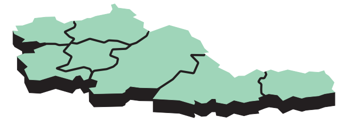
WEST MIDLANDS



PENSION FUND

Funding Strategy Statement 2009

April 2009

Funding Strategy Statement Update 2009

1. Introduction

1.1. The Fund has reviewed its investment strategy in January 2009 and updates to its Statement of Investment Principles and Investment Strategy have been published. These updates are related to the funding strategy and although the 2007 strategy is still valid further comments on risks are required.

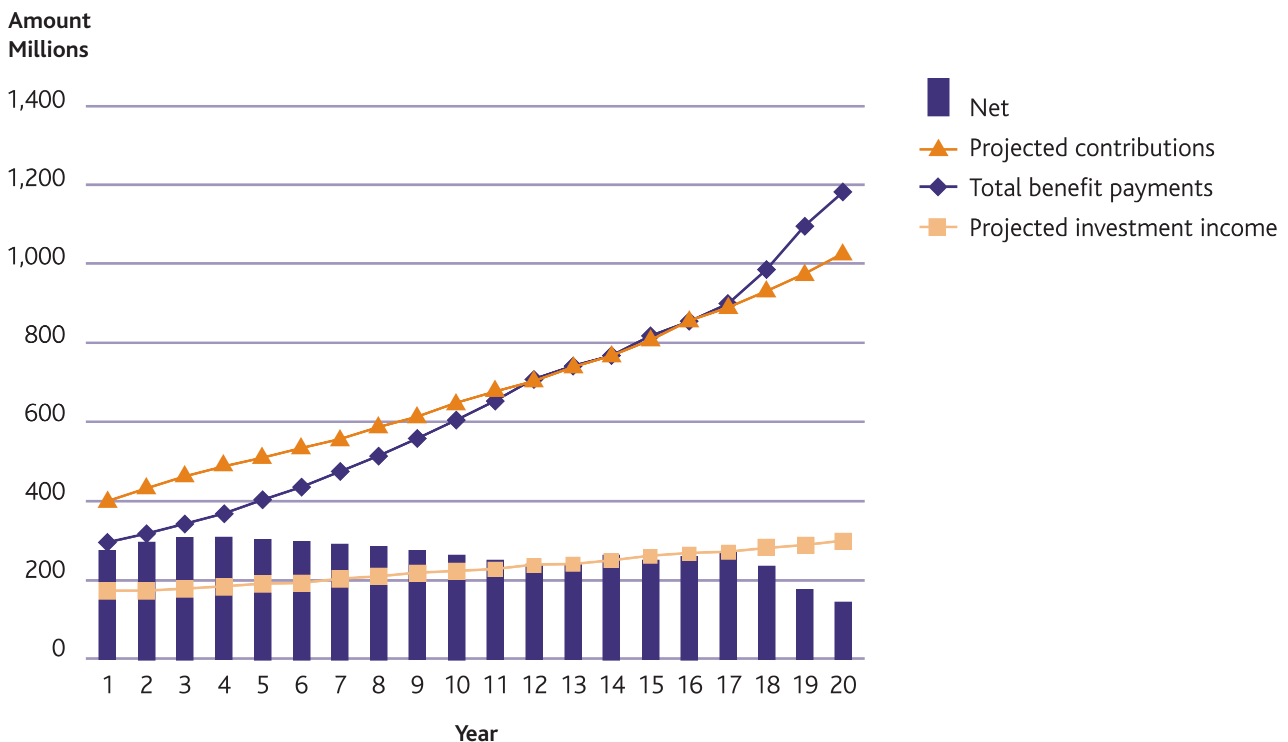
2. Updated Comments

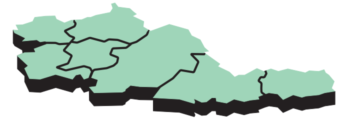
2.1. The 2008 market turmoil has significantly reduced asset values and led to increased funding deficits. This volatility, although extreme, is manageable in the context of the Fund's long-term approach to funding the liabilities.

The Fund's short- to medium-term cash flow is strongly positioned as shown below:

2.2. Therefore, provided asset returns revert back to something approaching the long-term historical position, the Fund can meet the very long-term funding requirements without having, over the short to medium-term, to vary the employing body contribution rates or raise with CLG the affordability of the Scheme benefits. CLG are currently well-advanced on cost sharing of any future benefit cost increases with employee representatives which will assist in mitigating risks.

