Appendix 1

Durham County Council

Durham County Council Pension Fund

Funding Strategy Statement

Version Updated 2005

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(A) STATUTORY BACKGROUND AND KEY ISSUES

1. The Local Government Pension Scheme (England and Wales) (Amendment) Regulations 2004 come into effect on 1st April 2004. They provide the statutory framework from which Local Government Pension Schemes (LGPS) administering authorities are required to prepare a Funding Strategy Statement (FSS) by 31 March 2005.

2. Key issues:

   - After consultation with relevant interested parties involved with the Fund, e.g. local authority employers, admitted bodies, scheduled/resolution bodies, the administering authority is required to prepare and publish their funding strategy.

   - In preparing the FSS, the administering authority has to have regard to:

     - CIPFA guidance
     - Its Statement of Investment Principles (SIP) published under Regulation 9A of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended).

   - The first statement must be published by 31 March 2005.

   - The FSS must be revised and published whenever there is a material change in policy either on the matters set out in the FSS or the Statement of Investment Principles.

   - Each Fund Actuary must have regard to the FSS as part of the fund valuation process and the Fund Actuary has therefore been consulted on the contents of this FSS.

   - Benefits payable under the Scheme are secure, because they are guaranteed by statute. The FSS addresses the issue of managing the need to fund those benefits over the long term, whilst at the same time, allowing for scrutiny and accountability through improved transparency and disclosure.

   - The Scheme is a defined benefit final salary scheme. The benefits are specified in the governing legislation, the Local Government Pension Scheme Regulations 1997 (the Regulations). Constraints on the levels of employee contributions are also specified in the Regulations.

   - Employer contributions are determined in accordance with the Regulations, which require that an actuarial valuation is completed every three years by the Fund Actuary.

(B) PURPOSE OF THE FUNDING STRATEGY STATEMENT

3. The purpose of this Funding Strategy Statement (FSS) 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 apply comprehensively for the Scheme as a whole, recognising that there will always 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.

(C) AIMS AND PURPOSE OF THE PENSION FUND

4. 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**

  The Administering Authority aims to keep employer contributions as nearly constant as possible, whilst taking account of:

  - the regulatory requirement to secure solvency
  - the requirement to ensure that costs are reasonable, and
  - maximising return from investments

  In order to achieve nearly constant employer contribution rates there may be a need to invest in assets that match the employer's liabilities.

  The Administering Authority currently invests a large proportion of the Fund in equities, which are perceived as having higher long-term rates of return. These assets are more risky in nature than fixed interest investments, and this can lead to more volatile returns in the short-term.

  This can have an effect on employer contribution rates as the funding position of the Pension Fund is measured at the triennial valuations. The impact of this can be reduced by smoothing adjustments at each actuarial valuation. Smoothing adjustments recognise that markets can rise and fall too far.

There is a balance to be struck between the Fund's investment policy, actuarial smoothing adjustments and employer's contribution rates.

- **Manage employers' liabilities effectively**

  The Administering Authority seeks to manage employers' liabilities effectively. This is achieved by seeking actuarial advice and regular monitoring of the investment of the Fund's assets through quarterly meetings of the Pension Fund Committee.

- **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 sufficient liquid assets to pay pensions, transfer values and other expenses. This position is continuously monitored and the cash available from contributions and cash held by Fund Managers is reviewed on a quarterly basis by the Pension Fund Committee.

- **Maximise the returns from investments within reasonable risk parameters.**

  The Administering Authority recognises the desirability of maximising returns from investments within reasonable risk parameters. Investment returns higher than those of fixed interest and index-linked bonds are sought from investment in equities and property. The Administering Authority ensures that risk parameters are reasonable by:

  - Taking advice from its professional advisers, e.g. the Fund Actuary, Investment advisers and investment managers
  - Controlling levels of investment in asset classes through the Statement of Investment Principles
  - Restricting investment to asset classes recognised as appropriate for UK Pension Funds.

5. The purpose of the fund is to:

- Receive money in respect of contributions, transfer values and investment income, and

- Pay out money in respect of scheme benefits, transfer values, costs, charges and expenses,

as defined in the Local Government Pension Scheme Regulations and in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998.

