

THE AVON PENSION FUND

SERVICE PLAN

2022 - 2025

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AVON PENSION FUND SERVICE PLAN

2022-25

1 BACKGROUND

With Covid restrictions finally easing across the UK the sense of normality has been replaced by the disbelief over the situation in Ukraine and the worldwide repercussions this will have. The Fund will not be immune from this, as trade and asset values are impacted by sanctions and geopolitical tensions, but the Risk Management Strategy, which was further strengthened during the past year, should provide some immediate cushioning. More importantly is the medium to long term outlook which will play into the 2022 valuation and investment strategy review which now looks to be far more challenging, with increasing concerns around inflationary impacts.

Operationally the Fund has had mixed success during the Covid isolation period with the Investment Strategy able to move ahead more easily into asset transition, expansion into private markets and renewables whilst making significant moves to combat climate change. The administration service however continues to have challenging performance, a combination of staff turnover and difficult operating conditions, but there are positive signs this has now turned a corner particularly with teams now able to operate more frequently in an office environment.

Having spent much time reviewing the challenges faced by the Administration a new operating model has been developed which will provide greater focus on digital enablement and support functions whilst still maintaining distinct Member and Employer services. This new model will allow the strengthening of the management team to enable transformation and project work to be more easily delivered and include greater flexibility in job structures through career grade roles which will support ongoing recruitment and retention. This new model will be delivered over the next twelve months. It is expected during this period that the Fund will be able to move into new offices at the River Suite Keynsham, scheduled for completion towards the end of the calendar year.

On the regulatory front, more “guidance” can be expected for the LGPS to align with government policy on Carbon reduction, Levelling Up and unsurprisingly Foreign Policy all of which will influence investment strategy; whilst at least on the Administration side much work has already been done on McCloud with the remedy still anticipated along with a revised Exit Cap, while the Pensions Dashboard is gathering momentum

Finally whilst the Fund will continue to implement technology to enhance Member and Employer digital services and in particular self-service, much more work will be undertaken on Cyber resilience as the threat levels across the public sector increase.

Administration

The post COVID return to a new normal will see services delivered in a mixed environment of virtual and collaborative working. The most obvious outcome of moving to hybrid working is that all communication, engagement and operations now have to be timetabled and planned. With limited visibility there is increased pressure on the management team to ensure all operations are effectively maintained. Whilst the development of digital tools to support this area are beginning to emerge, at present there remains a reliance on increased

management effort to sustain the status quo. A number of previously planned developments have been paused as a result but the need now to fully embrace digital operational capability provides a further logistical and management resource drain. Ensuring there remains sufficient management focus in key areas is now a major challenge for the administration and it is recommended that the management team is strengthened in quite specific area to accommodate this. Also, the increase in resource across the Pensions Payroll team to build resilience and assist with operational support is also recognised.

The new operating environment also requires structural transformation to support it and whilst the service has adapted, the change is far from complete. The development and implementation of a new operating model incorporating a tiered structure will maximise digital service delivery whilst separately providing greater focus and control on workload and performance. A business support and development function will subsume the remaining services and lead on commissioning activity and projects. Whilst this transformation is being established a project to kick start some of this work particularly the delivery of digital services and Customer support will be implemented. More detail of the planned transformation workstreams and timetable are contained in Appendix 3. A high-level admin structure chart to support the transformation process and maintain business operational needs is shown as Appendix 4. It is anticipated that the net cost of this structural change will be £148k with some of the costs being met by existing budgets.

