LOCAL GOVERNMENT ASSET POOLING, A COMPLEX OPPORTUNITY

PROPOSALS BY THE UK GOVERNMENT TO POOL LOCAL GOVERNMENT PENSION SCHEME (LGPS) ASSETS PRESENT A NUMBER OF COST SAVING OPPORTUNITIES, BUT THERE ARE ALSO CHALLENGES WHICH WILL NEED TO BE ADDRESSED, ACCORDING TO J.P. MORGAN.

Proposals by the UK government to pool local government pension scheme (LGPS) assets present a number of cost saving opportunities, but there are also challenges which will need to be addressed, according to J.P. Morgan.

There are approximately 90 LGPS funds in England and Wales, and the UK government wants to bring about economies of scale by pooling assets across them. Such consolidation, the government argues, could help improve returns, scale back deficits and enable greater capacity for investment into infrastructure, an economic priority for the current leadership following the Brexit vote in June 2016.

The government estimates pooling could incur savings of around £660 million per year. “The core benefit of pooling LGPS is that it will create scale, which can allow these organisations to deliver better value for money,” said Benjie Fraser, managing director, global pensions executive, at J.P. Morgan.

At present, the UK local government pensions market is highly fragmented, giving these institutional investors limited scope to put pressure on active management fees. It can also result in different pension funds having major discrepancies with each other in terms of how much they pay managers running similar asset classes or delivering identical returns.

Research conducted by Thomas Murray Investor Services more than three years ago identified that local pension funds in Devon and Staffordshire were paying noticeably different investment fees despite having broadly similar portfolios spread across fixed income, equities, property and a small chunk reserved for alternatives. The Thomas Murray Investor Services data found that Staffordshire’s local pension fund paid almost £4 million more than Devon in investment management fees alone. Such fee divergences could potentially become a thing of the past under LGPS consolidation.

Reigning in fees is particularly important following the UK Financial Conduct Authority’s (FCA) recent market study which criticised the high fees levelled by active asset managers, many of whom the regulator argued had delivered below par returns relative to what investors were paying.

Nonetheless, pension funds have traditionally been cognizant of fee levels, a point made by Fraser. “The LGPS community and asset managers have spoken regularly about fees, particularly large pension funds, who have been drilling deep down into what they are paying their managers. The scale that LGPS consolidation will bring is going to, by definition, result in fewer mandates being awarded to external managers, which means...”

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there could be further fee pressure down the line on asset managers,” said Fraser. Pooling could help local pension funds boost not only their manager selection capabilities but their internal asset management know-how.

“Pooling will allow LGPS to increase their internal investment talent and expertise. This is a trend we have witnessed in Australia and the Netherlands, for example. Both of these countries have robust public pension fund set ups which attract quality people with investment management experience,” said Fraser.

Managing private equity or hedge fund portfolios internally could have cost savings. At present, a number of local council pension funds will invest into private equity via investment consultants or through funds of private equity funds. If LGPS reaches the scale the government is targeting, it will allow these pensions to go direct or co-invest alongside private equity managers, which will lead to bigger returns.

However, losses can also be more concentrated and impactful in direct investments and co-investments. Given the criticism of fees charged by alternative asset managers, a number of pensions are seeking different sources of revenue and alpha.

While pooling has benefits, there are issues these pension funds need to address. Most LGPS in this pooled set-up will operate an Authorised Contractual Scheme (ACS), in what will give their stakeholders tax efficiency. Tax transparency is the key selling point of the ACS, a UK fund structure, which is expected to enjoy impressive growth over the next few years. Northern Trust, for example, estimated ACSs could manage up to $250 billion by the end of 2017. However, pensions need to get to grip with the operational requirements of running an ACS.

“Running an ACS, which is FCA regulated, is going to require LGPS to learn a new knowledge set, similar to what may be expected of an asset manager. These LGPS are going to have to better understand services such as fund administration and what it means to strike a net asset value (NAV), and transfer agency mechanics. LGPS will generally need to oversee their service provider relationships in more depth,” said Phil Caldwell, global head of tax-transparent fund services at J.P. Morgan.

The role of the asset servicer is therefore likely to grow as LGPS pooling gains momentum. “Asset servicers will play a much increased role for the new funds. Aside from custody and its appointment through the associated regulated depositary services function, the funds will look for extra support and tools from their custodians for the increased needs concerning data reporting, analytics and governance. The metamorphosis from being a pension fund manager to owning and running regulated investment funds will mean that LGPS will need to find an appropriately competent and skilled asset servicing partner to support their increasingly complex needs,” said Caldwell.

The most likely outcome is that the UK will join other major markets such as Australia in having a highly sophisticated pension fund market. Willis Towers Watson data indicates the Australian pension market is one of the world’s fastest growing, with asset growth rates of 9.1% over the last 10 years. “The direction of travel for the UK pension market is going to be towards the Australian model. The super fund model in Australia is a direct result of consolidation among mid-sized pension schemes, and this scale has allowed them to grow their in-house expertise. LGPS consolidation is therefore a positive for the UK pensions industry,” said Fraser.

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