

**NORTHUMBERLAND COUNTY COUNCIL PENSION FUND**  
**Funding Strategy Statement**  
**March 2017**

## **1. INTRODUCTION**

### **Overview**

This Statement, originally prepared in accordance with Regulation 76A of the Local Government Regulations 1997, has been reviewed in accordance with Regulation 58 of the Local Government Pension Scheme Regulations 2013. The Statement describes Northumberland County Council's strategy, in its capacity as administering authority ("the administering authority"), for the funding of the Northumberland County Council Pension Fund ("the Fund").

As required by Regulation 58(4)(a) (as amended) of the Local Government Pension Scheme Regulations 2013 ("the 2013 Regulations"), this Statement has been prepared having regard to the guidance set out in the document published in September 2016 by CIPFA, the Chartered Institute of Public Finance and Accountancy and called "Preparing and Maintaining a Funding Strategy Statement in the LGPS" (2016 edition).

### **Consultation**

In accordance with Regulation 58(3) of the 2013 Regulations, all appropriate persons (including employers participating within the Northumberland County Council Pension Fund and the principal trade unions representing the contributors) have been consulted on the contents of this Statement and their views have been taken into account in formulating the Statement. However, the Statement describes a single strategy for the Fund as a whole.

In addition, the administering authority has had regard to the Fund's Investment Strategy Statement published under Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (the Investment Regulations).

The Fund Actuary, Aon Hewitt Limited, has also been consulted on the contents of this Statement.

### **Purpose of this Statement**

The main purpose of this Funding Strategy Statement is to set out the processes by which the administering authority:

- establishes a clear and transparent funding strategy, specific to the Fund, which will identify how employers' pension liabilities are best met going forward;
- supports the desirability of maintaining as nearly constant a primary rate of contributions as possible, as defined in Regulation 62(5) of the 2013 Regulations;
- ensures that the regulatory requirements to set contributions so as to ensure the solvency and long-term cost efficiency of the Fund are met; and

- takes a prudent longer-term view of funding the Fund's liabilities;

noting that whilst the funding strategy applicable to individual employers or categories of employers must be reflected in the Funding Strategy Statement, its focus should at all times be on those actions which are in the best long term interests of the Fund.

### **Links to investment policy set out in the Statement of Investment Principles**

The Authority has produced this Funding Strategy Statement having taken an overall view of the level of risk inherent in the investment policy set out in the Statement of Investment Principles / Investment Strategy Statement and the funding strategy set out in this Statement.

The assets that most closely match the liabilities of the Fund are fixed interest and index-linked Government bonds of appropriate term relative to the liabilities. The Fund's asset allocation as set out in the Investment Strategy Statement invests a significant proportion of the Fund in assets such as equities which are expected, but not guaranteed, to produce higher returns than Government bonds in the long term. The administering authority has agreed with the Fund Actuary that the Funding Target on the ongoing basis will be set after making some allowance for this higher anticipated return. However, the administering authority recognises that outperformance is not guaranteed and that, in the absence of any other effects, if the higher expected returns are not achieved the solvency position of the Fund will deteriorate.

The funding strategy recognises the investment targets and the inherent volatility arising from the investment strategy, by being based on financial assumptions which are consistent with the expected return on the investments held by the Fund, and by including measures that can be used to smooth out the impact of such volatility.

The administering authority will continue to review both documents to ensure that the overall risk profile remains appropriate including, where necessary, commissioning asset liability modelling or other analysis techniques.

### **Review of Statement**

The administering authority undertook its latest substantive review of this Statement between February and March 2017.

The administering authority will formally review this Statement as part of each triennial valuation of the Fund unless circumstances arise which require earlier action.

The administering authority will monitor the funding position of the Fund on an approximate basis at regular intervals between actuarial valuations and will discuss with the Fund Actuary whether any significant changes have arisen that require action.

## **2. AIMS AND PURPOSE OF THE FUND**

### **Purpose of the Fund**

The purpose of the Fund is to invest monies in respect of contributions, transfer values and investment income to produce a Fund to pay Scheme benefits over the long term and to pay out monies in respect of the Scheme benefits, transfer values, costs, charges and expenses.

### **Aims of the Fund**

The aims of the Fund are set out under a) to e) below. Aims a), c), d) and e) reflect requirements of the Scheme legislation and associated CIPFA guidance. b) is specific to the Fund.

- a) To comply with Regulation 62 of the 2013 Regulations and specifically to adequately fund benefits to secure the Fund's solvency while taking account of the desirability of maintaining as nearly a constant primary contribution rate as possible
- b) To maintain as nearly constant an overall contribution rate as possible

The administering authority recognises that the requirement to keep employer contribution rates as nearly constant as possible can run counter to the following requirements:

- the regulatory requirement to secure solvency and long term cost efficiency which should be assessed in light of the risk profile of the Fund and risk appetite of the administering authority and employers;
- the requirement that the costs should be reasonable to Scheduled and Admission Bodies, other bodies and to taxpayers (subject to not taking undue risks); and
- maximising returns from investments within reasonable risk parameters (see (e) below).

