Pension Fund Committee

10 September 2015

Pension Fund Policy Documents – Funding Strategy Statement and Statement of Investment Principles

Durham County Council

Report of Don McLure, Corporate Director Resources

Purpose of the Report

1 To inform Members of the outcome of the consultation of the policy documents and to seek approval of these documents.

Background

2 The Local Government Pension Scheme (England and Wales) (Amendment) Regulations 2004 provide the statutory framework from which Local Government Pension Schemes (LGPS) administering authorities are required to have prepared a 'Funding Strategy Statement' (FSS).

3 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 Authority must have regard to :

    i. the guidance issued by the Chartered Institute of Public Finance (CIPFA) for this purpose; and
    ii. their own Statement of Investment Principles (SIP) for the Fund.
    iii. 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.

4 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 require administering authorities to prepare and review a written statement recording the investment policy of the Pension Fund – the 'Statement of Investment Principles' (SIP).

5 The 2009 regulations also require pension fund administering authorities to state the extent to which they comply with guidance given by the Secretary of State, previously CIPFA's Pensions Panel Principles for Investment

Decision Making in the Local Government Pension Scheme in the United Kingdom.

6 At the last meeting of the Pension Fund Committee, it was agreed that the final versions would be circulated to all relevant interested parties for comment.

Consultation

7 The Administration Regulations require the Administering Authority to consult with such persons that it considers appropriate, and that they ‘have regard’ to the 2004 CIPFA guidance.

8 Although not mandatory, the 2012 CIPFA Guidance requires consultation with the employers, on both the process to revise the FSS and on the revision to the FSS.

9 In line with Regulations, the FSS and SIP have been the subject of consultation with the Fund’s employers before publication.

10 The documents were circulated to all employers in the Pension Fund, the Actuary and external Auditor on 25 June 2015 with a closing date of 31 July 2015.

11 Comments were received on the SIP from our Advisers, and their suggested amendments have been incorporated into the attached documents.

12 Following the consultation, changes were made only to the SIP and are highlighted in the document which is attached at Appendix 2. The main changes were to reflect the change of name from AllianceBernstein to AB and a revision to a maximum regional allocation in North America for CBRE.

13 The FSS remains unchanged from the version reported to Committee in June 2015 and is attached at Appendix 1.

14 It is suggested that the attached versions of the FSS and SIP now be published on the Council’s website.

15 Any further changes to the information contained within the FSS or SIP that emerges before March 2016 will be part of the review of documents reported to the Committee in March 2016.

Recommendations

16 It is recommended that:

- Members approve the contents of the revised Pension Fund's policy documents for publication on the Council's website.

Background papers

(a) Pension Fund Committee - 25 October 2004 – Funding Strategy Statement

(b) Pension Fund Committee – 21 June 2010 – The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009

(c) Pension Fund Committee – 6 March 2014 - Pension Fund Policy Documents – Funding Strategy Statement and Statement of Investment Principles

(d) Pension Fund Committee – 5 June 2014 - Pension Fund Policy Documents – Funding Strategy Statement and Statement of Investment Principles

(e) Pension Fund Committee – 11 September 2014 - Pension Fund Policy Documents – Funding Strategy Statement and Statement of Investment Principles

(f) Pension Fund Committee – 4 March 2015 - Pension Fund Policy Documents – Funding Strategy Statement and Statement of Investment Principles

(g) Pension Fund Committee – 4 June 2015 - Pension Fund Policy Documents – Funding Strategy Statement and Statement of Investment Principles

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Appendix 1

Durham County Council Pension Fund

Funding Strategy Statement

2015

Version Updated May 2015

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(A) STATUTORY BACKGROUND AND KEY ISSUES

1. The Local Government Pension Scheme (England and Wales) (Amendment) Regulations 2004 came into effect on 1 April 2004. They originally provided the statutory framework from which Local Government Pension Schemes (LGPS) administering authorities were required to prepare a Funding Strategy Statement (FSS) by 31 March 2005. The requirements at the date of writing this Statement are now set out under Regulation 58 of the Local Government Pension Scheme Regulations 2013 (the Regulations).

2. Key issues:

- After consultation with such persons as it considers appropriate, the administering authority is required to prepare and publish their funding strategy.

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

  - Guidance published by CIPFA in March 2004 entitled "Guidance on Preparing and Maintaining a Funding Strategy Statement and to the Fund's Statement of Investment Principles" and updated guidance published by CIPFA on 3 October 2012.

  - Its Statement of Investment Principles (SIP) published under Regulation 12 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (the Investment Regulations).

- 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.

- The FSS addresses the issue of managing the need to fund benefits over the long term, whilst at the same time, allowing for scrutiny and accountability through improved transparency and disclosure.

- Until 1 April 2014, the Scheme was a defined benefit final salary scheme. From 1 April 2014, the Scheme is a defined benefit career average revalued earnings scheme. The benefits at the date of writing this Statement are specified in 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.

3. This Statement was as part of the triennial valuation as at 31 March 2013, and has been updated in March 2015.

(B) PURPOSE OF THE FUNDING STRATEGY STATEMENT

4. The purpose of this Funding Strategy Statement (FSS) is to document the processes by which the Administering Authority:

- establishes a clear and transparent fund-specific strategy which will identify how employers' pension liabilities are best met going forward;
- supports the desirability of regulatory requirement of maintaining as nearly constant a common rate of employer contribution rates as possible; and
- takes a prudent longer-term view of funding the Fund's liabilities.

The intention is for this Strategy to apply comprehensively for the Fund as a whole to reflect its best interests, 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) PURPOSE AND AIMS OF THE PENSION FUND

5. 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 in so doing to smooth out the contributions required from employers over the long term.

