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Transaction Costs Disclosure: Improving Transparency in Workplace Pensions - Call for Evidence

I am responding on behalf of the Local Government Association (LGA) and the Local Government Pensions Committee (LGPC) to the above consultation document.

The LGA is a politically-led, cross-party membership organisation that works on behalf of councils to ensure local government has a strong, credible voice with national government. In total, 414 local authorities are presently members of the LGA. The Local Government Pensions Committee (LGPC) is a committee constituted by the Local Government Association (LGA), the Welsh Local Government Association (WLGA) the Convention of Scottish Local Authorities (COSLA) and the Northern Irish Local Government Officers' Superannuation Committee (NILGOSC). The LGPC considers policy and technical matters affecting the Local Government Pension Scheme (LGPS) in the UK, a scheme which has over 5 million members.

The consultation document sets out proposals for increased transparency with regard to Defined Contribution (DC) pension arrangements. However in paragraph 25 it states:

25. The new governance and charges requirements being introduced from April 2015 apply to those schemes insofar as they offer money purchase benefits. However, feedback would be welcome as to whether there is a need for increased transparency of costs and charges in non-money purchase schemes more broadly.

The LGA would like to provide such feedback and in particular express support for the extension of regulatory transparency of costs and charges to the Local Government Pension Scheme (LGPS). In stating this support the LGA would seek to ensure that any such extension:

- Ensures the levels of transparency are those required for effective decision making by LGPS pensions committees.
- Provides an effective balance between the level of detail exposed and the cost of such exposure (similar to that currently in place for Dutch Defined Benefit arrangements).
- Supports a greater degree of understanding of and accountability for scheme investment costs.

The LGA is of the view that an open and transparent market for LGPS investment costs is an effective way to both drive toward greater value for money and demonstrate increased accountability to the scheme's members, employers and to local tax payers.

The annex to this letter provides further information in support of this submission as summarised below:

- Background information on the LGPS - *5 million members, 10,000 employers £200 billion in assets and £500 million per annum in declared investment costs, reporting basis set out in regulation, accounting standards and guidance*
- The issues caused by limited transparency - *inconsistency in reporting, a lack of clear accountability, potential for overcharging, reputational risk*
- Wider industry issues and moves toward transparency - *IA proposals for disclosure, US experiences, the Dutch model, wider EU support for change*
- Options for greater transparency in the LGPS - *recommendation of a regulatory rather than voluntary compliance with levels of disclosure similar to those in place in the Dutch pensions industry.*

The LGA would be happy to provide further information as requested and to work with DWP, the FCA and collaboratively with CIPFA, in the development of detailed proposals for and the potential benefits of an extension of increased investment cost transparency to the LGPS. In particular, we would welcome and encourage a further consultation specifically addressing how further transparency in respect of investment costs may be achieved in DB schemes.

Yours faithfully

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Annex

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Note: Some of the content of this annex is based on publicly available information and is used to provide a general overview of the issues faced in the LGPS, the steps that have been taken elsewhere to increase transparency in DB schemes and, consequentially, some options that could be considered for increasing transparency in the LGPS. It should not be taken to mean that the LGA has independently verified and endorsed the research or conclusions reached by any third party.

Background information on the LGPS

Reporting bases

The LGPS in England & Wales is administered locally by bodies known as administering authorities. Administering authorities are required to account for local government pension funds in accordance with the CIPFA Code of Practice for Local Authority Accounting in the United Kingdom (the Code). In turn the Code is based on International Financial Reporting Standards (IFRS). The primary standard relating to pension fund accounts is IAS 26 Retirement Benefit Plans.

The pension fund annual report requirements are given in regulation (57) of the LGPS Regulations 2013, paragraph (3) of which states that, 'In preparing and publishing the pension fund annual report, the authority must have regard to guidance given by the Secretary of State'. Using the Secretary of State's ability to delegate their power to issue guidance, DCLG have confirmed that CIPFA's 'Preparing the annual report' 2014 guidance is to be regarded as the Secretary of State guidance for the purpose of this regulation.

Individual fund annual reports are therefore prepared observing the Code and the requirements of Scheme Regulations but also with regard to the aforementioned CIPFA guidance. The guidance goes some way towards improving consistency and comparability, but it is not mandated and so its effectiveness in this regard is therefore limited.

In practice

The second Scheme Annual Report provides an aggregation of all individual fund report and accounts in England & Wales as at 31 March 2014 (key LGPS statistics above). The funds range in size from over £10bn (3); between £2bn and £10bn (29), between £0.5bn and £2bn (52) and less than £0.5bn (7). Some investments/funds are managed internally, while others are externally managed portfolios or pooled funds. Reported investment expenses aggregated for the entire scheme total 0.30%, however, fund investment expenses range from 0.02% to 1.13%.

