SOUTH YORKSHIRE
PENSIONS AUTHORITY

Medium Term Financial Strategy

1920 - 2122

Contents

1. Foreword

1.1 This document is the first medium term financial strategy produced by the South Yorkshire Pensions Authority covering the period from the 2019 Actuarial Valuation. This period will see not just the valuation which will take place in the context of a significantly different funding position but also the transition of the Authority’s investment assets into the pooling structures provided by the Border to Coast Pensions Partnership.

1.2 The strategy covers both the costs of running the Authority’s operations and the income and expenditure of the pension fund, although this is significantly more difficult to forecast than routine running costs such as staff salaries.

1.3 Any financial strategy is based on a series of key assumptions and throughout this document these assumptions are highlighted, and will be subject to ongoing review as the process of producing this strategy develops over time.

1.4 The financial strategy (and the budget which is the annual expression of the strategy) is, put simply, the financial expression of the policy position set out in the corporate strategy. Hence this strategy will be updated each year as the Corporate Strategy is updated to reflect changed circumstances.

1.5 While SYPA is less exposed to the wider constraints on the public sector financial environment than our colleagues in the major employing organisations within the Pension Fund we still have a responsibility to manage the resources for which we are responsible in such a way that our expenditure does not negatively impact on the overall performance of the Pension Fund. This strategy sets out how we aim to achieve this in as transparent a way as possible.

2. Setting the context for the medium term financial strategy

2.1 Public Sector Finance

2.1.1 The public sector financial environment is, probably, the most significant factor defining the context in which this strategy is developed. Key issues like the level of pay awards impact on some aspects of the fund's liabilities as well as elements of the Authority's cost base.

2.1.2 The main factors affecting the Authority and the Fund are concerned with local government finance. In general terms growth in local government spending tends to lag growth in the generality of government spending, although pay tends to mirror the headline change in public sector pay.

2.1.3 While there has been some relaxation of the downward pressure on pay in the last year which has been reflected in the recent two year agreement for the bulk of local government staff the consensus view of forecasters and treasurer's seems to be that there is unlikely to be any significant widening of the financial envelope for local government in the period up to the next scheduled general election in 2022.

2.1.4 What this means for the Authority and the Fund is that it is likely that headline pay increases in the medium term will be around the level of the recent agreement (c. 2%), and that major employers (and probably schools and colleges as well) will continue to need to identify significant year on year savings. This impacts on a number of areas, including the affordability of contribution rates, the balance of membership between active, deferred and pensioner members, and the number of early retirements on grounds of redundancy. These factors will influence the value of benefits in payment, the average lifetime in retirement and the value of lump sum "strain" payments into the Fund. All of these factors will need to be reflected in forecasts of income and expenditure and in the debate over contribution rates at each valuation.

2.2 The Pensions Sector

2.2.1 What is happening in the wider pensions sector impacts the Authority and the Fund in a less direct way, although no less significantly. For example a significant change in the funding level of the remaining private sector defined benefit schemes could change the value of certain assets classes used to address the results of the change (e.g. a search for index linked gilts if funding levels increased). This could impact on the potential rate of growth in the value of the fund or could make it harder to deploy capital into specific types of asset if other funds take up the supply of assets.

2.2.2 In addition trends in the wider pensions sector tend, over time, to influence developments within LGPS and in the wider public sector pension's space. These trends may arise from regulatory emphasis, such as the continuing focus on data quality, or from changes in technology such as the growing emphasis on various forms of e-communication, and methods of engaging with scheme members.

2.3 The Economic Environment

2.3.1 The wider economic environment impacts the Fund in terms of both its assets and its liabilities. Clearly the underlying economic environment impacts the performance of investments in the financial markets while key metrics such as inflation and interest rates feed in to the actuarial calculations which determine the Fund's liabilities.

2.3.2 It remains incredibly difficult to forecast the movements in key economic indicators therefore it makes sense for this strategy to use assumptions based on key factors already reflected in the financial framework such as the assumed level of investment return included in the actuarial valuation. This is not a protection against any forecast being wrong, it almost certainly will be, but it uses an underlying set of assumptions that have been subject to a more rigorous set of testing than it would be possible to achieve internally.

