

# Lancashire County Pension Fund

## Funding Strategy Statement 2013

For consideration by Pension Fund Committee on  
27 March 2014

Lancashire County Council as  
administering authority of  
**Lancashire County Pension Fund**



# Contents

1. Introduction	3
2. Purpose of the FSS in policy terms	5
3. Aims and Purpose of the Pension Fund	5
4. Responsibilities of the main parties	6
5. Solvency issues and target funding levels	7
6. Link to investment policy set out in the Statement of Investment Principles	11
7. Identification of risks and counter-measures	14
Annex 1 - Method and assumptions used in calculating the funding target	16
Annex 2 – SIP Investment Strategy	22
Annex 3 – Key risks identified	23



# Lancashire County Pension Fund

## Funding Strategy Statement (FSS)

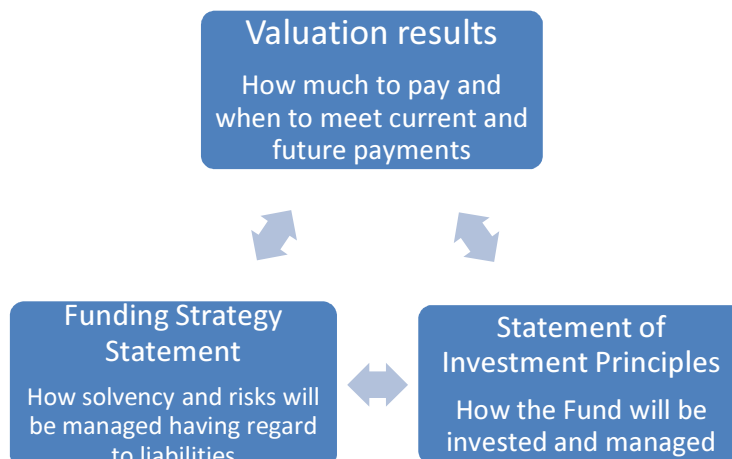
This Statement has been prepared by Lancashire County Council (as Administering Authority) to set out the funding strategy for the Lancashire County Pension Fund (the Fund), in accordance with the Local Government Pension Scheme Regulations and the guidance paper issued in March 2012 by the Chartered Institute of Public Finance and Accountancy (CIPFA) Pensions Panel.

### 1. Introduction

The Local Government Pension Scheme (LGPS) Regulations provide the statutory framework within 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 fund the administering authority will prepare and publish its 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.
- The FSS should be complete and approved by the Pensions Committee (or equivalent) prior to the completion of each valuation.
- The fund actuary must have regard to the FSS as part of the fund valuation process.

The statements relate as follows:



Benefits payable under the Scheme are guaranteed by statute and therefore 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.

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.

The Fund 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. The Fund, like many other similar public and private sector funded schemes, has a gap between its assets and pension liabilities which this strategy addresses.

A number of factors have contributed to the funding gap and contribution rates for employers:

- Investment returns relative to movements in liabilities;
- Increases in longevity of pensioners;
- Falling long-term interest rates.

There are some steps that the actuary can take to assist employing bodies. These include:

- Recognising the long-term nature of local government, so that deficits are recovered over time;
- Phasing increases in contributions where appropriate;
- Recognising such financial 'improvements' as a reduction in ill-health retirements, prevalence of spouse's and dependants' benefits on a members' death, and anticipated changes to the LGPS being finalised;
- Giving weight to a balanced investment strategy.

The Fund, since it was established in its current form in 1974, has seen variations in its funding level. The funding level has previously been below 70% and subsequently recovered. Over this long period, there has been a consistent approach with the actuarial valuation process, the link to an investment strategy, and balanced management of the risks. The current arrangements continue this approach, and are focussed upon securing diversified investment market returns from global markets. The approach adopted prioritises the achievement of at least market return and, in line with best practice, utilises asset management to deliver a substantial element of the investment target.

## 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 desirability to maintain as nearly constant a common contribution rate as possible; and
- to take a prudent longer-term view of funding those liabilities.