Producing low volatility in employer contribution rates requires material investment in assets which 'match' the employers' liabilities. In this context, 'match' means assets which behave in a similar manner to the liabilities as economic conditions alter. For the liabilities represented by benefits payable by the Local Government Pension Scheme, such assets would tend to comprise gilt edged investments.

Other classes of assets, such as stocks and property, are perceived to offer higher long term rates of return, on average, and consistent with the requirement to maximise the returns from investments within reasonable risk parameters, the administering authority invests a substantial proportion of the Fund in such assets. However, these assets are more risky in nature, and that risk can manifest itself in volatile returns over short term periods, and a failure to deliver the anticipated returns in the long term.

This short term volatility in investment returns can produce a consequent volatility in the measured funding position of the Fund at successive actuarial valuations,

with knock on effects to employer contribution rates. The impact on employer rates can be mitigated by use of smoothing adjustments at each valuation.

The administering authority recognises that there is a balance to be struck between the investment policy adopted, the smoothing mechanisms used at valuations, and the resultant stability of employer contribution rates from one valuation period to the next.

The administering authority also recognises that the position is potentially more volatile for Admission Bodies with short term contracts, where utilisation of smoothing mechanisms is less appropriate.

c) To ensure that sufficient resources are available to meet all liabilities as they fall due

The administering authority recognises the need to ensure that the Fund has, at all times, sufficient liquid assets to be able to pay pensions, transfer values, costs, charges and other expenses. It is the administering authority's policy that such expenditure is met, in the first instance, from incoming employer and employee contributions to avoid the expense of disinvesting assets. The administering authority monitors the position to ensure that all cash requirements can be met.

d) To manage employers' liabilities effectively

The administering authority seeks to ensure that all employers' liabilities are managed effectively. In a funding context, this is achieved by seeking regular actuarial advice, ensuring that employers are kept informed and consulted, and through regular monitoring of the funding position and the outlook for employers' contributions.

e) To maximise the returns from investments within reasonable risk parameters

The administering authority recognises the desirability of maximising investment income within reasonable risk parameters. Investment returns higher than those available on government bonds are sought through investment in other asset classes, such as stocks and property. The administering authority ensures that risk parameters are reasonable by:

- restricting investment to the levels permitted by the Investment Regulations;
- restricting investment to asset classes generally recognised as appropriate for UK pension funds;
- analysing the volatility and absolute return risks represented by those asset classes in collaboration with the Fund's actuary, investment advisers and fund managers and ensuring that they remain consistent with the risk and return profiles anticipated in the funding strategy;
- limiting concentration of risk by developing a diversified investment strategy; and
- monitoring the mis-matching risk, i.e. the risk that the investments do not move in line with the Fund's liabilities.

### **3. RESPONSIBILITIES OF THE KEY PARTIES**

The three parties whose responsibilities to the Fund are of particular relevance are the administering authority, the individual employers and the Fund Actuary.

Their key responsibilities are as follows:

The **administering authority** will:

- a) Administer the Fund
- b) Collect investment income and other amounts due to the Fund as set out in the Regulations including employer and employee contributions and, as far as it is able, ensure these contributions are paid by the due date

Individual employers must pay contributions in accordance with Regulations 67 to 70 of the 2013 Regulations. The administering authority will ensure that all employers are aware of these requirements especially the requirement of the Pensions Act 1995 that members' contributions are paid by the 19th of the month following the month that it is paid by the member. The administering authority may charge interest on late contributions in accordance with Regulation 71 of the 2013 Regulations.

The administering authority will ensure that action is taken to recover assets from Admission Bodies whose admission agreement has ceased (and from other employers whose participation in the Fund has ceased) by:

- requesting that the Fund Actuary calculates any deficiency at the date of the exit; and
  - notifying the body that it must meet any deficiency at exit.
- c) Pay from the Fund the relevant entitlements as set out by Regulations 22 to 52 of the 2013 Regulations
  - d) Invest surplus monies in accordance with the Regulations

The administering authority will comply with Regulation 7 of the Investment Regulations, which states that surplus fund money, not needed immediately, must be invested in a wide variety of suitable investments, after taking proper advice.

- e) Ensure that cash is available to meet liabilities as and when they fall due

The administering authority recognises this duty and discharges it in the manner set out in section 2(c) above.

f) Manage the valuation process in consultation with the Fund Actuary

The administering authority ensures it communicates effectively with the Fund Actuary to:

- agree timescales for the supply of information and provision of valuation results;
- ensure provision of data of suitable accuracy;
- ensure that the Fund Actuary is clear about the content of the Funding Strategy Statement;
- ensure that participating employers receive appropriate communication throughout the process; and
- ensure that reports are made available as required by guidance and regulation.

g) Prepare and maintain an Investment Strategy Statement and a Funding Strategy Statement after due consultation with interested parties

The administering authority will ensure that both documents are prepared and maintained in the required manner.

h) Monitor all aspects of the Fund's performance and funding and amend these two documents if required

In order to monitor developments, the administering authority may from time to time request informal valuations or other calculations. Generally, these are undertaken quarterly and the calculations will be based on an approximate roll forward of asset and liability values, with liabilities calculated by reference to assumptions consistent with the most recent preceding valuation. Specifically, it is unlikely that the liabilities would be calculated using individual membership data, and nor would the assumptions be subject to review, as occurs at formal triennial valuations.

