MERCER

AVON PENSION FUND

BRIEFING NOTE TO SUPPORT ADJUSTMENT TO THE TERMINATION POLICY PROCESS

Introduction

1. This briefing note has been produced at the request of the Administering Authority of the Avon Pension Fund ("the Fund"). This briefing note is intended to clarify and support the Fund's policy, as set out in the Appendix to the Funding Strategy Statement ("the FSS"), applicable in the event of an employer terminating its participation within the Fund. In time the FSS will be updated but we do not feel a formal update or consultation with employers is necessary at this stage as it relates to a change in operational process and an update of the actuarial advice.

2. This clarification note has become necessary as a result of a change in the LGPS Regulations governing the options and treatment available to Administering Authorities either at termination, or prior to an expected termination at some point in the future.

3. The Regulations have been amended such that termination assessments are now automatically triggered for any employer in the Fund when the last active member leaves service (i.e. the employer becomes an "exiting employer"). The amended Regulations now provide a power for the Administering Authority to use its discretion to agree an instalment plan to recover any outstanding debt over a pre-determined period. Separate legal opinion obtained by the Administering Authority has concluded that any instalment plan entered into would be a non-reviewable payment plan once certified by the Fund Actuary and this is the Fund Actuary's view also.

4. The termination policy including the aspects outlined in this note, along with all other Fund policies will continue to be monitored for appropriateness. The FSS will also be formally reviewed next in 2015 in conjunction with the interim valuation.

Existing Policy

5. When an employer leaves the Fund, there is no further recourse to that body if the accumulated assets notionally allocated to that body prove to be inadequate in meeting future benefit payments. As the body supporting these liabilities will have no ongoing responsibility in respect of these liabilities once they have left the Fund, the residual liabilities will then become the responsibility of any existing guarantor in the Fund or by the Fund as a whole (i.e. all participating employers), in which case they become known as "orphan liabilities". The

orphan liabilities at the 2013 valuation were 1.8% of the total liabilities so relatively small and given the ongoing nature of the Fund they are never likely to become too significant.

6. Therefore, unless any deficit is subsumed by the guarantor within the Fund, an exit contribution payment will be requested from the outgoing employer. As set out in the FSS, the deficit will be assessed using market conditions as at the exit date i.e. based on the market yields at that point and assessed market value of the assets relating to that employer. Given that the assessment uses corporate bond yields as a basis for determining the termination deficit (unless another employer in the Fund assumes responsibility for the liabilities), this provides a contingency margin against adverse changes in market conditions. It could be possible to introduce further margins for the financial assumptions but we do not feel that this is appropriate at the current time given the relative size of the liabilities. I also feel that using this approach is fair and equitable in the long term given that if the orphan liabilities became a more significant proportion of the Fund it is highly likely a bespoke investment strategy would be implemented which would involve a significant proportion of corporate bonds and other instruments to provide a cashflow matching profile which runs off these liabilities. This would more than support the current approach in terms of the financial assumptions.

Margin for adverse demographic risk factors

7. Given that certain employers (some of which are quite large) are potentially seeking to exit the Fund due to their own financial circumstances, we have advised Fund Officers that there is justification for introducing a further adjustment when assessing final termination contributions. This is to further protect the other participating employers in the Fund against the risk of adverse future demographic experience especially in relation to improving life expectancy as this is not easily matched by any investment strategy excluding insurance via a “buy-in” or a longevity swap – both of which would likely not be an option given the relatively small scale of liabilities being covered. The existing approach does mitigate the financial risks in relation to market factors by introducing prudence in the assumptions and is supportable for the reasons given above. However, it does not incorporate any *further* prudential margin relative to the ongoing valuation funding assumptions in order to reduce the risk of future adverse demographic experience. For example, this could include further increases in life expectancies and/or the impact of potential future ill-health retirements, although the likelihood is that potential increases in longevity will pose the greatest risk.

8. We therefore recommend that in order to build in a sufficient margin for adverse demographic experience, modified longevity assumptions should be used when assessing the liabilities as described in paragraph 6. We have advised the Fund Officers that with immediate effect, a higher improvement rate in life expectancies than that incorporated in the 2013 valuation funding assumptions should be adopted for assessing the exit payment due when an employer terminates participation.

9. The actuarial assumptions adopted at the most recent triennial valuation are based on industry-wide standard tables published by The Continuous Mortality Investigation (CMI), and are then adjusted to reflect the actual experience of the Fund membership. These assumptions also build in an allowance for longevity ‘improvement’ year-on-year in line with the CMI projections subject to a long-term trend of 1.5% per annum. We have advised the Fund Officers that increasing the improvement allowance to a long-term trend of 2.0% per

annum is reasonable and proportionate at this stage. However, the precise application of this may be refined further (e.g. for larger cases), having regard to advice provided by the Fund Actuary on a case by case basis.

Operational changes & flexible recovery plans

10. As stated in paragraph 3, the amended Regulations now enable the Administering Authority to agree to an instalment plan at its own discretion, in advance of an employer's exit, to recover any outstanding debt over a pre-determined period.

11. The Administering Authority's default position is for the exit payment to be paid immediately; however it is appreciated that this is not always possible on the grounds of affordability and it may be in the interests of the Fund to agree an instalment plan to maximise the monies recovered where the employer has little resources available. Therefore, the Administering Authority will monitor and engage with all the relevant employers as they naturally approach the end of their participation, or because of some other reason (e.g. a small number of active members, insecure funding streams etc.).

12. The Administering Authority may therefore use its discretion, in conjunction with advice received from the Fund Actuary, in managing debt repayment plans for employers approaching their exit from the Fund. This will be driven by each employer's own affordability constraints and this will be balanced against the overall covenant strength/future business plans and funding streams.

13. Legal opinion obtained by the Administering Authority has confirmed that any instalment plan entered into would be a fixed, non-reviewable one. Therefore, the Fund Actuary will construct the final certification such that it affords the flexibility to the Fund Officers to adjust the fixed plan over the agreed recovery period to recover monies due in an efficient and effective manner. In addition the Administering Authority reserves the right to enter into a separate agreement on a case by case basis in order to formalise any pledges and undertakings made by the employer to support the required termination funding plan.

Mercer Limited
September 2014