Coming of age:
development of the LGPS

Improving governance in local government pension schemes
November 2013

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Executive summary

Governance and structural arrangements in local government pension scheme (LGPS) funds are under considerable and increasing scrutiny. The English, Welsh and Scottish governments are seeking solutions to the increasing public sector pensions bill. Many funds are re-appraising and strengthening their governance arrangements in response.

This is Grant Thornton's review of governance in LGPS funds, based on comprehensive research with pension fund senior officers and supported by insights from pension fund auditors. It aims to help managers and trustees assess the strength of their governance arrangements and to prepare for the challenges ahead.

The LGPS provides pension benefits to 4.6 million members across the UK and has over £150 billion of assets. There are 99 funds within the scheme, which offers great potential for mutual co-operation.

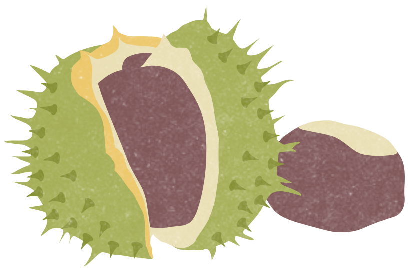
LGPS funds are looking to strengthen their governance for many reasons. These include: increasing financial pressures on pension funds; the impact of regulatory changes following the Public Service Pensions Act 2013; and the Department for Communities and Local Government (DCLG) led review of the structure of LGPS funds.

Increasing costs resulting from greater complexity in pension schemes and the overall pressure to ensure the LGPS is sustainable and can be fully funded at a cost affordable to its members and taxpayers are two further factors leading to the need to bolster governance arrangements.

There is a wide variety of practice in the management of LGPS funds across the UK. There are many well-managed LGPS funds, where pension committees have reviewed and improved how they work to strengthen governance arrangements and to achieve a more sustainable fund. Many funds are learning from each other and sharing expertise and capacity to achieve better results. In other cases, there is scope for significant improvement. Interestingly, there is no evidence to suggest that the size of the fund affects their adequacy or effectiveness of governance arrangements.

In this age of austerity, effective governance frameworks are essential to support sound decision making. During 2014, we expect supporting regulations for implementation of the new LGPS governance framework set out in the Public Service Pension Act 2013 to be issued for LGPS funds in England and Wales. Changes for Scottish LGPS funds are expected to be implemented in 2015. We recommend that funds review their existing governance arrangements now to ensure they are in the strongest position prior to the implementation of the new national governance frameworks.

This report poses a number of questions for management and pension committees to help them assess the strength of existing governance arrangements. Together with the more detailed commentary and good practice examples in this report, these questions are intended to provide a basis for funds to assess and develop their governance arrangements.



Many funds are learning from each other and sharing expertise and capacity to achieve better results.

Methodology
This report is based on a detailed survey of our auditors of 30 local government pension schemes. It covers almost 30% of funds in the UK. We support the survey findings with detailed discussions with auditors and council officers to understand and identify good practices plus a review of local government pension scheme websites.

Our auditor survey's findings are supplemented by responses to a higher level survey sent to senior officers managing local government pension fund schemes nationally. This survey included questions on key challenges, skills and capacity, and communications with members.

Areas of priority focus:

Pension committees

The arrangements for pension committees and the way they work varies widely. Some are limited in scope, focusing on investments only. This ignores important aspects of pension fund management such as benefits administration, collection of contributions and ensuring the effective and efficient operation of the fund.

Seventy per cent of funds have a single pension committee with no supporting sub-committees, panels or groups. Those that do use sub-groups find they are able to act more quickly and flexibly and have a greater focus on the strategic management of the fund, while ensuring they give proper consideration to the important aspects of operation.

While 95% of funds receive a performance report at each meeting, the majority of reports do not cover funding levels, liabilities, member cash flows, risk management or administration performance. Instead, they often concentrate on investment performance and investment manager performance alone.

Investment strategies

Some funds maintain a continuous strategic review of their investment strategies and over half have changed strategies significantly in recent years. Others concentrate on in-year performance of investment managers and only periodically review their strategy. Investment strategies need to have a long-term focus. However, it is also important to review the investment strategy continually in order to understand the potential impact of market trends, fund demographics and regulatory factors, and to be prepared to make changes when appropriate.

Only a small number of funds have started to explore liability management through their investment strategies. This is an important gap when funding deficits are rising, as the increase in the value of their liabilities can outstrip the improvement in investment performance. Liability-driven investment strategies match the investment strategy to any changes in the value of liabilities. For example, this will mean moving towards a more gilts-based investment strategy or using hedging instruments to guard against changes in inflation, interest rates and longevity.

As funds change their investment strategies, they are moving into more complex areas to achieve greater diversification and reduced volatility. More complex strategies require different skills and knowledge, which not all funds can access.

Identifying and managing risk

Only 25% of funds provide regular (more than once a year) reports on important risks affecting the fund to their pension committee. Again, there is a wide range of practice and some funds focus only on investment risks. Over half of those that do provide regular reports also report on other risks such as liabilities, administration and process risks. Some funds have embedded risk management throughout their overall performance management of the fund. This results in greater clarity over the risks and how they are managed, and providing assurances to management, trustees and contributors.

Capacity, skills and knowledge

The Chartered Institute of Public Finance and Accountancy (CIPFA) code of practice on public sector pensions finance knowledge came into effect from 1 April 2012. The code was devised in response to Lord Hutton's recommendation that every public sector pension scheme should have a properly constituted, trained and competent pensions board. It also represents an important element in complying with the Myners principles of effective decision making.

The majority of funds have adopted CIPFA's knowledge and skills framework and the move towards having a properly constituted, trained and competent pensions board. But only 22% of funds are implementing action plans as a result.

More funds should give serious consideration to the appointment of independent professional trustees and/or professional advisers who can support the work of pension committees. They can provide a continuity of experience and knowledge across the range of the pension fund activities and support the sharing of practices across the public and private sector.

There are many examples of funds working together to reduce costs, share expertise and improve services. The lessons learnt from these exercises and the benefits in terms of cost and effectiveness need to be pulled together and shared at a national level.

Controls

Pension funds would benefit from completing their own separate annual governance statement. This would ensure that they give their governance arrangements the same depth of consideration that the administering authority gives to its other activities.

While internal audit of pension funds exists in all bar 7% of cases, its coverage is variable and often focused narrowly on the payment of pensions and receipt of contributions. For example, in 45% of funds internal audit did not complete any work around investments. Where internal audit is provided, the results are only reported to the pension committee at 42% of funds.

Administration cost review and reduction

Administrative costs are relatively small compared to the size of the pension funds and their deficits. However, it is important that funds understand their costs and are taking action to reduce them. Sixty per cent of funds benchmark their costs and have reduced them in recent years through a variety of actions. For others, this is an under-developed area with around 40% not taking any action. Reporting to pension committees on administration costs and savings is also under-developed.