The Fund currently has a strong net cash inflow (including investment income). The FSS supports the process of ensuring adequate funds are put aside on a regular basis to meet future benefit liabilities. Whilst the LGPS regulations specify the approach and requirements, the implementation of the funding strategy is the responsibility of the Fund acting upon expert advice and following consultation.

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, its focus should at all times be on those long-term interests of the fund as a whole.

The solvency of the Fund is a long-term management issue. It is essential that funds are made available to ensure that all future pension payments can be met when they become due.

## 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 (subject to the administering authority not taking undue risks) at reasonable cost to the taxpayers, scheduled, resolution and admitted bodies, whilst achieving and maintaining fund solvency, which should be assessed in light of the risk profile of the fund and the risk appetite of the administering authority and employers alike;
- manage employers' liabilities effectively and ensure that sufficient resources are available to meet all liabilities as they fall due; and
- seek returns on investment 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 and as required in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009.

#### **4. Responsibilities of the key parties**

The LGPS regulations set out the responsibilities of the key parties, which are summarised below:

The administering authority (Lancashire County Council) is required to:

- collect employer and employee contributions, investment income and other amounts due to the pension fund as stipulated in LGPS Regulations;
- pay from the pension fund the relevant entitlements as stipulated in LGPS regulations;
- invest surplus monies in accordance with the LGPS Regulations;
- ensure that cash is available to meet liabilities as and when they fall due;
- take measures as set out in the regulations to safeguard the fund against the consequences of employer default;
- manage the valuation process in consultation with the fund's actuary;
- prepare and maintain a Funding Strategy Statement and a Statement of Investment Principles, both after proper consultation with interested parties;
- monitor all aspects of the fund's performance and funding and amend Funding Strategy Statement/ Statement of Investment Principles accordingly;
- effectively manage any potential conflicts of interest arising from its dual role as both fund administrator and scheme employer.

The individual employer is required to:

- deduct contributions from employees' pay correctly
- pay all contributions, including their own as determined by the actuary, promptly by the due date
- develop a policy on certain discretions and exercise those discretions as permitted 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 active membership which affect future funding.



The fund actuary should:

- prepare valuations including the setting of employers' contribution rates at a level to ensure fund solvency after agreeing assumptions with the administering authority and having regard to the Funding Strategy Statement and LGPS Regulations
- prepare advice and calculations in connection with bulk transfers and individual benefit-related matters such as pension strain costs, ill-health retirement costs, compensatory added years costs, etc
- provide advice and valuations on the termination of admission agreements
- provide advice to the administering authority on bonds or other forms of security against the financial effect on the fund of employer default
- assist the administering authority in assessing whether employer contributions need to be revised between valuations as required by the regulations
- ensure that the administering authority is aware of any professional guidance or other professional requirements which may be of relevance to his or her role in advising the fund.

## **5. Solvency issues and target funding levels**

Including income received from investments, the Fund currently has a strong net cash inflow and can, therefore, take a medium to long-term view on determining employing body contribution rates to meet future liabilities through operating a fund with an investment strategy that reflects this long-term view. It allows short-term investment market volatility to be managed so as not to cause volatility in employing body contribution rates.

The Fund recognises the different characteristics of the variety of participating employer organisations, and will set funding strategy appropriately having regard to factors such as:

- strength of covenant, and security of future income streams;
- support or guarantor arrangements from other Scheme employers, particularly those with tax raising powers;
- prospective period of participation in the Fund, and specifically the implications if the employer has closed membership of the scheme to new employees.

Taking these factors into account, case-by-case assessment and review of contribution requirements may, in some cases, prove necessary as part of the triennial valuation process.

In line with its Admissions and Terminations Policy the Fund will continue to seek either guarantees from existing scheduled employers or external insurance in the form of bonds when considering admitting new employers to the Fund.

In cases where an element of an existing Scheme employer's deficit is transferred to a new employer on its inception, the Scheme employer's deficit recovery contributions, as shown on the schedule to the Rates and Adjustments Certificate, may be reallocated between the Scheme employer and the new employer to reflect this, on advice of the Actuary and as agreed with the Administering Authority.

