ability to invest in assets that best manage risks while seeking return. Given the likely trend towards 'other' assets it is critical that **the LGPS investment regulations are reformed. In particular they need to be revised to better reflect the framework that exists in the private sector where a fiduciary duty is placed upon the funds, so they have a clear obligation to effectively manage their investment risks and meet their long term funding objectives.**

1. Introduction

The Local Government Pension Scheme (LGPS) and its constituent funds are going through a period of radical change. Reform of public sector pensions, the introduction of auto-enrolment, and changes to the state pension all add to the cost and administration of LGPS funds. These changes come at a time when the demographic composition of the LGPS is changing, with the result that funds are maturing rapidly and tough economic conditions are creating new challenges for funding levels and investment strategies.

This report examines the changes that the LGPS funds are going through and considers what this might mean for Local Authority (LA) fund investment strategies and trends. It also examines the implications for the governance and regulation of the scheme and makes a number of recommendations for Government and regulators to ensure that the LGPS can continue to provide sustainable pensions whilst also providing value for the taxpayer.

NAPF Annual Survey 2012 and Local Authority Member Survey 2013

This report uses data from the NAPF Annual Survey 2012[1] to explore the underlying trends of LA pension fund investment. 32 NAPF LA fund members responded to the Annual Survey – just under a third of all LA funds. The Survey covered £83bn of assets and 2.2m members, over half of all scheme members covered by the LGPS. On average LGPS funds each had assets worth £2.6 billion.

In addition, a recent poll was conducted of NAPF LA fund members to understand how the changing landscape may impact on their investment strategies (and the wider UK economy) over the next few years. 28 members responded to this poll.

The report also utilises data from the Department for Communities and Local Government's (DCLG) annual statistical release on the LGPS in England and Wales[2] as well as asset allocation trend data from the LAPF Strategic Investment Forum[3].

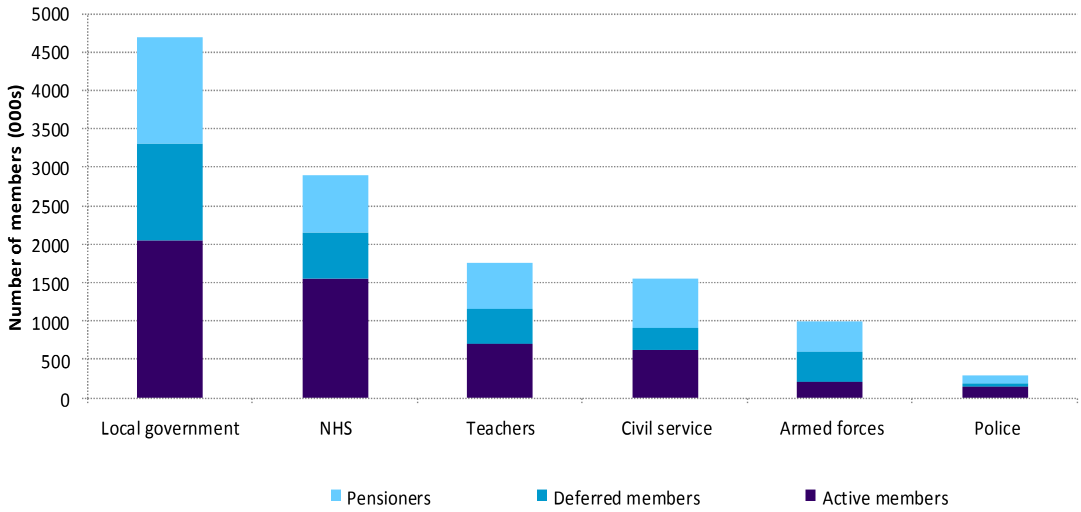
[1] The 2012 NAPF Annual Survey.
[2] DCLG Statistical Release: LGPS in England 2011-2012, 17 October 2012.
[3] LAPF Strategic Investment Forum Asset Allocation data.

2. The LGPS

The LGPS is a statutory funded pension scheme set up under the 1972 Superannuation Act[4]. It is a final salary defined benefit (DB) scheme for employees predominately working for Local Government and public service organisations[5]. The LGPS is administered by 99[6] LA funds each of which has an average of 115 participating employers[7]. The total market value of the LA funds in England and Wales at the end of March 2012 was £148 billion[8].

As Figure 1 shows, with 4.6 million members[9], the LGPS is the largest public service pension scheme. It is also, by some way, the largest funded pension scheme in the UK.

Figure 1: Membership of public sector pension schemes



Source: Hutton Commission interim report, 2011

[4] Superannuation Act 1972.
[5] Other employers can join the scheme through achieving admitted body status.
[6] Source: LGPS website - England, Scotland and Wales.
[7] Source: NAPF Annual Survey 2012.
[8] The market value of the funds at end of March 2012 was £148 billion. This represents an increase of 4% on March 2011 and an increase of 52% on March 2009. (DCLG statistical release, LGPS England and Wales, Oct 2012).
[9] Source: Hutton Commission Interim Report, 2011.

3. The LGPS at a time of change

The LGPS has been through significant change since the 1972 Superannuation Act set up the scheme in its current form. The most recent changes to the structure of the scheme took place in 2008 and, while keeping the final salary nature of the scheme and scheme normal retirement age at 65:

- changed the accrual rate from 1/80ths to 1/60ths, but introduced the ability for scheme members to commute their pension in exchange for a lump sum;
- reformed the rate of employee contributions from 6% to a band covering 5.5% to 7.5%;
- introduced a cap and share arrangement as a mechanism to control costs; and
- reformed ill health benefits.

These changes came into effect on 1 April 2008. In addition, in the June 2010 Emergency Budget[10] the Chancellor announced that CPI, rather than RPI, will be used for the indexation of benefits, tax credits and public service pensions from April 2011.

Policy change

However, arguably the biggest change and time of challenge for the LGPS and the LA funds is set to come. The introduction of the new scheme in 2014 resulting from the Hutton reforms, the roll out of auto-enrolment, and the abolition of contracting out in 2016 will all have significant implications for scheme funding, design, governance, administration and investment.

The new LGPS

In 2010 the Government asked Lord Hutton of Furness to chair an independent commission[11] to review all the current public service pension arrangements and make recommendations for reform that would be sustainable and affordable in the long term and fair to both the public service workforce and the taxpayer. Lord Hutton published his final report in June 2011[12]. His key recommendations for all public service pension arrangements were:

- they should be based on career average (rather than final) salary;
- normal retirement ages should be linked to the state pension age (except for uniform services, which should be 60);
- accrued rights should be honoured in full;
- employee contribution rates should be tiered depending on salary;
- the new arrangements should be cost capped to limit taxpayer exposure;
- to have new and improved governance arrangements, with member representation; and
- all reforms should be introduced by the end of the current Parliament (2015).

The Government accepted Lord Hutton's recommendations as an overarching proposal for all schemes and a basis for negotiations. Following this (in November 2011) the Local Government

[10] June 2010, Emergency Budget Red Book.
[11] Independent Public Service Pension Commission.
[12] Independent Public Service Pension Commission Final Report.

Association (LGA) and unions agreed a 'heads of terms' deal to deliver the Hutton reforms in the LGPS. A final deal was published in May 2012. The key differences to the reform of the LGPS, compared with other public sector schemes, are:

- the reforms will be implemented a year earlier in 2014. This is because it better fits with the LGPS's valuation cycle and enables the scheme to avoid short-term employee contribution increases that might have encouraged opt outs; and
- a lower cost 50/50 option that will mean employees can opt to pay reduced contributions in return for reduced benefits. This is designed to encourage participation amongst younger workers and those on low incomes.

Both the reforms to public service pensions overall, and the specific changes to the LGPS were in line with recommendations made by the NAPF.

This is an ambitious reform, and whilst the Public Service Pension Reform Act has now achieved Royal Assent, there is still much to be done for the new scheme to be up and running by 2014. The scheme rules have the potential to be complex and unnecessarily onerous. This is because compliance with the new regime will require adjustments from all LA funds as they will have to deal with the governance and administration burden of running both the new and old schemes, whilst also managing transitional protections. At the same time the role of the various regulators - The Pensions Regulator (TPR), DCLG and HM Treasury (HMT) - remains unclear.

Auto-enrolment

The roll out of auto-enrolment from October 2012 means that all employers will need to offer a pension scheme to their employees and auto-enrol eligible employees unless they decide to opt out.

This places a burden on employers, both in terms of ensuring compliance with the complex regulations and the cost of making additional employer contributions. LA funds are no exception, despite already contractually enrolling their employees into good quality pension schemes they will still have to enrol people who have already opted out and they will face the additional cost and complexity of complying with auto-enrolment regulations. Given these additional burdens many LA funds have chosen to take advantage of the option of postponing their staging date to September 2016.

State pension reform and the ending of contracting out

Government plans to introduce a new single tier flat rate pension from 2016, including the abolition of contracting out, will also impact on the LGPS and the constituent LA funds.