6. The aims of the fund are to:

- **Comply with Regulation 62 of the Regulations and specifically to adequately fund benefits to secure the Fund's solvency while taking account of the desirability of maintaining as nearly constant employer contribution rates as possible**

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

  - o the regulatory requirement to secure solvency, which should be assessed in the light of the risk profile of the Fund and risk appetite of the Administering Authority and employers

- o the requirement to ensure that costs are reasonable to Scheduled Bodies, Admission Bodies, other bodies and to taxpayers (subject to not taking undue risks), and

- o maximising return from investments within reasonable risk parameters

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

The Administering Authority currently invests a large proportion of the Fund in equities, which are perceived as having higher long-term rates of return consistent with the requirement to maximise the returns from investments, within reasonable risk parameters. These assets are more risky in nature than fixed interest investments, and this can lead to more volatile returns in the short-term and a failure to deliver the anticipated returns in the long 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.

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.

- **Manage employers' liabilities effectively**

  The Administering Authority seeks to manage employers' liabilities effectively. In a funding context, 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 and appropriate segregation of employers for funding purposes.

- **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, through investment in unmatched investments. Investment returns higher than those of fixed interest and index-linked bonds are sought from investment in equities, property and other growth assets. 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

  - Limiting default risk by restricting investment to asset classes recognised as appropriate for UK Pension Funds.

  - Analysing the volatility and absolute return risks represented by those asset classes in collaboration with the Investment Adviser and Fund Managers, and ensuring that they remain consistent with the risk and return profiles anticipated in the funding strategy statement.

  - Limiting concentration risk by developing a diversified investment strategy.

  - Monitoring the mismatching risk, i.e. the risk that the investments do not move in line with the Fund's liabilities.

(D) RESPONSIBILITIES OF THE KEY PARTIES

7. Although a number of parties including investment fund managers and external auditors have responsibilities to the fund, the three parties whose responsibilities to the Fund are of particular relevance are the Administering Authority, the individual employers and the Fund Actuary:

8. The administering authority should:

- Administer the Fund

- Collect employer and employee contributions as set out in the Regulations

- 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 material late payments of contributions to the Pensions Regulator.

- Take action to recover assets from admission bodies whose Admission Agreement has ceased and other bodies whose participation in the Fund has ceased.

- Invest surplus monies in accordance with the Regulations.
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- Pay from the Fund the relevant entitlements as set out in 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 content of the Funding Strategy Statement;

    - 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 regularly as part of the on-going monitoring process.

- Effectively manage any potential conflicts of interest arising from its dual role as both Administering Authority and as a Scheme Employer.

9. 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.

- Develop a policy on certain discretions and exercise discretions within the regulatory framework, ensuring that the Administering Authority has copies of current policies covering those discretions.

- Make additional contributions in accordance with agreed arrangements in respect of, for example, additional membership or pension, 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.

- Noting, and if desired responding to, any consultation regarding the Funding Strategy Statement, the Statement of Investment Principles, or other policies.

10. 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, individual benefit-related matters, valuations of exiting employers and other forms of security for the Administering Authority against the financial effect on the Fund of the employer's default. Such advice will take account of the funding position and Funding Strategy Statement, as well as other relevant matters when instructed to do so.

- Assist the Administering Authority in assessing whether employer contributions need to be revised between actuarial valuations as required by the Regulations.

- In response to a request from the Administering Authority, assess the impact of Regulatory changes on costs.
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- Ensure that the Administering Authority is aware of any professional guidance or other professional requirements which may be of relevance to his or her role in advising the Administering Authority.

(E) FUNDING TARGETS, SOLVENCY AND NOTIONAL SUB-FUNDS

Risk based approach

11. 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, rather than relying on a 'deterministic' approach which gives little idea of the associated risk. In practice, three key decisions are required for the risk based approach:

- what the Solvency Target should be (the funding objective - where the Administering Authority wants the Fund to get to),
- the Trajectory Period (how quickly the Administering Authority wants the Fund wants to get there), and
- the Probability of Funding Success (how likely the Administering Authority wants it to be now that the Fund will actually achieve the Solvency Target by the end of the Trajectory Period).

These three choices, supported by complex risk modelling carried out by the Fund Actuary, define the appropriate levels of contribution payable now and, by extension, the appropriate valuation approach to adopt now. Together they measure the riskiness of the funding strategy.

These three terms are considered in more detail below.

Solvency and 'funding success'

12. 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. The Solvency Target is the amount of assets which the Fund wishes to hold at the end of the Trajectory Period (see later) to meet this aim.

13. The Fund is deemed to be solvent when the assets held are equal to or greater than 100% of the Solvency Target.

- For Scheduled Bodies, and certain other bodies, of sound covenant whose participation is indefinite in nature, 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's financial position continued to be assessed by use of such methods and assumptions, and contributions were paid in accordance with those methods and assumptions, there would be a chance of at least 80% that the Fund would continue to be 100% funded over a time period considered appropriate at the time of assessment. 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 certain Admission Bodies, bodies closed to new entrants and other bodies whose participation in the Fund is believed to be of limited duration through known constraints or reduced covenant, and for which no access to further funding would be available to the Fund after exit, the required Probability of Maintaining Solvency will be set at a level higher than 80% 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

14. 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.

15. 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. The Administering Authority will not permit contributions to be set following a valuation that have an unacceptably low chance of achieving the Solvency Target at the end of the relevant Trajectory Period.

Funding Target

16. The Funding Target is the amount of assets which the Fund needs to hold at the valuation date to pay the liabilities at that date as indicated by the chosen valuation method and assumptions. 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 costs and any adjustment for the surplus or deficiency simply serve to set the level of contributions payable, which 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).

17. Consistent with the aim of enabling employers' 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 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 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

18. Some comments on the principles used to derive the Solvency and Funding Targets for different bodies in the Fund are set out below.