LGPS Regulations require the long-term funding objectives to achieve and maintain assets sufficient to cover 100% of the projected accrued liabilities. The level of assets necessary to meet this 100% funding objective is known as the 'funding target'. The role of the actuary in performing the necessary calculations and determining the key assumptions used, is an important feature in determining the funding requirements.

Individual employers have a range of discretions available to them in terms of the benefits available to scheme members. Where the exercise of these discretions results in the potential for there to be a loss of future contributions to the Fund or an increased deficit a "strain payment" calculated by the Fund's actuary becomes due to the Fund from the employer immediately.

The approach to the actuarial valuation process and key assumptions used at each three-yearly valuation are consulted upon and the valuation forms part of the consultation undertaken with the FSS.

### **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.

This allows us to take a longer term view when assessing the contribution requirements for certain employers. As part of this valuation when looking to potentially stabilise contribution requirements we will consider whether we can build into the funding plan the following:-

- some allowance for changes in market conditions that have occurred since the valuation date;
- some further allowance for interest rates and bond yields to revert to higher levels over the medium to long term.

In considering this the Administering Authority, based on the advice of the Actuary, will consider if this results in a reasonable likelihood that the funding plan will be successful.

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 arising from the 2013 actuarial valuation:

- 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 2014, following completion of the 2013 actuarial valuation, the increase from the rates of contribution payable in the year 2014/15 may be implemented in equal steps, over a maximum period of 3 years.

The employer contributions will be expressed and certified as two separate elements:

- a percentage of pensionable payroll in respect of the future accrual of benefit
- a schedule of lump sum amounts over 2014/17 in respect of the past service deficit (subject to the review from April 2017 based on the results of the 2016 actuarial valuation).

The contributions for any employer may be varied as agreed by the Actuary and Administering Authority to reflect any changes in contribution requirements as a result of any benefit costs being insured with a third party or internally within the Fund.

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.

However, the Administering Authority has ultimate discretion where the particular circumstances of any given Employer warrant a variation from these objectives.

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 annual monetary lump sums, subject to review based on the results of each actuarial valuation.

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 and the security of future income streams;
- any contingent security available to the Fund or offered by the Employer such as guarantor or bond arrangements, charge over assets, etc.
- length of expected period of participation in the Fund.

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 2013 valuation show the liabilities to be 78% covered by the current assets, with the funding deficit of 22% 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 (or return seeking) based strategy, so that actual asset out-performance between successive valuations could diverge significantly from the overall out performance assumed in the long term.

## What are the risks?

### 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 employer's contribution rate on service delivery and admitted/scheduled bodies.

### Demographic

- Longevity horizon continues to expand;
- Deteriorating pattern of early retirements (including those granted on the grounds of ill health).

### Regulatory

- Further 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 HMRC rules.

### Governance

- 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;
- Changes in Committee membership.

These risks are incorporated as part of a comprehensive Fund risk register referred to in Annex 3 below. Such risks will be monitored and reviewed in line with the monitoring and review guidelines identified elsewhere within the Funding Strategy Statement.

## **Investments**

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 investment policy and monitoring overall performance. The Committee meets four times a year, and currently comprises 14 elected County Councillors, 4 representatives of the District Councils and Unitary Authorities within the Fund, 2 representatives of scheme members and a representative of the Higher and Further Education Sectors in Lancashire.

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.

### **Investment Panel**

The Investment Panel consists of two independent advisors, the Treasurer to the Fund (as Chair), the officer of the County Council fulfilling the role of Chief Investment Officer for the Fund and an officer of the County Council identified by the Treasurer to the Fund to oversee investment compliance activities.

The Panel meets at least quarterly, or otherwise as necessary. The Panel may operate through sub groups to undertake particular tasks. It formulates recommendations to the Treasurer to the Fund and/or the Pensions Fund Committee through meetings of the full Panel.

