

AVON PENSION FUND

FUNDING STRATEGY STATEMENT (FSS)

This Statement has been prepared by Bath and North East Somerset Council (the Administering Authority for the Local Government Pension Scheme in the area formerly known as Avon) to set out the funding strategy for the Avon Pension Fund (“the Fund”), in accordance with Regulation 76A of the Local Government Pension Scheme Regulations 1997 (as amended) and the guidance paper issued in March 2004 by the Chartered Institute of Public Finance and Accountancy (CIPFA) Pensions Panel.

1. Introduction

The Local Government Pension Scheme (England and Wales) (Amendment) Regulations 2004 provide the statutory framework from which the Administering Authority is required to prepare a Funding Strategy Statement. The key requirements for preparing the FSS can be summarised as follows:

- After consultation with all relevant interested parties involved with the Scheme the Administering Authority will prepare and publish their funding strategy;
- In preparing the FSS, the Administering Authority must have regard to:-
 - (i) the guidance issued by CIPFA for this purpose; and
 - (ii) the Statement of Investment Principles (SIP) for the Scheme published under Regulation 9A of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended);
- The FSS must be revised and published whenever there is a material change in either the policy set out in the FSS or the Statement of Investment Principles.

Benefits payable under the Scheme are guaranteed by statute and thereby the pensions promise is secure. The FSS addresses the issue of managing the need to fund those benefits over the long term, whilst at the same time

facilitating scrutiny and accountability through improved transparency and disclosure.

The Scheme is a defined benefit final salary scheme under which the benefits are specified in the governing legislation (the Local Government Pension Scheme Regulations 1997 (as amended), the “Regulations”). The required level of employee contributions are also specified in the Regulations.

Employer contributions are determined in accordance with the Regulations (principally Regulation 77) which require that an actuarial valuation is completed every three years by the actuary, including a rates and adjustments certificate. Contributions to the Scheme should be set so as to “secure its solvency”, whilst the actuary must also have regard to the desirability of maintaining as nearly constant a rate of contribution as possible. The actuary must have regard to the FSS in carrying out the valuation.

2. Purpose of the FSS in policy terms

Funding is the making of advance provision to meet the cost of accruing benefit promises. Decisions taken regarding the approach to funding will therefore determine the rate or pace at which this advance provision is made. 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 the professional advice provided by the actuary.

The purpose of this Funding Strategy Statement is:

- **to establish a clear and transparent fund-specific strategy which will identify how employers’ pension liabilities are best met going forward;**
- **to support the regulatory requirement to maintain as nearly constant employer contribution rates as possible; and**
- **to take a prudent longer-term view of funding those liabilities.**

The intention is for this strategy to be both cohesive and comprehensive for the Fund as a whole, recognising that there will be conflicting objectives which need to be balanced and reconciled. Whilst the position of individual employers must be reflected in the statement, it must remain a single strategy for the Administering Authority to implement and maintain.

3. Aims and purpose of the Pension Fund

The aims of the fund are to:

- enable employer contribution rates to be kept as nearly constant as possible and at reasonable cost to the taxpayers, scheduled, resolution and admitted bodies

- manage employers' liabilities effectively
- ensure that sufficient resources are available to meet all liabilities as they fall due, and
- maximise the returns from investments within reasonable risk parameters.

The purpose of the fund is to:

- receive monies in respect of contributions, transfer values and investment income, and
- pay out monies in respect of scheme benefits, transfer values, costs, charges and expenses,
- as defined in the Local Government Pension Scheme Regulations 1997 (as amended) and in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended).

4. Responsibilities of the key parties

The Administering Authority should:

- collect employer and employee contributions
- invest surplus monies in accordance with the Regulations
- ensure that cash is available to meet liabilities as and when they fall due
- manage the valuation process in consultation with the actuary
- prepare and maintain an FSS and a SIP, both after due consultation with interested parties, and
- monitor all aspects of the Scheme's performance and funding, amending the FSS/SIP as necessary.

The Individual Employer should:

- deduct contributions from employees' pay correctly
- pay all contributions, including their own as determined by the actuary, promptly by the due date
- exercise discretions within the regulatory framework

- make additional contributions in accordance with agreed arrangements in respect of, for example, augmentation of scheme benefits, early retirement strain, and
- notify the Administering Authority promptly of any changes to membership which may affect future funding, preferably before the event.