All employers within the LGPS are currently required to contract out their employees from the State Second Pension. As a result, they and their employees pay a lower National Insurance rate to reflect contributions being made into the scheme[13]. The introduction of a flat-rate state pension in April 2016 will mean the abolition of the both the State Second Pension and contracting out, and therefore the

[13]Contracted out National Insurance rebate: 1.4% employee and 3.4% employer between the Lower Earnings Limit (£5,564) and the Upper Accrual Point (£40,040).

loss, overnight, of the National Insurance rebate. In the private sector employers will be able to make use of a statutory override to adjust scheme benefits to make up for this loss by, for example, changing the future accrual rate of the scheme. However, in the public sector employers will not be able to make changes and, all other things being equal, will have to absorb this loss. Of the £3.4 billion in lost employer National Insurance rebate for public sector schemes in 2016, around £1bn is likely to fall on LGPS employers[14]. This is something Government should take into account when determining the 2015/16 Spending Review, due in June 2013.

Economic and societal change

It is not just policy change or scheme redesign with which the LA funds will have to contend. Wider societal and economic factors are having a major impact on the running and funding of LA funds with schemes struggling to navigate their way through the current low gilt yield and low return environment. This is compounded by the funding pressures that LAs are under and increasing longevity exposing schemes to ever increasing liabilities and funding risk.

Quantitative easing and the low yield low return environment

Whilst LA funds are not subject to the same funding framework as those DB schemes currently regulated by TPR, they are required to produce both an annual funding report (calculated on an FRS17 basis with liabilities valued on AA corporate bond yields), and a triennial valuation (carried out by each fund in the LGPS on a regular three year cycle with the latest in 2013). In the case of the triennial valuations, LA funds are required to select a discount rate, like private sector DB funds, which can be based off expected returns on assets, a 'gilts plus' approach, or something in between. Given the higher allocations to equities within LA funds' investment strategies it seems likely that they would be selecting a higher discount rate, on average, than private sector schemes[15]. And whilst their funding positions will have been affected by the financial crisis, the associated volatility in asset prices, and the £375 billion of Quantitative Easing since 2008, 2010 was a relatively favourable year for valuations given the upward movement in the equity markets.

The 2013 valuations could be far more challenging than those of 2010. Recent analysis by KPMG estimates that LA fund deficits will have doubled since 2010 to over £80 billion[16]. KPMG actuaries have estimated the increase in the aggregate LGPS deficit to be as much as £50 billion in the last three years[17]. They find that, whilst assets will have increased by approximately 20%, the value of the liabilities will have increased by more than 40% due principally to the current historically low gilt yields.

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[14] Employers with DB schemes would pay higher NI contributions (£3.4 billion public sector employers (including LGPS), £0.8 billion private sector employers in 2016, 2011 earnings terms). LGPS accounts for 30% of the public sector's 5.3 million active members.

[15] Audit Commission Information Paper Report, 2010. The report showed that in the 2007 valuation the average discount rate used by LGPS funds was around 6% (ranging from 1.7%, to 4.1%, above inflation). These expected returns were not realised between 2007 and 2010.

[16] KPMG analysis of the likely outcome of the 2013 LGPS valuations, April 2013.

[17] Based on projections of assets and liabilities, inflation data and gilt yields and factoring in new contributions, using publically available data for the LGPS funds in England and Wales in 2010.

As a result, employers participating in the LGPS may see a significant increase in their contributions from 1 April 2014, despite the move to the new scheme and the implementation of an employer cost cap. This will be in a period when employers will also have to deal with the additional costs of auto-enrolment and the loss of the National Insurance rebate as a result of state pension reform, both of which will place increasing pressure on employer budgets.

The fiscal environment

The UK Government's economic strategy, set out in its June 2010 Emergency Budget[18] seeks to place the public finances on a more sustainable footing through an ambitious programme of spending cuts. Whilst the Government has been heavily criticised for failing to stimulate economic growth, it has succeeded in reducing the deficit by a third over the three years from 2009-10. The 2010 Spending Review announced tough spending settlements across Government, with many Departments seeing their budgets fall between 2010-11 and 2014-15.

The DCLG faces a 33% cut to their budget in real terms over the period, combined with some further devolution of funding (around £1.6 billion) to local government. For local government the spending review promised to provide a settlement "that radically increases local authorities' freedom to manage their budgets" whilst requiring "tough choices on how services are delivered within reduced allocations"[19]. The total local government resource budget is projected to reduce from £28.5 billion in 2010-11 to £22.9 billion in 2014-15, with the full impact of those cuts yet to feed through.

The design of the LGPS 2014 is estimated by the Government Actuary's Department (GAD) to cost 19.5% of pensionable payroll[20]. With the average employee contribution proposed to remain at 6.5% this means a notional employer Future Service Rate (FSR) for employers of 13%. This compares favourably with the most recent GAD costs of 21.7% for the current scheme with an implied 15.2% FSR for employers. This is expected to create an average cost reduction of 2%, or £600 million a year, across funds in England and Wales.

However, the FSR is only one element which impacts on the total employer contribution rate, with the cost of meeting past service still falling on employers. Any increases to the costs of meeting past service will need to be met through deficit reduction strategies and employer contributions. Given the difficult market conditions currently being faced, it is quite possible that many employers will see their total contribution rates increasing in future years, even with the new LGPS 2014 design in place.

Longevity

Increasing longevity is also having a major impact on the funding of all DB schemes, whether public or private. Analysis from Club Vita[21] based on the experience of pensioner members of 158 occupational pension schemes, including 45 LA funds, suggests that period life expectancy for males (at age 65) has risen from 79.6 in 1993 to 83.8 in 2011. This is an increase in life expectancy of around 2.8 months for each year, or 2.3 years for each decade. Whilst life expectancy for women has also increased it has

18 June 2010, Emergency Budget Red Book.
19 Spending Review 2010, public sector reforms.
20 LGPS 2014 Employer Overview.
21 Bespoke analysis of the Club Vita dataset for the NAPF, May 2013.

done so less rapidly than for men – partly due to the reduction in smoking in recent decades which has disproportionately benefited men. Club Vita's analysis of the LA funds suggests that their overall trends in life expectancy are the same as for occupational pension schemes as a whole.

One estimate has suggested that an extra year of life expectancy increases DB liabilities by between 3-4%[22]. On that basis, DB liabilities in LA funds are likely to have risen by 7-9% since the early 1990s in response to observed longevity improvements. Private sector DB schemes have been trying to manage these risks through a variety of methods, for example, insuring against future longevity movements through buy outs and buy ins, by explicitly hedging longevity risk or by closing schemes to new members and/or future accrual. The first LA fund to hedge longevity risk was the Berkshire pension scheme in 2009. The demand for these strategies is likely to increase as LA funds mature and longevity risk becomes a major item on the pension fund balance sheet.

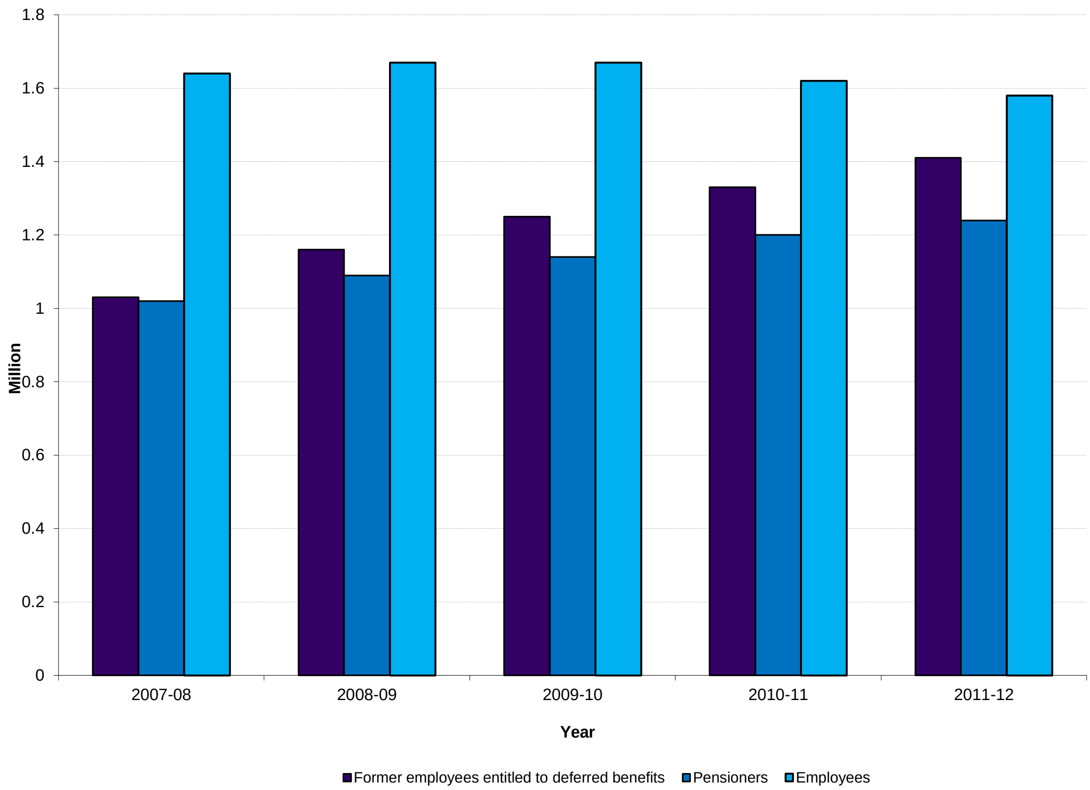
Future costs for the LGPS 2014 will be managed by linking Normal Pension Age and the State Pension Age. In order to ensure that this link continues to effectively manage risk in the scheme, proposals have been put forward by the LGA and LGPS to work with fund actuaries to develop an LGPS longevity index. This would enable fund actuaries to track the match (or mismatch) between increases to SPA and longevity within the scheme and recommend action should they diverge. These measures will combine to ensure that in the future not all the longevity risk falls on the employer but is shared with employees.

