

THE AVON PENSION FUND

SERVICE PLAN

2020 - 2023

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AVON PENSION FUND SERVICE PLAN

2020-23

1 BACKGROUND

This Service Plan is presented against a background of global uncertainty and financial concern caused by the COVID 19 coronavirus and the unprecedented actions taken by governments and organisations across the world to prevent its spread. Having met the challenges caused by the 2008 recession, our members, our employers, indeed the world faces an even deeper recession, one that in some quarters is suggested could represent a game-changer as to how some societies live their lives.

As a Fund we currently face challenges to all aspects of our operations, whilst the impacts on Employers may in the short term undermine our Funding Strategy and cause concern for the 2022 valuation. The focus now is on maintaining business continuity through the lockdown period, recognising that future operations will be impacted by the current changes, not least in the shift to greater use of digital communications.

The direction of travel for the period 2020-2023, recognises these new challenges, developing the digital opportunities, whilst enhancing covenant risk assessment work amongst other things; inevitably though there has been an impact on programmed work as the service adapts. This plan updates the progress on planned activities taking account of COVID impacts although it remains to be seen what the long term impacts will be on the LGPS.

Governance

The Coronavirus Act 2020 enables public bodies to establish virtual meetings during the pandemic period and The Local Authorities and Police and Crime Panels (Coronavirus) (Flexibility of Local Authority and Police and Crime Panels)(England and Wales) Regulations 2020 ('the Regulations') sets out the details by which they should operate. It is likely that some of the Funds future meetings may be held in this way.

Operationally the Fund is still in transition as it adapts to the changes in its investment arrangements and the complexity that arises from ongoing fragmentation of its employer base. The transition of the assets and the need to implement the investment strategy through the pool requires engagement by the Fund at both committee and officer levels. Although the Fund's governance arrangements takes this into account, it is kept under review as the new arrangements are still evolving, including the engagement process between Brunel, the Oversight Board and the Fund. Further changes may be required in the future to ensure the Fund's requirements are addressed, its interests are protected and the governance arrangements are operationally effective.

As agreed by Committee, the remit of Pensions Board has been expanded to provide greater input to the Administration Strategy. The Board role will be developed over the next year enabling the Committee to focus more on Strategic issues improving the overall efficiency and governance arrangements.

Pooling of Investment Assets

The FCA investment management company, Brunel, is managing c. £2.3 billion or 51% of the Fund's assets as at 31 March 2020. The focus through 2021/22 is on the transition of the remaining client assets to Brunel and the development of the ongoing monitoring of the portfolios. In addition to the transitions from legacy managers, the Fund has made allocations to Brunel's Renewable Energy Infrastructure and Secured Income portfolios. The impact of the pandemic has inevitably led to a delay in transition arrangements until 3Q20 due to market volatility, however the impact on savings is not considered to be materially impacted.

Although much time and resources has been spent establishing the pool and Brunel since 2016, significant resources are now required to work with Brunel and the wider pool to ensure the transition plan keeps on track, client strategies (and changes to them) are accommodated within the portfolio structure and that client monitoring is robust to give assurance to the Brunel Oversight Board, and local committees, that Brunel is delivering value for money to its clients. This continues to be an area of development and ongoing engagement with Brunel

Investment Strategy

Following a period of returns above expectations, 2018/19 saw the return of volatility to markets; the diverse strategy and focus on risk protected the Fund from significant declines in some assets.

The Strategic Asset Allocation has been reviewed following the 2019 actuarial valuation to ensure the Fund continues to fund its pension liabilities efficiently and provide value to its employers in terms of stable and affordable contributions. Further the impact of COVID 19 on planned investment changes was again thoroughly tested to ensure the overall strategy remained robust. The agreed changes to the asset allocations will be implemented through Brunel portfolios or, if a portfolio is not available, as an elective service by Brunel or by the Fund directly.

The Equity Protection Strategy has also been revised a result of the Strategic Review and will be subject to ongoing monitoring. In addition an assessment of implementing a more dynamic equity hedging strategy will be undertaken. The review thoroughly considered the financial impact of climate change on each asset class and the agreed actions continue to ensure the Fund moves towards alignment with Paris targets.

Funding Strategy

Over the last few years significant work has been undertaken to de-risk the employer position within the Fund through the Funding Strategy. In addition to the captive ill-health insurance scheme and the liability hedging strategy already implemented, a strategy to match the liabilities of employers that have exited the Fund was being implemented during 2019. This de-risked a further £130m of liabilities within the Fund. The options of developing bespoke funds for select groups reflecting their deficit, risk assessment and financial positions will be explored further and the option of moving towards a fully unitised approach will also be explored in time. This will be an important consideration by the Fund given the nature and diversity of employers within the Fund and will be considered on affordability and practical operational criteria.

The 2019 valuation saw a significant improvement in the funding position (increased from 86% to 94%) which meant total contributions were kept as stable as possible. The McCloud judgement and lack of a remedy significantly increased the complexity of the valuation, but the potential costs were provided for in the valuation. Significant work around employer covenants was undertaken to support the proposed funding plans at the employer level, given the difficult funding environment faced by many employers; this work will now continue given the financial challenge resulting from the pandemic.

