Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND COMMITTEE**	
MEETING DATE:	**24 JUNE 2016**	**AGENDA ITEM NUMBER**
TITLE:	**DRAFT FUNDING STRATEGY STATEMENT 2016**	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of attachments to this report: Appendix 1 – Draft Funding Strategy Statement		

1 THE ISSUE

1.1 The Local Government Pension Scheme (LGPS) regulations require each administering authority to prepare and publish a Funding Strategy Statement (FSS). The FSS sets out the key assumptions which the actuary has used in preparing the actuarial valuation and the policies adopted by the Administering Authority.

1.2 A Committee workshop was held on 8 March 2016 to discuss the broad principles in the FSS prior to it being prepared.

1.3 The actuary will present the draft FSS at the meeting. Once the Committee has agreed the draft, it will be circulated to the employing bodies for comment. The comments arising from the consultation will be reported to the September Committee meeting when the FSS will be approved.

1.4 The actuarial outcome will be reported to Committee at December 2016 meeting

1.5 Individual employer results will be disseminated in October and November. A Forum to explain the outcome (at the Fund level) to employers will be arranged for 4Q16.

2 RECOMMENDATION

The Committee:

2.1 **Approves the draft Funding Strategy Statement as set out in Appendix 1, subject to the insertion of information which can only be included when the actuarial valuation is complete, for consultation to employing bodies**.

3 FINANCIAL IMPLICATIONS

3.1 The actuarial costs for reviewing the FSS are included in the 2016 actuarial valuation fee and are provided for in the 2016/17 budget.

4 BACKGROUND AND PROCESS

4.1 The LGPS regulations require each administering authority to prepare and publish a FSS. The key points of the regulation for the FSS are as follows:-

- After consultation with all employing bodies, the administering authority must prepare and publish their funding strategy
- In preparing the FSS, the administering authority must have regard to:
  - (i) Guidance issued by CIPFA for this purpose
  - (ii) The Statement of Investment Principles[1] (or Investment Strategy Statement (ISS) under Regulation 12 of the LGPS (Management and Investment of Funds) Regulations 2016 if this is published within this time period)
- The FSS must be revised and published whenever there is a material change in either the policy on the matters set out in the FSS or the Statement of Investment Principles/ISS.
- The Fund's actuary must have regard to the FSS as part of the valuation process.

  [1] The LGPS (Management and Investment of Funds) Regulations 2016, which require funds to have an ISS, have yet to be published hence the Statement of Investment Principles is still the statutory document.

4.2 The FSS sets out all the key assumptions which the actuary will use in preparing the actuarial valuation, together with the Administering Authority's policies in the areas where it has discretion to manage the funding position of the Fund.

4.3 The draft FSS attached as Appendix 1 is based on preliminary information that can only be finalised once the valuation and associated analysis has been completed.

4.4 The draft FSS will be circulated to employers for consultation during July and August. Comments will be considered by Officers and reported to the Committee at the September meeting where the FSS will be approved. Under the governing regulations, the Fund's actuary cannot finalise the valuation until the FSS has been approved by the Committee.

4.5 The 2016 valuation outcome will be reported to Committee in December 2016 together with a review of the covenant assessment process and update on scheduled and admitted bodies within the scheme.

5 FUNDING STRATEGY STATEMENT

5.1 At the Committee workshop on 8 March 2016, the actuary gave a presentation on the FSS covering the broad principles, how it relates to the actuarial valuation process and the basis for the assumptions to be used in the valuation.

5.2 The FSS is an important document for the Fund and its employers. It sets out a clear and transparent funding strategy that will identify how each employer's pension liabilities will be met going forward. Therefore the policies and information contained within the FSS will have a financial and operational impact on all participating employers within the Fund. In addition it contains the key policies by which the Fund manages funding and financial risk.

5.3 The FSS is the key governance document as it sets out the risk management strategy by which the administering authority ensures the solvency of the Fund for all employers. The other key strategy, the investment strategy, influences the FSS as the Actuary must allow for the investment return expectations when finalising the discount rate assumption adopted in the funding strategy.

5.4 The objective of the FSS is to secure the solvency and long term cost efficiency of the Fund. In doing this it seeks to balance solvency with affordability of the employing bodies.

5.5 The key financial and demographic assumptions in the FSS are set following advice from the Scheme Actuary after consultation with the administering authority. Some of the demographic assumptions have yet to be finalised but the Actuary has done some preliminary analysis to inform on the "direction of travel".

5.6 In the draft FSS 2016 the following changes are being incorporated:

(1) Discount Rate basis for past service liabilities (funding target)

The key assumption which drives the value of the pension Fund liabilities (the future benefit payments) and therefore deficit is the discount rate. This is set by the Actuary to reflect the overall investment return which we expect to achieve on the Fund's assets over the long term with a suitable and necessary allowance for prudence. In terms of setting contributions, the relationship of the expected investment return on assets compared to the rate of expected future increases in benefit payments (i.e. CPI inflation) is critical (in other words we need to reflect the "real" investment return expected on the Fund assets).

