

AVON PENSION FUND COMMITTEE ANNUAL REPORT TO COUNCIL (April 2016 - March 2017)

1 BACKGROUND TO THE AVON PENSION FUND

The Avon Pension Fund is a statutory scheme regulated by the Local Government Pension Scheme Regulations 2014 (as amended) and the Local Government Pension Scheme Regulations (Management and Investment of Funds) Regulations 2016 (as amended). Bath & North East Somerset Council (“the Council”) administers the Fund on behalf of approximately 300 employing bodies including the four unitary authorities (of which c. 180 are academies). The Fund has approximately 107,000 members and the value of the Fund as at 31 March 2017 was £4.4 billion. In 2016/17 the Fund received £146m in pension contributions and paid out £164m in pension payments and transfers.

The Local Government Pension Scheme is going through a period of rapid and challenging change. The pressure on administrators has increased exponentially with the accelerated growth in scheme employers and membership. Benefit calculations have to be made separately to reflect different periods of service accrual and a further layer of complexity has been introduced with the advent of the career average revalued earnings structure requiring all member data to be captured accurately on an annual basis.

2 GOVERNANCE

The scheme is heavily regulated and now overseen by the Pensions Regulator. Other bodies and agencies undertake key roles, particularly the LGPS Advisory Board, the Department for Communities and Local Government, and CIPFA, which sets the accounting standards

The Council has delegated responsibility for the Fund to the Avon Pension Fund Committee (the “Committee”) which is the formal decision-making body for the Fund. The Committee’s role is strategic in nature, setting policy framework and monitoring implementation and compliance within that framework. Due to the wide scope of the Committee’s remit it is supported by the Investment Panel (the “Panel”) which considers the investment strategy and investment performance in greater depth. The Committee has delegated authority to the Panel for specific investment decisions. The Terms of Reference, agreed by the Council, for the Committee and Panel are set out in Appendix A to this report.

The Pensions Committee and administering authority are scrutinised by the Local Pension Board ensuring that the governance surrounding the scheme is remains robust and fit for purpose.

Committee Membership

The Committee structure is as follows:

Voting members (12)	5 elected members from B&NES (subject to the rules of political proportionality of the Council) 2 independent trustees 1 elected member nominated from each of the other 3 West of
---------------------	--

	England unitary councils 1 nominated from the Higher and Further 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

The Committee meets quarterly. In 2016-17 two extra committee meetings were held. An informal pooling update followed by a formal approval on the joint submission from the Brunel Pension Partnership (BPP) and a meeting to formalise and approve the Responsible Investment Policy (R.I.). Attendance at these meetings was 93% for the voting members and 72% for the non-voting members.

Ad hoc workshops are arranged as necessary reflecting the Committee's meeting agendas. During the last twelve months four workshops were arranged covering:

- Two updates on pooling of the investment assets
- Two reviewing the Responsible Investing Policy

Investment Panel

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

The Panel met formally four times during the year with attendance at 96%.

3 TRAINING

The Fund provides training to committee members to ensure they possess an appropriate level of knowledge, skill and understanding to discharge their fiduciary duties. The administering authority must 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. Much of the training is delivered through detailed Committee and Panel reports and workshops where the topic is explored greater in detail.

In addition, members attended a number of seminars and conferences which broaden their understanding of investments and topics of relevance to the LGPS.

4 REVIEW OF THE YEAR

a) INVESTMENTS

- The Fund's assets increased by £618m to £4,355m at 31 March 2017. The Fund generated an investment return of 17.2% during the year, with a return of 9.2% p.a. over the last three years.
- The investment return was primarily driven by the significant rise in equity markets which account for 50% of the fund assets and further falls in UK government and corporate bond yields following the EU referendum, although all the assets in the portfolio contributed positively. The depreciation of sterling meant that the impact of hedging the foreign currency exposure within the portfolio detracted from the overall return. Excluding the foreign currency hedge the returns were 20.2% over one year and 10.8% per annum over three years.
- During the year the investment in infrastructure was implemented, funded by a reduction in the equity allocation. A review of the currency hedging strategy concluded that the strategic decision to hedge foreign currency exposure to protect the value of the assets in sterling terms should be maintained. The Responsible Investing Policy was reviewed and further developed especially with regard to risks arising from climate change. Lastly, significant work was undertaken to put in place a framework to manage the liability risks more effectively within the investment portfolio to provide greater protection against changes in the values of the liabilities. The development of the liability risk management framework is a large piece of work and marks an important development in the Fund's investment strategy.