The Panel is required to provide advice to the Treasurer of the Fund regarding:

- a. Recommendations to the Pension Fund Committee in relation to the Investment Strategy for the Fund;
- b. The broad composition of the Fund's investment portfolio, management style and types of investment;

- c. The proposed procurement process, tender award criteria and evaluation methodology for external advisers and other external assistance including investment managers, property agents and advisors, corporate governance adviser, Fund Custodian, performance measurement advisers, the Fund Actuary and the Fund's AVC Provider ("external support") to enable the Treasurer to the Fund to seek the approval of the Pension Fund Committee to commence the procurement of any required external support.
- d. The selection and appointment of any required external support (subject to the role of the Pension Fund Committee), their remit and terms of office;
- e. The allocation of ranges and thresholds within which the Investment Managers should operate;
- f. Review of the Statement of Investment Principles and compliance with investment arrangements;
- g. Recommendations on the detailed management of the investment portfolios including the selection of pooled funds; and
- h. To oversee the performance of the investment managers appointed by the Fund and to report on the Fund's performance.

### **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.

All Fund managers are subject to investment due diligence and all the segregated fund managers are UK FCA or equivalent organisation. New allocations may be made from time to time and Investment Managers are added to, removed or changed as necessary.

The Fund's Investment Managers are listed in its Annual Report.

### **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.

## 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 1.6% p.a.

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.

##### *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 for supply/demand distortions in the bond market (an "inflation risk premium") is incorporated and
- An allowance for pensions being increased annually by the change in the Consumer Price Index rather than the Retail Price Index.

The overall reduction to RPI inflation as implied by the investment markets at the valuation date is 1.0% per annum.

##### *Salary increases*

The assumption for real salary increases (salary increases in excess of price inflation) in the long term will be determined by an allowance of 1.5% p.a. over the inflation assumption as described above. This includes allowance for promotional increases.

In addition to the long term salary increase assumption allowance has been made for expected short term pay restraint for all employers in the fund. This results in a total salary increase of 1% per annum for 3 years.

### ***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 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 mortality tables used are set out below, with a loading reflecting Fund specific experience. The derivation of the mortality assumption is set out in a separate paper as supplied by the Actuary. Current members who retire on the grounds of ill health are assumed to exhibit average mortality equivalent to that for a good health retiree at an age 4 years older whereas for existing ill health retirees we assume this is 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 1.5% per annum.

The mortality before retirement has also been adjusted based on LGPS wide experience.

### ***Commutation***

It has been assumed that, on average, 50% of retiring members will take the maximum tax-free cash available at retirement and 50% will take the standard 3/80ths cash sum. The option which members have to commute part of their pension at retirement in return for a lump sum is a rate of £12 cash for each £1 p.a. of pension given up.

### ***Other Demographics***

Following an analysis of Fund experience carried out by the Actuary, the incidence of retirement in normal health and in ill health and the proportions married/civil partnership assumption have been modified from the last valuation. Other assumptions are as per the last valuation.

### ***Expenses***

Expenses are met out the Fund, in accordance with the Regulations. This is allowed for by adding 0.4% of pensionable pay to the contributions as required from participating employers. This addition is reassessed at each valuation. Investment expenses have been allowed for implicitly in determining the discount rates.

### ***Discretionary Benefits***

The costs of any discretion exercised by an employer in order to enhance benefits for a member through the Fund will be subject to additional contributions from the

employer as required by the Regulations as and when the event occurs. As a result, no allowance for such discretionary benefits has been made in the valuation

### **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 CPI price inflation) of 3% per annum, with a long term average assumption for price inflation of 2.6% per annum. These two assumptions give rise to an overall discount rate of 5.6% 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 2013 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 2013 actuarial valuation**

Long-term gilt yields	
Fixed interest	3.2% p.a.
Index linked	-0.4% p.a.
Past service Funding Target financial assumptions	
Investment return/Discount Rate	4.8% p.a.
CPI price inflation	2.6% p.a.
Long Term Salary increases	4.1% p.a.
Pension increases/indexation of CARE benefits	2.6% p.a.
Future service accrual financial assumptions	
Investment return	5.6% p.a.
CPI price inflation	2.6% p.a.
Long Term Salary increases	4.1% p.a.
Pension increases/indexation of CARE benefits	2.6% p.a.

