Centre for Policy Studies

Pointmaker

LGPS (2018)

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SUMMARY

- This paper follows a recent sister paper *The LGPS: Unsustainable* (2015) that reveals evidence of a forthcoming cashflow crisis for the Local Government Pension Scheme (LGPS). It makes some remedial proposals that incorporate the Chancellor's desire that the LGPS's 89 disparate funds pool their assets into a few infrastructure-oriented British Wealth Funds.

- This may buy some time for the LGPS, but economies of scale can only go so far, and infrastructure investment is not a panacea: returns are quite low. Together, they are insufficient to ameliorate the pending cashflow crisis and repair the deficits. The LGPS will remain unsustainable.

- Consequently, this paper's proposals go much further. LGPS (2014) should be replaced by LGPS (2018), a defined contribution (DC) scheme, perhaps with a cash balance arrangement (a form of defined benefit, DB) offered for an interim period. NEST (and its competitors) could deliver the former, a single LGPS fund the latter.

Addressing the DB accruals

- Two alternative methods for meeting LGPS (2014)'s DB accruals are discussed; funded and pay-as-you-go (PAYG). If the former, then all the assets of the 89 LGPS funds should be pooled into a few British Wealth Funds (BWF) and the LGPS structure disassembled. LGPS fund selection could be based upon their latest valuation to minimise the range of funding ratios within each BWF.

- This paper introduces the idea of incentivising the BWFs to invest in infrastructure by providing a Treasury-funded "Social Premium" for any such investment. As an annual return "kicker", it would be paid in acknowledgement of the BWFs socialising the benefit of their assets across the whole of society (we all use airports, railways, roads and utilities). It would also provide an implicit, rather than explicit, mechanism for deficit repair in respect of the LGPS's DB accruals.

- Alternatively, if PAYG were the preferred method of meeting DB accruals, a few British Wealth Funds could be established as competing endowment funds (i.e. funds without liabilities), seeded with LGPS assets. The rest could be sold to reduce the national debt. Politically independent governance would be required, perhaps involving the recently established National Infrastructure Commission.

THE PROPOSALS

- **Proposal 1:** The Government should replace LGPS (2014) with LGPS (2018), a defined contribution (DC) scheme. A cash balance arrangement (a form of DB) could be offered for an interim period. NEST (and competitors) could deliver the former, a new single fund the latter. Collective decumulation should be offered by default, perhaps delivering 5% per year of the pot size available at retirement, with automatic lifetime annuitisation of assets remaining at age 75. Members would be free to opt out, to embrace the 2014 Budget's freedom and choice as individuals.

- **Proposal 2:** If DB accruals were to be met on a funded basis, then all the assets of the 89 LGPS funds should be pooled into a few British Wealth Funds. LGPS fund selection could be based upon their latest valuation to minimise the range of funding ratios within each BWF.

- **Proposal 3:** The Chancellor could incentivise the BWFs to invest in infrastructure by paying an annual "Social Premium" for any such investment. It would serve as an implicit, rather than explicit, mechanism for deficit repair in respect of past DB accruals.

- **Proposal 4:** LGPS (2018) contribution rates should be renegotiated in light of the change to post-2018 pension benefits. Given that the Treasury would be assuming the DB accruals funding deficit (and exposure to any subsequent deterioration), it should be entitled to some ongoing contributions.

- **Proposal 5:** If DB accruals were to be met on a pay-as-you-go basis, a few British Wealth Funds could be established as competing endowment funds, seeded with LGPS assets. They could invest in infrastructure, but without liabilities, nor on-going contributions, the BWFs would be dependent on asset performance for income. Alternatively, the Chancellor could pursue his interest in infrastructure investment by seeding one National Infrastructure (or sovereign wealth) Fund with LGPS assets, to be sold off for cash to fund projects as they arose.

- **Proposal 6:** The DCLG's 2014 proposals to end investment in actively managed funds of listed assets, and sell all fund of funds, should be adopted irrespective of where the LGPS's assets were ultimately housed.

- **Proposal 7:** A politically independent governance committee should be appointed to oversee any infrastructure portfolio that emerged from rearranging the LGPS's assets. This could involve the recently established National Infrastructure Commission.

INTRODUCTION

Today's LGPS emerged in 2014, following Lord Hutton's review of public service pension provision. It is fundamentally flawed because, during negotiations, the Government made a late concession to the unions, by offering ten year grandfathering.[1] This rendered Lord Hutton (cost-saving) proposals impotent for at least a decade: no material cashflow savings will materialise until after 2024. This could be the LGPS's undoing.

In the interim, the LGPS risks running out of cash to meet pensions in payment, evidenced in the sister paper. Its cashflow faces a perfect storm, due to a combination of past under-funding; the end of contracting out rebates (from April 2016, costing some £700 million per year); potentially sclerotic investment returns in a post-QE world; employers opting out of the scheme; destructive demographics (the membership is both living longer and ageing); mis-aligned cost and income drivers; and a crippling accrual rate (increased by 63% since 2008).

Only now is the LGPS coming into political prominence. There is a growing recognition that its cumbersome, indeed dysfunctional, operational structure is the source of considerable value leakage (through third party fund management charges and carried interest).[2] In addition, redeploying its assets could help address the Budget deficit.

