Pensions Committee

2.00pm, Wednesday, 24 June 2020

Funding Strategy Statement

Item number 5.8

1. Recommendations

The Pensions Committee (Committee) is requested to:

1.1 note that the Fund will consult with its employers on this revised draft Funding Strategy Statement; and

1.2 approve the draft revised Funding Strategy Statement, subject to any further amendment arising from the forthcoming employer consultation being reported to Committee at its next meeting.

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Funding Strategy Statement

2. Executive Summary

2.1 The Lothian Pension Funds' Funding Strategy Statement has been reviewed to set out a revised approach to setting employer contributions. It is proposed that a risk-based approach will now be used. This risk-based approach will take into consideration specific employer circumstances including employer covenants. A further change is that experience will no longer be shared for smaller employers open to new entrants. This means there will be no small employer pool and such employers will have contribution rates calculated on an individual basis for the first time.

2.2 Other changes have also been made to reflect the previously agreed revised Contribution Stability Mechanism and on a change in approach for employers which have exited the Fund.

2.3 As required under the Local Government Pension Scheme (Scotland) Regulations, a consultation exercise will be carried out with the Fund's employers following Committee.

3. Background

3.1 The Funding Strategy Statement (FSS) is a policy document which summarises the approach to funding the pension liabilities of the Lothian Pension Fund and the Scottish Homes Pension Fund. This includes coverage of:

- employer admissions;
- bulk transfers;
- employers leaving the fund; and
- charging.

3.2 The FSS is formulated under guidance issued by the Chartered Institute of Public Finance and Accountancy (CIPFA) which states that the FSS must be reviewed formally at least every three years and in advance of completion of the triennial valuation. The valuation sets employer contribution rates within the framework provided by the FSS. The FSS should also be reviewed if there are any material changes in the policy set out in the FSS.

3.3 The FSS was last reviewed and updated in March 2019 following the introduction of the Local Government Pension Scheme (Scotland) Regulations 2018. Changes were also made to the Bulk Transfer policy at that time.

3.4 The draft revised FSS is attached as Appendix 1 to this report.

4. Main Report

Funding Strategy Statement – review in advance of Actuarial Valuation 2020

4.1 As was the case in 2017, consideration of proposed changes to the FSS, along with the required employer consultation, is being undertaken at a much earlier stage in the actuarial valuation process than had historically been the case. The advantage is that clarity can be attained from the Fund's key stakeholders on the funding principles, prior to the issue of draft results (minimum contribution rates) to individual employers.

Setting employer contribution rates

4.2 Following consultation with the Actuary, the Fund intends to introduce a revised approach to setting employer contribution rates. This risk-based approach will take into consideration specific employer circumstances including employer covenants.

4.3 Previously, formal valuations of the Fund were a calculation exercise with contribution rates being set for all employers (except for those participating in the Fund's Contribution Stability Mechanism) based on a single set of assumptions - a 'deterministic approach'. The disadvantage of a deterministic approach is that it does not allow the Fund, employer or Fund Actuary to assess the risk associated with the proposed contribution rate. Risk in this context means the likelihood that the employer will achieve its funding target over the agreed period.

4.4 With increased scrutiny on the LGPS, and the requirement to consider covenant strength of the employer when setting contributions, there is an increased focus on using the valuation as an opportunity to assess risk. Therefore, we intend to work with the Fund Actuary to adopt a 'risk-based' approach to setting contributions for all employers for contributions payable from 1 April 2021. The risk-based approach is a 'stochastic methodology', which allows for thousands of future economic scenarios (rather than a single set of assumptions). This allows the Fund to quantify the risk of an employer meeting its funding target, e.g. if the employer meets or exceeds its funding target in 4,000 out of 5,000 possible future economic scenarios, there would be an 80% chance of the employer meeting its funding target.

4.5 The risk-based approach sets a contribution strategy where the likelihood (probability) of meeting the funding target at the end of a specified time horizon is suitable for a given employer, based on its individual circumstances (employer type, covenant etc.). The following parameters will be set for each employer:

1. The funding target is based on a set of ongoing assumptions about the future (e.g. investment returns, inflation, pensioners' life expectancies). If an employer is approaching the end of its participation in the Fund then its

funding target may be set on a more prudent basis, so that its liabilities are less likely to be spread among other employers after its cessation.

2. The time horizon required over which the funding target is achieved. Employers may be given a lower time horizon if they are closed to new entrants, or do not have tax-raising powers to increase contributions if investment returns under-perform.
3. The likelihood of achieving the funding target over that time horizon will be dependent on the Fund's view of the strength of employer covenant and its funding profile. Where an employer is considered to have weaker financial strength then the required likelihood will be set higher, which in turn will increase the required contributions (and vice versa).

4.6 Fund officers will discuss the parameters to be used for each employer alongside reviewing the initial employer results with the Fund Actuary, and report back to the Pensions Committee in December 2020.

Pooling of small employers

4.7 The Fund currently operates a contribution pool for small admitted bodies who are open to new entrants, allowing for experience (particularly ill-health experience) to be shared when contribution rates are set. However, the introduction of the low-risk and medium-risk investment strategies in 2015 and 2018 respectively, together with an increased number of small employers electing to leave the Fund means that the pool has become smaller in each successive triennial valuation. As such, the benefits provided by pooling have reduced. More fundamentally, however, the Fund no longer considers that it is equitable, or desirable, to perpetuate a funding arrangement where inevitably, through the operation of contribution pooling, some employers effectively subsidise others, typically for the three-year duration of the actuarial valuation as a minimum.

4.8 It is proposed therefore that the Fund no longer operates any kind of pooling mechanism and instead all employers currently part of the pool will instead have contribution rates set based on their own specific circumstances. Such employers will remain in the primary investment strategy and will also be required to confirm that contribution rates set by the Actuary are not unaffordable.

Employer exits

4.9 When an employer exits the Fund, the Scheme regulations require that an exit valuation is carried out. Unless the employer is a transferee admission body (or is treated as such due to the nature of their admission to the scheme), the exit valuation is carried out on a prudent basis. Once the exit valuation has been completed, assets and liabilities for the exiting employer currently remain part of the low-risk strategy which is invested primarily in index-linked government bonds.

4.10 Once an exit valuation has been carried out, the Fund is unable to obtain any further monies from the exiting employer. Instead, if the assumptions made when calculating the exit valuation are incorrect and the liabilities exceed assets, the guarantor/aligned body of the exiting employer will be responsible for these liabilities. To offer potential for the Fund to maximise its long-term return on investment assets, it is proposed that following exit, assets and liabilities of an exiting employer will be moved to the primary strategy, unless the relevant guarantor/aligned body states otherwise.

Contribution Stability Mechanism

4.11 The FSS has also been updated to include details of the revised contribution stability mechanism (CSM) which was approved by Committee in December 2019.

As a reminder, the revised CSM states that for those employers offered stability. rates will be frozen at the current rate for 4 years from 1 April 2021 and will then increase/decrease by no more than 0.5% per year. The aim will be to maintain a total contribution rate for all stabilised employers of between previously agreed parameters. There may be specific employer circumstances which will merit the Actuary certifying a contribution rate outside these parameters, which will be applied at the discretion of the Fund.

Suspension notices

4.12 The FSS has been updated to clarify the position should the Fund exercise its discretion and issue a suspension notice to an employer leaving the Fund. Issuing a suspension notice suspends the employer's liability to make an exit payment at the time of payment. In these cases, the employer must continue to make contributions to the Fund at a level agreed by the Fund and its Actuary. At the end of the suspension period, a further exit valuation will be carried out.

4.13 The Policy on Employers Leaving the Fund (Appendix C) has been amended to confirm that the further exit valuation will be carried out based on the relevant market conditions, asset values and updated membership data at the time the suspension period comes to an end.

4.14 This means that investment and other experience risks during the suspension period will be borne by the employer rather than the Fund.

Other changes

4.15 Following the judgement made in the McCloud case in 2018, and subsequent confirmation that this applied to all public sector pension schemes, the benefit structure of the Local Government Pension Scheme is being reviewed. The Policy on Employers Leaving the Fund (Appendix C) has been amended to confirm that until clarity on a remedy is available, a loading factor will be applied to exit valuations.

4.16 The FSS has also been refreshed in line with the fund's new 'Style Guide'.

Consultation with Employers

4.17 As required under the Scheme Regulations, following Committee approval of the draft FSS, the fund will carry out a consultation exercise with employers.

4.18 Feedback from the consultation exercise will be presented to Committee. Any substantial amendments be required following the consultation will be included in the final updated FSS to be presented to Committee for approval in March 2021.

5. Financial impact

5.1 The funding strategy should ensure that the Fund has sufficient assets in the long term to meet its liabilities.

6. Stakeholder/Regulatory Impact

6.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the fund and they are invited to comment on the relevant matters at Committee meetings.

