Appendix 'A'

Lancashire County Pension Fund
Funding Strategy Statement (FSS)

This Statement has been prepared by Lancashire County Council (as Administering Authority) to set out the funding strategy for the Lancashire County Pension Fund (the Scheme), in accordance with the Local Government Pension Scheme Regulations 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 Regulations 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 :-
  - the guidance issued by CIPFA for this purpose; and
  - the Statement of Investment Principles (SIP) for the Scheme published under Regulation 12 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (as amended);
- 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 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 governing legislation. The required levels of employee contributions are also specified in the Regulations.

Employer contributions are determined in accordance with the Regulations 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 Scheme 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. (A detailed statement of the Fund's Investment Objective is found in the Statement of Investment Principles)

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

4. Responsibilities of the key parties

The Administering Authority should:

- collect employer and employee contributions by the due dates
- invest surplus monies in accordance with the LGPS (Management and Investment of Funds) Regulations 2009 (as amended)
- 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 a Funding Strategy Statement and a Statement of Investment Principles, both after due consultation with interested parties, and
- monitor all aspects of the Scheme's performance and funding and amend Funding Strategy Statement/Statement of Investment Principles.
- Ensure sound corporate governance in respect of all aspects of the administration and investment of the Fund.

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 all changes to membership or, as may be proposed, which affect future funding.

The Fund actuary should:

- prepare valuations including the setting of employers' contribution rates after agreeing assumptions with the Administering Authority and having regard to the Funding Strategy Statement
- prepare advice and calculations in connection with bulk transfers and individual benefit-related matters, and
- advise on funding strategy.

5. Solvency issues and target funding levels

The funding objective

To meet the requirements of the Regulations the Administering Authority's long term funding objective is for the Fund to achieve and then maintain sufficient assets to cover 100% of projected accrued liabilities (the "**funding target**") assessed on an ongoing basis including allowance for projected final pay.

Determination of the funding target and recovery period

The principal method and assumptions to be used in the calculation of the **funding target** are set out in Annex 1.

Underlying these assumptions are the following two tenets:

- that the Scheme is expected to continue for the foreseeable future; and
- favourable investment performance can play a valuable role in achieving adequate funding over the longer term.

As part of each valuation separate employer contribution rates are assessed by the actuary for each participating employer or group of employers. These rates are assessed taking into account the experience and circumstances of each employer (or employer grouping), following a principle of no cross-subsidy between the various employers in the Scheme.

In attributing the overall investment performance obtained on the assets of the Scheme to each employer a pro-rata principle is adopted. This approach is effectively one of applying a notional individual employer investment strategy identical to that adopted for the Scheme as a whole.

The Administering Authority, following consultation with the participating employers, has adopted the following objectives for setting the individual employer contribution rates:

- A maximum deficit recovery period of 19 years will apply. Employers will have the freedom to adopt a recovery plan on the basis of a shorter period if they so wish. A different period may be applied in respect of particular employers where the Administering Authority considers this to be warranted (see Deficit Recovery Plan below).
- Where increases in employer contribution rates are required from 1 April 2011, following completion of the 2010 actuarial valuation, the increase from the rates of contribution payable in the year 2010/11 may be implemented in equal steps, over a maximum period of 3 years.
- On the cessation of an employer's participation in the Scheme, the actuary will be asked to make a termination assessment. Any deficit in the Scheme in respect of the employer will be due to the Scheme as a termination contribution, unless it is agreed by the Administering Authority and the other

parties involved that the assets and liabilities relating to the employer will transfer within the Scheme to another participating employer.

In determining the above objectives the Administering Authority has had regard to:

- the responses made to the consultation with employers on the FSS principles
- relevant guidance issued by the CIPFA Pensions Panel
- 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
- the Administering Authority's views on the strength of the participating employers' covenants in achieving the objective.

Deficit recovery plan

If the assets of the scheme relating to an employer are less than the **funding target** at the effective date of any actuarial valuation, a recovery plan will be put in place, which requires additional contributions from the employer to meet the shortfall.

Additional contributions will be expressed as a level percentage of pensionable payroll.

In determining the actual recovery period to apply for any particular employer or employer grouping, the Administering Authority may take into account some or all of the following factors:

- the size of the funding shortfall;
- the business plans of the employer;
- the assessment of the financial covenant of the Employer;
- any contingent security available to the Fund or offered by the Employer such as guarantor or bond arrangements, charge over assets, etc.