1. CONFUSED PERSPECTIVE

The case has long been made for the LGPS's shoal of 89 predominately sub-scale funds to be ushered into a few, much larger, investment pools. Economies of scale could reduce the pressure to increase contributions, benefitting both the membership and employers (and, in turn, councillors in respect of not having to increase council tax). But individual funds continue to adhere to localism, resolutely flying the flag of local accountability to justify "no change". This is an unjustifiable nonsense: no Section 151 officer[3] has ever been held to account and, in any event, only 18% of the £9.4 billion in 2014-15 contributions were funded through council tax.[4]

Consequently the LGPS has been allowed to become a staggeringly inefficient, self-serving empire, the interests of those who work within it, or provides services to it, riding roughshod over the interests of its membership, employers and taxpayers, as well as common sense and economic rationale.

There is a gulf in perspective. Individual funds want to retain their identity, forgetting that they are part of what is, ultimately, a single occupational pension scheme. Consequently, many decisions are inconsistent with the broader context, at huge economic cost to

[1] "Grandfathering": transitional protection given to anyone within ten years of retirement.

[2] 2014-15's reported fund management costs of £748 million are probably half the true figure, and this excludes carried interest retained by third party service providers.

[3] Section 151 of the Local Government Act 1972 requires every local authority to appoint a suitably qualified officer responsible for the proper administration of its affairs.

[4] The rest came from central government grants (46%), employees (28%) and through the business rate retention scheme (8%). LGPS contributions comprised £2.07 billion from employees and £7.32 billion from employers, the latter being funded by a combination of council tax (25% of revenue expenditure), central Government grants (63.9%) and the business rate retention scheme (11.8%). See *Local Authority Revenue Expenditure and Financing: 2014-15 Final Outturn, England*; DCLG, November 2015.

members and employers (i.e. taxpayers). High costs have been stealthily and iniquitously eroding capital, paid for by employee and taxpayer-funded employer contributions that would otherwise have been lower. That said, think tank pressure and heighted media interest in the LGPS has not gone unnoticed.[5]

2. TINKERING

2.1 Collaboration: false friend?

Some local authorities have embarked upon a gamut of collaboration projects to generate cost savings. But collaboration is not necessarily the panacea that many believe; organisations rarely think because of fear of conflict. The stultifying conformity of joint committees, striving to avoid conflict, means that many struggle to accommodate creativity and innovation. In addition, they are usually dominated by extroverts who drown out the quiet introverts. Yet history tells us that it is independent, individualistic introverts who tend to catalyse creativity, including Newton, Apple's Steve Wozniak, Einstein, JK Rowling, Darwin and Google's Larry Page. They prefer to work independently, solitude being a catalyst for innovation.[6]

2.2 Collective Investment Vehicles (CIVs)

Shared services are in vogue, including administration, the procurement of actuarial and investment consultancy, global custody and legal services. Some LGPS funds are establishing CIVs, platforms through which they can buy investment firms' services for lower fees than on the open market. Partnerships, such as the one between Lancashire and the London Pension Fund Authority (LPFA), perhaps go a little further, by combining the pursuit of asset growth with a strategy to meet liabilities. But none of this will bring about the transformational change necessary to put the LGPS on a sustainable footing.

2.3 Avoiding tough decisions

More noticeable is what the LGPS funds have *not* been doing. They have resolutely avoided merging their assets, taking asset management in-house and ending the nonsense of paying active fund managers to under-perform benchmark indices (net of costs). In truth, what we are witnessing is mere tinkering, partly driven by a desire to be seen to be doing just enough to keep the show on the road, masking the fundamental home truth that the LGPS is not sustainable. Tinkering will only produce incremental annual savings of, perhaps, a few £ tens of millions: nowhere near enough.

Meanwhile, the individual funds continue to adhere to localism, claiming "local accountability" as a protective shroud: it is a chimera concocted by those with vested interests to defend.

3. CENTRAL GOVERNMENT STIRS

3.1 An evolving structure

Successive governments have baulked at the prospect of confronting the cornucopia of vested interests that plague the LGPS. There have been occasional forays of mild intent, including a 2014 consultation[7] on two specific

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5 The case for "scaling up" is detailed in *What price localism? A case study: the Local Government Pension Scheme;* Johnson, CPS, 2014; *The Local Government Pension Scheme: opportunity knocks*; Johnson, CPS, 2013; and *Self-sufficiency is the key;* Johnson, CPS, 2011.

6 Wozniak's memoires: *I don't believe that anything really revolutionary has been invented by committee. Work alone if you aspire to great creativity. Not on a committee. Not on a team.*

7 The proposals were to move all of the LGPS's £85 billion of actively managed listed assets into passive fund management, and to exit all to "fund of funds" arrangements. *Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies*; DCLG, May 2014. The proposals first appeared in *The local Government Pension Scheme:*

proposals that would have saved the LGPS at least £660 million per year in investment fees and transaction costs.[8] That initiative got nowhere, but it did establish some momentum within the Department for Communities and Local Government (DCLG), sponsor of the LGPS. With Cabinet Office encouragement, it asked PWC to propose a design for the structure and governance of efficient and effective CIVs for LGPS funds.