Background

Context

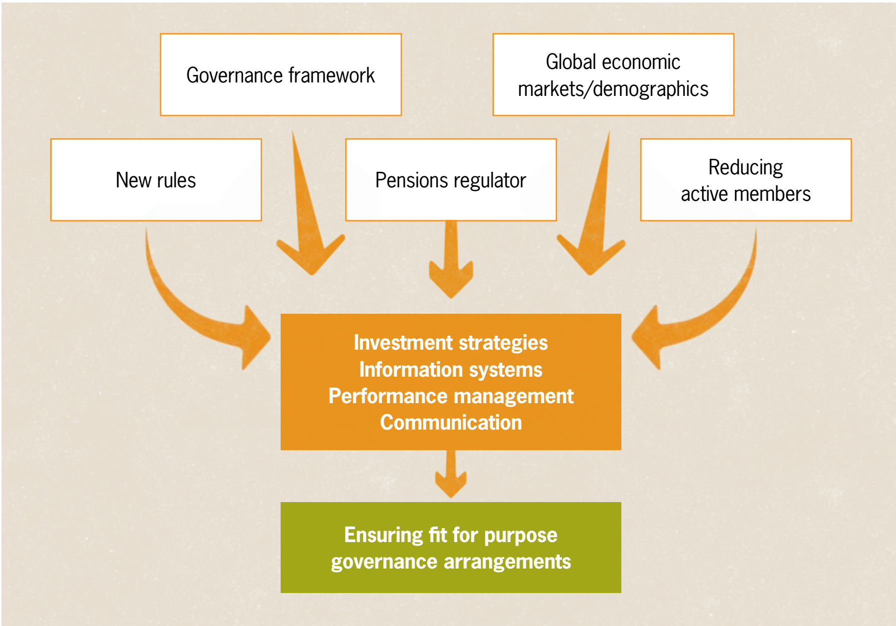
Governance arrangements for LGPS funds remain under considerable scrutiny. Many funds are re-appraising and strengthening their current arrangements to ensure the LGPS is sustainable and can be fully funded at a cost affordable to its members and tax payers.

The factors affecting this include an increasingly complex regulatory environment (see 'Regulatory factors' box out) and ever-growing financial pressures. These pressures are increasing due to a combination of:

- difficult market conditions affecting investments and the valuation of liabilities
- reducing levels of contributions as local authorities reduce staff numbers
- increasing pension payments due to increasing numbers of retirements
- increasing longevity of members.

In addition, the Department of Communities and Local Government (DCLG) led review of the future structure of LGPS funds has called for evidence on these structures. This is with a view to improving efficiency and investment performance in the LGPS, while maintaining a high level of accountability to local taxpayers and interested parties.

Figure 1 Key factors facing the sector



Regulatory factors

The sector is facing a number of regulatory changes with a corresponding impact on LGPS structures and governance.

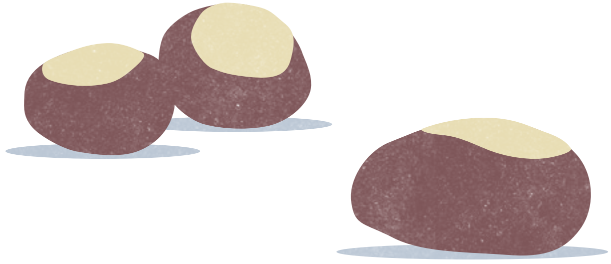
The Public Service Pension Act 2013

The changes made to LGPS as a result of this act, which are due to implemented in April 2014 in England and Wales (referred to as LGPS 2014), will include:

- the introduction of a career average scheme with accompanying legislation requiring more detailed record keeping by pension funds and the maintenance of a separate pension account for each member of the scheme
- the creation of a new governance structure that brings the LGPS within the remit of The Pensions Regulator
- the creation of a national LGPS advisory board and local pension boards.

The creation of the national scheme advisory board

This board is set up under section 7 of the Public Service Pensions Act 2013. It is operating in shadow form until the relevant LGPS governance regulations are laid out. Its role is to encourage best practice, including transparency, and to co-ordinate technical and standards issues. Five sub-committees have now been set up, one dealing with governance and standards. It will be important for all funds to be aware of the work of the board and any recommendations it may make.

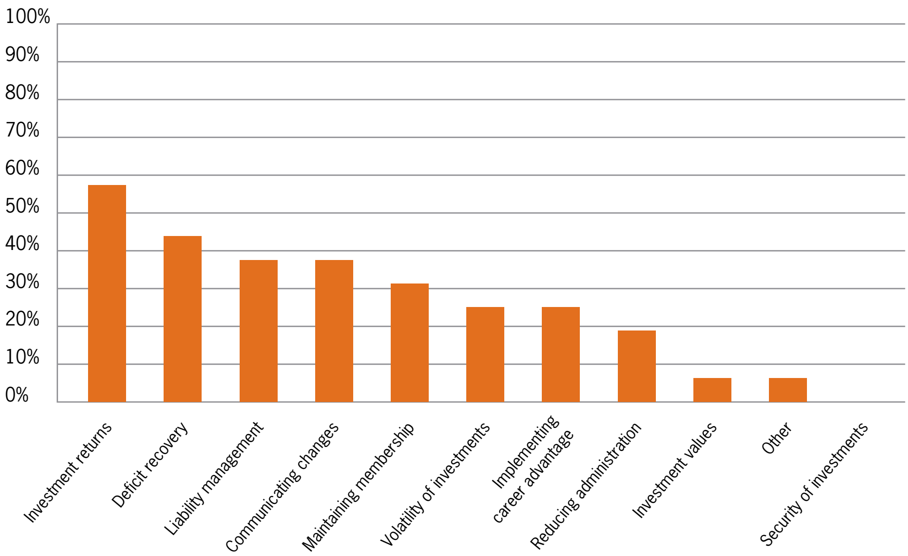


LGPS response

In response to these challenges, a number of pension funds have been making changes to how they manage their funds and the related governance arrangements. These include:

- significant changes to investment strategies – moving into new areas and new types of investments to improve returns, reduce volatility and achieve greater security of assets in the longer-term
- developing their approach to liability management
- increasing scrutiny over the value for money offered by their fund managers and advisers, and over general administration costs
- recognising the need to provide clear communications around the changes to the LGPS from 1 April 2014 and the implementation of automatic enrolment.

Figure 2 Main challenges to pension funds



Senior officers perceived investment returns and deficit recovery to be the top two challenges facing their pension funds. Liability management and communicating changes to employers, employees and other pension fund members came joint third.