6.2 There are no adverse governance, compliance or regulatory implications as a result of this report.

7. Background reading/external references

7.1 None.

8. Appendices

Appendix 1 - Draft Revised Funding Strategy Statement

Appendix 1

LOTHIAN PENSION FUND

Funding Strategy Statement

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1. INTRODUCTION

This is the Funding Strategy Statement (FSS) of Lothian Pension Fund ("the Fund"). It is prepared and maintained by the City of Edinburgh Council, the Administering Authority for the Fund, in consultation with the Fund's Actuary and following a period of consultation with participating employers.

The FSS is a summary of the Fund's approach to funding liabilities. It is not an exhaustive statement of policy on all issues.

This FSS is produced in accordance with the Chartered Institute of Public Finance & Accountancy (CIPFA) revised statutory guidance "Preparing and maintaining a funding strategy statement in the Local Government Pension Scheme (LGPS) 2016", which affirms the FSS as being a key part of a pension fund's risk management framework.

This statement was agreed by the Pensions Committee on [•] March 2021 and is effective from 1 April 2021. It replaces all previous Funding Strategy Statements and policies on funding.

1.1 Maintenance

The Administering Authority will review the FSS every three years in conjunction with actuarial valuations or more frequently if considered appropriate

1.2 Availability

This document is available on the Fund's website (www.lpf.org.uk).

2. PURPOSE OF THE FUNDING STRATEGY STATEMENT

CIPFA's 'Preparing and maintaining a funding strategy statement in the Local Government Pension Scheme 2016' states that the purpose of the FSS "is best defined by reference to the discussion paper issued by the Office of the Deputy Prime Minister (ODPM) on 23 July 2003, 'Local Government Pension Scheme – Strategy Proposals: Stocktake Discussion Paper – Funding Strategy Statement Proposals', namely:

1. to establish a clear and transparent fund-specific strategy that will identify how employers' pension liabilities are best met going forward;
2. supports the desirability of maintaining as nearly constant a primary contribution rate as possible; and
3. takes a prudent longer-term view of funding those liabilities.

These objectives are desirable individually - but may be mutually conflicting.

The FSS shall also ensure that the regulatory requirements to set contributions to ensure the solvency and long-term cost efficiency of the fund, as defined by the Public Service Pensions Act 2013, are met.

The statement and appendices set out how the Administering Authority balances the potentially conflicting aims of affordability of contributions, transparency of process, stability of employers' contributions, and prudence in the funding basis. Specific clarity is provided as to the Fund's policies in respect of:

1. employers being admitted to the Fund;
2. employers leaving the Fund (exits);
3. bulk transfers; and
4. the charging for services and recovery of costs incurred.

2.1 Regulatory Framework

Pension benefits accrued by members of Lothian Pension Fund are determined by statute.

The contributions paid by the members of the Fund are fixed in the Scheme Regulations. Employers pay the balance of the cost of delivering the benefits, however, in line with the requirements of the Public Service Pensions Act 2013, the Scheme Regulations incorporate a cost sharing mechanism to ensure sustainability of the Scheme over the long term.

The FSS focuses on the pace at which employers pay for the benefits i.e. the approach used to determine contribution rates. It forms part of a framework that includes:

- the Local Government Pension Scheme) (Scotland) Regulations 2018 (as amended), the Local Government Pension Scheme (Governance) (Scotland) Regulations 2015 and the LGPS (Management and Investment of Funds) (Scotland) Regulations 2010;
- the Pensions Committee, the Pensions Audit Sub-Committee and the Pension Board;

- the Rates and Adjustments Certificate, which can be found appended to the Fund Actuary's valuation report;
- actuarial factors for valuing early retirement costs and the cost of buying extra service; and
- the Fund's Annual Report, including the Annual Governance Statement, the Governance Compliance Statement and the Statement of Investment Principles.

This is the framework within which the Fund's Actuary carries out triennial valuations to set employers' contributions and provides recommendations to the Administering Authority when other funding decisions are required, such as when employers join or leave the Fund.

3. AIMS AND PURPOSE OF THE FUND

3.1 Aims of the Fund

The aims of the Fund are to:

- manage employers' liabilities effectively and ensure that sufficient resources are available to meet all liabilities as they fall due;
- seek returns on investment within reasonable risk parameters; and
- enable primary contribution rates to be kept as nearly constant as possible and (subject to the administering authority not taking undue risks) at reasonable cost to scheduled and admitted bodies, whilst achieving and maintaining fund solvency and long-term cost efficiency. This should be assessed taking appropriate cognisance of the risk profile of the fund and employers and the risk appetite of the administering authority and employers alike.

3.2 Purpose of the Fund

The Fund provides benefits to members and their dependants. The purpose of the Fund is to:

- receive monies in respect of contributions, transfer payments and investment income and recover costs and charges, pay pension benefits, transfer values and administration costs, charges and expenses; and
- make investments to meet the future costs of pension promises made to members of the Scheme.

4. AIMS AND RESPONSIBILITIES OF THE KEY PARTIES

The sound and effective management of the Fund can only be achieved if all interested parties exercise their statutory responsibilities conscientiously. Although a number of these parties, including investment managers and external auditors, have a responsibility to the Fund, the following may be considered of particular relevance to the funding strategy:

4.1 The Administering Authority should:

- operate the Fund as per the Regulations;
- collect and account for employer and employee contributions, investment income and other amounts due to the Fund as stipulated in the Scheme regulations;
- invest surplus monies in accordance with the regulations;
- ensure that sufficient cash is available to meet liabilities as and when they fall due;
- pay relevant benefits from the Fund as set out in the Scheme regulations;
- manage the actuarial valuation process in consultation with the Fund's Actuary, including providing all required data and employer covenant analysis;
- prepare and maintain a Funding Strategy Statement and Statement; of Investment Principles after proper consultation with interested parties;
- monitor all aspects of the Fund's performance and funding, and amend the Funding Strategy Statement/Statement of Investment Principles accordingly;
- take measures as set out in the Scheme regulations to safeguard the Fund against the consequences of employer default;
- effectively manage any potential conflicts of interest arising from its dual role as both Fund administrator and scheme employer;
- manage any exit valuation in consultation with the Fund's Actuary;
- prepare and maintain admission, exit, bulk-transfer and charging policies. The admission, exit and charging policies are included in this document,
- enable the Pension Board to review the valuation process as set out in their Constitution; and
- fulfil all other duties as specified in Lothian Pension Fund's Pensions Administration Strategy – available in the 'Publications' section of the Fund's website www.lpf.org.uk

4.2 The individual Employers should:

- calculate an employee's contribution rate and deduct the correct contributions from members' salaries;
- pay employee and employer contributions to the Administering Authority on a timely basis and provide appropriate supporting documentation in a format and timescale specified by the Fund;
- develop and maintain a policy where discretion can be exercised within the regulatory framework (e.g. granting enhanced benefits) bearing in mind costs;
- make additional contributions, in accordance with agreed arrangements, for example, award of additional pension and early retirement strain costs;
- notify the Administering Authority promptly of organisation changes for example, changes in ownership or structure, TUPE transfers which could affect future funding;
- notify the Administering Authority of a possible ending of its admission agreement/participation in the Fund within the terms of that agreement or otherwise as required by the Regulations (typically a 3 month notice period is required), including closed employers where the last employee member is leaving (whether due to retirement, death or otherwise leaving employment);

- pay any exit payments due on ceasing participation in the Fund in line with provisions set out in the Fund's Policy on employers leaving the Fund (see Appendix C);
- meet costs as specified in the Charging Policy (see Appendix D); and
- fulfil all other duties as specified in the Fund's Pensions Administration Strategy. This includes provision of all data required for effective administration and record-keeping, and payment of any charges levied by the Fund following poor performance by the employer.

4.3 The Fund Actuary should:

- prepare actuarial valuations to assess the solvency of the Fund and the required employers' contribution rates;
- engage with the Administering Authority in consultation processes;
- prepare advice and calculations in connection with bulk transfers and the funding aspects of individual benefit related matters such as pension strain costs, ill-health retirement costs, compensatory added years costs, etc.;
- provide advice and valuations on the on the exit of employers from the Fund;
- provide advice to the Administering Authority as required on bonds or other forms of security against the financial effect on the fund of employer default;
- assist the Administering Authority in assessing whether employer contributions need to be revised between valuations as required by the regulations; and
- ensure that the Administering Authority is aware of any professional guidance or other professional requirements that may be of relevance to his or her role in advising the Fund.

5. GENERAL FUNDING AND SOLVENCY ISSUES

5.1 Funding Principles

The cost of the benefits is not known in advance. The approach to funding determines the pace at which employers pay for the benefits and the ways in which the Fund ensures that it will have enough money to pay the benefits due to its members.

5.2 Solvency

The notes to the Public Service Pensions Act 2013 state that solvency means that the rate of employer contributions should be set at “such level as to ensure that the scheme’s liabilities can be met as they arise”.

It is not regarded that this means that the pension fund should be 100% funded at all times. Rather, and for the purposes of Section 13 of the Public Service Pensions Act 2013, the rate of employer contributions shall be deemed to have been set at an appropriate level to ensure solvency if they are set to target a funding level (assets divided by liabilities) for the whole fund of 100% over appropriate time periods and using appropriate actuarial assumptions.