(D) RESPONSIBILITIES OF THE KEY PARTIES

6. Although a number of parties including investment fund managers and external auditors have responsibilities to the fund, the following are considered to be of particular relevance:

7. The administering authority should:

- Collect employer and employee contributions

- Determine a schedule of due dates for the payment of contributions - Section 70(1)(a) of the Pensions Act 2004 suggests that Administering Authorities are now required to report breaches as defined in Section 70 (2) of the 2004 Act. This places monitoring of the date of receipt of employer contributions on the Administering Authority and therefore places a duty to report late payments of contributions to the Occupational Pensions Regulatory Authority (Opra).

- Take action to recover assets from admission bodies whose Admission Agreement has ceased.

- 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 fund's actuary.

  Ensure effective communications with the Fund's Actuary to:

  - Ensure that the Fund Actuary is clear about the Funding Strategy;
  - Ensure reports are made available as required by guidance and regulation;
  - Agree timetables for the provision of information and valuation results;
  - Ensure provision of accurate data; and
  - Ensure that participating employers receive appropriate communications.

- Consider the appropriateness of interim valuations.

- Prepare and maintain an FSS and a SIP, both after proper consultation with interested parties, and

- Monitor all aspects of the fund's performance and funding and amend the FSS and SIP on an annual basis as part of the on-going monitoring process.

8. The individual employers 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 and early retirement strain, and
- Notify the administering authority promptly of all changes to membership, or as may be proposed, which affect future funding.

9. The fund actuary should:

- Prepare triennial 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.
- In response to a request from the Administering Authority, assess the impact of Regulatory changes on costs.

(E) SOLVENCY ISSUES AND TARGET FUNDING LEVELS

10. LGPS administering authorities prudentially seek to achieve full funding. The scheme regulations refer to each administering authority securing solvency by means of employer contribution rates established by mandatory valuation exercises and to the desirability of maintaining as nearly constant a rate as possible.

11. The LGPS however remains outside of the solvency arrangements established for private sector occupational pension schemes. It is not therefore unreasonable for administering authorities to establish longer-term recovery periods than those in the private sector where this is considered to be prudentially appropriate and relevant to local circumstances, and linked to the scheme's triennial valuation exercise requirements.

12. The Administering Authority will prudentially seek to secure the solvency of the Fund. Solvency is defined as being achieved when the value of the Fund's assets is greater than or equal to the value of the Fund's liabilities, as measured by the Fund's Actuary. Solvency is not defined in the Regulations, and its definition is therefore the Administering Authority's interpretation. Funding can be interpreted differently

depending on the assumptions used. The liabilities are measured on 'on-going' actuarial methods and assumptions where 'on-going' actuarial assumptions and methods are taken to be measurement by use of the projected unit method of valuation, using assumptions generally recognised as suitable for open, ongoing UK pension fund with a sponsoring employer of sound covenant.

13. The Administering Authority will agree with the Fund's Actuary the assumptions used in this calculation prior to each actuarial valuation.

14. The Administering Authority has agreed with the Fund Actuary that a market led approach should be used for future valuations at least for the foreseeable future. Under this method of valuation, the assets are taken into account at their mid market value and the value is then compared with the value of the Fund's liabilities calculated using consistent, market rates of interest. The Administering Authority has also agreed with the Fund Actuary that some element of smoothing of the assets can be used in the valuations. The size of the smoothing adjustment will be discussed at each valuation.

15. The rates of interest are obtained by examination of prevailing yields in the long term gilt market, which are then adjusted to make partial allowance for excess returns expected on other types of riskier investments such as equities. The risk of this approach is that the additional returns may not be achieved.

16. Where a valuation shows the Fund to be in surplus or deficit against the solvency measure, employer's contribution rates will be adjusted to reach the solvent position over a number of years. The 'recovery period' for reaching 'full' funding is set by the Administering Authority in consultation with the Actuary and the employer.

17. It is recognised that a large proportion of the Fund's liabilities are expected to arise as benefits payments over a long period of time. The Administering Authority is therefore prepared to agree recovery periods that are longer than the average future working lifetime of the membership of that employer. There is however a risk involved in relying on long recovery periods and the Administering Authority has agreed with the Actuary a maximum recovery period of 30 years. It is the intention of the Administering Authority to agree with employers a recovery period of as short a time as possible within this 30 year limit having regard to the affordability of the revised contribution rate in general taking into account the legislative requirements of securing solvency and maintaining as nearly a constant a contribution rate as possible. For each individual employer the following will also be taken into account:

- covenant and strength of any guarantee relating to an employer and hence the risk of default
- length of participation in the Fund
- whether the employer is closed to new entrants or is likely to have a contraction in its membership of the Fund

18. 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 equal 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.