All of these changes are dependent on good decision making, which emphasises the need for:

- robust arrangements for developing the capacity and capability of officers and members
- a culture of strong governance
- effective risk management
- effective internal audit
- effective scrutiny and challenge
- accessible and useful communications to stakeholders
- appropriate and reliable information.

It is important to recognise that some aspects of the work of pension funds are not directly controllable by them, although the LGPS community as a whole is working to influence them. These include:

- the LGPS (Management and Investment of Funds) Regulations 2009 which restricts the investments that LGPS funds can make. It is difficult to see why this level of prescription is required for the LGPS but not for other pension funds. A duty to manage investment risks effectively and meet longer-term funding objectives would be a more mature way of regulating this area
- the variability of actuarial assumptions, which mean that the size of a fund's liabilities are affected significantly by the actuary they use. The industry accepts that a range of assumptions are justifiable and appropriate. However, for pension funds, a small difference in critical assumptions, particularly around the discount rate, can result in a significant difference in the overall value of liabilities.

How the pension committee works

The statutory framework

Currently, pension committees are not a statutory requirement, but guidance from the secretary of state expects LGPS schemes to operate them. While their terms of reference differ, they largely perform the important role of setting the strategic direction and overseeing the overall management of the pension fund.

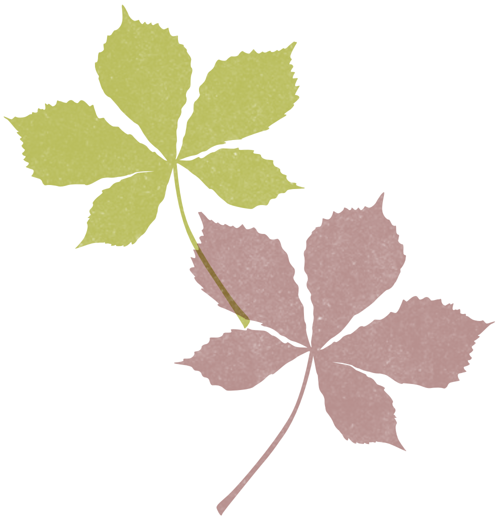
LGPS 2014 will introduce the requirement for each locally administered LGPS fund to have a pensions board and a scheme manager. Where the scheme manager is a committee of the local authority, section 5 of the Public Services Act 2013 allows for that committee also to be the pensions board. The exact way in which these work will depend on the supporting regulations, which are expected to be put in place during 2014.

The main role of the new pensions board is to ensure compliance with regulations. The government is consulting on whether an existing pension fund committee – whose normal role is to ensure effective management of the fund – could also be a pensions board.

Whatever the new arrangements are, there will be some important changes. These will include:

- a clearly specified minimum role for the board
- a greater emphasis on avoiding conflicts of interest and ensuring effective internal control
- the introduction of an employer cost cap – and monitoring and actions to keep within it
- the introduction of regulatory oversight by The Pensions Regulator.

Over the coming year, it will be important to ensure that the pension committee and pension board are fit for purpose. Existing committees may find it useful to re-appraise their current way of working in this context.



Case studies: Sub-groups bring flexibility

Cumbria Pension Fund has an investment sub-group consisting of members, senior officers and the fund's advisers. This group deals with the detailed monitoring of individual fund managers and investment decisions within the investment strategy as agreed by the full committee. The director of finance has delegated decision making authority, subject to tight rules. This enables the pension committee to focus more on strategic management of the fund, which, for example, has improved the scrutiny and challenge of benefits administration. The sub-group's structure, plus enhanced investment training for its members, enables detailed investment decisions to be actioned more responsively outside the constraints of a formal committee timetable, while ensuring it is working within the overall strategy set by the pension committee.

Lancashire Pension Fund has a similar arrangement with its investment panel. The fund has made significant changes to its investment strategy involving considerable alterations to portfolio mandates, changes in investment managers and the creation of an in-house managed portfolio. The creation of the panel has been essential in enabling these changes as it has allowed far greater flexibility and responsiveness in decision making.

Current practice

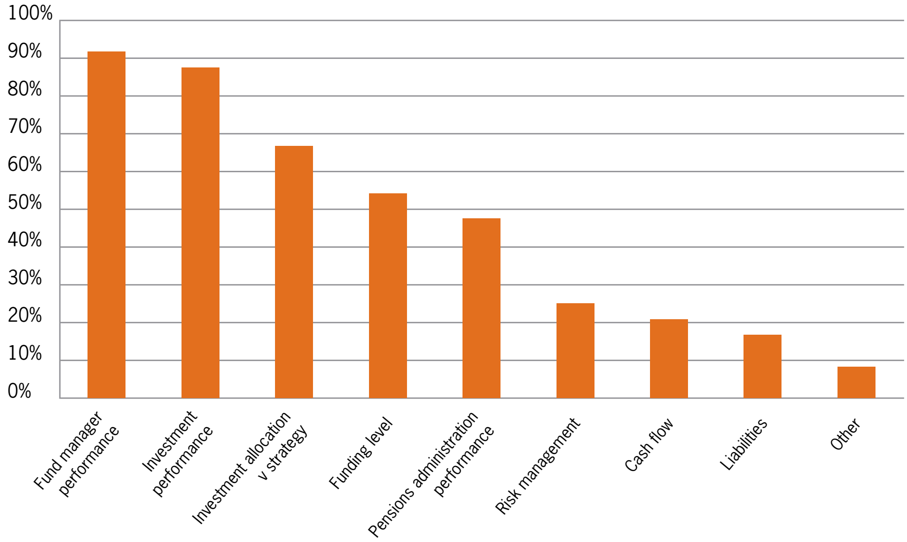
Most, but not all, LGPS funds have a pension committee. Given the size and complexity of these funds, we recommend they have a separate committee to provide the necessary level of governance.

The way they work varies widely across the UK. Due to the multi-employer nature of many of these funds, and the need to have adequate representation, such committees can be large. Most of the funds operate as a single committee. Less than a third are supported by panels and/or sub-committees covering such areas as investments and pensions administration.

Some committees have created additional groups to consider, for example ethics, governance and audit issues; and to more widely represent stakeholders on important issues such as the annual report.

The value of the sub-groups is to allow a smaller number of people to consider and debate important areas, enabling the larger, full committee to concentrate on the overall performance of the fund and its strategic response. Pension funds that have formed informal sub-groups have found that this adds more flexibility and responsiveness than the formal committee structure allows.

Figure 3 Percentage of performance reports covering each specified area



The clarity of the strategic framework agreed by a pension committee, and the rules around delegation and reporting back, are all essential to enable such arrangements to work effectively without losing accountability.

In some cases, the scope of the pension committee only covers investments and not the wider management of the fund. Even where the scope is wider, the work of the pension committee is often focused on investment performance and reviewing the performance of individual managers.