PWC's recently-published report looks at some technical aspects for CIV structures (legal, regulatory and tax), as well as some governance and operational considerations.[9] It recommends a co-ownership version of an Authorised Contractual Scheme ("ACS"), whereby each individual LGPS fund would hold units in the ACS. This model has already been adopted by 33 London Councils to pool their investments, giving the London CIV a head start.

3.2 Osborne rides in

(a) The summer Budget and Party conference (2015)

The flurry of tinkering by the LGPS funds has not fooled the Chancellor. In July's summer Budget, funds were invited to come forward with their own proposals to meet common criteria for delivering savings. Additional titbits were provided in the Chancellor's speech at October's Conservative Party conference:

> *At the moment, we have 89 different local government pension funds with 89 sets of fees and costs. It's expensive and they invest little or nothing in our infrastructure. So I can tell you today we're going to work with councils to create instead half a dozen British Wealth Funds spread across the country. It will save hundreds of millions in costs, and crucially they'll invest billions in the infrastructure of their regions.*

Some with vested interests in the LGPS's *status quo* responded with wilful blindness, including service providers; better 89 different clients than six. In addition, a delicate ballet has been in play, with the Government torn between top-down diktat and offering funds the prospect of self-determination (to avoid offending local sensibilities). This engineered ambiguity could easily have been interpreted as a lack of serious intent. But no more.

(b) The 2015 Autumn Statement: from nudging to shoving

Coinciding with November's Autumn Statement, the Government published some criteria for the pooling of investments to realise benefits of scale (see Appendix I).[10] Up to six so-called British Wealth Funds (BWF) are to be created, each with a pool size of at least £25 billion, ten times the size of today's average LGPS fund. The London CIV will, most likely, become one such wealth fund, and DCLG will be responsible for making sure similar arrangements are in place across the LGPS. In addition, active fund management, for example, should only be used where it could be shown to deliver value for money (how measured?), and authorities should report how fees and net performance in each listed asset class compare to a passive index. These are all very welcome developments: the challenge is in their implementation.

Simultaneously, a consultation was published aimed at loosening the LGPS's investment

opportunity knocks; Michael Johnson, Centre for Policy Studies, September 2013.

8 *LGPS structure analysis;* Hymans Robertson LLP, December 2013.

9 *Design of the structure and governance of efficient and effective CIVs for LGPS Funds*; PWC, 20 November 2015.

10 *Local Government Pension Scheme: Investment Reform Criteria and Guidance*; DCLG, Nov. 2015.

regulations, the intention being to encourage more investment into infrastructure.[11] There is a declared intent that the LGPS develops the capacity and capability to become a world leader in infrastructure investment, to help drive growth.

Administering authorities have been "invited" to come forward with initial proposals for pooling by 19 February 2016, final proposals being due by 15 July 2016, detailing plans at both an individual fund and collective level. This is a tight timetable….but it appears to be having an effect. In December, eight Midlands LGPS funds announced that they will create a £35 billion multi-asset investment pool to meet the government's plans to cut costs.[12] So far, so encouraging. But a purring press release states that the funds intend to retain their separate identities and local accountability, greatly limiting the scope for cost savings. In addition, *collaboration would offer each fund an equal say in the oversight of the new entity*. Indecision to the fore? Furthermore, there is no reference to infrastructure.

(c) The driving imperative

The mood music has clearly changed, but why? The causes are multi-various, but they include the Chancellor's fiscal imperative to achieve a Budget surplus in 2019-20 (a £73.5 billion deficit is expected for 2015-16). If he could encourage a greater allocation of the LGPS's £214 billion of assets towards infrastructure, it could reduce the pressure on central government coffers. In addition, perhaps we could then fund our own nuclear energy industry, for example, obviating the need for (costly?) Treasury loan guarantees?[13]

4. A GOVERNANCE MINEFIELD?

The Treasury's interest in infrastructure raises a major question: to what extent could it pressurise administering authorities to invest in infrastructure, via their LGPS funds, i.e. what leverage does it *really* have? CIPFA was quick to issue a warning:

> *The funds must not become the investor of last resort, for example, for politically desirable infrastructure schemes that the markets do not see as investment grade proposals.*[14]

In parallel, proposed new regulations will provide the DCLG's Secretary of State with the power to intervene if he does not think an administering authority is investing "appropriately"…..meaning what, exactly? The DCLG is urging local authority funds to "explain" how infrastructure would feature within the new pooling arrangements, as well as how pooling would improve their ability to invest in the asset class. But what if a fund were to decide that investing in infrastructure did not meet its risk / return criteria? Who is then going to progress the Chancellor's aspiration into action? Or, if a fund were to invest, how might it align its own risk / reward appetite with those of other co-investing funds within a single British Wealth

[11] *Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 Consultation*; DCLG, Nov. 2015.

[12] The participating funds are Cheshire Pension Fund, Derbyshire County Council, Nottinghamshire County Council, Staffordshire Pension Fund, Shropshire County Pension Fund, West Midlands ITA, West Midlands Pension Fund and Worcestershire County Council.

[13] The government has recently guaranteed up to £2 billion in support for the planned Hinkley Point C nuclear power plant, paving the way for Chinese investment.

[14] Rob Whiteman, chief executive of CIPFA, the Chartered Institute of Public Finance and Accountancy, the professional body for people in public finance.

Fund? How should value for money be assessed? And what could prevent BWFs, for example, from purchasing securitised debt instruments to replace, rather than augment, potential infrastructure investment?

