Appendix 1

AVON PENSION FUND COMMITTEE
ANNUAL REPORT TO COUNCIL
(April 2013 - March 2014)

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 2009 (as amended). Bath & North East Somerset Council ("the Council") administers the Fund on behalf of more than 190 employing bodies including the four unitary authorities. The Fund has c. 96,000 members and the value of the Fund as at 31 March 2014 was £3.3 billion. In 2013/14 the Fund received £143 million in pension contributions and paid out £146 million in pension payments.

(a) GOVERNANCE

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.

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 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

The Committee meets quarterly. Attendance at these meetings was 83% for the voting members and 62% 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 twelve months three workshops were arranged covering the following: the Funding Strategy Statement, the implementation project for the LGPS 2014 and the opportunities for investing in infrastructure.

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 five times during the year with attendance at 77%. Each meeting was followed by a workshop where selected investment managers present on their performance and outlook for their portfolio. In addition Panel members attended two selection panels held to appoint new managers.

2 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. Many of the areas identified by the framework are covered through detailed Committee and Panel reports and workshops where the topic is explored greater in detail.

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

3 REVIEW OF THE YEAR

a) INVESTMENTS

- The Fund generated an investment return of 6.6% during the year, generating a return of 7.8% p.a. over the last three years.
- The 2013/14 investment return was driven primarily by the strong returns from the equity portfolios which comprise 50% of the Fund's assets, the exception being emerging market equities which fell c.10% during the year. Bond returns turned negative in 2013/14 following a period of exceptional gains. The reversal was due to the improvement in economic activity which could result in interest rates rising from current low levels.

- Changes to the investment portfolio were implemented during the year following the review of the investment strategy in March 2013. New investments were made to Diversified Growth Funds and the allocation to Emerging Market Equities was increased.

b) FUNDING LEVEL

- As at 31 March 2014 the Actuary has estimated that the funding level has risen to 84% from 78% declared a year earlier.
- The funding level has increased 6% over the year from 78% to c. 84% and the deficit has contracted to c. £636m from £876m.
- The improvement in the funding level was initially due to a rise in real gilt yields used to value the liabilities. However, as the year progressed and bond yields fell back slightly, the improvement has been driven by investment returns exceeding expectations.
- The value of the future pension liabilities is calculated using a discount rate based on UK gilt yields and the benefits are indexed to inflation. Thus an increase in real gilt yields will reduce the value of the liabilities.
- The triennial valuation as at March 2013 has been completed and this sets the employer contribution rates for the three years from April 2014 to March 2017.

c) New LGPS 2014

- Project plan developed to manage the implementation and rollout of the new scheme.
- Project plan covered a number of areas including:
    - Application of new regulations
    - Introduction and testing of new pensions software
    - Training internal staff and staff at employing bodies – 10 presentation and workshop sessions arranged with Fund employers.
    - Forums to explain changes to members – 101 presentation events arranged with Fund employers over a six month period covering in excess of 1,500 members.
    - Committee workshop event to give overview of scheme changes and APF project plan.
    - Review and update of APF website and all associated communication documents
    - Newsletters (2) issued to members and regular communications with employers.
    - Feedback questionnaire covering employer responsibilities issued to identify further training requirements.
- Administration teams restructured to address the need for greater focus on accuracy of member records and data quality control in accordance with forthcoming regulator standards

d) PENSIONS ADMINISTRATION

(i) Budget

- During the year to 31 March 2014, total administration costs (excluding governance and investment management costs) were £2.2 million a saving of £170,000 (7%) on the budget.
- Total costs including Investment Management, custody fees and governance costs, were £17.7 million, 13% over budget due to a 16% increase in assets values since the setting of the budget.
- The investment management and custody fees of £15.1 million equate to 0.45% 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".
- In 2012/2013 the Fund's overall costs at £17.34 p.a. per member were less than the average of £21.42. Staffing costs (excluding payroll) were significantly less at £5.99 per member against £9.29. Payroll costs per pensioner member of £1.88 compares favourably against the average of £3.41.
- The Fund invests heavily in communications with communication costs at £1.87 per member compared to the average of £0.84. Although significantly higher, the Committee has prioritised resources to this area as it strongly believes in the importance of providing members with timely, accurate information. This is delivered by specific newsletters to active and pensioner members, a high quality website, provision of member access to their "account" via the website and the facility for scheme employers to send information via the website's secure portal. Savings are being realised through the increased use of electronic delivery for employers 'ESS' & 'i-Connect' and through the introduction and promotion of the member self-service facility 'MSS'.