While 95% of funds receive a performance report at each meeting, in the majority of cases this does not cover funding levels, liabilities, member cash flows, risk management or administration performance. Instead, performance reports often concentrate on the performance of managers and their investments.

Looking at the wide range of risks that LGPS funds face, it is difficult to see how committees with a narrow focus can fulfil their role of offering the necessary challenge and scrutiny to ensure the funds are being managed effectively. The implementation of LGPS 2014 will, in any event, require a review of the scope of responsibilities for existing pension committees and/or pension boards.

A number of pension committees ensure a more strategic level debate and challenge all aspects of the fund by using performance reports. These collate a picture of performance across all aspects of the pension fund and highlight trends and actions being taken to address any risks.

Case studies: Keeping a focus on strategic level performance

Lancashire Pension Fund's performance report clearly sets out upfront the following three key indicators of performance:

1. Update of funding position, using actuarial, roll-forward tools
2. Cash flow position comparing member payments against contributions and the level of investment income
3. Investment returns against their benchmark of gilts +2.5%. This enables the fund to understand how it is performing against the actuarial assumptions and therefore the extent to which it is reducing its funding deficit

This report is discussed at the beginning of each meeting and sets the context for all other items. This has necessitated moving the Part II items to the beginning of the agenda. A separate pensions administration report is also provided showing performance against agreed targets.

Merseyside Pension Fund has developed an annual business plan for the management of its pension fund. This clearly sets out the specific strategic projects agreed for the year, linked to fund developments.

The business plan incorporates a risk register for projects, analysing the probability of events occurring and the impact they would have. Reports on progress to date and any specific issues encountered are provided to members of the governance and risk working group during the year.

Next steps

LGPS 2014 introduces some new factors which the pension committee and/or new pension boards will need to have oversight of. This will include monitoring the newly introduced cost cap, and giving greater attention to ensuring compliance with the scheme regulations and the requirements imposed by The Pensions Regulator.

As soon as the expected requirements around the working of pension boards and scheme managers become clearer, pension committees will need to consider how they might move towards the new requirements. Within this, they may need to re-consider the necessary skill sets of the committee.

Pension committees should ask:

- are our current arrangements fit for purpose?
- do they cover all aspects of the management of the pension fund and do they enable us to consider and challenge effectively our overall strategy for the fund's management?
- how have we added value in our role as a committee during the last year or so?
- do we have sufficient information and understanding to challenge effectively?
- what needs to change?

Capacity and skills

Background

Managing and operating a pension fund requires specialist knowledge and skills. The same is true for the members of the pension committee whose role it is to provide effective oversight and challenge. As the environment within which pension funds operate becomes more complex, this will be an even greater challenge.

Senior officers of LGPS funds told us they were reasonably confident that officers had the skills and capacity to respond to the challenges ahead. But they were slightly less confident about the skills and capacity of committee members.

The lower level of confidence in the skills of members of the pension fund committee is not surprising given the specialist nature of pension funds. Elected members may not have a relevant background and they are subject to change following each set of elections. This is a particular challenge for LGPS funds.

Figure 4 Senior officer confidence in the skills and capacity to respond to future challenges

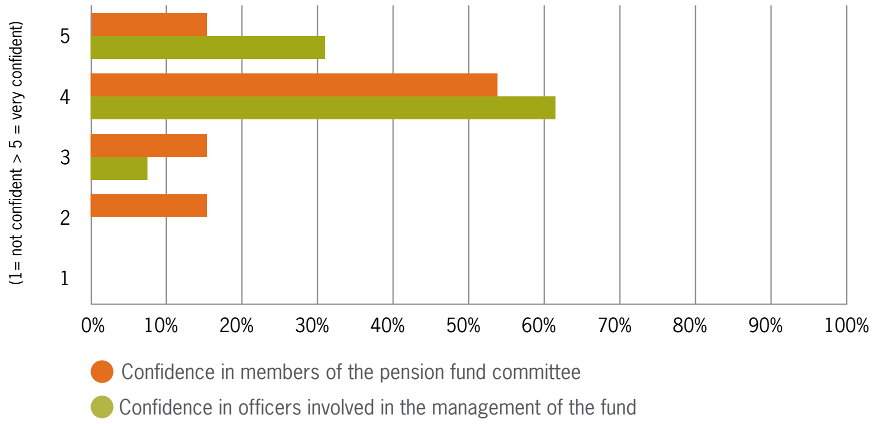
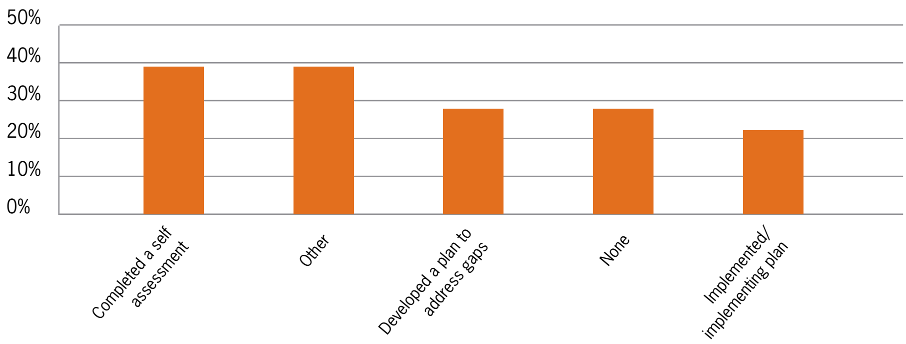


Figure 5 Stages of response to CIPFA's code



Current practice

CIPFA produced a code of practice for knowledge and skills for those involved in the management and administration of pension funds in 2011. This came with a self-assessment toolkit that enables them to identify skills gaps and fill them.

Underpinning the code is a recognition that effective management can only be achieved where:

1. Those involved have the requisite skills and knowledge
2. Formal and comprehensive objectives, policies and practices are in place to ensure effective acquisition and retention of such knowledge and skills
3. Such policies and practices are guided be reference to a comprehensive framework of knowledge and skills requirements
4. There is a nominated individual responsible for ensuring that these policies are implemented

While 86% of funds have adopted the CIPFA code of practice, there is a wide variation in the stage of implementation achieved. Only 22% had implemented the action plan arising from this analysis. For others, there has been no reference to this issue since the original adoption of the code.

The LGPS has an additional challenge in relation to the continuity of membership of the pension committee which can change significantly following local elections. This makes it particularly difficult to maintain a continuous or improving level of knowledge and skills within the committee. The majority of funds do have a continuous programme of training for their pension committees, but it is unclear how much of this is targeted following an analysis of needs.