2.4 The Starting Point

2.4.1 The starting point has a significant impact on any strategy. In this case the starting point is reflected in the current cost base for the Authority's operations and its fund management arrangements and the level of funding within the scheme achieved since the 2016 valuation.

2.4.2 In some senses the starting point is possibly more influential than other aspects of the context, for example achieving full funding, or close to full funding would lead to an alteration to the strategic asset allocation moving funds out of equities into less volatile, preferably income generating assets. Unfortunately these tend to be more expensive assets to manage thus a change in the cost base is almost inevitable. Whether the focus is on net of fees return or gross fees is irrelevant because both will ultimately have the same impact on the value of and performance of the Fund.

2.4.3 For the South Yorkshire Fund the starting point is assumed to be close to full funding, although no change in asset allocation can be assumed until the completion of the review of the Investment Strategy which will be undertaken alongside the triennial actuarial valuation.

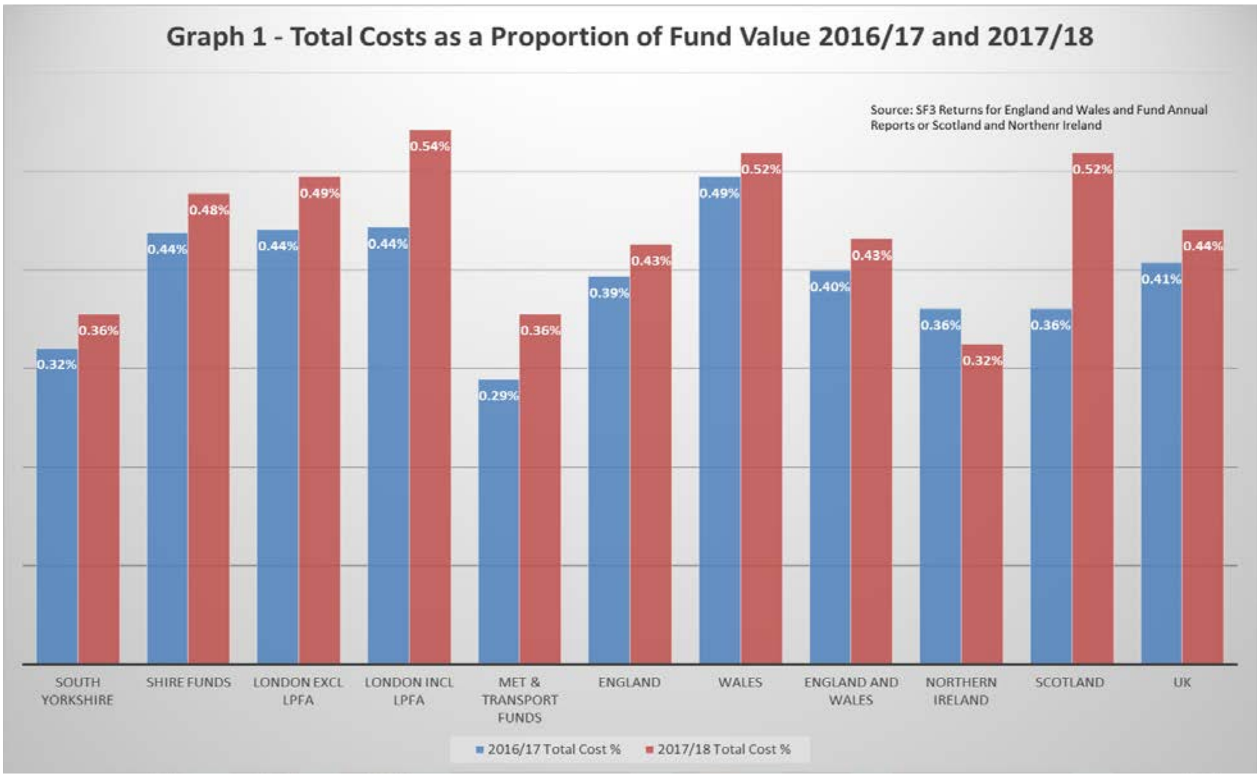
3. Financial objectives

3.1 For any strategy it is important to understand what you are aiming to achieve. This is no less true of this MTFS and this section sets out objectives in relation to the control of costs in the overall context of the Fund. In order to set these objectives we need to understand how SYPA's costs compare to the rest of the LGPS.