b) POOLING OF ASSETS

- Since 2015 when the government announced that the assets of the LGPS funds should be pooled to reduce costs and increase the capacity across the LGPS to invest in infrastructure, the Fund has been participating in the Brunel Pension Partnership (BPP), a collaboration of 10 LGPS funds.
- Initial proposals were submitted to government in February 2016, with a more detailed proposal submitted in July 2016. The partnership developed a full business case which was approved by all 10 authorities early in 2017. This milestone enabled work to start on setting up the FCA (Financial Conduct Authority) company that will manage the assets on behalf of the funds in the partnership.
- Under these new arrangements, the Avon Pension Fund will retain responsibility for setting its investment strategy (or asset allocation), as well as the funding and administration strategies. The FCA company will implement the investment strategy for each fund within the pool; it will be responsible for appointing and monitoring the investment managers. The FCA company BPP Ltd, was established on 18 July 2017 and it is expected to be operating as an FCA authorised company by 1 April 2018.

- The governance arrangements for the pool are in place. The Committee member will represent the Fund on the Oversight Board. The Investments Manager will represent the Fund on the Client Group.
- Officers and appropriate members of the Committee have dedicated significant time and effort in supporting the development of BPP and the necessary governance and oversight bodies required to represent client interests.

c) FUNDING LEVEL

- The funding level at 31 March 2017 is estimated to have risen to 95% (from 86% a year earlier) and the deficit to have narrowed to £230m million from £618m a year earlier. This improvement reflects the significant increase in asset values over the period. The Fund will review its investment strategy during 2017/18 which will take account of the improvement in the funding position.
- Each valuation the increase in and diversity of the employer base increases the complexity of the valuation process. The 2016 valuation, completed during the year, was no exception and entailed significant resource in agreeing and applying the funding strategy to individual employers. Fortunately, the increases in contribution rates were lower than anticipated; however, employers face significant financial pressures and taking affordability in to account was a key element of the funding strategy. The 2016 valuation sets the contribution rates for employers from 1 April 2017 to 31 March 2020.

d) PENSIONS ADMINISTRATION

(i) Budget

- During the year to 31 March 2017, total administration costs (excluding governance and investment management costs) were £1.8 million, a saving of £0.2m (12%) on the budget.
- Total costs including Investment Management, custody and governance costs, but excluding transaction costs deducted at source and performance fees that are not yet due for payment, were £20.6 million, £0.4 million below budget. Investment management fees were slightly higher than expected (£0.1m) due to the rise in asset values during the year. Governance costs were slightly lower than expected (£0.3m) due to lower than anticipated expenditure on consultants.
- The investment management and custody fees of £19.6 million equates to 0.45% of the Fund's assets.

(ii) Chartered Institute of Public Finance & Accountancy (CIPFA) Benchmarking (Benefits Administration)

- The Fund participates in the annual CIPFA Pensions Administration Benchmarking Club. This compares administration costs and performance indicators against other participating LGPS funds and against a group of funds of similar size. The results are used to identify areas for improvement in the Service Plan, to understand the specific service pressures that the

Fund faces and to help the Fund operate as efficiently and effectively as possible. In addition it provides an indication of relative operational costs.

- The latest available report for 2015/16 identifies the cost per member for the Fund as £15.79 compared with £16.55 in 2014/15. This is significantly less than the cost for the average fund which is £18.58 per member. The Fund's own performance targets are set out in the SLAs it has in place with employers, covering over 80% of the active membership. In many cases these targets are more challenging than the industry standard. Regular SLA review meetings are held with these employers to review each party's performance. The Fund also publishes a Customer Charter on its website. This includes its targets (in working days) for completion of processing of member benefits.

(iii) Pensions Administration Strategy

- The Administration Strategy sets out how the administering authority and scheme employers will work together to provide an improving quality level of service to Fund members.
- The strategy ensures the Fund can continue to deliver a high quality pension service at a time when the operating environment is becoming more complex: the employer base has fragmented, especially with the creation of academies, furthermore the increase in the number of third party HR and payroll providers (favoured by a number of local education authority (LEA) schools) has added a further layer to the process and provision of data. The tables overleaf show how the Fund's employer and membership base has changed over time.
- The Fund revised its Administration Strategy in 2015 to include a more detailed ICT Strategy and also to ensure the governance and administration requirements of the Pension Regulator are properly addressed as they fall to the Fund and employers. The Administration Strategy will be further reviewed in 2017/18 to ensure it remains focussed on the Funds key objectives and challenges ahead.