LGPS as a maturing scheme

The LGPS has been gradually maturing as more members start to take pension benefits and the number of active scheme members falls. Local government employment reached its lowest ever level in Q4 2012 (2.5m). This is 6.1% lower than Q4 in 2011 and 15% lower than its peak in Q3 2006[23]. In addition there has been a noticeable increase in the proportion of workers who are part-time, up from 25.5% in Q1 2008 (a figure which was stable over the previous decade) to 27.5% in Q3 2012[24]. This maturing of the scheme has accelerated rapidly in recent years as increased member contributions and wage freezes have led to further member opt outs. There have also been increases in early retirements and redundancy as the Government's austerity plans have started to bite. In 2011-12 27,500 members left the scheme as a result of redundancy, an increase of more than 55% on 2010-11[25].

[22] Coughlan G., D. Epstein, A. Ong, A. Sinah, I Balevich, J. Hevia-Portocarrero, E. Gingrich, M. Khalaf Allah and P. Joseph, (2007), LifeMetrics A Toolkit for Measuring and Managing Longevity and Mortality Risks, JP Morgan, London.
[23] ONS Statistical Bulletin, March 2013.
[24] Source: ONS table 'EMP01'.
[25] DCLG Statistical Release: LGPS in England 2011-2012, 17 October 2012.

Figure 2: Membership of the Local Government Pension Scheme



Source: DCLG Statistical Release: LGPS in England 2011-2012, 17 October 2012

Figure 2 shows that active membership of the LGPS has dropped by 4% since 2008 at the same time as the number of deferred and pensioner membership has increased by 28% and 21% respectively over the same period. If this trend continues the active to deferred/pensioner ratio is likely to invert in the very near future.

Looking at a comparison of LGPS and private sector schemes, NAPF Annual Survey data shows that at present LA funds have, on average, 38% active members; 31% deferred members; and 30% pensioner members. By contrast schemes in the private sector (due to closure and relative maturity) have a very different ratio, with the average scheme having 20% active members, 39% deferred members and 41% pensioner members[26].

Positive vs. negative cash flow and increasing member opt outs

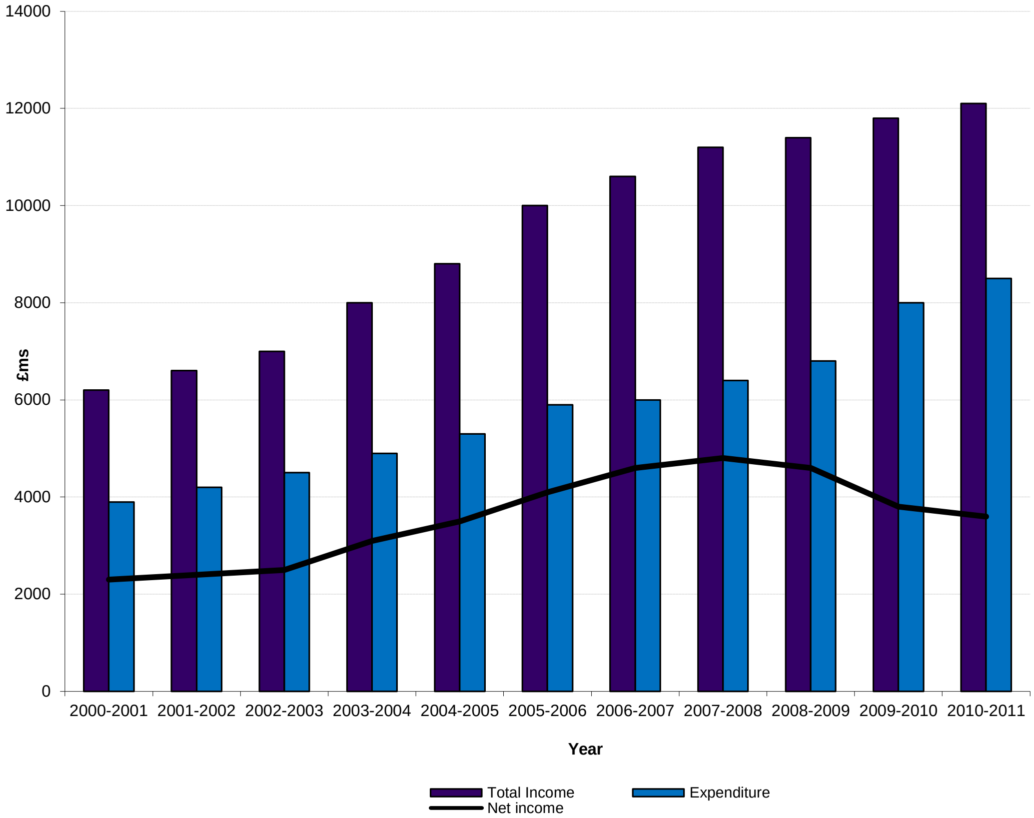
The effect of this changing membership profile is reflected in the financial position of the LGPS. Employee contributions peaked in 2010/11 at around £2 billion but fell by more than 6% in 2011/12 to £1.8 billion demonstrating falling income from scheme membership[27]. Furthermore, in 2011-12 total expenditure accounted for 74% of the LGPS income, up from 58% in 2007-08. Overall the positive net cash flow into the LGPS has fallen by 20% in the last two years. Should this downward

[26] NAPF Annual Survey 2012.
[27] DCLG Statistical Release: LGPS in England 2011-2012, 17 October 2012.

trend continue at the same rate, within 4-5 years the average fund could be in negative cash flow, with some funds reaching this point sooner.

This reduced cash flow has been exacerbated by increasing opt outs, which are expected to continue. 74% of the respondents to the NAPF LA member poll[28] said that their active membership had declined in the last three years, with the majority (90%) experiencing an increase in opt-out rates of up to 20%, and a minority (10%) experiencing an increase of 20-40%. In addition, 59% of respondents thought that member opt-out rates would increase in the next three years, by up to 20%. This reduction in active scheme membership could have a real impact on fund cash flows and investment strategies as pension benefits may no longer be able to be paid from annual contributions.

Figure 3: LGPS net cash flow 2001-2010/11



Source: DCLG scheme fund data, 2011

Admitted bodies

All of these changes are likely to prove an even greater burden for the smaller employers who use the LGPS (known as Admitted Bodies) and who are increasing in number. The 2012 NAPF Annual Survey shows that the average number of employers involved in LGPS funds has increased to 115 from 87 in 2011[29]. This is likely to be due to increased out-sourcing of LA services and the creation of academies who have Admitted Body status within the LGPS. These employers are likely to have a different employer covenant (as their risk of insolvency is much greater than that of the administering

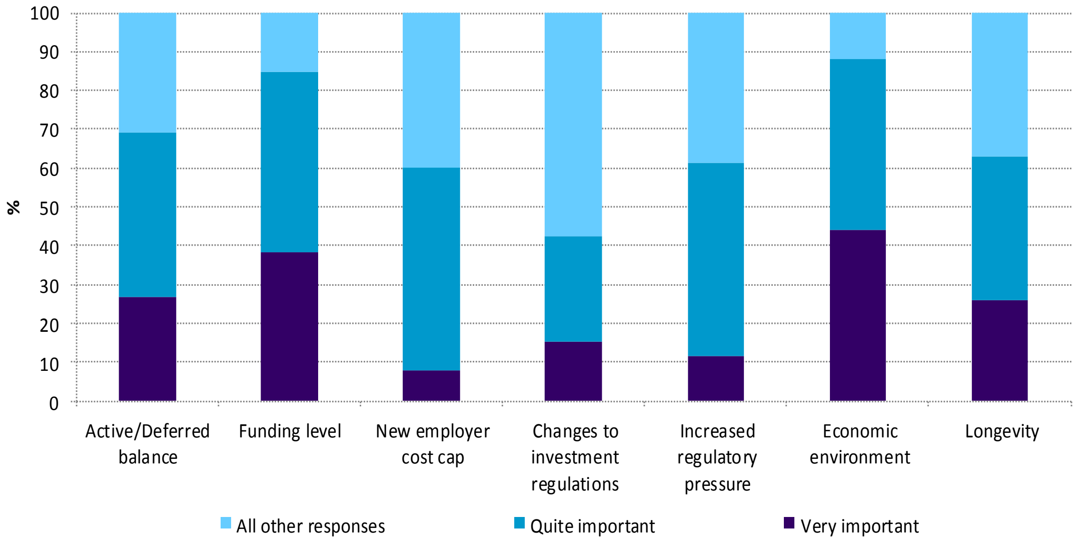
[28] Poll conducted of all NAPF LA Members in April 2013, 28 respondents.
[29] The 2012 NAPF Annual Survey.

authority) and are therefore likely to have shorter recovery plans and higher individual employer contribution rates. This makes any additional cost burdens placed upon them difficult to bear and could, in turn, impact on the cost of the delivery of LA services.

