Appendix 1

AVON PENSION FUND COMMITTEE ANNUAL REPORT TO COUNCIL (April 2010 - March 2011)

1 BACKGROUND TO THE AVON PENSION FUND

The Avon Pension Fund is a statutory scheme regulated by the Local Government Pension Scheme Regulations 2008 (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 100 employing bodies including the four unitary authorities. The Fund has c. 85,000 members and the value of the Fund as at 31 March 2011 was £2.6 billion.

The Fund's target asset mix is 60% equities, 20% bonds, 10% property and 10% fund of hedge funds. The Fund's assets are managed by external investment managers.

(a) AVON PENSION FUND COMMITTEE TERMS OF REFERENCE

The Council has delegated responsibility for the Fund to the Avon Pension Fund Committee (APFC) whose terms of reference, as agreed by the Council in May 2010, are set out below:

> "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 investment policy objectives, ensuring appropriate investment management arrangements are in place including the appointment of investment managers and monitoring investment performance; commissioning actuarial valuations in accordance with the provisions of the Local Government Pension Scheme Regulations; considering requests from organisations wishing to join the Fund as admitted bodies; making representations to Government as appropriate concerning any proposed changes to the Local Government Pension Scheme; and all aspects of benefit administration. At all times, the committee must discharge its responsibility in the best interest of the Avon Pension Fund."

(b) COMMITTEE MEMBERSHIP

The Committee structure is as follows:

Voting members (12)	5 elected members from B&NES 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

(c) INVESTMENT PANEL

The Investment Panel is a formal sub-committee of the APFC, established to consider the management and investment of the Fund's assets and to advise APFC on such matters. The Panel's terms of reference which were agreed by the Council in May 2010 are:

The Panel shall:

- recommend strategic investment objectives, policy and strategic asset allocation
- regularly review in detail and assess the performance of the investment managers, investment advisors, custodian and actuary
- recommend appointment and termination of investment managers and professional service providers as required
- review the Statement of Investment Principles and submit to APFC for approval
- make recommendations to the APFC on matters relating to investment strategy and management as the Panel considers appropriate. This will include issues of a more urgent nature, where the view of the Panel would be taken into consideration. (The Section 151 Officer has delegated powers regarding urgent actions, and these would be exercised having consulted the Chair of the Panel)
- review any legislative changes which have implications for investment governance and make recommendations to the APFC as appropriate.

The Panel has no delegated powers and can only make recommendations to the Committee.

The Panel consists of up to 6 voting members from the APFC and meets at least quarterly ahead of Committee meetings.

2 TRAINING AND WORKLOAD

Committee members are required to undertake a significant amount of training in order to have sufficient expertise to be able to make strategic investment decisions and to evaluate critically any advice they receive. As a result, on joining the committee all voting members attend an introductory training course customised for the Local Government Pension Scheme (LGPS) which covers the LGPS regulations, the benefits structure and basic investment concepts. The opportunity to attend this course is also extended to non-voting members although it is not compulsory. In addition, all committee members have the opportunity to attend a number of additional training courses and conferences each year.

Training activity during the year comprised:

- 1 committee member attended the 3-day customised training course organised by the Local Government Pensions Committee (LGPC)
- 5 members attended investment conferences during the year

Committee meetings and workshops:

- The Committee meets quarterly.
- Ad hoc workshops are arranged as necessary for the APFC. These workshops are designed to explore specific policy issues in detail. During the last 12 months, one workshop was arranged to review the Funding Strategy Statement which forms the basis of the triennial actuarial valuation. Another workshop was held to review the investments in hedge funds.