5 COMMITTEE ACTIVITY TO MARCH 2017

a) Investment Strategy

In March 2017 the Fund published its first Investment Strategy Statement (ISS), which replaced the Statement of Investment Principles. The LGPS (Management and Investment Funds) Regulations 2016 require funds to produce an ISS which sets out the principles that guide the decision making for investing the Fund's assets. It also sets out the framework for investing the Fund's assets to ensure consistency with the Funding Strategy Statement. A wide range of investments are permitted to ensure the Fund achieves an optimal risk/return profile and that assets are sufficiently diversified. The LGPS regulations no longer list restrictions in particular types of investments but instead seek to transfer decisions and their considerations more fully to the Fund within a new prudential framework.

The ISS replaces the Statement of Investment Principles and sets out the Fund's core beliefs that underpin the investment strategy, the process for ensuring the

suitability of investments and the key risks the Fund is exposed to, and how these risks are managed.

Key elements include:

- Investment objective
- Management of the main sources of risk
- Responsible Investing: environmental, social and environmental (ESG) considerations
- Exercise of voting rights
- The Fund's approach to pooling its assets with other funds (Brunel Pension Partnership)
- Compliance with the Investment Governance Principles

During the year the Fund reviewed specific aspects of its investment strategy, namely the currency hedging policy, liability risk management and the Responsible Investing policy.

- **Currency Hedging Policy:**

The passive currency hedging strategy was reviewed following the sharp devaluation of sterling following the result of the EU referendum. It was concluded that the rationale for putting the currency hedge in place remained valid and that the Fund should continue to protect the value of the assets in sterling terms. The suitability of the Fund's currency hedging programme will be reassessed as part of the triennial investment strategy review in July 2017.

- **Liability risk management Policy:**

The Fund invests in assets such as fixed interest bonds to provide some matching to the value of the liabilities, in order to reduce the volatility in the funding position. To improve the effectiveness of the "matching" assets the Committee agreed that a liability risk management framework should be implemented. The framework should increase the certainty of the Fund's assets achieving the cash flows required to meet the pension payments as they fall due.

The initial step was to switch the fixed interest gilts into index-linked gilts. The next phase being implemented in 2017/18 is to include synthetic instruments designed to more closely match the Fund's inflation linked cash flows and increase the certainty of asset returns in line with the assumed strategic return. Significant time and resource was required to design, develop and set-up the framework, and the future implementation of the framework will form a large part of the workplan of Committee, Panel and Officers going forwards.

- **Responsible Investing Policy**

This policy was reviewed with a focus on the risks to the portfolio from climate change and investing in sustainable equities and infrastructure. The revised policy was published in 4Q16.

The Fund has continued to support the Local Authority Pension Fund Forum (LAPFF) as part of its Responsible Investing Policy, with members and officers attending quarterly meetings. LAPFF act on behalf of local authority funds to promote best practice in governance in investee companies either on its own or in collaboration with other organisations with similar objectives.

b) Funding Strategy

Following the 2016 valuation the Fund implemented a captive ill health insurance scheme within the und to assist the smaller/medium sized employers to manage the cost of early retirements due to ill health. The scheme is designed to be cost neutral over time and will be reviewed at each triennial valuation.

c) Approval of the 3-year Service Plan and Budget 2017/20

The forward looking three year Service Plan 2017/20 sets out the key service objectives and milestones. It also reviews the achievement against the previous year's plan. The main focus of the plan is:

- To fully engage in the development and implementation of pooled funds in the interest of the Avon Pension Fund; ensure local governance arrangements are in place to accommodate pooling
- To continue implementation of the IT strategy to achieve a digital step change in service delivery and to mitigate service demand growth.
- Undertake a review of investment strategy to ensure it is consistent with updated cash flows post the valuation and investment returns expectations.
- To continue to support the requirements of the Local Pension Board.

The later years will focus on consolidation, realising efficiencies and embedding partnership working with stakeholders.

The budget approved for Administration in 2017/18 is £2.706m.

