

London Borough of Waltham Forest Pension Fund

Funding Strategy Statement (FSS)

This Statement has been prepared by London Borough of Waltham Forest (the Administering Authority) to set out the funding strategy for the London Borough of Waltham Forest Pension Fund ("the LBWFPPF"), in accordance with Regulation 76A of the Local Government Pension Scheme Regulations 1997 (as amended) and the guidance papers issued in March 2004 and November 2004 by the Chartered Institute of Public Finance and Accountancy (CIPFA) Pensions Panel.

1. Introduction

The Local Government Pension Scheme (England and Wales) (Amendment) Regulations 2004 provide the statutory framework from which the Administering Authority is required to prepare a Funding Strategy Statement. The key requirements for preparing the FSS can be summarised as follows:

After consultation with all relevant interested parties involved with the LBWFPPF the administering authority will prepare and publish their funding strategy;

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

- the guidance issued by CIPFA for this purpose; and
- the Statement of Investment Principles (SIP) for the LBWFPPF published under Regulation 9A of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended);

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

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

The LBWFPPF is a defined benefit final salary scheme under which the benefits are specified in the governing legislation (the Local Government Pension Scheme Regulations 1997 (as amended), "the Regulations"). The required levels of employee contributions are also specified in the Regulations. Changes to the scheme benefits from 1st April 2008 are specified in the Local Government Pension Scheme Regulations (Benefits, Membership, and Contributions) Regulations 2007 (As Amended). Provisions dealing with transition to the new scheme are specified in the Local Government Pension Scheme Transitional Provisions Regulations 1997 (As Amended).

Employer contributions are determined in accordance with the Regulations (principally Regulation 77) which require that an actuarial valuation is completed every three years by the actuary, including a rates and adjustments certificate. Contributions to the LBWFPPF should be

set so as to “secure its solvency”, whilst the actuary must also have regard to the desirability of maintaining as nearly constant a rate of contribution as possible. The actuary must have regard to the FSS in carrying out the valuation.

2. Purpose of the FSS in policy terms

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

The purpose of this Funding Strategy Statement is:

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

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

3. Aims and purpose of the LBWFPP

The aims of the LBWFPP are to:

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

The purpose of the LBWFPP is to:

- receive monies in respect of contributions, transfer values and investment income, and
- pay out monies in respect of scheme benefits, transfer values, costs, charges and expenses,

as defined in the Local Government Pension Scheme Regulations 1997 (as amended), the Local Government Pension Scheme Regulations (Benefits, Membership, and Contributions) Regulations 2007 (As Amended), the Local Government Pension Scheme Transitional Provisions Regulations 1997 (As Amended), and in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended).

4. Responsibilities of the key parties

The Administering Authority should:

- collect employer and employee contributions
- invest surplus monies in accordance with the Regulations
- appoint, terminate and monitor the performance of investment managers
- ensure that cash is available to meet liabilities as and when they fall due
- manage the valuation process in consultation with the LBWFPP's actuary
- prepare and maintain an FSS and a SIP, both after due consultation with interested parties
- prepare the annual report and accounts for the LBWFPP and arrange for the actuary to provide FRS17 solvency statements for the separate employers in the LBWFPP
- monitor all aspects of the LBWFPP's performance and funding and amend the FSS/SIP as and when appropriate
- review the investment strategy of the LBWFPP
- appoint, terminate and monitor the performance of the providers for additional voluntary contributions, and
- manage the appointment and relationships with the administrators in a manner consistent to support the above.

The Individual Employer should:

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

The Fund actuary should:

- prepare valuations including the setting of employers' contribution rates after agreeing assumptions with the Administering Authority and having regard to the FSS
- prepare advice and calculations in connection with bulk transfers and individual benefit-related matters
- advise on funding strategy, the preparation of the FSS, and the inter-relationship between the FSS and the SIP, and

- prepare annual FRS17 solvency statements for the employers in the LBWFPF, where required.

5. Solvency Issues and Target Funding Levels

The funding objective

To meet the requirements of the Regulations the Administering Authority's long term funding objective is for the LBWFPF to achieve and then maintain sufficient assets to cover 100% of projected accrued liabilities (the "**funding target**") assessed on an ongoing basis including allowance for projected final pay.

Determination of the funding target and recovery period

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

Underlying these assumptions are the following two tenets:

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

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

All costs in relation to early retirements (including those due to ill health) will be funded as they occur over a maximum period of 3 years. These costs will be assessed on the basis of the actuary's advice.

