Appendix 1

AVON PENSION FUND COMMITTEE
ANNUAL REPORT TO COUNCIL
(April 2011 - March 2012)

1 BACKGROUND TO THE AVON PENSION FUND

The Avon Pension Fund is a statutory scheme regulated by the Local Government Pension Scheme Regulations 2008 (as amended) and the Local Government Pension Scheme Regulations (Management and Investment of Funds) Regulations 2009 (as amended). Bath & North East Somerset Council ("the Council") administers the Fund on behalf of more than 100 employing bodies including the four unitary authorities. The Fund has c. 85,000 members and the value of the Fund as at 31 March 2012 was £2.7 billion.

The Fund's target asset mix is 60% equities, 20% bonds, 10% property and 10% fund of hedge funds. The Fund's assets are managed by external investment managers.

(a) AVON PENSION FUND COMMITTEE TERMS OF REFERENCE

The Council has delegated responsibility for the Fund to the Avon Pension Fund Committee (APFC) whose terms of reference, as agreed by the Council in May 2012, are set out below:

> "To discharge the responsibilities of Bath and North East Somerset Council in its role as lead authority for the administration of the Avon Pension Fund. These include determination of investment policy objectives, ensuring appropriate investment management arrangements are in place including the appointment of investment managers and monitoring investment performance; commissioning actuarial valuations in accordance with the provisions of the Local Government Pension Scheme Regulations; considering requests from organisations wishing to join the Fund as admitted bodies; making representations to Government as appropriate concerning any proposed changes to the Local Government Pension Scheme; and all aspects of benefit administration. At all times, the committee must discharge its responsibility in the best interest of the Avon Pension Fund."

(b) COMMITTEE MEMBERSHIP

The Committee structure is as follows:

Voting members (12)	5 elected members from B&NES 2 independent trustees 3 elected members nominated from the other West of England unitary councils 1 nominated from the education bodies 1 nominated by the trades unions
Non-voting members (4)	1 nominated from the Parish Councils Up to 3 nominated from different Trades Unions

Committee meetings and workshops:

- The Committee meets quarterly. Attendance at these meetings was 87.5% for the voting members and 50% for the non-voting members
- Ad hoc workshops are arranged as necessary reflecting the Committee's meeting agendas. These workshops are designed to explore specific policy issues in detail. During the last 12 months, two workshops were arranged to review the Interim Actuarial Valuation and another to review the Fund's policy for Socially Responsible Investing.

(c) INVESTMENT PANEL

The Investment Panel is a formal sub-committee of the APFC, established to consider the management and investment of the Fund's assets and to advise APFC on such matters. The Panel's terms of reference which were agreed by the Council in May 2012 are:

The Panel shall:

- recommend strategic investment objectives, policy and strategic asset allocation
- regularly review in detail and assess the performance of the investment managers, investment advisors, custodian and actuary
- recommend appointment and termination of investment managers and professional service providers as required
- review the Statement of Investment Principles and submit to APFC for approval
- make recommendations to the APFC on matters relating to investment strategy and management as the Panel considers appropriate. This will include issues of a more urgent nature, where the view of the Panel would be taken into consideration. (The Section 151 Officer has delegated powers regarding urgent actions, and these would be exercised having consulted the Chair of the Panel)
- review any legislative changes which have implications for investment governance and make recommendations to the APFC as appropriate.

The Panel has no delegated powers and can only make recommendations to the Committee.

The Panel consists of up to 6 voting members from the APFC and meets at least quarterly ahead of Committee meetings.

As there was a new Panel from June 2011 (due to the elections), the Panel met formally 3 times during the year with attendance at 87.5%. In addition one workshop was held as part of the Panel's programme to review the performance of each of the investment managers over a twelve month period. The rest of these reviews were accommodated within the regular meetings.

Committee members also attended the Fund's Annual Employers' Conference which was held in February 2012. This well attended conference provides an opportunity for employers to meet with the Fund officers and committee members to discuss the overall service provided and explore topical issues that affect the employers.