The word "infrastructure" would appear to have become a nudging vehicle for changing the LGPS's *structure and behaviour*, i.e. well beyond decisions concerning asset allocation.

5. INFRASTRUCTURE

5.1 Some attractions

Infrastructure assets are an obvious asset class for pension funds to match their long-term liabilities. They can offer one or a combination of:

- relatively predictable long-term returns, with stable cashflow;
- low (price) volatility compared to equities and listed property;
- access to an illiquidity premium;
- built-in inflation protection; and
- diversification from traditional asset classes and market risks.

However, the UK's private sector defined benefits (DB) pension funds are increasingly focused on risk management, cashflow and liquidity. For many, increasing their investment in infrastructure is not an obvious fit, given the de-risking agendas, a growing tendency towards short-termism and the illiquidity of many infrastructure assets.

But the LGPS is different. Administering authorities are essentially corporations without end, there being no mechanism to place them into bankruptcy. Essentially, they have an infinite call on local taxpayers. Consequently, LGPS funds' investment criteria are probably more disposed to accepting the premium on offer for infrastructure's illiquidity and long-dated returns. Indeed, some LGPS funds are already looking seriously at infrastructure, notably the London Pensions Fund Authority and the Greater Manchester Pension Fund. Together, they intend to invest £500 million into such projects over the next three to four years.

5.2 Lack of supply invites deteriorating risk / return

There are some significant practical challenges to investing in infrastructure, particularly on the scale that the Government would like to see. Although the 2014 National Infrastructure Plan values the UK pipeline at £466 billion, of which £277 billion is currently under construction, critics highlight the lack of available projects that meet pension funds' risk / return criteria. Several LGPS funds have commented on the difficulty in filling even today's targets for infrastructure investment[15], and the Pensions Infrastructure Platform, for example, has struggled to develop. A lack of available cash is not cited as an issue.[16]

One problem is that to access what funds want (mature assets with stable cash flows), they sometimes have little choice but to invest via private equity-style vehicles with high fees, blind risk pools and quite a degree of concentration. Indeed, infrastructure investing has been described as "private equity-lite", essentially buyouts in disguise, albeit sold as low-risk, stable and with inflation-beating returns.

[15] Shropshire, for example, has allocated some £35 million to infrastructure, but has only managed to deploy £16 million to date (November 2015).

[16] Launched by the National Association of Pension Funds and the Pension Protection Fund, in 2011.

That aside, prices will inevitably rise given that the market knows of the forthcoming demand from the wealth funds….resulting in lower returns, perhaps 1.5% to 2% over publicly-listed equities. This is not the asset performance miracle that is required to save the LGPS. Falling returns also invite the risk of the "infrastructure" label being attached to investments that are not what we would ordinarily consider to be "infrastructure".[17] Furthermore, many projects are accompanied by substantial debt (leverage being a key source of return), at a time when we may be at the low point in the interest rate cycle. The M6 toll road and Wightlink are two infrastructure examples that were brought down by leverage (and "clever" financial engineering).

6. REALITY CHECK REQUIRED

Even if the Chancellor's vision for a few British Wealth Funds were realised, incorporating all of the 89 funds' assets (to harvest economies of scale), *and* if all asset management were conducted in-house (to cut fees and retain any carried interest), performance may improve by, at best, £1 billion per year. This would buy some time for the LGPS, but it would not avert its demise.

If, in addition, contributions were significantly increased, this could tip the balance, but it would risk a sharp rise in employee opt outs, and withdrawals by employers (particularly those without tax-raising powers)….weakening cashflow. It would also place huge additional pressure on politically sensitive councils (as employers). In reality, further (post-Hutton) hikes to contributions are highly unlikely to be considered (and grandfathering will not be reversed). Consequently, if the LGPS is to have a long-term future, its DB status will have to cease.

Meanwhile, one adverse consequence of continuing with DB provision is that salary growth is more likely to be restrained, to reduce the pressure on cashflow: smaller employer contributions today, smaller pensions tomorrow.

7. LOCAL GOVERNMENT PENSIONS: THE FUTURE

7.1 The end of the LGPS (2014) scheme

The Government should identify a date on which the LGPS 2014 scheme ceases; April 2018, say (transition day, "T-Day").[18] Subsequent pension provision should be on a defined contribution (DC) basis, perhaps achieved by offering, as part of the negotiation process, a cash balance arrangement (a form of DB), for an interim period only.[19] Today, of the four FTSE 100 companies that provide any form of DB pension provision to new recruits, three provide such schemes (Diageo, Johnson Matthey and Morrisons).[20]

Significantly, employees with post-T-Day pots would be able to take advantage of the pensions liberalisations introduced in 2015, but they would bear their own longevity risk (i.e. the risk of out-living their assets).

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17 Examples include directory services, care for the elderly and commercial real estate (e.g. motorway service stations). These have been referred to as "adjacent sectors".

18 LGPS 2014 for England and Wales was launched on 1 April 2014 as a career average pension scheme. It was spawned from Lord Hutton's proposals to reform the LGPS, replacing the old final salary scheme.

19 Cash balance schemes promise a funded pot size at retirement, not a specific, ongoing, income in retirement. Contributions are accumulated in members' retirement accounts, the employer providing an assured rate of return on the account (such as CPI), thereby assuming the investment risk, up until retirement. At retirement, the "cash balance" is passed to the retiree who then assumes his own longevity risk.

