

Bath & North East Somerset Council		
MEETING:	AVON PENSION FUND INVESTMENT PANEL	
MEETING DATE:	11 September 2015	AGENDA ITEM NUMBER
TITLE:	MANAGING LIABILITIES	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of attachments to this report:		
Appendix 1 – Mercer Report: Risk Management Framework		

1 THE ISSUE

- 1.1 The Committee requested that the Panel review the range of investment options available to more effectively manage liability risks, how they may be implemented and the potential cost.
- 1.2 Mercer have evaluated the options and provided the rationale for the proposed way forward for consideration by the Panel. Appendix 1 provides the detailed analysis and recommendations from Mercer.

2 RECOMMENDATION

- 2.1 The Panel considers the recommendations from Mercer (summarised in paragraph 6.1) and agrees next steps

3 FINANCIAL IMPLICATIONS

- 3.1 There is provision in the 2015/16 budget for investment advice relating to the review of the Fund's management of liability risks. Any future implementation of a liability risk management framework may incur additional costs for future budgets.

4 BACKGROUND

- 4.1 Pension liabilities are the accrued benefits that will be paid out in the future. The monetary values of these cashflows are known. 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". The funding strategy calculates the contributions required to be paid into the Fund to fully fund pension cashflows as they fall due.
- 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 2 largest factors affecting changes in the value of liabilities are as follows:
- 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)
 - Changes in inflation rate – higher rates of inflation lead to larger benefits payments to members
- 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' of 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.

5 MERCER REPORT

- 5.1 The report produced by Mercer (see Appendix 1) includes the following:
- (1) How interest rates and inflation rates impact the liabilities and investments portfolio and how the 'mismatch' in changes to liabilities and assets arises.
 - (2) How by using current bond assets more efficiently the Fund can significantly improve the matching characteristics of the investments portfolio.
 - (3) How by setting a target level of matching and putting an appropriate framework in place to reach that target the Fund can ensure the programme is implemented in an efficient manner.

- (4) How by managing this mismatch, the increased certainty of outcome allows the actuary to reassess the level of prudence assumed when valuing the liabilities and thereby manage consistent contribution levels.
- (5) An explanation of the nature of the investments to be made to achieve the desired outcome.

5.2 When considering the report, Members should also have in mind the following:

- (1) How will the proposed changes impact upon the actuarial valuation? Will the changes improve the Fund's ability to stabilise employer contribution rates?
- (2) How will the proposed changes impact upon the investments portfolio? Will the expected return and volatility targets of the investments strategy alter? Will income available from the investments portfolio be reduced?
- (3) How will the implementation of the changes impact the Fund? The Fund would have to invest in specific instruments to achieve the intended outcome, and such instruments introduce additional risks such as counterparty risk, liquidity impacts and valuation mismatch.
- (4) The cost of adopting the proposed changes will depend upon the subsequent implementation choices.

6 RECOMMENDATIONS

6.1 Mercer summarise their recommendations in Appendix 1. They comprise:

- (1) An immediate change to the UK government bond portfolio to improve matching.
- (2) Developing a three year plan to increase the level of matching.
- (3) Establish a longer term plan to reach a target level of matching when affordable.

6.2 Having considered Mercer's report and recommendations, the Panel will need to determine the next steps.

7 RISK MANAGEMENT

7.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in place that is regularly monitored. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

8 EQUALITIES

8.1 An equalities impact assessment is not necessary as the report contains only recommendations to note.

9 CONSULTATION

9.1 N/a

10 ISSUES TO CONSIDER IN REACHING THE DECISION

10.1 Are set out in the report.

11 ADVICE SOUGHT

11.1 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	
Please contact the report author if you need to access this report in an alternative format	