

Local government

National report

October 2006

 **audit**  
commission

# Efficiency challenge

Costs of administering local government  
pension funds in London



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# 1

## Introduction

- 1 There is a single pension scheme for local government in England and Wales. The scheme is split into pension funds on a geographical basis which are administered by individual councils known as administering authorities.
- 2 In London, local government pension funds are administered by the 32 individual London boroughs and the City of London. In addition, the London Pensions Fund Authority (LPFA) administers pensions for the former Greater London Council (GLC) and Inner London Education Authority (ILEA), for parts of the Greater London Authority (GLA) family and for a number of smaller bodies.
- 3 The unit costs for pension administration (combining both core administration and fund management costs<sup>1</sup>) are generally higher in London than elsewhere in the country (**Figure 1**). This short study has sought to identify the reasons for the higher costs of pension administration in London, and the options for reducing those costs.
- 4 This report sets out the main findings, highlighting the key cost drivers, potential savings available and the options for change.

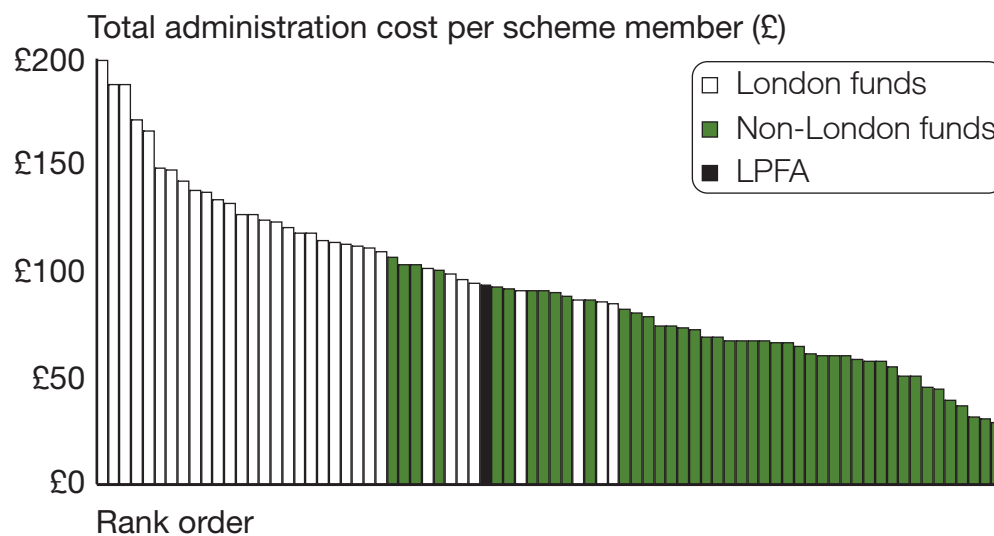
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<sup>1</sup> Fund management costs are principally externally charged fees for investment management advice and monitoring.

**Figure 1**

**Total pension administration costs per scheme member 2003/04**

Unit costs for pension administration are generally higher in London than elsewhere in the country.



**Source:** Audit Commission analysis of Office of the Deputy Prime Minister (ODPM)<sup>I</sup> data for 2003/04<sup>II</sup>

- 5 The funds within the scope of this study are the 33 London borough funds and the LPFA. Other related pension funds in London (including the Metropolitan Police Authority (MPA), Transport for London (TfL) and part of the Firefighters Pension Scheme) were excluded from this study as they are not members of the Local Government Pension Scheme (LGPS) (**Figure 2, overleaf**).

