

## West Yorkshire Pension Fund

### Funding Strategy Statement (FSS)

#### 1. Introduction

- 1.1 The Local Government Pension Scheme Regulations 2013 provide the statutory framework under which the Administering Authority is required to prepare a FSS. The key requirements for preparing the FSS can be summarised as follows:

After consultation with all such persons as it considers appropriate, including officers and elected members and other employer representatives, the Administering Authority will prepare, maintain and publish their funding strategy;

In preparing the FSS, the Administering Authority must have regard to:-

- the statutory guidance issued by CIPFA for this purpose; and
- the Investment Strategy Statement (ISS) published under Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (as amended) (“The Investment Regulations”).

The FSS must be revised and published in accordance with Regulation 58 of the Local Government Pension Scheme Regulations 2013 (as amended), whenever there is a material change in either the policy on the matters set out in the FSS or ISS.

- 1.2 Benefits payable under the Local Government Pension Scheme (LGPS) are guaranteed by statute and thereby the pension 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.
- 1.3 The LGPS is a defined benefit scheme under which the benefits are specified in the governing legislation, currently the Local Government Pension Scheme Regulations 2013 (as amended) (“the Regulations”).
- 1.4 Employer contributions are determined in accordance with the Regulations which require that an actuarial valuation be completed every three years by the actuary, to include a rates and adjustments certificate. The primary rate of employers' contributions to the Fund should be set so as to “secure its solvency”. The actuary must have regard to the desirability of maintaining as nearly constant a primary rate of employer contribution as possible in addition to the requirement to secure the solvency of the pension fund and the long term cost efficiency of the Scheme, so far as relating to the pension fund. The actuary must also have regard to the FSS in carrying out the valuation.

## **2. Purpose of Funding Strategy Statement (FSS)**

- 2.1 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, the implementation of the funding strategy is the responsibility of the Administering Authority, acting on professional advice provided by the actuary.
- 2.2 The purpose of this FSS is to set out the processes by which the Administering Authority:
- 2.2.1 establishes a clear and transparent fund-specific strategy which will identify how employers' pension liabilities are best met going forward;
  - 2.2.2 supports the regulatory requirement that it is desirable to maintain as far as possible stable primary employer contribution rates;
  - 2.2.3 ensures that the regulatory requirements to set contributions so as to ensure the solvency and long-term cost efficiency of the Fund are met;
  - 2.2.4 takes a prudent longer-term view of funding the liabilities.
- 2.3 It should be stressed at the outset that, supplementary to the regulatory requirement to consider the desirability of maintaining a constant primary employer contribution rate as referred to in 2.2.2 above, a key priority for the Administering Authority is to bring stability to employers' total contributions through gradual increases (or decreases) phased in over a number of years. Views will be taken on what is reasonable and appropriate for employer contributions and, therefore, the degree of risk inherent within the funding targets and associated periods for recovery of deficits or return of surpluses.
- 2.4 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 all employers will be referred to in the FSS, its focus should at all times be on those actions which are in the best long-term interests of the Fund. Consequently, the FSS must remain a single strategy for the Administering Authority to implement and maintain.

## **3. Aims and Purpose of the Pension Fund**

- 3.1 The aims of the Fund are to:
- 3.2.1 enable primary employer contribution rates to be kept as constant as possible and (subject to the Administering Authority not taking undue risks) at reasonable cost to the taxpayers, scheduled, designating, and admitted bodies,

- 3.2.2 enable overall employer contributions to be kept as constant as possible and (subject to the Administering Authority not taking undue risks) at reasonable cost to the taxpayers, scheduled, designating, and admitted bodies whilst achieving and maintaining the solvency of the Fund, which should be assessed in light of the risk profile of the Fund and the risk appetite of the Administering Authority and employers alike;
- 3.2.3 manage employers' liabilities effectively and ensure that sufficient resources are available to meet all liabilities as they fall due. The Fund has a significant positive cash flow in terms of income received, including investment income, offset by monies payable; and
- 3.2.4 maximise the returns from investments within reasonable risk parameters.

3.2 The purpose of the Fund is to:

- 3.2.1 receive monies in respect of contributions from employers and employees, transfer values and investment income; and
- 3.2.2 pay out monies in respect of Scheme benefits, transfer values, costs, charges and expenses as defined in the LGPS Regulations and as required in the Investment regulations.

**4. Responsibilities of Key Parties**

4.1 The sound management of the Fund relies on all interested parties exercising their duties and responsibilities conscientiously and diligently. The key parties in this statement are the Administering Authority, Scheme employers and the actuary.