The administering authority monitors investment performance of the Fund on a quarterly basis.

The Investment Strategy Statement will be formally reviewed annually, unless circumstances dictate earlier amendment.

The administering authority will formally review this Statement as part of each triennial valuation process, unless circumstances arise which require earlier action.

i) Take measures as set out in the 2013 Regulations to safeguard the Fund against the consequences of employer default

j) Effectively manage any potential conflicts of interest arising from its dual role as both administering authority and as a Scheme Employer

k) Enable the Local Pension Board to review the valuation process as set out in their terms of reference

**Individual employers will:**

- deduct contributions from employees' pay correctly;
- pay all ongoing contributions, including their employer contribution as determined by the Fund Actuary, promptly by the due date;
- develop a policy on certain discretions and exercise those discretions within the regulatory framework, ensuring that the administering authority has copies of current policies covering those discretions;
- pay for additional benefits awarded to members, early release of benefits or other one off strain costs in accordance with agreed arrangements;
- notify the administering authority promptly of all changes to membership, or other changes which affect future funding;
- pay any exit payments required in the event of their ceasing participation in the Fund; and
- note and if desired respond to any consultation regarding the Funding Strategy Statement, the Investment Strategy Statement or other policies.

**The Fund Actuary will:**

- a) Prepare triennial actuarial valuations including the setting of employers' contribution rates at a level to ensure solvency and long term cost efficiency and issuing a Rates and Adjustments Certificate, after agreeing assumptions with the administering authority and having regard to the Funding Strategy Statement

Valuations will be prepared in accordance with generally accepted actuarial methods and reported on in accordance with current actuarial reporting Standards issued by the Financial Reporting Council, to the extent that the Standards are relevant to the Fund.

- b) Prepare advice and calculations in connection with

- bulk transfers and individual benefit-related matters;
- valuations on the termination of admission agreements or when an employer ceases to employ any active members; and
- bonds and other forms of security against the financial effect on the Fund of employer's default.

- c) Assist the administering authority in assessing whether employer contributions need to be revised between actuarial valuations as required or permitted by the 2013 Regulations

- d) Ensure that the administering authority is aware of any professional guidance requirements which may be of relevance to the Fund Actuary's role in advising the administering authority

Such advice will, where appropriate, take account of the funding position and funding and investment strategy of the Fund, along with other relevant matters.

## **4. FUNDING STRATEGY**

### **Risk based approach**

The Fund utilises a risk based approach to funding strategy.

A risk based approach entails carrying out the actuarial valuation on the basis of the assessed likelihood of meeting the funding objectives. In practice, three key decisions are required for the risk based approach:

- the Solvency Target (the value of assets the administering authority requires the Fund to hold to meet the Fund's liabilities);
- the Trajectory Period (how quickly the administering authority requires the Fund to get there); and
- the Probability of Funding Success (the current likelihood as required by the administering authority that the Fund will actually achieve the Solvency Target by the end of the Trajectory Period).

These three choices, supported by risk modelling carried out by the Fund Actuary, define the discount rate and, by extension, the appropriate levels of contribution payable. Together they measure the riskiness of the funding strategy.

These three terms are considered in more detail below.

### **Solvency Target**

The administering authority's primary aim is long-term solvency. Accordingly, employers' contributions will be set to ensure that 100% of the liabilities can be met over the long term using appropriate actuarial assumptions. The Solvency Target is the value of assets which the administering authority wishes the Fund to hold at the end of the Trajectory Period (see later) to meet this aim.

The Fund is deemed to be solvent when the assets held are equal to or greater than 100% of the Solvency Target, where the Solvency Target is the value of the Fund's liabilities evaluated 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%.

For employers:

- regarded by the administering authority as being of sound covenant with an indefinite period to expected exit; or
- with guarantors of sound covenant agreeing to subsume the employer's assets and liabilities following exit;

appropriate actuarial methods and assumptions are taken to be measurement by use of the Projected Unit method of valuation, and using assumptions such that, if:

- the Fund had reached the Solvency Target; and



- 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;

then there would be a chance of at least 80% that the Fund would continue to be 100% funded after a reasonable timeframe. The level of funding implied by this is the Solvency Target. For the purpose of this Statement, the required level of chance is defined as the Probability of Maintaining Solvency.

For all other employers, including bodies with limited duration in the Fund or whose liabilities are expected to be orphaned following exit, the required Probability of Maintaining Solvency will be set at a more prudent level dependent on circumstances. For most such bodies, the chance of achieving solvency will be set commensurate with assumed investment in an appropriate portfolio of Government index linked and fixed interest bonds after exit.

### **Probability of Funding Success**

The administering authority deems 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.