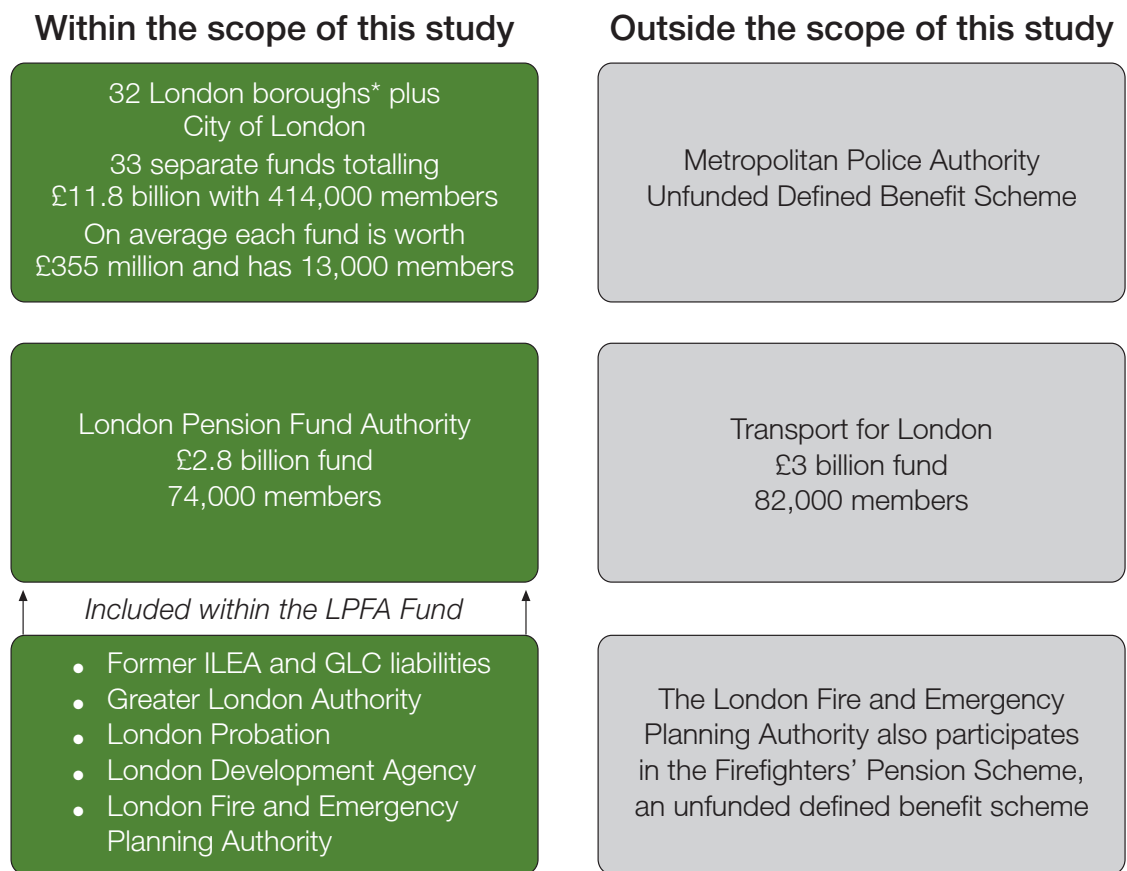
<sup>I</sup> The Office of the Deputy Prime Minister became the Department for Communities and Local Government in the 2006 reshuffle; we have retained the old title in this report for consistency.

<sup>II</sup> These are the most up-to-date data at individual authority level that were available at the time this report was prepared.

**Figure 2**

**Local and regional government pension funds in London**

Some pension funds in London are outside the scope of this study as they are not members of the LGPS.



\* 10 London boroughs have outsourced their pension administration to LPFA or to a private sector company

**Source:** Audit Commission

- 6 The average London borough pension fund has a value of £355 million and has around 13,000 members. This contrasts with the rest of the country where pension funds are much larger. Metropolitan areas such as West Midlands, Merseyside, West Yorkshire and Greater Manchester each have a single pension fund covering several large metropolitan borough employers. The average metropolitan fund has a value of over £4 billion and has around 159,000 members. The average value of a county fund is around £1 billion with around 45,000 members. Even the smallest county fund (Northumberland with 18,000 members) has more members than the largest London borough.
- 7 **Appendix 1** contains detailed information about the size of each of the London boroughs' pension funds.