West Midlands Pension Fund - RPI 3%pa, 2007 Valuation Planned Employer Contributions





Funding Strategy Statement 2007

December 2007

Funding Strategy Statement 2007

1. Introduction

1.1. The LGPS Regulations require funds to produce a Funding Strategy Statement (FSS) having regard to the guidance produced by CIPFA.
This statement has been drawn up by the West Midlands Pension Fund in accordance with the regulations and following consultation.

1.2. The FSS complements and adds to the Statement of Investment Principles (SIP). The Investment Strategy Statement (ISS) is a supporting document, alongside the actuarial review 2004 and 2007, together with their supporting documentation.

1.3. The statements relate as follows:

1.4. The Fund's actuary takes account of the FSS in his actuarial work for the Fund, most notably, the actuarial valuation process. This has been done in respect of the 2004 and 2007 valuations.

1.5. The FSS reflects the statutory nature of the Local Government Pension Scheme (LGPS), particularly the defined benefit nature and the benefit payable guarantee. The FSS sets out how benefits will be funded over the long term through an accountable, transparent process with full disclosure of relevant details and assumptions.

1.6. The LGPS is a long-established, well-managed, funded final salary scheme. Work currently being carried out by the Department for Communities and Local Government (DCLG) on updating the Scheme is intended to ensure its sustainability into the longer term.

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

1.8. A number of factors have contributed to the funding gap and rise in contribution rates for many employers:

(a) investment returns relative to movement in liabilities;

(b) increases in longevity of pensioners;

(c) falling long-term interest rates.

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

(a) recognising the long-term nature of local government, so that deficits are recovered over time. At the last valuation, the period was increased to 25 years from 13 years. Active service and drawdown of benefits will occur over a long period going forward and this has been maintained at 25 years;

(b) phasing increases in contributions over six years;

(c) recognising such financial 'improvements' as a reduction in ill-health retirements and changes to the LGPS (such as retirement at aged 65, and no early retirements before 55 and taking of additional lump-sums);

(d) giving weight to a balanced investment strategy.

1.9. The Fund, since it was established in 1974, has seen variations in its funding level as did the earlier district funds. The funding level has previously dipped to 75% and recovered. Over this long period, there has been a consistent approach with the actuarial valuation process, the link to an investment strategy and balanced management of the risks. The current arrangements continue this approach. The critical element is securing diversified investment market returns from world markets. The Fund has a long record of achieving solid returns for all of its portfolios. The approach adopted is to ensure a priority is given to achieving at least a market return and as recommended best practice indicates, use asset allocation to deliver the overall investment target.

2. Purpose of the Funding Strategy Statement in Policy Terms

2.1. The purpose of this FSS is:

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

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

2.3. The FSS is a comprehensive strategy for the whole Fund. It balances and reconciles the many direct interests that arise from the nature of the Scheme and funding of the benefits now and in the future.

2.4. The solvency of the Fund is a long-term management issue. Currently, the net cash inflow is over £200m p.a., but it is essential that funds are made available to ensure all future benefits payments can be met when they become due.

3. Aims and Purposes of the Fund

3.1. 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 and admitted bodies having regard to the liabilities.
- Manage employers' liabilities effectively through regular review of contributions and additional contributions for early retirements which lead to a strain on funding.
- Ensure that sufficient resources are available to meet all liabilities as they fall due.
- Maximise the returns from investments within reasonable risk parameters.

3.2. The purpose of the Fund is to:

- Receive and invest monies in respect of contributions, transfer values and investment income.
- Pay out monies in respect of Scheme benefits, transfer values, costs, charges and expenses.

The Local Government Pension Scheme Regulations and in particular the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 define these purposes.

4. Responsibilities of the Key Parties

4.1. The LGPS regulations set out the responsibilities of the key parties which are summarised below. Further details are available on the Fund's website where operational and management arrangements are set out.

4.2. The administering authority (Wolverhampton City Council):

- Collects employer and employee contributions.
- Invests surplus monies in accordance with the regulations and agreed strategy.
- Ensures that cash is available to meet liabilities as and when they fall due.
- Manages the valuation process in consultation with the Fund's actuary.
- Prepares and maintains a FSS and a SIP.
- Monitors all aspects of the Fund's performance and funding. Amends the FSS and SIP as appropriate.

