Bath & North East Somerset Council	
MEETING:	**AVON PENSION FUND COMMITTEE**
MEETING DATE:	**26 JUNE 2015**
TITLE:	**LIABILITY RISK MANAGEMENT**
WARD:	**ALL**
AN OPEN PUBLIC ITEM	
List of attachments to this report: Appendix 1 – Mercer Report – Management of Liability Risks: Developing a Risk Management Framework	

1 THE ISSUE

1.1 The Strategic Investment review undertaken in 2013 concluded that the management of liability risk should be considered in detail to ascertain whether it could be managed more effectively within the investment portfolio.

1.2 The value placed on the Fund's liabilities can change significantly over time due to changes in the assumptions used to value the liabilities. Some of these assumptions are derived from financial markets so they vary as market conditions change. This causes volatility in the funding level and contribution rates.

1.3 The liabilities can only be funded over time through contributions and the investment portfolio. Given the funding environment facing scheme employers, affordability of contribution levels is a critical consideration when agreeing the funding strategy. As a result, the investment portfolio will become ever more important in managing the liability risk in the future.

1.4 The Fund manages liability risk by investing in Stabilising Assets (currently bonds) within the investment portfolio. These assets help moderate the volatility in the funding level as their value changes in a similar way over time to the value of the liabilities. This paper explains the rationale for reviewing the way in which the risks arising from the liabilities are managed within the asset portfolio, and recommends delegation to the Investment Panel to carry out the review.

1.5 Mercer's report at Appendix 1 provides explanation supporting the information in sections 4 and 5 of this report.

2 RECOMMENDATION

The Avon Pension Fund Committee is asked to:

2.1 **Agree the scope and timing of the review set out in 5.1 and 5.2**

2.2 **Agree the delegation to Panel set out in 5.3**

3 FINANCIAL IMPLICATIONS

3.1 The triennial valuation of the Fund's liabilities and assets determines the contribution levels. The extent to which changes in the value of the Fund's liabilities can be managed and the cost of doing so will affect the next triennial valuation in 2016.

3.2 The costs of a review have been provided for in the 2015/16 budget.

4 LIABILITY RISK MANAGEMENT

4.1 Pension liabilities are the accrued benefits that will be paid out in the future. The monetary values of these cashflows are known. The funding strategy calculates how much must be paid into the Fund to fully fund these cashflows as they fall due. However, the "net present value" of these liabilities changes over time and the investment strategy only partially matches these cashflows, i.e. there is a "mismatch".

4.2 **Why manage these risks?** By managing the mismatch between the change in value of assets and liabilities over time, the Fund can minimise funding level volatility and stabilise employer contribution rates more effectively.

4.3 **What are the causes of such risks?** The largest factors affecting changes in the value of liabilities are as follows:

(1) Changes in interest rate – higher interest rates increase the discount rate used to value liabilities, thereby reducing the current value put on future liabilities (and vice versa)

(2) Changes in inflation rate – higher rates of inflation lead to larger benefits payments to members

(3) Changes in longevity – a rise in life expectation increases the future liabilities as it is assumed on average they have to be paid for longer (and vice versa).

4.4 **How can we manage these risks?** The impact of these risks on the funding level and contributions can be reduced by investing in assets whose value responds to changes in interest rates, inflation rates or longevity, in a similar way as the value of liabilities responds to such changes (i.e. by improving the 'matching characteristics' within the stabilising portfolio to the liabilities).

4.5 The stabilising portfolio seeks to reduce volatility in the valuation outcome; the majority of the investment portfolio remains invested in growth assets that generate higher returns. These "excess" returns help reduce the deficit contributions and employer contribution rates within the funding strategy.

4.6 Mercer's report (see Appendix 1) provides further explanation of the issue, and the scope and timeframe of the review.

5 REVIEW SCOPE AND PROCESS

5.1 Scope - Following an analysis of the investment portfolio's matching properties, the review will consider the range of investment options available to more effectively manage these liability risks, how they may be implemented and the cost.

5.2 As the impact of any decisions will need to be considered as part of the 2016 triennial valuation process, it is anticipated the recommendations will be considered by the Committee in early 2016.

5.3 It is proposed that the Investment Panel undertake the review, as the focus will be on detailed investment strategies, and make recommendations to Committee. The Committee Terms of Reference delegates the review of strategic opportunities outside the strategic asset allocation or review of investment issues in detail to the Panel.

6 RISK MANAGEMENT

6.1 A key risk to the Fund is that the investments fail to generate the returns required to meet the Fund's future liabilities. This risk is managed via the Asset Liability Study which determines the appropriate risk adjusted return profile (or strategic benchmark) for the Fund and through the selection process followed before managers are appointed. An Investment Panel has been established to consider in greater detail investment performance and related matters and report back to the committee on a regular basis.

7 EQUALITIES

7.1 An Equality Impact Assessment has not been completed as this report is for information only.

8 CONSULTATION

8.1 This report is for information and therefore consultation is not necessary.

9 ISSUES TO CONSIDER IN REACHING THE DECISION

9.1 The issues to consider are contained in the report.

10 ADVICE SOUGHT

10.1 The Council's Monitoring Officer (Divisional Director – Legal and Democratic Services) and Section 151 Officer (Divisional Director – Business Support) have had the opportunity to input to this report and have cleared it for publication.

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Background papers	JLT Strategy Review 2013
Please contact the report author if you need to access this report in an alternative format	