

# Clwyd Pension Fund (CPF)

## 2007 Funding Strategy Statement (FSS)

*This Statement has been prepared by Flintshire County Council (the Administering Authority) to set out the funding strategy for the Clwyd Pension Fund (the CPF), in accordance with Regulation 76A of the Local Government Pension Scheme Regulations 1997 (as amended) and the guidance paper issued in March 2004 by the Chartered Institute of Public Finance and Accountancy (CIPFA) Pensions Panel.*

### 1. INTRODUCTION

The Local Government Pension Scheme (England and Wales) (Amendment) Regulations 2004 provide the statutory framework from 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 relevant interested parties involved with the fund the Administering Authority will prepare and publish their funding strategy.
- In preparing the FSS, the Administering Authority must have regard to :-
- the guidance issued by CIPFA for this purpose; and
- the Statement of Investment Principles (SIP) for the CPF published under Regulation 9A of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended);
- The FSS must be revised and published whenever there is a material change in either the policy on the matters set out in the FSS or the Statement of Investment Principles.

Benefits payable under the CPF are guaranteed by statute and thereby the pensions promise is secure. The FSS addresses the issue of managing the need to fund those benefits over the long term, whilst at the same time, facilitating scrutiny and accountability through improved transparency and disclosure.

The CPF is a defined benefit final salary scheme under which the benefits are specified in the governing legislation (the Local Government Pension Scheme Regulations 1997 (as amended), "the Regulations"). The required levels of employee contributions are also specified in the Regulations. Employer contributions are determined in accordance with the Regulations (principally Regulation 77) which require that an actuarial valuation is completed every three years by the actuary, including a rates and adjustments certificate. Contributions to the CPF should be set so as to "secure its solvency", whilst the actuary must also have regard to the desirability of maintaining as nearly constant a rate of contribution as possible. The actuary must have regard to the FSS in carrying out the valuation.

## **2. PURPOSE OF THE FSS IN POLICY TERMS**

Funding is the making of advance provision to meet the cost of accruing benefit promises. Decisions taken regarding the approach to funding will therefore determine the rate or pace at which this advance provision is made. Although the Regulations specify the fundamental principles on which funding contributions should be assessed, implementation of the funding strategy is the responsibility of the Administering Authority, acting on the professional advice provided by the actuary.

The purpose of this Funding Strategy Statement is:

- to establish a clear and transparent fund-specific strategy which will identify how employers' pension liabilities are best met going forward;
- to support the regulatory requirement to maintain as nearly constant employer contribution rates as possible; and
- to take a prudent longer-term view of funding those liabilities.

The intention is for this strategy to be both cohesive and comprehensive for the CPF as a whole, recognising that there will be conflicting objectives which need to be balanced and reconciled. Whilst the position of individual employers must be reflected in the statement, it must remain a single strategy for the Administering Authority to implement and maintain.

## **3. AIMS AND PURPOSE OF THE CPF**

**The aims of the Fund are to:**

- enable employer contribution rates to be kept as nearly constant as possible and at reasonable cost to the taxpayers, scheduled, resolution and admitted bodies
- manage employers' liabilities effectively
- ensure that sufficient resources are available to meet all liabilities as they fall due, and
- maximise the returns from investments within reasonable risk parameters.

**The purpose of the Fund is to:**

- receive monies in respect of contributions, transfer values and investment income,
- and pay out monies in respect of scheme benefits, transfer values, costs, charges and expenses as defined in the Local Government Pension Scheme 1997 Regulations (as amended) and in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended).

**4. RESPONSIBILITIES OF THE KEY PARTIES**

**The Administering Authority should:**

- collect employer and employee contributions
- invest surplus monies in accordance with the Regulations
- ensure that cash is available to meet liabilities as and when they fall due
- manage the valuation process in consultation with the CPF's actuary
- prepare and maintain an FSS and a SIP, both after due consultation with interested parties, and
- monitor all aspects of the CPF's performance and funding and amend FSS/SIP.