- **Scheduled Bodies and certain other bodies of sound covenant**
  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 low risk assets for Scheduled Bodies and certain other bodies which are long term in nature.

- **Admission Bodies and certain other bodies whose participation is limited**
  For Admission Bodies, bodies closed to new entrants and other bodies whose participation in the Fund is believed to be of limited duration through known constraints or reduced covenant, and for which no access to further funding would be available to the Fund after exit the Administering Authority will have specific 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 whether a guarantor exists to subsume the notional assets and liabilities).

Full Funding and Solvency

19. The Fund is deemed to be fully funded when the assets held are equal to 100% of the Funding Target. 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.

20. The Fund is deemed to be solvent when the assets held are equal to or greater than 100% of the Solvency Target.

Recovery Periods

21. 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.

22. Where a valuation shows the Fund to be in surplus or deficit against the

Funding Target, employers' contribution rates will be adjusted to reach the solvent position over a number of years. 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. As noted earlier, the valuation method, including the components of Funding Target, future service costs and adjustment for surplus or deficiency simply serve to set a level of contributions payable, which in turn dictates the chance of achieving the Solvency Target at the end of the Trajectory Period. For (most) scheduled bodies in the Fund, the Trajectory Period, at the date of reviewing this FSS, is set to be 25 years.

23. The Recovery Period applicable for each employer is set by the Fund Actuary in consultation with the Administering Authority 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.

24. The Administering Authority recognises that a large proportion of the Fund’s liabilities are expected to arise as benefits payments over a long period of time. For employers of sound covenant, 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. In general for employers that are closed to new entrants and are of sufficient term, the recovery period is set to be the estimated future working lifetime of the active membership (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.

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25. However, the Administering Authority also recognises the risk involved in relying on long Recovery and Trajectory Periods and has agreed with the Actuary a maximum recovery period of 30 years for both, for employers which are assessed by the Administering Authority as being a long term secure employer. 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. A period of 18 years has been used for Durham County Council, the largest employer in the Fund. Trajectory and 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.

26. 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

Stepping

27. 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.

Grouping

28. In some circumstances it may be desirable to group employers within the Fund together for funding purposes (i.e. 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.

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

30. Where employers are grouped together for funding purposes, this will only occur with the consent of the employers involved.

31. All employers in the Fund are grouped together in respect of the risks associated with payment of lump sum benefits on death in service – in other words, the cost of such benefits is shared across the employers in the Fund. Such lump sum benefits 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.

Notional sub-funds

32. 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 (or group of employers where grouping operates), as if each employer had its own notional sub-fund within the Fund.

33. This subdivision is for funding purposes only. It is purely notional in nature and does not imply any formal subdivision of assets, or ownership of any particular assets or groups of assets by any individual employer or group.

Roll-forward of sub-funds

34. The notional sub-fund 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 allocated as set out below. 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.

35. 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 determined consistent with the Funding Target transferred from one employer to the other unless some other approach has been agreed between the two employers.
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- Allowance for lump sum death in service and other benefits shared across all employers in the Fund (see earlier).

- 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.

36. 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.

- Where, in the opinion of the Fund Actuary, the cash flow data which is unavailable is material, 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 relative to the surplus or deficiency exhibited at the previous valuation. Having established an expected surplus or deficiency at this valuation, comparison of this with the liabilities evaluated at this valuation leads to an implied notional asset holding.

37. Analysis of gains and losses methods will also be used where the results of the cash flow approach appears to give unreliable results perhaps because of unknown internal transfers.

Fund maturity

38. 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.

39. In certain circumstances, 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.

40. Where defined capital streams are required, the Administering Authority will review at future valuations whether any new emerging deficiency will give rise to a new, separate, defined stream of contributions, or will be consolidated with any existing stream of contributions into one new defined stream of contributions.

(F) SPECIAL CIRCUMSTANCES RELATED TO CERTAIN EMPLOYERS

Interim reviews

41. Regulation 64 of the Regulations provides the Administering Authority with a power to carry out valuations in respect of employers who are likely to become an exiting employer, and for the Actuary to certify revised contribution rates, between triennial valuation dates.

42. The Administering Authority's overriding objective at all times in relation to employers 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 exit date may be unknown (for example, participation may be assumed at present to be indefinite), and also because market conditions change daily.

43. The Administering Authority's general approach in this area is as follows:

    - Where the exit date is known, and is more than 3 years hence, or is unknown and assumed to be indefinite, the Administering Authority will generally not deem it necessary to carry out an interim valuation.

- For Admission Bodies admitted under paragraph 1(d) of Part 3, Schedule 2 of the Regulations 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 exit date 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 the next 3 years, the Administering Authority will keep an eye on developments and may see fit to request an interim valuation at any time.

44. 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 Regulations applies.

Guarantors

45. 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 exits 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.
- 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.

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

Bonds and other securitization

47. Paragraph 6 of Part 3, Schedule 2 of the 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 admitted under paragraph 1(d)(i) of that Part), an assessment taking account of actuarial advice of the level of risk on premature termination by reason of insolvency, winding up or liquidation.

48. 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 who either funds, owns or controls the functions of the admission body.

49. The Administering Authority's approach in this area is as follows:

- In the case of Admission Bodies admitted under Paragraph 1(d) of Part 3, Schedule 2 of the Regulations 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 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, but this should not be construed as advice to the relevant Scheme Employer on this matter. The Administering Authority notes that levels of required bond cover can fluctuate and recommends that relevant Scheme Employers review the required cover regularly, at least once a year.

- In the case of:
    - Admission bodies admitted under paragraph 1(e) of Part 3, Schedule 2
    - Admission bodies admitted under paragraph 1(d) of Part 3, Schedule 2 where the Administering Authority does not judge the Scheme Employer to be of sufficiently strong covenant
    - 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 to 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 will recommend the relevant Scheme Employer to jointly review the required cover with it regularly, at least once a year.