If the conditions above are met, then it is expected that the Fund will be able to pay scheme benefits as they fall due.

The Fund’s Actuary is required to report on the solvency of the Funds and recommend future employer contribution rates every three years. In assessing the solvency and employer contribution rates, the Actuary must make a number of financial and demographic assumptions (see below). The solvency of the Funds and the contribution rates can be very sensitive to these assumptions.

In calculating solvency, the Actuary values the benefits using the assumptions described below. Assets are taken into account at their market value.

The Regulations specify the principles which must be used in the funding strategies. However, it is the responsibility of the Administering Authority, acting on the advice of the Fund’s Actuary, to determine the precise approach and the financial and demographic assumptions to be used in the actuarial valuation.

The principal issues facing the solvency of the Funds include the ability to finance liabilities as and when they arise, the rate or volatility in the rate of contribution paid by the employers, the pace at which deficits are recovered (or surpluses used up) and the returns on the Fund’s investments.

The Fund carries out annual employer covenant reviews to gather a range of key financial and non-financial information. This includes a request for details of funding sources and for annual financial statements to be provided. In addition, membership numbers are regularly reviewed to monitor membership maturity. The results of the covenant review are used to rank employers on risk level, with details being provided to the Fund’s Actuary to inform the actuarial valuation.

As required under Section 13(4)(c) of the Public Service Pensions Act, The Scottish Public Pensions Agency has appointed the Government Actuary's Department to report on whether the rate of employer contributions to the Fund is set at an appropriate level to ensure the solvency of the Fund and the long-term cost efficiency of the Scottish Local Government Pension Scheme, so far as relating to the Fund. Such reports must be made following each triennial valuation of the Fund.

When developing this Funding Strategy, the Administering Authority has had regard to the review under Section 13(4)(c).

5.3 Long term cost efficiency

The notes to the Public Service Pensions Act 2013 state "Long-term cost-efficiency implies that the rate must not be set at a level that gives rise to additional costs. For example, deferring costs to the future would be likely to result in those costs being greater overall than if they were provided for at the time".

The rate of employer contributions shall be deemed to have been set at an appropriate level to ensure long-term cost efficiency if the rate of employer contributions is sufficient to make provision for the cost of current benefit accrual, with an appropriate adjustment to that rate for any surplus or deficit in the fund.

In assessing whether the above condition is met, the review under Section 13(4)(c) may have regard to the following considerations:

- the implied average deficit recovery period
- the investment return required to achieve full funding over different periods, e.g. the recovery period
- if there is no deficit, the extent to which contributions payable are likely to lead to a deficit arising in the future
- the extent to which the required investment return is less than the administering authority's view of the expected future return being targeted by a fund's investment strategy, taking into account changes in maturity/strategy as appropriate.

5.4 Financial Assumptions and link to investment strategies

The key financial assumption in calculating the solvency and contribution rates is the rate of return which will be achieved on the Funds' investments. The Fund must be able to meet all benefit payments as and when they fall due. These payments will be met by contributions (resulting from the funding strategy) or asset returns (resulting from the investment strategy). To the extent that investment returns may be lower than expected, then higher contributions may be required from employers, and vice versa. Hence, the funding and investment strategy are inextricably linked.

The expected return is based on the yield on UK government bonds (gilts) at the time of the actuarial valuation. If appropriate, allowance is made for the fact that the

investment strategy includes assets other than gilts which are expected, over the long term, to deliver a higher return for the Fund.

The discount rate(s) adopted in the actuarial valuation is derived by considering the expected rate of investment return which is anticipated to be achieved by the underlying investment strategy.

The Funds invest in assets other than gilts in order to reduce the cost to the employers in the long term, subject to the alignment to the expected duration and admission basis of the individual employer's membership. However, the investments are not guaranteed to deliver returns in excess of gilts. This means that the funding level can be volatile, particularly in the short term. In order to minimise the degree of short-term change in employer contribution rates, expected investment returns are considered over the long term.

The Pensions Committee is responsible for setting investment strategies after taking professional investment advice.

A formal review of the Funds' investment strategies is undertaken at least every three years to ensure appropriate alignment with liabilities. This is typically after the results of the triennial Actuarial Valuation are known and the Pensions Committee is responsible for agreeing that the strategies are appropriate. Implementation of the investment strategies is delegated to the Executive Director of Resources of the City of Edinburgh Council, under the advice of the Joint Investment Strategy Panel.

The Panel comprises the Chief Executive Officer and Chief Investment Officer of Lothian Pension Fund together with a minimum of two external, independent expert advisers. The Panel meets quarterly to monitor the risk, return and implementation of investment strategy, and to discuss current issues, including asset allocation. This involves an appraisal of the current investment market opportunities and risks and the distribution of the Funds' investments across different assets, countries, sectors and companies to ensure that overall risk is being managed appropriately.

Further information on the investment strategies can be found in the Funds' Statement of Investment Principles which is available on the Fund's website (www.lpf.org.uk).

5.5 Demographic Assumptions

The Actuary makes a number of demographic assumptions including mortality, salary growth, rates of retirement, commutation experience and withdrawal. They are intended to be best estimates of the future experience of the Funds.

The assumptions take into account the past experience of the employer and Funds, other Local Government Pension Schemes and/or the general population, as considered appropriate by the Actuary.

5.6 Contributions

Employee contributions are determined by the Local Government Pension Scheme (Scotland) Regulations 2018. A member's contribution rate is calculated by the employer on an annual basis, dependent on their actual pensionable pay at 31 March each year and allowing for any election made under Regulation 10 (50:50 option).

Employer contributions are calculated by the Fund Actuary. They are made up of two elements:

A: the **primary** rate of the employers' contribution. This is the contribution rate required to meet the cost of the future accrual of benefits expressed as a percentage of pensionable pay, ignoring any past service surplus or deficit but allowing for any employer specific circumstances, such as the membership profile of that employer, the funding strategy adopted for that employer, the actuarial method chosen and/or the employer's covenant, and,

B: the **secondary** rate of the employers' contribution. This is an adjustment to the primary rate to arrive at the rate each employer is required to pay. If there is a surplus, there may be a contribution reduction, if there is a deficit there may be a contribution increase. For all employers, contributions to cover any deficit are expressed as a fixed monetary sum, rather than as a percentage of payroll. The period over which any funding deficit or surplus is spread for each Fund is covered further in Sections 6, 7 and 8 below. Any deficit contributions should be paid in equal monthly instalments along with the primary rate contributions, or by prior arrangement as a one-off lump sum at the start of the year.

For any employer, the rate they are required to pay is the sum of the primary and secondary rates.

The rates for all employers are shown in the Fund's Rates and Adjustments Certificate, which forms part of the formal Actuarial Valuation Report. The contributions stated are minimum amounts – employers can pay more than this. The Actuary will take account of any higher amounts paid at subsequent valuations.

All employers are required to pay the estimated additional cost (strain cost) of **non-ill health early retirements**, to allow for the fact that the pension is paid earlier and for longer. This is calculated at the time of the early retirement. The Fund's general policy is that strain costs are payable as a one-off payment at the time of the early retirement, however at the Fund's discretion, alternative arrangements may be permitted if the early retirement occurs at the time of exit, depending on the employer's circumstances.

The Administering Authority monitors the actual contributions received to ensure they are in line with those expected. As set out in the Fund's Pensions Administration Strategy, employers are expected to provide requisite detailed information on a monthly basis to assist this monitoring exercise and to substantiate the payments made.

6. FUNDING – SCOTTISH HOMES PENSION FUND

Scottish Government acts as guarantor to the Scottish Homes Pension Fund. A bespoke funding strategy has been developed for the Scottish Homes Pension Fund. This has been agreed by the Administering Authority, the Fund's Actuary and the Scottish Government (previously known as the Scottish Executive).

The strategy aims for the Fund to be 100% solvent by 2044 using a discount rate based on government bonds. It includes target funding levels at each actuarial valuation. Contributions from the Scottish Government are determined by reference to the target funding levels. The deficit recovery period is 8 years.

As the Fund is closed to new members and the liabilities will mature over the time, the investment strategy is designed to reflect the expressed requirements of the Scottish Government, namely low risk, with investments now exclusively bonds.

7. FUNDING – LOTHIAN PENSION FUND

7.1 Objectives of the Lothian Pension Fund's Funding Strategy

The objectives of the funding strategy include:

- to ensure the long-term solvency of the overall Fund;
- to ensure the solvency of each individual employers' share of the Fund based on their expected term of participation in the Fund;
- to minimise the degree of short-term change in employer contribution rates;
- maximise the returns from investments within reasonable and considered risk parameters, and hence minimise the cost to the employer;
- to ensure that sufficient cash is available to meet all liabilities as they fall due for payment;
- to help employers manage their pension liabilities; and
- where practical and cost effective, to make allowance for the different characteristics of different employers and groups of employers.

7.2 Investment Strategy

The Fund has put in place four investment strategies for differing employer risk profiles.