Case study

Training policy at work at Cumbria

Cumbria Pension Fund's committee has agreed a training policy incorporating mandatory sessions for all members of the committee and potential substitutes. It follows this with a relatively simple self-assessment for all members. The fund uses this to identify common gaps in understanding and provide further training where necessary.

Where the fund is considering new strategies or products, specific training is provided prior to the committee's considerations. It also provides all members with a reference pack of important documents and adds to this over time.

In the private sector, there is a growing preference for the appointment of an independent professional chair, who performs this role across a number of pension funds. This brings a depth and breadth of experience that private funds are finding to be increasingly helpful.

This arrangement is not directly transferable to LGPS since chairs of pension committees need to be elected members in line with the Local Government Act 1972. However, the DCLG guidance on governance compliance statements does recognise the value of making this type of expertise available to pension funds. The guidance encourages pension funds to invite an independent professional observer to "participate in the governance arrangement to enhance experience, continuity, knowledge, impartiality and performance of committees or panels".

Many pension committees employ professional investment advisers, but few employ a wider pension fund adviser. In some cases, the investment advisers have such a broad range of experience that they can and do provide that wider perspective across the whole management of the pension fund. Given the increasingly complex and challenging environment within which funds are operating, pension committees should be looking to gain access to such advice if they do not already have it.

In addition to professional investment advisers, pension funds can appoint co-opted voting members to their committees. These are independent of all employers, members and other stakeholders. As voting members, these appointees can bring a depth of experience, gained from executive and non-executive appointments, to bear on the full scope of management issues

Case study

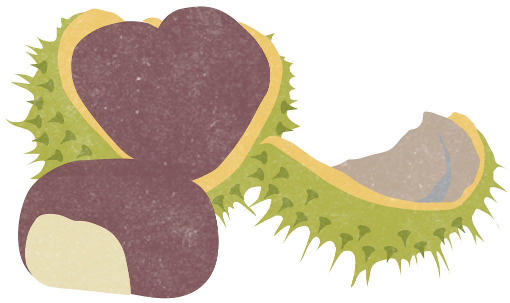
Co-opted members widen experience at Avon fund

Avon Pension Fund's committee has two independent, co-opted members who have full voting rights. The two members were appointed following a normal recruitment process and were selected to ensure they brought to the committee a range of investment, pension administration and financial experience. They also bring the benefits of continuity, independence, expertise and wider board or private sector experience. This has proved invaluable in ensuring continuity of the decision making process, diversifying the expertise of the committee and bringing broader experience to the committee in areas such as risk management and governance.

considered by a pension committee. The additional costs associated with any of these options would need careful consideration.

For many funds, as they review the way in which they work to reduce costs, deliver changes in pension administration and implement more complex investment strategies, the answer to gaps in officer's capacity or skills is to work collaboratively with others. They can do this either through formal contractual arrangements or through partnerships.

18% of respondents to our external survey had bought in additional expertise/capacity and 36% were working in partnership with other pension funds to address these gaps.



National LGPS frameworks

Created by 'LGPS funds, for LGPS funds', the national LGPS frameworks are multi-user, multi-provider procurement frameworks. They are open to all LGPS funds and employing authorities nationally, for the procurement of services from a range of qualified providers.

The frameworks are designed to save significant time and money for LGPS funds and ensure best practice, European Union compliant procurement and access to services with proven track record and expertise. The frameworks allow the LGPS funds to use their combined purchasing power while still supporting local accountability, decision making and service needs.

Frameworks available now or coming soon include:

- benefit and actuarial consultancy services
- investment consultancy services
- global custody services (from October 2013)
- legal services (from summer 2014).

Some of the benefits of using the frameworks include:

- a fast, efficient and European Union compliant procurement framework:
  - procurement timescales reduced from six to 12 months to four to eight weeks
  - procurement overheads cut by 90% (for example, custodian procurement costs reduced from £100,000 to £10,000)
- access to pre-agreed terms and conditions
- ceiling prices reduced by further competition at tender and a collaborative rebate for all funds that let services from the framework
- straightforward 'call off' process with detailed user guides, support and templates
- additional benefits, for example, user groups to optimise the LGPS buying power.

The frameworks were initially the result of collaboration between Buckinghamshire, Cambridgeshire, Croydon, Hackney, Lincolnshire, Northamptonshire, Norfolk and Suffolk pension funds. They are now supported by procurement, legal and project management specialists from Norfolk County Council and the Norfolk Pension Fund.

There are many examples of joint working across the LGPS nationally. Funds report that this has resulted in a reduction in costs and it has enabled the sharing of expertise in particular areas and the creation of centres of excellence. These include shared procurement exercises for actuarial and custodial services, shared benefit administration services, and investment consultancy services. To aid the national debate around the future structure of the LGPS, it would be helpful to see more clearly stated outcomes about the costs and benefits of such exercises.

Next steps

Bearing in mind managers' and pension committees' best view on the future strategy for their fund and the changes they are expecting to implement over the medium-term, they should ask:

- do members of the pension committee have a sufficient level of knowledge and understanding?
- do members of the pension committee have access to expert advice covering the full range of the management of the pension fund?
- are we doing enough to access the skills and capacity across the LGPS that will enable us to fulfil our roles efficiently and effectively?
- do we know where our gaps in capacity and skills are? Are we ensuring an effective plan is in place to address them?
- what do we need to change?

Investment strategies

Background

The investment strategy is a crucial part of the management of any pension fund. An effective investment strategy is critical to ensuring the sustainability of the fund and providing for the pension needs of its members in the long-term.

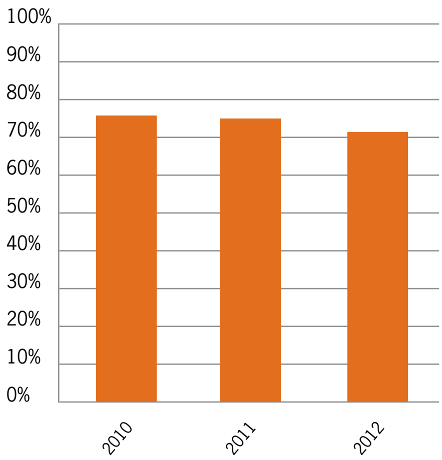
The volatility of investment markets following the financial crisis had a significant impact on funding levels. But investment strategies have to fit the long-term nature of pension funds and are not expected to change in response to every short-term change in the market.

Investment strategies should be kept under continuous review in light of changes to the nature of the fund as well as investment markets. Recent changes to the LGPS regulations have also given funds a little more flexibility in the distribution of their funds, allowing an increase in the proportion of funds that can be invested in partnerships from 15% to 30%.