Consistent with the aim of enabling employers' contribution rates to be kept as nearly constant as possible, the required chance of achieving the Solvency Target at the end of the relevant Trajectory Period for each employer or employer group can be altered at successive valuations within an overall envelope of acceptable risk.

Following a valuation, the administering authority will not permit contributions to be set that have an unacceptably low chance of achieving the Solvency Target at the end of the relevant Trajectory Period.

### **Funding Target**

In order to satisfy the legislative requirement to secure long term cost efficiency, the administering authority's aim is for employer contributions to be set so as to make provision for the cost of benefit accrual, with an appropriate adjustment for any surplus or deficiency. This is achieved through the setting of a Funding Target.

The Funding Target is the value 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. It is a product of the triennial actuarial valuation exercise and is not necessarily the same as the Solvency Target. It is instead the product of the data, chosen assumptions, and valuation method. The valuation method, including the components of Funding Target, future service contributions and any adjustment for surplus or deficiency to set the level of contributions payable, in turn dictates the chance of achieving the Solvency Target at the end of the Trajectory Period (defined below). The Funding Target will be the same as the Solvency Target only when the methods and assumptions used to set the Funding Target are the same as the appropriate funding methods and assumptions used to set the Solvency Target (see above).

Consistent with the aim of enabling employers' primary contribution rates to be kept as nearly constant as possible:

- Contribution rates 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 (primary) 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.
- For employers who no longer admit new members, the Attained Age valuation method is normally used. This means that the future service (primary) contribution rate is derived as the average cost of benefits accruing to members over the period until they die, leave the Fund or retire.

### **Application to different types of body**

Some comments on the principles used to derive the Funding Target for different bodies in the Fund are set out below.

For employers:

- regarded by the administering authority as being of sound covenant with an indefinite period to expected exit; or
- with guarantors of sound covenant agreeing to subsume the employer's assets and liabilities following exit;

the administering authority will adopt a general approach in this regard of assuming indefinite investment in a broad range of assets of higher risk than risk free assets. With regard to guarantors, they must have been judged to be of suitable covenant by the administering authority (see section on Guarantors in section 5).

For all other employers, including bodies with limited duration in the Fund or whose liabilities are expected to be orphaned following exit, the administering authority will have regard to the potential for participation to cease (or 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).

### **Full funding**

The Fund is deemed to be fully funded when the assets held are equal to 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. When assets held are greater than this amount the Fund is deemed to be in surplus, and when assets held are less than this amount the Fund is deemed to be in deficiency.

### **Smoothing adjustments**

Consistent with the aim of enabling employer contribution rates to be kept as nearly constant as possible, and having regard to the risks inherent in such an approach,

the administering authority may also agree with the Fund Actuary the use of explicit smoothing adjustments in the calculation of the Funding Target. It is unlikely that use of these smoothing adjustments will be extended to employers whose participation in the Fund is for a fixed period (for example, an employer admitted by virtue of having been awarded a best value outsourcing contract).

### **Trajectory and Recovery Periods**

The Trajectory Period in relation to an employer is the period between the valuation date and the date on which solvency is targeted to be achieved.

Where an actuarial valuation reveals that the Fund is in surplus or deficiency against the Funding Target, employers' contribution rates will be adjusted to target restoration of the Funding Target over a period of years (the Recovery Period). The Recovery Period in relation to an employer or group of employers is therefore a period over which any adjustment to the level of contributions in respect of a surplus or deficiency relative to the Funding Target used in the valuation is payable.

The Recovery Period applicable for each participating employer is set by the administering authority in consultation with the Fund Actuary and the employer, with a view to balancing the various funding requirements against the risks involved due to such issues as the financial strength of the employer and the nature of its participation in the Fund.

The administering authority recognises that a large proportion of the Fund's liabilities are expected to arise as benefit payments over long periods of time. For employers of sound covenant, the administering authority is prepared to agree to Recovery Periods which are longer than the average future working lifetime of the membership of that employer (i.e. the estimated period of time until the last active member leaves or retires). The administering authority recognises that such an approach is consistent with the aim of keeping employer contribution rates as nearly constant as possible. However, the administering authority also recognises the risk in relying on long Recovery Periods and has agreed with the Fund Actuary a limit of 21 years, for employers which are assessed by the administering authority as being long term secure employers at the triennial valuation at 31 March 2016.

The administering authority's policy is generally to set Recovery Periods for each employer which are as short as possible within this framework (although a different policy applies for academies – see below). In general, for employers that are closed to new entrants and the participation is of sufficient term, the Recovery Period is set to be the estimated future working lifetime of the active membership.

The exception to this limit is Northumberland College, for whom the administering authority has agreed to use a Recovery Period of 30 years to assist in smoothing contribution rates as the employer transitions to an alternative Funding Target.

For employers whose participation in the Fund is for a fixed period, it is unlikely that the administering authority and Fund Actuary would agree to a recovery period longer than the remaining term of participation.