3.2 Comparative Costs

3.2.1 The only real source of data to compare SYPA with other LGPS funds is the annual SF3 return completed by all English and Welsh funds and submitted to MHCLG. Similar data for the Scottish and Northern Irish funds can be added to this from fund annual reports to give a UK wide comparison. There are flaws with this data, particularly with regard to the disclosure of non-invoiced investment costs, which are gradually being worked out of the system. However, it is the only comprehensive data set available and does give a broad indication of how SYPA compares with other LGPS funds.

3.2.2 Graph 1, below shows how SYPA's total costs compare with those of both the totality of other LGPS funds and of particular types of fund. This shows South Yorkshire squarely at the lower end of the spectrum of costs, although not quite as low as the average for the costs of the English Metropolitan and Transport funds.

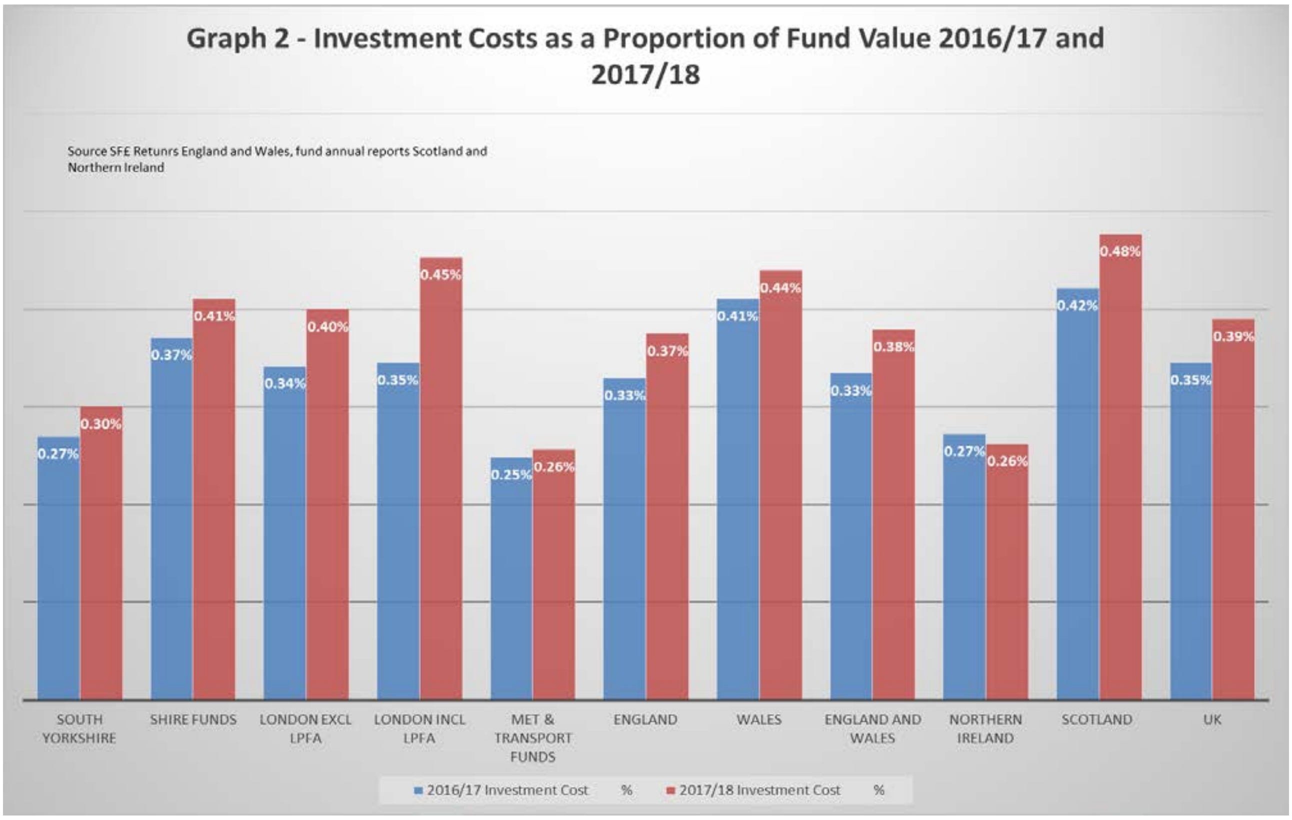


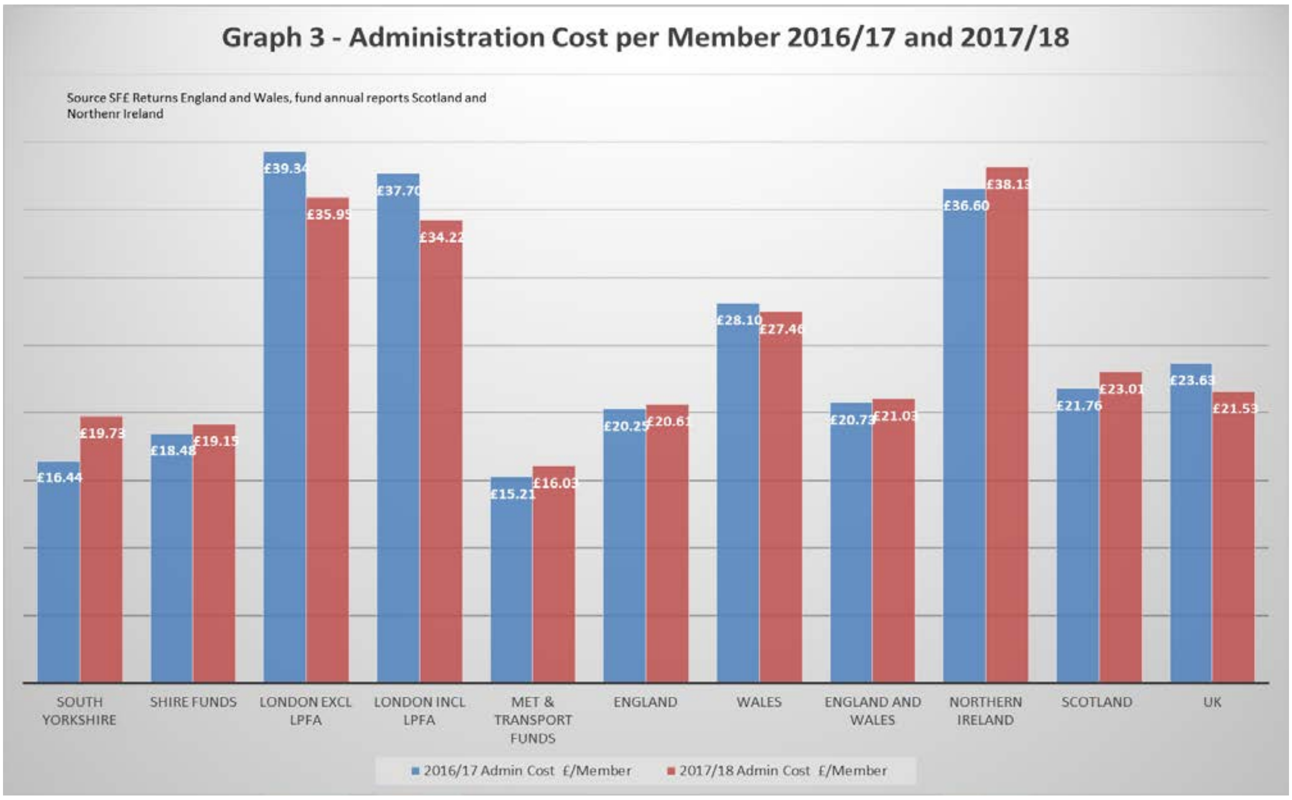
3.2.3 While this reflects good performance in controlling costs, particularly when matched with good long term investment performance it should not give rise to complacency as there are a number of factors which are likely to lead to a longer term increase in costs, in particular:

- The Fund's strategic asset allocation is moving more of the portfolio into unlisted assets such as private equity and infrastructure which in general tend to be more expensive to manage.
- The under-reporting of un-invoiced fees, which are deducted from NAV is gradually being reduced and while SYPA has already made significant progress with this further progress will increase reported (although not actual) costs, although the increase for South Yorkshire may well be less than for other funds.
- The Government's pooling initiative results in SYPA's listed assets in future being managed within pooled structures provided by Border to Coast, which while cheap in comparison to external managers are more expensive than the previous, admittedly unsustainable in house arrangements.