The Fund Actuary should:

- prepare valuations including the setting of employers' contribution rates after consulting the Administering Authority and having regard to the FSS, and
- prepare advice and calculations in connection with bulk transfers and individual benefit-related matters, and
- advise on funding strategy, the preparation of the FSS and the inter-relationship between the FSS and the SIP.

5. Solvency issues and target levels

To meet the requirements of the Regulations the Administering Authority's long-term funding objective is to achieve and then maintain assets equal to 100% of projected accrued liabilities, assessed on an ongoing basis including allowance for projected final pay.

The financial assumptions making up the funding strategy and as adopted for the 2004 valuation are:

	Past Service	Future Service
Rate of discount	6.95% per annum (pre-retirement) 5.8% per annum (post-retirement)	6.5% per annum
Rate of Pensionable Pay Inflation	4.05% per annum	3.75% per annum
Rate of price Inflation	2.8% per annum	2.5% per annum

The key financial assumptions are as follows:

- the extent to which the Fund's investments are expected to outperform a portfolio of Government bonds ("asset outperformance assumption" – AOA). An AOA of 2.35% per annum has been assumed in respect of pre-retirement liabilities and 1.2% per annum in respect of post-retirement liabilities.
- the expected rate of Pensionable Pay increase above price inflation ("real Pensionable Pay growth"). This has been assumed to be 1.25% per annum.

The AOA represents the advance allowance which, for valuation purposes, the actuary is making for the return which will be achieved on the Fund's assets over and above Government bonds. This reflects the liability profile of the Fund and the fact that the Fund is invested 75% in equities (UK and overseas) and 25% in bonds (fixed interest and index-linked, including overseas). If the return actually achieved is higher than this the Fund deficit will be reduced; if the return is lower then the Fund deficit will increase (provided that all the other assumptions remain valid).

The rate of pensionable pay inflation relates to pay increases for scheme members during their period of employment (this will determine the level of their final salaries, on which the pension is based). If the actual rate of pensionable pay inflation is greater than the actuary's assumption the Fund deficit will increase; if it is lower then the Fund deficit will be reduced (again, provided that all the other assumptions remain valid).

The rate of price inflation applies primarily to pensions in payment, given that they are increased each April by the Retail Price Index applying in the previous September.

In testing whether actual experience has been in line with the actuary's assumptions (which are intended to be long term allowances rather than predictive of rates in the three year period between valuations), any monitoring exercise would need to focus on their aggregate effect.

The 2004 valuation has also taken into account increased longevity, the mortality assumptions being based on more up to date actuarial tables. Since the last valuation in 2001 projected longevity, based on recent surveys, has increased at a greater rate than previously expected. However, the assumptions made in the valuation reflect the fact that historically local authority pension schemes have tended to exhibit higher mortality than pension schemes generally.

The 2004 valuation has also taken into account the reduction in liabilities arising from the abolition of the "Rule of 85".

The following two tenets underpinned the 2004 valuation:

- that the Fund and the major employers are expected to continue for the foreseeable future; and
- favourable investment performance can play a valuable part in achieving adequate funding over the longer term.

The current actuarial valuation of the Fund is effective as at 31 March 2004. The results indicate that overall the assets of the Fund represented 80% of projected accrued liabilities at the valuation date.

Historically, any shortfall of assets relative to liabilities has been recovered over a period of 15 years. As administering authority for the Avon Pension Fund, Bath & North East Somerset Council would not wish to discourage employing

bodies from adhering to this practice. However, in recognition of the prospective increase from 60 to 65 of the date on which a scheme member can draw an unreduced pension and the financial pressures likely to confront most employing bodies in the financial year 2005/2006 and beyond, the Council, with the consent of the actuary, has in most cases agreed to a request from an employing body to increase the recovery period from 15 to 20 years.

Similarly, given the scale of increase in contribution rates necessary to restore full funding - and again with the actuary's consent - the Council has allowed employing bodies to phase in the increase over a period not exceeding three years.

Special arrangements will generally apply to bodies admitted under Regulation 5A of the Local Government Pension Scheme Regulations 1997 (as amended).