20 The fourth (Tesco) provides a career average revalued earnings ("CARE") scheme, which is now in consultation to be closed to both new entrants and future accrual. *Accounting for pensions 2015*; LCP, August 2015.

7.2 Post-T-Day pension provision

(a) DC

(i) Accumulation: NEST plus others

The Government should use NEST as one of a number of competing providers of DC provision. There should be no need for taxpayers to fund another administrative structure.

(ii) Decumulation: collective (optional)

Retiring employees should be offered the opportunity to pool their longevity risk with others, i.e. a collective form of decumulation. The default structure could, for example, deliver 5% per year of the pot size available at retirement, with automatic lifetime annuitisation of whatever assets remained at age 75 (perhaps subject to a minimum threshold). Members should, of course, be free to opt out of any default arrangement, to embrace the 2014 Budget's freedom and choice.

(iii) Political matters

There is the question of how to overcome Danny Alexander's now infamous 2011 statement to the House of Commons, when announcing the Hutton-inspired reforms to public service pensions: "*I believe that we will have a deal that can endure for at least 25 years, and hopefully longer*."[21] Opinions vary on how robust this may be in law; at the very least, a politically challenging U-turn would be required to terminate DB accruals.

(iv) Legal matters

Section 22 of the Public Service Pensions Act 2013 refers to a "protected period" ending on 31 March 2040, but it also prescribes a procedure for making changes before expiry, including the word "consult". National governments would be required to lay a report before their relevant parliament to make the case for breaching the protected period. One would expect this to include a reference to financial unsustainability, and perhaps employment equality between those performing similar roles in the public and private sectors. Governments should decide before proposing any changes whether there was much chance of a court being persuaded to overturn them.

If the LPGS's deficit were to be transferred to the Treasury, state aid approval *may* be required from the European commission (as it was for the Royal Mail Pension Plan, RMPP). In addition, all section 67 protections would have to be preserved.[22]

(v) Administration and communication

If the Government were to separate the LGPS's DB accruals (as at T-Day) from future pension provision, it should recall the lessons from its experience with the RMPP, further discussed below. Since 2012, most RMPP members' pensions have been derived from two different sources.[23] Consequently, administration is a bit more complex, and considerable care is needed in respect of membership communication; both need to be a seamless experience for members.

(b) Cash balance

If the Government were to offer a cash balance scheme for an interim period, contributions should go into a single fund. All participating employers should pay the same contribution rate, and a salary-dependent tiered structure may be appropriate for members. There should be at least one, simple, cost control lever in

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21 Danny Alexander MP, when Chief Secretary to the Treasury; House of Commons, 2 November 2011.

22 The actuarial equivalence requirements from the Pensions Act 1995, which apply whenever a power to modify an occupational pension scheme is exercised.

23 From 2012, pension incomes come from the RMSPS in respect of pre-2102 DB accruals, and the RMPP for subsequent DB accruals, and DC for post-2008 entrants.

place to maintain a healthy cashflow (such as a variable assured rate of return on the scheme's investments), but it would not be required in the early years (there being many contributing members, but few pensioners). Again, a collective decumulation option should be offered, with a default.

Alternatively, LGPS (2018) could be incorporated within the BWFs, thereby ensuring that the latter continued *ad infinitum* (otherwise the BWFs would disappear once the membership with DB accruals had died out). This would be, however, operationally more complicated than running a completely separate LGPS (2018) requiring, for example, DB and cash balance cashflow separation.[24]

> **Proposal 1:** The Government should replace LGPS (2014) with LGPS (2018), a defined contribution (DC) scheme. A cash balance arrangement (a form of DB) could be offered for an interim period. NEST could deliver the former, a new single fund the latter. Collective decumulation should be offered by default, perhaps delivering 5% per year of the pot size available at retirement, with automatic lifetime annuitisation of assets remaining at age 75. Members would be free to opt out, to embrace the 2014 Budget's freedom and choice as individuals.

8. MEETING DB ACCRUALS

Outlined below are two alternative ways of meeting the LGPS's accumulated DB accruals: funded or unfunded.

8.1 Funded

(a) LGPS funds: consolidated into BWFs

The LGPS's 89 individual funds could be fully pooled into the Chancellor's British Wealth Funds (BWFs), with the underlying local LGPS fund structures dismantled. This could be executed on a regional basis (perhaps renamed as Regional Investment Funds), but relatively strong funds would end up subsidising weaker ones (based upon T-Day funding ratios, and assuming standardised contributions rates within a given BWF).[25] A London BWF, for example, would include Brent (56% funded at the last valuation) and Wandsworth (95%).

An alternative BWF pooling method, perhaps fairer in respect of the socialisation of liabilities, would be to rank the individual LGPS funds by their latest triennial valuations, and then group them into approximately equal sized BWF pools, as measured by asset size. This would significantly reduce the range of funding ratios within each of the BWFs. Appendix II shows the outcome based upon there being five BWFs, ranked A to E, using the most recent valuations. Their funding ratios range between 93% and 70%.

> **Proposal 2:** If DB accruals were to be met on a funded basis, then all the assets of the 89 LGPS funds should be pooled into a few British Wealth Funds. LGPS fund selection could be based upon their latest valuation to minimise the range of funding ratios within each BWF.