The increased expenditure budgeted for 2017/18 reflects the Funds response to the increasing pressure of dealing with the continued growth in the number of employers and the importance of maintaining accurate and up to date data. Savings have been made through changes in working arrangements and the adoption of digital technology to promote efficiency while maintaining the level of service. Ongoing savings made in 2015/16 continue to be invested in the IT Strategy that will realise further savings and or mitigate cost pressures in future years. Wherever possible the effect of inflation has been absorbed.

d) The Pension Regulator – Code of Practice 14

- The Pension Regulator's (TPR) Code of Practice 14 and the Public Service Pensions (Record Keeping & Miscellaneous Amendments) Regulations 2014 set out the requirements for public sector pension funds to maintain comprehensive and accurate data on their members and their member's pension contributions.
- The Fund has undertaken a detailed review of its core data and processes and assessed its level of compliance with regulation requirements in respect of:
 - Scheme record keeping
 - Maintaining contributions
 - Providing information to members

- The regulations require 100% completeness of data across a number of core areas. In 2015, the Fund tested 102,000 membership records through a series of analytical reports and measured the overall level of completeness of data accuracy at 92%. A data improvement plan was produced to address the issues identified over a two year period. Accordingly, the data improvement plan will be further reviewed and updated in 2017/18 following the Local Pension Boards next annual review of compliance.
- To ensure continued compliance the Fund has also undertaken to review its existing procedures relating to the monitoring of late payment of monthly contributions from employers and its Internal Dispute Resolution Procedure (IDRP).
- Detailed reports on compliance and the data improvement plan are presented to both Pensions Committee and Local Pensions Board on a quarterly basis.

e) Treasury Management Policy and Cash Management Policy

- The Committee approves the Fund's Treasury Management Policy annually. The 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 (via separate bank account) to the Council's and the Fund has a bespoke Treasury Management Policy.

f) Administration

- During the year the fund undertook a restructure of its Administration function to create specific member and employer focussed services. The key drivers for change being:
 - Continued growth in employer base
 - Compliance with the Pension Regulators Code of Practice no. 14 and associated record keeping requirements.
 - Compliance with increased scrutiny from Scheme Advisory Board and Local Pension Board.
- The Pensions Committee in recognising these challenges agreed a package of investment in the service to strengthen resources, enhance employer services and create new and enhanced roles.
- The restructure and its success will shape the future of the Avon Pension Fund administration and ensure it can deal adequately with significant challenges of its expanding employer portfolio whilst ensuring compliance with the requirements of the Pensions Regulator and Scheme Advisory Board.

g) Workplans

- Separate workplans are prepared for the Committee and Panel detailing the forthcoming areas of work relating to the investment and funding strategies

and to the administration of benefits to give the Committee and officers the opportunity to review the workload and accommodate issues that may arise.

6 FUTURE ACTIVITY

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

a) Investments

- Conclude on the options to more effectively manage the liabilities through hedging the interest rate and risks and implement.
- Review the investment strategy following the 2016 valuation with particular focus on meeting updated cash flow requirements and implementing decisions arising from the review of the Responsible Investing Policy.
- Pooling of assets – agree the allocation of assets to the portfolios set up by BPP and monitor the transition of assets.

The work required to progress the implementation of a revised investment strategy and the implementation of asset pooling is significant and the increase in the workload required of officers is considerable.

b) Funding Strategy

- Explore investment options for improved matching of liabilities funded on the corporate bond basis.

c) Benefits Administration

- Continue to ensure maintained compliance with stringent requirements of The Pensions Regulator (TPR).
- Review the AVC Strategy on the number and types of funds to be offered to members to assist them in saving towards retirement.

d) Governance of the LGPS

- Work closely with the (Shadow) Oversight Board of Brunel Pension Partnership to establish the FCA company and monitor the preparation to transfer assets to the company.
- Understand the significance and impact of the pooling proposals on the Avon Pension Fund own internal governance arrangements and put forward recommendations to Council as required.
- Engage with and respond to government consultations or consultations from the LGPS Scheme Advisory Board. It is expected that the focus will be on the outcome of the 2016 valuation and the administration of academies across the LGPS.

Terms of Reference for the Avon Pension Fund Committee and Investment Panel

1 Avon Pension Fund Committee

Bath and North East Somerset Council, in its role as administering authority, has executive responsibility for the Avon Pension Fund. The Council delegates its responsibility for administering the Fund to the Avon Pension Fund Committee which is the formal decision making body for the Fund.

Function and Duties

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 all Fund specific policies concerning the administration of the Fund, investing of Fund monies and the management of the Fund's solvency level. In addition, the Committee is responsible for all financial and regulatory aspects of the Fund. At all times, the Committee must discharge its responsibility in the best interest of the Avon Pension Fund.