In certain instances, and in particular for Fund employers which are considered by the Administering Authority to provide a high level of covenant, an allowance may be made as part of the recovery plan for investment performance at a higher level than that assumed for assessment of the **funding target**. This higher level of return assumed will, in particular, reflect the actual investment strategy of the Fund, on the basis that this is to be maintained over the entire recovery period. The assumptions to be used in these Recovery Plan calculations are set out in Annex 1.

The normal cost of the scheme (future service contribution rate)

In addition to any contributions required to rectify a shortfall of assets below the **funding target** contributions will be required to meet the cost of future accrual of benefits for members after the valuation date (the "normal cost"). The method and assumptions for assessing these contributions are also set out in Annex 1.

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

The results of the 2010 valuation show the liabilities to be 80% covered by the current assets, with the funding deficit of 20% being covered by future deficit contributions due from the participating employers.

In assessing the value of the Scheme's liabilities in the Valuation, allowance has been made for asset out-performance as described in Annex 1, taking into account the investment strategy adopted by the Scheme, 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 outgoings. 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 Scheme's assets in line with the least risk portfolio would minimise fluctuations in the Scheme's ongoing funding level between successive actuarial valuations, assuming that the scheme started in a fully funded position.

If, at the Valuation date, the Scheme had been invested in this portfolio, then in carrying out the Valuation it would not be appropriate to make any allowance for out-performance of the investments.

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 investment strategy, as set out in the SIP, is shown at Annex 2

7. Identification of risks and counter-measures

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 Scheme's funding is the investment risk inherent in the predominantly equity based strategy, so that actual asset out-performance between successive valuations could diverge significantly from the out-performance currently required on the basis of the 2010 Valuation assumptions.

The responsibility for the investment management of the Lancashire County Pension Fund is detailed in the Statement of Investment Principles and is as follows:

Lancashire County Council is responsible for administering the Fund under the Local Government Pension Scheme Regulations. It discharges its responsibilities through:

- The Pension Fund Committee;
- The Fund's Investment Panel;
- The Fund's Investment Managers.

The division of responsibility is detailed below.

Pension Fund Committee

The Pension Fund Committee has overall responsibility for approval of the investment policy and strategy, the appointment of suitable persons to implement the policy and regular review of the Fund's performance investments and investment managers. The Committee meets at least four times per annum, and currently comprises 14 elected County Councillors, 4 representatives of the District Councils and Unitary Authorities within the Fund, 2 Trade Union representatives, a and representative from Lancashire's Further Education/Higher Education establishments. The 21 members of the Committee have full voting rights. Members of the Investment Panel also attend meetings of the Committee but they do not have any voting rights.

Investment Panel

The Investment Panel consists of two external investment advisors, the Head of Pension Fund and Treasury Management, the Assistant Director of Finance and the Treasurer to the Pension Fund. The Panel meet five times a year to monitor the investment activities and performance of the Fund's investment managers. The Panel is responsible for making recommendations to the Pension Fund Committee regarding taking strategic decisions relating to the broad sector composition of the portfolio, subject to general guidelines set by the Committee.

Investment Managers

The management of the Fund's investments is structured so as to provide diversification of management style and produce an acceptable spread of risk across the portfolio whilst maximising returns.

The Fund Managers have full discretion to invest within the policy limits laid down by the Pension Fund Committee and the Investment Panel.

The Administering Authority ensures that the members of the Pension Fund Committee receive suitable training each year on Pension Fund issues

In addition to the greatest risk, CIPFA have identified a number of other key risks that are shown at Annex 3 of this document. These risks will be subjected to the monitoring and review process as described in section 8 below.

8. Monitoring and Review

The Administering Authority has taken advice from the actuary in preparing this Statement, and has also consulted with the following key stakeholders:

- Fund Employers.
- The Pension Fund Committee

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 Scheme.

Appendix 'A'

Annex 1

Method and assumptions used in calculating the funding target

Method

The actuarial method to be used in the calculation of the funding target is the Projected Unit method, under which the salary increases assumed for each member are projected until that member is assumed to leave active service by death, retirement or withdrawal from service. This method implicitly allows for new entrants to the scheme on the basis that the overall age profile of the active membership will remain stable. As a result, for those employers which are closed to new entrants, an alternative method is adopted (the Attained Age method), which makes advance allowance for the anticipated future ageing and decline of the current closed membership group.

Financial assumptions

Investment return (discount rate)

A yield based on market returns on UK Government gilt stocks and other instruments which reflects a market consistent discount rate for the profile and duration of the Scheme's accrued liabilities, plus an Asset Out-performance Assumption ("AOA") of 2.5% p.a. for the period pre-retirement and 1% p.a. post-retirement.