<u>Primary Strategy</u>
This strategy adopts a long-term investment strategy, aiming to maximise the investment return within reasonable and considered risk parameters and hence minimise the cost to the employer.

This strategy applies to the following types of employers:

- Large employers with enduring membership which are open to new entrants (including but not limited to Councils and other statutory bodies);
- All other employers which are open to new entrants and have 5 or more active members
- Transferee Admitted Bodies; and
- Employers admitted to the Fund following a transfer of staff from another Fund employer and the ceding employer has agreed the employer can be treated as Transferee Admitted Bodies for funding purposes.
- Employers which have exited the Fund and their guarantor/aligned body agrees that assets can be moved to the primary strategy in order to maximise investment returns.

Employers invested in the Primary Strategy will have individual contribution rates certified by the Actuary.

<u>Lower Risk Strategy</u>
This strategy adopts a lower-risk approach for employers which have a short expected duration in the Fund and invests in index-linked government bonds to reduce the degree of short-term change in funding level and employer contribution rates in the period prior to the employer leaving the Fund and hence manage risks for both the individual employer and for the Fund as a whole.

This strategy was first introduced with effect from 1 April 2015.

This strategy applies to the following types of employers:

- Employers who have left the Fund (excluding bodies which may be aligned);
- Employers which are closed to new entrants and:
- Have fewer than five active members and/or
- Average membership age of 55 or higher.

Such employers will have individual contribution rates certified by the Actuary.

Medium Risk Strategy

This strategy adopts a balanced investment strategy reflecting the maturing membership and liability profile of the relevant employers. It is intended to act as a transition between the Primary Strategy and the Lower Risk Strategy, for those employers which are closed to new entrants. Accordingly, investments will be targeted to represent 50% allocation from the Primary Strategy and the Lower Risk Strategy. This will serve to reduce the degree of change in employer contribution rates which would result from moving immediately from the Primary Strategy to the Lower Risk Strategy. This strategy was first introduced with effect from 1 April 2018.

This strategy applies to the following types of employers:

- Employers which are closed to new entrants but do not meet the criteria for the low-risk strategy.

Such employers will have individual contribution rates certified by the Actuary

Lothian Buses

A bespoke strategy is in place for Lothian Buses. Lothian Buses closed to new entrants in 2008 and this strategy reflects the maturity of the membership and liability profile.

Allocation to strategies

Relevant employers will move between strategies as appropriate following the 2017 valuation on 1 April 2018.

An employer will change to an alternative Strategy with immediate effect between valuations in the following situations:

- An employer closing to new entrants will move to the medium-risk or low-risk strategy as appropriate;
- An employer part of the medium risk strategy which falls below five active members, will move to the low-risk strategy.

In these circumstances, the Actuary will provide revised employer contribution rates.

Where an employer has closed to new entrants, it will not be able to reverse this decision and offer membership to new staff without the agreement of the Administering Authority and where applicable, the body acting as guarantor.

The Fund may consider a request for an employer to be assigned to an alternative investment strategy to that which strict application of the criteria would indicate, but only in circumstances where a higher risk strategy is supported by an explicit guarantor and/or where the Fund would not consider such to represent a scenario of greater risk exposure to other employer(s). The Fund may also consider a request for a riskier investment strategy should provision of satisfactory security over assets be offered.

It is not practical for the Fund to offer individual employers full flexibility on asset allocation.

7.3 Employer Asset Tracking

The Lothian Pension Fund is a multi-employer fund. Previously, individual employer asset shares have been calculated triennially at formal valuations by the Fund's Actuary using an analysis of surplus technique and tracked between valuations using a cash flow or roll forward approach. However, in order to enhance the transparency, accuracy and auditability of individual employer asset allocations and reduce any cross-subsidy between participating employers, from 1 April 2014 the Fund introduced an employer asset tracking system based on cash flows. This is a form of unitisation of investments, where each investment or disinvestment of monies involves the purchase or selling of units in the fund. By sub-dividing the assets into units, the fund can more easily and accurately track each individual employer's assets. Changes in the value of the underlying assets are reflected by changes in unit prices.

Such unitisation therefore provides an efficient way of accurately apportioning assets to individual employers by allowing for employer cash flows and investment returns achieved by the Fund. In addition, this provides a mechanism for facilitating and managing a range of investment strategies within the single Fund to meet the needs of employers with different maturity profiles, funding levels or investment objectives.

7.4 Setting employer contribution rates

All employers in the Fund are required to fund the benefits of their own employees; therefore, the Actuary calculates a different contribution rate specific to each employer.

The Actuary uses a three-step process in calculating employer contribution rates which requires the Fund and the Actuary to consider for each employer:

1. The employer's **funding target**, which is based on a set of ongoing assumptions about the future (e.g. investment returns, inflation, pensioners' life expectancies). If an employer is approaching the end of its participation in the Fund then its funding target may be set on a more prudent basis, so that its liabilities are less likely to be spread among other employers after its cessation.

2. The **time horizon** required over which the funding target is achieved. Employers may be given a lower time horizon if they are closed to new entrants, or do not have tax-raising powers to increase contributions if investment returns under-perform.

3. The **likelihood of achieving** the funding target over that time horizon will be dependent on the Fund's view of the strength of employer covenant and its funding profile. Where an employer is considered to have weaker financial strength then the required likelihood will be set higher, which in turn will increase the required contributions (and vice versa).

A risk-based approach is used to set employer contribution rates. This risk-based approach allows for thousands of possible future economic scenarios when assessing the likelihood of contributions being sufficient to meet both the accrued and future liabilities over a given time horizon for each employer

Changes in employer contributions may be phased over time in order to minimise the degree of short-term change and enhance affordability. The Administering Authority, in consultation with the Fund's Actuary decides how any reductions or increases to contribution rates are introduced, taking into account specific employer circumstances.

Further information on calculating employer contribution rates is set out in Appendix E.

7.5 Contribution Stability

The policy of the Fund is to operate a Contribution Stability Mechanism on an ongoing basis, subject to regular reviews, in order to provide certainty of pension contributions to Fund employers for future years, together with ensuring appropriate assurance of funding level to the Fund. Contribution stability will not be offered to all employers – each employer's particular circumstances will be considered, in particular the strength of the covenant offered and the extent of membership commitment to the Fund. Employers are not obliged to participate in the Contribution Stability Mechanism, but if they wish to opt out, they must make an election at the outset. This election will cover the entire duration of the Contribution Stability Mechanism as well as future reviews of the Contribution Stability Mechanism. Any decision to allow an employer to join the Contribution Stability Mechanism at a later date will be at the discretion of the Administering Authority.

An employer which chooses not to participate will instead pay the theoretical contribution rate as set by the Fund Actuary at the actuarial valuation.

Employers which are open to new entrants and have contribution rates calculated based on their individual circumstances will be offered contribution stability subject to:

- satisfactory assessment of the employer covenant, and;
- agreement by their guarantor to inclusion of the employer in the contribution stability mechanism (where appropriate).

An employer's participation in the Contribution Stability Mechanism is expected to extend to the full duration of the mechanism. However, contribution stability will be subject to ongoing review by the Fund which reserves the right to remove an employer from the Contribution Stability Mechanism should particular circumstances deem it prudent to do so, for example assessment of employer covenant, financial or demographic experience. In addition, if an employer closes to new entrants they will be removed from the Contribution Stability Mechanism and a recalculation of their contribution rate may be required.

Contribution stability will not be afforded to the following employers:

- Employers which are closed to new entrants;
- Transferee Admission Bodies; and
- Small Community Admission Bodies without a guarantor.

Full information on the Contribution Stability Mechanism is available on the Fund's website.

In 2019, the Fund, in conjunction with the Actuary reviewed the Contribution Stability Mechanism introduced at the 2014 valuation. This review concluded that for employers who are eligible for stabilised rates, contribution rates from 1 April 2021 will:

- remain frozen for 4 years and
- then increase/decrease by a maximum of 0.5% per annum.

The Fund will aim to keep contribution rates for stabilised employers between agreed parameters, however, there may be specific circumstances relevant to an employer which will merit the Actuary certifying a rate outside these parameters. Each case will be reviewed at the Fund's discretion.

7.6 Deficit/Surplus spreading

In deciding the period over which any funding deficit or surplus is spread, the Administering Authority considers a number of factors including the objective of minimising the degree of short-term change in employer contribution rates and employers' ability to meet their commitments to the Fund.

The deficit recovery periods used for different employers range from 20 years for Councils, to the remaining contract period for Transferee Admission Bodies which can in some cases be a matter of months. The differences in deficit recovery periods reflect the financial strength of the employers and the perceived long-term commitment to the Fund.

The following table shows the employers in the Fund for which are required to fund the benefits of their own employees, setting out the key characteristics of each type of employer which influence the period over which any surplus/deficit has been spread.

Where an employer can offer security over assets or otherwise improve their covenant, the Fund may, at its discretion, allow a longer recovery period to be used.