(b) Deficit repair via a Social Premium

Ultimately, notwithstanding what legislation may say about where the buck stops for the LGPS's liabilities (local taxpayers, via LGPS administering authorities), in practice only the Treasury has access to the necessary resources (i.e. general taxation). Consequently, it will have to ensure that the BWFs meet their liabilities in respect of the LGPS's DB accruals as at T-Day.

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24 But any Tontine effects from running a closed DB scheme could be eliminated.

25 Today, employer contribution rates take into account the funding status of the LGPS fund.

The Chancellor could motivate (nudge) the BWFs to invest in infrastructure by providing an annual "Social Premium" in respect of any such investment (i.e. a boosted return). This could be presented as an acknowledgement of the LGPS socialising the benefit of its assets, through the BWFs, across the whole of society (we all use airports, railways, roads and utilities). It would also provide an implicit, rather than explicit, mechanism for deficit repair in respect of past accruals.

> ***Example***: Assuming an initial funding ratio of 80%, a 25% allocation to infrastructure and an annual 2.5% Social Premium, the initial 20% deficit could be recovered in 29 years.[26]

To be clear, the BWFs would not be forced to invest in infrastructure, *but* at the same time, The Pensions Regulator (the LGPS's regulator) should spur them on to close their deficits.

> **Proposal 3:** The Chancellor could incentivise the BWFs to invest in infrastructure by paying an annual "Social Premium" for any such investment. It would serve as an implicit, rather than explicit, mechanism for deficit repair in respect of DB accruals.

Thus, the Chancellor could combine deficit repair with an incentive to invest in infrastructure. One might expect that over time, given the Social Premium, the weaker BWFs (i.e. those with larger deficits) would be the more inclined to assume larger asset allocations to infrastructure.

(c) Contributions

Today's LGPS contributions comprise two elements, in respect of (i) meeting on-going (in-service) pension promises, and (ii) deficit repair. If PAYG were adopted for meeting DB accruals, future contributions (to either a DC or cash balance scheme) could be lower, which would be appreciated by employees and employers alike. The Treasury, however, having swallowed the DB accruals deficit as at T-Day (and continuing to be exposed to any subsequent increase in the deficit in respect of those accruals), should be entitled to some ongoing contributions: a matter for negotiation.

> **Proposal 4:** LGPS (2018) contribution rates should be renegotiated in light of the change to post-2018 pension benefits. Given that the Treasury would be assuming the DB accruals funding deficit (and exposure to any subsequent deterioration), it should be entitled to some ongoing contributions.

8.2 Unfunded: pay-as-you-go

The Chancellor could introduce LGPS (2018) and "acquire" today's LGPS assets in return for committing to meet all DB accruals on a pay-as-you-go (PAYG) basis, funded from general taxation. The LGPS's deficit would be swallowed by the Treasury, to subsequently unwind itself, slowly and innocuously, within the PAYG cashflow.

But what would be the most appropriate use for the LGPS's assets? The Chancellor would not be short of suggestions; three are outlined here.

(a) PAYG: what of the LGPS's assets?

(i) Debt reduction: the Royal Mail Pension Plan precedent

In 2012 the Government assumed the Royal Mail Pension Plan's (RMPP) assets and DB liabilities, which included a £9 billion deficit.[27] This was

[26] Assuming that all the accumulating Social Premium were reinvested in infrastructure. Note that we are, of course, assuming that the initial deficit does not subsequently increase. The LGPS (in aggregate) was 79% funded at the last triennial valuation (March 2013).

[27] The Postal Services Act 2011 introduced powers for the government to take over the liabilities of the

considered necessary to facilitate the subsequent privatisation of the business (which raised only £3.3 billion, clearly a rum deal for taxpayers). The £28 billion of assets were added to the Government's books (available to reduce the national debt), and taxpayers assumed the £37 billion of pension liabilities, housed within a new, unfunded, Royal Mail Statutory Pension Scheme (RMSPS). These liabilities are now being met on a PAYG basis, in common with some 85% of other public service pensions; today's LGPS is the major exception.

Post-2012 DB accruals remain in the existing, now much smaller, RMPP, which continues to receive contributions. Shorn of its pre-transfer DB liabilities, the RMPP is now the best funded scheme in the UK, with a £3.2 billion surplus as at 29 March 2015.[28]

Applying the RMPP precedent to the LGPS would involve much bigger numbers, not least because its membership comprises more than 10% of *all* adults in the UK.[29] At the time of the last triennial valuation (March 2013), liabilities totalled £225 billion against assets of £178 billion. The £47 billion deficit, in cash terms, made for an aggregate LGPS funding level of 79%. By end-March 2015, assets had grown to £214 billion, but deficits are expected to be higher at the next triennial valuation (end-March 2016).

(ii) BWFs as endowment funds

With PAYG, the Chancellor's proposal for a few BWFs could become redundant. Alternatively, the BWFs could be established as competing endowment funds, seeded with some (or all) of the LGPS assets but without any liabilities or any assured source of income (other than from investments). The BWFs, perhaps organised on a regional basis, could, of course, invest in infrastructure.