4.2 The Administering Authority should:-

- 4.2.1 operate a pension fund;
- 4.2.2 collect employee and employer contributions, investment income and other amounts due to the pension fund;
- 4.2.3 invest all monies held in accordance with the SIP;
- 4.2.4 maintain adequate records for each Scheme member;
- 4.2.5 exercise discretions within the regulatory framework, taking into account the cost of decisions;
- 4.2.6 take measures as set out in the regulations to safeguard the fund against the consequences of employer default;
- 4.2.7 ensure sufficient cash is available to meet liabilities as they fall due;
- 4.2.8 pay from the pension fund the relevant entitlements as stipulated in the Regulations;
- 4.2.9 provide membership records and financial information to the actuary promptly when required;
- 4.2.10 prepare and maintain a Funding Strategy Statement and a Statement of Investment Principles / Investment Strategy Statement in proper consultation with interested parties;

- 4.2.11 monitor all aspects of the Fund's performance and funding and amend the FSS/SIP/ISS accordingly;
- 4.2.12 manage the valuation process in consultation with the actuary;
- 4.2.13 effectively manage any potential conflicts of interest arising from its dual role as both fund administrator and Scheme employer; and
- 4.2.14 enable the Local Pension Board to review the valuation process as set out in their terms of reference.

#### 4.3 Each individual employer should:

- 4.3.1 deduct contributions from employees' pay correctly;
- 4.3.2 pay all ongoing contributions, including their own as determined by the actuary, and any additional contributions promptly by the due date;
- 4.3.3 develop a policy on certain discretions and exercise those discretions as permitted within the regulatory framework, taking into account the cost of decisions;
- 4.3.4 make additional contributions in accordance with agreed arrangements in respect of, for example, award of additional pension and early retirement strain;
- 4.3.5 provide adequate membership records to the Administering Authority promptly as required;
- 4.3.6 notify the Administering Authority promptly of all changes or proposed changes to membership which affect future funding;
- 4.3.7 notify the Administering Authority promptly of possible or intended changes that could affect the basis of participation in the Fund which affect future funding; and
- 4.3.8 be aware that responsibility for compensatory added years, which the Administering Authority pays on behalf of the employer as a paying agent, lies with the employer which awards and is recharged for the cost of compensatory added years.
- 4.3.9 pay any exit payments required in the event of their ceasing participation in the Fund.

#### 4.4 The Fund Actuary should:

- 4.4.1 prepare triennial valuations including the setting of employers' contribution rates at a level to ensure fund solvency and long-term cost efficiency after agreeing assumptions with the Administering Authority and having regard to the FSS and the Regulations;
- 4.4.2 prepare advice and calculations in connection with bulk transfers and individual benefit-related matters such as pension strain costs, ill health retirement costs, etc.;
- 4.4.3 provide advice and valuations on the exiting of employers from the Fund.
- 4.4.4 provide advice to the administering authority on bonds or other forms of security to mitigate against the financial effect on the fund of employer default;
- 4.4.5 assist the Administering Authority in assessing whether employer contributions need to be revised between valuations as permitted or required by the regulations; and

- 4.4.6 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, Target Funding Levels and Long-term Cost Efficiency**

### **Risk Based Approach**

- 5.1 The Fund adopts a risk based approach to funding strategy. In particular the discount rate (for most employers) has been set on the basis of the assessed likelihood of meeting the funding objectives. The Administering Authority has considered 3 key decisions in setting the discount rate:
  - 5.1.1 the long-term Solvency Target (i.e. the funding objective - where the Administering Authority wants the Fund to get to);
  - 5.1.2 the Trajectory Period (how quickly the Administering Authority wants the Fund to get there), and
  - 5.1.3 the Probability of Funding Success (how likely the Administering Authority wants it to be now that the Fund will actually achieve the Solvency Target by the end of the Trajectory Period).
- 5.2 These three choices, supported by complex (stochastic) risk modelling carried out by the Fund Actuary, define the discount rate (investment return assumption) to be adopted and, by extension, the appropriate employer contributions payable. Together they measure the riskiness (and hence also the degree of prudence) of the funding strategy. These are considered in more detail below.

### **Solvency Target**

- 5.3 The Administering Authority's primary aim is the long-term solvency of the Fund. Accordingly, employers' contributions will be set to ensure that 100% of the liabilities can be met over the long term using appropriate actuarial assumptions.
- 5.4 The Fund is deemed to be solvent when the assets held are equal to or greater than the value of the Fund's liabilities assessed using appropriate actuarial methods and assumptions. The Administering Authority believes that its funding strategy will ensure the solvency of the Fund because employers collectively have the financial capacity to increase employer contributions should future circumstances require, in order to continue to target a funding level of 100%.

- 5.5 For secure Scheduled Bodies and Admission Bodies where a Scheme Employer of sound covenant has agreed to subsume its assets and liabilities following cessation, appropriate actuarial methods and assumptions are taken to be:
- 5.5.1 the Projected Unit method of valuation; and
  - 5.5.2 assumptions such that, if the Fund had reached the Solvency Target, its financial position continued to be assessed by use of such methods and assumptions, and contributions were paid in accordance with those methods and assumptions, there would be an 80% chance that the Fund would be at least 100% funded after a period of 25 years.

This then defines the Solvency Target.

- 5.6 For Admission Bodies whose liabilities are expected to be orphaned following exit, a more prudent approach will be taken. The Solvency Target will be set by considering the valuation basis which would be adopted should the body leave the Fund. For most such bodies, the Solvency Target will be set commensurate with assumed investment in an appropriate portfolio of Government index linked and fixed interest bonds after exit.
- 5.7 For scheduled bodies with no guarantee from local or central government and Admission Bodies where there is no subsumption commitment but which continue to admit new members to the Fund and are considered by the Administering Authority to be sufficiently financially secure, the Solvency Target will take into account the fact that the employer's exit is not expected to take place for a considerable period of time.

