Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND COMMITTEE**	
MEETING DATE:	**24 June 2022**	**AGENDA ITEM NUMBER**
TITLE:	**DRAFT FUNDING STRATEGY STATEMENT 2022**	
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 Fund's Actuary has used in preparing the actuarial valuation and the policies adopted by the Administering Authority.

1.2 A Committee workshop will be held on 17 June 2022 to discuss the broad principles in the FSS in more detail prior to the committee meeting.

1.3 The Actuary will be at the meeting to present the draft FSS and answer any queries. Once the Committee has agreed the draft, it will be circulated to the employing bodies and Pension Board for comment. The comments arising from the consultation will be reported to the Committee meeting on 23 September 2022 when the FSS will be approved.

1.4 The actuarial outcome will be reported to Committee at the March 2023 meeting.

1.5 Individual employer results will be disseminated in October and November.

2 RECOMMENDATION

The Committee:

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

2.2 **Delegates power to officers, having taken advice from the Actuary, to amend the draft FSS as new legislation or guidance is issued as appropriate.**

3 FINANCIAL IMPLICATIONS

3.1 The actuarial costs for reviewing the FSS are included in the 2022 actuarial valuation fee and are provided for in the 2022/23 budget.

4 BACKGROUND AND PROCESS

4.1 The LGPS regulations require each administering authority to prepare and publish a Funding Strategy Statement. The key requirements for preparing the FSS are as follows:

- After consultation with all relevant interested parties involved with the Fund, 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 Investment Strategy Statement (ISS) for the Fund published under the LGPS (Management and Investment of Funds) Regulations 2016
- 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 ISS.
- The Fund's Actuary must have regard to the FSS as part of the valuation process.

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, consultation processes and associated analysis have been completed.

4.4 The draft FSS will be circulated to employers and interested parties for consultation during July and August. Comments will be considered by Officers and reported to the Committee at the Committee meeting (23 September 2022) 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 2022 valuation outcome will be reported to Committee in March 2023.

5 DRAFT FUNDING STRATEGY STATEMENT

5.1 At the Committee workshop on 17 June 2022, the Actuary will give 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, employer 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 Although the Regulations specify the fundamental principles on which funding contributions should be assessed, implementation of the funding strategy is the responsibility of the Administering Authority, acting on professional advice provided by the Actuary.

5.5 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. The purpose of the FSS is therefore

- To establish a clear and transparent fund-specific strategy which will identify how employers' pension liabilities are best met going forward by taking a prudent longer-term view of funding those liabilities
- To establish contributions at a level "to secure the solvency of the pension fund" and the "long term cost efficiency"
- To have regard to the desirability of maintaining as nearly constant a primary rate of contribution as possible.

5.6 The key financial and demographic assumptions in the FSS are set following advice from the Fund 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".

5.7 In the draft FSS 2022 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 Fund, based on advice from 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).

The discount rate reflects the "real" expected asset return above the CPI baseline assumption when assessing the long-term solvency target. This is a challenge for this valuation given the current significant increase in inflation which increases the liabilities as the benefits are inflation linked and potentially reduces the real return on assets. A judgement is needed as to how persistent this period of higher inflation could be, with the risk that understating its duration in this valuation will transpire into higher contributions at the next valuation in 2025.

The Actuary is proposing to reduce the expected level of real return above CPI by 0.25% from the 2019 valuation to CPI+1.50% per annum, to maintain an appropriate level of prudence (as in the probability of achieving in the discount rate). However given that investment returns have been higher than expected in 2019, the funding level has improved when allowing for the lower discount rate, and the deficit has reduced (at the overall Fund level although the experience for individual employers will vary considerably and markets have declined post 31 March 2022). The Actuary has carried out expected return analysis to model the potential returns that will be achieved on the Fund's assets in the future.

(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.

The Actuary's view is that the real return applied in 2019 could be too optimistic given the impact of inflation on investment returns and the challenging outlook since the valuation and advises a discount rate of CPI +2.00% per annum be considered (a 0.25% reduction). As a result, there will be upward pressure on the FSR (all other things equal).

