

## **A G Bisset & Co submission to the Independent Public Services Pensions Commission chaired by John Hutton**

### **Background**

A.G.Bisset & Co Ltd is the UK subsidiary company of A.G.Bisset & Co Inc, the US based currency manager which was founded in 1981 and manages US \$ 2.3 billion for US, UK and European pension funds, non-profit organisations and other institutions.

**Cristoforo Rocco** is the Managing Director of A G Bisset & Co and he has been actively involved with authorities that manage funds under the Local Government Pension Scheme (LGPS) over many years in both his current and previous employments.

Prior to his retirement, **Geoff Singleton** was employed in local government for over 35 years during which time he was responsible, at different times, for running the Greater Manchester and Strathclyde Pension Funds. On leaving local government he worked for more than 10 years with Hymans Robertson where he carried out pensions investment consultant assignments for many administering authorities. He is now a Non Executive Director of A G Bisset & Co.

### **Introduction**

The focus of this note is purely the LGPS which is different from most other public sector pension schemes in that it is a funded scheme with assets of over £100 billion invested globally. It is not our intention to rehearse all of the arguments in favour of retaining the LGPS or to try to argue the role of good pension provision in society, though undoubtedly greater pension provision in all sectors would be an important national asset that would reduce the burden on future public expenditure. However, we do wish to signal our strong support for the continued existence of LGPS as a standalone, funded, pension scheme in the public sector, re-structured in a sustained and affordable manner, and to draw attention to selected arguments where we feel that there has been bias or unfairness in presentation to date or which may not otherwise be raised.

### **Public and Private Sector employment Terms – A Balance to be Struck**

There has been much comment suggesting that public sector pay has drawn ahead of private sector pay and that the public sector has to a large extent been protected from the economic downturn while the private sector has borne the brunt of a worse economic climate. In particular The Policy Exchange report of June 2010 (Controlling Public Spending – Pay, Staffing and Conditions in the Public Sector – Holmes and Lilico – The Policy Exchange - June 2010), which contains much challenging and stimulating discussion, makes this case and poses the question should the public sector be enjoying a “gold plated pension scheme” and job security if their pay is better than the private sector? This report was widely commented upon in the press.

We noted that the term “job security” was already being viewed with jaundiced eyes among the regular local government contacts that we maintain and wondered, given the job cuts that have already been seen in local government and those envisaged, whether Holmes and Lilico’s report has already being overtaken by events and is already, to some extent, simply a historical survey of the scene.

Of course the report by Holmes and Lilico looked at the entire public sector and in fact very few remarks or examples given in the paper related directly or solely to Local Government or the LGPS. It would be unfair if that report were to colour the debate about LGPS, which Holmes and Lilico acknowledge (op cit - June 2010 - page 57), is the only one of the six large public sector pension schemes to be funded and which has a proper accounting system to identify the assets, liabilities and deficits. The other large public sector schemes are unfunded with current contributions being used to offset public expenditure and current liabilities being met out of general revenues. It is in the nature of such schemes that, typically, unfunded approaches do not reflect the actual costs of young pension schemes. That under provision has to be made up in later years as schemes mature by what then seems like high costs because no reserves have been set aside and there have been no investment returns to offset costs. Doubtless there were those who conveniently put forward sophisticated arguments at the time as to why the public sector did not need to account properly for its pension's provision but the threadbare nature of those arguments may now be seen in the relative strength of the LGPS Funded scheme compared to the other, unfunded, schemes.

Anecdotally, at least, there may be some truth in the incidence of the impact of the economic downturn to date being felt primarily by the private sector as there have been reports, and experience, of private sector firms cutting back, freezing pay, voluntary pay reductions etc. It is also true that the public sector has benefitted under the previous government and pay may well have got ahead of the private sector, especially given the urgent need for pay restraint in the private sector caused by the downturn. These things are often cyclical and as Holmes and Lilico (op cit – June 2010 - page 7) remarked, the public sector was 4% less well paid than the private sector in 1997, on the basis of their calculations. However, we can expect the private sector to feel, and react to, the burden of recessionary conditions first and it is simply in the nature of things that the public sector reacts much more slowly. No-one, however, is in any doubt of the scale of the changes to come for the public sector and it would be wrong to predicate reform on current differentials in the knowledge that whatever advantage has been enjoyed in the relative short term are to be swiftly eroded. Under those conditions a stable and reliable pension provision as an integral part of a remuneration package drawn from a self funded scheme will become increasingly important as authorities compete to retain and recruit the necessary staff to deliver vital services.