Any significant change to an investment strategy usually involves changing portfolios and investment managers. These require major procurement exercises with time and cost implications. It is particularly important to keep the investment strategy under review in this context. Once a strategy is set, changes would only be expected where there have been significant changes in the fund, relevant investment markets, or in regulation. Most funds have reported improvements in asset values since the last actuarial valuations in 2010. They have also reported a bigger increase in their liabilities due to the change in gilt and corporate bond yields. This is a consequence of investments being more heavily weighted towards return giving assets, such as equities, absolute return funds and property, whose values have not increased at the same rate as fund liabilities.

Figures reported by funds showed a gradual deterioration in the average funding rate between 2010 and 31 March 2012, from 75.5% to 71%. The first full results of the 2013 actuarial valuation are just starting to emerge and these will provide increased clarity over the latest funding positions.

Figure 6 Average funding levels



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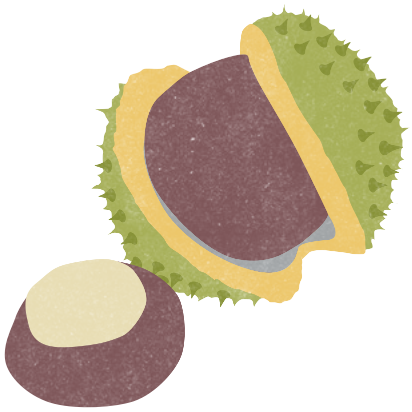


Current practice

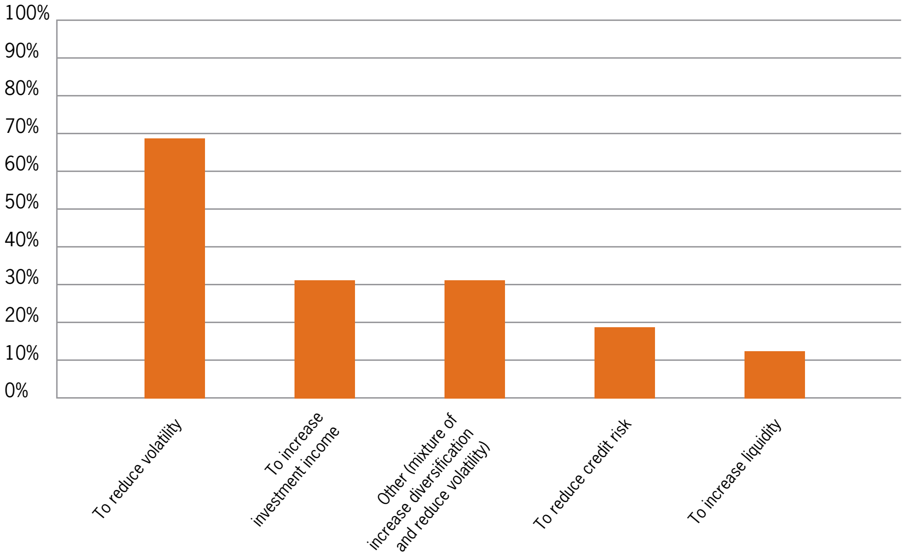
Over 50% of funds have made significant changes to their investment strategies in recent years. It is perhaps surprising that more have not done so. The main aims of those changes have been to reduce volatility and to improve performance by diversifying portfolios into new areas.

Case study

Lancashire investment strategy changes reap early results

Since 2011, Lancashire Pension Fund has made substantial asset allocation and fund manager changes to reduce volatility and increase diversification. It has reduced the equity portfolio, moved from largely UK based investments into global investments, and started using more active investing styles. While performance should be viewed over the medium- rather than the short-term, the fund has seen immediate effects. The overall return achieved during 2012/13 was 14.9% compared to the benchmark return of 13.5%, the actuarial liability benchmark of Gilts+2.5% (7.9%) and the average local authority return of 13.8%. The majority of out-performance has come from new active equity mandates, property and internally managed funds. To support the fund in making the changes, it has recruited specific capital markets expertise into its in-house team.

Figure 7 Key aims of changes to investment strategies



A relatively small number of funds are also looking to reduce their liability risk. Traditionally, LGPS funds have not considered liability risk management as part of an investment strategy. This is despite the fact that it has been an integral part of investment strategies in the private sector for many years.

Liability risk cannot be ignored. Integrating it into an investment strategy does, however, require a different knowledge and skill set and funds will need to consider this. Some funds have not reviewed their strategies for several years, and only reviewed the performance of individual fund managers in the interim. Investment strategies do need to have a long-term focus. However, it is also important to review the strategy continually, to understand the potential impact of market trends, fund demographics and regulatory factors on such strategies, and be prepared to make changes when appropriate. As regular changes to investment strategies can be disruptive and costly, they should only be made where there are significant factors highlighting a need for change.

In setting an investment strategy there are four key factors which apply to all funds:

1 Strength of the employer covenant – that is, the degree to which funds can rely on the employer being there in the future to pay future contributions. A weaker employer covenant should result in a lower risk investment strategy. This would also normally include consideration of the ability of the employer to pay a given level of contribution. In the LGPS context, this will include consideration of the impact of the employer contributions cap introduced by LGPS 2014
2 The funding target set by the employers and trustees. For example, a fund looking to bridge a funding gap of 25% within 10 years will adopt a different strategy from one that seeks achieve this over 20 years
3 The profile of the fund's liabilities in terms of its exposure to risks such as inflation, longevity and interest rate risks
4 The profile of the settlement of the liabilities

Once set, review of strategy and performance should concentrate on three factors:

1 Performance against pre-set benchmarks
2 Quarterly estimated funding positions
3 Any changes in the underlying nature of the fund

Next steps

We suggest management and pension committees should ask:

- do we have the right information to help us to understand the important factors affecting our funding position?
- is our current investment strategy appropriate in light of this information?
- do we need to consider managing our liability risk?
- do we have the right skills, knowledge and capacity to deal with a more complex investment environment?
- what do we need to change?

Risk management

Background

Effective risk management is an essential part of any governance framework as it identifies risks and the actions required to mitigate their potential impact. For a pension fund, those risks will come from a range of sources including the funding position, investment performance, membership changes, benefits administration, costs, communications and financial systems. Good information is important to help ensure the complete and effective identification of significant risks and the ability to monitor those risks.