**Demographic assumptions**

The post retirement mortality tables adopted for this valuation are as follows:

Life expectancy at 65 in 2013		Base table	Adjustment	Improvement model	Long term rate
CURRENT ANNUITANTS	Normal health	S1PxA	100% / 98%	CMI_2012	1.5%
	Ill health	S1PxA	Normal health + 3 years	CMI_2012	1.5%
	Dependants	S1PMA/S1DFA	158% / 115%	CMI_2012	1.5%
	Future dependants	S1PMA/S1DFA	114% / 105%	CMI_2012	1.5%
CURRENT ACTIVES / DEFERREDS	Actives normal health	S1PxA	100% / 98%	CMI_2012	1.5%
	Actives ill health	S1PxA	Normal health + 4 years	CMI_2012	1.5%
	Deferreds	S1PxA	100% / 98%	CMI_2012	1.5%
	Future dependants	S1PMA/S1DFA	114% / 105%	CMI_2012	1.5%

**Other demographic assumptions are noted below**

Withdrawal	As for 2010 valuation
Other demographics	Based on LG scheme specific experience.
50:50 Option	Allowance for certain employers

### **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 which are considered by the Administering Authority to provide a high level of financial covenant and are required to increase contributions (compared to the 2014/15 levels that would have been payable under the previous funding plan), an allowance may be made as part of the recovery plan for interest rates and bond yields to revert to higher levels over a period of 5 years.

In isolation, the effect of this increase in yields is to reduce the funding deficit by primarily lowering the value of the fund's liabilities over time, thus reducing the level of deficit contributions required by the employer during the recovery period.

### **Increases in yields on fixed and index linked gilts**

The impact of the assumed yield reversion described above is taken to be equivalent to an immediate increase in fixed and index linked gilt yields of up to 0.5% p.a.

As indicated above, this variation to the assumptions in relation to the recovery plan can only be applied for those employers which the Administering Authority deems to be of sufficiently high financial covenant to support the anticipation of increased gilt yields 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 a funding deficit exists the impact of the anticipated increases in gilt yields will be limited so that the total employer contributions emerging from the valuation will be no less the 2014/15 levels that would have been payable under the previous funding plan.

## Annex 2

### SIP INVESTMENT STRATEGY

The current investment strategy may be revised in light of the latest actuarial valuation, but will largely follow the same direction set out when the strategy was significantly overhauled in 2010.

In addition, 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 strategy sets out a balance between different asset classes as follows:

<b>Asset Class</b>	<b>Range %</b>
<b>Global Equities – Active and Passive, Physical and Index. Private and Publicly Quoted</b>	<b>40-60</b>
<b>Diversified Property –UK and Overseas. Direct and indirect.</b>	<b>10-20</b>
<b>Lower Volatility Strategies -  (including but not exclusively, Fixed Income, PFI, Credit strategies, Infrastructure, Currency, Commodities, Absolute Return, Cash, funds and index, Local development/PPP type allocations)</b>	<b>20-40</b>

The Active Public Equity and Fixed Interest Managers have full discretion to invest within each investment category subject to statutory limits and any asset allocation ranges around the benchmark, agreed between the Investment Panel and the Managers. The Property Manager's mandate is advisory with final decisions being taken by the Treasurer to the Fund based upon that advice.

With pooled funds, the manager of the investment fund operates within the constraints imposed by the constitution of the pooled fund, as reviewed and approved by the Investment Panel.

A separate strategy has been approved by the Pension Fund Committee in relation to each of the individual asset classes described in the above table.