Historically the discount rate/investment return assumption was derived as gilts plus a fixed asset out performance (which is reviewed at each valuation) to arrive at the overall expected return at that time. However, long term real gilt yields have been very volatile and have fallen significantly over the last three years, whilst the expected real return on the assets held by the Fund has remained broadly constant based on the analysis performed. Therefore, simply using this same "mathematical" approach to derive the discount rate/investment return assumption would result in a significantly lower discount rate than at 2013 (despite the expected return on assets remaining broadly similar) and therefore a higher value of the liabilities. The Actuary advises that this builds in too much "prudence" into the funding strategy given the long term objectives of the Fund.

The Actuary has therefore recommended expressing the discount rate for the 2016 valuation based on the "real" expected asset return above the CPI baseline assumption when assessing the long term solvency target. Importantly this discount rate would build in the same level of real return above CPI as that used in 2013 valuation, meaning that there is consistency in the assumed level of future asset returns and therefore level of prudence versus the long term investment strategy expectations.

(2) Future service rate (FSR) discount rate basis:

The future service liabilities are calculated using the same assumptions as the funding target except that a different financial assumption for the discount rate is used. A critical aspect here is that the Regulations state the desirability of keeping the “Primary Rate” (which is the future service rate) as stable as possible so this needs to be taken into account when setting the assumptions.

As future service contributions are paid in respect of benefits built up in the future, the FSR should take account of the market conditions applying at future dates, not just the date of the valuation, thus it is justifiable to use a slightly higher expected return from the investment strategy. In addition the future liabilities for which these contributions will be paid have a longer average duration than the past service liabilities as they relate to active members only.

For these reasons the FSR is based on a higher assumed real return. In 2013 this was CPI +3%. The Actuary’s view is that this real return is too optimistic given the investment outlook and advises an initial discount rate of CPI +2.75% per annum is adopted. The Actuary also notes that if the future economic and return outlook persists the discount rate may need to reduce further. As a result there will be upward pressure on FSRs (all other things equal).

(3) 50:50 Scheme

Based on current information the Actuary will not make any allowance for members to join the 50:50 scheme in future as uptake has been minimal. In 2013 an uptake of 5% was assumed when calculating the liabilities at the whole fund level. The assumption of a 5% uptake was only applied to the unitary authorities. However, the Actuary will take into account those members that have already opted for the 50/50 scheme when assessing the contribution rates.

(4) Mortality assumption

The baseline and short term trend in mortality will be adjusted to reflect the scheme’s experience since 2013. Based on preliminary analysis for the Fund mortality rates have risen slightly since 2013 so life expectancy has fallen, which would reduce the baseline liabilities. There is no evidence that the long term mortality trend has deteriorated. The assumption in 2013 includes a 1.5% p.a. long-term improvement (i.e. reduction) in mortality rates. This improvement rate allowance may be increased if industry and LGPS data suggest it is prudent to do so. Analysis is being carried out to determine the appropriate assumptions to adopt but overall it is expected that liabilities will fall.

(5) Deficit Recovery Period

The average deficit recovery period is proposed to reduce from the 2013 by at least three years to 17 years; plus the medium term aspirational target recovery period will also contract by three years to 12 years.

5.7 Employer covenants within the scheme are diverging as the public sector and its funding regimes change. Therefore the covenant assessment process is now a key element of the valuation and the objectives of this are included in the FSS.

5.8 The FSS has been re-drafted to also reference the requirements under the Public Service Pensions Act 2013.

6 RISK MANAGEMENT

6.1 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. In addition it monitors the benefits administration, the risk register and compliance with relevant investment, finance and administration regulations. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

6.2 A specific liability risk management framework is being considered for implementation. This will be designed to reduce risk and provide more stability/certainty of outcome for funding. This would be done on an opportunistic basis to ensure the most efficient and cost effective approach is taken. This is subject to approval by the Committee. This could have implications on future actuarial valuations but does not impact on the 2016 valuation approach. Reference has been made to the framework in the draft FSS. Further detail is contained in the separate Committee paper.

7 EQUALITIES

7.1 An equalities impact assessment is not necessary.

8 CONSULTATION

8.1 This is reporting the outcome of a consultation process.

9 ISSUES TO CONSIDER IN REACHING THE DECISION

9.1 Are contained in the report.

10 ADVICE SOUGHT

10.1 The Council's Monitoring Officer (Divisional Director – Legal & 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.

Contact person	Liz Woodyard, Investments Manager 01225 395306
Background papers	CIPFA Pensions Panel (guidance on preparing FSS) Correspondence with actuary
Please contact the report author if you need to access this report in an alternative format	