# 2

## Cost drivers

- 8 Total pension administration costs per scheme member are on average higher in London than elsewhere in England (**Table 1**).

**Table 1**

**Average pension administration costs per scheme member 2003/04**

Total pension administration costs per scheme member are higher on average in London than elsewhere. This holds true for both core administration and fund management costs.

Type of fund	Core administration costs per scheme member	Fund management costs per scheme member	Total administration costs per scheme member
County fund	£22	£46	£68
Metropolitan fund <sup>1</sup>	£17	£27	£44
LPFA	£55	£39	£94
London fund	£47	£79	£126

**Source:** Audit Commission analysis of ODPM data 2003/04

- 9 Total administration costs for London funds are on average 85 per cent higher than county funds and over 200 per cent higher than metropolitan funds.
- 10 The study examined a number of possible drivers of pension administration costs for London pension schemes. These included:
- the 'London effect' (the higher cost of salaries and office accommodation in London);

<sup>1</sup> We have excluded the West Yorkshire pension fund data from the calculation of the average cost for metropolitan funds, because the figures for West Yorkshire are outliers (ie, including them in the calculation would give a misleadingly low impression of the metropolitan funds' average costs).

- the size of scheme; and
- other factors (set out in detail in paragraph 19 overleaf).

## The London effect

- 11 The Lyons Independent Review of Public Sector Relocation looked in detail at cost differentials between London and elsewhere. The review demonstrated that there is a higher cost associated with organisations locating in London. For example:
  - public sector wages are 26 per cent higher in central London than the UK average (**Ref. 1**); and
  - the cost of an average workstation (including rent, rates, hard and soft facilities management, and a management cost) in London in 2002 was £13,000 which was nearly twice as expensive as outside London (**Ref. 2**).
- 12 The London effect accounts for an extra £10 of the average core administration cost per scheme member for a London fund.

## Size of scheme

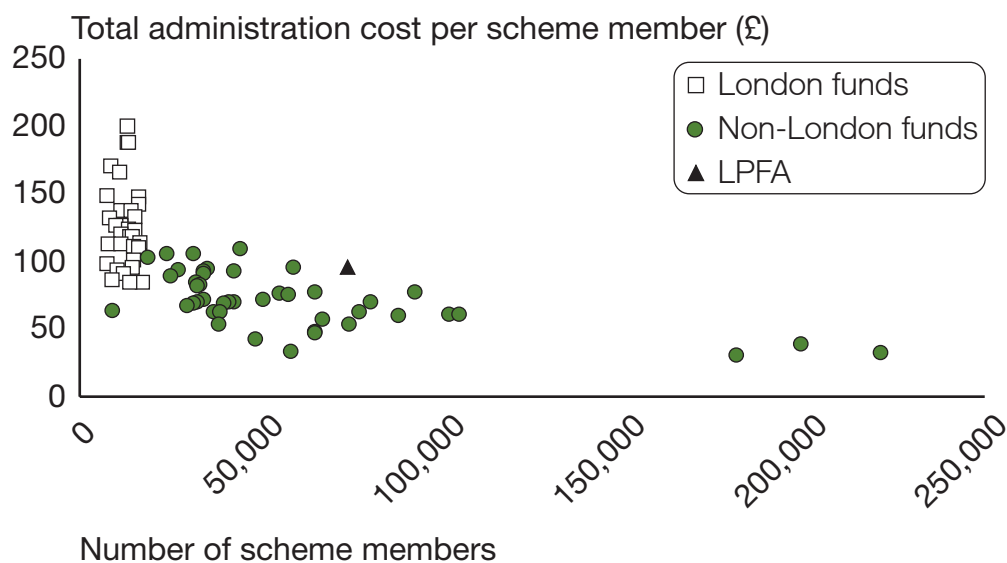
- 13 The effect of the size of scheme on unit costs is even greater than the London effect as a driver of the cost per scheme member.
- 14 We already know that London funds are smaller than non-London funds<sup>1</sup>, and that they have higher administration costs per scheme member. On average, the larger a scheme is, as measured by number of members, the lower the total administration cost per scheme member (**Figure 3, overleaf**). These economies of scale also hold separately for core administration costs and for fund management costs.