### **A “Gold Plated” Scheme?**

The overwhelming majority of LGPS members are in part time and low paid occupations. The Audit Commission (Local Government Pensions in England – An Information Paper – Audit Commission – July 2010) says that over half of the pensions in payment are less than £3,000 while work by West Midlands Pension Fund suggests that 90% of pensions in payment in that fund are less than £10,000 per annum.

Apart from the obvious observation that in absolute terms pension payments by this fund are not generous (nor are they “free” – contributions having been paid throughout service) one of the outstanding advantages of a Defined Benefit Scheme is that it shares market risk with organisations better able to assume risk than individuals; it is a form of co-operative. Most people take some co-operative, or risk sharing, approach when it comes to dealing with their major assets (e.g. Homes, Home Contents) and would, rightly, be regarded as irresponsible if they did not. Strange, therefore that in the pensions arena we increasingly see the introduction of Defined Contribution Schemes which transfers market risk to the individual. Even allowing for what appears to be an unstoppable

trend one might be forgiven for asking the question to what extent is it fair and reasonable to transfer market risk to those least likely to have both the knowledge and the skills to evaluate it, a description which, to be honest, covers the majority of the members of the LGPS. Are their interests not better protected within an adequately funded, well managed, scheme with appropriate levels of governance and transparency?

Moreover, for many of these pensioners the receipt of a low value pension will simply disqualify them from other state benefits, or reduce their call on them thus offsetting other public expenditure while adding little to their net wealth. This relationship and the relationship with the Welfare Reforms being studied by the Work and Pensions Secretary (Iain Duncan Smith) should be better understood before radical changes are made to the scheme.

At a more general level it does seem remarkably short sighted in public policy terms for governments of all persuasions to be permitting the general levelling down of employer pensions provision when it is commonly agreed that the State Pension is wholly inadequate and that savings levels and private retirement provision are far too low. It is clear that this combination will lead to upward pressure on the Welfare Budget (already running at 32% of Public Expenditure according to Alistair Darling's Pre-Budget Report of 2009) in future years (quite apart from the additional demographic burden).

Do we really wish to see public sector employers emulating the short term policies of the private sector which is actively shifting the Pensions Promise that it should carry and reflect in the cost of goods and services it provides to future generations of tax payers through inadequate contributions to employees' pension?

## **Funding Levels**

The Audit Commission (Op Cit July 2010 - Page 8) has estimated that English LGPS Funds are, on average, around 75% funded and that in turn implies a deficit of about £40bn. It is likely that the Welsh funds have similar funding levels though for historical reasons the Scottish LGPS funds are better funded while in Northern Ireland the results of the 2007 Actuarial Valuation estimated the funding level in the Northern Ireland Local Government Officers Superannuation Scheme at 85% (Deficit £396m).

Overall the deficit in respect of LGPS for the United Kingdom is likely to be in the region of £45 bn.

Examination of the performance statistics published by WM Performance Services (a State Street Company) (see Appendix 1) tells us that LGPS Funds are well run and, as a class, tend to enjoy similar investment returns to their private sector peers. Why then should there be a deficit?

Some allowance has to be made for generally poor investment returns since 2000 but

- much damage was done to the English and Welsh Funds when they were permitted to target a 75% funding level (since rescinded) in order to help the then Government to implement the Poll Tax in the late 1980's.