Implications for LGPS investments

To ascertain what the current changes to the LGPS might mean for LA fund investment, the NAPF ran a poll of its LA members to gauge their views on what factors will have the biggest impact on their fund's investment strategy over the next 3-5 years[30].

Figure 4: Which factor(s) would be most important in influencing fund's investment strategy over the next 3-5 years?



Source: NAPF LA Member Poll, April 2013

The issues identified as most important were:

- **The economic environment:** 88% of respondents thought the economic environment was very or quite important;
- **The impact on funding levels:** 84% felt that funding levels were very or quite important;
- **Scheme demographics:** the balance of active to deferred members as funds mature and the costs of longevity increases were the next most important issues, with 69% of poll respondents saying that the active/deferred balance was very or quite important and 61% saying that longevity was very or quite important; and
- **Regulatory landscape:** 61% responded that increased regulatory pressure was very or quite important. 60% said that the new employer cost cap was very or quite important.

In the next section we explore current investment trends within LA funds and take a look at what impact these factors may have on future investment trends.

[30] Funds were asked how important the following factors will be in influencing your fund's investment strategy over the next 3-5 years? Active/deferred balance, funding level, the new employer cost cap, changes to the investment regulations, increased regulatory pressure, the economic environment and longevity.

4. Investment trends of LA funds

The LGPS funds manage around £150 billion of assets in total. The largest of those funds are of a similar size to their private sector counterparts – the largest fund holds £11 billion in assets and one in four funds holds over £2.8 billion. Perhaps not surprisingly, the relative immaturity of the LA funds, combined with a differing regulatory framework from that governing private sector schemes and a strong employer covenant, means that they tend to hold a larger proportion of return seeking assets then their private sector counterparts.

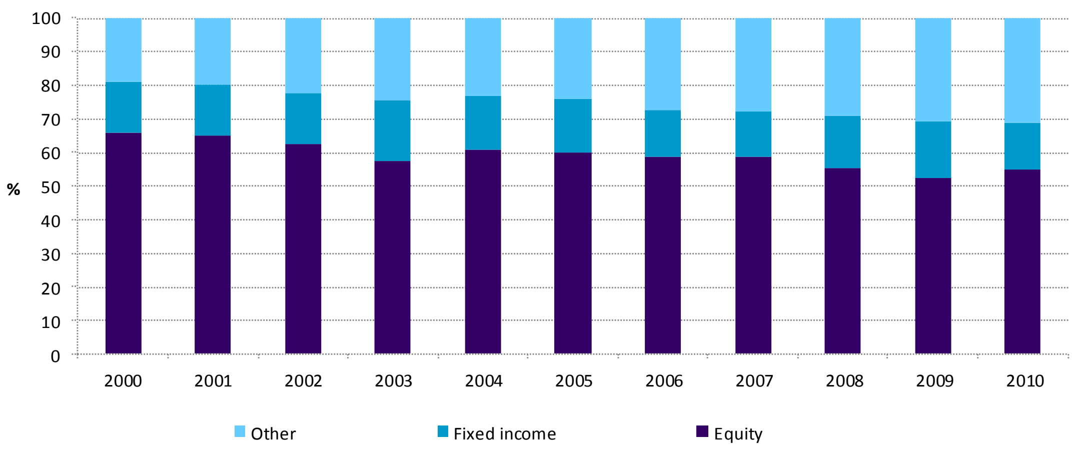
The section below explores these trends in more detail, using the 2012 NAPF Annual Survey which covered 32 of the 99 LGPS funds and an estimated £83 billion assets, along with data from the LAPF Strategic Investment Forum asset allocation[31].

LA funds asset allocation trends

LA funds, like other DB pension schemes, are long term investors. Conventional wisdom suggests that, as such, they should be adopting a buy and hold approach rather than reacting to noise in the markets. Over the last decade or so this appears to have been realised, and there has been only a gradual change in the aggregate investment behaviour of the LA funds.

As Figure 5 shows, investment in equities still dominates asset allocations in the LGPS funds, with the average percentage held, per fund, in equities standing at 55% in 2010, compared to 65% in 2000.

Figure 5: Equity allocation of LGPS funds

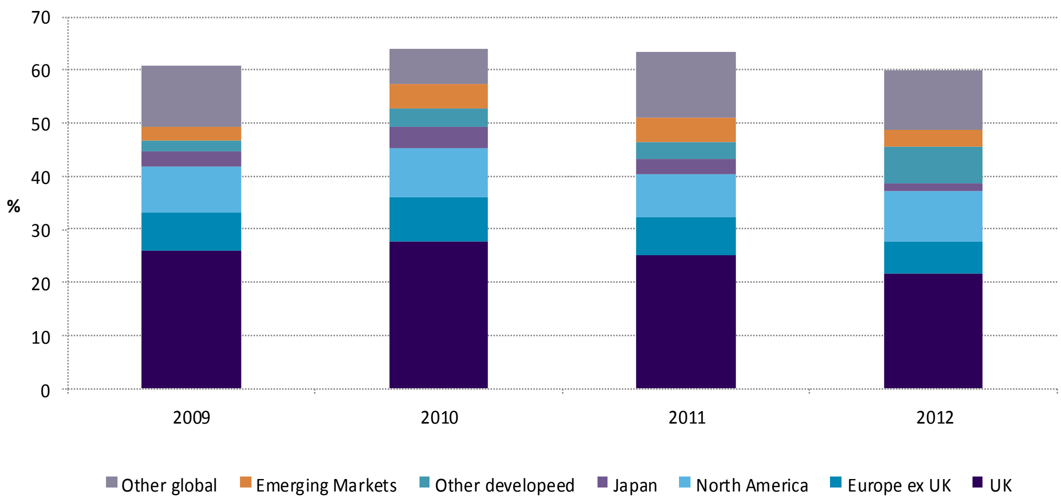


Source: LAPF Strategic Investment Forum Asset Allocation data

[31] LAPF Strategic Investment Forum Asset Allocation data.

As Figure 6 shows there have been some fluctuations year on year in equity holdings which will reflect, in part, changes in asset prices. In addition there has been a small decline in holdings of UK equities offset by an increase in holdings of 'other developed' equities. However, UK equities still represent a sizeable proportion of total equity holdings in LGPS funds, with the average invested in UK equities per fund standing at 22% in 2012.

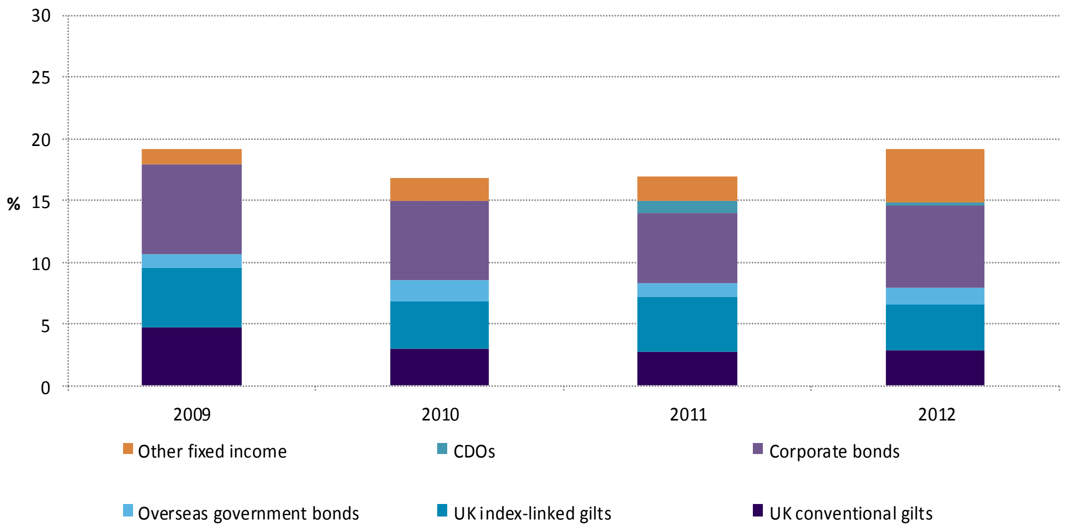
Figure 6: Equity allocation of LGPS funds



Source: NAPF Annual Survey

In terms of fixed income, Figure 7 shows that the key movements between 2009 and 2012 have been between fixed income classes with decreases in holdings of conventional and index-linked gilts being offset by increases in 'other fixed income'. While there have been fluctuations in the allocations to fixed income year on year (again, most likely reflecting changing asset prices rather than tactical switches) the total allocation has remained remarkably constant over the last decade at around 17%.