Investments & Funding

Significant progress has been made in the last twelve months to prepare for the next strategic cycle of the 2022 triennial valuation and strategic investment review. Specifically

- a) The interim valuation provided an indication of the issues that will need to be considered at the next valuation; however, the funding level has improved (was c. 100% at the time of the exercise) which should provide more flexibility when setting the funding strategy at the valuation.
- b) Our covenant assessment process is in place, providing a risk based approach to managing employer risks which will feed into the 2022 valuation.
- c) The review of the allocation across the equity portfolios has been completed, resulting in a switch from the passive Low Carbon Equity portfolio to the new Paris Aligned portfolio and exiting the dedicated Emerging Market Equity portfolio.
- d) Setting new climate targets for short and medium term. These intermediate targets to reduce the absolute emissions of the equity portfolio by 43% by 2025 and 69% by 2030 (versus 2020 baseline) provide clear milestones during the transition period for the Fund to achieve net zero by 2050.
- e) Publishing our TCFD statement in 2021 to demonstrate our commitment to reducing our carbon exposure.
- f) Restructuring the Equity Protection Strategy (EPS) to implement a dynamic strategy where the protection level adapts to evolving market conditions, thus removing timing risk. It also has a lower governance burden.
- g) Creation of the Funding and Risk Management Group (FRMG) to provide a more robust and efficient governance framework for the Investment Risk Management Strategies. Whilst these strategies were developed and implemented there was significant and ongoing involvement of the Investment Panel. The new framework

ensures the Committee/Panel focuses on delivery and strategic effectiveness rather than detailed operational aspects.

- h) Completion of transition of our assets to Brunel; this milestone was reached in 2Q21 and the relationship is now evolving towards strategic focus and business as usual monitoring of service delivery.

In addition, we have increased communications with our members regarding our investment strategy and approach to Responsible Investing (RI). This included a short animation to explain our strategy to achieve a net zero asset portfolio, a member survey on Responsible Investing and articles in newsletters discussing some of our sustainable and renewable investment assets.

The key project for 2022 is the triennial valuation which always involves significant engagement with our employers. Given the growth in the employer portfolio since the last valuation, this will be complex with more individual employer issues that will need consideration. In addition, we are seeing more movement and changes within the employer base as employers are more actively monitoring and managing their pension liabilities, especially given the 'flexibilities' now permitted in the regulations. This in turn has led to greater engagement and workload for the team with more of the team's resource being used to manage employer risk. It also means we are commissioning more legal and actuarial advice to ensure the Fund is fully protected. Having reviewed the impact of this on team resources during 2021, the Funding & Actuarial team will be strengthened by adding a senior post to support (and deputise for) the Funding & Valuation Manager. This will ensure there is sufficient resource for policy development and implementation as well as dealing directly with employers.

The investment focus for the year ahead is the strategic investment review (aligned with the valuation) and Brunel's 2022 (Paris Agreement) Stocktake. These projects will be run in parallel as the Fund will need to consider the outcome of the 2022 Stocktake before it finalises its strategic policy. It is planned that the strategic review will conclude in 1Q23. The strategic review will consider the level of return and risk required to achieve our funding strategy given the current funding position and outlook for markets as well as the risk management strategies we have in place to protect our funding position. The 2022 Stocktake will build on the Brunel's industry leading work already completed in 2021 to develop Paris aligned benchmarks for equity portfolios and will assess the need for selective divestment. In addition, during 2022 we expect further guidance on pooling, TCFD disclosures and LPGS role in Levelling Up from DULHC which may put further demands on the team.

The addition of a Senior Investments Officer (SIO) in early 2021 has enabled the Investments team to increase its member communication output as well as successfully complete two major projects (the equity portfolio review and EPS restructuring). With the transition of most of the assets (and related operational risk) to Brunel, the level of ongoing workload is now stable and the team is adequately resourced. This team also supports the FRMG which has increased the level of monitoring done internally on the Risk Management Strategies to ensure we are proactively managing key risks such as inflation and market volatility.

Addressing the Climate Emergency

The Fund's strategy to reduce its carbon emissions and exposure encompasses all aspects of its activities. As part of B&NES Council it is committed to achieving the Council's goal of being net zero by 2030. In respect of its operations it will achieve this by fully digitalising its service delivery to members and employers, accepting that it will have to provide non digitalised service to those that are not electronically enabled in the meantime. In addition, use of technology to enable remote working and online learning and seminars will reduce the carbon emissions from commuting to work and travel to conferences and seminars.