Notwithstanding the above, the Council, in consultation with the actuary, has also had to consider whether any exceptional arrangements should apply in particular cases.

In formulating its policy with regard to both the deficit recovery period and phasing, the Council has had regard to:

- the comments made by the employing bodies at a meeting held on 9 June 2004 to discuss the 2004 actuarial valuation
- the need to balance a desire to attain the target as soon as possible against the short-term cash requirements which a shorter period would impose, and
- the capacity of participating employing bodies to meet the contribution rate increases.

6. Link to investment policy set out in the Statement of Investment Principles

The results of the 2004 valuation show the liabilities to be 80% covered by the current assets, with the funding deficit of 20% being covered by future deficit contributions.

In assessing the value of the Fund's liabilities in the valuation, allowance has been made for asset out-performance as described below, taking into account the investment strategy adopted by the Fund, as set out in the SIP.

It is not possible to construct a portfolio of investments which produces a stream of income exactly matching the expected liability outgo. However, it is possible to construct a portfolio which closely matches the liabilities and represents the least risk investment position. Such a portfolio would consist of a mixture of long-term index-linked and fixed interest gilts.

Investment of the Fund's assets in line with the least risk portfolio would minimise fluctuations in the Fund's ongoing funding level between successive actuarial valuations.

If, at the valuation date, the Fund had been invested in this portfolio, then in carrying out this valuation it would not be appropriate to make any allowance for out-performance of the investments. On this basis of assessment, the assessed value of the Fund's liabilities at the 2004 valuation would have been significantly higher, by approximately 30% and the declared funding level would be correspondingly reduced to 62%.

Departure from a least risk investment strategy, in particular to include equity investments, gives the prospect that out-performance by the assets will, over time, reduce the contribution requirements. The funding target might in practice therefore be achieved by a range of combinations of funding plan, investment strategy and investment performance.

The current benchmark investment strategy, as set out in the SIP, is:

	% of Fund
UK Equities	45.0%
Overseas Equities	30.0%
Index-Linked Gilts	6.5%
Fixed Coupon Gilts	7.5%
UK Corporate Bonds	7.5%
Overseas Fixed Interest	3.5%

The funding strategy adopted for the 2004 valuation is based on an assumed asset out-performance of 2.35% in respect of liabilities pre-retirement and 1.2% in respect of post-retirement liabilities. Based on the liability profile of the Scheme at valuation, this equates to an overall asset out-performance allowance of 1.9% per annum in the short term to keep pace with the liabilities. The Administering Authority believes that this is a reasonable and prudent allowance for asset out-performance, based on the investment strategy set out in the SIP.

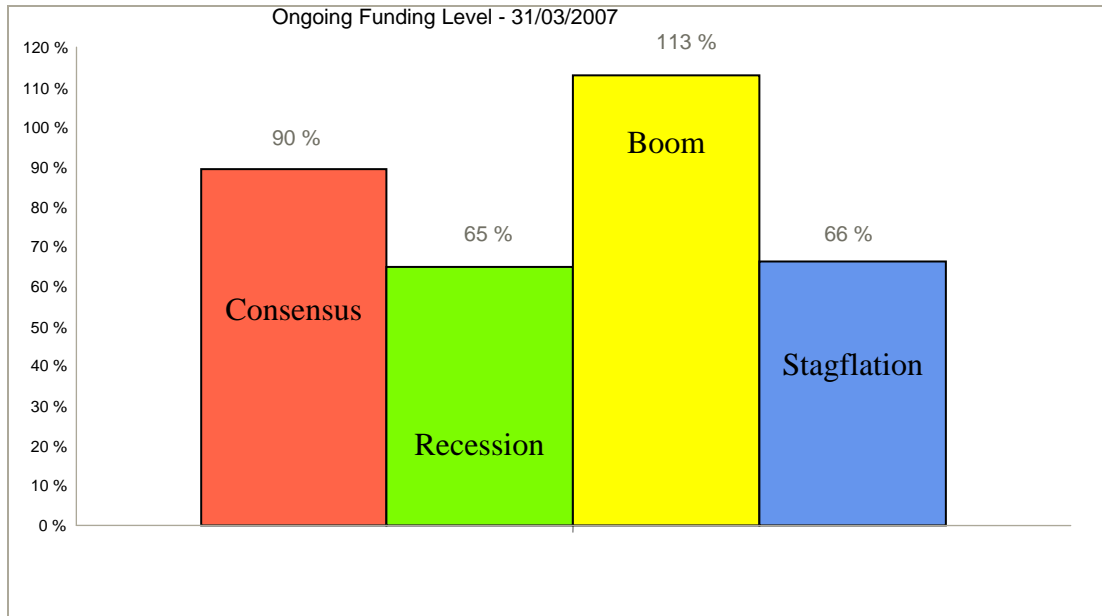
7. Identification of risks and counter-measures