- Strong investment returns in the 1980s encouraged Actuaries to advise administering authorities that they could make lower employer's contributions in order to run down the then surpluses. For example, the very large Strathclyde Pension Fund was able to stop making any employers contributions for a number of years in the 1990's and paid employers contribution rates which were less than the Future Service Rate for the entire period 1986 to 1998. Hindsight suggests that this was not wise.
- The buoyancy of Funds in the 1980s encouraged the then Government to change the rules in the late 1980s whereby Pensions Increases, which historically had been charged to the Councils' General Revenue Account and paid for from current taxation, could be charged to the Funds. Although we would consider the present approach to be correct the fact remains that Funding policy up to that date had not taken account of those charges and the extra burden has contributed towards the impression of rising employer costs in the Funds when in fact they were a transfer of those costs from the General Account to the Pension Fund Accounts.
- The Labour Government of 1998 changed the rules in respect of the recoverability of Advanced Corporation Tax which damaged the income returns of all pension funds and has continued so to do to this day. It also meant that the actuarial value of investments was reduced (because less income could be expected from them) which in turn meant that assessments of deficits increased.
- Moreover, economic and market uncertainty in addition to the stabilization measures (still in force) introduced across the industrialised world has led to an unprecedented and lengthy period of very low interest rates and the resulting impact on bond yields has significantly affected the valuation of pension funds. It would only take even a modest rise in yields to have a significantly positive effect on estimated deficits.
- Steadily improving longevity levels, though unequally experienced across the nation, was only belatedly recognised in actuarial calculations of liabilities putting pressure on funding levels at the worst possible time.
- Finally, there is a conflict inherent in the Regulations which govern the LGPS between prudent fund management and keeping employers' contribution rates stable. One might reasonably imagine that where a deficit appears a practical and prudent plan is devised to recover that deficit as soon as possible while bearing in mind that there is an implied gilt edged underwriting of the LGPS. However, the pressure to stabilise employer's contribution rates (and thereby keep tax increases at levels lower than they ought to be) has resulted in Regulations which result in Actuaries pushing out deficit recovery periods to what might be regarded by some as entirely unrealistic timescales. It hardly needs pointing out that where there is a significant deficit then investment returns to the fund are depressed below the level that might reasonably be expected simply because there are not enough assets to match the liabilities that the fund has. This, in turn, contributes to the overall problem.

It seems to the authors that while poor investment returns in recent years may have played a part in causing the current deficits there is no evidence to suggest that deficits are due to any mismanagement on the part of the administering authorities or are, indeed, anything that they could have exercised control over themselves.

On the other hand it is clear that political interference in the funds and actuarial advice which, with hindsight, probably relied overmuch on the continuation of the extremely favourable investment returns experienced in the latter part of the 1980s have contributed to the position.

While it is beyond the scope of this paper to calculate the various impacts, it would be instructive to identify the causes of the current deficit.

## Efficiency

It is generally accepted that LGPS funds are well managed and enjoy comparable returns to their private sector peers. It is not widely recognised, for example, that the LGPS in its entirety implemented the investment principles that formed part of the recommendations of the Myners Report (2001). There is scope for some consolidation of funds, perhaps on a regional basis, unpopular though that would be. A case could be made that this should lead to efficiency gains and better use of economies of scale.

Whilst the magnitude of savings would be difficult to establish it could be expected that

- a professional dimension to the Investment Committee by the nomination or appointment of professional trustees should improve the strategic thinking in respect of investment strategy
- the concentration of the existing level of resources into regional teams should, over time, create stronger, deeper management teams
- these Management teams would be less reliant on external investment consulting advice, and
- they would be more demanding of investment consultants where they did seek investment advice, and
- better able to challenge Actuarial Advice
- larger, Regional Funds would be able to drive lower fee bargains for investment management, custody and other investment services

## A New Settlement

We believe that the Hutton Commission should draw a line under the past.

There should be a clear distinction between the costs arising under the existing LGPS arrangements and any new scheme. In particular we believe that it would be manifestly unfair if future generations of LGPS employees were to pay for, or contribute towards, the faults, failings and imperfections of the current system.

Any future scheme or package will be an exercise in responsible employee relations and it is not for us to attempt prescription. The precise benefit structure and the cost sharing arrangements, we believe, are for negotiation between employees and the Trades Unions on the one hand and the employers or their representative body on the other with Government as the Regulator holding the balance of fairness between the taxpayer (in the broadest sense) and the employees and in the light of other pay issues.

One method of avoiding future confusion over costs and the arrangements that they arise from would be to create a second set of funds to hold and invest the monies from any new scheme.

This need not be viewed as a costly proposition since pooling and unitisation techniques can be applied which will enable the same sets of investment management arrangements to be shared between the different generations of funds at very little additional custodial costs. However, such an arrangement would permit different investment strategies to be adopted in respect of each generation of Fund while preserving clear cost accountability.