19. The Administering Authority will permit some employers to be treated as a group for the purposes of setting contribution rates. For smaller employers the contribution rate can be volatile due to the increased likelihood that demographic movements could have a material effect. 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 and which other employers it is grouped with. If the employer objects to this grouping, it will be offered its own contribution rate. The Administering Authority recognises that grouping can give rise to cross subsidies from one employer to another over time.

20. For employers whose participation is for a fixed period, grouping is unlikely to be permitted.

(F) LINKS TO INVESTMENT POLICY SET OUT IN THE STATEMENT OF INVESTMENT PRINCIPLES

21. The current investment strategy, as set out in the SIP, is summarised below:

General Principles and diversification

22. The Fund believes that the emphasis of investment over the long term should be on real assets, particularly equities and property. These are most likely to maximise the long term returns. The balance between UK and Overseas equities is, however, a matter of investment judgement. The Fund should also be diversified to include other real assets, such as Index-Linked and 'monetary' assets, such as Bonds and Cash.

23. The neutral benchmark proportions of the various asset classes have been determined by the Fund in consultation with the Investment Advisers and are reviewed at least once every three years to coincide with the Triennial Actuarial Valuation.

24. The active Investment managers are expected to adopt an active asset allocation policy to take advantage of the shorter term relative attractions of the various asset types.

25. The Administering Authority has produced this Funding Strategy Statement having taken a view on the level of risk inherent in the

investment policy set out in the Statement of Investment Principles (SIP) and the funding policy set out in this document.

26. The SIP sets out the investment responsibilities and policies relevant to the Fund.

27. The Administering Authority will continue to review both documents to ensure that the overall risk profile remains appropriate.

(G) IDENTIFICATION OF RISKS AND COUNTER-MEASURES

28. The Administering Authority seeks to identify all risks to the Fund, will monitor the risks and take appropriate action to limit the impact of them wherever possible.

For ease of classification some of the key risks may be identified as follows:

29. Financial

These include:

- 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 reallocations 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 admitted or scheduled bodies

30. Demographic

These include:

- The longevity horizon continues to expand
- Deteriorating pattern of early retirements

The Administering Authority will ensure that the Actuary investigates these matters at each valuation. Prudent management of the fund should ensure that sound policies and procedures are in place to manage, e.g. potential ill health or early retirements.

31. Regulatory

These include:

- Changes to regulations, e.g. more favourable benefits package, potential new entrants to the scheme, e.g. part-time employees

- Changes to national pension requirement and/or Inland Revenue rules

The Administering Authority will keep up to date with all proposed changes, and, if appropriate, request the Actuary to assess the impact on costs of the changes. The Administering Authority will notify employers of the likely impact of changes.

32. Governance

These include:

- Administering authority unaware of structural changes in an employer's membership (e.g. 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 Administering Authority requires regular communication with employers to ensure that it is made aware of any such changes in a timely manner.

33. Solvency

These include:

- Allowing for future investment returns in excess of those available on government bonds introduces an element of risk, in that those additional returns may not materialise

The Administering Authority's policy will be to monitor the underlying position assuming no such excess returns are achieved to ensure that the funding target remains realistic relative to the low risk position.

34. Smoothing of Assets

These include:

- The 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

The Administering Authority's policy is to review the impact of this adjustment at each valuation to ensure that it remains within acceptable limits.

35. Recovery Period

These include:

- 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 is to discuss the risks inherent in each situation with the Fund Actuary and to limit the permitted length of recovery period to no longer than 30 years.

36. Stepping

These include:

- Permitting contribution rate changes to be introduced by annual steps rather than immediately introduces a risk that action to restore solvency is insufficient in the early years of the process

The Administering Authority's policy is to discuss the risks inherent in each situation with the Fund Actuary and to limit the number of permitted steps to three annual steps or, in exceptional circumstances, to six annual steps.

(H) MONITORING AND REVIEW

37. The FSS should be reviewed formally at least every three years and in advance of the triennial valuation cycle. The valuation exercise will establish contribution rates for all employers contributing to the fund for the following three years within the framework provided by the strategy.