**The Individual Employer should:**

- deduct contributions from employees' pay correctly
- pay all contributions, including their own as determined by the actuary, promptly by the due date
- exercise discretions within the regulatory framework
- make additional contributions in accordance with agreed arrangements in respect of, for example, augmentation of scheme benefits, early retirement strain, and
- notify the Administering Authority promptly of all changes to membership or, as may be proposed, which affect future funding.

**The Fund actuary should:**

- prepare valuations including the setting of employers' contribution rates after agreeing assumptions with the Administering Authority and having regard to the FSS
- prepare advice and calculations in connection with bulk transfers and individual benefit-related matters,

- advise on funding strategy, the preparation of the FSS, and the inter-relationship between the FSS and the SIP.

## 5. SOLVENCY ISSUES AND TARGET FUNDING LEVELS

### Funding Objective

To meet the requirements of the Regulations the Administering Authority's long term funding objective is for the Fund to achieve and then maintain sufficient assets to cover 100% of projected accrued liabilities (the "funding target") assessed on an ongoing past service basis including allowance for projected final pay. The long term employer rate would therefore revert to the Future Service Rate.

### Determination of the Funding Target and Recovery Period

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

Underlying these assumptions are the following two tenets:

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

As part of each valuation separate employer contribution rates are assessed by the actuary for each participating employer or group of employers. These rates are assessed taking into account the experience and circumstances of each employer (or employer grouping), following a principle of no cross-subsidy between the various employers in the Scheme. In attributing the overall investment performance obtained on the assets of the Scheme to each employer a pro-rata principle is adopted. This approach is effectively one of applying a notional individual employer investment strategy identical to that adopted for the Scheme as a whole.

The Administering Authority, following consultation with the participating employers, has adopted the following objectives for setting the individual employer contribution rates arising from the 2007 actuarial valuation:

- A maximum deficit recovery period of 17 years will apply. Employers will have the freedom to adopt a recovery plan on the basis of a shorter period if they so wish. A shorter period may be applied in respect of particular employers where the Administering Authority considers this to be warranted (see Deficit Recovery Plan below).
- Where increases in employer contribution rates are required from 1 April 2008, following completion of the 2007 actuarial valuation, the increase from the rates of contribution payable in the year 2008/09 may be implemented in steps, over a maximum period of 3 years.

- On the cessation of an employer's participation in the Scheme, the actuary will be asked to make a termination assessment. Any deficit in the Scheme in respect of the employer will be due to the Scheme as a termination contribution, unless it is agreed by the Administering Authority and the other parties involved that the assets and liabilities relating to the employer will transfer within the Scheme to another participating employer. Details of the approach to be adopted for such an assessment on termination will, in due course, be set out in a separate Admission Bodies Policy document.

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

- the responses made to the consultation with employers on the FSS principles
- relevant guidance issued by the CIPFA Pensions Panel
- the need to balance a desire to attain the target as soon as possible against the short-term cash requirements which a shorter period would impose, and
- the Administering Authority's views on the strength of the participating employers' covenants in achieving the objective.

### **Deficit Recovery Plan**

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

Additional contributions will be expressed as a level percentage of pensionable payroll or as separate lump sum amounts increasing over the recovery period on an annual basis by 4.35%.

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

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

In certain instances, and in particular for Fund employers which are considered by the Administering Authority to provide a high level of financial covenant, an allowance may be made as part of the Recovery plan for investment performance at a higher level than that assumed for assessment of the funding target. This higher level of return assumed will, in particular reflect the actual investment strategy of the Fund, on the basis that this is to be maintained over the entire recovery period. The assumptions to be used in these Recovery Plan calculations are set out in Appendix 2.

### **The Normal Cost of the Scheme (Future Service Contribution Rate)**

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

## **6. LINK TO INVESTMENT POLICY SET OUT IN THE STATEMENT OF INVESTMENT PRINCIPLES (See Appendix 2)**

The results of the 2007 valuation show the liabilities to be 75% covered by the current assets, with the funding deficit of 25% being covered by future deficit contributions.