3.2.4 There are specific factors which might be expected to give rise to SYPA having a higher than average cost base, in particular the fact that it is a stand-alone pension organisation bearing its own corporate overheads, rather than sharing them with a council. In broad terms this does not seem to be borne out and SYPA's costs are materially lower as a proportion of the value of the Fund than the London Pensions Fund Authority which is the only other comparable free standing pension organisation in the English LGPS. The Northern Irish Fund (NILGOSC) is also a free standing organisation and while there are some issues with costs comparison SYPA also has lower cost than this organisation.

3.2.5 Looking at costs in a bit more detail the following two graphs illustrate how SYPA's administration and investment costs compare with the rest of the Local Government Pension Scheme across the UK.





3.2.6 Again at this more granular level South Yorkshire appears to be at the lower end of the spectrum of costs, with the difference from the lowest cost group in terms of investment costs likely accounted for by the mix of assets invested in, and a lower cost approach to the management of listed assets. The investment costs analysis does show the increasing impact of the greater disclosure of non invoiced costs on funds, in particular the year on year increases in London and Scotland are significantly driven by improvements in cost transparency.

3.2.7 In terms of administration it is clear that SYPA is benefitting from the economy of scale that comes from serving a large fund, while the much smaller London funds clearly see the diseconomies which arise from servicing much smaller funds. The significant increase in South Yorkshire's costs year on year is due to the inclusion of the full costs of the District Office teams for the first time due to the change in the focus of their work following the last restructure of the Administration function.

3.2.8 On one level it is hardly a revelation that South Yorkshire is a low cost fund that has benefited from economies of scale and the lower costs that come from an in house investment operation. On the other hand knowing the degree to which we are below the average is useful in planning how to address the potential cost pressures which we know we will face as a result of pooling. The challenge is how to use this information to set some clear objectives which will assist the Authority in managing its cost base while continuing to facilitate investment in the continued development and improvement of services to scheme members.

3.3 Financial Objectives

3.3.1 The Authority needs to set financial objectives which focus on the key streams of activity within its operations, administration and investment while bringing these together to focus on total cost. These objectives will mirror the financial constraint imposed on the district councils by the grant system, thus ensuring that SYPA is taking no more from the pension fund for its running costs than is absolutely necessary.

3.3.2 At the same time the Authority must be careful, as a small organisation, not to “shoot itself in the foot” by setting unachievable financial objectives which generate relatively large scale savings targets, which could not be delivered without impacting the customer experience.

3.3.3 In terms of administration the financial objective could be framed as follows:

“The annual increase in the budgeted cost per member for administration functions will be limited to an index made up of 70% local government pay and 30% August CPI.”

3.3.4 This limits the rate of increase in costs while allowing the benefits of any increase in productivity to be re-invested in the quality of the service provided to members, which is broadly in line with the Authority’s overall objectives. Such an approach also provides some buoyancy in the level of resources available in order to address the rising number of members and employers within the Fund. A similarly expressed objective could be placed on the Authority’s overall operating budget, which would place a helpful constraint on corporate costs. These two objectives are illustrated in the table below:

	2019/20 Baseline £/ Member	**2020/21 Cash Limit £/ Member[3]**	**2021/22 Cash Limit £/ Member**
Administration Service[1]	£18.27	£18.65	£19.04
Authority Operational Budget[2]	£33.64	£34.34	£35.06

Notes:
1. This represents the per member cost of the Administration cost centre within the Authority’s operational budget. This does not match the definition or accounting conventions used for the SF3 return but is used here for simplicity.
2. This is the total operational budget approved by the Authority at its meeting in November 2018.
3. Figures for future years are based on an annual inflationary increase of 2.1% (comprising 2% for local authority pay in line with the headline increase in the latest pay award and 2.3% for CPI inflation in line with the Actuary’s assumptions).
4. Membership is assumed to increase in line with recent trends at 3.2% per year.