Subsumed liabilities

50. 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 agrees to provide a source of future funding in respect of any emerging deficiencies in respect of those liabilities.

51. In such circumstances the liabilities are known as subsumed liabilities (in that responsibility for them is subsumed 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

52. 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 will 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 Regulation64 of the 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.

53. The Administering Authority will seek to minimise the risk to other employers in the Fund that any deficiency arises on the orphan liabilities such that this creates a cost for those other employers to make good the deficiency. To give effect to this, the Administering Authority will 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.

54. To the extent that the Administering Authority decides not to match these liabilities with Government bonds of appropriate term then any excess or deficient returns will be added to or deducted from the investment return to be attributed to the other employer's notional assets.

Cessation of participation

55. Where an employer becomes an exiting employer, an exit valuation will be carried out in accordance with Regulation 64 of the 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.

56. In particular, the exit valuation will distinguish between residual liabilities which will become orphan liabilities, and liabilities which will be subsumed by other employers.

- For orphan liabilities the Funding Target in the exit valuation will anticipate investment in low risk investments such as Government bonds.

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

57. 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.

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

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

General Principles and diversification

59. 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.

60. 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.

61. 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.

62. 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.

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

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

(H) IDENTIFICATION OF RISKS AND COUNTER-MEASURES

65. 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.

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

67. Investment

These include:

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

The specific risks associated with assets and asset classes are:

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

The Administering Authority reviews each investment manager's performance quarterly and annually considers the asset allocation of the Fund by carrying out an annual review meeting. The Administering Authority also annually reviews the effect of market movements on the Fund's overall funding position.

68. Employer

These include:

- the risk arising from ever changing mix of employers, from short terms and exiting 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 their employers, their basis of participation and their legal status and will use this information to set a funding strategy for the relevant employers

69. Liability

These include:

- Interest rates being lower than expected
- Pay increases being higher than expected
- Price inflation being higher than expected
- The longevity horizon continuing to expand
- Deteriorating patterns 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.

70. Regulatory

These include:

- Changes to general and LGPS specific 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

71. Liquidity and maturity

These include:

- An increased emphasis on outsourcing and alternative models for service delivery may result in active members leaving the LGPS
- Transfer of responsibility between different public sector bodies
- Scheme changes which might lead to increased opt-outs
- 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.

72. 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.

73. 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 at different places within that range.

The more optimistic the assumptions made in determining the Funding Target and Solvency Target, 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 Funding Target and Solvency Target calculated by reference to those assumptions.

The Administering Authority will not adopt assumptions for Scheduled Bodies and certain other bodies 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 (as defined earlier in this document). 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.

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.

74. 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 whether an approach is suitable and if so ensure the impact of this adjustment remains within acceptable limits.

75. 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 where appropriate. Details of the Administering Authority's policy are set out earlier in this Statement.

76. 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 as appropriate. Details of the Administering Authority's Policy are set out earlier in this Statement.

(I) MONITORING AND REVIEW

77. The Administering Authority must keep the FSS under review and make appropriate revisions following a material change in policy. The triennial valuation exercise will establish contribution rates for all employers contributing to the fund within the framework provided by the strategy.

Appendix 2

Durham County Council
Pension Fund

Statement of Investment Principles

Version Updated August 2015

Table of Contents

Introduction

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 consolidate the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (the "Regulations") which require administering authorities to prepare and review a written statement recording the investment policy of the Pension Fund. The 2009 regulations also require pension fund administering authorities to state the extent to which they comply with guidance given by the Secretary of State, previously the Chartered Institute of Public Finance (CIPFA) Pensions Panel Principles for Investment Decision Making in the Local Government Pension Scheme in the United Kingdom. The compliance statement is attached at Appendix A.

Durham County Council is the administering authority (the "Authority") for the Durham County Council Pension Fund (the "Pension Fund") and the purpose of this document is to outline the broad investment principles governing the investment policy of the Pension Fund, thereby satisfying the requirements of the Regulations.

Investment Responsibilities

The County Council, as Administering Authority, has delegated the investment arrangements of the Pension Fund to the Pension Fund Committee (the “Pension Fund Committee”) who decide on the investment policy most suitable to meet the liabilities of the Pension Fund and the ultimate responsibility for the investment policy lies with it. The Committee is made up of elected representatives of the County Council, Darlington Borough Council, Further Education Colleges, Other Statutory Bodies, Admitted Bodies and Member Representatives.

The Pension Fund Committee has full delegated authority to make investment decisions.

The Pension Fund Committee has responsibility for:

- Determining overall investment strategy and strategic asset allocation and ensuring that investments are sufficiently diversified, are not over concentrated in any one type of investment, and that the Pension Fund is invested in suitable types of investments;
- Preparing policy documents including the Statement of Investment Principles. Monitoring compliance with the Statement and reviewing its contents following any strategic changes and at least every three years;
- Appointing the investment managers, custodian, the Pension Fund actuary and any independent external advisers felt to be necessary for the good stewardship of the Pension Fund;
- Reviewing on a regular basis the investment managers’ performance against established benchmarks, and satisfying themselves as to the investment managers’ expertise and the quality of their internal systems and controls;
- Reviewing on a regular basis the performance of the independent external advisers;
- In cases of unsatisfactory performance of the investment managers and independent external advisers, taking appropriate action;

- Reviewing policy on social, environmental and ethical matters and on the exercise of rights, including voting rights; and
- Reviewing the funds allocated to investment managers on a regular basis to ensure that the strategic asset allocation is maintained (rebalancing).