2 TRAINING

The administering authority recognises the importance of training of Committee members given their fiduciary duties. The Fund provides training to committee members to ensure they possess an appropriate level of knowledge, skill and understanding to discharge these duties.

The Fund's approach to training is based on the Myners principles for best practice in decision making in pension funds which highlights the need for administering authorities to ensure:

- that decisions are taken by persons or organisations with the skills, knowledge advice and resources necessary to make them effectively and monitor implementation; and
- those persons or organisations have sufficient expertise to be able to evaluate and challenge the advice they receive, and manage conflicts of interest.

The Fund has in place a training framework which is based on CIPFA's (Chartered Institute of Public Finance and Accounting) Knowledge and Skills Framework for LGPS funds, which identifies six areas of knowledge as follows:

i. Legal and governance context
ii. Pensions Auditing and Accounting Standards
iii. Procurement and Relationship Management
iv. Investment Performance and Risk Management
v. Financial Markets and Product Knowledge
vi. Actuarial Methods, Standards and Practices

Committee training is delivered in a variety of formats, reflecting the strategic importance of the subject matter to the Committee's agenda and the differing level of knowledge and understanding across the Committee. Many of the areas identified by the framework are covered through detailed committee reports and workshops where the topic is explored greater in detail.

In addition, Committee members are encouraged to attend seminars and conferences which broaden their understanding of investments and topics of relevance to the LGPS.

As there were a number of new Committee members appointed after the local elections in May 2011, two Induction Sessions for new members, tailored to Committee's agenda, were delivered by officers. The topics covered included governance, administration strategy, investment strategy, fund solvency and risk management. During the year new committee members also attended the Fundamentals Training Courses offered by the Local Government Pension Committee.

3 REVIEW OF THE YEAR

a) INVESTMENT PERFORMANCE

The Fund generated an investment return of 3.6% during the year to 31 March which was 1% ahead of the average local authority fund return of 2.6%. Over the last three years the Fund's return was 14.5% p.a. which is in line with the average local authority fund return.

The 2010/11 investment return was driven by the 15.4% increase in the value of the bond portfolio due to the 'flight to safety' within the bond market as investors sought the relative safety of UK government bonds. Equities in contrast generated a small negative return overall (-0.4%) which detracted from the overall return given that 60% of the Fund's assets are invested in equities compared to just 20% invested in bonds.

Rolling forward to 30 June 2012, the Fund's 12 month return was 0.2% versus the average local authority fund return of -0.9% with equities still generating negative returns detracting from the positive returns from the bond portfolio.

b) FUNDING LEVEL

As at 31 March 2012 the Actuary has estimated that the funding level has fallen to 70% from 83% a year earlier *(at 30 June 2012 the estimated funding level was practically unchanged at 69%)*. This compares to 82% funding level at the 2010 valuation. This fall in the funding level is due almost exclusively to the increase in liabilities; the investment return is only marginally below expected returns over the period since the last valuation. The value of the future pension liabilities is calculated using a discount rate based on UK gilt yields. As gilt yields fall, the value of these liabilities rises. Unfortunately, gilt yields in the UK are currently near historic lows. These low yields are a result of investors seeking relative safety in non-euro denominated bonds, such as UK gilts as the Eurozone sovereign debt crisis has escalated. In addition, the Bank of England's policy to support the economy through its "quantitative easing" programme, in which the Bank purchases gilts from banks, has also kept yields low.

The next triennial valuation is due in March 2013 which will set the employer contribution rates for the following three years (April 2014 to March 2017). It is important to note that unlike most other public sector pension schemes, the Avon Pension Fund is a funded scheme and has a finding strategy in place to achieve full funding over a number of years.

c) POTENTIAL CHANGES TO THE LGPS

In line with other public sector pension funds, negotiations have been ongoing during the year to introduce a new scheme that will be more affordable and sustainable for the long term. The new scheme for the LGPS is expected to be introduced from 2014 and any changes to the benefits structure will be reflected in the 2013 triennial valuation.

d) PENSIONS ADMINISTRATION

(i) Budget

During the Year to 31 March 2012, total costs were £85,000 under the budget of £11.3 million. However, excluding Investment Management, custody fees and governance costs, administration costs were £201,000 under the budget of £2.1million, a saving of 9.6%. Savings were made across all budgets.