3.3.5 Following the transfer of staff to Border to Coast the Authority will incur very little investment related cost within its operating budget. The vast bulk of these costs will be incurred within the Fund either within legacy investments or the pooling structures. Given that broadly investment costs have a relationship to the value of invested assets it would be sensible to have an objective which recognised this, but also recognises the fact that the Authority’s investment strategy is to move out of listed into unlisted and more expensive assets and also that the Authority’s overall objective is to achieve the best possible net of fees risk adjusted returns meeting the actuarial return objective (currently c. 4.2%pa). This means that any financial objective around investment costs should not place an artificial constraint which prevents the Authority from making the right investment decisions.

3.3.6 Given the above framing an objective in relation to investment costs is quite difficult. However, something along the following lines could be appropriate:

“In any year the Authority will seek to limit the investment management expenses (excluding any transition costs) charged to the Fund to 0.40% of the Fund’s closing net assets.”

3.3.7 By excluding transition costs which are by their nature volatile and unpredictable this focuses on the underlying investment costs which can be influenced through negotiation and the pooling process. The upper limit chosen is the current calculated UK average shown in the graph above, rounded up. There is no science in this, having a limit above the current level of costs simply recognises the reality that SYPA faces both as a result of pooling and of changes in its investment strategy referred to above.

3.3.8 The targets set out in these financial objectives will be reviewed each year in the context of their impact on the Authority's overall financial position and their impact on the ability of the Authority to deliver its corporate objectives, while still driving improvements in efficiency. In addition to these objectives which can easily be measured in budget setting and which in effect place cash limits on the Authority's budget a number of financial performance measures related to comparative costs will be part of the suite of Corporate Strategy measures.

4. Financial forecasts

4.1 Forecast Assumptions

4.1.1 Any financial forecast is based on a series of assumptions. This is the first time that the Authority has produced a longer term financial forecast for its activities, hence the assumptions related to a number of highly volatile items (such as investment returns and transfer values) will need to be refined over time. The key assumptions are set out below:

- **Pay -** Pay awards will average 2% over the period in line with the headline increase in the most recent local government pay award.
- **Prices -** CPI inflation will be 2.3% over the period in line with Actuary's assumptions for the 2019 valuation. This impacts a small portion of the operational budget but is a key driver for the cost of benefits in payment.
- **Volume Driven Contribution and Benefit Costs / Income -** These are based on four year moving averages, adjusted where relevant for known large one off items such as the transfer of the Probation Service's portion of the Fund to the Greater Manchester Fund.
- For the operational budget the initial forecast is on a continuation basis with no provision for growth.
- Investment returns are assumed to be in line with actuarial assumptions.
- External investment management costs are initially assumed to increase in line with the increase in AUM plus CPI inflation. This assumption will be revised as Border to Coast comes out of its set up phase and its charges stabilise on a proportion of assets under management basis.
- Income budgets within the operational budget have not been inflated.

4.1.2 Based on current knowledge these assumptions are reasonable. However, considerable further work will be required over the next 12 months to develop and refine our forecasting techniques to provide a robust basis for resource planning.

4.2 Operational Budget Forecast

4.2.1 The Forecast for the Operational Budget is summarised in the table below:

	2018/19 Restated £	2019/20 Original £	2020/21 Forecast £	2021/22 Forecast £
Employees	3,460,400	3,715,000	3,789,300	3,865,090
Running Costs	2,059,900	1,836,600	1,861,390	1,886,520
Gross Expenditure	5,520,300	5,551,600	5,650,690	5,751,610
Income	-184,000	-106,000	-106,000	-106,000
Net Expenditure	5,336,300	5,445,600	5,544,690	5,645,610
Membership	156,880	161,900	167,081	172,428
Cost Per Member	£34.02	£33.64	£33.19	£32.74

4.2.2 These forecasts on a continuation of service basis meet the financial objective set out earlier in this document. While it is clearly good to maintain a downward pressure on the Authority's costs relative to membership there are a number of areas where some pressure for investment is likely to emerge over the planning period. These pressures will be addressed in each future budget round and in updates to this strategy, with preference being given to investment which is one off and can be funded from reserves or by the redirection of resources within the budget during the year. The likely areas of pressure for investment include:

- Investment to address the various workforce challenges facing the Authority. These challenges include the age structure of the current workforce and the need to invest in developing the skills of managers across the organisation, where there has been no investment for some considerable time.
- Investment in ICT to facilitate improvements in customer service, in particular the integration of voice and data to support the introduction of a customer centre over the course of the current planning period.
- Investment to modernise the Authority's back office systems as investment pooling changes the nature of the back office, to become more of a traditional support service than an adjunct to the investment function.
- Investment to support the transfer of transactions with members on line.