Administration Strategy

The previous decades has seen the APF employer base grow to 442; representing an increase in excess of 300%. This figure is expected to increase beyond 500 over the next 18 months and continues to represent a significant challenge to the administration. A review of the Employer Services team structure was undertaken during the year to better manage the receipt and upload of monthly employer data as the drive continues towards the onboarding of all employers to this digital solution.

The revised Administration Strategy has been implemented continuing progress towards a seamless automated pensions service. A number of medium/long term projects are in train to support key strategy objectives and manage risk together with a series of 'one off' projects identified to further improve member data and mitigate TPR compliance requirements. In support of the PAS, a new Service Level Agreement with employers, including a chargeable service option will be issued during the term of the current strategy. However, further exploration and development of joined up technical capabilities are required to support administration and further maximise service delivery. This has become increasingly relevant during the current situation ensuring staff have the right training and equipment to operate flexibly and further highlighted the need for systems improvements. During 2020/2021 the Fund will undertake a review of its IT infrastructure and digital service delivery and will report outcomes to the Committee as they begin to emerge.

The outcome of the McCloud judgement is still awaited with a solution for LGPS expected in 2021/2022. However, it is expected that any remedy will have a significant impact on scheme administration and resource and the Fund will continue to monitor outcomes to consider and prepare approach.

2 KEY OBJECTIVES – 2020/21 to 2022/23

Funding Strategy:

1. Implement the policy for ongoing covenant assessment for incorporating into the Funding Strategy and funding plans.
2. To explore further options for bespoke portfolios to manage the funding and liability position of specific employer risk groups
3. Ongoing management of smaller employers to ensure pension costs remain affordable for the employer and financially sustainable for the Fund

Investment Strategy:

4. To monitor the transition of assets to the Brunel Portfolios and performance of Brunel and portfolio thereafter.
5. To implement changes to the strategic asset allocation post 2019/20 review to ensure the Fund can achieve the returns required in the Funding Strategy and that all risks are effectively managed.
6. To revise the Investment Strategy Statement reflecting strategy developments and changes due to Brunel operations.
7. Monitor and develop the Risk Management Framework as required as a mechanism for managing liability risk through the investment portfolio and mitigating investment risk.
8. To increase communications with stakeholders about the investment strategy especially around how the strategy is mitigating the financial risk of climate change.
9. To realign the investment advice required post transition of assets to Brunel.

Administration Strategy:

10. To implement new SLA arrangements to all employers including chargeable service option.
11. To undertake a review of the IT structure and service delivery platform.
12. To complete the rollout of I-Connect and implement joint monthly contribution and data delivery module.
13. To introduce a training & development programme across all pension stakeholders
14. To complete the final phase of the GMP data reconciliation exercise as required by HMRC to ensure the fund is not at risk of erroneous pension liability.
15. To undertake review of pensioner member 'pots' to identify potential commutation opportunity.

16. To undertake an exercise to review and rectify any incorrect pensioner member annual increase amounts.
17. To continue the move towards electronic delivery of Scheme communications to members.
18. To monitor outcomes of McCloud judgement and implement actions to manage remedy.

Governance:

19. Keep governance arrangements under review to ensure effective monitoring of Brunel and the transition of the assets.
20. Review the Governance Statement following Good Governance Review (SAB)
21. To ensure the Committee and the Pensions Board is fully trained and briefed on current strategies and operations and in position to scrutinise and make decisions effectively. Retender advisory contracts to align contracts with Fund objectives.

A report on objectives, targets & progress towards objectives is given in Appendix 2.

3 RESOURCE IMPLICATIONS

The appointment to the Governance and Risk Advisor post in 2019 has significantly increased capacity of the management team to respond to the growing governance agenda, as well as improve support for the Committee and Pension Board members.

With the creation of Brunel, the resources within the team devoted to investment strategy, policy and operations diminished, giving rise to resilience and capacity issues. Despite assets transferring to Brunel, significant resources are still required to manage and develop the relationship with Brunel and the client side of the pool. Internal capability ensures the Fund strategy evolves efficiently to meet the Fund's objectives, there is proper control of implementation, that members are trained and supported, and there is adequate internal challenge of expert advice. As a result, a new post with specific focus on strategic investment issues including ESG was provided for in the 2019/20 budget. However, recruitment has not been successful, and the post remains vacant. Until this post is filled, the investment advisors will provide additional support to officers on a project basis.

In respect of administration, following previous Committee agreement for an increase and permanency of appointments in the 2019/20 budget the overall administration function is in a reasonable position. However, a high number of posts remain unfilled and a recruitment programme is currently underway to permanently fill all vacant posts albeit with some slippage due to COVID and remote working. Appendix 1a details the increase in resource since 2014 highlighting the growing void between agreed establishment and actual posts filled.

The 2020/21 budget allows for additional temporary resource to support the expected workload to manage the McCloud remedy, with increased use of external specialist support part of the ongoing solution to manage workload.