	Employer	Deficit Recovery Period (Years)
Councils/Large Scheduled bodies	City of Edinburgh Council	20
	Midlothian Council	
	West Lothian Council	
	East Lothian Council	
	Scottish Fire & Rescue Service (Civilians)	
	Scottish Police Authority	
	Lothian Valuation Joint Board	
	Scottish Water	
	Lothian Buses	FWL [1]
Universities / Colleges	Heriot-Watt University	15
	Newbattle Abbey College	
	Queen Margaret University College	
	Napier University	
	Edinburgh College	
	West Lothian College	
	Scottish Rural University College	FWL [1]
	University of Edinburgh	
Other Large employers	Audit Scotland	15
	Convention of Scottish Local Authorities	
	Visit Scotland	
	West Lothian Leisure	FWL [1]
	Edinburgh Leisure	
	CHAS	
	The Improvement Service	
	SESTRAN	
Transferee Admission Bodies		Shorter of FWL [1] or contract period
Other employers	Community Admission Bodies not named above	FWL [1]

[1] Future Working Lifetime of current active members or duration in Fund if shorter

7.7 Admission bodies – affordability constraints

As noted in section 5.6 above, the Actuary certifies minimum contributions which each employer is required to pay. In circumstances where an employer's membership of the Fund is not mandated by Regulations and that employer is unable to meet the minimum certified contributions, then its membership will be terminated, with notice period of three months being applied by the Fund.

At each valuation, therefore, every employer will require to confirm its commitment to meet the certified minimum contributions, otherwise, following the notice period as specified above, the Administering Authority will terminate the admission agreement, and Appendix C: "Policy on employers leaving the Fund" will apply. Specifically, the Fund will arrange for an exit valuation to be carried out to assess the level of the employer's liabilities. The Fund will then engage with the employer on repayment of any exit debt.

7.8 Post Valuation adjustments

When determining future employer contributions at the triennial actuarial valuation the Administering Authority may (after consultation with the Fund Actuary) take into account any events that arise after the valuation date, but before the formal valuation report is signed off (which must occur within one year of the valuation date), that materially affect the employer contributions referred to above. In doing so, the Fund will aim to minimise the degree of short-term change in employer contribution rates while still ensuring the long-term solvency of the overall Fund.

The contribution rates are subject to review and change if there are changes in employer circumstances between actuarial valuations, for example, if an employer has closed to new members or has left the Fund. In the latter case, any residual liability may impact upon the rate(s) payable by employer(s) remaining in the Fund. In all instances, any such changes would be determined by the Administering Authority and require certification by the Fund Actuary.

7.9 Employers joining the Fund

Appendix A sets out in full the Fund's policy on employers joining the Fund.

Bodies applying to join the Fund will be provided with a copy of this Statement and will be required to provide a written undertaking that they understand and are aware of the long-term financial implications of participation in the Fund.

7.10 Employers leaving the Fund

Appendix C sets out in full the Fund's policy on employers leaving the Fund in any of the following circumstances:

- When the employing authority is wound up or liquidated;
- When the last active member leaves or retires from an employer;
- When the admission agreement is otherwise terminated by either the employing authority or the admission authority, subject to the notice period specified in the admission agreement;
- In the case of Transferee Admission Bodies, when the contract comes to an end and is not renewed; and
- In the case of scheduled bodies, when the body no longer has an active member contributing to the Fund or through changes in over-riding legislation or Government policy can no longer contribute to the Local Government Pension Scheme.

Where an employer has an active admission agreement, but no active members and no new members will join in the future, then the admission agreement will be terminated and actions detailed in Appendix C will apply, other than where specific provision exists in the admission agreement for such circumstances.

7.11 Bulk Transfers

The treatment of bulk transfers of pension rights to and from the Fund are detailed in Appendix B.

LOTHIAN PENSION FUND

8. KEY RISKS AND CONTROLS

The Administering Authority has an active risk-management programme in place. The risk register is reviewed on an ongoing basis by the Risk Management Group, with a quarterly summary provided to the Pensions and Audit Sub-Committees. The following extract from the risk register, with Impact and Probability for each risk scored on a scale of 0-10, highlights those risks which can be considered of particular relevance to the funding strategy:

Risk Register as at 18 May 2020

Risk	Existing controls	Impact	Probability	Current Risk
Adverse Investment performance leading to pressure on employer contributions	• Investment management oversight model including reviews, policy statements and quantitative analysis. • Review of funding strategy, including longevity assessment • Formal review of strategy and investment assumptions as part of triennial actuarial valuation • Regular asset liability studies • Quarterly performance assessment by Joint Investment Strategy Panel. • Bespoke investment strategy offered to eligible employers.	5	5	25
Failure of an employer to pay contributions causes either a significant fall in funding level or requires higher contributions from other employers.	• Admissions Policy including use of guarantees. • Regular contact with employers. • Education to improve understanding, including grant funding implications. • Employer covenants review including membership monitoring • Funding Strategy Statement includes alignment of higher risk employers to Councils as appropriate. • Funding agreements in place for payment of cessation debt and security sought where appropriate • Affordability confirmation built into Funding Strategy Statement • Staff being reminded of internal reporting procedures regarding late payments to enable prompt action from the Fund	4	5	20

Adverse change in non-investment funding assumptions causes either funding levels to fall or requiring higher employer contributions	• Regular actuarial valuations and review of funding strategy, including longevity assessment. • Contribution stability mechanism in place and reviewed • Scheme cost and design monitoring by the Scheme Advisory Board • Monitor funding level (ongoing) • Employer covenant and affordability reviews	5	5	25

APPENDIX A: ADMISSION POLICY

1. Background

The Local Government Pension Scheme (LGPS) (Scotland) Regulations contain powers for the City of Edinburgh Council (acting in its separate capacity as administering authority) (LPF) to admit bodies into the Lothian Pension Fund. Those bodies must meet certain conditions, generally relating to their purpose and aims, contained in the regulations before being considered for admission.

This document sets out the policy of LPF in applying discretion to admit, on application, a new body into the fund for the purposes of allowing employees of that body access to the LGPS.

This policy will be reviewed as and when considered necessary.

2.General application of discretion to admit new bodies

LPF's Pensions Committee , as the executive body responsible for the administering authority function, delegates power to approve or reject applications to the Executive Director of Resources.

LPF will consider all applications from bodies who meet the conditions of the scheme regulations. In making his decision, due weight will be given to the merit of the body's financial covenant.

Approved applications will be subject to the conclusion of an admission agreement containing the appropriate matters prescribed in scheme regulations. Appropriate legal advice will be obtained in drafting and concluding admission agreements.

The body will be provided with a copy of the current Funding Strategy Statement of the Fund and will be required to provide a written undertaking that they understand and are aware of the long-term financial implications of participation in the Fund.

A bi-annual report will be submitted to the Pensions Committee providing details of the delegated decisions made during the year.

3.Policy in relation to Bodies admitted following the transfer of services from a Scheme Employer (TABs)

Such organisations will be admitted, subject to the conclusion of an admission agreement between LPF, the scheme employer (where different) and the TAB. The Scheme employer will also be required to act as a guarantor and undertake to meet any amounts due to the Fund in respect of any funding or contribution shortfall either during or at the cessation of the contract.

4.Policy in relation to other admission bodies

The applying organisation must provide documentary evidence of their:

1. aims and objectives;
2. articles of association;
3. latest annual accounts; and
4. future income streams including the source and timing.

The organisation will be expected to find a guarantor who will undertake to meet any amounts due to the Fund in respect of any funding or contribution shortfall either during or at the cessation of the admission agreement. The body must supply documentary evidence of the guarantee obtained and, where considered necessary by LPF, of the financial security of the guarantor.

APPENDIX B: BULK TRANSFER POLICY

1. Background

This is the policy of Lothian Pension Fund (“the Fund”) as regards the treatment of bulk transfers of pension rights to and from the Fund.

The purpose of bulk transfer negotiations is to determine the amount of service credits to be awarded and transfer payment to be paid when a number of members transfer their benefits from one pension scheme or Fund to another.

1. 1 Regulatory Framework

The Local Government Pension Scheme (Scotland) Regulations 2018 outline the general framework for employees and employers participating in the Local Government Pension Scheme in Scotland.

1.2 Reviews of Policy

This policy will be reviewed at least every three years following triennial valuations or following changes in the Regulations pertaining to employees transferring rights.

It should be noted that this statement is not exhaustive and individual circumstances may be taken into consideration where appropriate.

2. Principles

2.1. Over-riding Principles

Each bulk transfer will be dealt with on a case by case basis, however, in general the principles below will be applied.

<u>Transfers Out</u>

On transfers out to other LGPS Funds or other schemes, it is the Fund’s general policy that:

- If the transfer out will result in the employer having no remaining active members, the bulk transfer amount should not leave the Fund (and the specific employer concerned) with insufficient assets to meet the remaining members’ liabilities assessed on the appropriate exit basis as outlined in the Fund’s ‘Policy on employers leaving the Fund’;
- For all other cases, unless otherwise agreed, the transfer amount will be set equal to the value of the benefits accrued to the transfer date for transferring members on the Fund’s ongoing valuation basis, adjusted to take account of any underfunding in the transferring employer’s share of the Fund, such that the maximum transfer value is not greater than the reserves held for the transferring members. This is known as a ‘share of deficit’ approach and is subject to a cap equal to 100% of the value of the transferring benefits.