The investment managers are responsible for:

- The investment of the Pension Fund assets in respect of which they are appointed in compliance with applicable rules and legislation, the constraints imposed by this document and the detailed Investment Management Agreement covering their portion of the Pension Fund's assets;
- Stock selection within asset classes;
- Preparation of quarterly reports, including a review of investment performance;
- Attending meetings of the Pension Fund Committee as requested;
- Assisting the Corporate Director Resources and Pension Fund Committee in the preparation and review of this document; and
- Where specifically instructed, voting in accordance with the Pension Fund's policy.

The Global Custodian is responsible for:

- Its own compliance with prevailing legislation;
- Providing the administering authority with quarterly valuations of the Pension Fund's assets and details of all transactions during the quarter;
- Collection of income, tax reclaims, exercising corporate administration and cash management;
- Such other services as the Pension Fund shall procure, for example, in connection with performance measurement and reporting or fund accounting.

The Independent Advisers are responsible for:

- Assisting the Corporate Director Resources and Pension Fund Committee in determining the overall investment strategy, the strategic asset allocation and that the Pension Fund is invested in suitable types of investment, and ensuring that investments are sufficiently diversified.
- Assisting the Corporate Director Resources and Pension Fund Committee in the preparation and review of Policy documents;
- Assisting the Corporate Director Resources and Pension Fund Committee in their regular monitoring of the investment managers' performance;
- Assisting the Corporate Director Resources and Pension Fund Committee in the selection and appointment of investment managers, custodians and Pension Fund Actuary;
- Advising and assisting the Corporate Director Resources and the Pension Fund Committee on other investment related issues, which may arise from time to time; and
- Providing continuing education and training to the Pension Fund Committee.

The Actuary is responsible for:

- Providing advice as to the structure of the Pension Fund's liabilities, the maturity of the Pension Fund and its funding level in order to aid the Pension Fund Committee in balancing the short term and long-term objectives of the Pension Fund.
- Undertaking the statutory triennial valuation of the Fund's assets and liabilities.

The Corporate Director Resources is responsible for:

- Ensuring compliance with this document and bringing breaches thereof to the attention of the Pension Fund Committee;

- Ensuring that this document is regularly reviewed and updated in accordance with the Regulations;
- Exercising delegated powers granted by the County Council to:
    - Administer the financial affairs in relation to the County Council’s functions as a pension fund administering authority;
    - Exercise those discretions under the Local Government Pension Scheme Regulations 1997 as appear from time to time in Pension Fund Statements of Policy; and
    - Authorise, in cases of urgency, the taking of any action by an investment manager of the Pension Fund which is necessary to protect the interests of the Pension Fund.
- Managing the cash balances of the Pension Fund which the Investment Managers have not invested.

Authorised Investments

The powers and duties of the Authority to invest monies are set out in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 as amended from time to time and updated in 2009. The Authority is required to invest any money which is not required immediately to pay pensions and any other benefits and, in so doing, take account of the need for a suitable diversified portfolio of investments and the advice of persons properly qualified on investment matters.

Types of Investment

Investment can be made in accordance with the regulations in a broad spectrum of investments such as equities, fixed interest and other bonds, collective investment schemes, deposits, money market instruments, unquoted equities and property, both in the UK and overseas. The regulations also specify other investment instruments that may be used such as stock lending, financial futures, traded options, insurance contracts, sub underwriting contracts and a contribution to an unquoted limited liability securities investment partnership.

The limits on the amount of money that can be invested in each individual type of investment are specified in schedule 1, column 2 of the Regulations. We do not participate in stock lending or underwriting.

The Local Government Pension Scheme (Management and Investment of Funds) (Amendment) Regulations 2003 amended the regulations so as to give Authorities the option to increase some of the limits on certain types of investments provided that the Authority complies with the requirements of the Regulations. These requirements include taking proper advice, the suitability of particular investments and types of investments, the limit on the amount of such investment, the reason for such investment and the period for which the increase in the limit of the type of investment will apply. Any increase in the limit must be kept under review.

The 2009 Regulations now prevent the administering authority from investing the Pension Fund’s cash that is not required immediately along with its own cash. The Pension Fund Committee has agreed that as part of its investment strategy it will allow the administering authority to invest, in the short term, on its behalf in line with the administering authority's Treasury Management Strategy.

Investment Managers are instructed to comply with the regulations in respect of the relevant portfolio subject to any specific instructions. The Authority is responsible for oversight of how compliance affects the compliance of the Pension Fund as a whole.

Investment Risk

The investment policy has been set with the objective of controlling the risk that the assets will not be sufficient to meet the liabilities of the Pension Fund while achieving a good return on investment.

By dividing the management of the assets between seven investment managers, further controls risk. Asset allocation benchmarks have been set and performance is monitored relative to the benchmarks. This is to ensure the investment manager does not deviate from the Pension Fund Committee's investment strategy.

The setting of specific control ranges and other investment guidelines within which the investment managers must operate also controls risk.

The 2009 Regulations require the Pension Fund to describe how it measures and manages risk.

Risk is measured, in part, by the administering authority's risk management section as part of its assessment of the County Council's risks, and is reviewed as part of the independent Governance review undertaken by the Pension Fund.

Realisation of Investments

The vast majority of the Pension Fund's investments are readily marketable and may be easily realised if required. Some investments may be less easy to realise in a timely manner but the total value of these types of investments is not considered to have any adverse consequences for the Pension Fund.

Approval has been given to investment as follows:

In-house Management

i. **Midland Enterprise Fund for the North East Exempt Unit Trust**

- Small, private and growing companies in the North East of England
- £200,000 invested.

ii. **Capital North East**

- Start up and development capital for businesses in the North East:
- £400,000 invested, up to £500,000 may be invested.

External Investment Management

The Pension Fund Committee has appointed seven investment managers to manage the remainder of the Pension Fund's assets. They have been appointed under the terms of the Regulations and their roles are described in the Investment Policy in Appendix B.