## Performance Targets

Each manager is expected to achieve an excess return on the assets under their management greater than the relevant benchmark. In assessing performance of each manager the Investment Panel takes in to account the long-term nature of the investment process and returns are judged primarily on an annualised basis over a rolling three-year period. The Investment Panel reviews the appointment of each manager at least every three years or such shorter period as may be necessary.

The targets and benchmarks, where such assets are held, are as follows:

- ◆ The Global Equity specialist managers have a target to outperform the MSCI All World index by 2.5% (net of fees) on a rolling three year basis. They are benchmarked against the MSCI All World index.
- ◆ The Government Bonds manager is expected to outperform the FTSE All Stocks benchmark performance return by 0.75% (net of fees) on a rolling three year basis.
- ◆ The Corporate Bonds manager is expected to outperform the IBOXX sterling Non Gilts benchmark on a rolling three year basis.
- ◆ Bonds and cash held for treasury management purposes are expected to outperform the FT 7 day LIBID.
- ◆ The Private Equity Manager has a target to outperform the median return in the British Venture Capital Association (BVCA) survey of Private Equity returns by 3%. Historically, the Private Equity benchmark has been the FTSE All Share. Going forward, an absolute return target may be more appropriate, and the Fund's independent advisers have suggested a target in the range 8-12% per annum, with a natural mid-point of 10%.
- ◆ The Infrastructure managers are expected to outperform an 8% absolute benchmark on a rolling three year basis.
- ◆ The credit and fixed income funds have individual targets and benchmarks relating to their specific sub-class within the overall asset allocation.
- ◆ The UK direct property manager is expected to outperform the IPD All Property Index Benchmark return on a rolling three year basis. Overall, and as set out in the property strategy above, the core property strategy targets an Internal Rate of Return (IRR) of 6-8% per annum, whilst the specialist income/ opportunity strategies would be expected to return IRRs of 8-12% per annum.



## Annex 3

### Key Risks Identified

The following risks, as set out in the Fund's Risk register, will be monitored and reviewed in line with the monitoring and review guidelines identified elsewhere within the Funding Strategy Statement:

- Investment and funding risk;
- Employer risk;
- Skill and resource risk;
- Governance and compliance risk;
- Reputational risk;
- Administration risk.

The measures in place to mitigate the key risks in these areas are detailed below.