4.2.3 While there will be a continuing pressure for investment there is equally a need for the Authority to look to deliver savings and efficiencies. These will come through the delivery of work already in hand such as moves to reduce the volume of printing and postage and move to on line interaction with scheme members. However saving do not always come as direct reductions in the budget. If the administration team does not increase its total head count over the planning period this, all other things being equal, is a productivity improvement (based on the ongoing increase in membership) that equates to a little over 2 FTE each year. These sort of improvements will be captured and reported in future iterations of this strategy.

4.2.4 The key risks in relation to this forecast are as follows:

- Pay settlements and inflation running at a higher level than assumed in the forecast. This is clearly a risk, and in the case of pay there is significant pent up pressure in the system following a prolonged period of pay restraint. The forecasts used are prudent and reflect a broad consensus view. In the event of higher costs than forecast managers will seek to absorb the in-year impact through the management of vacancies and seeking to either defer one off expenditure or avoid aspects of running cost expenditure. This is the usual process of budgetary control and it seems unlikely that any cost increases would be on a scale beyond that which measures of this sort could address.
- Deterioration in budgetary control. While there has been some change in managerial personnel at senior management level, with further change due in the coming year there is no evidence from ongoing budget monitoring of a significant change in the control environment.
- Loss of external income. This is mitigated through prudent budgeting, for example not including any assumptions around additional software sales which tend to be sporadic and through securing longer term agreements with customers with staggered end dates so that not all agreements come to an end at the same time.

4.2.5 The operational budget is relatively low risk and is relatively simple in comparison to the Fund Budget being many times smaller and much less volatile. Consequently while it understandably receives specific scrutiny as a cost that, in effect, has to be borne by participants in the Fund variations are unlikely to have a material impact on the overall standing of the Fund

4.3 Pension Fund Forecast

4.3.1 The table below presents a summary of the forecast for the Pension Fund for the current and coming three years.

	Forecast 2018/19 £	Forecast 2019/20 £	Forecast 2020/21 £	Forecast 2021/22 £
Dealings with members, employers and others directly involved in the scheme	257,752,210	216,639,320	203,934,360	208,995,340
Benefits payable	288,261,140	295,702,420	301,911,550	308,590,470
Net additions/(withdrawals) from dealings with members	(30,508,930)	(79,063,100)	(97,977,190)	(99,595,130)
Management Expenses	30,829,970	32,955,710	34,968,550	36,883,500
Net returns on investments	398,613,730	463,459,190	464,270,330	480,393,560
Net increase/(decrease) in the Fund during the year	337,274,840	351,440,380	331,324,600	343,914,940
Net assets of the Fund at 1 April	8,030,353,240	8,367,628,080	8,719,068,460	9,050,393,060
At 31 March	8,367,628,080	8,719,068,460	9,050,393,060	9,394,308,000

4.3.2 In each year of the forecast investment costs (including those within the operational budget) are within the limit of 40 bps set out elsewhere in this strategy (rising from 33bps to 35 bps over the four years). However, this takes no account of any shift in strategic asset allocation which may take place from the end of 2019/20 when the review of the Investment Strategy is completed.

4.3.3 The forecast for the Pension Fund is much more susceptible to forecast error than that for the operational budget. In particular while there is some consistency in terms of data from previous years the Authority cannot control the numbers of members retiring in any year or the decisions which they make in relation to commutation of pension to lump sum, and similarly with the numbers of deaths amongst the membership of the Fund and the numbers of members transferring either into or out of the Fund. While the forecasts are based on historic information adjusting for known one off events and inflation where appropriate there is a significant amount of variability from year to year which it is extremely difficult to forecast.