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

- A maximum deficit recovery period of 20 years will apply. Employers will have the freedom to adopt a recovery plan on the basis of a shorter period if they so wish. A shorter period may be applied in respect of particular employers where the Administering Authority considers this to be warranted (see Deficit Recovery Plan below).
- Where increases in the rates of contribution are required, these may be implemented in steps, over a period of 3 years unless it has been agreed otherwise with the Administering Authority.
- On the cessation of an employer's participation in the LBWFPF, the actuary will be asked to make a termination assessment. Any deficit in the LBWFPF in respect of the employer will be due to the LBWFPF as a termination contribution, unless it is agreed by the Administering Authority and the other parties involved that the assets and liabilities relating

to the employer will transfer within the LBWFPPF to another participating employer. Details of the approach to be adopted for such an assessment on termination will be set out in the separate Admission Bodies Policy document to be agreed with the actuary in due course.

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

- the responses made to the consultation with employers on the FSS principles
- relevant guidance issued by the CIPFA Pensions Panel
- the need to balance a desire to attain the target as soon as possible against the short-term cash requirements which a shorter period would impose,
- the Government's aims as regards increases in local authority pension costs, as set out in the letter from the Office of the Deputy Prime Minister dated 10 September 2004, and
- the Administering Authority's views on the strength of the participating employers' covenants in achieving the objective.

Deficit recovery plan

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

Additional contributions will be expressed as a level percentage of pensionable payroll, unless arrangements are made otherwise in relation to any particular employer(s).

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

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

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

The normal cost of the LBWFPPF (future service contribution rate)

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

6. Link to investment policy set out in the Statement of Investment Principles

The results of the 2007 valuation show the liabilities to be 70% covered by the current assets, with the funding deficit of 30% being covered by future deficit contributions due from employers.

In assessing the value of the LBWFPP's liabilities above, allowance has been made for asset out-performance as described in Section 5 and the Appendix, taking into account the investment strategy adopted by the LBWFPP, as set out in the SIP.

It is not possible to construct a portfolio of investments which produces a stream of income exactly matching the expected liability outgo. However, it is possible to construct a portfolio which closely matches the liabilities and represents the least risk investment position. Such a portfolio would consist of a mixture of long-term index-linked and fixed interest gilts.

Investment of the LBWFPP's assets in line with the least risk portfolio would minimise fluctuations in the LBWFPP's ongoing funding level between successive actuarial valuations.

If, at the valuation date, the LBWFPP had been invested in this portfolio, then in carrying out the valuation it would not be appropriate to make any allowance for out-performance of the LBWFPP investments. On this basis of assessment, the assessed value of the LBWFPP's liabilities at the 2007 valuation would have been significantly higher, by approximately 28% and the declared funding level would be correspondingly reduced to approximately 55%.

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

The overall investment strategy of the LBWFPP is set out in the Statement of Investment Principles.

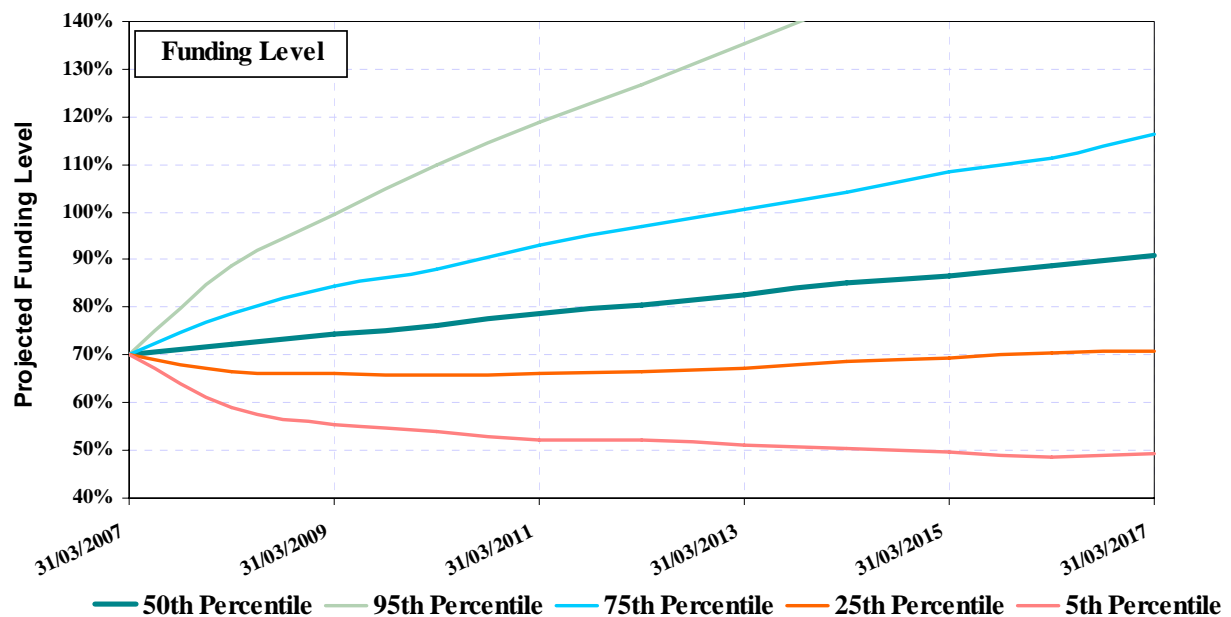
7. Identification of risks and counter-measures