The administering authority obtains the opinion of Northumberland County Council's Deputy Chief Executive to categorise each academy in Northumberland into one of three groups: A meaning robustly viable; B meaning viability less certain; or C

meaning concerns over viability. Each academy is categorised at inception and at each valuation date. For category A academies, a 21 year Recovery Period is applied; for category B a 14 year Recovery Period is applied; and for category C a Recovery Period of up to 7 years is applied unless the administering authority receives an instruction from the Department for Education to lengthen the Recovery Period of a specified academy, in which case, a Recovery Period of up to 21 years may be applied for category B and C academies.

A period of 21 years has been used for Northumberland County Council, the largest employer in the Fund. Recovery Periods for other employers or employer groups may be shorter, and may not necessarily be the same as each other, in order to suitably balance risk to the Fund and cost to the employer.

### **Long term cost efficiency**

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:

- the implied average deficit recovery period, allowing for the stepping of employer contribution changes;
- the investment return required to achieve full funding over the recovery period; and
- how the investment return compares to the administering authority's view of the expected future return being targeted by the Fund's investment strategy.

### **Stepping**

The administering authority will also consider at each valuation whether new contribution rates should be payable immediately or reached by being stepped over a number of years. Stepping is a generally accepted method of smoothing the impact of rate changes for local authority pension funds. In consultation with the Actuary, the administering authority accepts that long term employers may step up to the new rates in annual steps. This is in line with the aim of having contribution rates as nearly constant as possible. The administering authority usually allows a maximum of three steps, however in exceptional circumstances up to six steps may be used.

### **Grouping**

In some circumstances it is desirable to group employers within the Fund together for funding purposes to calculate employer contribution rates. Reasons might include reduction of volatility of contribution rates for small employers, facilitating situations where employers have a common source of funding or accommodating employers who wish to share the risks related to their participation in the Fund.

The administering authority recognises that grouping can give rise to cross subsidies from one employer to another over time. Employers may be grouped entirely, such that all of the risks of participation are shared, or only partially grouped such that only specified risks are shared. The administering authority's policy is to consider the

position carefully at each valuation and to notify each employer that is grouped that this is the case, which other employers it is grouped with, and details of the grouping method used. If the employer objects to this grouping, it will be offered its own contribution rate.

Following commencement in the Fund, non-academy Scheduled Bodies with less than 20 contributing members will be included within the 'Small Scheduled Bodies' group by default. All risks are shared and these employers have a common contribution rate set as a percentage of pay (although some adjustment has been made for those employers who have selected a shorter recovery period in the past).

All employers in the Fund are grouped together in respect of the risks associated with payment of benefits on death in service and ill-health retirement. In other words, the cost of such benefits is shared across all the employers in the Fund. Such benefits at no fault of the employer can cause funding strains which could be significant for some of the smaller employers without insurance or sharing of risks. The Fund, in view of its size, does not see it as cost effective or necessary to insure these benefits externally and this is seen as a pragmatic and low cost approach to spreading the risk.

### **Asset shares notionally allocated to employers**

In order to establish contribution rates for individual employers or groups of employers, it is convenient to notionally subdivide the Fund as a whole between the employers, as if each employer had its own notional asset share within the Fund.

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.

### **Roll forward of notional asset shares**

The notional asset share allocated to each employer will be rolled forward, allowing for all cash flows associated with that employer's membership, including contribution income, benefit outgo, transfers in and out and investment income. In general, no allowance is made for the timing of contributions and cash flows for each year are assumed to be made half way through the year, with investment returns assumed to be uniformly earned over that year. However, where significant one-off employer contributions have been paid, allowance is made for the timing of such contributions.

Further adjustments are made for:

- a notional deduction to meet the expenses paid from the Fund in line with the assumption used at the previous valuation;
- allowance for any known material internal transfers in the Fund (cash flows will not exist for these transfers). The Fund actuary will assume an estimated cash flow equal to the value of the liabilities transferred from one employer to the other, unless some other approach has been agreed between the two employers;
- allowance for death in service and other benefits shared across all employers in the Fund (see earlier); and

- 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.

In some cases information available will not allow for such cash flow calculations. In such a circumstance:

- where, in the opinion of the Fund Actuary, the cash flow data which is unavailable is of low materiality, estimated cash flows will be used; and
- where, in the opinion of the Fund Actuary, the cash flow data which is unavailable is material, or the results of the cash flow approach appears to give unreliable results perhaps because of unknown internal transfers, the Fund Actuary will instead use 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 cash flows and involve calculation of gains and losses to the surplus or deficiency exhibited at the previous valuation. Having established an expected surplus or deficiency at the current valuation, comparison of this with the liabilities evaluated at the current valuation leads to an implied notional asset holding.

### **Fund maturity**

To protect the Fund and individual employers from the risk of increasing maturity producing unacceptably volatile contribution adjustments as a percentage of pay, the administering authority will normally require defined capital streams from employers in respect of any disclosed funding deficiency.