<u>Transfers in</u>

In the event of a transfer in, the Fund’s actuary will be instructed to agree transfer terms with the transferring scheme’s (or Fund’s) actuary. For transfers in from a funded scheme (or another LGPS Fund), the Fund’s actuary will be instructed to agree terms where the minimum transfer amount from the transferring scheme is calculated on a 'share of deficit' basis. This approach is consistent to the calculation of the transfer amount if there was a transfer out of the Fund.

If the proposed transfer amount will result in a significant deterioration in the funding level of the receiving employer (due to, for example, the transferring scheme having a poor funding position), the Fund actuary may be instructed to seek a higher transfer amount. If the transfer is from an unfunded scheme, the Fund actuary will be instructed to ensure the transfer value is equal to the value of transferring benefits based on the Fund's ongoing valuation basis.

If a bulk transfer in results in a deterioration of the receiving employer's funding level, the receiving employer will be required to make good the shortfall. The Fund's general policy is that the employer will be required to restore the funding level to the position immediately prior to the transfer. The employer will be required to repay the required top-up as a lump sum, or where the Fund considers the employer's covenant to be sufficiently strong, over an agreed recovery period or through the ongoing contribution rate (subject to the Fund's discretion).

The Fund reserves the right to refuse to accept a transfer in should the receiving employer's covenant be weak.

Intra-fund transfers

On transfers from one Fund employer to another existing Fund employer, assets equal to 100% of the transferring liabilities will be transferred, unless otherwise agreed.

On transfer from one Fund employer to a new Fund employer, the following principles will apply:

1. A fully funded transfer, on the ongoing valuation basis, if the new employer is a TAB, unless otherwise agreed.
2. A share of deficit transfer, on the ongoing valuation basis for all other types of employer, unless otherwise agreed.

Direction Orders

The Scheme regulations specify the appropriate pension fund to which certain Scheme employers should belong. However, provisions exist to allow the Scottish Ministers to issue a direction order substituting a different Fund from that which is specified within the Regulations.

In these situations, the Fund will require the following assurances before agreeing to a transfer under a direction order:

When liabilities are transferred into the Fund:

- Before agreement to the transfer can be provided, the employer must provide sufficient assurance to the Fund's satisfaction;
- Where applicable, the employer's guarantor/aligned body must agree to the transfer;
- In situations where the transfer will result in a deterioration of the employer's funding level, the employer must undertake to make such additional contributions to make good the shortfall. The level of contributions required, and the period of time over which these will be paid will be determined by the Fund in consultation with the Actuary; and

- The ceding Scheme must provide assurance that membership data meets the Pension Regulator's common and conditional standards. This will ensure that liabilities transferred are correct.

Where liabilities are transferred out of the Fund:

1. Where all the employer's liabilities are transferred out, all of the employer's assets will be transferred, such that the transferring employer has no remaining assets or liabilities in the Fund.
2. Where all of the employer's active members are being transferred out, but the liabilities relating to deferred and pensioner members are remaining in the Fund, the employer must ensure that the remaining liabilities are fully funded on the exit basis. The Fund will not sign a Direction Order unless this condition is met.

2.2 Interaction with Funding policy

It is the Fund's policy that each employer is responsible for the funding of all Fund benefits of its own members, including current and previous employees. For the purpose of triennial funding valuations, the individual funding position for each employer is tracked by the Actuary at each valuation.

Any transfer of pension rights may have an effect on the valuation position of the employer and as noted above, a revised employer contribution rate may be required depending on the impact of the transfer on the employer's funding position and membership profile.

2.3 Principles for determining payment

The Fund will determine the transfer payment and service credits having taken actuarial advice.

The assumptions used to calculate transfer values out of the Fund will be based on those adopted for the latest formal valuation of the Fund updated for financial conditions on the date of transfer.

Transfers in should equally be updated to reflect financial conditions on the transfer date

There is normally a lag between the date of the actual transfer of staff and the date of payment. During this period, on transfers out, the agreed transfer value will be adjusted by a factor determined by an estimate of the movement in the investments as determined by the asset allocation of the Fund and the respective market indices.

This method of rolling up the transfer payment is to be recommended for incoming bulk transfers as well.

3. Process

3.1. Responsibilities of ceding/receiving employers

An employer which is aware of a transfer from or into the Fund is required to:

- advise the Fund, in writing, of the transfer. This communication should indicate where members are transferring to/from and how many members will potentially transfer;
- provide information and data as requested by City of Edinburgh Council and the actuary to the Fund which is relevant, including in particular any changes to the membership which could affect the liabilities (e.g. salary increases and early retirements), contact details for the ceding/receiving scheme, etc.; and
- assist in the administration of option forms to transferring members as and when required.

3.2. Responsibilities of the Administering Authority

The Administering Authority will gather information as required, including, but not limited to, the following:

- details of the transfer – where are members transferring to/from, how many members are involved and (where a transfer out to a non-LGPS scheme) if the receiving scheme is broadly comparable to the LGPS;
- complete membership data for the transferring members;
- commission the Fund actuary to carry out bulk transfer negotiations where necessary;
- where applicable, liaise with the employer and ensure they are aware of their responsibilities, in particular for any residual deficit or risk associated with the transfer; and
- ensure that payments or receipts of transfer value payments are carried out on the agreed dates.

3.3. Responsibilities of the Actuary

Following commission of bulk transfer negotiations by the Administering Authority, the Fund Actuary will:

- on notification of the transfer, ensure that the data and information required is collated;
- propose / agree assumptions and transfer values based on the policies set out by Lothian Pension Fund;
- propose / agree service credits in line with relevant legislation and policies; and
- negotiate and agree the final transfer payment date and amount.

APPENDIX C: POLICY ON EMPLOYERS LEAVING THE FUND

1. Introduction

This is the policy of Lothian Pension Fund ('the Fund') as regards the treatment of employers of the Fund.

This policy replaces all previous policies on employer termination and is effective from 1 April 2015.

1.1 Scope of Policy

This policy covers employers leaving the Fund in any of the following circumstances:

- when the employing authority is wound up or liquidated;
- when the last active member leaves or retires from an employer;
- when the admission agreement is otherwise terminated by either the employing authority or the admission authority, subject to the notice period specified in the admission agreement;
- in the case of Transferee Admission Bodies, when the contract comes to an end and is not renewed; and
- in the case of scheduled bodies, when the body no longer has an active member contributing to the Fund or, changes in over-riding legislation or Government policy determine that employees can no longer contribute to the Local Government Pension Scheme;

1.2 Reviews of Policy

This policy will be reviewed at least every three years following triennial valuations or following changes in the Scheme Regulations relevant to employers leaving the Fund.

2. Principles

2.1. Overriding Principles

If an employer leaves the Fund, or their admission agreement is otherwise terminated, the Administering Authority will instruct the Fund's Actuary to carry out a valuation of that employer's liabilities (an 'exit valuation').

Payment of any deficit does not guarantee that the assets in the fund will be sufficient for the liabilities in the future: the actual cost of benefits will only be known after the last dependant dies and there is a risk that the amount estimated in the exit valuation does not cover the actual cost of the liabilities. In this situation, the Fund would seek recourse from the body which acted as guarantor to the employer, or alternatively the body which the employer was aligned.

The basis used to carry out such a valuation will depend on the circumstances of the change. The Fund's general policy is that the valuation will be carried out on a more prudent basis than that used in the ongoing actuarial valuation. However, the Fund may take into account the covenant strength of any successor body and/or guarantor which may be in place after the exit date.

The employer, successor body and/or guarantor may be required to pay additional contribution(s) or capital payments to the Fund.

In normal circumstances, the Actuary will use the following assumptions for the exit valuation:

- A discount rate equivalent to the gilt yield at the date of the exit, with no allowance for outperformance of investments;
- An increase in the liabilities by 5% reflecting anticipated additional future improvements to life expectancies (over and above the ongoing valuation assumption); and
- Other assumptions would be consistent with the most recent actuarial valuation.

However, where the employer leaving the Fund is a Transferee Admission Body or if an employer was admitted owing to the transfer from another Fund employer (and the ceding employer has agreed to the treatment of the employer as a Transferee Admission body for funding purposes), the ongoing basis will be used. On joining the Fund, Transferee Admission Bodies are set up on a fully funded basis with contribution rates calculated based on the duration of the contract in order to reduce the likelihood of a deficit arising on leaving.

The Actuary may include an additional level of prudence when carrying out the exit valuation to take into consideration the McCloud judgement which found that the transition protections put in place when new public sector schemes were introduced were discriminatory. As a result, the benefit structure of the LGPS is being reviewed. Until clarity on a remedy is available, a loading factor will be applied to exit valuations.