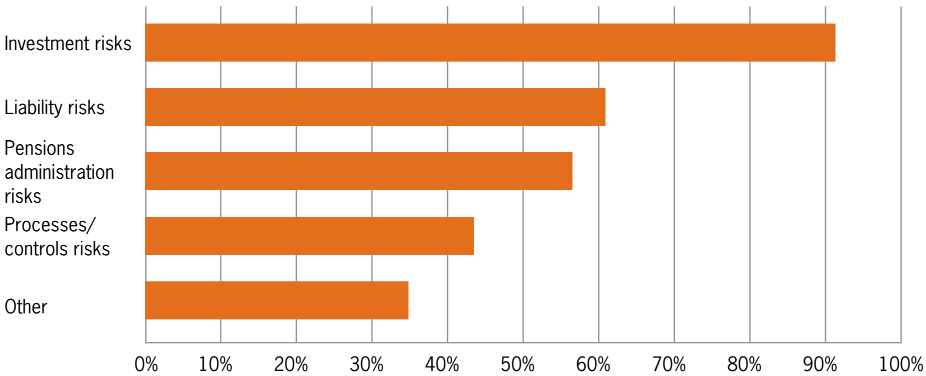
Current practice

Again, there is a wide variation of practice across pension funds in this area and in some it appears under-developed. Only 24% of funds provide regular (more than once a year) reports to their pension committees on the main risks affecting the fund. The most commonly reported risks are around investment. Over half of those who do provide regular reports on key risks also report on other risks such as liabilities and administration risks. A relatively new risk being picked up by some funds is around the acceptance of an increasing number of admitted bodies with the potential future liabilities they may bring.

In November 2012, CIPFA produced a paper on ‘Managing risk in the LGPS’. As a result, we have seen reports going through to pension committees around risk management and the production of risk registers.

This is early days and funds must avoid viewing and treating the registers as stand-alone documents with little impact on the management of risk. It is also essential that the identification and management of risks is integral to the overall performance management of the fund. As such, any performance reporting for the fund should also include clear identification of key risks and how they are being managed.

Figure 8 Reporting of risks to pension committees



Case studies: Maintaining a focus on risk

Norfolk Pension Fund operates a comprehensive risk register, which covers all aspects of the pension fund's activities. This is reported to members of the pension committee on a six-monthly basis. It is accompanied by a clear summary of the main risks affecting the fund and the actions being taken to address them, together with the wider implications for the fund.

A number of funds have established separate risk sub-committees or working groups. In some cases, they have broadened these into risk and governance groups. The advantage of such groups is to enable more detailed consideration of and development of de-risking strategies for specific risks. For example, this includes monitoring of progress on key projects; reviewing benchmarking data; and consideration of risks around implementing LGPS 2014 and risks around employer profiles as the number of smaller admitted bodies grows.

Next steps

We suggest management and pension committees should ask:

- do we understand the range of risks to the long-term sustainability of the fund and its efficient and effective management?
- do we know how those risks are being managed and are we confident they are being managed effectively?
- what needs to change in this regard?

Administration costs

Background

There is a national focus on the administration costs of the LGPS. The existence of 99 separately managed funds raises questions about whether a re-organisation of those funds could improve performance and reduce administration costs. By 'administration costs' we mean the costs of investment managers' services and investment transactions as well as the cost of administering the fund.

It is important for any organisation to keep its administration costs down, but especially so in the current economic climate. On average, funds report the costs of administration and investment managers as £6 million a year, but funds report a wide range within this.

These costs are relatively small amounts in the context of an individual fund, but across 99 funds, they are significant. Investment transactional costs are often reflected in bid or offer prices and therefore 'lost' within the cost of purchases and sales and would be additional to this cost. Costs can fluctuate considerably between years where significant portfolio changes or procurement exercises are being undertaken.

Current practice

Practice varies across the country. About 60% of funds have undertaken exercises to review their administration costs and to reduce them in recent years. This has included tendering exercises for various services,

Figure 9 Administration costs

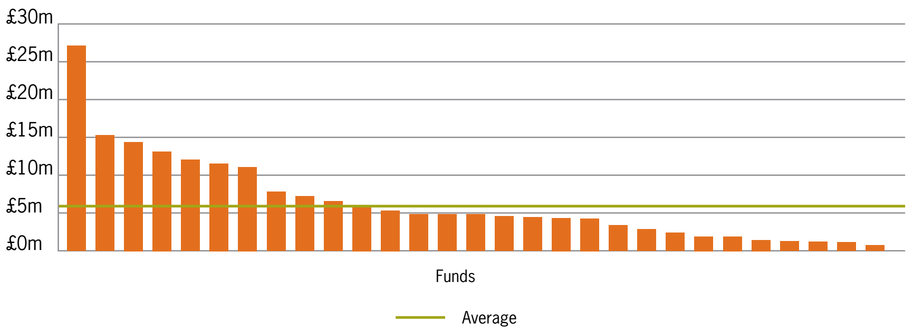
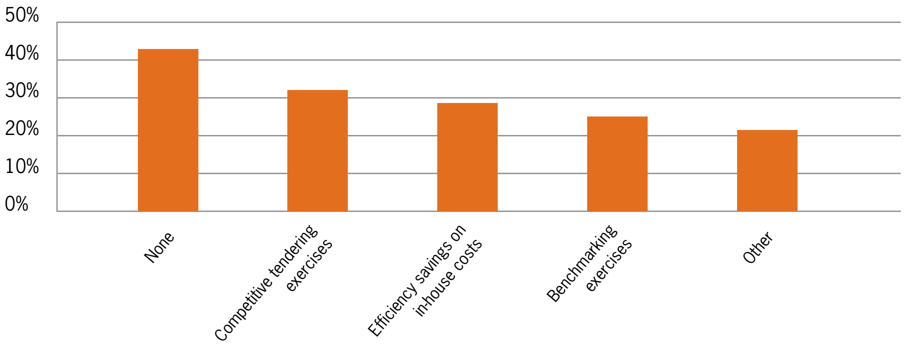


Figure 10 Actions taken to reduce the administration costs and investment management expenses of the fund



implementing efficiency savings, benchmarking and 'other' options, for example re-negotiating/specifying existing contracts. However, over 40% have not undertaken any work in this area.

Where funds have completed work to achieve savings in administration, most have not reported the value of such savings to their pension committees. Only three of the funds we audit had reported savings in this way. The savings totalled £1.4 million across the three funds.

Next steps

We suggest management and pension committees should ask:

- do we know what our fund administration costs are and what they consist of?
- have we done anything in recent years to review and reduce those costs and if so what?
- is their more we can do to reduce our administration costs or to be more efficient in the way the fund is managed?

Internal control and internal audit

Background

As with any governance framework, reliable systems of internal control are important to provide the assurances that processes are operating effectively. This should reduce the risk of failing to achieve objectives. Internal audit is usually a core part of providing management with assurance that the system of internal control is operating effectively via the auditor's review and testing of such processes.

Pension administration is about to become more complex with the introduction of a career average scheme. Three elements that will increase complexity are:

1. Relatively complex rules around protection for accrued pensions
2. Introduction of a 50/50 option, whereby members can opt to reduce contributions by 50% to obtain 50% less pension
3. Contribution bandings based on actual pay for part-time workers rather than full-time equivalent pay

Increasing complexity in pension benefits administration and in the investment environment means the need for good internal control is stronger than ever.