In certain circumstances, for example for secure employers considered by the administering authority as being long term in nature, contribution adjustments to correct for any disclosed deficiency may be set as a percentage of payroll. Such an approach carries an implicit assumption that the employer's payroll will increase at an assumed rate. If payroll fails to grow at this rate, or declines, insufficient corrective action will have been taken. To protect the Fund against this risk, the administering authority will monitor payrolls and where evidence is revealed of payrolls not increasing at the anticipated rate, the administering authority will consider requiring defined streams of capital contributions rather than percentages of payroll.

## **5. SPECIAL CIRCUMSTANCES RELATED TO CERTAIN EMPLOYERS**

### **Interim reviews for Admission Bodies**

Regulation 64 of the 2013 Regulations provides the administering authority with a power to carry out valuations in respect of employers which are expected to cease at some point in the future, and for the Fund Actuary to certify revised contribution rates between triennial valuation dates.

The administering authority's overriding objective at all times is that, where possible, there is clarity over the Funding Target for that body, and that contribution rates payable are appropriate for that Funding Target. However, this is not always possible, as any date of exit of participation may be unknown (for example, participation may be assumed at present to be indefinite), and also because market conditions change daily.

The administering authority's general approach in this area is as follows:

- where the date of exit is known, and is more than three years after the most recent preceding triennial actuarial valuation, or is unknown and assumed to be indefinite, interim valuations will generally not be carried out at the behest of the administering authority.
- for Admission Bodies admitted under paragraph 1(d) of Part 3, Schedule 2 of the Regulations (1(d) Admission Bodies) (formerly known as Transferee Admission Bodies) falling into the above category, the administering authority sees it as the responsibility of the relevant Scheme Employer to instruct it if an interim valuation is required. Such an exercise would be at the expense of the Relevant Scheme Employer unless otherwise agreed.
- a material change in circumstances, such as the date of exit becoming known, material membership movements or material financial information coming to light, may cause the administering authority to informally review the situation and subsequently formally request an interim valuation.
- for an employer whose participation is due to cease within three years of the most recent preceding triennial valuation, the administering authority will monitor developments and may see fit to request an interim valuation at any time.

Notwithstanding the above guidelines, the administering authority reserves the right to request an interim valuation of any employer at any time if Regulation 64(4) of the 2013 Regulations applies.

### **Guarantors**

Some employers may participate in the Fund by virtue of the existence of a Guarantor. The administering authority maintains a list of employers and their associated Guarantors. The administering authority, unless notified otherwise, sees the duty of a Guarantor to include the following:

- if an employer ceases and defaults on any of its financial obligations to the Fund, the Guarantor is expected to provide finance to the Fund such that the Fund receives the amount certified by the Fund Actuary as due, including any interest payable thereon; and

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if the Guarantor is an employer in the Fund and is judged to be of suitable covenant by the administering authority, the Guarantor may defray some of the financial liability by subsuming the residual liabilities into its own pool of Fund liabilities. In other words, it agrees to be a source of future funding in respect of those liabilities should future deficiencies emerge.

During the period of participation of an employer, a Guarantor can at any time agree to the future subsumption of any residual liabilities of the employer. The effect of that action may be to reduce the Funding and Solvency Targets for this employer, which would probably lead to reduced contribution requirements.

### **Bonds and other securitisation**

Part 3 of Schedule 2 of the 2013 Regulations creates a requirement for a new Admission Body to carry out, to the satisfaction of the administering authority (and the Scheme Employer in the case of an Admission Body falling under paragraph 1(d) (i) of Part 3 of Schedule 2 of the 2013 Regulations), an assessment taking account of actuarial advice of the level of risk on premature termination by reason of insolvency, winding up or liquidation.

Where the level of risk identified by the assessment is such as to require it, the Admission Body shall enter into an indemnity or bond with an appropriate party. Where it is not desirable for an Admission Body to enter into an indemnity or bond, the body is required to secure a guarantee in a form satisfactory to the administering authority from an organisation that either funds, owns or controls the functions of the Admission Body.

The administering authority's approach in this area is as follows:

- In the case of 1(d) Admission Bodies and other Admission Bodies with a Guarantor, and so long as the administering authority judges the relevant Scheme Employer or Guarantor to be of sufficiently sound covenant, any bond exists purely to protect the relevant Scheme Employer or Guarantor on default of the Admission Body. As such, it is entirely the responsibility of the relevant Scheme Employer or Guarantor to arrange any risk assessments and decide the level of required bond. The administering authority will be pleased to supply some standard calculations provided by the Fund Actuary to aid the relevant Scheme Employer or Guarantor, but this should not be construed as advice to the relevant Scheme Employer or Guarantor on this matter.
- In the case of:
  - Admission bodies admitted under paragraph 1(e);
  - Admission bodies admitted under paragraph 1(d) where the administering authority does not judge the Scheme Employer to be of sufficiently strong covenant; and
  - other Admission bodies with no Guarantor or where the administering authority does not judge the Guarantor to be of sufficiently strong covenant;

the administering authority must be involved in the assessment of the required level of bond to protect the Fund. The admission will only be able to proceed once the administering authority has agreed the level of bond cover. The administering authority will supply some standard calculations provided by the Fund Actuary to aid the relevant Scheme Employer form a view on what level

of bond would be satisfactory. The administering authority will also on request supply this to the Admission Body or Guarantor. This should not be construed as advice to the Scheme Employer, Guarantor or Admission Body.