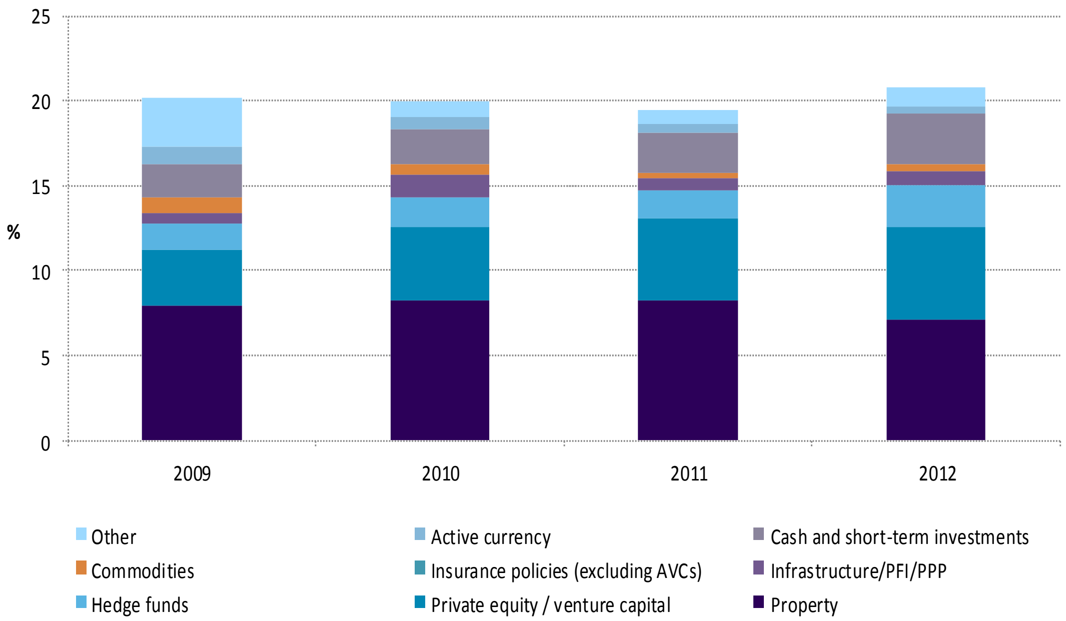
Figure 7: Fixed income allocation of LGPS funds



Source: NAPF Annual Survey

Over the last decade the allocation to 'other' assets has increased rapidly from 19% to 31% according to the LAPF data. Property dominates within the 'other' assets class although, as Figure 8 below shows, the last few years have seen private equity and hedge fund investment growing in importance for some funds.

Figure 8: 'Other' allocation of LGPS funds



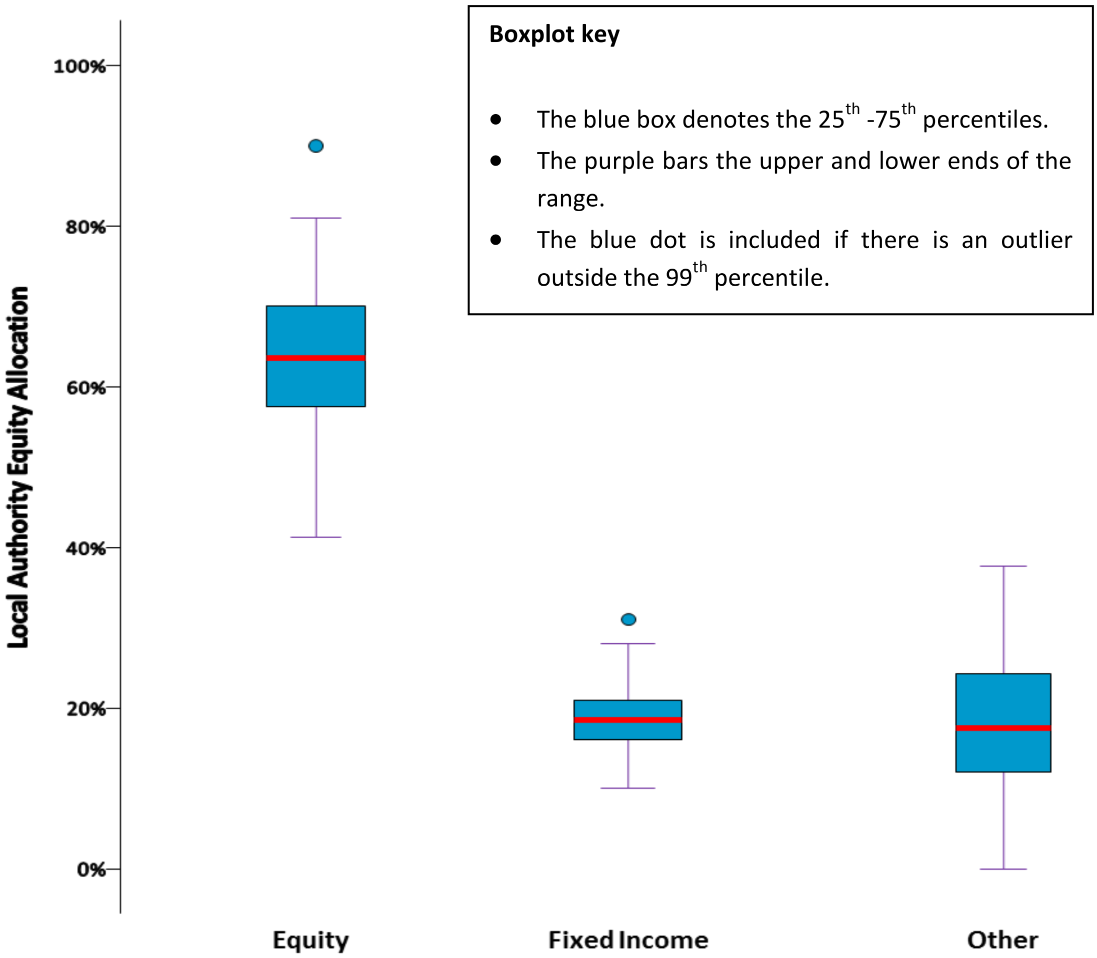
Source: NAPF Annual Survey

Differences between LA funds

The analysis above provides a high-level overview of the investment trends of funds within the scheme but, like their private sector counterparts, LA funds are not a homogenous group. In terms of their investment approach and governance, they differ in terms of their scheme maturity and membership profile, funding levels and investment objectives, scale (and associated ability to diversify), and pension committee behaviour and investment beliefs. That said the variation in asset allocations between funds is still relatively narrow.

Figure 9 uses data from the 2012 NAPF Annual Survey to illustrate the range of allocations that individual funds hold of different assets classes (in this case equity, fixed income and 'other'). The Figure shows that equity holdings dominate across the vast majority of the funds, with 75% of LGPS funds holding more than 57% in equities, and with one fund holding 91%. In terms of fixed income the spread is much narrower; the majority of funds hold between 10% and 28%, with one fund holding 31%.