Analysis of costs disclosed in audited accounts for the Annual Report have proven that direct fund for fund comparisons do not give an complete or accurate picture. Differences in administration and investment management structures coupled with disclosure requirements open to interpretation are some of the reasons for this. Additionally, administering authorities often share pension fund resources with other parts of the local authority, meaning staff costs and overheads are sometimes allocated to the pension fund in different proportions from one administering authority to another. Where this occurs, it is difficult to compare with explicit charges for outsourced services.

Administration and investment expenses were found to be listed in over 27 different types of cost headings. The transparency around cost is also blurred by the line between administration of the 'fund' and of the fund investments. Only a handful (five) of local authority funds itemised transaction costs in their accounts. In practice, most administration and investment expenses were listed under half a dozen broad headings.

Steps have been taken to improve the situation, and CIPFA's guidance for 2015 has been updated to include a third cost category (Other Internal Expenses/Oversight and Governance) in an attempt to provide a reporting structure that will give more clarity and comparability in how pension fund expenses are reported from one fund to the next.

The table below sets out the current reporting requirements in regulation, accounting standards and guidance definitions, and highlights the resulting differences in reporting that occurs in practice. Please note that for completeness this details all categories of cost incurred by LGPS pension funds.

Cost Category	**Regulations**	**Accounting Standard (the Code)**	**CIPFA Guidance**	**Reality/In practice**	**Transparent?**
Administration	n/a	Disclose administrative expenses in the fund account	Costs related to members and pensioners, costs related to scheme employers, and associated project costs	Face accounts show administration expenses – level of detail in notes varies considerably	Partly; some funds, yes; LGPS overall, no.
Investment	n/a	Ensures that all costs associated with management of assets are captured and reflected in the financial statements in one form or another (through either the fund account or changes in values in the net assets statement).	Expenses incurred in relation to the management of pension fund assets and financial instruments entered into in relation to the management of fund assets.	Face accounts show investment expenses – level of detail in notes varies considerably	Partly; some funds, yes; LGPS overall, no.
Internal Expense (Other) (Oversight and Governance)	n/a	n/a	A range of costs (commonly classified as administrative or investment related, or both) could be more accurately described as oversight and governance costs, Third cost category	First year of reporting under new guidance will be 2015	Should improve over time

Transaction	n/a	No definition is universally accepted. (the Federation of Dutch Pension Funds also includes hidden cost in the bid/offer spread)	Guidance adopts the definition of transaction costs as defined in the standard and the Code guidance does not require these costs be quantified and disclosed but the notes to the financial statements should explain their existence	Only 5 of 91 LGPS Funds E&W itemise transaction cost in their annual report and accounts	No
Asset Allocation (change)	n/a	Code para 6.5.5.1 f) and i) Reconciliation of movements in investments and derivatives. Market value at start and end of year, purchases, sales and change in market value	As code	Change in Investment Manager may not show in asset allocation change	No
Investment Manager (change)	n/a	Code para 6.5.5.1 g) Market value at start and end of year	As code	Change in Asset Allocation may not show in investment manager change	No
Turnover (reason)	(a) a report about the management and financial performance during the year of each of the pension funds maintained by the authority; (b) a report explaining the authority's investment policy for each of those funds and reviewing the performance during the year of the investments of each fund;	Not covered by accounting standard	Not covered by guidance	Under current disclosure requirements, there has been no obligation for an asset manager to provide information on transaction costs. This makes it difficult for those overseeing a fund to assess whether the investment strategy is capable of making up the drag on performance created by transaction costs.	No

The issues caused by limited transparency in the LGPS

The current reporting regime is effectively based on reporting invoiced fees as expenses and including other charges (for example transaction costs, FX fees and fund of fund layer fees) in the net return figure. This situation results in a number of issues which full and consistent transparency of charges could address:

- The reported investment costs in the 2014 LGPS annual reports in England and Wales ranged from 2 basis points to 113 basis points resulting in confusion amongst scheme members and attacks on the validity of the scheme from elements within the press and the wider pensions industry.

- The requirement to declare 'invoiced' fees takes no account of in-house costs leading to significant differences between internally and externally managed funds.
- The non-statutory nature of current codes of practice on reporting leads to inconsistency and an inability to effectively compare costs across LGPS funds.
- There is no directly reported correlation between costs and asset allocation, performance or turnover leading to uncertainty as to the source of the fees.
- The lack of transaction costs from the 'top line' charges (effectively hiding them in the net return figure) gives rise to the potential for overcharging due to the absence of oversight.
- The inability of funds to confirm or challenge total fee estimates quoted in the press and from figures within the industry results in a lack of accountability and a loss of confidence in the value the scheme achieves in making its investments.