### **Probability of Funding Success**

- 5.8 The Administering Authority considers funding success to have been achieved if the Fund, at the end of the Trajectory Period, has achieved the Solvency Target. The Probability of Funding Success is the assessed chance of this happening based on the level of contributions payable by members and employers and asset-liability modelling carried out by the Fund Actuary.

The discount rate, and hence the overall required level of employer contributions, has been set such that the Fund Actuary estimates there is just under a 70% chance that the Fund would reach or exceed its Solvency Target after 25 years.

## **Funding Target**

- 5.9 The Funding Target is the amount of assets which the Fund needs to hold at the valuation date to pay the liabilities at that date as indicated by the chosen valuation method and assumptions and the valuation data. The valuation calculations, including future service contributions and any adjustment for surplus or deficiency, set the level of contributions payable and dictate the chance of achieving the Solvency Target at the end of the Trajectory Period (defined below). The key assumptions used for assessing the Funding Target are summarised in Appendix 1.
- 5.10 Consistent with the aim of enabling the primary rate of employers' contributions to be kept as nearly constant as possible, contributions are set by use of the Projected Unit valuation method for most employers. The Projected Unit method is used in the actuarial valuation to determine the cost of benefits accruing to the Fund as a whole and for employers who continue to admit new members. This means that the future service contribution rate is derived as the cost of benefits accruing to employee members over the year following the valuation date expressed as a percentage of members' pensionable pay over that period. The future service rate will be stable if the profile of the membership (age, gender etc.) is stable.
- 5.11 For employers who no longer admit new members, the Attained Age valuation method is normally used. This means that the contribution rate is derived as the average cost of benefits accruing to members over the period until they die, leave the Fund or retire. This approach should lead to more stable employer contribution rates than adoption of the Projected Unit method for closed employers.

## **Funding Targets and assumptions regarding future investment strategy**

- 5.12 For Scheduled Bodies whose participation in the Fund is considered by the Administering Authority to be indefinite and Admission Bodies with a subsumption commitment from such Scheduled Bodies, the Administering Authority assumes indefinite investment in a broad range of assets of higher risk than risk free assets. This is known as the scheduled and subsumption body funding target.
- 5.13 For other Scheduled Bodies the Administering Authority may without limitation, take into account the following factors when setting the funding target for such bodies:
- 5.13.1 the type/group of the employer
  - 5.13.2 the business plans of the employer;
  - 5.13.3 an assessment of the financial covenant of the employer;
  - 5.13.4 any contingent security available to the Fund or offered by the employer such as a guarantor or bond arrangements, charge over assets, etc.

Where, by virtue of having taken account of some or all of the above factors, the Administering Authority adopts a less risky (more prudent) funding target than the scheduled and subsumption body funding target for any scheduled bodies, this is known as the intermediate funding target.

- 5.14 For Admission Bodies whose liabilities are expected to be orphaned on exit, the Administering Authority will have regard to the potential for participation to cease (or for the body to have no contributing members), the potential timing of such exit, and any likely change in notional or actual investment strategy as regards the assets held in respect of the body's liabilities at the date of exit (i.e. whether the liabilities will become 'orphaned' or a guarantor exists to subsume the notional assets and liabilities). This is known as the (ongoing) orphan admission bodies funding target. It is not the same as the exit basis.
- 5.15 For Admission Bodies where there is no subsumption commitment but which continue to admit new members to the Fund and are considered by the Administering Authority to be sufficiently financially secure, the Administering Authority may assume continued investment in a broad range of assets of higher risk than risk free assets for a longer period, albeit it will still consider any likely change in notional or actual investment strategy as regards the assets held in respect of the body's liabilities when the employer exits. This is known as the intermediate funding target.
- 5.16 The Fund is deemed to be fully funded when the assets are equal to or greater than 100% of the Funding Target, where the funding target is assessed based on the sum of the appropriate funding targets across all the employers/groups of employers.

### **Recovery Periods**

- 5.17 Where a valuation reveals that the Fund is in surplus or deficit relative to the Funding Target, the employers' contributions will be adjusted to target 100% funding over the Recovery Period. The Fund has a target of achieving the Funding Target within a maximum period of 22 years. Whilst this is longer than the expected average future period of membership of active members, the Administering Authority considers this is reasonable in the context of the LGPS as a statutory scheme. Further, this is based on the assumption that the Scheme (and the majority of the employers) will continue for the foreseeable future, and that favourable investment performance can play a valuable role in achieving adequate funding over the long term.
- 5.18 If the assets of the scheme relating to an employer are less than the funding target at the date of any actuarial valuation, a recovery plan will be put in place, which is expected to require additional contributions from the employer to meet the shortfall. Each employer will be informed of its deficit to enable it to make the necessary allowance in their business and financial plans. The Recovery Period in relation to an employer or group of employers is the period over which any adjustment to the level of contributions in respect of a surplus or deficiency relative to the Funding Target for that employer or group of employers is payable.