The Investment Panel met 4 times during the year. The Panel has explored the following issues in detail:

- Reviewed the Fund of Hedge Fund managers performance in detail in order to support the Committee's review of the Fund's hedge fund investments
- Reviewed the existing managers' performance in detail

3 REVIEW OF THE YEAR

a) INVESTMENT PERFORMANCE

2010/11 was another good year for investment markets and the Fund's investment returns was 7.8%. **The value of the Fund's assets rose by £204 million to £2,658 million at 31 March 2011.**

The Fund's return marginally lagged the average return of 8.2% for the Local Authority funds over the year due to its lower exposure to equities. **However, over 3 years the Fund's return was 6.3% per annum compared to the Local Authority average return of 5.4% which is due to the diversified investment strategy the Fund has adopted over this period.**

b) 2010 ACTUARIAL VALUATION

The regulations require that the Fund has an actuarial valuation every three years and the latest valuation was at 31 March 2010, which sets the employer contribution rates for the period 1 April 2011 – 31 March 2014. The funding level is 82% which compares to a funding level of 83% at the previous (31 March 2007). The average employer contribution rate is 16.6% of pensionable pay which is unchanged from the 2007 valuation. This has been achieved by extending the deficit recovery period to an average of 23 years from 20 years in 2007.

Overall the outcome was more favourable than initially anticipated, mainly due to the announcement that all public sector pension payments in the future will be linked to the Consumer Price Index (CPI) rather than the Retail Price index (RPI). As the CPI has historically been lower than RPI by 0.5-1.0% per annum, this change means the inflation assumption used for valuing the Fund's pension payments is lower which in turn reduces the Fund's liabilities. In terms of the assets, despite the strong recovery in markets in 2009/10, the overall investment return since 2007 fell short of the return assumed in the 2007 valuation.

Given the adverse public spending backdrop and taking into account affordability of the employers, the focus of the 2010 valuation was on

stabilising contribution rates within the existing funding framework as set out in the Fund's Funding Strategy Statement. Stable rates could only be achieved by extending the deficit recovery period (the period over which the 100% funding level will be achieved), where possible, from 20 years to an average of 23 years, with a maximum for an individual employer of 30 years.

It should be noted that the funding level does not impact the ability of the Fund to meet its pension obligations in the meantime. The Fund has a positive cash flow with current pension payments met by pension contributions, and this is expected to continue until approximately 2028 (based on the current benefits structure).

During the year the Hutton Commission set out recommendations to reform the public sector pension schemes to make them more affordable and fairer. The Government has indicated that it accepts the Commission's recommendations and will report further in the autumn of 2011. The main recommendations include an increase in the retirement age, moving from a final salary to career average re-valued earnings benefit structure for future accruals (generally accepted to be "fairer" to lower paid members) and full protection of existing accrued rights. Any savings that arise from changes to the LGPS will be reflected in the next valuation in 2013 and initially be used to bring the deficit recovery period down to 15-20 years.

The Treasury has also announced that, separate from the Hutton recommendations, the public sector schemes should increase employee contributions by on average 3% (i.e. taking the current average employee rate in the Avon Pension Fund from 6.4% to 9.4%) in order to reduce the cost of pensions to employers (i.e. the government) in the short term. This is proving a very contentious issue, with significant risk that opt-out rates will rise substantially. As a result the government are currently consulting with employers and member representatives as to how this could be implemented within the LGPS.

c) FUNDING LEVEL

As at 31 March 2011 the Actuary has estimated that the funding level has marginally increased to 83% from 82% at 31 March 2010. The increase in the asset value of the Fund exceeded the rise in liabilities, which was caused by the unwinding of the discount rate by one year (effectively adds one year of interest to the liabilities).

d) FUND GOVERNANCE

Fund governance and ensuring the governance structure properly reflects the parties involved in the Fund, namely the employers, scheme members and local taxpayers, is of significant importance to the administering authority and APFC alike.

The current governance structure has been established since 2009. **During the year the Committee completed a self-assessment of the effectiveness of its decision making process. The exercise concluded that the members have confidence in the decision making process in that it enables the Committee to discharge its responsibilities effectively.** However, it did identify a number of areas where the process could be improved. Most of these have been implemented with the Committee approving a more formal training programme which will provide more opportunity for members to access training covering general pension issues and more specific investment topics.

e) PENSIONS ADMINISTRATION

(i) Budget

During the Year to 31 March 2011, total costs were £661,000 under the budget of £9.8 million. However, excluding Investment Management and custody fees and governance costs, administration costs were £200,000 under the budget of £2.1million, a saving of 9%. Savings were made across the all budgets except for IT where spending was in line with the budget due to investment in upgrading the pensions processing system.