Spending on Investment Management and custody fees was £267,000 over budget. This was the result of higher than budgeted fees for the new dynamic currency hedging mandate that commenced during the year. The investment management fees of £8.8 million equate to 0.32% of the Fund's assets.

(ii) CIPFA Benchmarking (Benefits Administration)

The Fund participates in the annual Pensions Administration CIPFA Benchmarking exercise where its performance and running costs are compared against its peers and against the "average fund "

Overall costs at £17.58pa per member were less than the average of £18.47. Staffing costs were significantly less at £5.28 against £8.74 due to partly to lower payroll costs; this was balanced by accommodation costs which were higher than the average.

Communication costs also contributed at £3.17per member compared to the average of £0.88. Although significantly higher, the Committee is content to be overweight in this area as it strongly believes in the importance of providing members with top quality information and this is done by newsletters to both active and pensioner members, a high quality website which allows member web browser access to their personal pension data and provides simple calculation facilities reducing the number of requests to the Fund's Benefits Staff. Savings were made in the year by some employers sending the active newsletter electronically. This trend is set to continue.

Any significant results are brought to the attention of the Committee.

(iii) New Pensions Administration Strategy

The New Pensions Administration Strategy came into effect in April 2011 following consultation with participating employers in the Fund and approval by the Avon Pensions Fund Committee in December 2010. The purpose of the Strategy is to assist in helping employers and the Fund work more closely together to provide an ever improving level of service to Fund members.

Performance of both parties are now being closely monitored and reported on in Quarterly Performance Reports to larger employers, followed up by review meetings with larger employers. During the year meetings were held with four unitary authorities and problem areas discussed and resolved. The new Strategy has put into place a transparent and robust framework which makes both parties far more accountable and should result in improved performance. Although it is relatively early days, relationships with larger employers have been noticeably improved with the closer working together.

Following a study of a training *gap analysis* questionnaire sent to all employers, training sessions for employers' hands-on staff are being arranged for late 2012.

The Strategy is due for review in April 2013.

4 COMMITTEE BUSINESS TO MARCH 2012

a) Investment Strategy

During the year a number of strategic decisions were implemented as follows:

- Hedge Fund portfolios – following a workshop held in March 2011 it was agreed to maintain the strategic allocation to hedge funds but to adjust the allocation between the existing managers. This was implemented in July 2011.
- A manager was appointed to manage a programme to hedge the US dollar, Euro and Yen exposure arising from the Fund's investments in overseas equities. This programme will protect the Fund's value from

adverse movements in sterling (when sterling strengthens the Fund needs to be hedged) but allow the Fund to benefit from favourable movements in these exchange rates (when sterling weakens).

In 2011/12 the Committee began a review of the Fund's Responsible Investing Policy in order to ensure the Fund's policy reflected best practice across the whole Fund, subject to the constraints imposed by the current investment structure. The review will be completed in 2012.

b) Funding Strategy and Admitted Bodies

During the year an interim valuation was commissioned to up-date the Committee on the funding position. As at 31 March 2011 the funding level was 83% which was largely unchanged from the 2010 valuation level of 82%. However, turmoil in the Eurozone had led to a significant deterioration in the funding position which had fallen to 70% by 31 March 2012.

Given the tighter funding environment for public sector service providers, the Committee received a report during the year monitoring the financial position of the community admission bodies (CAB) within the Fund. Since 2005 CABs are only allowed to join the Fund if they have a guarantee. For those admitted prior to this date, the Fund seeks to obtain greater security for the liabilities where possible. There are 22 CABs in the Fund and at the 2010 valuation they accounted for 4.1% (£23 million) of the overall deficit.

c) Approval of the 3-year Service Plan and Budget 2012/15

The Service Plan details the new development proposals that are planned to be undertaken during the next three financial years (2012/2015). The new plan is designed to respond to known and anticipated legislative changes and Committee initiatives as well as to take the Pensions Service forward by improving performance and the overall quality of service to members and employers.