- 5.19 Additional contributions to meet any shortfall will be expressed as a monetary amount, and will increase annually in line with the assumption for pay growth used for the valuation unless a different increase rate is agreed between the employer and Administering Authority. The recovery period for which the additional contributions are payable will normally be subject to the following limits:-
- 5.19.1 scheduled bodies whose participation is deemed to be indefinite, designating and open admission bodies with subsumption guarantees from such bodies - 22 years
  - 5.19.2 open admission bodies without a subsumption guarantee and no fixed or known term of participation and scheduled bodies with no local or central government guarantee - 22 years, although the Administering Authority reserves the right to adopt a shorter period if it has concerns about the employer's strength of covenant
  - 5.19.3 admission bodies with a fixed or known term of participation - remaining period of participation (including those with a subsumption commitment)
  - 5.19.4 other admission bodies (i.e. those closed to new entrants) – average future working life of current active members (or period to contract end date if shorter )
- 5.20 In determining the Recovery Period to apply for any particular employer, the Administering Authority may take into account, without limitation, the following factors:
- 5.20.1 the type/group of the employer
  - 5.20.2 the size of the funding shortfall;
  - 5.20.3 the business plans of the employer;
  - 5.20.4 the assessment of the financial covenant of the employer;
  - 5.20.5 any contingent security available to the Fund or offered by the employer such as a guarantor or bond arrangements, charge over assets, etc.

### **Employer Contributions**

- 5.21 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, following a principle of no cross-subsidy , between the various employers in the Scheme, except in relation to death in service and (with effect from 1 April 2014) tier 1 and 2 ill health retirement experience where experience is shared across all employers. In attributing the overall investment performance obtained on the assets of the Scheme to each employer a pro-rata principle has been adopted. From 1 March 2018 the investment performance will be allocated on a monthly basis via the unitisation process (applied retrospectively to 1 April 2016 in respect of any inter-valuation calculations for any employer where the employer asset value is taken from the output of the unitisation model).

- 5.22 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 “primary contribution rate”). The method and assumptions for assessing these contributions are set out in Appendix 1.
- 5.23 The Administering Authority, following consultation with the participating employers, has adopted the following constraints for setting individual employer contribution rates:
- 5.23.1 a maximum deficit Recovery Period of 22 years. Employers will have the freedom to adopt a recovery plan on the basis of a shorter period if they so wish where their notional share of the Fund is in deficit. A shorter period may be applied in respect of particular employers where the Administering Authority considers this to be warranted (see below).
  - 5.23.2 where changes in employer contribution rates are required following completion of the actuarial valuation, the increase or decrease may be implemented in steps as long as the regulatory objectives of solvency and long-term cost efficiency are met.
  - 5.23.3 on the exit of an employing authority’s participation in the Scheme, the Fund Actuary will be asked to complete an exit valuation. Any deficit or surplus in the Fund in respect of the employer will be due to the Fund as a termination contribution, or by the Fund as an exit credit respectively, unless it is agreed by the Administering Authority and the other parties involved that all the assets and liabilities relating to the employer will transfer within the Scheme to another participating employer. Details of the approach to be adopted for such an assessment on exit are set out in the separate Policy on New Employers and Exit Valuations document at Appendix 2.
- 5.24 With regard to the funding for early retirement costs, all employers are required to make capital payments to the Fund to cover the costs of early retirements. This excludes the costs involved with deaths in service and ill health retirements which are built into the employer’s contribution rate. For deaths in service and tier 1 and tier 2 ill health retirements the experience will be spread across all employers.
- 5.25 Two key principles making up the funding strategy and to be adopted for the 2016 actuarial valuation are to:
- 5.25.1 provide stability in primary employer contribution rates and secondary employer contribution amounts as far as is possible, thereby avoiding wide fluctuations year on year. To achieve this stability and ensure gradual movements in employers’ contribution levels, the practice of phasing any increases or decreases in employers’ contribution requirements up to 6 years from 1 April 2017 will be adopted where appropriate and required;
  - 5.25.2 retain a maximum 22 year recovery period for meeting a deficit as adopted at the 2010 and 2013 valuations.

- 5.26 With regard to the two principles outlined in paragraph 5.25 above, every Scheme Employer (i.e. those identified in paragraph 5.19.1) will have the option of being treated on this basis. They may, however, choose to have a single increase in contributions or phase any increase over a shorter period than 6 years. However, as an alternative, the main Councils and West Yorkshire Fire and Police (Chief Constable and Police and Crime Commissioner) have been offered the option of paying contributions based on market conditions as at 30 September 2016 on the proviso that their contribution requirements will be reviewed as at 30 September 2017 and 30 September 2018 and increased from the following 1 April if required.
- 5.27 It may not be possible to adopt the two principles outlined in paragraph 5.25 for some or all of the employers identified in paragraphs 5.19.2, 5.19.3 and 5.19.4, although wherever possible they will be applied. Individual decisions may have to be taken for each employer featuring in these three groups with regard to an appropriate recovery period and whether the phasing of increases or decreases in contribution rates is feasible. Decisions on these issues will have regard to the Administering Authority's views on the strength of an employer's covenant, to its membership profile, and to its anticipated future period of participation in the Fund.
- 5.28 The strategic aim of the Fund is to operate within a funding range of 90% to 110%. Whenever the Fund as a whole is operating within this range of funding then for the majority of 'high covenant' employers it is anticipated that their contribution rates will remain stable as long as the requirement for contributions to be set so as to ensure the solvency and long-term cost efficiency of the Fund are still met. For other employers the Administering Authority will have regard to the potential for participation to cease, and require changes in contribution rates accordingly.
- 5.29 In determining the above principles and adopting the 22 year deficit recovery period for the 2016 Valuation, the Administering Authority has had regard to:
- 5.29.1 the responses to the consultation on the FSS principles;
  - 5.29.2 relevant guidance issued by the CIPFA Pensions Panel;
  - 5.29.3 the need to balance a desire to attain a target of 100% funding as soon as possible, within the 90% to 110% funding range against the short-term cash requirements which a shorter period would impose;
  - 5.29.4 the Administering Authority's views on the strength of the participating employers' covenants in achieving the objective.