The administering authority discharges its responsibilities with the active involvement from the major employers, the district councils and trade unions representatives combined with consultation with interested parties.

4.3. The individual employers:

- 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 and early retirement strain.
- Notify the administering authority promptly of all changes to membership, or as may be proposed, which affect future funding.
- Discharge their responsibility for compensatory added years which the administering authority pays on their behalf and is subsequently recharged to them.

4.4. The Fund's actuary:

- Prepares valuations including the setting of employers' contribution rates after agreeing assumptions with the administering authority and having regard to the FSS.
- Sets employer's contribution rates in order to secure the Fund's solvency having regard to the aims of maintaining contribution rates that are as constant as possible.
- Prepares advice and calculations in connection with bulk transfers and individual benefit-related matters.

5. Solvency Issues and Target Funding Levels

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

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

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

Determination of the Funding Target and Recovery Period

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

5.4. Underlying these assumptions are the following two tenets:

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

5.5 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. The general approach is effectively one of applying a notional individual employer investment strategy identical to that adopted for the Scheme as a whole.

5.6 The administering authority, following consultation with the participating employers, has adopted the following objectives for setting the individual employer contribution rates:

- A maximum deficit recovery period of 25 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 2007/08 may be implemented in steps, over a maximum period of six 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 are set out in the separate admission bodies policy document.

5.7 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

5.8 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.

5.9 Additional contributions will be expressed as a level percentage of pensionable payroll, but with contribution amounts due in excess of 25% of payroll expressed in cash terms.

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

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

5.11 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 the Appendix.

6. Links to Investment Policy Set Out in the Statement of Investment Principles (SIP)

6.1. The Fund has, for many years after each actuarial valuation, used an asset liability study or some other form of stochastic modelling in order to assist the process of formulating a strategic asset allocation. The outcome from the last exercise are reflected in the SIP. The exercise has been repeated as part of the 2007 valuation exercise and has been part of the consultation on it and the FSS. A revised SIP has been produced to reflect the FSS and Investment Strategy Review.

7. The Identification of Risks and Countermeasures

7.1. Evaluating risks that may impact on the funding strategy and expectations of future solvency is crucial to determining the appropriate measures to mitigate those risks. The FSS identifies those key risks specific to the Fund and the measures being taken or assumptions made to counter those risks.

7.2. Some of the key risks taken into account and responses are:

Financial

- Unexpected market-driven events.
- 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 allocations in volatile markets may lock in past losses.
- Pay and price inflation significantly more or less than anticipated.
- The effect of a possible increase in employer's contribution rate on service delivery and employers in general.

The Fund undertakes a three yearly review of its investment strategy taking into account investment risk and future benefit payments to determine a bespoke investment strategy that for a variety of future economic outcomes gives a high degree of certainty that the investment objectives will be achieved. Short-term investment management decisions to reflect anticipated market changes are strictly controlled against the investment strategy or benchmark.

Investment management briefs reflect the importance of capturing at least a market rate of return and minimising the risk of significantly underperforming an investment market. Further information is available in the SIP and on the Fund's website.

Demographic

- The longevity horizon of beneficiaries continues to expand.
- Cost of early retirements.

The Fund has in place policies and procedures to identify for employing bodies the impact of these factors and agrees how they will be managed in terms of annual contribution rates and/or as special additional contributions.

Regulatory

- Changes to regulations, eg, more favourable benefits package, potential new entrants to scheme.
- Changes to national pension requirements and/or Inland Revenue rules.

These changes agreed and proposed are evaluated and taken into account in the actuarial valuation and closely monitored between valuations in case any action is required.

Major employing bodies are invited to make provision within their contribution rate or make contributions to the Fund as cases are approved for early retirement and other employing body discretions that when exercised alter future liabilities.

Governance

- Administering authority unaware of structural changes in an employer's membership (eg, large fall in employee members, 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.

The Fund has established inter-valuation monitoring and working relations with its employers to ensure changes are detected, discussed, evaluated and appropriate action agreed. This includes regular reviews of funding levels, bond arrangements where appropriate and the assessment of the financial standing of employers that are not tax-raising bodies.

Employers

- Sustainability of an employer or their ability to meet their liabilities within the agreed funding strategy.