Attempts by the local authority finance professional body CIPFA to regularise and extend reporting requirements have been hampered by an inability to enforce through regulation, a lack of clear direction within the industry, a reliance on return net of fees as a guide to value, and the fragmented structure of the LGPS.

In September 2013 the actuarial firm Hymans Robertson and the benchmarking firm CEM investigated investment charges across 12 LGPS funds and compared them to a peer group of large international funds. The resulting report found that:

'Actual investment costs are double what is currently disclosed under current accounting conventions (c63bps vs c32bps – £0.32 per £100 of assets per annum)'

It must be stated however that the extra charges discovered did not point to a lack of value. Indeed it appeared that LGPS funds were achieving fee rates comparable with, if not better than, the peer group.

Nevertheless the report concluded that:

- There has not been sufficiently clear instruction on fee disclosure requirements (e.g. what should be in the reported data including layers of fees on pooled funds and funds of funds) and some information is hard to get.
- The impact of the undisclosed fees is reflected in fund performance measurement so the lack of transparent disclosure has not resulted in an overstatement of returns.
- Whatever the outcome of the Call for Evidence[1], transparency and full disclosure should become the norm. This would include disclosure of all layers of fees.
- Greater transparency will allow like-for-like comparisons to be made and enable us to understand the true cost of running LGPS investments and how that is changing over time.

[1] Call for Evidence on the structure of LGPS funds by the Department for Communities and Local Government in 2013

More recently the reporting structure of the LGPS has been challenged in the industry press and wider media with the scheme being accused of naivety in its dealings with the investment management industry and an absence of accountability to its members and the local tax payers.

One industry press article quoted KAS Bank managing director Chris Sier who a few years ago worked in a research capacity to find out how much the LGPS was paying in fund management fees. By analysing data on the scheme his research suggested equity turnover was over 100% across the funds, significantly more than claims by some investment managers that their turnover is only around 20%-30%.

An equity turnover of 100% would mean the portfolio is being turned over once a year, which, if true, could add to significant hidden costs. Sier found that a portfolio turning over once a year incurs on average 15 basis points (bps) for full service, research and execution costs in addition to 50 bps in stamp duty. This amounts to 65 bps, even before including implicit costs of trading such as bid/offer spread, market impact or implementation shortfall. If turnover is above 100%, costs will be even higher.

Such articles may be painting a picture that hide costs but alternatively could be explained by reasonable and appropriate activity by fund managers

As a simple example let's say a fund manager decides to change 10% of a portfolio worth £100Million and that it comprised of 10 shares (for simplicity here) – he wishes to sell one share in a Malaysian company worth £10 Million and buy one a Sri Lankan share worth £10 Million.

How much is the turnover. Firstly it is a buy and a sell 2 x £10Million = £20Million. Secondly there are currency conversion trades that need to use the market restricted currency pairs, so a sell involves a conversion into US dollars, then into UK£ so 2 x £10 M = £20 Million. A buy is the same in reverse, another £20Million.

So far we are up to £60 Million or 60% turnover. But what if the manager wants to use derivative contracts to ensure that the buy and sell decisions are not affected by currency movements in between completing the sell trade and buy trade (in practice a manager would rarely trade all the sells and buys at once due to market momentum) – in this case there could be another £40Million registered as transacted (two lots of two currency pair options). That takes us to £100 Million or 100% turnover.

The lack of a consistent, regulated and fully transparent reporting structure means it is currently difficult for the LGPS to either expose and deal with excess turnover or be assured that the activity is fully justified.

Wider industry issues and moves toward transparency

In February of this year the Investment Association published Meaningful Disclosure of Costs and Charges. Although targeted at the DC world this report concluded that success in bringing about greater transparency in costs should be judged by three key criteria:

- It should facilitate informed decision making
- It should allow for comparison between products and providers
- It should be designed to serve the best interest of investors

In the US the New York City Comptroller's office has published findings that indicate that 95% of gains made by the city's public pension funds have been lost in fees and according to the report of this position in the New York Times, published 8th April 2015:

'Scott Evans, the comptroller's chief investment officer, had to work backward from the footnotes in the reports to estimate just how much had been paid each year to a long list of Wall Street firms that managed investments in the public markets. He then calculated that those fees, combined with the significant underperformance of the investments in private assets like real estate, amount to a drag of more than $2.5 billion since the end of 2004.'

Additionally, the New York Times commented in the same article:

'Why the trustees of the funds… would not have performed those calculations in the past is not clear'.

