Written evidence from Unison Capital Stewardship Programme (PPF0060)

Introduction
This submission is made by UNISON’s Capital Stewardship Programme established in 2008. It is a unique function within the British trade union movement; its purpose is to support our trustees and local government pension scheme (LGPS) representatives.

We provide analysis of pension fund performance and support corporate governance activities and initiatives. We have a network of over 300 LGPS representatives and trustees trained and supported on line.

UNISON’s pension department will be supplying a response to the review’s key questions.

Summary of issue and recommendations

- The UK has structural defects in the DB system, far too many investment funds most of which are sub scaled – academic work suggests pension funds start to become efficient at $30bn of assets under management
- Trustees are unable to gain improvements in return that derive from large scaled investment funds
- With one notable exception, Railpen, no UK pension fund understands or can calculate the costs charged throughout the investment chain, this is a shocking state of affairs
- Therefore Trustees are unable to analyse the performance of their investment allocation net of all costs
- Estimates from the Transparency Task Force suggest that hidden costs may be costing pension funds anything between £40bn and £120bn per annum
- Jurisdictions such as the Netherlands regulate for cost transparency and underperforming pension funds are encouraged to merge their assets with other pension funds or seek the management of their assets by larger pension funds
- These two key initiatives to improve pension fund investment performance have been adopted by the government for the 89 funds within the LGPS
- We believe that these solutions offer a sustainable strategy for UK DB funds as well

Background
UK monetary policy has driven down government bond yields, consequently deficits have shot up as estimated rates of investment return use bond yields (interest rates) as one of the factors in this calculation. Yet this interest rate may bear little relation to the income-bearing potential of the assets in which the funds have invested.

Many of the UK’s surviving DB schemes are closed to new entrants, or even accruals, so most of that cash has long been placed in assets whose returns may differ significantly from those of gilts. If these pension funds can deliver returns that are adequate to meet the long-term benefit payments the scheme has entered into, there is no reason why fluctuations in government bond yields should require their immediate attention.

We require a deeper analysis to get past the headline figures that make for the shocking reading and demands for radical closure of the funds, which would leave many members facing pensioner poverty. Much more can be done to prevent this outcome, which effectively places the blame on the backs of the scheme members or the fact that we are all living too long.
**Observations on UK pension funds**

Pension funds throughout the 1980’s and 1990’s received good returns on their investments but these have been in decline throughout the last decade and continue to do so, ultimately reducing the flow of cash to pay pensions.

This can be explained in part by the fluctuations in economic performance or the booms and economic busts that we keep experiencing. But more likely this falling return is due to the extraction of money from pension funds through hidden costs taken by asset managers and others during the investment process.

The UK remains with a pension ‘market’ in which the ‘consumer’ is unable to make an informed choice due to a complete lack of cost and performance data. Trustees are unable to make an effective analysis of their fund’s investment strategy as they cannot measure true performance because there have been no reliable cost collection methodologies available or endorsed by regulators, or they said they are too difficult to collect.

Furthermore, the UK suffers from a disaggregated fund structure with few funds of any significant size. Academic and practical evidence and practical supports the creation of large funds, something the government has recognised and is implementing into the Local Government Pension funds in England and Wales.

Generally larger funds they have lower administration and fund management charges by employing internal fund management staff committed to the broad economic and social ambitions of the fund members.

However, scale and size of pension funds are but one element in a strategy to improve performance. One of the world’s leading experts on governance and pension fund performance, Keith Ambachtsheer, Director, Rotman International Centre for Pension Management, states that funds can improve performance if they meet the following criteria:

1. They align interests with scheme members
2. They have strong governance
3. Sensible investment beliefs – long term patient capital
4. Right-scaled, from $30bn+ of assets under management
5. Competitive compensation for fund staff

In our view one of the most effective models for pension fund performance is the Canadian public pension fund system. Their well-developed governance structure is one of the main reasons the funds are emulated by their peers internationally.