The key duties in discharging this role are:

1. Determining the investment strategy and strategic asset allocation.
2. Determining the pensions administration strategy.
3. Making arrangements for management of the Fund's investments in line with the strategic policy.
4. Monitoring the performance of investments, investment managers, scheme administration, and external advisors.
5. Approving and monitoring compliance of statutory statements and policies required under the Local Government Pension Scheme Regulations.
6. Approving the Pension Fund's Statement of Accounts and annual report.
7. Approving the annual budget for the Pension Board subject to the approval of Pension Board's workplan.
8. Commissioning actuarial valuations in accordance with the provisions of the Local Government Pension Scheme Regulations.
9. Making representations to government as appropriate concerning any proposed changes to the Local Government Pension Scheme.
10. Nominating a representative from the Committee to represent the Committee on the Oversight Board for Brunel Pension Partnership.

Delegations

In discharging its role the Committee can delegate any of the above or implementation thereof to the Sub-Committee (referred to as the Investment Panel) or Officers. The current delegations are set out in Sections 2 & 3 below.

Membership of the Committee

Voting members (12)	5 elected members from B&NES (subject to the rules of political proportionality of the Council) 2 independent members 1 elected member nominated from each of Bristol City Council, North Somerset Council and South Gloucestershire Council 1 nominated from the Higher and Further 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

The Council will nominate the Chair of the Committee.

Meetings

Meetings will be held at least quarterly. Meetings will be held in public, though the public may be excluded from individual items of business in accordance with the usual exemption procedures.

Quorum

The quorum of the Committee shall be 5 voting members, who shall include at least one Member who is not a Bath & North East Somerset Councillor.

Substitution

Named substitutes to the Committee are allowed.

2 Investment Panel

The role of the Avon Pension Fund Committee Investment Panel shall be to consider, in detail matters relating to the investment of the assets within the strategic investment framework and performance of investment managers in achieving the Fund's investment objectives.

The Investment Panel will:

1. Review strategic and emerging opportunities outside the strategic asset allocation and make recommendations to the Committee.
2. Review the Statement of Investment Principles and submit to Committee for approval.
3. Report regularly to Committee on the performance of investments and matters of strategic importance

and have delegated authority to:

4. Approve and monitor tactical positions within strategic allocation ranges.
5. Approve investments in emerging opportunities within strategic allocations.
6. Implement investment management arrangements in line with strategic policy, including the setting of mandate parameters and the appointment of managers.
7. Approve amendments to investment mandates within existing return and risk parameters.

8. Monitor investment managers' investment performance and make decision to terminate mandates on performance grounds.
9. Delegate specific decisions to Officers as appropriate.

Panel Membership

The Panel shall comprise a maximum of 6 voting Members of the Avon Pension Fund Committee, of which 3 shall be Bath and North East Somerset Councillors. The membership shall include the Chairman of the Committee and /or the Vice- Chair and 4 other Members (or 5 if the Chair or Vice-Chairperson is not a member of the Panel).

Note: The appointment of Bath and North East Somerset Councillors to the Panel is subject to the rules of political proportionality of the Council.

Members shall be appointed to the Panel for a term of one year.

The Council will nominate the Chair of the Panel.

Panel Meetings

Though called a "Panel", it is an ordinary sub-committee of the Committee. Accordingly, meetings must be held in public, though the public may be excluded from individual items of business in accordance with the usual exemption procedures.

The Panel shall meet at least quarterly ahead of the Committee meeting on dates agreed by Members of the Panel.

Panel Quorum

The quorum of the Panel shall comprise 3 Members, who shall include at least one Member who is not a Bath & North East Somerset Councillor.

Panel Substitution

Substitutes for the Panel must be members of Committee or their named Committee substitute.

Panel Minutes

Minutes of Panel meetings (whether or not approved by the Panel) shall appear as an item on the next agenda of the meeting of the Committee that follows a meeting of the Panel.

3 Officer Delegations

Officers are responsible for:

1. Day to day implementation and monitoring of the investment, administration, funding strategies and related policies.
2. Appointment of specialist advisors to support the Committee in discharging its functions.
3. The Section 151 Officer has authority to dismiss investment managers, advisors and 3rd party providers if urgent action is required (does not refer to performance failures but to their inability to fulfil their contractual obligations or a material failing of the company).

4. The Section 151 Officer has authority to suspend policy (in consultation with the Chairs of Committee and Panel) in times of extreme market volatility where protection of capital is paramount
5. Under its wider delegated powers, the Section 151 Officer has delegated authority to effectively manage the liabilities of the Fund including the recovery of debt.
6. Exercising the discretions specified in the Local Government Pension Scheme Regulations in connection with deciding entitlement to pension benefits or the award or distribution thereof.
7. Through delegations from Council, the S151 Officer has authority to progress the development of Brunel Pension Partnership pool.

Approved by Avon Pension Fund Committee 24 March 2017