Allocation Strategy

Having considered advice from the Independent Advisers, and also having due regard for the objectives, the liabilities of the Pension Fund and the risks facing the Pension Fund, the Pension Fund Committee have decided upon the following strategic target asset allocation:

Asset Class	Permitted Assets	Benchmark & Performance Target	Proportion of Total Fund *
Conventional Bonds	Investment grade sterling bonds	FTSE Over 5 Year Index-Linked Gilt Index +0.5%	20%
Broad Bonds	Global bonds	UK 3-month LIBOR +3.0%	15%
Global Equities	Global Equities	MSCI All Country World Index (unhedged) in GBP terms +3% MSCI World index +2.5%	15% 15%
Emerging Market Equities	Emerging Market Equities	MSCI Emerging Markets Net Index +2.5%	7%
Dynamic Asset Allocation	All major asset classes with the ability to take derivative positions	UK 3-month LIBOR +3.0%	20%
Global Property	Global property	UK Retail Price Inflation +5.0%	8%

* Excluding in-house managed funds

More detailed definitions of the mandates are given at Appendix B.

The Pension Fund Committee and the Corporate Director Resources, in conjunction with the Independent Advisers, will formally monitor the actual asset allocation of the Pension Fund on a quarterly basis.

Stock Selection

Individual investments are chosen by the Investment Managers with the Pension Fund Committee, Corporate Director Resources and independent external advisers able to question the investment managers on their actions at each quarterly meeting.

Cash Management

The administering authority will invest the short term cash balances on behalf of the Pension Fund. This will be done in line with the administering authority's Treasury Management Policy and interest will be paid quarterly to the Pension Fund.

Investments Requiring Prior Approval

Subject to changes and agreements with Investment Managers, as included at Appendix B, a detailed report must be submitted to and approved by the Pension Fund Committee prior to making investments in the following:

- Private equity/ Venture capital funds and enterprises
- Commodities
- Stock lending
- Currency Hedging - agreed in principle, subject to prior consultation with the Corporate Director Resources.

Socially Responsible Investing

The Pension Fund Committee must act with the best financial interests of the beneficiaries, present and future, in mind. The Pension Fund Committee believes that companies should be aware of the potential risks associated with adopting practices that are socially, environmentally or ethically unacceptable. As part of the investment decision-making process, Investment Managers are required to consider such practices and assess the extent to which this will detract from company performance and returns to shareholders.

Corporate Governance

Investment Managers are required to exercise voting rights on behalf of the Pension Fund when it is in the best interests of the Pension Fund. The quarterly report from investment managers should include details of voting activity.

Fee Structure

The Investment Managers' fees are based on the value of assets under management. In the case of two investment managers, a performance related fee structure is in place based on a base fee plus a percentage of out-performance. In the case of the remaining investment managers an ad-valorem fee is payable.

Independent Advisers' fees are based on a retainer for attendance at Pension Fund Committee and Annual Meetings and the provision of advice to the Pension Fund Committee. Fees for any additional work are based on a daily or hourly rate, as provided for by agreement or by separate arrangement.

Any additional work will be subject to a suitable fee arrangement or subject to separate tendering exercises.

The administering authority fee for Treasury Management will be based upon a flat fee for the service provided to the Pension Fund.

Reporting Requirements

The investment managers must report quarterly on matters covered in their individual agreements, but should include common items such as:

- Investment Managers' views on the UK or other relevant economies and the proposed asset allocation for the past, present and future quarter.
- Reports on any new investment policy issues requiring the approval of the Pension Fund Committee.
- Performance during the previous quarter, previous twelve months, three years and five years.
- A Portfolio valuation, including details of individual holdings.
- Investment transactions schedule for the previous quarter.
- Portfolio distribution and the changes in the markets - summarised by:
    - type of investment;
    - sector
    - geographic area as appropriate.
- Performance of any collective investment funds or internal pooled funds in which investments are held.
- Underwriting commitments relevant to the Portfolio.
- The cash position of the Pension Fund.
- Voting actions and forthcoming activity.
- Any material matters reported to the Financial Conduct Authority (FCA) or such other appropriate authority, in respect of the Portfolio or which reasonably might be brought to the attention of the Pension Fund Committee.
- Any material matters in respect of the interface with the Custodian.
- Investment or ancillary activities carried out in relation to the Portfolio where there arose a material risk of damage to the interests of the

Pension Scheme or where a material risk of damage may arise in the future.

- Dealing errors and action taken.
- Any breach of confidentiality.
- Any breach of their Investment Management Agreement.

Quarterly, the Global Custodian must present a detailed report relating to the individual investment managers' fund performance and the combined fund performance.

- Principles

This appendix sets out the extent to which Durham County Council as the Administering Authority of the Durham County Council Pension Fund complies with the six principles of investment practice set out in the document published in November 2012 by CIPFA, the Chartered Institute of Public Finance and Accountancy, and called "Principles for Investment Decision Making and Disclosure in the Local Government Pension Scheme in the United Kingdom 2012", in future, compliance with guidance given by the Secretary of State will be reported.

Principle 1 — Effective decision-making

Fully compliant: Investment decisions are made by those with the skill, information and resources necessary to take them effectively. A programme covering investment issues is being developed for new members joining the Pension Fund Committee and training is provided to all members.

Principle 2 – Clear objectives

Fully compliant: The overall investment objective for the Pension Fund is set out in the Funding Strategy Statement.

Principle 3 – Risk and Liabilities

Fully compliant: The overall investment objective is considered by the Fund. The risks associated with the major asset classes in which the Fund's assets are invested is regularly considered. A risk register has been completed for the Pension Fund and reports from Internal and External Audit are considered by the Pension Fund Committee.