### **Long-term cost efficiency**

- 5.30 In order to ensure that measures taken to maintain stability of employer contributions are not inconsistent with the statutory objective for employer contributions to be set so as to ensure the long-term cost efficiency of the Fund, the Administering Authority has assessed the actual contributions payable by considering:
- 5.30.1 The implied average deficit recovery period, allowing for the stepping of employer contribution changes;

- 5.30.2 The investment return required to achieve full funding over the recovery period; and
- 5.30.3 How the investment return compares to the Administering Authority's view of the expected future return being targeted by the Fund's investment strategy

### **Smoothing of Contribution rates for admission bodies**

- 5.31 The Administering Authority recognises that a balance needs to be struck as regards the financial demands made of admission bodies. On the one hand, the Administering Authority requires all admission bodies to be fully self-funding, such that other employers in the Fund are not subject to expense as a consequence of the participation of those admission bodies. On the other hand, requiring achievement of full funding over a short time horizon may precipitate failure of the body in question, leading to costs for other participating employers.
- 5.32 Where the Administering Authority considers it necessary to relax the requirement that the contribution rate targets full funding temporarily, the Administering Authority will engage with the largest employers in the Fund with a view to seeking agreement to this approach.
- 5.33 The implication of this is that, during the period of relaxation, contribution rates for admission bodies can be set at a level lower than full funding would require. However, where deficit payments are being deferred, the bodies should be aware that, all things being equal, this will lead to a higher contribution requirement in future. As a minimum, such bodies should pay contributions equal to the cost of benefits accruing for their members calculated on the Funding Target method and assumptions adopted for scheduled bodies and those with a subsumption guarantee. It should be noted that should an employer exit the Fund during the period when contribution rates have been relaxed, the full value of the employer's liabilities in the Fund will be taken into account in the exit valuation, i.e. the employer will, in effect, be required to make up any additional underfunding by virtue of contributions having been relaxed.

### **Notional sub-funds**

- 5.34 In order to establish contribution rates for individual employers or groups of employers the Fund Actuary notionally subdivides the Fund assets between the employers, as if each employer had its own notional sub fund within the Fund.
- 5.35 This subdivision is for funding purposes only. It is purely notional in nature and does not imply any formal subdivision of assets, nor ownership of any particular assets or groups of assets by any individual employer or group.

- 5.36 The notional sub fund allocated to each employer was tracked between the 2013 and 2016 valuations by rolling it forward allowing for all cashflows associated with that employer's membership, including contribution income, benefit payments, transfers in and out and investment income allocated as set out below. In general no allowance was made for the timing of contributions and cashflows for each year were assumed to be made half way through the year with investment returns assumed to be uniformly earned over that year. Further adjustments were made for:
- 5.36.1 A notional deduction to meet the expenses paid from the Fund in line with the assumption used at the 2013 valuation.
  - 5.36.2 Allowance for any known internal transfers within the Fund (cashflows will not exist for these transfers). For material transfers where members are being transferred under TUPE, the Fund Actuary assumed an estimated cashflow equal to the value of the liabilities transferred from one employer to the other (a "fully funded transfer") or equal to the value of the liabilities adjusted to allow for any deficit in the Fund (a "share of fund transfer") as instructed by the Administering Authority. For individual transfers, the Fund Actuary assumed a cashflow equal to the estimated cash equivalent transfer value appropriate to the valuation date in relation to the member who transferred from one employer to the other.
  - 5.36.3 Allowance for death in service and other benefits shared across all employers in the Fund (see above).
  - 5.36.4 An overall adjustment to ensure the notional assets attributed to each employer is equal to the total assets of the Fund which will take into account any gains or losses related to the orphan liabilities.
- 5.37 In some cases information available will not allow for such cashflow calculations. In such a circumstance:
- 5.37.1 Where, in the opinion of the Fund Actuary, the cashflow data which is unavailable is not material, estimated cashflows were used.
  - 5.37.2 Where, in the opinion of the Fund Actuary, the cashflow data which is unavailable is material, or the results of the cashflow approach appears to give unreliable results perhaps because of unknown internal transfers, the actuary instead used an analysis of gains and losses to roll forward the notional sub fund. Analysis of gains and losses methods are less precise than use of cashflows. They involve calculation of gains and losses to the surplus or deficit at the previous valuation and then compare the surplus or deficit calculated at the valuation with the liabilities evaluated at this valuation to determine the employer's implied notional asset holding.