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

The Administering Authority has been advised by the actuary that the greatest risk to the LBWFPP's funding is the investment risk inherent in the predominantly equity-based strategy, so that actual asset out-performance between successive valuations could diverge significantly from that required on the basis of the 2007 valuation assumptions.

The chart below shows a "funnel of doubt" funding level graph, which illustrates the range and uncertainty in the future progression of the funding level, relative to the funding target adopted at the valuation. Using a simplified model, the chart shows the probability of exceeding a certain funding level over a 10 year period from the valuation date. For example, the top line shows the 95th percentile level (i.e. there is a 5% chance of the funding level at each point in

time being better than the funding level shown, and a 95% chance of the funding level being lower.)



The Administering Authority's overall policy on risk is to identify all risks to the LBWFPF, and take appropriate action to limit the impact of these both before, and after, they emerge wherever possible. The main risks to the LBWFPF are:

Financial

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

Demographic

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

Regulatory

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

Governance

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

The Administering Authority's policy is to require regular communication between itself and employers, and to ensure regular reviews of those items identified above.

8. Monitoring and Review

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

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

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

- if there has been a significant change in market conditions, and/or deviation in the progress of the funding strategy
- if there have been significant changes to the LBWFPP membership, or LGPS benefits
- if there have been changes to the circumstances of any of the employing authorities to such an extent that they impact on or warrant a change in the funding strategy
- if there have been any significant special contributions paid into the LBWFPP.

Appendix

Actuarial Valuation as at 31 March 2007

Method and assumptions used in calculating the funding target

Method

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

Financial assumptions

Investment return (discount rate)

A yield based on market returns on UK Government gilt stocks and other instruments which reflects a market consistent discount rate for the profile and duration of the LBWFPP's accrued liabilities, plus an Asset Out-performance Assumption ("AOA") of 2.0% p.a. for the period pre-retirement and 1% p.a. post-retirement.

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

Individual Employers

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

Inflation (Retail Prices Index)

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

Salary increases

The assumption for real salary increases (salary increases in excess of price inflation) will be determined by an allowance of 1.5% p.a. over the inflation assumption as described above. This includes allowance for promotional increases.

Pension increases

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

Mortality

The mortality assumptions will be based on the most up-to-date information published by the Continuous Mortality Investigation Bureau, making allowance for future improvements in longevity and the experience of the LBWFPP. The mortality tables used are PA92 Year of Birth tables with medium cohort improvements, with an age rating reflecting fund specific experience of +2 years.

Members who retire on the grounds of ill health are assumed to exhibit average mortality equivalent to that for a good health retiree at an age 5 years older.

Method and assumptions used in calculating the cost of future accrual

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

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

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

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

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

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

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

| | |
|---|---|
| Long-term gilt yields | |
| Fixed interest | 4.4% p.a. |
| Index linked | 1.3% p.a. |
| Implied RPI price inflation | 3.1% p.a. |
| Past service Funding Target financial assumptions | |
| Investment return pre-retirement | 6.4% p.a. |
| Investment return post-retirement | 5.4% p.a. |
| Salary increases | 4.6% p.a. |
| Pension increases | 3.1% p.a. |
| Future service accrual financial assumptions | |
| Investment return | 6.5% p.a. |
| RPI price inflation | 2.75% p.a. |
| Salary increases | 4.25% p.a. |
| Pension increases | 2.75% p.a. |
| Demographic assumptions | |
| Non-retired members' mortality | PA92 MC YoB tables + 2 years (+7 years for retirements in ill health) |
| Retired members' mortality | PA92 MC YoB tables + 2 years (+7 years for retirements in ill health) |
| Commutation | One half of members take maximum lump sum, others take 3/80ths |

Assumptions used in calculating contributions payable under the recovery plan

Investment return on existing assets and future contributions

A **maximum** overall return effective as at the valuation date of 6.9% p.a. (i.e. a total return of 2.5% p.a. in excess of gilts) reflecting the underlying investment strategy of the LBWFPP and, in particular, including the assets of the LBWFPP that underlie the pensioner as well as the non-pensioner liabilities.

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

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