Alongside the operational strategy, the investment strategy embeds responsible investing throughout the investment process starting with setting the investment objectives. A number of climate change objectives are in place and the implementation of the investment strategy will be consistent with achieving these goals. These goals will be kept under review as the development of UK and international government policies, advances in technology and creation of investment solutions should mean the milestones can be brought forward over the next 5-10 years.

As a responsible investor the Fund will continue to improve its disclosure on its climate related and broader stewardship activities by reporting annually in line with the Task Force on Climate-Related Financial Disclosures and the Financial Reporting Council's Stewardship Code. In addition, we will be developing further our interaction with members and employers about our activities and how, as an investor, we are promoting change and demonstrating leadership in the field of responsible investment.

Governance

The Scheme Advisory Board's (SAB) Good Governance review has set out several recommendations which would improve the Governance of the LGPS. The Phase 3 report was published in February 2021 and contained details on the implementation of the recommendations. The timeline for the statutory guidance necessary for Good Governance recommendations to take formal effect is in the hands of the DLUHC; however, SAB recommend that in the meantime LGPS funds identify any gaps and take steps to improve governance against the recommendations without waiting for statutory guidance.

In 2021/22 we reviewed our governance arrangements against the recommendations. We are pleased to say that we meet most of the recommendations but have an action plan to address aspects where our arrangements/policies could be improved. Where it will add value, we will get support from advisors to develop the policies or provide support. An example of this is the use of the Hyman Robertson's Learning Academy by committee and board members as well as officers. Other areas to be developed are a Fund specific Conflicts of Interest Policy, Representation Policy and Training Policy.

The Pension Regulator (TPR) is expected to publish its Single Code of Practice later in 2022 with new modules covering cyber security, transfers and scams of particular note. The Fund is currently undertaking a review of its position against the new code and particularly in regard to cyber security. A report on the findings of our cyber security review plus action plan for will be presented to committee and pension board in the summer of 2022.

As the Good Governance Review has increased the workload relating to governance, a junior post is being created to support the Governance and Risk Advisor.

Workload

For a number of years the Fund has increased resources to meet the ongoing challenge of employer and regulatory growth and for the time being there is no sign of this abating. The operating circumstances have been challenging over the past two years during which, productivity and particularly the management of new developments and projects have remained challenged in respect of delivery times. The service plan priorities have been reviewed and realigned to reflect a gradual emergence from operating constraints and provide a more realistic delivery timescale. The key to success now very much hinges on the necessary developments in technology to enable efficient hybrid working; essential for project delivery strategy and policy development, cultural and social cohesion. The Administration Strategy is under review to ensure that all the issues experienced by the service through this difficult period can be recognised and addressed. The admin strategy will be refocused on areas of communications, training and transformation but the size of the challenge ahead should not be underestimated.

2 KEY OBJECTIVES – 2022/23 to 2024/25

Funding Strategy:

1. Undertake the triennial valuation (which will set employer contribution rates with effect from April 2023).
2. For individual employers implement the Fund's policies within the Funding Strategy Statement that will enable greater flexibility in managing employer risk and scheme exits. For smaller employers in particular this will ensure pension costs remain affordable for the employer and financially sustainable for the Fund
3. Ongoing covenant assessment for incorporating into the Funding Strategy and funding plans.
4. Explore further options for bespoke portfolios to manage the funding and liability position of specific employer risk groups.

Investment Strategy:

5. Review the investment strategy ensuring the investment objectives are consistent with the funding objectives and that all RI risks are being managed. This will include reviewing our climate targets and the Risk Management Strategies.
6. Monitor the performance of Brunel and their portfolios, ensuring Brunel are delivering the Fund's strategic objectives.
7. Actively participate in the 2022 Stocktake led by Brunel to ensure the Fund's RI objectives are met
8. Through FRMG monitor the Risk Management Framework as required as a mechanism for managing liability risk through the investment portfolio and mitigating investment risk.
9. Support initiatives and undertake activity to demonstrate the Fund's commitment to meeting its climate emergency targets such as annual reporting in line with the TCFD recommendations and as a signatory to IIGCC initiatives to influence government policy and regulatory change.
10. Continue to improve communications with our broad array of stakeholders about the investment strategy with a focus on how the strategy is mitigating the financial risk of climate change.