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<sup>1</sup> Measured by number of members and value of funds invested.

**Figure 3****Total administration costs per scheme member compared to total scheme members 2003/04**

The larger the scheme the lower the total administration cost per scheme member.



**Source:** Audit Commission analysis of ODPM data 2003/04

- 15 One of the contributors to these economy of scale effects is the existence of fixed costs within core administration costs for pensions. For example, each fund requires a minimum number of staff to run the scheme regardless of the number of scheme members. Based on ODPM data no fund has fewer than three administrative staff. We have estimated that the economy of scale effect adds £20 to the core administration cost per scheme member in London.
- 16 The sorts of costs included in fund management do not, by their nature, vary greatly with the size of the fund: in other words, they contain an element of fixed costs. For example, while the number of fund managers required increases with the size of the fund, it is not directly proportional. A fund ten times bigger than another will not require ten times as many fund managers.

- 17 These fixed costs mean that London boroughs are suffering from diseconomies of scale in fund management as well as in their core administration costs. We have analysed the structure of the charges for investment management in a range of London boroughs, and found that £24 of the unit costs of fund management in London can be directly attributed to diseconomies of scale in investment management fees.
- 18 Due to the fixed cost element in other fund management charges, it is likely that up to £28 of the additional unit costs for fund management in London is also due to diseconomies of scale.

## Other factors

- 19 As part of the study we also tested whether:
  - investment strategies adopted in London are consistently more active than those adopted by schemes outside London (active investment strategies aim to outperform the relevant market index and are therefore more time consuming and result in higher fees than passive strategies, but can produce higher returns);
  - outsourced pensions administration is cheaper than administration retained in-house;
  - London funds have a higher proportion of active members than funds elsewhere, which may cause higher administration costs;
  - London pension funds carry out a significant amount of non-pension activity compared with non-London funds; and
  - London pension funds deliver a higher quality of service than non-London funds, which cause higher costs.
- 20 In order to test these hypotheses we gathered and analysed a range of data, including:
  - comparing the returns achieved by London borough funds with those achieved by other funds in England, to estimate whether London boroughs were employing more active strategies;
  - examining public and private sector data on the costs of outsourcing pension administration;
  - comparing the proportion of active members in London pension funds compared with those in non-London funds;

- reviewing whether London funds charge a greater proportion of non-pension activity to their funds than non-London funds; and
  - examining available data on the quality of service provided by London funds and non-London funds.
- 21 In each case we found no convincing evidence that any of these additional hypotheses explain the higher costs of administration in London.

## Conclusion

- 22 The difference in total administration cost per scheme member between the average for a metropolitan fund at £44 and the average at a London fund at £126 is £82 (Table 1). This cost difference is due to diseconomies of scale and the London effect (**Figure 4**).
- 23 The final section of this report explores options that would enable London funds to take advantage of the economies of scale enjoyed by non-London funds, and to address the London effect.

**Figure 4**

**Pension administration cost difference between London and metropolitan funds 2003/04**

Cost differences between London and metropolitan funds are due to diseconomies of scale and the London effect.

Total administration cost per scheme member in London	Split between core administration and fund management costs in London	Cost differences between London and metropolitan funds
<p style="text-align: center;">£126 Average total administration cost per scheme member</p>	<p style="text-align: center;">£47 Average core administration cost per scheme member</p>	<p style="text-align: center;">£10 The London effect</p>
		<p style="text-align: center;">£20 Additional cost due to smaller size of London fund (diseconomies of scale)</p>
		<p style="text-align: center;">£17 Average core administration cost per scheme member at metropolitan fund</p>
	<p style="text-align: center;">£79 Average fund management cost per scheme member</p>	<p style="text-align: center;">£28 Other diseconomies of scale</p>
		<p style="text-align: center;">£24 Diseconomies of scale – investment management fees</p>
		<p style="text-align: center;">£27 Average fund management cost per scheme member at metropolitan fund</p>