- The administering authority notes that levels of required bond cover can fluctuate and it will review, or it recommends that the relevant Scheme Employer reviews, the required cover at least once a year.

### **Subsumed liabilities**

Where an employer is exiting the Fund such that it will no longer have any contributing members, it is possible that another employer in the Fund (the 'accepting employer') has agreed to provide a source of future funding in respect of any emerging deficiencies in respect of those liabilities.

In such circumstances, the liabilities are known as subsumed liabilities (in that responsibility for them is taken on by the accepting employer). For such liabilities the administering authority will assume that the investments held in respect of those liabilities will be the same as those held for the rest of the liabilities of the accepting employer. Generally, this will mean assuming continued investment in more risky investments than Government bonds.

### **Orphan liabilities**

Where an employer is exiting the Fund such that it will no longer have any contributing members, unless any residual liabilities are to become subsumed liabilities, the administering authority may act on the basis that it will have no further access for funding from that employer once any exit valuation, carried out in accordance with Regulation 64 of the 2013 Regulations, has been completed and any sums due have been paid. Residual liabilities of employers from whom no further funding can be obtained are known as orphan liabilities.

The administering authority will seek to minimise the risk to other employers in the Fund that any deficiency arising on the orphan liabilities creates a cost for those other employers to make good such deficiency. To give effect to this, the administering authority may seek funding from the outgoing employer sufficient to enable it to match the liabilities with low risk investments, generally Government fixed interest and index linked bonds.

However, if these liabilities are deemed to be small compared to the liabilities of the whole Fund (and therefore the risk related to these liabilities is small) then the administering authority may decide to use the Funding Target used for Scheduled Bodies for practical reasons.

Any excess or deficient returns on the notional or actual assets attributable to these liabilities relative to the Funding Target, will be added to or deducted from the investment return to be attributed to the notional assets of all employers in the Fund.

### **Exit valuations**

Where an employer exits the Fund, an exit valuation will be carried out (in accordance with Regulation 64 of the 2013 Regulations). That valuation will take account of any activity as a consequence of exit regarding any existing contributing

members (for example any bulk transfer payments due) and the status of any liabilities that will remain in the Fund.

In particular, the exit valuation may distinguish between residual liabilities which will become orphan liabilities, and liabilities which will be subsumed (see above) by other employers.

For subsumed liabilities, the exit valuation will anticipate continued investment in assets similar to those held in respect of the subsuming employer's liabilities.

For orphan liabilities the Funding Target in the exit valuation will anticipate investment in low risk investments, such as Government bonds, or be calculated in the same way as subsumed liabilities as considered appropriate.

For the avoidance of doubt, if an academy were to cease participation in the Fund, in the absence of another employer of sound covenant taking responsibility for future funding of residual liabilities, the resulting exit valuation would be carried out on a Funding Target consistent with orphan liabilities as detailed above.

Regardless of whether the residual liabilities are orphan liabilities or subsumed liabilities, the departing employer will be expected to make good the funding position revealed in the exit valuation. In other words, the fact that liabilities may become subsumed liabilities does not remove the possibility of an exit payment being required.

The administering authority's policy is that in the normal course of events, any deficiency that exists at the exit of an employer from the Fund, will be payable immediately as a single payment. In extreme cases, the administering authority may be prepared to agree payment over a period of years. However, this period is very unlikely to exceed five years and any decision will be at the administering authority's discretion.

## **6. IDENTIFICATION OF RISKS AND COUNTER MEASURES**

The administering authority's overall policy on risk is to identify all risks to the Fund and to consider the position both in aggregate and at an individual risk level. The administering authority will monitor the risks to the Fund, and will take appropriate action to limit the impact of these, both before and after they emerge, wherever possible. The administering authority will ensure that funding risks are included within the overarching risk management framework and strategy, linking to their risk register and risk management policy as appropriate and including a defined role for the Local Pension Board within this framework. The main risks to the Fund are:

### **Liability**

The main risks include interest rates, pay and price inflation, changing retirement patterns and other demographic risks. The administering authority will ensure that the Fund Actuary investigates these matters at each valuation or, if appropriate, more frequently, 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.

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 of bonds that are in place for Admission Bodies.

### **Regulatory and compliance**

These risks relate to changes to general and LGPS regulations, national pension requirements or HM Revenue & Customs rules. The administering authority will keep abreast of proposed changes to the LGPS and, where possible, express its opinion during consultation periods after careful consideration. The administering authority's policy will be to ask the Fund Actuary to assess the impact on costs of any changes and, where these are likely to be significant, the administering authority will notify employers of this likely impact and the timing of any change.

### **Liquidity and maturity**

The LGPS is going through a series of changes, each of which will impact upon the maturity profile of the LGPS and have potential cash flow implications. The increased emphasis on outsourcing and other alternative models for service delivery may result in the following:

- active members leaving the LGPS;
- transfers of responsibilities between different public sector bodies;
- scheme changes which might lead to increased opt-outs; and/or
- spending cuts and their implications.