(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.
- Performance of both the Fund and employers is closely monitored by officers and the Committee. The Strategy provides a transparent and robust operating and performance framework which improves accountability and has successfully focussed attention on the need for both parties to invest in and make use of electronic data provision to improve efficiency.
- The Strategy is due for review during 2014/15.

4 COMMITTEE BUSINESS TO MARCH 2014

a) Investment Strategy

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

- Much of the revised investment strategy was implemented during the year. The investment Panel selected two Diversified Growth Funds and appointed an additional manager to manage the increased allocation to emerging market equities.
- The hedge fund mandate with MAN Investments was terminated due to poor performance against target.
- The Fund has increased its involvement with 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) 2013 Actuarial Valuation

- The Committee's approved the Funding Strategy Statement (FSS) which set the parameters used by the Actuary in the actuarial valuation.
- Due to the fall in gilt yields since the 2010 valuation, the deficit has increased as have future service costs. The future service costs were partially offset by savings arising from the new scheme. Given affordability constraints the cost increases have been phased for the majority of employers within the Fund.
- The Committee reviewed the outcome of the valuation with particular attention as to how the Actuary has applied the FSS across the employers and how the covenant of individual employers had been taken into account.
- The Committee are updated quarterly on the funding position as part of the financial monitoring process.

c) Approval of the 3-year Service Plan and Budget 2014/17

- The Service Plan sets out the Pension Fund's objectives for the next three years (2014/17). The three year budget supports the objectives and actions arising from the plan.
- The initial focus of the plan is the Fund's response to two key government initiatives, the new governance arrangements and the restructuring of the local LGPS funds, and the introduction of the new scheme. In addition, there are investment and funding projects that need to be undertaken as well as further development of the Fund's electronic capability and facilities for stakeholder access. The later years focus on consolidation, realising efficiencies and embedding partnership working.
- Having invested in capacity and IT systems in previous years, the 2014/15 budget for Administration, Governance and Compliance of £2,834,300 included savings of £175,000 over 2013/14. The removal of one off items included in the 2013/14 budget such as the actuarial valuation and advisory costs for the strategic investment review were partially offset by investment required to maintain the level of service. Wherever possible savings have been made and inflation absorbed.
- The Service Plan included a cash flow forecast reflecting the more rapid maturing of the Fund which is no longer cash flow positive on a monthly basis. Investment income is now required to meet pension payments so

closer monitoring of the cash flow position is required for the investment strategy to be effectively managed.

d) Public Service Pensions Act 2013 and other Government initiatives

- The Public Sector Pensions Act 2013 (PSPA2013) will change the governance structure of the local LGPS funds. There was an informal consultation as to how the Act could be applied to the local LGPS funds. A formal consultation is expected in 2014/15.
- PSPA2013 also gives the Pensions Regulator a role in regulating the public service schemes including the LGPS. The Regulator issued a draft of best practice standards to be applied to public sector pension schemes to which the Committee responded. The Regulator will require greater disclosure of member training and require all members to attain a satisfactory level of knowledge in order to discharge their duties.
- The DCLG issued a “Call for Evidence” about the future structure of the 89 local LGPS funds in England. This focused on achieving savings in administration of the local schemes and in the investment fees paid by the funds.
- The Committee responded to these consultations and further consultations on the regulations for the new scheme.