If an employer becomes insolvent and it, or its guarantor, is unable to meet any deficit, additional contributions will be required from each remaining employer in the Fund, in proportion to their liabilities. This means that the majority of any deficit will fall on the large employers. However, where it has been established that there is a specific alignment to one or more other employers, then the pension liability will be assigned or apportioned accordingly to those other employer(s).

In the event of a Transferee Admission Body leaving the Fund and being unable to pay additional contributions to the Fund, the employer granting the contract will be liable for the additional contributions or capital payments.

The purpose of an exit valuation is to determine the level of any surplus or deficit in an employer's share of the Fund as at the date the employer leaves the Fund. Unless the cost of doing so is deemed to outweigh the likely recovery to the Fund, the Fund will pursue an outgoing body (including the liquidator, receiver, administrator or successor body if appropriate) for any deficit. The Fund will also pursue guarantor, for payment where appropriate.

It is the Fund's policy that the determination of any surplus or deficit on termination should aim to minimise, as far as is practicable, the risk that the remaining, unconnected employers in the Fund have to make contributions in future towards meeting the past service liabilities of current and former employees of employers leaving the Fund.

2.2 Principles for Determining Payment of Exit Debt

The Administering Authority will determine the deficit/surplus attributable to the employer on exit having taken actuarial advice.

Where an exit valuation identifies that an employer is in surplus, this surplus will be returned to the employer.

If it is determined that there is a deficit and the employer will be required to make a payment to the Fund, the administering authority will advise the employer of the amount required. The Fund's general policy is for any deficit on exit to be recovered through a single lump sum payment to the Fund. The Fund may, at its discretion issue a suspension notice to an employer leaving the Fund, suspending the employer's liability to make an exit payment. In such cases, the employer must continue to make contributions to the Fund at a level agreed by the Fund and the Fund Actuary.

In exceptional circumstances, and where it considers that this does not pose a material risk to the solvency of the Fund, the Fund may consider:

- allowing payment of any exit debt over longer terms rather than insisting on payment as a one-off payment or over shorter terms previously agreed;
- agreeing repayment of debt less than the exit debt in order to avoid employer insolvency, with an appropriate agreement which allows the Fund to revisit the repayment of the remaining debt at a future date (i.e. the debt would be a contingent liability and hence not recognised on an employer's balance sheet); and
- seeking, where appropriate, suitable anti-embarrassment provisions in legal agreement covering future increase in employer asset values.

The Fund may take into account the covenant strength of any successor body and/or guarantor which may be in place after the exit date. In this instance, interest at a rate advised by the Actuary will be applied to determine the appropriate payments to be made.

Adopting such principles would protect the interests of the Fund as a whole.

APPENDIX D: CHARGING POLICY

This appendix sets out Lothian Pension Fund's policy on meeting the cost of actuarial fees and other service costs which are recharged to employers. It covers the main circumstances where fees are payable but is not exhaustive.

The Fund will obtain the consent of the employer or member before carrying out any work which is likely to lead to fees being recharged.

1. Costs recharged to Scheme members

The costs of general pension administration are not recharged to members of the pension fund. However, costs associated with complex pieces of work, as well as costs of providing certain other confirmation may be recharged. This includes (but is not limited to) the following:

- costs associated with providing valuations under the Family Law (Scotland) Act 1985;
- costs of implementing pension sharing orders;
- costs of providing further cash equivalent transfer values where this information has already been provided once in the last twelve months; and
- costs of appointments with the Fund's independent medical advisers where appointments have been repeatedly missed without good reason, or where habitual requests for assessment are received without new medical evidence.

Details of the costs payable can be found on the Fund's website (www.lpf.org.uk). These costs will increase annually each April by CPI over the 12 months to the previous September.

2. Costs recharged to Scheme employers

Employers should always contact the Fund in the first instance to establish whether fees will be recharged for any administration process or obtaining professional advice, and to obtain an estimate of likely fees.

Actuarial charges will be met by Lothian Pension Fund where the work is common to all or most employers, or where the work is required by the Scheme regulations and the employer has no choice whether the work is carried out.

However, where work is carried out or advice obtained at the request of a single or small number of employers, is not required by other employers, and is not a regulatory requirement, then the charges for that work or advice are generally recharged to the employer(s) concerned.

The schedule below sets out these activities for which fees will be charged to the Fund and those that will be recharged to the commissioning employer.

3. Schedule

3. 1 Actuarial Fees

Activities for which Lothian Pension Fund should be charged:

- all matters relating to the triennial actuarial valuation, except additional work done at the direct request of an individual employer;
- interim actuarial valuations if and when the Administering Authority require such valuations;
- actuarial advice regarding questions concerning the interpretation of Scheme Regulations and matters pertaining to the administration of Fund benefits;
- preparation for and attendance at the Fund meetings; and
- any other matters which affect or are likely to affect all or a significant number of Fund employers.

Activities for which actuarial fees will be recharged to an employer:

- extra, non-standard triennial actuarial valuation work done for and at the direct request of an individual employer;
- a common actuarial service used by most employers is the provision of figures for IAS19/FRS17/FRS102 accounting disclosure purposes. As this information is for the benefit of individual employers and not the Fund itself, the relevant costs are recharged to the individual employers;
- interim valuations where these are not a requirement for all employers but are either: -
    - required by an employer's admission agreement or;
    - not required but specifically requested by the employer concerned;
- calculations etc. in respect of the admission of a new Fund employer;
- Best Value and other outsourcing calculations and consequent interim valuations;
- where an employer has been admitted to the Fund and is required to provide a bond or indemnity to meet any shortfall in funding in the event of the employer ceasing to participate in the Pension Fund, the cost of assessment and subsequent annual reassessment of the value of the bond or indemnity;
- assessing whether a potential/actual contractor's pension arrangement is "broadly comparable" to the Local Government Pension Scheme;
- any other interim valuations for an employer that is required through some action, or failure to act, by that employer;
- bulk transfer work in respect of transfers out of or into the Fund;
- exit valuations; and
- any other charges specific to one employer, or specific to such a small number of employers that it would be unreasonable to spread the cost between the membership as a whole. Where a number of employers are involved, the charges will be proportioned in light of the circumstances of the case.

3.2 Other charges

In addition to recharging actuarial fees as specified above, certain requests which result in:

- additional administrative work and advice over and above the norm;
- complex calculations;
- specific work for high earners; and

- the requirement for the Fund to seek advice or commission work from other providers e.g. lawyers will be charged to employers on a full cost recovery basis where this work is specific to one employer or specific to such a small number of employers that it would be unreasonable to spread the cost across all employers. Where more than one employer is involved, charges will be proportioned depending on the circumstances of the case.

Activities for which fees will be recharged to an employer:

- disclosure of information relating to Senior Officers and Councillors for inclusion in Local Authority Accounts:
    - provision of Cash Equivalent Transfer Value calculations and appropriate pension benefit calculations;
    - charges applied per case;
- setting up an Admission Agreement with the Fund for new employers joining the Fund;
    - costs to cover legal fees incurred by the Fund in drafting and finalising the Admission Agreement;
    - See note 1 below;
- attendance at meetings and associated work in connection with Employer projects involving transfers of staff (e.g. outsourcing, mergers etc);
    - a charge will be made where the Fund considers the work undertaken to be in excess of normal advice to employers;
    - costs will be based on Fund Officers time plus VAT; and
- interest payable on an exit valuation where the Fund allows payment to be spread over an agreed period; and interest will be charged at a rate advised by the Fund Actuary

Regulatory recharges

Where an employer has chosen to award compensation in the form of additional membership under Part III of the Local Government (Discretionary Payments and Injury Benefits) (Scotland) Regulations 1998, for ease of administration the Fund will pay the compensation pension to the member along with the funded pension. The compensation pension will be recharged to the employer on a monthly basis. However, should the awarding employer cease to exist, the compensation pension will cease. The funded pension would be unaffected.

Notes:

1. Any additional costs arising if specialist actuarial, legal etc advice is requested will be charged in full in addition to the figures quoted above.
2. The Fund will act in accordance with relevant procurement guidance in obtaining external professional services.

APPENDIX E: CALCULATION OF EMPLOYER CONTRIBUTIONS

Section 7.4 of the Funding Strategy Statement sets out a broad description of the way in which employer contribution rates are calculated. This appendix considers these calculations in more detail.

The Fund Actuary uses a three-step process to calculate an employer's contribution rate:

1) Calculate the funding target for that employer, i.e. the estimated amount of assets it should hold in order to be able to pay all its members' benefits. The funding target is based on a set of assumptions about the future (e.g. investment returns, inflation, pensioners' life expectancies). If an employer is approaching the end of its participation in the Fund then its funding target may be set on a more prudent basis, so that its liabilities are less likely to be spread among other employers after its cessation;
2) Determine the time horizon over which the employer should aim to achieve that funding target. Employers may be given a lower time horizon if they have a less permanent anticipated membership, or do not have tax-raising powers to increase contributions if investment returns under-perform; and
3) Calculate the employer contribution rate such that it has at least a given likelihood of achieving that funding target over that time horizon (allowing for various possible economic outcomes over that time horizon). The likelihood of achieving the funding target over the employer's time horizon will be dependent on the Fund's view of the strength of employer covenant and its funding profile. Where an employer's financial strength is considered to be weaker, then the required likelihood will be set higher, which in turn will increase the required contributions (and vice versa).