- 5.38 The distribution of the investment portfolio between asset classes, and the allocation of investment performance, will be exactly the same for every employer in the Fund. The Fund has one investment portfolio, and employers' shares of the portfolio will be pro-rata to their participating share of the Fund. The Fund's Investment Advisory Panel approves the distribution of the investment portfolio between the various asset classes, and no separate or different notional distribution will be applied to any employer.
- 5.39 With effect from 1 April 2016 a unitised approach will be used to track the notional employer sub-funds. The unitisation model will use the notional sub-funds as at 31 March 2016 (the date of the current actuarial valuation) as its starting point and hence won't be place until the 2016 valuation has been completed. Calculations with an effective date on or after 1 April 2016 requiring an updated calculation of the notional sub-fund for any employer will use the output of the unitisation model where available. However, any actuarial calculations with an effective date of after 1 April 2016 which are finalised before the unitisation model is operational will not be revised unless this has been specifically agreed by the Administering Authority.

### **Former Participating Bodies**

- 5.40 Where an employer ceases to participate in the Fund, the Administering Authority will obtain an exit valuation from the actuary which will determine an exit contribution on the assumption that, unless a subsumption arrangement is in place, the assets will assumed to be invested in low risk investments and this will be sufficient to meet the liabilities. This approach minimises the risk that a deficit could arise on these liabilities in future which would incur a cost for the other employers in the Fund. Further details of the Administering Authority's policy for exit valuations are set out in Appendix 2.
- 5.41 Liabilities in the Fund which are already orphaned will be assumed to be 100% funded on the appropriate funding target at each valuation. This will be achieved by notionally re-allocating assets within the Fund as required.

### **6. Link to investment policy set out in the Investment Strategy Statement (ISS)**

- 6.1 In assessing the value of the Fund's liabilities in the valuation, allowance has been made for future investment returns, as described in Appendix 1, which takes into account the investment strategy adopted by the Fund, as set out in the ISS.
- 6.2 It is possible to construct a portfolio that represents a lower risk investment position and one which closely matches the liabilities should there be no employers to fund the liabilities in future. Such a portfolio would consist of a mixture of long-term index-linked and fixed interest gilts.

- 6.3 Investment of the Fund's assets in line with the least risk portfolio would minimise fluctuations in the value of the Fund's assets between successive actuarial valuations. However, if, at the valuation date, the Fund had been invested in this portfolio, then in carrying out the valuation it would not be appropriate to set the discount rate by considering the returns on growth assets such as equities. On this basis the discount rate would be lower, the assessed value of the Fund's liabilities valuation would be significantly higher, and the declared funding level would be correspondingly reduced
- 6.4 Departure from a least risk investment strategy, in particular to include a significant element of Equity investment, gives the prospect that out-performance by the assets will, over time, reduce the employers' contribution requirements. The funding target might in practice therefore be achieved by a range of combinations of funding plan, investment strategy and investment performance.
- 6.5 The Fund's current benchmark investment strategy, as set out in its ISS, is that the biggest proportion of the Fund's investments will be in Equities. This type of investment bias is intended to maximise growth in the value of assets over the long term. The expected rate of return and the target set for investment returns in the ISS are reviewed annually as a matter of course, and the relationship with the requirements of the FSS are considered at the same time.

## **7. Identification of risks and counter-measures**

- 7.1 Whilst the activity of managing the Fund exposes the Administering Authority to a wide range of risks, those most likely to impact on the funding strategy are investment risk, liability risk, liquidity/maturity risk, regulatory/compliance risk, employer risk and governance risk.

### **Investment risk**

- 7.2 This covers items such as the performance of financial markets and the Fund's Investment managers, asset reallocation in volatile markets, leading to the risk of investments not performing (income) or increasing in value (growth) as forecast. Examples of specific risks would be:
- 7.2.1 assets not delivering the required return (for whatever reason, including manager underperformance)
  - 7.2.2 systemic risk with the possibility of interlinked and simultaneous financial market volatility
  - 7.2.3 insufficient funds to meet liabilities as they fall due
  - 7.2.4 inadequate, inappropriate or incomplete investment and actuarial advice is taken and acted upon
  - 7.2.5 counterparty failure

7.3 The specific risks associated with assets and asset classes are:

- 7.3.1 equities – industry, country, size and stock risks
- 7.3.2 fixed income - yield curve, credit risks, duration risks and market risks
- 7.3.3 alternative assets – liquidity risks, property risk, alpha risk
- 7.3.4 money market – credit risk and liquidity risk
- 7.3.5 currency risk
- 7.3.6 macroeconomic risks

7.4 The Fund mitigates these risks through diversification, permitting investment in a wide variety of markets and assets, and through the use of specialist managers with differing mandates in addition to the internal investment management team, which has a wide variety of experience within its members.

7.5 The performance of both markets and managers is reviewed regularly by the Investment Advisory Panel, which has the appropriate skills and training required to undertake this task.