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.
- The policy has been revised in line with the Council’s policy due to the downgrading of the credit ratings of the UK banks, to ensure there is adequate flexibility for the efficient management and investment of the short term cash.

f) Responsible Investing Annual Report

- The Fund has a Responsible Investing (RI) Policy which supports its investment strategy. As transparency and disclosure are an important element of being a responsible investor the Fund publishes an annual report of its activities, the first of which was published in 2013.
- The policy sets out how the Fund will incorporate and manage the risks arising from its investment activities that relate to Environmental, Social or Governance factors (ESG). The approach is to identify and manage these risks in a variety of ways: through considering how they can impact the overall risk and return of the Fund; by understanding how the investment managers evaluate the materiality of such risks within their investment decisions; by using its votes as a long term shareholder and to engage with company Boards to influence corporate behaviour

- The 2013 report highlighted the main activities as follows:
    - Identified and strategically addressed ESG risks by embedding analysis of the ESG risks of asset classes in the review of the Fund's investment strategy;
    - Held managers to account and interrogated the assessment of ESG risks in their investment process and reviewed whether engagement activity of managers was in line with their policies;
    - Analysed voting patterns and sought explanations of voting behaviour from managers to evidence preferences and to seek to influence;
    - Increased participation in collaboration and engagement activities of Local Authority Pension Fund Forum.

g) Administration

- In accordance with the Pensions Administration Strategy the Committee monitors the KPI for pensions administration and the scheme employers quarterly.
- Focus in 2013/14 was on the rollout of electronic receipt and delivery of data with employers. Work with employers in this area has resulted in a significant move towards electronic data transfer with 58% of scheme employers now submitting member data electronically, representing 72% of overall fund membership.
- The committee monitored Fund's New LGPS 2014 scheme implementation plan

h) 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.

5 FUTURE BUSINESS

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

a) Investments

- Investment Strategy – invest in infrastructure in line with the agreed strategy.
- Review the composition of the hedge fund portfolio.
- Investigate how liability driven investing could assist in hedging the interest rate and inflation impact on the liabilities.
- Re-tender investment advisory contract.

b) Funding Strategy

- Explore options for insuring against ill-health retirements.
- Re-tender actuarial contract.

c) Benefits Administration

- Respond to the on-going consultation exercises relating to the Governments recommendations arising from their analysis of the call for evidence.
- Ensure compliance with stringent requirements of The Pensions Regulator following outcome of TPR consultation exercise.
- Review the AVC Strategy on the number and types of funds to be offered to members to assist them in saving towards retirement.
- Approve any changes as a result of the Review of the Pensions Administration Strategy due during 2014/15.

d) Governance (Public Sector Pensions Act 2013 and restructuring of the LGPS funds)

- Engage with and respond to government consultations expected during the year on the governance structure of funds at the local level. PSPA2013 requires the new governance structures to be effective from 1 April 2015.
- Engage with and respond to proposals to change the arrangements for the investment of assets across the LGPS funds nationally. A formal consultation was issued in April 2014 following the "Call for Evidence" jointly issued by the DCLG and LGA in 2013. The priorities set out in the Call for Evidence of reducing fund deficits and improving investment returns were underpinned by one overarching objective: that the Scheme remains sustainable and affordable for employers, taxpayers and members in the long term. This consultation focuses on improving investment returns through lower investment costs with proposals to (i) create common investment vehicles; (ii) use of passive management for listed assets and (iii) keep asset allocation with the local fund authorities.
- The government proposes not to pursue fund mergers at this time and has decided not to consult on administration reform at this time. The Call for Evidence highlighted the scope for potential administrative efficiencies but the Government proposes to allow the administrative arrangements for the 2014 Scheme to mature before considering reform any further.

Avon Pension Fund

June 2014

Appendix A

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

(i) Avon Pension Fund Committee:

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. Commissioning actuarial valuations in accordance with the provisions of the Local Government Pension Scheme Regulations.
8. Considering requests from organisations wishing to join the Fund as admitted bodies.
9. Making representations to government as appropriate concerning any proposed changes to the Local Government Pension Scheme."

Delegations

In discharging its role the Committee can delegate any of the above or implementation thereof to the Sub-Committee ("the Investment Panel") or Officers.

Investment Panel

The role of the Avon Pension Fund Committee Investment Panel is 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.