There was an under-spend in Investment Management and custody fees due to the delay in appointing the global equity manager, whose expected costs where included in the budget. The investment management fees of £6.8 million equate to 0.26% of the Fund's assets.

(ii) CIPFA Benchmarking (Benefits Administration)

The Fund annually benchmarks its Pensions Administration costs through the CIPFA Benchmarking Club where its performance and running costs are compared against its peers and against the "average size. " The results are analysed and reported to Committee annually for further scrutiny where performance targets are also reviewed.

The Fund's administration costs remain competitive. The unit cost of £2.73 per member for paying pensions remains one of the lowest in the UK. The overall costs of £18.33 per member compares favourably with the comparator group average cost of £23.49 per member.

(iii) New Pensions Administration Strategy

The Fund has produced and issued a *Pensions Administration Strategy* (PAS) to improve the way it works with the hundred or so Fund employers. This was issued following in depth consultation with employers and came into effect on 1 April 2011. The main areas covered are communications, training and performance reporting. As part of the Strategy all employers will have new *Service Level Agreements* which will include a deadline in 2012 by which they will have to submit all information on member changes to the Fund electronically. A key strand of the PAS is joint accountability with regular performance measurement reports and progress review meetings. This development has been well received by employers and, in time, is expected to improve the level of service to Scheme Members.

4 COMMITTEE BUSINESS TO MARCH 2011

a) Review of Investment Strategy

In 2009 the Fund's investment consultant, JLT Actuaries & Consultants Ltd (JLT), were commissioned to review the strategic investment strategy (that is, allocations to various asset classes) given the outlook for investment markets following the financial crisis experienced in 2008/09. Most of the decisions were implemented in 2009/10 but a number of decisions were carried forward into 2010/11 as follows:

- Review of Hedge Fund investments – following a workshop held in March 2011 it was agreed to maintain the strategic allocation to hedge funds but to adjust the allocation between the existing manager

- Hedging the foreign currency exposure arising from the Fund's investments in overseas equities, to protect the Fund's value from adverse movements in sterling (weak sterling is positive for the Fund) – agreed to appoint a manager to actively hedge the non-sterling exposure

- Review the Fund's policy for Socially Responsible Investing – agreed brief for review in 2011/12

b) Allocation to UK equities

In light of the fall in the price of BP shares the Committee asked the Investment Panel to consider the allocation between UK and overseas equities that are managed on a "passive" basis (the portfolios mirror respective equity indices). BP highlighted the risks of passive investing when the underlying index (in this case the FTSE All Share Index) has significant stock and sector concentrations. Prior to its price decline, BP accounted for c. 7% of the FTSE All Share Index. In contrast, global equity indices are more diversified at both the sector and stock levels and thus have less concentration risk. The Committee accepted the Panel's recommendation that the asset allocation within the equity portfolio should be adjusted from 45% UK equities: 55% overseas equities to 30% UK:70% overseas with the switch implemented within the passive equity portfolios.

c) Funding Strategy Statement

The LGPS regulations require the Fund to prepare and publish a Funding Strategy Statement (FSS). The FSS sets out the key assumptions which the Actuary uses in preparing the actuarial valuation and, in those cases where the Administering Authority has some discretion, the policies adopted by the Fund. The purpose of the FSS is to:

- Establish a clear and transparent Fund specific strategy which will identify how employers' pension liabilities are best met going forward;
- To maintain as nearly constant employer rates where possible;
- To take a prudent long-term view of funding those liabilities.

The Committee reviewed the FSS ahead of the 2010 triennial valuation. The focus of the Committee was to strike a balance between affordability of the employers and securing the solvency of the Fund. The draft FSS was circulated to employers for consultation prior to it being approved by the Committee.

d) Approval of the 3-year Service Plan and Budget 2011/2014

The Service Plan details the new development proposals that are planned to be undertaken during the next three financial years (2011/2014) and also reports on progress made against the 2010/11 planned actions. The new plan is designed to respond to known and anticipated legislative changes and Committee initiatives as well as to take the Pensions Service forward by improving performance and the overall quality of service to members and employers. Specifically the Fund is rolling out its Administration Strategy that will focus on working more closely in partnership with the Fund's employing bodies and utilising technology to deliver and process information.