Risks and mitigations

Ref	Area	Risk	Cause	Impact	Mitigation in place
I001	Investment and funding risk	Asset / liability mismatch	Assets insufficient to fund liabilities	Inability to make benefit payments, meaning cash injections required from employers	Increasing focus on liability management, new investment strategy, diversified portfolio
I002	Investment and funding risk	Inflation risk	Increases in commodity prices push up the level of inflation	Inflation increases pension payments but assets do not grow at required level	Hold some index linked assets
I003	Investment and funding risk	Concentration of assets	Over reliance of assets in one particular area	A significant allocation in a particular type asset will lead to an over exposure in that area and therefore vulnerability to significant changes.	New investment strategy is moving away from a large investment in equities. Amount of the fund in particular assets in governed by the pension fund regulations. Monthly monitoring of asset allocations by Investment Panel.
I004	Investment and funding risk	Falling share prices and therefore asset value	Actions of companies in who the pension fund invests (fraud, poor corporate governance)	Falling share prices and therefore a decrease in the assets held by the fund.	Investment portfolio is diverse in order to minimise such risks. Member of LAPFF and PIRC to promote engagement.
I005	Investment and funding risk	Under performance by fund managers	Fund managers not meeting required returns	Returns achieved lower than those anticipated in funding strategy leading to a greater funding gap	Mixture of active and passive managers, monitoring of investment manager performance, new investment strategy moving to a greater reliance on the internal team.
I006	Investment and funding risk	Liability risk: Discount rate	Market conditions between valuation dates produces a lower discount rate than expected by the actuary	The estimated value of liabilities will be higher than expected and therefore assets insufficient to fund them	Increasing focus on liability management, new investment strategy, diversified portfolio
I007	Investment and funding risk	Liability risk: Inflation rate	Assumed inflation rate within liability valuation applied to future pension increases and salary rises is lower than actual rate	The estimated value of liabilities will be higher than expected and therefore assets insufficient to fund them	Increasing focus on liability management, new investment strategy, diversified portfolio
I008	Investment and funding risk	Liability risk: Salary increase	Salary increases higher than expected (and maybe linked to inflation expectations)	The estimated value of liabilities will be higher than expected and therefore assets insufficient to fund them	Provision for employers to top-up contributions to offset the increasing liabilities.
I009	Investment and funding risk	Liability risk: Longevity	The assumptions of future life expectancy and improvements in life expectancy may be lower than actual. Members may live longer and benefits may be paid for	The estimated value of liabilities will be higher than expected and therefore assets insufficient to fund them	
I010	Investment and funding risk	Liability risk: Early retirement/ ill-health retirement	Members retiring earlier than normal retirement age with no reduction in benefit will require employers to make greater contributions	The estimated value of liabilities will be higher than expected and therefore assets insufficient to fund them	Provision for employers to top-up contributions to offset the increasing liabilities.
I011	Investment and funding risk	Liability risk: Diversification	Diversification of asset portfolio less than expected	Assets move in unpredictable directions, potentially increasing the funding gap between assets and liabilities	Increasing focus on liability management, new investment strategy, diversified portfolio
I012	Investment and funding risk	Liability risk: LGPS Regulations	Pension benefits are governed by statute, and any changes will impact on the fund's liabilities causing them to either increase or decrease	Liabilities are affected by statutory changes to LGPS	Increasing focus on liability management, new investment strategy, diversified portfolio. Lobbying of Government.
I013	Investment and funding risk	Custody risk	Custodian does not adequately meet the requirements of their contract	Problems with custodian leading to missed dividends or corporate actions.	Subscribe to services of Thomas Murray as custodian monitor.
I014	Investment and funding risk	Investment returns below peer groups	Investment managers do not meet the required returns	Reputational risk, increasing gap between assets and liabilities	Regular monitoring and review
I015	Investment and funding risk	Missed investment opportunities	Lack of awareness or slow decision making	Missed investment opportunities could result in reduced returns for the fund	Maintain a good relationship with investment managers and build strength in the internal team. Awareness of timetables and protocols
I016	Investment and funding risk	Mismatch of funding plan and investment strategy	Incorrect assumptions made regarding assets and liabilities	Incorrect contribution rates could be set	Funding strategy and investment strategy to be linked to triennial reviews
I017	Investment and funding risk	Insufficient cash available to meet requirements	Poor management of liquidity	If liquidity is not managed, assets may need to be sold quickly meaning the best price is not achieved	Implement effective cash management strategies
I018	Investment and funding risk	Transition risk of the new investment strategy	Unforeseen events	Incurring unexpected costs while moving the assets	Specialist transition manager has been appointed to oversee this process on behalf of the pension fund.