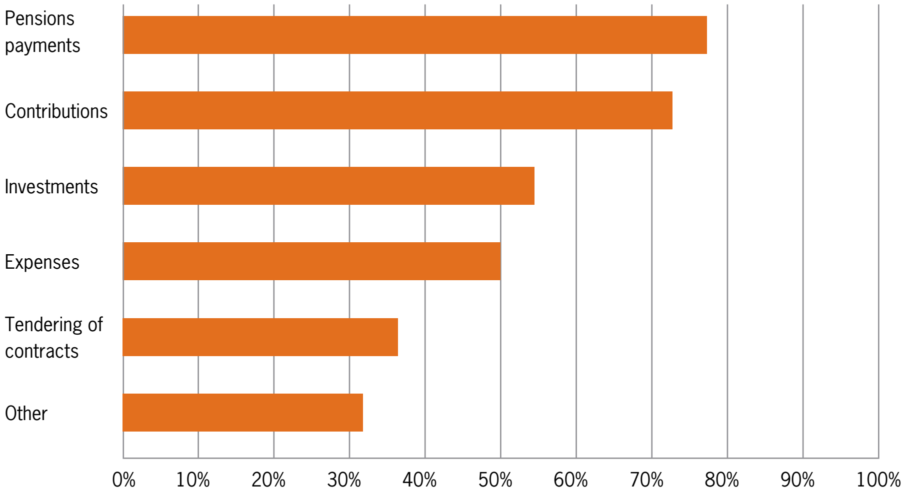
Current arrangements

Usually, the fund is just one element of the work of the wider local authority. The administering body's audit committee and the internal auditor consider the internal control arrangements as part of that wider framework.

The annual governance statement of administering authorities sets out how responsible officers and members obtain assurance around the overall governance of the organisation and whether there are any specific issues which need to be addressed. In only 25% of our funds does this statement refer specifically to the pension fund.

Pension funds often refer to their governance compliance statement which they are required to publish within their annual report in mitigation. However, this statement does not serve the same purpose and in particular it does not show clearly the assurances over risks and controls that have been obtained during the year, nor any significant issues arising, nor any resultant action plans. Instead, the governance compliance statement shows the extent to which funds' governance arrangements comply with DCLG guidance on committee structure, membership, voting rights, training, frequency of meetings, access to committee papers, scope and publicity.

Figure 11 Internal audit coverage of pension funds over the last three years



Obtaining assurance over effectiveness of controls

Where internal audit do report to the pension committee, the common approach is that a separate internal audit plan is produced and discussed with the pension committee. It covers all aspects of the pension fund operation. They receive reports during the year on the conduct of the audit and its outcome as well as an annual report of the internal auditor's findings in respect of the pension fund. This enables the pension committee to have a good understanding of the control environment as it impacts on the pension fund and gives them an opportunity to feed into the internal auditor's risk assessment.

Most funds have specific coverage by internal audit, although 7% of funds have no internal audit coverage at all. The range of coverage by internal audit teams also varies, with most internal audit plans covering pension payments and contributions, and just over half covering investments and expenses.

Any internal audit plan is based on a risk assessment of the overall control risks facing the administering authority as a whole. The danger of not considering the pension fund separately is that pension fund risks are not given the significance they may require.

While internal audit make their reports to audit committees, only 42% of them reported their plan and outcomes back to the pension committee. It is difficult for the members of the pension committee to carry out their role without that assurance.

Next steps

We suggest management and pension committees should ask:

- what are our sources of assurance that the controls affecting the pension fund are operating effectively?
- if we want some additional assurance, do we have a way of doing that?
- are we aware of any controls issues and, if so, do we know if they are being addressed effectively?
- does our annual governance statement cover the activities of the pension fund adequately?
- what do we need to change?

Appendix 1

Questions for management and pension committees

Throughout this report we have posed a number of questions that management and pension committees could use to help them to consider and challenge the way in which their pension fund is operated. These questions are summarised below to assist with any such review.

How the pension committee works

- Are our current arrangements fit for purpose?
- Do they cover all aspects of the management of the pension fund and do they enable us to consider and challenge effectively our overall strategy for the fund's management?
- How have we added value in our role as a committee during the last year or so?
- Do we have sufficient information and understanding to challenge effectively?
- What needs to change?

Capacity and skills

- Do members of the pension committee have a sufficient level of knowledge and understanding?
- Do members of the pension committee have access to expert advice covering the full range of the management of the pension fund?
- Are we doing enough to access the skills and capacity across the LGPS that will enable us to fulfil our roles efficiently and effectively?
- Do we know where our gaps in capacity and skills are? Are we ensuring an effective plan is in place to address them?
- What do we need to change?

Investment strategies

- Do we have the right information to help us to understand the important factors affecting our funding position?
- Is our current investment strategy appropriate in light of this information?
- Do we need to consider managing our liability risk?
- Do we have the right skills, knowledge and capacity to deal with a more complex investment environment?
- What do we need to change?

Risk management

- Do we understand the risks to the long-term sustainability of the fund and its efficient and effective management?
- Do we know how those risks are being managed and are we confident they are being managed effectively?
- What needs to change in this regard?

Administration costs

- Do we know what our fund administration costs are and what they consist of?
- Have we done anything in recent years to review and reduce those costs and, if so, what?
- Is their more we can do to reduce our administration costs or to be more efficient in the way the fund is managed?

Internal control and internal audit

- What are our sources of assurance that the controls affecting the pension fund are operating effectively?
- If we want some additional assurance, do we have a way of doing that?
- Are we aware of any controls issues and, if so, do we know if they are being addressed effectively?
- Does our annual governance statement cover the activities of the pension fund adequately?
- What do we need to change?

About Grant Thornton

Dynamic organisations know they need to apply both reason and instinct to decision making. At Grant Thornton, this is how we advise our clients every day. We combine award-winning technical expertise with the intuition, insight and confidence gained from our extensive sector experience and a deep understanding of our clients.

Grant Thornton UK LLP is a leading business and financial adviser with client-facing offices in 24 locations nationwide. While we understand regional differences and can respond to needs of local authorities, our clients can also have confidence that our team of local government specialists is part of a firm led by 200 partners and employing nearly 4,000 professionals, providing personalised audit, tax and specialist advisory services to over 40,000 clients.

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Our approach combines a deep knowledge of local government, supported by an understanding of wider public sector issues, drawn from working with associated delivery bodies, relevant central government departments and with private-sector organisations working in the sector. We take an active role in influencing and interpreting policy developments affecting local government and responding to government consultation documents and their agencies. We regularly produce sector-related thought leadership reports, typically based on national studies, and client briefings on key issues. We also run seminars and events to share our thinking on local government and, more importantly, understand the challenges and issues facing our clients.

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