The asset out-performance assumptions represent the allowance made, in calculating the funding target, for the long term additional investment performance on the assets of the Fund relative to the yields available on long dated gilt stocks as at the valuation date. The allowance for this out-performance is based on the liability profile of the Scheme, with a higher assumption in respect of the "pre-retirement" (i.e. active and deferred pensioner) liabilities than for the "post-retirement" (i.e. pensioner) liabilities. This approach thereby allows for a gradual shift in the overall equity/bond weighting of the Fund as the liability profile of the membership matures over time.

Individual Employers

Having determined the AOAs as above for the Fund overall, it is important to consider how the financial assumptions in particular impact on individual participating employers. As employers in the Fund will have different mixes of active, deferred and pensioner members, adopting a different pre/post retirement investment return approach is equivalent to hypothecating a different equity/bond mix investment strategy for each employer. Such an approach would be inconsistent with the Fund practice, as set out in the FSS, of allocating investment performance pro rata across all employers based on a "mirror image" investment strategy to the whole Fund. In completing the calculations for individual employers therefore, a single, composite, pre and post retirement asset out-performance assumption of 1.55% has been calculated which, for the Fund as a whole, gives the same value of the funding target as the separate pre and post retirement AOAs.

Inflation (Consumer Prices Index)

The inflation assumption will be taken to be the investment market's expectation for RPI inflation as indicated by the difference between yields derived from market instruments, principally conventional and index-linked UK Government gilts as at the valuation date, reflecting the profile and duration of the Scheme's accrued liabilities but subject to the following two adjustments.

- An allowance of 0.3% p.a. for supply/demand distortions in the bond market (an "inflation risk premium") is incorporated and
- An allowance of 0.5% p.a. for pensions being increased annually in future by the change in the Consumer Price Index rather than the Retail Price Index, as announced in June 2010. This change will apply from April 2011 and the assumptions make due allowance for this revision as advised by the Actuary.

The overall reduction to RPI inflation as implied by the investment markets at the valuation date is 0.8% per annum.

Salary increases

The assumption for real salary increases (salary increases in excess of price inflation) will be determined by an allowance of 2.0% p.a. over the inflation assumption as described above. This includes allowance for promotional increases.

Pension increases

Increases to pensions are assumed to be in line with the inflation (CPI) assumption described above. This is modified appropriately to reflect any benefits which are not fully indexed in line with the CPI (e.g. Guaranteed Minimum Pensions in respect of service prior to April 1997).

Mortality

The mortality assumptions will be based on the most up-to-date information published by the Continuous Mortality Investigation (CMI), making allowance for future improvements in longevity and the experience of the scheme. The derivation of the mortality assumption is based on Fund specific analysis. Members who retire on the grounds of ill heath are assumed to exhibit average mortality equivalent to that for a good health retiree at an age 3 years older. For all members, it is assumed that the accelerated trend in longevity seen in recent years will continue in the longer term and as such, the assumptions build in a minimum level of longevity 'improvement' year on year in the future in line with the CMI projections subject to a minimum rate of improvement of 1% per annum.

Method and assumptions used in calculating the cost of future accrual

The cost of future accrual (normal cost) will be calculated using the same actuarial method and assumptions as used to calculate the funding target except that the financial assumptions adopted will be as described below.

The financial assumptions for assessing the future service contribution rate should take account of the following points:

- contributions will be invested in market conditions applying at future dates, which are unknown at the effective date of the valuation, and which are not directly linked to market conditions at the valuation date; and

- the future service liabilities for which these contributions will be paid have a longer average duration than the past service liabilities.

The financial assumptions in relation to future service (i.e. the normal cost) are not specifically linked to investment conditions as at the valuation date itself, and are based on an overall assumed real return (i.e. return in excess of price inflation) of 3.75% per annum, with a long term average assumption for price inflation of 3.0% per annum. These two assumptions give rise to an overall discount rate of 6.75% p.a.

Adopting this approach the future service rate is not subject to variation solely due to different market conditions applying at each successive valuation, which reflects the requirement in the Regulations for stability in the “Common Rate” of contributions. In market conditions at the effective date of the 2010 valuation this approach gives rise to a somewhat more optimistic stance in relation to the cost of accrual of future benefits compared to the market related basis used for the assessment of the funding target.

At each valuation the cost of the benefits accrued since the previous valuation will become a past service liability. At that time any mismatch against gilt yields and the asset out-performance assumptions used for the funding target is fully taken into account in assessing the funding position.