In Europe, Holland has been leading the way on transparency. The annual FTK (Financial Assessment Framework) reports will (as of mid-2015) require costs to be transparent and broken down into administrative costs, costs for managing the assets and transaction costs. Pension funds will also be obliged to break down the integrated costs for managing the assets per asset class through the new accounting rules.

Transaction cost analysis is required in the report and the question of implicit costs for transactions not conducted on an agency basis has been resolved by introducing a standard basis for estimates. The Pensioen Federatie (Pensions Federation) in the Netherlands has produced a matrix of transaction cost estimates for different asset classes and the use of these estimates is compulsory if the actual cost is unknown. These cost estimates are conservative and widely believed to be overestimates. However, this does not affect portfolio net asset values, though they do reflect on the efficiency of investment manager performance production.

The EIOPA Report on Costs and charges of IORPs (Jan 2015) recognised the importance of costs and charges in DB schemes arrangements where:

'..the management of costs and charges is mostly the responsibility of the board or the trustees of the IORP. Members of DB schemes may be less directly affected by costs and charges, since their benefits are defined and costs do not have an immediate effect on their accrued rights (though costs do have a direct impact on the financial reserves of the IORP and therefore on the capacity of the IORP to finance indexation of the accrued rights). However, costs may affect the affordability of the scheme for sponsors (who typically bear the costs of running DB pension scheme arrangements).'

In Australia a raft of new regulatory body reporting requirements from APRA (the Australian Prudential Regulatory Authority), have driven transparency, costs and efficiency to the forefront.

Options for greater transparency in the LGPS

In order to secure greater transparency in costs across the LGPS the following options could be considered. It is the initial view of LGA that the Dutch model appears to provide the most effective combination of regulatory force, appropriate levels of disclosure and cost effectiveness. Further research would however need to be undertaken in order to ensure that specific proposals along any of the below lines would achieve the fundamental aim of increased transparency in a manner that provides consistency and is resource efficient.

Comply or explain - CIPFA guidance
A set of standards for disclosure of costs in the following categories is set for LGPS funds to report in their annual accounts:-

- Administration costs (per scheme member)
- Asset management costs (internal and external expressed as a percentage of assets under management)
- Transaction costs (expressed as a percentage of assets under management)

A standard methodology for the calculation of the above would be determined in agreement with the Financial Conduct Authority (FCA) and The Pensions Regulator (TPR).

Asset management and transaction costs would be disclosed alongside information related to the asset mix (including changes to the mix), long term performance, turnover of assets and changes in external managers. Again the methodology for determining these numbers would be set out in the guidance.

The purpose of the guidance would be to set out a framework for the transparent and consistent reporting of LGPS costs and although it would be consistent with the relevant accounting standards and the *Code of Practice for Local Authority Accounting in the United Kingdom*, it would not be mandatory. Funds could either choose to follow the guidance or to disclose the reasons why they have not.

This option has the advantage of being able to be implemented relatively quickly and without the need for legislation. However, unless all funds followed the guidance to the letter the overall picture would remain confused, opaque and open to the same criticism it currently faces.

The FCA/DWP proposed DC model
Under this option the framework and regulatory regime agreed for disclosure of costs (including transaction costs) for DC arrangements would be translated directly into the DB world.

Although requiring legislation this option would provide a level of consistency across both sides of the pensions industry and a level playing field for all funds. However it may not best reflect the needs of DB members and trustees for understandable, appropriate and cost effective levels of disclosure.

The framework proposed for DC is untested in a DB environment and may require considerable time, effort and expense to implement which may negate the potential benefits.

The Dutch model

The closest to a proven model that exists for the regulated transparent reporting of DB costs is currently in place in the Netherlands. Regulated by the Dutch regulator - de Nederlandsche Bank (DNB) - the model covers far more than management and transaction costs, but includes a tried and tested methodology for the collection and disclosure of such costs.

Although not yet achieving 100% coverage this model has already achieved some notable success in driving forward value by significantly improving the range and depth of data available to trustees.

Use of the model would avoid re-inventing the wheel and, given that it is gaining momentum outside Holland, could provide the ability for cross border comparison of costs giving trustees a wider perspective.

Around 60% of the data in the Dutch template is already being collected (if not published) by LGPS funds. The remainder is available for collection with the right combination of resource and will.

The Dutch model should be able to achieve most if not all of the objectives set out in the DC proposal on what would appear to be a more cost effective basis. Nevertheless, the expense and complication of any such process should not be underestimated and should be approached with realistic expectations of the time and resource required of LGPS administering authorities In particular the expertise of dedicated fund account resource is essential to this process as is the effective liaison with and the co-operation of the custodian and asset managers.