### **Liability risk**

7.6 The main risks include interest rates, pay and price inflation, changing retirement patterns and other demographic risks.

7.7 The Administering Authority will ensure that the Fund Actuary investigates these matters at each valuation and reports on developments. The Administering Authority will agree with the Fund Actuary any changes which are necessary to the assumptions underlying the measure of solvency to allow for observed or anticipated changes.

7.8 The Fund Actuary will also provide quarterly funding updates to assist the Administering Authority in its monitoring of the financial liability risks. The Administering Authority will, as far as practical, monitor changes in the age profile of the Fund membership early retirements, redundancies and ill health early retirements and, if any changes are considered to be material, ask the Fund Actuary to report on their effect on the funding position.

7.9 If significant liability changes become apparent between valuations, the Administering Authority will notify all participating employers of the anticipated impact on costs that will emerge at the next valuation and consider whether to require the review the bonds that are in place for Admission Bodies.



## **Liquidity and Maturity risk**

7.10 This is the risk of a reduction in cash flows into the Fund, or an increase in cash flows out of the Fund, or both, which can be linked to changes in the membership and, in particular, a shift in the balance from contributing members to members drawing their pensions. Changes within the public sector and to the LGPS itself may affect the maturity profile of the LGPS and have potential cash flow implications. For example,

- 7.10.1 budget cuts and headcount reductions could reduce the active (contributing) membership and increase the number of pensioners through early retirements;
- 7.10.2 an increased emphasis on outsourcing and other alternative models for service delivery may result in falling active membership (e.g. where new admissions are closed),
- 7.10.3 public sector reorganisations may lead to a transfer of responsibility between different public sector bodies, (e.g. to bodies which do not participate in the LGPS),
- 7.10.4 scheme changes and higher member contributions in particular may lead to increased opt-outs;
- 7.10.5 a high take-up of the 50/50 option will reduce member contributions to the Fund.

7.11 The Administering Authority seeks to maintain regular contact with employers to mitigate against the risk of unexpected or unforeseen changes in maturity leading to cashflow or liquidity issues.

## **Regulatory and compliance risk**

7.12 Regulatory risks to the scheme arise from changes to general and LGPS specific regulations, taxation, national changes to pension requirements, or employment law. The Government is also carrying out a review of the structure of the LGPS.

7.13 The Administering Authority will keep abreast of all the changes to the LGPS 2014. The Administering Authority will normally respond to consultations on these matters where they have an impact on the Fund, and it would encourage employers, who frequently have a greater interest in proposed changes, to respond independently.

## **Employer risk**

7.14 These risks arise from the ever-changing mix of employers, from short-term and ceasing employers, and the potential for a shortfall in payments and/or orphaned liabilities.

7.15 The Administering Authority maintains a knowledge base on its employers, their basis of participation and their legal status (e.g., charities, companies limited by guarantee, group/subsidiary arrangements) and uses this information to inform the FSS.

## **Governance risk**

- 7.16 Governance risk is essentially one of communication between employer and the Fund, where, for example, an employer fails to inform the Fund of major changes, such as the letting of a contract involving the transfer of significant numbers of staff to another employer, or an admission body closing the scheme to new entrants.
- 7.17 The Fund seeks to maintain regular contact with employers to mitigate this risk, and has Pension Fund Representatives for this purpose. The Fund would also advise employers to pay past service deficit payments as lump sums, rather than as a percentage of payroll, to avoid an under payment accruing as a result of a reduction of the payroll.
- 7.18 To protect the Fund on the admission of a new employer, the existing scheme employer (which should liaise with the Fund) or the Fund if there is no existing scheme employer, will undertake a risk assessment and determine the requirement for a bond or indemnity, which should be reviewed annually.
- 7.19 The Fund will monitor employers with a declining membership, and may introduce a more conservative Funding strategy for such employers.

## **8. Monitoring and Review**

- 8.1 The Administering Authority has taken advice from the Fund Actuary in preparing this Statement, and will consult with senior officials of all the Fund's participating employers.
- 8.2 A full review of this Statement will occur no less frequently than every three years, to coincide with completion of a full valuation. Any review will take account of the current economic conditions and will also reflect any legislative changes.
- 8.3 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:
- 8.3.1 if there has been a significant change in market conditions, and/or deviation in the progress of the funding strategy.
  - 8.3.2 if there have been significant changes to the Scheme membership, or LGPS benefits.
  - 8.3.3 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
  - 8.3.4 if there have been any significant special contributions paid into the Scheme.

## **APPENDIX 1**

### **Actuarial Valuation as at 31 March 2016**

#### **Method and assumptions used in calculating the funding target**

The actuarial method to be used 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.

#### **Principal assumptions**

##### **Investment return (discount rate)**

The discount rates adopted vary according to the solvency target as set out in section 5. For the 2016 valuation the discount rate is 4.7% p.a. for the periods pre and post retirement (the scheduled and subsumption body funding target), with the exception of:

- Admission Bodies which will ultimately give rise to Orphan liabilities where the discount rate is 4.1% in service (equivalent to the yield on long-dated fixed interest gilts at a duration appropriate for the Fund's liabilities plus an asset out-performance assumption of 2.0%) and 2.5% (left service), which is intended to be equivalent to the yield on long-dated fixed interest gilts at the valuation date but which has, in the interests of affordability and stability of employer contributions, been increased by 0.4% in light of the Actuary's view of the possible future increase in gilt yields. This is the ongoing orphan admission body funding target.