11. Maintain the Investment Strategy Statement reflecting strategy developments and changes due to Brunel operations.
12. Retender the Investment Consultancy contract.

Administration Strategy:

13. Develop a new digital service platform providing Customer services and digital records management
14. Review wider operating model and structure to include member and employer services and separate support and development function.
15. Continue the move towards digital delivery of Scheme communications to stakeholders reflected in a revised communications strategy.
16. Complete the rollout of I-Connect and the receipt of monthly member data returns.
17. 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.
18. Monitor outcomes of McCloud judgement and implement actions to manage remedy.
19. Undertake necessary work to ensure the Fund meets regulatory compliance with DWP Pensions Dashboard requirements ahead of the expected compulsion date.
20. Develop revised Admin Strategy proposals to reflect the digital transformation and to take to Pensions Committee.

Governance:

21. Keep governance arrangements under review to ensure effective monitoring of Brunel.
22. Implementation of the Good Governance Review (SAB) recommendations.
23. To ensure the Committee and the Pensions Board is fully trained and briefed on current strategies and operations and in a position to scrutinise and make decisions effectively.
24. Retender advisory and service contracts to align contracts with Fund objectives, e.g. Procurement of a new AVC provider in 2022.
25. Implementation of action plan following review of TPR's Single Code of Practice, particularly in regard to cyber security.
26. Ongoing review of committee meeting reports and transition of monitoring reports to the Modern Gov library.
27. Review of risk management process with links to risks better demonstrated in committee reports.

A report on objectives, targets & progress towards objectives and those rebased and temporarily put on hold is given in Appendix 2.

3 RESOURCE IMPLICATIONS

To address the changing focus of work within the actuarial team, the team's capacity is being increased at a senior level to support the Funding and Valuation Manager in developing and implementing policies and dealing with employer specific events.

Despite assets transferring to Brunel, the investment team still requires significant resources to manage and develop the relationship with Brunel and the client side of the pool as well as delivering the investment strategy, including Responsible Investing and Risk Management. This internal specialist capability ensures the Fund's 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/external advice. Following the appointment of a Senior Investments Officer in early 2021, with a specific focus on ESG and RI capacity in the team is now sufficient for the current workload and strategic focus. Therefore the second vacant SIO post provided for in the 2021/22 budget is no longer required.

As discussed earlier, a junior post has been created to support the increasing workload of the Governance & Risk Advisor.

In respect of administration, an ongoing recruitment programme has been in place over the past twenty months to complete the establishment. At the same time the COVID pandemic has facilitated a channel shift in employer requirements with the opportunity for home working creating a more competitive market. A number of key administrative posts remain vacant at this time and will aim to be filled in the early part of the year. Further recruitment to better structure the management team and support transformational needs of the service will be introduced as part of the 2022/23 budget and operationally the administration resources will be considered later in the year as part of the Administration Strategy review.

The 2022/23 budget allows for additional temporary resource to support the governments planned introduction of the Pensions Dashboard Programme, this is in addition to the previously agreed temporary resource introduced to manage the McCloud remedy, with the use of external specialist support as part of the ongoing solution to manage elements of other specific project work.

4 BUDGET

This Service Plan period includes the costs of managing investment assets through Brunel. The transition of assets has resulted in lower fee rates across the transitioned portfolios. 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 2022/23 is £5.9m.

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 includes the costs of supporting the Fund's RI strategy to manage the impact of climate change on the asset portfolio. The total budget committed to RI 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 2021/22 budget of £220,602

The budget includes additional resource to strengthen the management team and £115k is provided for the continued additional temporary resources to meet expected increased workload resulting from the McCloud remedy. The provision of £20,000 made in the previous budgets to provide equipment to support flexible working during the pandemic will continue into 2022/23 as part of the office relocation. The budget also includes the costs to complete the GMP rectification exercise.