The Administering Authority recognises that there may occasionally be particular circumstances affecting individual employers that are not easily managed within the rules and policies set out in the Funding Strategy Statement. Therefore, the Administering Authority reserves the right to direct the actuary to adopt alternative funding approaches on a case-by-case basis for specific employers.

Calculation of employer contribution rates: calculation methodology

The Primary rate is calculated such that it is projected to:

1) meet the required funding target for all future years' accrual of benefits*, excluding any accrued assets,
2) within the determined time horizon;
3) with a sufficiently high likelihood, as set by the Fund's strategy for the category of employer

*The projection is for the current active membership where the employer no longer admits new entrants, or additionally allows for new entrants where this is appropriate.

The Secondary rate is calculated as the balance over and above the Primary rate, such that the total contribution rate is projected to:

1) meet the required funding target relating to combined past and future service benefit accrual, including accrued asset share,
2) at the end of the determined time horizon,

3) with a sufficiently high likelihood, as set by the Fund's strategy for the category of employer.

The projections are carried out using an economic modeller (the "Economic Scenario Service") developed by the Fund's actuary Hymans Robertson: this allows for a wide range of outcomes on key factors such as asset returns (based on the Fund's investment strategy), inflation, and bond yields. The measured contributions are calculated such that the proportion of outcomes meeting the employer's funding target (at the end of the time horizon) is equal to the required likelihood.

Actuarial Assumptions used to calculate employer contribution rates

These are expectations of future experience used to place a value on future benefit payments ("the liabilities") and future asset values. Assumptions are made about the amount of benefit payable to members (the financial assumptions) and the likelihood or timing of payments (the demographic assumptions). For example, financial assumptions include investment returns, salary growth and pension increases; demographic assumptions include life expectancy, probabilities of ill-health early retirement, and proportions of member deaths giving rise to dependants' benefits.

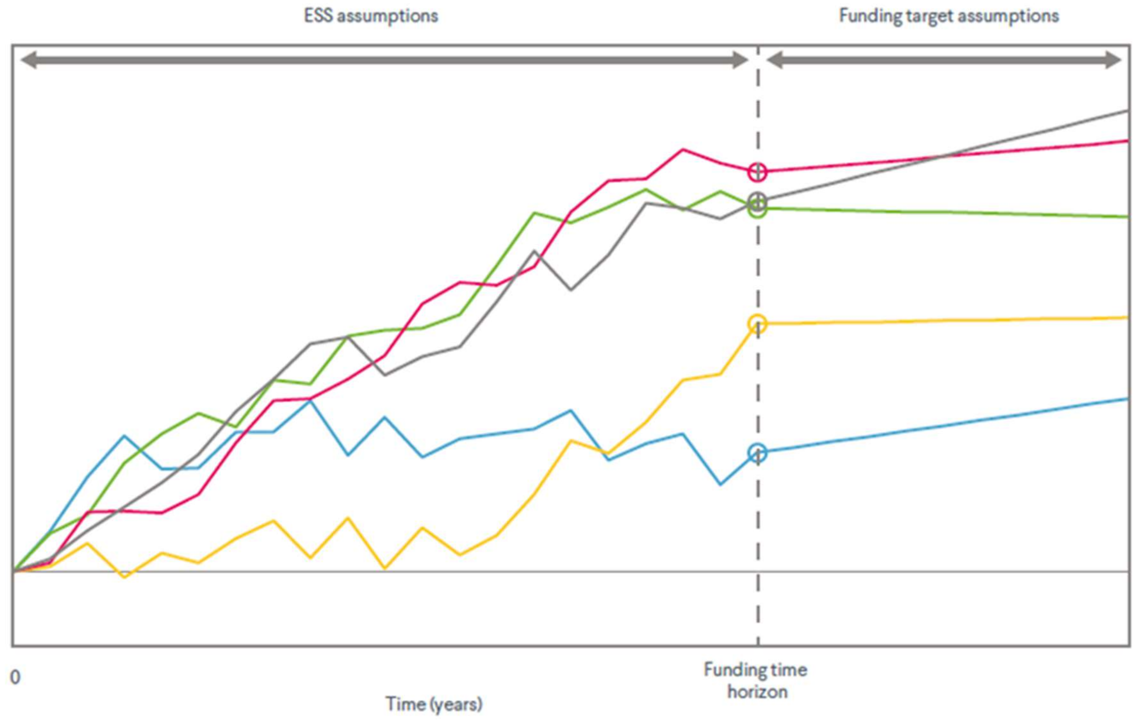
Changes in assumptions will affect the funding target and required contribution rate. However, different assumptions will not of course affect the actual benefits payable by the Fund in future.

The actuary's approach to calculating employer contribution rates involves the projection of each employer's future benefit payments, contributions and investment returns into the future under 5,000 possible economic scenarios. Future inflation (and therefore benefit payments) and investment returns for each asset class (and therefore employer asset values) are variables in the projections. By projecting the evolution of an employer's assets and benefit payments 5,000 times, a contribution rate can be set that results in a sufficient number of these future projections (determined by the employer's required likelihood) being successful at the end of the employer's time horizon. In this context, a successful contribution rate is one which results in the employer having met its funding target at the end of the time horizon.

Setting employer contribution rates therefore requires two types of assumptions to be made about the future:

1) Assumptions to project the employer's assets, benefits and cashflows to the end of the funding time horizon. For this purpose, the actuary uses Hymans Robertson's proprietary stochastic economic model - the Economic Scenario Service ("ESS").

2) Assumptions to assess whether, for a given projection, the funding target is satisfied at the end of the time horizon.



What assumptions are used in the ESS?

The actuary uses Hymans Robertson's ESS model to project a range of possible outcomes for the future behaviour of asset returns and economic variables. With this type of modelling, there is no single figure for an assumption about future inflation or investment returns. Instead, there is a range of what future inflation or returns will be which leads to likelihoods of the assumption being higher or lower than a certain value.

The ESS is a complex model to reflect the interactions and correlations between different asset classes and wider economic variables. The table below shows the calibration of the model as at 31

		Annualised total returns									
		Cash	Index Linked Gilts (medium)	Fixed Interest Gilts (medium)	UK Equity	Overseas Equity	Property	CorpMedium A	Inflation	17 year real yield	17 year yield
5 years	16th %'ile	-0.6%	-3.0%	-2.9%	-5.3%	-5.2%	-3.7%	-2.1%	1.3%	-2.7%	0.2%
	50th %'ile	0.2%	0.0%	-0.3%	3.7%	3.9%	2.1%	1.3%	2.8%	-1.8%	1.3%
	84th %'ile	1.0%	3.0%	2.5%	13.6%	13.4%	8.7%	4.5%	4.3%	-0.9%	2.5%
10 years	16th %'ile	-0.4%	-2.5%	-2.0%	-2.1%	-2.1%	-1.8%	-1.1%	1.4%	-2.2%	0.6%
	50th %'ile	0.6%	-0.4%	-0.5%	4.3%	4.3%	2.5%	0.8%	2.9%	-0.9%	2.0%
	84th %'ile	1.7%	1.8%	1.0%	10.7%	10.5%	7.2%	2.6%	4.6%	0.3%	3.8%
20 years	16th %'ile	0.2%	-1.5%	-0.6%	0.6%	0.8%	0.2%	0.2%	1.4%	-1.6%	1.2%
	50th %'ile	1.6%	0.2%	0.2%	5.2%	5.3%	3.6%	1.3%	2.9%	0.1%	3.1%
	84th %'ile	3.3%	1.9%	1.0%	9.9%	10.0%	7.4%	2.4%	4.5%	1.9%	5.7%
	Volatility (Disp) (1 yr)	0%	7%	8%	27%	28%	14%	10%	1%		

March 2020. All returns are shown net of fees and are the annualised total returns over 5, 10 and 20 years, except for the yields which refer to the simulated yields at that time horizon.

What assumptions are used in the funding target?

At the end of an employer's funding time horizon, an assessment will be made – for each of the 5,000 projections – of how the assets held compare to the value of assets required to meet the future benefit payments (the funding target). Valuing the cost of future benefits requires the actuary to make assumptions about the following financial factors:

- Benefit increases and CARE revaluation
- Salary growth
- Investment returns (the "discount rate")

Each of the 5,000 projections represents a different prevailing economic environment at the end of the funding time horizon and so a single, fixed value for each assumption is unlikely to be appropriate for every projection. For example, a high assumed future investment return (discount rate) would not be prudent in projections with a weak outlook for economic growth. Therefore, instead of using a fixed value for each assumption, the actuary references economic indicators to ensure the assumptions remain appropriate for the prevailing economic environment in each projection. The economic indicators the actuary uses are: future inflation expectations and the prevailing risk-free rate of return (the yield on long term UK government bonds is used as a proxy for this rate).