Source: Audit Commission

# 3

## Options for change

- 24 If London boroughs were able to reduce their total administration costs per scheme member to the level of the average county fund it would cost £24 million less every year across the capital. If they were able to reduce costs to the same level as the average metropolitan fund it would cost £34 million less each year.
- 25 Reducing expenditure by £34 million each year would require significant change to take place and would therefore take time. For example, a significant element of the administration cost of pension funds are those costs recharged for the provision of support services (such as payroll or accommodation costs). In the short term the authority would still need to bear these costs, even if they are no longer allocated to the pension fund.
- 26 We have identified a number of options for change available to London funds to take advantage of the economies of scale enjoyed by non-London funds and to address the London effect. Each option has its own set of advantages and disadvantages (**Table 2**).

**Table 2**

### Advantages and disadvantages of options for change

We have identified five options for change, each with its own set of advantages and disadvantages.

	Option	Advantages	Disadvantages
1	Retaining the status quo	<ul style="list-style-type: none"> <li>• established vehicle for administering the local government pension scheme</li> </ul>	<ul style="list-style-type: none"> <li>• high ongoing cost compared with arrangements outside London</li> <li>• potential for savings not exploited</li> <li>• inconsistent with the current environment, in particular the Gershon Review and the efficiency agenda</li> <li>• pensions funds are so small in London that training and development / career development opportunities are limited</li> </ul>

	Option	Advantages	Disadvantages
2	Creating one London-wide pension fund	<ul style="list-style-type: none"> <li>• potential to achieve economies of scale</li> <li>• potential for boroughs to achieve savings</li> <li>• potential to reduce the workload (as members change council within London it would not be necessary for them to leave one fund and join another)</li> <li>• consistent level of service across London</li> <li>• clear separation of activity between pension fund and non-pension fund work</li> <li>• more training and development / career development opportunities for pensions administration staff</li> </ul>	<ul style="list-style-type: none"> <li>• set-up costs of new fund</li> <li>• short-term practical issues in setting up new fund</li> <li>• councils will perceive an increased risk in giving up direct responsibility for managing the performance of their fund, with a possible impact on the level of their council tax</li> </ul>
3	Merging funds to create a smaller number of London pension funds (for example, based on geographical areas, or inner and outer London)	<ul style="list-style-type: none"> <li>• potential achievement of economies of scale</li> <li>• potential for boroughs to achieve savings</li> <li>• potential to reduce the workload (as members change council within London it would not be necessary for them to leave one fund and join another)</li> <li>• more consistent level of service across London</li> </ul>	<ul style="list-style-type: none"> <li>• set-up costs of new fund</li> <li>• short-term practical issues in setting up new fund</li> <li>• councils will perceive an increased risk in giving up direct responsibility for managing the performance of their fund, with a possible impact on the level of their council tax</li> </ul>

	Option	Advantages	Disadvantages
		<ul style="list-style-type: none"> <li>• clear separation of activity between pension fund and non-pension fund work</li> <li>• more training and development / career development opportunities for staff</li> </ul>	
4	Creating a pension authority or authorities for core pensions administration (leaving the responsibility for funding with individual boroughs)	<ul style="list-style-type: none"> <li>• the benefits of economies of scale in core administration</li> <li>• individual boroughs would retain responsibility for investment strategy and funding decisions</li> <li>• there would be a clear separation of pension fund and non-pension fund work</li> <li>• more training and development / career development opportunities for staff</li> </ul>	<ul style="list-style-type: none"> <li>• set-up costs of new pension authority</li> <li>• increased communication and coordination costs</li> <li>• there may be short-term practical issues in transferring roles to the new pension authority</li> </ul>
5	Working collaboratively or in partnership	<ul style="list-style-type: none"> <li>• potential to achieve some economies of scale</li> <li>• sharing of knowledge and experience</li> <li>• potential for more training / career development opportunities for staff</li> </ul>	<ul style="list-style-type: none"> <li>• achievement of economies of scale would be limited</li> <li>• may lead to an inconsistent approach across London with some boroughs choosing to work together and others not</li> </ul>