(iii) Infrastructure investment

Alternatively, the Chancellor could pursue his interest in infrastructure investment by simply seeding a National Infrastructure (or sovereign wealth) Fund with some of the LGPS assets, to be sold off for cash to fund projects as they arose. The rest of the assets could be sold off to reduce the public debt.

> **Proposal 5:** If DB accruals were to be met on a pay-as-you-go basis, a few British Wealth Funds could be established as competing endowment funds, seeded with LGPS assets. They could invest in infrastructure, but without liabilities, nor on-going contributions, the BWFs would be dependent on asset performance for income. Alternatively, the Chancellor could pursue his interest in infrastructure investment by seeding one National Infrastructure (or sovereign wealth) Fund with LGPS assets, to be sold off for cash to fund projects as they arose.

(b) A *de facto* Crown guarantee

If the Chancellor were to meet DB accruals on a PAYG basis, he would be introducing a *de facto* Crown guarantee for DB benefits accrued up until T-Day. This should put an end to the "localism" defence of those in favour of the operational *status quo*, as well as the current ambiguities concerning both the varying quality of the many different employer covenants and the range of funding levels amongst the LGPS funds. Indeed, the "new" RMPP was supported by the Communication Workers Union partly because it provided members with such a guarantee for the RMSPS.

RMPP, with changes effective on 31 March 2012. DB accruals ceased for new members in 2008, replaced by a DC scheme, and it is expected that *all* DB accruals will cease in March 2018.

[28] Assets of £6.5 billion and liabilities of £4.9 billion; an asset / liability ratio of 133%.

[29] 5.17 million members, as 1,893,802 contributing members, 1,775,356 deferred members and 1,489,175 pensioners and dependents; SF3 data returns.

A *de facto* Crown guarantee would be merely making explicit a practical reality, but the unfunded liabilities would have to be reported in the Whole of Government Accounts (WGA). The most recent WGA (for 2013-14) report an unfunded public service pensions liability of £1,302 billion, which is net of £228 billion of funded scheme assets (almost entirely in the LGPS). Thus, if the LGPS were to be moved onto a PAYG basis, the reported unfunded liability would rise to £1,530 billion, but the LGPS's assets would reappear elsewhere in the WGA.

9. GOVERNANCE

9.1 Fund management

Following the introduction of LGPS (2018), irrespective of who controlled the substantial portfolio of LGPS assets (be it the Treasury, British Wealth Funds, a National Infrastructure Fund, or a combination thereof), appropriate expertise should be put in place to manage it. This should be the case even if the plan were to liquidate the portfolio for cash, which would take years to execute to avoid market disruption. Ideally, DCLG's May 2014 proposals would be embraced, to replace all actively managed listed assets with passive funds, and to sell all fund of funds investments as soon as practicable (see Section 3.1).

Proposal 6: The DCLG's 2014 proposals to end investment in actively managed funds of listed assets, and sell all fund of funds, should be adopted irrespective of where the LGPS's assets were ultimately housed.

Costs are controllable, whereas asset performance across a large diversified fund, beyond asset class allocation, is fundamentally driven by the global economy, not individual fund selection.[30]

9.2 Infrastructure

An infrastructure portfolio would require a governance committee, which could fall under the aegis of the recently established National Infrastructure Commission. Certainly, decisions concerning infrastructure investment should not be allowed to become a pawn of political patronage. We would want no repeat, for example, of Harold Wilson's pledge to build the under-utilised Humber Bridge made just ahead of the Hull North 1966 by-election (at the time of a wafer-thin three-seat majority at Westminster).

Proposal 7: A politically independent governance committee should be appointed to oversee any infrastructure portfolio that emerged from rearranging the LGPS's assets. This could involve the recently established National Infrastructure Commission.

10. CONCLUSION

Putting the LGPS onto a sustainable footing requires political bravery, but doing nothing in respect of the on-going DB pension accruals is not an option. Politicians should bear in mind that the inevitable cashflow crisis risks ceding management control to the media.

The Chancellor's British Wealth Funds potentially provides a funding link between the LGPS, his enthusiasm for infrastructure ("get Britain building"), and reducing the funding pressures on both central and local government. But addressing the LGPS's lack of sustainability requires further imagination, and needs to include deficit repair, achieved either visibly (perhaps through the Social Premium, if DB accruals are to be met on a funded basis) or invisibly (while meeting DB accruals on an unfunded, PAYG basis). Inevitably, it will be the taxpayer who pays.

[30] Numerous studies evidence that, on average, active fund managers of listed assets do not outperform the market.

APPENDIX I

LGPS asset pooling criteria[31]

Asset pools must achieve benefits of scale

- The size of the pool once fully operational
- Rationale for maintaining assets outside of the pool
- The type and legal structure of the collaborative vehicle
- How the pool will operate
- Timetable for establishing the pool.

Strong governance and decision making

- Maintenance of appropriate management and oversight at local level
- Adequate risk management and assessment at pool level
- Governance structure of the pool – including accountability of local/pool level.

Reduced costs and excellent value for money

- Active management must be shown to deliver value for money on a risk-adjusted, long-term basis
- A full transparent assessment of investment costs and fees as at March 31 2013
- A detailed forecast estimate of savings over the next 15 years.

An improved capacity to invest in infrastructure

- Current allocation to infrastructure
- Planned allocation to infrastructure

Plans for developing capacity and capability to assess infrastructure projects.

