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Super funds: Benefits and challenges

By: Naomi Rainey | 01 Nov 2013 | 0 Comments

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As DCLG considers the benefits of a single LGPS investment fund, Naomi Rainey looks at the challenges of moving to a super fund structure.

Last week's confirmation that a single national Local Government Pension Scheme (LGPS) investment fund may be on the cards was not a surprise.

The Department for Communities and Local Government's (DCLG) decision to research potential savings in three collaborative models (*PP Online, 22 October*) was the strongest indication yet that England and Wales' 89 funds are soon to be radically overhauled.

DCLG's latest statistics for the English and Welsh funds show assets of £178bn across the two countries. If a single investment fund were to be pursued, it would create a formidable asset base.

By comparison, two of Britain's largest funds, the BT Pension Scheme and Universities Superannuation Scheme (USS), were valued at £38.78bn and £34.23bn respectively in their most recent accounts.

The debate for scale is not limited to the public sector; the National Association of Pension Funds (NAPF) has long advocated fewer large schemes in the UK, akin to those seen in the US, Canada and Australia. But what are the challenges facing the UK in getting there?

Risk of scale

Putting the politics of the LGPS aside, merging schemes brings the challenge of designing a scheme infrastructure to support appropriate oversight and investment for hundreds of billions of assets.

While efficiencies may be found in larger funds, it is important to consider potential risks of pooling assets on such a scale, Burges Salmon partner Michael Hayles says.

He explains: "The flipside of economies of scale is the greater risk; you're making much bigger decisions on investment. You need to have very high levels of scrutiny to ensure those decisions that are being made are the best decisions that you can make on this information."

Hayles highlights the potential for investment decisions to have a greater impact on performance, both for better and for worse.

Stephenson Harwood partner Fraser Sparks says a fund with hundreds of billions in assets could face issues over finding the right investments that allow them to properly diversify.

"You've got to invest the money, and there's a question of finding enough good opportunities to invest it," Sparks says.

"You've got to diversify, you've got the assets to do it, but is there enough scope to invest that kind of money effectively?"

Linklaters partner Isabel France also raises the burden of investment governance for schemes of such scale.

She says: "Governance in large schemes is becoming increasingly complex, so ensuring proper oversight that doesn't become too demanding would require a lot of work.

"You really need to think about the pressures of what is being inherited from current structures, as well as the burden of reporting and dealing with matters such as diversification in a large scheme."

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Working with what you've got

Some of the complexity around scheme mergers involves existing structures. Of course, in defined benefit (DB) schemes, this raises the inevitable issue of funding and deficits.

Hayles says real consideration would need to be given about the impact of merging well-funded schemes with those in a less favourable funding position.

He says: "You have to make sure you maintain some sort of notional relative funding to make sure a particular local authority or former fund isn't worse off."

But working with what is already in place could turn out to be an advantage. For Linklaters' France, scheme size may become less relevant beyond a certain scale, which the UK has already reached.

She explains: "Once schemes reach a certain size, increasing the value doesn't necessarily appear to change much."

"If you look at £5bn schemes versus £15bn, there is often not much that sets them apart in terms of structure and operation. There are a lot of common features, including creative investment strategies and a strong governance approach.

"It might suggest having a scheme worth a three-figure billion value would not change much at all."

A new philosophy

Hayles agrees that any super fund is likely to learn lessons from the likes of BT Pension Scheme and USS, as well as the largest LGPS funds, in the UK. But of course, there are international schemes that dwarf some of our biggest funds.

Sparks argues that schemes such as the California Public Employees' Retirement System (CalPERS), valued at \$265.1bn (£163.77bn), and the Ontario Teachers' Pension Plan, valued at CA\$129.5 (£76.62bn), operate under "a different philosophy".

He says: "The big US pension funds operate almost as a private equity fund; they invest in a completely different way to your average £100m fund in the UK which invests through a couple of managers. It's a very different setup you'd need to be thinking about."

However, Sparks also raises questions about the impact a fund of that size could have on the market.

Sparks explains there have been examples of diversified asset allocation funds used for pooled investments that have been limited to a value of £10bn in the past, as managers were concerned about the impact of significant assets switching between classes.

While greatly increasing scale could pose challenges for investment, it may also open doors to projects and opportunities currently out of the reach of individual funds, Hayles says. The increased opportunity for infrastructure investment is an obvious example.

Bringing assets of such value together in one fund will also give the scheme a far greater voice as a shareholder, Sparks says, giving real weight to discussions around stewardship and shareholder activism.

Whatever the outcome of DCLG's analysis, it may not just be a bold step for the LGPS, but could radically overhaul the UK pensions landscape as it stands.

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