In assessing the value of the CPF’s liabilities in the valuation, allowance has been made for asset out-performance as described in Appendix 1, taking into account the investment strategy adopted by the CPF, as set out in the SIP.

It is not possible to construct a portfolio of investments which produces a stream of income exactly matching the expected liability outgo. However, it is possible to construct a portfolio which closely matches the liabilities and represents the least risk investment position. Such a portfolio would consist of a mixture of long-term index-linked and fixed interest gilts. Investment of the CPF’s assets in line with the least risk portfolio would minimise fluctuations in the CPF’s ongoing funding level between successive actuarial valuations.

Departure from a least risk investment strategy, in particular to include equity type investments, gives the prospect that out-performance by the assets will, over time, reduce the contribution requirements. The funding target might in practice therefore be achieved by a range of combinations of funding plan, investment strategy and investment performance.

The current benchmark investment strategy, as set out in the SIP, is:

Asset Class (Summary)	%
Equities	55.0
Fixed Interest	13.0
Alternative Investments	32.0
TOTAL	100.0

Asset Class (Detailed)	%
<b>Equities</b>	
Global	5.0
UK traditional active	15.0
UK portable alpha FTSE	12.0
US equities	5.0
Europe equities	6.0
Japan equities	4.0
PacRim equities	4.0
Emerging market equities	4.0
	<b>55.0</b>
<b>Fixed Interest</b>	
Unconstrained	13.0
	<b>13.0</b>
<b>Alternative Investments</b>	
Commodities	2.0
Asset Allocation	5.0
Private Equity	8.0
Property	8.0
Hedge Fund of Funds	5.0
Currency Fund	4.0
	<b>32.0</b>
<b>TOTAL</b>	<b>100.0</b>

The funding strategy adopted for the 2007 valuation is based on an assumed asset out-performance of 2.0% in respect of liabilities pre-retirement, and 1.0% in respect of post-retirement liabilities. Based on the liability profile of the CPF at the valuation, this equates to an overall asset out-performance allowance against gilts of around 1.4% p.a. in the long term to keep pace with the liabilities.

## 7. IDENTIFICATION OF RISKS AND COUNTER MEASURES

The funding of defined benefits is by its nature uncertain. Funding of the CPF is based on both financial and demographic assumptions. These assumptions are specified in the Appendices and the actuarial valuation report. When actual experience is not in line with the assumptions adopted a surplus or shortfall will emerge at the next actuarial assessment and will require a subsequent contribution adjustment to bring the funding back into line with the target.

The Administering Authority has been advised by the actuary that the greatest risk to the CPF's funding is the investment risk inherent in the predominantly equity (or return seeking) based strategy, so that actual asset out-performance between successive valuations could diverge significantly from the overall out performance assumed in the long term.

## **What are the Risks?**

### **Financial**

- Investment markets fail to perform in line with expectations
- Market yields move at variance with assumptions
- Investment Fund Managers fail to achieve performance targets over the longer term
- Asset re-allocations in volatile markets may lock in past losses
- Pay and price inflation significantly more or less than anticipated
- Effect of possible increase in employer's contribution rate on service delivery and admitted/scheduled bodies

### **Demographic**

- Longevity horizon continues to expand
- Deteriorating pattern of early retirements

### **Regulatory**

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

### **Governance**

- Administering Authority unaware of structural changes in employer's membership (e.g. large fall in employee numbers, large number of retirements)
- Administering Authority not advised of an employer closing to new entrants
- An employer ceasing to exist with insufficient funding or adequacy of a bond.
- Changes in Panel membership.

## **8. MONITORING AND REVIEW**

The Administering Authority has taken advice from the actuary in preparing this Statement, and has also consulted with employing organisations.

A full review of this Statement will occur no less frequently than every three years, to coincide with completion of a full actuarial valuation. Any review will take account of then current economic conditions and will also reflect any legislative changes.