Principle 4 – Performance Assessment

Partial compliance: Appropriate benchmarks have been set in consultation with the independent advisers and the actuary. Benchmarks are considered regularly as part of the review of the Strategic Asset Allocation. Performance against benchmarks is considered quarterly at the Pension Fund Committee. Investment Managers' performance is measured quarterly. Separate monitoring of Pension Fund Committee performance and independent adviser performance has yet to be established.

Principle 5 – Responsible Ownership

Partial compliance: The Pension Fund's policy for socially responsible investing is set out in the Statement of Investment Principles.

Explicit written mandates agreed with all investment managers. Investment Managers are required to exercise voting rights on behalf of the Pension Fund when it is in the best interests of the Pension Fund. Normal practice is to allow the Investment Managers to follow their in-house voting policy unless otherwise instructed by the Pension Fund Committee. The mandates do not specifically incorporate the principle of the US Department of Labor Interpretative Bulletin on activism.

Principle 6 – Transparency and Reporting

Fully compliant: The Pension Fund Committee acts in a transparent manner, communicating with its stakeholders on issues relating to their management of investment, its governance and risks, including performance against stated objectives through the publication of Committee reports and Minutes on the County Council website. The Funding Strategy Statement and the Statement of Investment Principles are also available on the internet and are included in the Pension Fund's Annual Report and Accounts. The Annual Report and Accounts includes the statutory documents that the Pension Fund is required to provide.

The Pension Fund provides regular communication to scheme members in a Newsletter and Annual Statements which are considered the most appropriate form.

- Investment Managers

The Pension Fund Commitee currently has appointed seven Investment Managers: Aberdeen Asset Management ('Aberdeen'), AB (formerly AllianceBernstein Limited) ('AB'), BNY Mellon Investment Management Ltd ('BNY Mellon'), Mondrian Investment Partners Ltd ('Mondrian'), Royal London Asset Management ('RLAM'), CB Richard Ellis Collective Investors Limited ('CBRE') and BlackRock Investment Management (UK) Limited ('BlackRock') to manage the assets of the Pension Fund.

The current long-term strategic allocation is as follows (the actual allocation may vary due to market movements):

Investment Manager	%	Asset Classes	Investment Style
Aberdeen	15	Global Equities	Active
BNY Mellon	15	Global Equities	Active
Mondrian	7	Emerging Market Equities	Active
AB	15	Global Bonds	Active
RLAM	20	Investment grade sterling and non-sterling bonds	Active
CBRE	8	Global Property	Active
BlackRock	20	Dynamic Asset Allocation - all major asset classes with derivative overlay	Active

The investment restrictions detailed in this Appendix form part of the contractual agreement with Investment Managers and will only be varied after consultation with the Investment Managers in accordance with their contracts.

The Investment Manager may hold cash up to the value of 5% of the market value of the portfolio in respect of which the Investment Manager has been appointed, subject to agreements with individual Investment Managers, who may require a different limit to invest their part of the Pension Scheme's assets. Cash in excess of this value should be returned to Durham County Council as Administering Authority.

The mandates for each Investment Manager, subject to the overall requirements of the Regulations and this Statement of Investment Principles, are as follows:

Aberdeen

The Pension Fund Committee has appointed Aberdeen to manage a portfolio to be invested in active Global Equities.

The Investment Manager's objective is to outperform the benchmark by 3% per annum gross of fees over a rolling three year basis.

The benchmark allocation is as follows:

Asset Class	Benchmark
Global Equity	MSCI All Country World Index (unhedged)

Aberdeen intends to invest in the following to achieve their objective:

Portfolio	%
World Equity Fund	100

The Aberdeen World Equity Fund adopts an unconstrained approach to achieve its objective and as such does not maintain hard restrictions on stock, sector and country exposures. Internal guidelines though are used to assess risk against the benchmark:

	Range
Individual stock exposure	0 - 5% of total portfolio
Deviation in sector exposure	+ / - 15% from the benchmark
Deviation in country exposure	+ / - 35% from the benchmark
Cash holdings	Maximum of 5%

BNY Mellon

The Pension Fund Committee has appointed BNY Mellon to manage a portfolio to be invested in active Global Equities.

The benchmark allocation is as follows:

Asset Class	Benchmark
Global Equity	MSCI World

The Investment Manager's objective is to outperform the Index by 2.5% per annum gross of fees over a full market cycle.

BNY Mellon intends to invest in the following to achieve their objective:

Portfolio	%
Long Term Global equity Fund	100

The BNY Mellon Long Term Global Equity Fund is a UCITS fund and as such is required to adhere to UCITS Investment Guidelines. Additional restrictions imposed by BNY Mellon are:

	Range
Emerging Market equities	Maximum of 20%
Investments in Collective Investment Schemes	Maximum of 10%
Investments in bonds, convertibles, cash and money market instruments	Maximum of 25%
Cash holdings	Maximum of 5%

Mondrian

The Pension Fund Committee has appointed Mondrian to manage a portfolio to be invested in active Emerging Market Equities.

The benchmark allocation is as follows:

Asset Class	Benchmark
Emerging Market Equities	MSCI Emerging Markets Net Index

The Investment Manager's objective is to outperform the Index by 2.5% per annum gross of fees over a full market cycle.

Mondrian intends to invest in the following to achieve their objective:

Portfolio	%
Emerging Market Equities	100

There are limitations that apply with the construction of the Mondrian portfolio. They are as follows:

	Range
Investments in REITS	Maximum of 20% (client to be informed at any greater than 10%)
Individual Securities	Maximum of 5% in single stock
Sector restrictions	Maximum of 25% of portfolio in single industry
Cash holdings	Maximum of 5%

AB

The Pension Fund Committee has appointed AB to manage a portfolio to be invested in Global Bonds.