Figure 9: 2012 Allocation spread of LGPS funds[32]

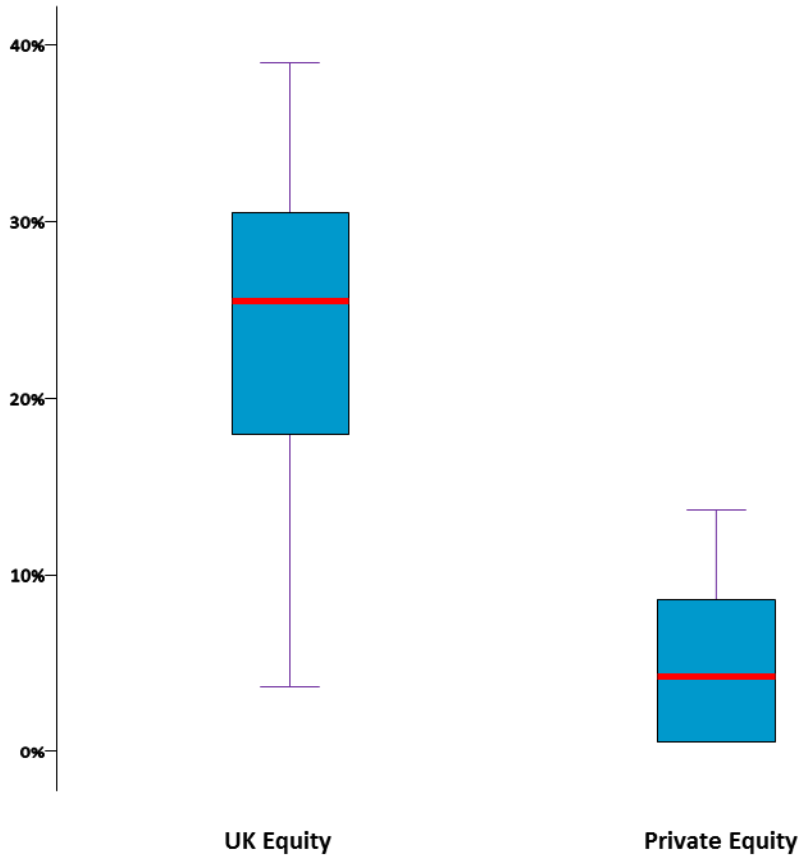


Source: NAPF Annual Survey

[32] Figures 9 and 10 show boxplots mapping the full range of responses under each category with the blue box denoting the 25-75 percentiles and the purple bars the upper and lower ends of the range. The blue dot is the outlier in each range.

There are some interesting results for particular asset classes. For example, funds typically allocate 20% to 40% of their assets to UK equities and there are no funds with no allocation to UK equities. Figure 10 shows that half of the funds in the range have allocations concentrated between 26% and 39%. At the other end of the spectrum, the vast majority of LA funds have no or low allocations to private equity but there is a significant minority with high enough allocations to increase the average allocation.

Figure 10: 2012 Allocation spread of UK equity and private equity in LGPS funds



Source: NAPF Annual Survey

Comparison of LA fund investment with private sector DB schemes

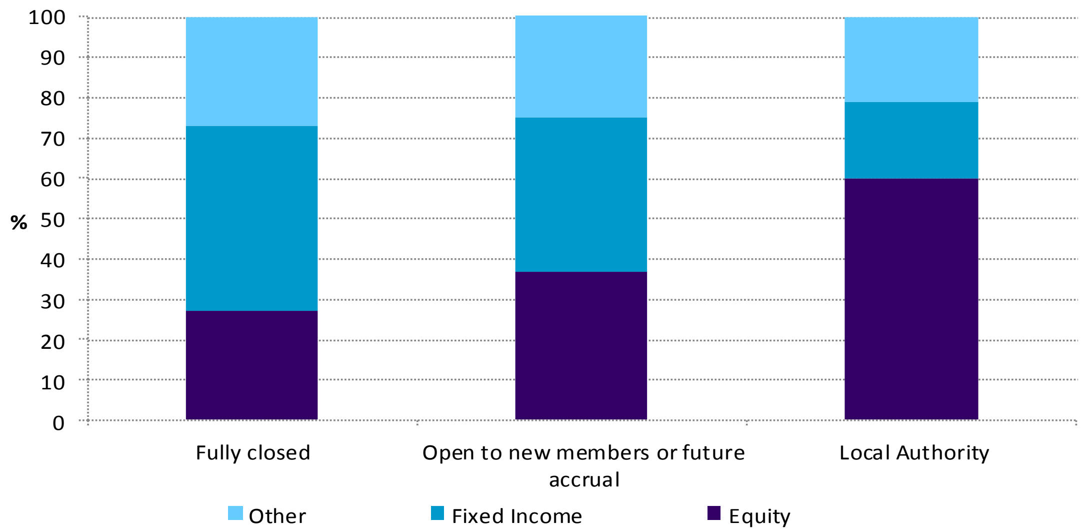
There are good reasons to expect the investment behaviour of LA funds to differ from their private sector counterparts. First, many schemes in the private sector have already closed to new members or to new and future accrual. The 2012 NAPF Annual Survey showed that just 13% of private sector DB schemes remain fully open (ie open to new members as well as future accruals), compared to 100% of LA funds. As scheme membership and liabilities mature, and cash-flows decrease, there is likely to be increasing focus by pension committees on managing their investments to more closely match future liabilities and the cash payments that will fall due.

Second, many private sector DB schemes argue that the regulatory framework, and the requirement to agree recovery plans and deficit recovery contributions based on triennial valuations that can fluctuate wildly in response to changing market conditions and interest rates, drive them to liability match or hedge their investments to manage this volatility. Where they and the sponsoring employers are looking to de-risk, they may be pursuing strategies that require them to match movements in the gilts markets so that they are well positioned to buy-in or buy-out sections of their liabilities. This has exacerbated the demand for gilts in general, and inflation linked gilts and other index linked assets in particular, which are good hedges for movements in the liabilities.

As a result, there have been radical changes in the investment behaviour of private sector DB schemes as they have matured and increasingly closed. Only 35% of assets in open private sector DB schemes were invested in equities in 2012 (55% in 2007), whilst LA funds held, on average, 63% in equities. The picture is more stark when looking at the 31% of fully closed private sector DB schemes, that have only 27% of their total assets in equities, less than half the average of LA funds.

Whilst LA funds face some of the same pressures (as the value of gilts assets can also impact on their discount rate assumptions and funding positions), their relative immaturity and the differing regulatory framework means that these will be acting as less of a binding constraint on the investment behaviour of pension committees.

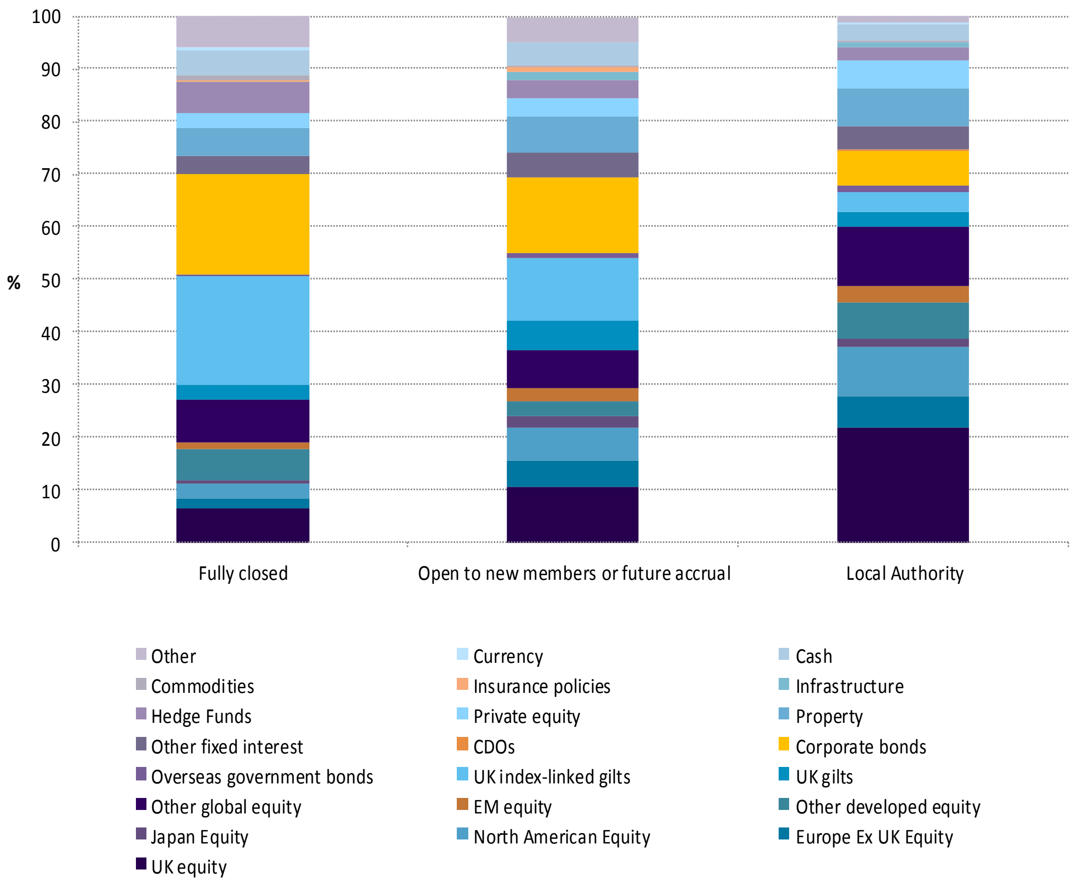
Figure 11: High level asset allocation split by scheme type



Source: NAPF Annual Survey

Looking at a more detailed breakdown of asset allocation the differences remain unsurprising. UK equity investment is much higher in LA funds than in private sector schemes, but with corporate bond and index-linked gilts holdings lower. Although, interestingly, the private equity holdings in a small number of LA funds are larger than the average amount held in both open and closed private sector schemes.