## Summary of Views

Our views may be summarised as follows:

- LGPS is unique among the major public sector schemes in that it is a funded scheme.
- The membership of the scheme is dominated by low paid and part time workers.
- The overwhelming majority of benefits paid out by the scheme are very modest.
- LGPS should remain a Defined Benefit scheme because of the issues around risk transfer.
- LGPS should continue as a funded scheme.
- LGPS has been, and continues to be, run in an efficient, responsible, and transparent manner.
- The shortfall of assets to liabilities (estimated at £45 bn) is due to factors largely beyond the control of the administering authorities, though lessons have been learnt.
- The requirement to have regard to the stability of contribution rates should be removed and the emphasis on prudent deficit recovery restored.
- There is scope, however, for greater efficiencies through some consolidation of Funds which should also lead to better economies of scale.
- Whatever new pension promise is negotiated between the employers and employees should ignore the existing deficits. Future generations of local government pensioners should not be expected to pay for past mistakes.

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## Appendix 1

### Note on the Performance of LGPS Funds

The authors between them have been observers and participants in the local government pension's world for almost 25 years. Because of the high levels of subscription to the WM Performance Services, a subsidiary company of State Street, there is a good history of all UK Pension Funds investment performance in existence.

Historically the LGPS Funds as a whole tended to adopt broadly the same asset allocation as funds in the private sector and enjoyed similar levels of performance. The LGPS Universe looked just like any other homogenous subset of the broad All Funds Universe. This ought not to be a cause of surprise since both the public and private sector funds used the same investment advisors and investment managers.

In more recent years, however, the asset allocation strategies of public and private sector funds have begun to diverge quite markedly and continue so to do as the tables below demonstrate.

#### End Quarter 1 2007

WM Universe		Equities	Bonds	Cash	Alternatives	Property
	Note	%	%	%	%	%
All Funds	1	63	24	2	3	7
50	2	62	24	2	4	8
Corporate	3	61	27	2	3	7
Local Authority	4	69	17	4	2	8

#### End Quarter 1 2010

WM Universe		Equities	Bonds	Cash	Alternatives	Property
	Note	%	%	%	%	%
All Funds	1	51	34	2	7	6
50	2	49	36	2	7	6
Corporate	3	45	41	1	7	6
Local Authority	4	66	17	4	7	6

#### Notes

1. The WM All Funds Universe captures the results of all pension funds measured by them including LGPS funds.
2. The WM 50 Universe captures the results of the 50 largest pension funds measured by them. It will include a small number of LGPS funds
3. The WM Corporate Universe captures the results of all corporate pension funds measured by them.
4. The Local Authority Universe captures the results of all LGPS funds measured by them.

Source: UK Pensions Quarterly – Industry Results – Quarter 1 2010 – WM Performance Services  
WM Local Authority Quarterly Review – Quarter 1 2010 – WM Performance Services

The principal strategy difference between LGPS and others lies in the respective emphasis on equities and bonds with LGPS Funds maintaining their historically high allocation to equities while corporate funds have significantly reduced that allocation in favour of a larger allocation to bonds. Over time it is expected that equities will outperform bonds but the return from equities has more risk (i.e. it is more volatile year on year). Bonds on the other hand display less volatility but overall generate lower returns over an extended period.

Another way of looking at this would be to say that local authorities are seeking higher returns and accepting greater variability of return in order to lower costs falling on the taxpayer while Corporate Pension Funds prefer less volatility because that has less impact on the sponsoring company balance sheet.

**Pension Fund Total Asset Returns**

<b>WM Universe</b>	<b>3 years</b>	<b>5 years</b>	<b>10 years</b>
	<b>% pa</b>	<b>% pa</b>	<b>% pa</b>
All Funds	1.8	7.0	3.7
50	1.8	7.1	4.0
Corporate	1.8	7.0	3.3
Local Authority	1.7	7.1	3.8

Source: UK Pensions Quarterly – Industry Results – Quarter 1 2010 – WM Performance Services  
 WM Local Authority Quarterly Review – Quarter 1 2010 – WM Performance Services

As asset allocation strategies diverge we would expect performance to diverge also with superior returns accruing to LGPS funds although in fact the returns remain similar reflecting the fairly recent emergence of the diverging trend.