All of these may result in workforce reductions that would reduce membership, reduce contributions and prematurely increase retirements in ways that may not have been taken into account in previous forecasts.

The administering authority's policy is to require regular communication between itself and employers and to ensure reviews of maturity at overall Fund and employer level where material issues are identified.

## **Governance**

This covers the risk of unexpected structural changes in the Fund membership (for example the closure of an employer to new entrants or the large scale withdrawal or retirement of groups of staff), and the related risk of the administering authority not being made aware of such changes in a timely manner.

The administering authority's policy is to require regular communication between itself and employers, and to ensure regular reviews of such items as bond arrangements, financial standing of non-tax raising employers and funding levels.

Particular examples are set out below:

### Early retirement strain payments

No allowance is made in the triennial valuation and consequent employer rates for the additional value of the benefits when a member is made redundant or leaves on the grounds of efficiency.

To counter the potential increase in Funding Target emerging at the next valuation, a payment is calculated (using methods and assumptions agreed with the Fund Actuary) and made by the Scheme Employer to the Fund to meet this additional cost at the date the member is made redundant or leaves on the grounds of efficiency.

### Body ceasing to exist with unpaid deficiency

Some employers can cease to exist and/or become insolvent, leaving the employers in the Fund open to the risk of an unpaid deficiency. Any such deficiency will be met by the relevant Scheme Employer with regard to a 1(d) Admission Body and there is therefore no risk to other employers in the Fund (provided of course that the relevant Scheme Employer is itself of good covenant). Any unpaid deficiency in relation to other employers falls on all employers in the Fund, and the administering authority will ensure that risks are reduced by use of bond arrangements or ensuring there is a Guarantor to back the liabilities of the body.

### Employers with a small and declining number of contributing members

A recent legal judgement indicates that under the current LGPS regulations, employers with no contributing members cannot be charged contributions under Regulation 62 of the 2013 Regulations. This ruling, however, does not affect the ability to collect contributions following an exit valuation under Regulation 64 of the 2013 Regulations. The regulations may alter in the future, but there is a risk of a body ceasing to pay contributions with a deficiency in the Fund.

The administering authority will monitor Scheme Employers with declining membership to ensure that funding is close to 100% by the time the last member leaves service, and may alter the funding strategy accordingly. It will also ensure

that an exit valuation is carried out for employers once it is clear there will be no contributing members relating to that employer in the future.

## **Investment**

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 are:

- assets not delivering the required return (for whatever reason, including manager underperformance);
- systemic risk with the possibility of interlinked and simultaneous financial market volatility;
- insufficient funds to meet liabilities as they fall due;
- inadequate, inappropriate or incomplete investment and actuarial advice is taken and acted upon; and
- counterparty failure.

The specific risks associated with assets and asset classes are:

- equities – industry, country, size and stock risks;
- fixed income – yield curve, credit, duration and market risks;
- alternative assets – liquidity, property and alpha risks;
- money market – credit and liquidity risks;
- currency risks; and
- macroeconomic risks.

The administering authority reviews each investment manager's performance quarterly, and at least annually considers the asset allocation of the Fund by carrying out a review with its Investment Adviser. The administering authority also annually reviews the effect of market movements on the Fund's overall funding position.

## **Employer**

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.

The administering authority will put in place a Funding Strategy Statement which contains sufficient detail on how funding risks are managed in respect of the main categories of employer (e.g. Scheduled and Admission Bodies) and other pension fund stakeholders.

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 choice of funding strategy for each employer.

## **Choice of Solvency and Funding Targets**

The administering authority recognises that future experience and investment income cannot be predicted with certainty. Instead, there is a range of possible outcomes, and different assumed outcomes will lie within that range.

The more optimistic the assumptions made in determining the Solvency and Funding Targets, the more that outcome will sit towards the 'favourable' end of the range of possible outcomes, the lower will be the probability of experience actually matching or being more favourable than the assumed experience, and the lower will be the Solvency and Funding Targets calculated by reference to those assumptions.

The administering authority will not adopt assumptions for bodies regarded by the administering authority as being of sound covenant which, in its judgement, and on the basis of actuarial advice received, are such that it is less than 55% likely that the strategy will deliver funding success. Where the probability of funding success is less than 65% the administering authority will not adopt assumptions which lead to a reduction in the aggregate employer contribution rate to the Fund.

### Smoothing

The administering authority recognises that utilisation of a smoothing adjustment in the solvency measurement introduces an element of risk, in that the smoothing adjustment may not provide a true measure of the underlying position. If such an adjustment is used, the administering authority's policy is to review the impact of any adjustment made at each valuation to ensure that it does not alter the disclosed solvency level by more than 5%.

### Recovery Period

The administering authority recognises that permitting surpluses or deficiencies to be eliminated over a Recovery Period, rather than immediately, introduces a risk that action to restore solvency is insufficient between successive measurements. The administering authority's policy with regard to Recovery Periods is set out in section 4 of this Statement.

**March 2017 version**