Given that the "new Scheme" will be introduced in 2012/13 with an expected implementation date of April 2014, much of the plan's focus is on the roll out of the new scheme, especially the Fund's communications, IT and training strategy. The Fund will need to inform Scheme members of the changes to their benefits and explain to employers the financial implications of any changes and also any changes in data the Fund requires from payroll systems. In addition, the Investment and Finance Team is being strengthened to manage more effectively the increased volume of investment and actuarial work.

The 2012/13 administration budget increased by £70,000 reflecting the need for extra resources to meet the increase in administrative pressures on the Fund. Savings of £66,000 were also identified across the service mainly through identifying better ways of delivering the service through greater use of electronic systems.

d) Treasury Management Policy

The Fund's Treasury Management Policy sets out how the Fund's cash is invested to meet its day –to –day requirements. The cash managed under this policy at any time is c. £25 million, which represents less than 1% of the Fund's value.

The management of this cash is delegated to the Council's Treasury Management Team. However, the Fund's cash is invested separately to the Council's and the Fund has a bespoke Treasury Management Policy. It should be noted that the Fund and Council have separate bank accounts since April 2009.

Following significant downgrades of credit ratings of the UK banks it became increasingly difficult to invest in line with the policy. In March 2012 the Committee approved a revised policy that provides flexibility to ensure efficient management and investment of the short term cash.

In addition, the Committee were advised that the Fund's cashflow profile is "maturing" more rapidly than previously anticipated (the monthly payment of pension payments is forecast to exceed the monthly receipt of pension contributions). This is due to the number of active members declining due to redundancies and the fact that pensions are indexed to inflation whereas salaries have been frozen.

e) Administration

In accordance with the new Pensions Administration Strategy, the Committee reviewed 2 quarterly Summary Monitoring Reports of the Fund's and employers' performance. The Committee will use its influence where appropriate to assist Officers with poor performing employers. This was not felt necessary for these reports.

f) Workplans

Separate workplans are prepared for the Committee and Investment Panel detailing the forthcoming areas of work relating to investments strategy and policy and Benefits administration to give the Committee and officers the opportunity to review the and accommodate issues that may arise.

5 FUTURE BUSINESS

The Committee's (and Investment Panel's) focus over the next twelve months will be as follows:

a) Investments

- Complete the review of the Fund's policy towards Socially Responsible Investing
- Strategic Investment Review – review the current invest strategy given funding pressures, maturing cashflow profile, macro-economic environment
- Review Cash Management Policy to meet monthly pension payments

b) 2013 Valuation

- Arrange workshop to assess impact of new scheme changes and investment markets on the 2013 valuation

c) Benefits Administration

- Respond to the consultation exercise on the new LGPS Scheme and monitor the project to implement the new scheme coming in from April 2014 and the campaign to explain the changes and their significance to members and employers to minimise the number of members who might opt out.
- Review the AVC Strategy on the number and types of funds to be offered to members to assist them in saving towards retirement.

- Decide in December 2012 whether the Summary Reports of employer and Fund administration performance which are currently taken in Exempt Session should hence be taken in Open Session.
- Approve any changes as a result of the Review of the Pensions Administration Strategy due in April 2013.

d) Auto Enrolment (of all employers eligible staff into an appropriate pension arrangement –a legal requirement form October 2012)

Although not the legal responsibility of the Avon Pension Fund, the Committee is keen to ensure that a workable process is put in place to auto-enrol eligible staff (and re-enrol opt outs at 3-year intervals) of participating employers. Focus groups will be established between the Officers and employers to try to ensure a standard approach is adopted by employers that will minimise the administration work of the Fund. In June 2013 the Fund's actuary is running an information session for all Fund employers. Reports of progress will be given to Committee in the run up to the first employer staging date of March 2013.

Avon Pension Fund

June 2012