4.3.4 The important message in the above forecast is that the anticipated decline in deficit recovery contributions from 2020/21 results in a significant increase in the requirement for the harvesting of investment income (at least £20m pa). This will have an impact on the review of the Investment Strategy possibly resulting in a prioritisation of investment in assets which generate a consistent long term income stream.

4.3.5 The key risks in terms of this forecast are as follows:

- Financial market volatility, which will impact on both the asset value of the Fund and on the level of investment income and large swings in asset value will result in significant variation from the forecast. This is a constant risk for pension funds and while steps have been taken both through the broad asset allocation and through equity protection to reduce the potential volatility in the Fund the risk of events which might cause significant market dislocation remains and, if anything, is at the current time heightened as a result of tensions around international trade and Brexit.

- A further significant wave of service reductions across major employers resulting in workforce reductions which have the effect of reducing the number of active members contributing and further increase the imbalance between contributions received and benefits paid. Other than changes in the Strategic Asset Allocation to focus on income generation and delivering investment returns above actuarial assumptions to build resilience into the Fund there are limited options available to the Fund in this area, although structuring contribution cash flows may provide some further assistance in dealing with the issue. The political and fiscal uncertainty evident at present heightens this risk.
- Failure of pooling to contain investment costs. While SYPA is not expecting to make any significant savings as a result of pooling in the short to medium term the expectation is that the process of pooling will contain costs. However, should the pool fail to achieve its objectives in this area there will be an impact on net of fees returns. To date, although it is very early, the evidence is that in this respect Border to Coast are delivering in line with their plan, and should the initial moves of other partner funds into the range of internally managed funds continue or increase there may well be the opportunity for costs in relation to listed assets to reduce towards the pre-pooling levels. Should the Pool fail to deliver cost savings as anticipated then further mitigation will come through the collective action of the 12 partner funds to address under-performance.

4.3.6 This forward forecast indicates a challenging position when looked at in the context of market conditions and uncertainty as at the time of writing. All economic forecasts indicate that we are moving into a somewhat lower return environment which is reflected in the actuarial assumptions used in producing the forecast. This results in the need for the Fund and the Pool to focus on securing good assets and sustained income streams within its revised strategic asset allocation.

5. Policy on reserves

5.1 Reserves are funds which are put aside:

- Either "just in case" a risk materialises and additional money is required; or
- To "save up" for a particular item or project.

5.2 All of SYPA's costs are met by the Pension Fund therefore, unlike a local authority, the first contingency argument for holding reserves does not hold as costs incurred, for example, as a result of a building fire, would simply fall to the Pension Fund which is about 1,000 times the size of the Authority's budget and such costs are therefore unlikely to be material.

5.3 The argument for holding reserves to save up for things does, though hold. In order to save up in this way managers will have had to underspend their budgets and thus the ability to use money thus saved acts as an incentive to manage within the available resources. However, there is a balance to be struck as reserves could be allowed to accumulate to a level where they became significant in the context of the Authority's budget at which point they would in effect be depriving the Fund of cash to invest. Consequently some limitation on the level of reserves is necessary to maintain this balance. Thus:

"The Authority will maintain its reserves at a level equivalent to no more than 7.5% of its operational budget, the establishment of new reserves will be approved by the Authority on the recommendation of the Treasurer, and the level of reserves will be reviewed by the Treasurer each year as part of his report on the final accounts of the Authority"

5.4 Based on the 2019/20 budget this would allow total reserves of around £400k to be held. Following the commitment of reserves to various ICT developments and the relocation to Gateway Plaza they are considerably below this level. Setting the maximum level of reserves at this order of magnitude allows the Authority to save towards major projects, such as any future need to replace a major ICT system.

5.5 At the present time the Authority maintains two reserves:

- The Corporate Strategy Reserve, which exists to fund non-recurrent costs arising from projects which are required to implement the Corporate Strategy.
- The ICT Reserve, which exists to meet the costs of replacement ICT equipment and software on a cyclical basis. Any net income from sales of software to other LGPS funds is added to this reserve allowing either accelerated equipment replacement or the acquisition or enhancement of additional software.

5.5 Any commitment of funding from these reserves requires the approval of the Authority in response to a recommendation from the Treasurer.