Ref	Area	Risk	Cause	Impact	Mitigation in place
E001	Employer Risk	Inability of an employer to meet its contribution requirements due to legislative or actuarial changes.	Increased level of contributions required from employer	Overall fund faces increasing liabilities	Monitor risk picture of the employers, particularly with reference to the size of their liability
E002	Employer Risk	Employer ceasing to exist	Employer closes	If there is insufficient funding, bond of guarantee in place any shortfall will be attributed to the whole fund, thereby increasing the level of	Monitor employers risk profiles and ensure bonds are sufficient
S001	Skill and Resource risk	Key person risk	Someone leaving the organisation and only a limited market from which to seek their replacement	Knowledge gap which it may be difficult to fill	Maintain a system of staff cover; succession planning and development
S002	Skill and Resource risk	Lack of expertise / resources of officers involved in the Pension Fund	Insufficient training or continuous development	Either inappropriate staffing or insufficient resources in a particular area meaning that the fund cannot be managed or administered properly and mistakes are made.	Regular performance appraisals and training plans in place. On the job training.
S003	Skill and Resource risk	Insufficient knowledge of pension fund committee members	Insufficient training or continuous development	Inappropriate decisions taken at committee meetings or inability to make decisions through lack of understanding	Implement training for new members. Have an on-going training requirement for members and officers to ensure knowledge remains up to date. Mixture of in-house and external sessions. Officer expert advice.
S004	Skill and Resource risk	Insufficient external expertise	Failure to employ specialist advisers when their skills are required	Under performance of fund	Employ specialists where appropriate from consultancy bench and develop in-house expertise
S005	Skill and Resource risk	Inappropriate decision making	Production of poor or inappropriate performance management information	Incorrect decisions being taken due to the reliance on this information	Use of independent Custodian. Implement regular monitoring in an agreed format. Regular monitoring of performance information and on-line access to NT Passport system.
G001	Governance and compliance risk	Non compliance with LGPS regulations	Lack of technical expertise / staffing to research any regulation changes	Non compliance with legislation change could result in penalties or sanctions leading to financial loss	Monitor legislative changes, engage in consultations, attend pension update briefings / courses.
G002	Governance and compliance risk	Non compliance with investment policies	Lack of understanding of investment policies	Non compliance with investment policies could increase the risk profile of the fund.	Periodic monitoring of investment types against regulations. Individual investments checked in advance of commitment as part of internal Due diligence.
G003	Governance and compliance risk	Production of incorrect financial statements	Production of misleading information and misleading stakeholders	Misunderstanding or wrong decisions	Review and sign off process in place.
G004	Governance and compliance risk	Conflict of interest	Officers or members fail to declare a conflict of interest leading to decisions that are not in the best interest of the fund	Inappropriate decisions taken	Training on what constitutes a conflict and ensuring register of interests/ gift and hospitality entries are made where appropriate.
G005	Governance and compliance risk	Failure to minute meetings correctly	Important decisions are not documented and then there is no record of them when evidence of the decision is	Unable to prove that a decision has been taken	All meetings to be minuted and agreed by members
G006	Governance and compliance risk	Failure to implement an proper monitoring system	Performance of the fund cannot be monitored over time	Incorrect decisions are taken	Implement a regular monitoring system
G007	Governance and compliance risk	Information loss (intellectual property and confidential information)	Sensitive information could be lost damaging the reputation of the fund and putting the fund members at risk	Damaged reputation / litigation risk	Ensure confidential information is secure
G008	Governance and compliance risk	Information governance	Loss of information which means that the fund is unable to operate	Unable to undertake day to day functions	Back up of ICT network. Use of Northern Trust web-based Passport system.
G009	Governance and compliance risk	Non-existent assets	The risk that assets purchased by the pension fund do not exist, or fund managers are not bona fide.	Misrepresentation of assets held. Reputational damage.	Due diligence undertaken as part of investment review process either by Fund officers or investment consultants.
R001	Reputational risk	Actions damage the perception of the fund	Reputation of the fund will be damaged which may impact on participation rates and investment strategies		Good governance, open communication. Use of PIRC/ LAPFF to engage with shareholder companies to encourage good governance.
A001	Administration risk	Failure to process pension payments and lump sums on time	Unavailability of IT / staff, or errors	Maintenance of IT, staff cover and training	Testing of system including audit
A002	Administration risk	Failure to collect contributions from employers and employees	Unavailability of IT / staff, or errors or poor communication	Maintenance of IT, staff cover and training	Robust back-up systems in place
A003	Administration risk	Inability to provide service due to loss of facilities	Fire, flood etc	Unable to provide service	Business continuity
A004	Administration risk	Loss of funds through fraud	Fraud or misappropriation of funds	Financial loss to fund	Internal controls – separation of duties. Internal and external audit reviews.
A005	Administration risk	Failure to hold personal data securely	Poor procedures for data transfer, data retention and back	Data is lost or compromised	Internal ICT controls. Information governance awareness.
A006	Administration risk	Failure to keep records up to date	Poor or non-existent notification of changes	Incorrect records held and therefore incorrect pensions paid	Documented internal controls. Robust training. Regular monitoring.