##### **Inflation (Retail Prices Index (RPI) and Consumer Prices Index (CPI) inflation)**

The RPI inflation assumption is taken to be the Capital Market Assumption at the valuation date as produced by Aon Hewitt Limited. In formulating the Capital Market Assumption, both consensus forecasts and the inflation risk premium are considered.

The CPI inflation assumption at the valuation date is set as RPI inflation less 1.1%.p.a. The deduction has been set having regard to the estimated difference between RPI and CPI arising from the difference in the calculation approach between the two indices. This estimate (and hence the assumed difference between CPI and RPI) will vary from time to time.

##### **Salary increases**

The assumption for real salary increases (salary increases in excess of consumer price inflation) will be determined by an allowance of 1.25% p.a. over the consumer price inflation assumption as described above.

## **Pension increases**

Increases to pensions are assumed to be in line with the inflation (CPI) assumption as determined 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**

### **Post-retirement Mortality**

#### Base Rates

Normal Health: Standard SAPS S2P Normal Health tables, year of birth base rates, adjusted by a scaling factor.

Ill-health: Standard SAPS S2 Ill-health tables, year of birth base rates adjusted by a scaling factor.

#### Scaling Factors

Rates adjusted by scaling factors as dictated by Fund experience

Males (normal health, current pensioner)	105%
Females (normal health, current pensioner)	90%
Males (normal health, current non-pensioner)	115%
Females (normal health, current non-pensioner)	90%

Males (ill-health)	120%
Females (ill-health)	135%

#### Future improvement to base rates

An allowance for improvements in line with CMI\_2016Proposed2015, for men or women as appropriate, with a long term rate of improvement of 1.50% p.a.

### **Pre-retirement mortality**

Males:	As for normal health retirements but with a 50% scaling factor
Females:	As for normal health retirements but with a 25% scaling factor

## Early retirements

Active members and Deferred members who left before 1 April 2016 who are protected in respect of their Rule of 85 Age following the benefit changes introduced in 2008 (i.e. those members who joined the Fund before 1 October 2006 and who would be aged over 60 on 31 March 2016) will be assumed to retire at the Rule of 85 Age or age 60 if higher with no reduction to accrued benefits.

Active members who joined the LGPS after 31 March 2014 are assumed to retire at their normal retirement age (which is aligned with state pension age).

All other active and deferred members are assumed to retire at age 65.

## Withdrawals

Allowance is made for withdrawals from service. On withdrawal, members are assumed to leave a deferred pension in the Fund and are not assumed to exercise their option to take a transfer value.

## Retirement due to ill health

Allowance is made for retirements due to ill health. Proportions assumed to fall into the different benefit tiers applicable after 1 April 2008 are:

Tier 1 (upper tier)	75%
Tier 2 (middle tier)	10%
Tier 3 (lower tier)	15%

## Family details

A man is assumed to be 3 years older than his spouse, civil partner or cohabitee. A woman is assumed to be 3 years younger than her spouse, civil partner or cohabitee.

80% of non-pensioners are assumed to be married / cohabitating at retirement or earlier death.  
80% of pensioners are assumed to be married / cohabitating at age 65.

## Commutation

Each member is assumed to take cash such that the total cash received (including statutory 3N/80 lump sum) is 75% of the permitted maximum amount permitted of their past service pension entitlements.

## Take up of 50/50 scheme

All members are assumed to remain in the scheme they are in at the date of the valuation.

### **Promotional salary increases**

Allowance is made for age-related promotional increases.

### **Expenses**

0.3% of Pensionable Pay added to the cost of future benefit accrual.

### **Method and assumptions used in calculating the cost of future accrual**

The cost of future accrual (primary contribution rate) will be calculated using the same actuarial method and assumptions as used to calculate the funding target.

### **Funding method**

For most employers, the actuarial method to be used is the Projected Unit method with a one year control period. For employers who do not permit new employees to join the Fund, the actuarial method to be used is the Attained Age method. Under both funding methods 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.

### **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

### **Summary of key whole Fund principal financial assumptions used for calculating funding target and cost of future accrual (the “primary contribution rate”) for the 2016 actuarial valuation**

Discount rate (in service)	4.7% for Scheduled, Resolution and Bodies with subsumption guarantees  4.1% Orphan Admission Bodies funding target (see paragraph 5.15)
Discount rate (left service)	4.7% Scheduled, Resolution and Bodies with subsumption guarantees  2.5% Orphan Admission Bodies
Rate of general pay increases	3.25%
Rate of price inflation (RPI)	3.1%
Rate of price inflation (CPI)	2.0%
Rate of pension increases (on benefits in excess of GMPs)	2.0%
Rate of pension increases on post-88 GMPs	1.8%
Rate of deferred pension increases	2.0%
Rate of GMP increases in deferment	3.25%