[31] *Local Government Pension Scheme: Investment Reform Criteria and Guidance*; DCLG, November 2015.

APPENDIX II

Five British Wealth Funds derived from LGPS fund assets (England and Wales)

Ranked by 2013 triennial valuation, the funds have been divided into approximately equal asset size pools, averaging £42.8 billion.

		Funding ratio 31 March 2013	Fund mkt value 31 March 2015 £000's	Wealth Fund assets £000's
British Wealth Fund A	Teesside	101%	£3,243,794	
Overall funding ratio 93%	West Yorkshire	96%	£11,319,225	
	Kensington and Chelsea	95%	£825,896	
	Wandsworth	95%	£1,205,812	
	Greater Manchester	91%	£17,591,201	
	LPFA (Active and Pensioner sub funds)	91%	£4,617,208	
	Dyfed / Carmarthenshire UA	89%	£1,906,719	
	Merton	89%	£541,572	
	Bexley	87%	£671,951	
	West Sussex	87%	£2,972,669	**£44,896,047**
British Wealth Fund B	Greenwich	86%	£1,056,702	
Overall funding ratio 83%	South Yorkshire PTA	86%	£212,424	
	City of London Corporation	85%	£823,744	
	Enfield	85%	£888,155	
	Gwynedd	85%	£1,497,373	
	Hounslow	85%	£803,014	
	Nottinghamshire	85%	£4,078,600	
	Durham	84%	£2,334,975	
	Derbyshire	83%	£3,694,389	
	Devon	83%	£3,374,426	
	Hammersmith and Fulham	83%	£868,475	
	Hertfordshire	83%	£1,963,058	
	Kent	83%	£4,539,037	
	Richmond	83%	£607,280	
	Southwark	83%	£1,247,731	
	Bromley	82%	£741,975	
	Buckinghamshire	82%	£2,188,549	
	Cardiff and Vale of Glamorgan	82%	£1,653,151	
	Cheshire	82%	£4,097,211	
	Dorset	82%	£2,301,132	
	Oxfordshire	82%	£1,845,479	**£40,816,880**
British Wealth Fund C	Tyne and Wear	82%	£6,378,063	
Overall funding ratio 80%	East Sussex	81%	£2,746,549	
	Essex	81%	£4,932,623	
	Northumberland	81%	£1,067,121	
	Swansea	81%	£1,537,706	
	Hampshire	80%	£5,137,088	
	West Midlands PTA	80%	£474,886	
	Barnet	79%	£911,724	
	Powys	79%	£502,898	
	Suffolk	79%	£2,198,441	
	Avon / Bath & NE Somerset	78%	£3,839,316	
	Cumbria	78%	£2,027,316	
	East Riding	78%	£3,677,391	
	Isle of Wight	78%	£482,669	
	Lancashire	78%	£5,830,674	**£41,744,465**
British Wealth Fund D	Norfolk	78%	£2,948,870	
Overall funding ratio 75%	Rhondda Cynon Taf	78%	£2,410,321	
	Redbridge	77%	£636,282	
	Warwickshire	77%	£1,638,059	
	Camden	76%	£1,265,449	
	Merseyside	76%	£6,862,704	
	Shropshire	76%	£1,512,735	
	South Yorkshire	76%	£6,277,138	
	Berkshire / Windsor & Maidenhead UA	75%	£1,649,769	
	City of Westminster	75%	£1,096,916	
	Cornwall	75%	£1,522,243	
	Somerset	75%	£1,595,212	
	Lambeth	73%	£1,136,522	
	Newham	73%	£1,068,417	
	North Yorkshire	73%	£2,399,869	
	Cambridgeshire	72%	£2,264,187	
	Ealing	72%	£967,496	
	Hillingdon	72%	£802,300	
	Leicestershire	72%	£3,128,170	
	Lincolnshire	72%	£1,750,942	**£42,933,601**
British Wealth Fund E	Staffordshire	72%	£3,768,709	
Overall funding ratio 70%	Surrey	72%	£3,193,520	
	Tower Hamlets	72%	£1,091,327	
	Barking and Dagenham	71%	£757,822	
	Greater Gwent (Torfaen)	71%	£2,276,999	
	Kingston upon Thames	71%	£646,311	
	Lewisham	71%	£1,048,149	
	Northamptonshire	71%	£1,849,740	
	Wiltshire	71%	£1,852,603	
	Bedfordshire	70%	£1,709,956	
	Gloucestershire	70%	£1,709,074	
	Hackney	70%	£1,146,793	
	Haringey	70%	£1,045,355	
	Harrow	70%	£674,845	
	Islington	70%	£1,087,055	
	West Midlands	70%	£11,464,000	
	Worcestershire	69%	£3,581,039	
	Clwyd / Flintshire UA	68%	£1,394,549	
	Sutton	67%	£506,786	
	Croydon	66%	£858,779	
	Havering	61%	£574,669	
	Waltham Forest	60%	£742,177	
	Brent	56%	£657,050	**£43,637,307**
			£214,028,300	

THE AUTHOR

Michael Johnson is a Research Fellow of the Centre for Policy Studies and a highly regarded pensions analyst. He originally trained with JP Morgan in New York and, after 21 years in investment banking, joined Towers Watson, the actuarial consultants. More recently he was Secretary to the Conservative Party's Economic Competitiveness Policy Group.

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