The 2011/12 administration budget includes savings of 5.0% (£110,000) on the 2011/12 budget which was approved as part of the three year budget in March 2010. The savings have been made across the service mainly through identifying better ways of delivering the service through greater use of electronic systems.

e) SIP and updated Myners Principles for effective decision making by pension funds

The Fund is required under the regulations to publish a Statement of Investment Principles (SIP) which sets out the Fund's investment and risk management policy. It also includes a statement as to the Fund's compliance with the Myners Principles for effective decision-making for pension funds ("the principles"). In March 2011 the Committee approved the principles which were revised for the following:

- Changes to asset allocation and the appointment of new global equity manager
- Updated Myners' compliance to include self assessment of the effectiveness of the decision-making processes of the Committee and the training programme

f) FRC Stewardship Code

Corporate governance is an integral part of responsible investing. In the UK there has been a well defined framework for the role of investors in corporate governance but as the financial crisis of 2007/08 confirmed, the framework was not always effective. As a result the Financial Reporting Council (FRC) has taken over responsibility for the corporate governance framework with the publication of the Stewardship Code. This code is a set of best practice principles that are intended to improve the extent and effectiveness of shareholder engagement with companies. Shareholder engagement includes the voting of shares at company meetings and meeting with companies to discuss governance issues. The principles include the following:

- Investors must publicly disclose their policy on how they will discharge their stewardship responsibilities
- How investors monitor the investee companies with regard to governance issues
- Have a clear policy on voting and disclosure of voting activity

Importantly the FRC code requires investors to report their compliance with the Code. The Fund published its compliance with the code in December 2010. Its level of compliance will be strengthened in 2011 through the appointment of a vote monitoring agent who will monitor the voting activities of the Fund's external managers, against best practice principles.

g) Approval of Administration Strategy

In recent years LGPS funds have been encouraged to have a Pensions Administration Strategy as a matter of best practice. In 2010 the Avon Pension

Fund developed its strategy and, after a period of consultation with scheme employers, implementation of the strategy began with effect from 1 April 2011.

The strategy is key to preparing the Avon Pension Fund for the change anticipated over the next 3-5 years. The primary objective of the strategy is for the Fund and employers to work together more effectively in order to meet future challenges and deliver an excellent level of service.

Key elements of the strategy are improving communications between employers and the Fund, comprehensive training of both in-house staff and pension staff at the employers, and utilising technology more effectively to capture and process data.

The strategy incorporates performance targets for both the Fund and employers which are set out in Service Level Agreements (between the Fund and scheme employers). Performance of both parties will be monitored via Stewardship reports which will be discussed at regular review meetings with employers. In addition, performance will be monitored by the Committee on a quarterly basis once sufficient data has been compiled.

h) Workplans

Separate workplans are prepared for the Committee and Investment Panel detailing the forthcoming areas of work relating to investments strategy and policy and Benefits administration to give the Committee and officers the opportunity to review the and accommodate issues that may arise.

<u>5 FUTURE BUSINESS</u>

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

a) Investments

- Review the Fund's policy towards Socially Responsible Investing

b) Fund solvency

- Review potential impact of changes to the scheme structure on the funding and investment strategies

c) Governance

- Roll out the formal training policy for both Members.

d) Benefits Administration

- The Fund will roll out the Administration Strategy during 2011/12 and as data is compiled, the Committee will begin to monitor the performance against targets of both the employers and the Fund.

- It is expected that the government will issue its proposals for the future scheme in autumn 2011 for consultation with all relevant stakeholders. The Fund will fully participate in all consultations engaging fully with the Committee, national and regional LGPS groups as well as ensuring Fund members and employers understand how the proposed changes will affect them.

Avon Pension Fund

June 2011