The Fund's approach to the outcome of the 2007 valuation has had regard to balancing the needs of funding the liabilities and the cost to employers. This is reflected in the approach to the phasing of increase, the recovery period for meeting any funding gap, together with the risks associated with the investment strategy. It is considered the approach adopted represents an 'affordable' solution taking all factors into account.

A risk assessment of the sustainability of all employers has been undertaken seeking to establish the risk of an employer failing to meet their pension liabilities. The analysis has looked at the following levels of risk:

Low Risk

Scheduled and resolution bodies as statutory entities that are either required, or can choose to offer membership of the LGPS. This category would cover:

- A local authority, or equivalent.
- A body for which the Fund has a guarantee of liabilities from a local authority (or its equivalent).
- A body which receives funding from local or central government (eg, colleges and universities).
- A body which has a funding deficiency guarantee from local or central government.
- A best value type body for which a local authority within the Fund effectively stands as the ultimate guarantor on the termination of the admission agreement as a result of Regulation 78(2A).

Medium Risk

Scheduled bodies not considered as low risk and admitted bodies with no statutory underpin but:

- Can provide satisfactory evidence of financial security (eg, parent company guarantee, bond, indemnity, insurance).
- Is part of a group of related or pooled bodies which share funding on default.

High Risk

An admitted body:

- With no external funding guarantee or reserves.
- With a known limited lifespan or fixed contract term of admission to the Fund.
- Which has no active contributors and/or is closed to new joiners.
- Which relies on voluntary or charitable sources of income.

This analysis indicates the risk to the Fund's solvency and ability to meet prior liabilities to be low. It will, however, continue to be monitored.

In respect of bodies that have fixed-term funding, the valuation reflects any recovery period to full funding must be achieved with a high degree of certainty by the end of the funding period. Further information is available in the separate admission bodies funding policy document.

Appendix

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 outperformance assumption (AOA) of 2% p.a. for the period pre-retirement and 1% p.a. post-retirement.

The AOAs 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 outperformance is based on the liability profile of the Scheme, with a higher assumption in respect of the 'pre-retirement' (ie, active and deferred pensioner) liabilities than for the 'post-retirement' (ie, 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. Therefore, in completing the calculations for individual employers, a single, composite, pre- and post-retirement AOA of 1.4% p.a. 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 1.75% 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 (eg, guaranteed minimum pensions in respect of service prior to April 1997).

Full details of the assumptions adopted are set out in the actuary's formal valuation report.

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 (ie, 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 (ie, return in excess of price inflation) of 3.75% p.a. with a long-term average assumption for price inflation of 2.75% p.a. These two assumptions give rise to an overall discount rate of 6.5% p.a.

Adopting this approach the future service rate is not subject to variation solely due to different market conditions applying at each successive valuation, which reflects the requirement in the regulations for stability in the 'common rate' of contributions. In market conditions at the effective date of the 2007 valuation this approach gives rise to a somewhat more optimistic stance in relation to the cost of accrual of future benefits compared to the market related basis used for the assessment of the funding target.

At each valuation the cost of the benefits accrued since the previous valuation will become a past service liability. At that time any mismatch against gilt yields and the AOAs 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	4.85% 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	4.5% p.a.
Pension increases	2.75% p.a.

Principal demographic assumptions

Non-retired members' mortality	PA92 MC YoB tables + 1 year +6 years for retirements in ill-health)
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

Assumptions Used in Calculating Contributions Payable Under the Recovery Plan

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

Investment Return on Existing Assets and Future Contributions

An overall additional return of 2.5% p.a. above the liabilities consistent gilt yield (4.4% p.a. effective as at the valuation date) reflecting the underlying investment strategy of the Scheme and, in particular, including the assets of the Scheme that underlie the pensioner as well as the non-pensioner liabilities.

This is equivalent to a total rate of investment return of 6.9% p.a. effective as at the 2007 valuation date.

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

The above variation to assumptions in relation to the recovery plan can only be applied for those employers which the administering authority deems to be of sufficiently high covenant to support the anticipation of investment returns, based on the current investment strategy, over the entire duration of the recovery period.

No such variation in the assumptions will apply in any case to any employer which does not have a funding deficit at the valuation (and therefore for which no recovery plan is applicable). Where the variation in the assumptions does apply, the resultant total contribution rate(s) implemented following the 2007 valuation will be subject to a minimum of both:

- the contribution rate(s) originally planned for 2008/09 onwards based on the 2004 actuarial valuation, and
- the normal future service contribution rate for the employer concerned.

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