The Investment Manager's objective is to outperform the benchmark by 3% per annum net of fees over a rolling three year basis, with 5 – 10% volatility.

The benchmark allocation is as follows:

Asset Class	Benchmark
Broad Bonds	UK 3-month LIBOR

AB intend to invest in the following to achieve their objective:

Portfolio	%
Diversified Yield Plus Fund	100

AB can use a wide variety of financial instruments to generate returns within the portfolio.

AB intends to make use of financial derivative instruments and shall employ the Value-at-Risk (VaR) approach to measure risk associated with the use of such instruments. The Diversified Yield-Plus strategy employed by AB anticipates VaR exposure of less than or equal to 5%, as calculated by AB or its delegates. VaR reports will be produced and monitored on a daily basis based on the following criteria:

- 1 month holding period
- 99% confidence level.

The limitations that apply to the investments are detailed below:

Sector	Range
High Yield	0% to 30%
Emerging Markets	0% to 20%
Foreign Exchange	0% to 30% gross, 0% to 15% net
Sovereign	0% to 100%
MBS	0% to 40%
CMBS/ABS	0% to 30%
Investment- Grade Corporates	0% to 75%

Up to 100% of the Portfolio may be invested in Unit-linked Insurance Contracts issued by Associates of the Investment Manager. Direct investment in Collective Investment Schemes (CIS) is subject to prior approval.

RLAM

The Pension Fund Committee has appointed RLAM to manage a portfolio to be invested in Investment Grade Bonds.

The Investment Manager's objective is to outperform the benchmark by 0.5% per annum net of fees over a rolling three year basis.

The benchmark allocation is as follows:

Asset Class	Benchmark
Conventional Bonds	FTSE Over 5 Year Index-Linked Gilt Index

RLAM intend to invest in the following to achieve their objective:

Portfolio	%
Segregated - with a specified range of +/- 2 years duration of the benchmark, mainly index-linked securities	100

RLAM can invest in a wide variety of bonds to generate returns within the Fund. The limitations to the extent of the investments in each classification are detailed below:

Bond classification	Range
UK Government Index Linked Bonds	50% to 100%
Overseas Government Index-Linked Bonds*	0% to 20%
UK Non-Government Index Linked Bonds	0% to 20%
UK Conventional Government Bonds	0% to 20%
UK Investment Grade Corporate Bonds (or equivalent)	0% to 20%
Overseas Conventional Bonds**	0% to 10%
Derivatives***	0%
Cash or cash equivalents (less than 1 year maturity)	0% to 10%

*Includes government and non-government bonds

**Includes government and corporate bonds and Currency hedged into sterling.

***Derivatives may only be used for the purpose of hedging currency risk.

There are limits on the holding of the following asset classes:

Asset Class	Maximum Holding
Collective Investment Schemes (CIS)	0% of the Portfolio or as otherwise advised in writing from time to time
Any single security excluding government bonds	Maximum of 5% of portfolio

CBRE

The Pension Fund Committee has appointed CBRE to manage a portfolio to be indirectly invested in Property. Investment will not be restricted to UK vehicles, but can be invested globally as well as a pan-European basis.

The Investment Manager's objective is to outperform the benchmark by 5% per annum net of fees to be achieved over a five year time horizon.

The benchmark allocation is as follows:

Asset Class	Benchmark
Global Property	UK Retail Price Inflation

CBRE intend to invest in the following to achieve their objective:

Portfolio	%
CB Richard Ellis RPI +5%	100

There are limitations that apply with the construction of the CBRE portfolio. They are as follows:

Restrictions	Range
Collective Investment Schemes (CIS)	0% to 50% until notified in writing and thereafter 0% to 100%
Maximum allocation to any single fund	0% to 15%
Maximum allocation to listed investments	0% to 30%
Maximum allocation to any single country (including the UK)	0% to 25%
Maximum regional allocations:	
Asia Pacific Region	0% to 40%
North American Region	0% to 45%
Other Regions (excluding Europe)	0% to 10%

In the case of Collective Investment Schemes (CIS) taken on at the Effective Date, the requirement shall be that the Investment Manager liquidate these assets at a time that is appropriate in the reasonable opinion of the Investment Manager. There is no long stop date on this process.

BlackRock

The Pension Fund Committee has appointed BlackRock to manage a portfolio to be invested in a fully diversified Global portfolio. It is expected that target return will be delivered using dynamic asset allocation over the market cycle incorporating the full range of global investment opportunities.

The Investment Manager’s objective is to outperform the benchmark by 3% per annum net of fees over a rolling three year basis.

The benchmark allocation is as follows:

Asset Class	Benchmark
Multi asset	3-month LIBOR

BlackRock intend to invest in the following to achieve their objective:

Portfolio	%
Dynamic Diversified Growth Strategy	100

BlackRock can use a wide variety of asset classes to generate returns within the Fund.

The objective of the strategy is to deliver long term consistent growth with low volatility and a strong focus on downside protection. The risk profile is typically one third to one half of equity market risk.

The limitations to the extent of the investments in each classification are detailed overleaf:

Sector	Range / Restrictions
Leverage	The fund may not be leveraged through: • The use of borrowing to purchase additional investment; • Gaining aggregate market exposure (physical long positions plus net economic exposure gained through the use of derivatives) in exess of 100% NAV
High Yield Restriction	15% maximum
Property Restriction	15% maximum
Currency	Minimum GBP exposure of 60% of NAV Exposure of the Portfolio should not exceed + / - 30% of NAV to any single non GBP denominated currency
Maximum allocation to equity	65%

BlackRock are not permitted to hold the following Funds:

Fund
Aberdeen World Equity Fund
AB Diversified Yield Bond Plus Fund,
BNY Mellon Long Term Equity Fund