The Administering Authority will monitor the progress of the funding strategy between full actuarial valuations. If considered appropriate, the funding strategy will be reviewed (other than as part of the triennial valuation process), for example:

- if there has been a significant change in market conditions, and/or deviation in the progress of the funding strategy
- if there have been significant changes to the CPF membership, or LGPS benefits in light of the new cost sharing mechanism being implemented
- 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 e.g. closure to new entrants
- if there have been any significant special contributions paid into the CPF

**Kerry Feather**

**County Finance Officer (Administrator & Treasurer to the Fund)**

**Flintshire County Council as lead authority for the Clwyd Pension Fund**

**ACTUARIAL VALUATION AS AT 31 MARCH 2007**

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

**Method**

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

**Financial assumptions**

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

A yield based on market returns on UK Government gilt stocks and other instruments which reflects a market consistent discount rate for the profile and duration of the Scheme's accrued liabilities, plus an Asset Out-performance Assumption ("AOA") of 2% p.a. for the period pre-retirement and 1% p.a. post-retirement.

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

***Individual Employers***

Having determined the AOAs as above for the Fund overall, it is important to consider how the financial assumptions in particular impact on individual participating employers. As employers in the Fund will have different mixes of active, deferred and pensioner members, adopting a different pre/post retirement investment return approach is equivalent to hypothecating a different equity/bond mix investment strategy for each employer. Such an approach would be inconsistent with the Fund practice, as set out in the FSS, of allocating investment performance pro rata across all employers based on a "mirror image" investment strategy to the whole Fund. In completing the calculations for individual employers therefore, a single, composite, pre and post retirement asset out-performance assumption of 1.4% p.a. in the long term has been calculated which, for the Fund as a whole, gives the same value of the funding target as the separate pre and post retirement AOAs.

### ***Inflation (Retail Prices Index)***

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

### ***Salary increases***

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

### ***Pension increases***

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

### **Demographic assumptions**

#### ***Mortality***

The mortality assumptions will be based on the most up-to-date information published by the Continuous Mortality Investigation Bureau, making allowance for future improvements in longevity and the experience of the scheme. For retirements in good health the mortality tables used are PA92 Year of Birth tables with medium cohort improvements, with an age rating reflecting Scheme specific experience of +1 years. Members who retire on the grounds of ill health are assumed to exhibit average mortality equivalent to that for a good health retiree at an age 5 years older.

#### ***Early retirement***

Some members are entitled to receive their benefits (or a part of their benefits) unreduced from an age prior to the Fund's normal pension age under the "Rule of 85" provisions of the Regulations. This age will be at some point between ages 60 and 65, depending on the length of a member's pensionable service. The calculations in respect of past service allow for a proportion of the active membership to retire in normal health prior to age 65, as set out below.

	% retiring per annum		% retiring per annum	
Age	Males		Females	
60	24.0		41.0	
61	15.0		20.0	
62	21.0		20.0	
63	22.0		19.0	
64	26.0		23.0	

For future service the situation is different since the “Rule of 85” rule has been removed for service from April 2008 (October 2006 for new entrants to the Scheme). For future service we have assumed the earliest age at which unreduced benefits become an entitlement is 65 except for those members who have protected status under the transitional provisions.

No allowance has been made for non-ill health early retirements prior to age 60. Additional capital contributions will be paid by employers in respect of the cost of these retirements normally over a period of no more than 3 years.

### ***Ill health retirement***

A small proportion of the active membership has been assumed to retire owing to ill health. As an example of the rates assumed, the following is an extract from the decrement table used:

	% leaving per annum	
Age	Males	Females
35	0.06	0.11
45	0.28	0.38
55	1.25	1.69

### ***Withdrawals***

This assumption relates to those members who leave the scheme with an entitlement to a deferred pension or transfer value. It has been assumed that active members will leave the Scheme at the following sample rates:

	% leaving per annum	
Age	Males	Females
25	13.5	14.9
35	3.4	4.2
45	1.7	2.6

### ***Commutation***

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

### ***Proportion married/in civil partnership and age difference***

It has been assumed that the proportions of members below will on death give rise to a spouse's/civil partner's/dependant's pension, and that spouses/partners of female (male) members are three years older (younger), on average than the member.