(3) Mortality assumption

The baseline and short-term trend in mortality will be adjusted to reflect the Fund's experience since 2019. The full demographic analysis has yet to be completed. However there is some indication that life expectancy has fallen (even ignoring any adjustment for COVID at this stage) which will reduce the baseline liabilities. The longevity assumption used will be in line with current Continuous Mortality Investigation (2021) with a long-term improvement trend of 1.75% p.a. and this is set out within the FSS. Overall initial indications are that the liability impact is a c. 2-3% reduction versus 2019.

(4) Deficit Recovery Period

The Fund's objective is that deficits are paid off as quickly as possible taking into account the employer's covenant, competing cost pressures and the requirement to ensure intergenerational fairness between current and future tax-payers. It is important to note that the recovery period can be an important tool for managing significant increases in deficits; therefore it is important to reduce the period when it is affordable to do so. The FSS sets out differing target recovery periods by type of employer, driven by the covenant assessments.

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

5.9 National Issues that will need to be reflected in the FSS:

The FSS was updated in 2021 to reflect the changes to the regulations (greater flexibility for employer exit payment plans etc). Therefore there are few significant new issues included in this update of the FSS.

(1) Climate change analysis

An important part of the risk analysis underpinning the funding strategy will be to identify the impact of climate transition risks and physical risks on the potential funding outcomes. The impact of different scenarios at the whole Fund level versus the baseline (which assumes the funding assumptions are played out) will be considered as part of the valuation to ensure the funding strategy is sufficiently robust to the risks posed by climate change.

This section of the FSS is not finalised as we are still waiting guidance from GAD of what must be considered.

(2) McCloud

The McCloud discrimination case relates to the protections provided to members close to retirement when the Fund benefits were changed in 2014. The costs of the remedy (as it was unknown) was not included in the 2019 valuation balance sheet although the estimated cost of a potential remedy was allowed for in employer contributions where employers opted for this. The DLUHC has now set out how the remedy should be treated at the 2022 valuation to ensure consistency (as changes to the Regulations have yet to be passed into law). Therefore in line with this recommendation, the Fund's approach will be to include amendments for all employers in the 2022 valuation to reflect the McCloud remedy when valuing past service liabilities. The McCloud benefit window ended on 31 March 2022 and so it does not affect employer future service contribution rates at the 2022 valuation.

(3) GAD S13 Report

GAD reviews all fund valuations after each valuation and benchmarks each fund against GAD KPIs. The Actuary will take these KPIs into account but where it can be evidenced that they are not optimal for managing risk, the Actuary will advise the Committee and explain the possible consequences of adopting the proposed strategy.

5.10 **Changes to Fund specific policies:**

The only new policy in the 2022 FSS covers ‘Notifiable Events’. It is best practice to have a defined set of notifiable events that employers are obliged to inform the Fund about as it may have a material effect on the covenant or the liability or membership profile. Whilst in most cases regular covenant updates will identify some of the key employer changes, in some circumstances, employers are required to proactively notify the Administering Authority of any material changes. This policy sets out when this may happen and the notifiable events process.

The existing policies have all been reviewed and streamlined to enable stakeholders to read and understand the information in a clear and concise way. However, the majority of the content remains unchanged (except to reflect the 2022 valuation updates such as assumption and date changes etc).

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 in place. This is designed to reduce risk and provide more stability/certainty of outcome for funding. The strategies are implemented on an opportunistic basis to ensure the most efficient and cost-effective approach is taken. Reference is made to the framework in the draft FSS. Full details are contained in the Investment Strategy Statement.

7 CLIMATE CHANGE

7.1 The Fund is implementing a digital strategy across all its operations and communications with stakeholders to reduce its internal carbon footprint. The Fund acknowledges the financial risk to its assets from climate change and addresses this through its strategic asset allocation to Paris Aligned Global Equities, Sustainable Equities and renewable energy opportunities. The strategy is monitored and reviewed by the Committee.

8 EQUALITIES

8.1 An equalities impact assessment is not necessary.

9 CONSULTATION

9.1 A consultation process will follow after agreement from the Committee.

10 ISSUES TO CONSIDER IN REACHING THE DECISION

10.1 Are contained in the report.

11 ADVICE SOUGHT

11.1 The Council's Monitoring Officer and Section 151 Officer have had the opportunity to input to this report and have cleared it for publication.

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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	