Summary of key whole Fund financial assumptions used for calculating funding target and cost of future accrual (the “normal cost”) for the 2010 actuarial valuation

Long-term gilt yields	
Fixed interest	4.5% p.a.
Index linked	0.7% p.a.
Market-implied RPI price inflation	3.8% p.a.
Assumed CPI price inflation	3.0% p.a.
Past service Funding Target financial assumptions	
Investment return pre-retirement	7.0% p.a.
Investment return post-retirement	5.5% p.a.

Salary increases	5.0% p.a.
Pension increases	3.0% p.a.
Future service accrual financial assumptions	
Investment return	6.75% p.a.
CPI price inflation	3.0% p.a.
Salary increases	5.0% p.a.
Pension increases	3.0% p.a.

Assumptions used in calculating contributions payable under the recovery plan

The contributions payable under the recovery plan are calculated using the same assumptions as those used to calculate the **funding target**, with the exception that, for certain employers, the required contributions are adjusted to allow for the following variation in assumptions during the period of the recovery plan:

Investment return on existing assets and future contributions

An overall additional return of 3% p.a. above the liabilities consistent gilt yield (4.5% p.a. effective as at the valuation date) reflecting the underlying investment strategy of the scheme and, in particular, including the assets of the scheme that underlie the pensioner as well as the non-pensioner liabilities.

This is equivalent to a total rate of investment return of 7.5% p.a. effective as at the 2010 valuation date.

The investment return assumed for the contributions under the recovery plan is taken to apply throughout the recovery period. As a result, any change in investment strategy which would act to reduce the expected future investment returns could invalidate these assumptions and therefore the funding strategy.

The above variation to assumptions in relation to the recovery plan can only be applied for those employers which the Administering Authority deems to be of sufficiently high covenant to support the anticipation of investment returns, based on the current investment strategy, over the entire duration of the recovery period. No such variation in the assumptions will apply in any case to any employer which does not have a funding deficit at the valuation (and therefore for which no recovery plan is applicable). Where the variation in the assumptions does apply, the resultant total contribution rate(s) implemented following the 2010 valuation will be subject to a minimum of both:

- the contribution rate(s) originally planned for 2011/12 onwards based on the 2007 actuarial valuation, and
- the normal future service contribution rate for the employer concerned.

Appendix 'A'

Annex 2

SIP INVESTMENT STRATEGY

The investment strategy is currently being revised by the Investment Panel taking into consideration the result of the latest actuarial valuation. A proposed new approach for investment strategy was approved by the Pension Fund Committee in the meeting held on 10 December 2010. The Investment Panel has had approval to dynamically manage the Fund's interest and inflation rate exposure and the Fund's longevity risk.

The Investment Panel are proposing that the fund adopts a "target range" asset allocations for increased flexibility. The specifics of this range and the performance measures for managers is still being finalised by the Investment Panel.

The Fund is currently still being measured by the approved benchmark allocation as shown in the current Statement of Investment Principles (Table 1).

Table 1

Current benchmark asset allocation as shown in the Statement of Investment Principles

Asset Class	Allocation (%)	Managed on an Active Basis (%)	Managed on a Passive Basis (%)
UK Equities	32	14	18
Overseas Equities	32	10	20
Bonds	17	11	6
Property	6	6	
Hedge Fund of Funds	3	3	
Private Equity	3	3	
Index Linked	4	1	3
Cash	3	3	
Total	100	73	27

Performance Targets

The current performance targets are as follows:

- The active equity managers are expected to outperform the Fund specific benchmark return (index return) by 1.5% (net of fees) over rolling three years.
- The active bonds manager is expected to outperform the Fund specific benchmark return by 0.75% (net of fees) over rolling three years.
- The property manager is expected to outperform the IPD small funds benchmark return (£10m to £300m) by 1% over rolling three years.
- The Private Equity manager is expected to outperform the BVCA median return.
- The Hedge Fund of Funds manager is expected to outperform cash returns by 6% (net of fees) over rolling three years.
- The index tracking manager is expected to track indices.

Appendix 'A'

Annex 3

Key Risks Identified

The following risks will be monitored and reviewed in line with the monitoring and review guidelines identified within section 8 of the Funding Strategy Statement

Financial

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 employers contribution rate on service delivery and admitted / scheduled bodies

Demographic

Longevity horizon continues to expand
Deteriorating pattern of early retirements

Regulatory

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

Governance

Administering Authority unaware of structural changes in employers membership (eg 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 bond.
Lack of frequent Pension Fund Committee meetings
Insufficient member training
Unclear decision making procedures
Changes to Pension Fund Committee membership

It should be noted that this list is not exhaustive and may be amended from time to time as part of the monitoring and review process.