	% spouse/partner	
Age	Males	Females
25	34	56
35	81	84
45	92	93

### ***Expenses***

Expenses are met out the Fund, in accordance with the Regulations. This is allowed for by adding 0.5% of pensionable pay to the contributions as required from participating employers. This addition is reassessed at each valuation. Investment expenses have been allowed for implicitly in determining the discount rates.

### ***Discretionary Benefits***

The costs of any discretion exercised by an employer in order to enhance benefits for a member through the Fund will be subject to additional contributions from the employer as required by the Regulations as and when the event occurs. As a result, no allowance for such discretionary benefits has been made in the valuation

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

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

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

- contributions will be invested in market conditions applying at future dates, which are unknown at the effective date of the valuation, and which are not directly linked to market conditions at the valuation date; and
- the future service liabilities for which these contributions will be paid have a longer average duration than the past service liabilities.

The financial assumptions In relation to future service (i.e. the normal cost) are not specifically linked to investment conditions as at the valuation date itself, and are based on an overall assumed real return (i.e. return in excess of price inflation) of 3.75% per annum, with a long term average assumption for price inflation of 2.75% per annum. These two assumptions give rise to an overall discount rate of 6.5% p.a (i.e. 3.75% plus 2.75%).

Adopting this approach the future service rate is not subject to variation solely due to different market conditions applying at each successive valuation, which reflects the requirement in the Regulations for stability in the “Common Rate” of contributions. In market conditions at the effective date of the 2007 valuation this approach gives rise to a somewhat more optimistic stance (i.e. allows for a higher AOA) in relation to the cost of accrual of future benefits compared to the market related basis used for the assessment of the funding target.

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

**Summary of key whole Fund assumptions used for calculating funding target and cost of future accrual (the “normal cost”) for the 2007 actuarial valuation**

Long-term gilt yields	
Fixed interest	4.4% p.a.
Index linked	1.3% p.a.
Implied RPI price inflation	3.1% p.a.
Past service Funding Target financial assumptions	
Investment return pre-retirement	6.4% p.a.
Investment return post-retirement	5.4% p.a.
Salary increases	4.35% p.a.
Pension increases	3.1% p.a.
Future service accrual financial assumptions	
Investment return	6.5% p.a.
RPI price inflation	2.75% p.a.
Salary increases	4.0% p.a.
Pension increases	2.75% p.a.
Demographic assumptions	
Non-retired members’ mortality	PA92 MC YoB tables + 1 year (+6 years for retirements in ill health)

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Retired members' mortality	PA92 MC YoB tables + 1 year (+6 years for retirements in ill health)
Commutation	One half of members take maximum lump sum, others take 3/80ths
Withdrawal	Increased allowance compared to 2004 valuation for younger members to leave service
Other demographics	As for 2004 Valuation

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**Assumptions used in calculating contributions payable under the recovery plan**

The contributions payable under the recovery plan are calculated using the same assumptions as those used to calculate the funding target, with the exception that, for certain employers which are considered by the Administering Authority to provide a high level of financial covenant, an allowance may be made as part of the Recovery plan for investment performance at a higher level than that assumed for assessment of the funding target. Therefore the required contributions are adjusted to allow for the following variation in assumptions during the period of the recovery plan:

**Investment return on existing assets and future contributions**

A maximum overall return effective as at the valuation date of 7.4% p.a. (i.e. a return of 3.0% p.a. in excess of gilts) reflecting the underlying investment strategy of the scheme and, in particular, including the assets of the scheme that underlie the pensioner as well as the non-pensioner liabilities.

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

As indicated above, this variation to the assumptions in relation to the recovery plan can only be applied for those employers which the Administering Authority deems to be of sufficiently high financial covenant to support the anticipation of investment returns, based on the current investment strategy, over the entire duration of the recovery period. No such variation in the assumptions will apply in any case to any employer which does not have a funding deficit at the valuation (and therefore for which no recovery plan is applicable). Where a funding deficit exists the additional return over and above that built into the funding target assumptions will be limited so that the total employer contributions emerging from the 2007 valuation will be no less than the current level of contributions payable by the employer or the Future Service Contribution Rate.