4 BUDGET

This Service Plan period includes the costs of managing investment assets through Brunel; savings in investment management fees are materialising as the transition of assets progresses. The Fund is expected to realise net (of transition costs) cumulative savings by 2024-25, with the business case forecasting cumulative savings of £73m by 2036.

The Fund budget (excluding investment costs) proposed for 2020/21 is £4,776,226.

In the areas of Governance and Compliance and Investment Management, where expenditure cannot be directly controlled, the budget reflects the expected volumes of work and fees.

The budget reflects the increasing focus on communications around the investment strategy, especially in relation to how the Fund is managing the impact of climate change on its assets. In addition, following the strategic review there is an increase in the cost of ESG affiliations to support the Fund's Responsible Investing Policy. The total budget committed to Responsible Investing including staff costs, affiliations, advice and communications is around £150,000 p.a.

Within the directly controlled budget for Administration there is a proposed increase in net expenditure over the 2019/20 budget of £241,081. This net increase includes additional temporary resources to meet expected increased workload resulting from the McCloud remedy and the additional resource introduced to manage the electronic monthly employer data receipt via i-Connect. Provision has been made for consultancy on IT systems review although this will be offset by the removal of the existing IT development budget pending the review. Additional provision of £20,000 has been made in 2020/21 to provide equipment to support flexible working during the pandemic and beyond. The budget also includes the cost of one-off projects to carry out address tracing and mortality checks and completion of the GMP rectification exercise.

Investment Management fees:

The estimated investment management fees are flat versus the 2019/20 budget at £28.9m even after allowing for a 6% increase in asset values during 2020/21.

The annual management fees of £19.5m are lower than last year's budget (£19.8m); this reflects the lower fees arising from the assets that have transitioned to Brunel. To date this includes the UK Equity, Global Equity, Emerging Market and Low Carbon Passive Equities. In addition, lower fees for the Risk Management Strategies have been implemented following the appointment of a single manager for the pool. The fees do not include the cost of transitions which is deducted from the

asset values. In addition, the budget does not include planned transitions during 2020/21 but assumes legacy mandates are retained.

Performance fees are estimated to marginally increase from £9.1m to 9.4m and reflect returns in excess of target from the global property and infrastructure portfolios.

The actual fees paid in 2020/21 will depend on the change in asset values over the year and the performance of the assets subject to the performance fees (performance fees accrue within each year but are only payable when the underlying assets are realised).

It should be noted that the Fund's strategy is to increase the allocation to private market assets, sourcing the allocation from listed market assets will lead to upward pressure on the underlying fee rates. This is because fee rate paid on private market assets is higher (in basis points) than for listed assets, leading to upward pressure on underlying fee rates.

Brunel management costs:

The shareholders have approved the 3-year budget and Business Plan for Brunel for 2020/21 to 202/23. The budget ensures there are adequate resources to (i) deliver the transition plan within an agreed timeline in order that clients can implement their investment strategy efficiently and (ii) to support client funds with business as usual reporting and activities. The overall costs of Brunel of £10.4m are flat compared to 2019/20 after allowing for in year carry forwards; in the later years of the Business Plan, the budget remains stable as the costs associated with the transition fall out of the budget.

However, as more assets transition and more of the costs are applied to the portfolios on an AUM basis, Avon's share of the overall cost has risen.

Governance Costs:

Ongoing governance costs have reduced as the 2019 Valuation has fallen out of the budget. Currently the Fund's investment advisor provides advice on both the legacy mandates and the Brunel portfolios. When the contract is retendered in 2021/22, the new relationship will reflect the requirements post Brunel. The budget (and that for 2021/22) includes the cost for advice and implementation of a dynamic equity hedging strategy; however if implemented there will be savings of the periodic costs to renew the strategy that will no longer be required.

Salaries:

There is slight upward pressure on the salaries in the Investments Team where recruitment of specialist/technical posts have failed due to competition from other financial companies and pension funds in the local area.

Pensions Board:

The Pension Fund is required to meet the costs of the Pensions Board that became operational in July 2015. The estimated full year costs of the Board for 2019/20 to 2021/22 have been added to the overall cost to the Fund for the three year budget.

5 CASH FLOW

As the Fund's profile matures, monitoring future cash flow trends increases in importance. The Fund is transitioning from being cash flow positive (accumulating cash from contributions at a greater rate than paying out cash in benefits and expenses) to being cash flow negative. The cash flow is currently monitored on a monthly basis and reported quarterly to Committee. As a result of the advance lump sum deficit payments due to be made by the major employers in April 2020 the Fund will have larger cash in-flows. However, the consequent absence of these deficit payments in the following two years will result in greater negative annual cash flows. The negative cash flows are managed by using income from the investment portfolio and divestments as required. Divestments are delegated to Officers as part of their operational duties. Consideration is given to the actual allocation against the strategic allocation as well as the view of investment markets.

Full details of the budget between 2020-21 and 2022-23 together with a cash flow forecast for the payment of benefits and the receipt of contributions are given in **Appendix 3**.