Investment Management fees:

The annual investment management fees of £21.7m are 18% higher than in last year's budget of £18.4m. This is due partially to the assets increasing in value over the last year by 14% (between the dates used to estimate the fees for the budget) and an increase in the amount of capital committed to private markets which incur higher fees. During the year further recurring fee reductions were achieved on assets that transitioned to Brunel portfolios with savings of c. £0.25m p.a. on the Brunel Multi Asset Credit portfolio, the only (and last) transition in 2021/22. To date the cumulative investment fee savings from transitions are c. £3.6m p.a. (when comparing to the fees paid prior to transition and ignoring later strategic allocation changes).

Offsetting the recurring fee savings are the strategic allocation switches from lower cost to higher cost portfolios especially from lower cost listed asset portfolios to higher cost private market assets which puts upward pressure on fees. In addition very low performance fees were accrued in 2021/22 whereas this is expected to increase in 2022/23; this reflects the rebound in property and infrastructure values from the fall due to the pandemic.

As at 31/12/21, Brunel manage £4.9 billion or 83% of the Fund's assets as follows:

Brunel portfolio	Value at 31/12/21
Passive Low Carbon Equities	£226m
Passive Paris Aligned Equities	£596m
Sustainable Equities	£649m
Global High Alpha Equities	£756m
UK Property	£198m
Diversified Return Funds	£536m
Multi Asset Credit	£324m
Private Market Assets	£561m
Risk Management Strategies	£1,046m

The estimated fees for 22/23 assume legacy mandates are retained and no strategic changes are made.

The actual fees paid in 2022/23 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).

Brunel management costs:

The shareholders have approved the 3-year budget and Business Plan for Brunel for 2022/23 to 2024/25. The budget ensures there are adequate resources to

- (i) deliver a suite of portfolios to ensure clients can implement their investment strategy efficiently;
- (ii) support the clients' RI objectives;
- (iii) ensure resilience and capability in the private markets team as the assets under its management increase and

- (iv) implement the revised reporting to clients as the business moves from the transition phase to business as usual.

The overall costs of Brunel of £11.7m for 2022/23 is c.5% increase year on year, reflecting inflationary pressure and higher costs to improve client reporting and deliver on the client's RI objectives. As the transition of assets is now complete, the costs of Brunel are allocated to each client split by 1/10th for non-portfolio related costs and on an AUM basis for the costs directly relating to the portfolios (the client is invested in). Currently Avon's share is c. 12% of the total cost at £1.45m p.a. (or 3bps).

Governance Costs:

Ongoing governance costs, primarily actuarial and investment advice are determined by the work programme of the Fund and Committee. The actuarial workload continues to increase as the team deals with more employer specific events and changes to the regulations (such as the new funding flexibilities) lead to more activity, all of which is pushing up costs. In addition, in 2022/23 the triennial valuation increases costs significantly (as happens every 3 years). Overall, there is a 37% increase in actuarial costs (over 2020/21 budget) to c. £1 million, a quarter of which is relates to the 3 yearly valuation exercise. It also includes technical and compliance support for the admin team. Aligned to the increasing employer related work, the budget for legal costs is also being increased now more legal advice is now required by officers when advising employers and / or the Service Director around employer specific events and in the drafting of policies.

There is a small decrease in the budget for Investment Advice, which was inflated last year by the cost of implementing the Dynamic Equity Protection Strategy. The proposed budget includes the strategic investment review, including further climate analysis, and the ongoing cost of the FRMG which monitors the Risk Management Strategies.

The Governance budget is increasing this year as we are anticipating the resumption of more in person training and attendance at conferences as well as the provision of online training modules for all committee members and senior officers. In addition, there are some projects related to our Good Governance action plan that will require advice from consultants.

Salaries:

There is slight upward pressure on the salaries in the Finance & Investments Team with a net increase of one junior post in the budget.

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 2021/22 to 2022/23 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 monthly and reported quarterly to Committee. As a result of the advance future service rate payments, due to be made by the major employers in April 2022, the Fund will have larger cash in-flows at the start of the

financial year. The consequent absence of these in the following months will result in greater negative monthly 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 2022-23 and 2024-25 together with a cash flow forecast for the payment of benefits and the receipt of contributions are given in **Appendix 5**.