Source: Audit Commission

- 27 Option 2 (creating one London-wide pension fund) would create a fund of substantial size – it would be of similar value to the British Airways pension fund, and would rank among the largest 15 pension schemes in the country. The impact on the stock market of creating such a large fund is not known, but there is no evidence to suggest that this would have a distorting effect.
- 28 Options 2 and 3 could be combined with a sectional approach to fund management. This would involve the funds for all London boroughs being jointly managed, while still giving each borough the opportunity to have its own investment strategy and funding decisions within the scope of the overall fund.
- 29 Options 2 to 5 could all be combined with relocating the administration function outside London, which would increase the potential for savings to be achieved. The Lyons review reported that organisations moving outside London have recorded annual savings of 20 to 30 per cent, sharp reductions in staff turnover and improvements in service quality and productivity.
- 30 While relocation outside London would be a complex process with many factors to consider including the impact on staff, similar relocations have already taken place for revenues and benefits administration in some London boroughs.
- 31 The Audit Commission recommends that London Councils (the former Association of London Government), with the support of the Department for Communities and Local Government, works with the 33 councils in London to develop further the options we have identified in this report to improve the efficiency of pension fund administration in London.

## References

- 1 National Statistics / University of Warwick Institute for Employment Research.
- 2 *The Total Office Survey 2002*, City University Business School, 2002.

# Appendix 1 – Profile of London borough pension funds

**Table 3**  
**Profile of London borough pension funds**

Authority	Administration	Number of scheme members	Fund market value at end of 2003/04
Barking and Dagenham	In-house	11,103	360,170
Barnet	In-house	17,126	359,404
Bexley	Outsourced – LPFA	9,888	290,375
Brent	Outsourced – LPFA	14,188	344,228
Bromley	Outsourced – Liberata	10,257	226,044
Camden	In-house	16,208	524,695
City of London	In-house	8,510	334,269
Croydon	Outsourced – Liberata	14,514	340,458
Ealing	Outsourced – external company	14,946	373,670
Enfield	In-house	10,878	356,313
Greenwich	In-house	13,691	488,211
Hackney	Outsourced – LPFA	14,883	415,892
Hammersmith and Fulham	Outsourced – LPFA	11,030	317,150
Haringey	In-house	16,117	405,318
Harrow	In-house	11,080	284,628
Havering	In-house	11,763	252,517
Hillingdon	In-house	13,242	392,672
Hounslow	Outsourced – LPFA	14,297	278,109
Islington	In-house	13,976	486,076

Authority	Administration	Number of scheme members	Fund market value at end of 2003/04
Kensington and Chelsea	In-house	7,395	254,474
Kingston upon Thames	In-house	8,578	207,591
Lambeth	In-house	14,857	476,146
Lewisham	In-house	16,493	485,716
Merton	In-house	7,356	190,807
Newham	Outsourced – LPFA	15,779	376,794
Redbridge	In-house	11,101	224,338
Richmond upon Thames	In-house	7,907	216,507
Southwark	In-house	15,947	492,785
Sutton	In-house	7,561	193,724
Tower Hamlets	In-house	12,963	457,660
Waltham Forest	In-house	13,555	318,252
Wandsworth	In-house	13,086	479,666
Westminster	Outsourced – LPFA	13,316	500,411
London borough average	–	12,533	354,699

**Source:** Audit Commission

**Note to the table:** the figures in this table are intended only to provide context for the report as a whole.

Please note that it is not appropriate to divide the market value of the funds by the number of scheme members to derive a ‘fund value per scheme member’. For example, some funds may have a high proportion of members about to retire, and therefore, other things being equal, would need a higher value per fund member than funds that are less mature.

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1st Floor, Millbank Tower,  
Millbank, London SW1P 4HQ  
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