Figure 12: Detailed asset allocation breakdown split by scheme type

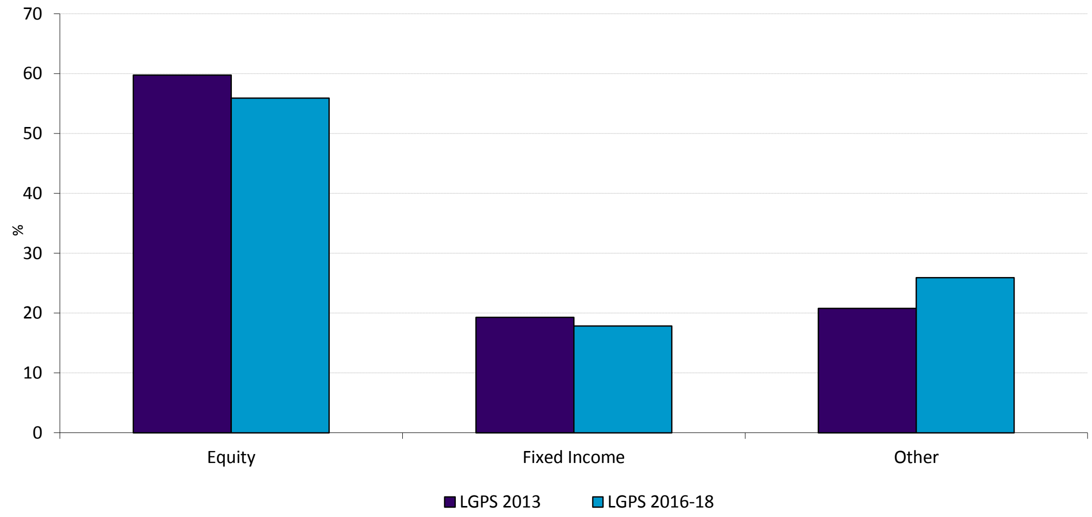


Source: NAPF Annual Survey

The impact of change on LGPS investment trends

Whilst LA funds' investment strategies have not seen a radical shift over the last decade, our analysis suggests that the on-going trend towards greater diversification is likely to continue. NAPF polling suggests that, over the next 3-5 years, LA funds are expecting a move away, predominantly, from equities towards 'other' assets such as property and infrastructure.

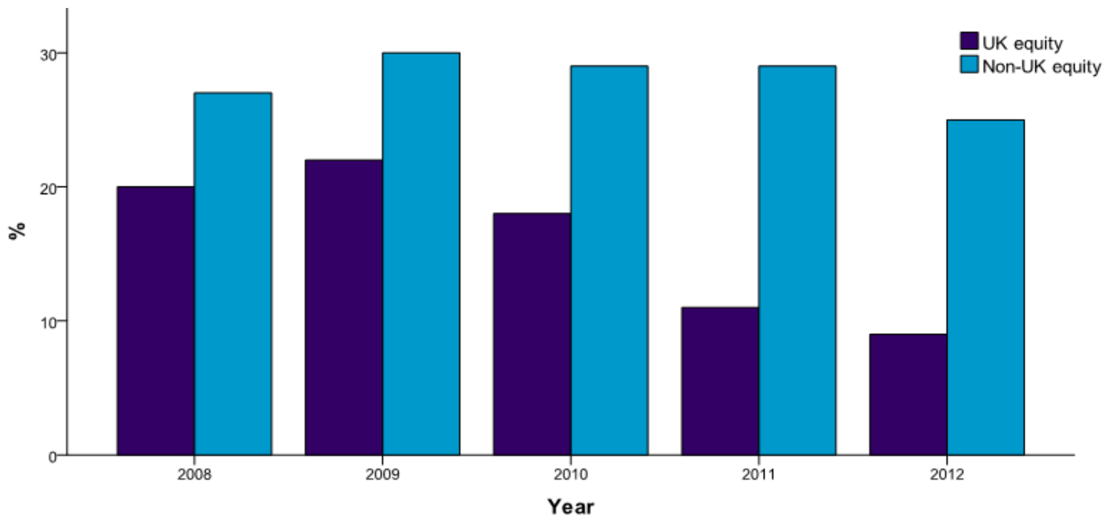
Figure 13: LA funds likely asset allocation now and in 3-5 years' time



Source: NAPF LA Member poll, April 2013

Whilst the adjustments in allocation may be relatively minor, assuming this trend is applied uniformly across all LGPS participating funds, this would indicate an movement of assets away from equities in the region of £5.7 billion over this period[33]. Given the investment trends of large private sector schemes, it is reasonable to infer that this would predominantly be a movement away from UK equities. NAPF research shows that larger schemes in the private sector have tended to move out of UK equities at a faster rate than non-UK equities (see Figure 14 for schemes with over £2bn assets).

Figure 14: Equity allocation of private sector DB schemes with over £2bn



Source: NAPF Annual Survey

[33] And a move of £2.2bn away from fixed income.

The continuation of this trend could also lead to an extra £7.7bn being invested in 'other' assets[34] - a 25% increase on current allocations. This marks a continuing move towards 'non-traditional' assets.

These trends have potential implications for the influence of pension funds as stewards of UK companies and the wider economy. LAs have historically taken their role as engaged stewards of UK (and overseas) investee companies very seriously. Indeed, LA pension funds and their pension committees have often been very vocal advocates of good corporate governance within the UK and have collaborated well to achieve greater influence and leverage than their equity holdings would otherwise suggest.

Companies have a clear interest in having shareholders who take a long-term view of their company and as stewards of its long-term interests engage in important strategy and investment discussions. While the LA funds will no doubt continue to exert influence over the companies in which they invest – seeking to protect and promote members' interests and to help improve and protect the returns on their investments – the trend away from investment in UK equities to a more global and diversified portfolio may in turn dilute and shift their 'voice' elsewhere. In turn this may require further thought to be given to how stewardship considerations should be incorporated into the increasing role of non-equity investments and how influence can be leveraged by the LGPS, as both owners and creditors of investee companies. Long-term factors relevant to the current and likely future health of an investee company matter to both bond and equity-holders.

Pensions and infrastructure

The NAPF has been told by our LGPS members that they want to invest more in infrastructure, but to do so the terms need to be right and give pension funds what they want. In response to the lack of opportunities for pension funds to access infrastructure as an asset class, the NAPF has been facilitating the development of the Pensions Infrastructure Platform (PIP). The PIP will be a new infrastructure fund 'for pension funds, by pension funds'. With a target size of £2bn, the PIP is expected to invest in core infrastructure assets. It is seeking returns of RPI+ 2% to 5% with appropriate remuneration packages for the PIP's investment managers and low leverage.

Ten pension organisations have become Founding Investors of the PIP. They include: British Airways Pension Schemes, BAE Systems Pension Funds, BT Pension Scheme, Lloyds TSB Pension Scheme, London Pension Fund Authority, the Pension Protection Fund, the Railways Pension Scheme, Strathclyde Pension Fund, and the West Midlands Pension Fund. Subject to the PIP being established on satisfactory terms, each has expressed an intention to invest £100m in the PIP. The PIP is expected to launch later this year.

[34] Figures based on percentage moves applying to £148bn held by all LGPS funds.

5. Getting the architecture right

The next few years are going to be a challenging time for the LGPS. Not only do LA funds need to implement the new 2014 scheme but, as outlined in section three, they will need to meet a large number of pressing policy and economic challenges. Crucial to the future success of the LGPS and its constituent funds will be having a legislative and regulatory architecture that enables funds to innovate and deliver on behalf of scheme members and taxpayers.

In terms of the current architecture the debate is currently focusing on:

- driving efficiencies, in particular whether having fewer larger schemes will deliver better value for money for the taxpayer;
- scheme governance and administration and the new role for TPR; and
- LA fund investment and whether the current investment regulations allow sufficient investment innovation.

Driving efficiencies

Lord Hutton's review of public service pensions examined the administration and running of the individual LA funds. Lord Hutton argued that the obvious question was whether there may be scope for streamlining and combining administration functions to increase efficiency and value for money, noting that scale can drastically reduce the costs of administration[35]. The review noted that a number of LA funds had begun to explore the opportunity of sharing administrative services and contracts. It recommended that central and local government should closely monitor the benefits associated with the current joint-working projects (such as the National Procurement Framework) within the LGPS, with a view to encouraging the extension of this approach.

National procurement framework

One of the key ways in which the LGPS funds have been working together to deliver efficiencies is through the National Procurement Framework, part of a HM Treasury and Cabinet Office efficiency programme. These frameworks provide pre-approved panels of service providers for specific fund services such as administration, actuarial advice and investment consultancy. The aim is to enable LA funds to replace service providers without the time, energy and cost involved in running an individual procurement exercise. The first framework, for actuarial and benefit consultancy services, was launched in July 2012 and the latest, on investment consultancy, in May 2013.

[35] Hutton Commission Interim Report, 2011.