The funding of defined benefits is by its nature uncertain. Funding of the Scheme is based on both financial and demographic assumptions. These assumptions are specified in the actuarial valuation report. When actual experience is not in line with the assumptions adopted a surplus or shortfall will emerge at the next actuarial assessment and will require a subsequent contribution adjustment to bring the funding back into line with the target.

The Administering Authority has been advised by the actuary that the greatest risk to the funding level is the investment risk inherent in the predominantly equity based strategy, so that actual asset out-performance between successive valuations could diverge significantly from that assumed in the long term.

The following chart shows the Scheme's approximate funding level after three years from the 2004 valuation under various future economic scenarios, based on the revised employer contribution rates following the 2004 valuation. It

should be borne in mind that these figures are projections, not estimates, and day to day changes in market conditions can have a marked effect on the valuation results over relatively short periods of time.



Financial

The financial risks are as follows:-

- Investment markets fail to perform in line with expectations
- Market yields move at variance with assumptions
- Investment Fund Managers fail to achieve performance targets over the longer term
- Asset re-allocations in volatile markets may lock in past losses
- Pay and price inflation significantly more or less than anticipated
- Effect of possible increase in employer's contribution rate on service delivery and admitted/scheduled bodies

In practice the extent to which these risks can be reduced is limited. However, the Fund's asset allocation is kept under constant review and the performance of the investment managers is regularly monitored.

Demographic

The demographic risks are as follows:-

- Longevity horizon continues to expand
- Deteriorating pattern of early retirements

Increasing longevity is something which government policies, both national and local, are designed to promote. It does, however, result in a greater liability for pension funds.

Apart from the regulatory procedures in place to ensure that ill-health retirements are properly controlled, employing bodies should be doing everything in their power to minimise the number of ill-health retirements. Early retirements for reasons of redundancy and efficiency do not affect the solvency of the Fund because they are the subject of a direct charge.

Regulatory

The regulatory risks are as follows:-

- Changes to Regulations, e.g. more favourable benefits package, potential new entrants to scheme, e.g. part-time employees
- Changes to national pension requirements and/or Inland Revenue Rules

Membership of the Local Government Pension Scheme is open to all local government staff and should be encouraged as a valuable part of the contract of employment. However, increasing membership does result in higher employer costs. At the present time, the benefits package is being modified in order to make it more affordable.

Governance

Governance risks are as follows:-

- Administering Authority unaware of structural changes in employer's membership (e.g. large fall in employee numbers, large number of retirements)
- Administering Authority not advised of an employer closing to new entrants
- An employer ceasing to exist with insufficient funding or adequacy of a bond.

For these risks to be minimised much depends on information being supplied to the Administering Authority by the employing bodies. Bond arrangements are strictly controlled and monitored, but in most cases the outsourcing employer, rather than the Fund, bears the risk.

8. Monitoring and Review

The Administering Authority has taken advice from the actuary in preparing this Statement.

A full review of this Statement will occur no less frequently than every three years, to coincide with completion of a full actuarial valuation. Any review will take account of the current economic conditions and will also reflect any legislative changes.

The Administering Authority will monitor the progress of the funding strategy between full actuarial valuations. If considered appropriate, the funding strategy will be reviewed (other than as part of the triennial valuation process), for example:

- if there has been a significant change in market conditions, and/or deviation in the progress of the funding strategy
- if there have been significant changes to the Scheme membership, or LGPS benefits
- if there have been changes to the circumstances of any of the employing authorities to such an extent that they impact on or warrant a change in the funding strategy
- if there have been any significant special contributions paid into the Fund.

Approved by the Avon Pension Fund Committee on 4th March 2005