Given the size, reach and influence of the top ten pension funds, their governance model also encourages good corporate governance practices in Canada’s capital markets. They also have sufficient scale on account of their large member base and the fact that members, once enrolled, make regular and automatic contributions to the funds.

This scale allows them to participate in alternative asset classes, including capital intensive assets such as infrastructure. It also allows them to manage their investments internally, thereby lowering their cost structure significantly, and putting them in a stronger negotiating position when setting external investment management fees.

**Costs in the investment chair must be transparent, measurable to assist improvements in investment performance**

The only jurisdiction in the world in which regulators require the collection and publication of asset management fees and transaction costs is the Netherlands. It is worth repeating that
no other pension system in the world can accurately measure the cost of running the pension fund.

Recent work by the Transparency Task Force (TTF) has created a listing of pension fund costs. The template found more than 300 lines of costs and charges on investments and pension schemes, including administration, investment and risk management fees, client communication, legal, governance, regulation, compliance and intermediary fees.

The taskforce has identified six main stages of charges in the template: set-up, contribution, ongoing – steady state, ongoing – changes, withdrawal and wind-up. All the stages except set-up and the ongoing – steady state have transaction costs within them. The research has been carried out for six months by a 39-member 'costs and charges team' at the TTF.

Estimates from the TTF costs and charges team, show UK pension funds could be losing between £40bn and £120bn in hidden costs throughout the investment chain.

The issue of cost control is critical to the future of DB in the UK, reducing costs improves financial performance. The more cash available above what is necessary to pay pensions allows for more investment, growth in the value of assets and increased returns.

Over the last two years Railpen the investment fund for railway workers, undertook a forensic investigation into its private market investment allocation. This revealed a 400% increase in its annual asset management costs from £70m to £290m.

The fund has since begun to claw back some £100m over the next five years, which when compounded into the future will become a £1bn increase in return over 10 years.

**Practical example of scale and cost transparency - Local Government Pension Funds England and Wales**

The future of the LGPS is at the centre of government plans to significantly alter the governance shape of the largest funded public pension system in Europe. With assets nudging the £220bn mark, and 5.1 million members employed by over 11,800 employers, the management of these assets and liabilities remains a huge challenge for the 89 funds in England and Wales.

The government over a period of consultation as accepted the key tenants of the Canadian model of scale and in-house fund management. The criteria set by the government include the following.

- The establishment of Common Investment Vehicles (CIV) rather than merging the assets into actual pension funds
- A minimum of £25bn of assets under management
- Transparent costs – with a backward look at them to 2013
- Active asset management must be no more costly than passive
- More in house management
- Effective governance for the participant funds and scheme members
- Effective capital stewardship
- More infrastructure investing

The implications of change for asset managers may be more drastic. Pooling will overall reduce fees and income. There will be some winners but many losers.
More internal asset management going forward will create stiff competition when tendering mandates. Fee reductions for plain equity indexing may reduce fees to virtually zero via joint procurement.

Alongside this process the Local Government Pension Scheme Advisory Board has negotiated a cost collection template with the Investment Association and will be undertaking a review of investment fees and transaction costs in 2017; the Investment Association has suggested that this should become the default cost collection system for the rest of the pension market.

The data collection spreadsheet is a variant of the model used in the Netherlands by the Central Bank.

**Conclusion**
Setting aside the need to reform pension fund valuation methodologies the UNISON Capital Stewardship programme believes that structural and regulatory reforms could underpin the funds and even allow for their rebirth. We suggest that if the government can undertake the initiative to scale up the LGPS funds and demand cost transparency then the same can be done for DB schemes outside of the LGPS.

One such structure to consider would be Common Investment Vehicles on an industry wide basis. Cost transparency is a matter of urgency for all pension schemes; the DWP/FCA investigation into competition in the fund management sector is making slow progress and is way behind the LGPS solution.

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