There is currently an active debate within the LGPS about how greater efficiencies can be driven as a result of schemes working together and the form that collaboration could take. There is a spectrum of options being discussed from more joint working through to full mergers. Other options being considered include:

- Collective Investment Funds, which would establish a central entity having the expertise to procure, monitor and replace the best investment managers in each asset class, leaving individual LA funds to decide asset allocations between those managers; and
- Framework Funds, which would go further by creating a single legal framework for a group of LA funds, handling many operational matters on a collective basis. Administering Authorities would still choose asset allocations and negotiate individual contribution rates.

It is important that this debate is taking place as continuing to drive down costs and improving scheme performance will be central to a successful LGPS.

But scheme mergers, consolidation and even joint procurement exercises are not straightforward. It is important that there is a considered and open debate on how schemes can work together to reduce costs, increase performance and drive efficiency. Importantly, the right structures and processes need to be in place that allow LA funds to work together, for mutual benefit, to harness efficiencies and to drive better value for money.

The Government should facilitate an open debate on the case for schemes working together to drive efficiency and ensure that the LGPS is providing value for money.

Governance and administration

Good pension scheme governance is crucial to making sure LA funds are well-run and remain affordable over the long term and many LA funds already operate with very high levels of governance. The Public Service Pensions Act 2013 includes provisions for scheme-level boards and oversight by TPR of the governance and administration of all public service pension schemes, including the LGPS.

This will be the first time TPR has played an active role in the oversight of public service pensions. However, whilst TPR's role is intended to be restricted to governance and administration in the LGPS, a number of NAPF LA members are concerned about potential mission creep. This is because in a funded scheme it may be difficult to draw a clear line between investment governance, investment strategies and recovery plans.

At present, LA funds have quite lengthy recovery periods – data from the 2012 NAPF Annual Survey showed the average recovery period for a LA fund was 21 years compared with 9.5 years in the private sector[36]. It could be argued the strength of the employer covenant in the LGPS would prevent any pressure being placed on the length of recovery plans. However, increasing numbers of new

[36] NAPF Annual Survey 2012

employers are entering the LGPS (as Admitted Bodies) and their ability to meet their employer contributions may not be the same for the Administering Authorities. This may lead to Admitted Bodies' recovery periods coming under further pressure, particularly if fund deficits increase.

In addition to new regulatory scrutiny at a UK level, funds will also be affected by investment regulations from Europe. The majority (46%) of respondents to the NAPF LA poll thought that European investment regulations – such as the new bilateral standards for trading derivatives and the Financial Transaction Tax being taken forward by 11 EU member states – will make investment more costly over the next three years. Views on the scale of likely additional costs varied, but the majority thought the impact would be an increase in cost of up to 20%.

Above all, governance and administration of LA funds needs to continue to remain fit for purpose. Oversight by TPR could be a key driver in cementing the already strong features of governance found in many LA funds. But there are areas for concern. TPR are planning to consult on their public sector pensions Codes of Practice later this year. Their Codes of Practice will need to apply across all public service pension schemes and, as such, they may fail to reflect the unique nature of the LGPS as a funded scheme. LA funds are also unique when compared with their private sector counterparts, who TPR are used to regulating. They are less mature and benefit from strong employer covenants. Regulation of governance, and particularly investment governance, needs to recognise this. It is also not clear at present how TPR is planning to engage with the LA funds. Given the on-going role for DCLG (and Government more widely) in regulating the funding regime and operating the employer cost cap, there is the potential for duplication and confusion in regulatory oversight of the scheme.

The Pensions Regulator (TPR) needs to work with LA funds and understand their uniqueness. The regulatory architecture needs to be clear in order to avoid mission creep and the risk of duplication of regulatory activity by the Pensions Regulator and the Department for Communities and Local Government (DCLG).

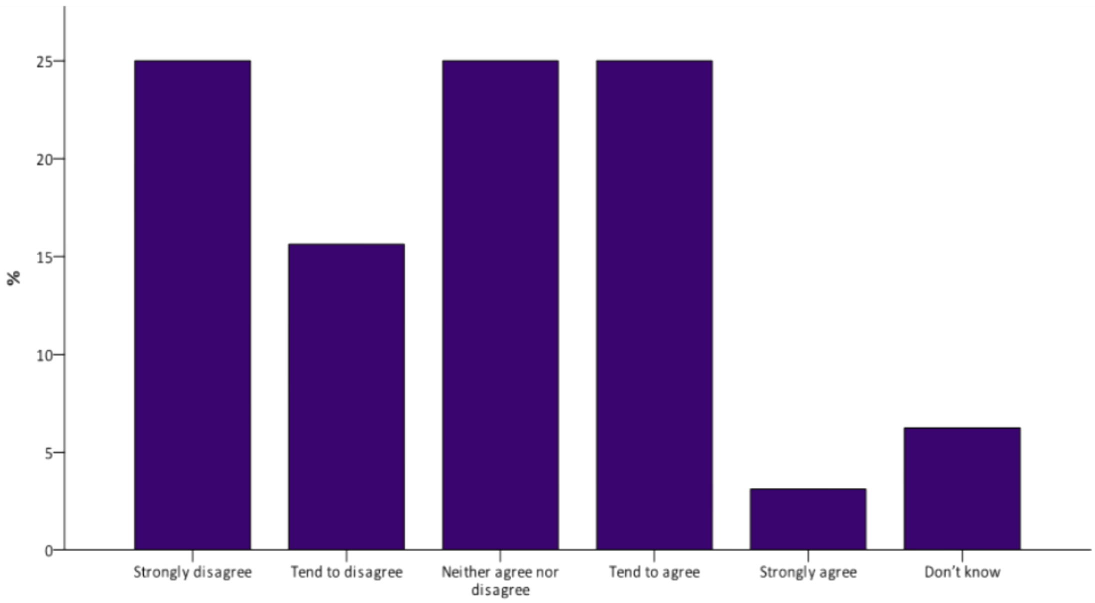
Investment regulations

The NAPF has long argued that the LGPS Investment Regulations are overly prescriptive and out of date. They do not meet the needs of LA funds in enabling them to effectively manage their investment risks and meet their long term funding objectives to meet the needs of their beneficiaries and provide value to the taxpayer.

In contrast to private sector occupational pension schemes, the LGPS Investment Regulations prescribe limits on the amount LA funds can invest in certain types of legal structures, for example limited partnerships or collective investment schemes. This potentially leads to sub-optimal investment allocations for LA funds. This is because the reference to the underlying legal structure is somewhat arbitrary and does not necessarily correspond to the underlying risk of the investments. This is compounded by the fact that the regulations have also failed to keep up with changes in the investment world or funds' needs for diversification, making it difficult for funds to make appropriate investment choices.

LA funds need flexibility so they can invest for the good of the scheme, the scheme members and taxpayers. LA funds want change. In last year's NAPF Annual Survey[37], less than one third of LA respondents thought the Investment Regulations were a useful way to manage investment risk.

Figure 16: I find the LGPS Investment Regulations helpful when managing risk



Source: NAPF Annual Survey

The NAPF welcomes the recent increase in the cap on limited partnerships, which LA funds told us was preventing them investing in assets such as infrastructure. In addition, the NAPF welcomes the Government's commitment to wider reform of the LGPS Investment Regulations. However, if LA funds wish to continue to shift their asset allocations away from equities and towards 'other' assets it is vital that funds are enable to do this now. Therefore we would urge the Government to reform these regulations as soon as possible. These reforms should reflect the framework that exists in the private sector where a clear fiduciary duty is placed on the funds and they have a clear duty to effectively manage their investment risks and meet their long term funding objectives. The NAPF believes that the reformed regulations need to form an integral part of the regulatory regime for the new 2014 scheme.

The LGPS Investment Regulations need revising to better reflect the framework that exists in the private sector where a fiduciary duty is placed on the funds and they have a clear obligation to effectively manage their investment risks and meet their long term funding objectives.

[37] The 2012 NAPF Annual Survey.

6. Conclusion

It is clear that the LGPS is at a critical juncture in its history. This will affect how the scheme is administered and governed, but, crucially, will affect the investment strategies and decisions of the individual funds in the future. The NAPF will be closely monitoring the impact of the various reforms, changing scheme demographics and the economic environment on the governance of LA funds and their investment strategies. We will continue to seek views from our members on how they are managing these changes and whether the legislative and regulatory landscape is fit for purpose.

In the short term the key priorities for Government and the regulators are that:

- the Government facilitates an open debate on the case for schemes working together to drive efficiency and ensure that the LGPS is providing value for money;
- TPR works with LA funds to understand their unique nature and the regulatory architecture is made clear in order to avoid mission creep and the risk of duplication of regulatory activity by TPR and DCLG; and
- the LGPS Investment Regulations are revised to better reflect the framework that exists in the private sector where a fiduciary duty is placed on the funds and they have a clear obligation to effectively manage their investment risks and meet their long term funding objectives.

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May 2013

'Securing the future of pensions'