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Lothian Pension Fund Scottish Homes Pensioner Transfer

Operation of Scottish Executive Guarantee

Preamble

The Scottish Homes Pension Fund¹ (SHPF) is to be transferred to the Lothian Pension Fund (LPF) prior to the wind up of the Scottish Homes residuary body, with the LPF assuming responsibility for the management of its assets and liabilities with effect from 1 July 2005.

This note documents the funding objective for the transferred liabilities and particularly how any requirement for Scottish Ministers to make payments under the Local Government Pension Scheme (Scotland) Regulations 1998 (as amended by the Local Government Pension Scheme (Scotland) Amendment (No. 2) Regulations 2005) will be determined. Nothing in this note over-rides the regulations. This note has been prepared for the City of Edinburgh Council, as Administering Authority to the LPF, after consultation with the Scottish Executive and Scottish Homes.

Liabilities for payment of the pensions in payment and deferred pensions of the SHPF at 30 June 2005 are being transferred to the LPF along with the residual assets of the SHPF. The first pension instalment being paid by LPF will be on 15 August 2005 in respect of the month from 16 July². The bulk transfer of the assets held in the SHPF will be transferred on 1 July 2005. The transferred assets from the SHPF will be assimilated within the LPF, albeit invested on a different strategy to that used for open ongoing employers.

The Scottish Executive will act as the Guarantor for the transferred SHPF liabilities. The Guarantor's intention is that over time the transferred assets together with any additional contributions that may be made under this agreement should be sufficient to fund the SHPF liabilities. This guarantee will continue until all liabilities of the former SHPF are extinguished.

Notes: All administration costs, including the cost of administering this guarantee will be charged directly to the Scottish Homes element of the LPF. The ongoing contact for operational issues (for example, exercising discretions under the Local Government Pension Scheme (Scotland) Regulations 1998, as amended) will be with Communities Scotland (or its successor) and for funding / guarantee issues will be the Scottish Executive (or its successor).

Any future legislative/regulatory changes affecting the operation of this guarantee should not have an adverse impact on the LPF.

Actuarial valuation procedure and further contributions

The liabilities relating to the SHPF element of the LPF will be valued at 1 July 2005, at 31 March 2008 and subsequently at three yearly intervals. The valuation assumptions, including the assumed future yields on different asset classes, will be set by the LPF actuary and will be demonstrably consistent with those used for the balance of the LPF, except to the extent that the SHPF liabilities exhibit peculiar characteristics that are not already reflected in the valuation assumptions.

However, the funding target for the SHPF element will be different in recognition of the nature of the liabilities and the existence of the guarantee.

¹ Both the SHPF and LPF operate under the Local Government Pension Scheme (Scotland) Regulations 1998

² The final SHPF pension payment will be made on 28 June 2005 in respect of the period from 1 June 2005 to 15 July 2005.

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Funding Targets

The Target Funding Level (TFL) is expressed in terms of the valuation of liabilities without anticipating any excess returns from equities. The TFL will rise over time as the liabilities become more mature, as shown in the table below.

Valuation Date	Target Funding Level
2005	85.0%
2008	87.5%
2011	89.5%
2014	91.5%
2017	93.0%
2020	94.5%
2023	95.5%
2026	96.5%
2029	97.5%
2032	98.0%
2035	98.5%
2038	99.0%
2041	99.5%
2044 & thereafter	100.0%

At each three yearly valuation point, regardless of the actual investment strategy by the LPF for the former SHPF liabilities, the LPF actuary will calculate the ratio of the value of the assets to the remaining liabilities discounted using the real redemption yield on index-linked government bonds of appropriate term to the undischarged liabilities. This quantity is called the Actual Funding Level (AFL). There will be no anticipated out-performance from non Government bonds nor any deduction for investment expenses in the valuation of the liabilities.



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Guarantor's Payments

The AFL and the TFL will be compared at each triennial valuation to assess whether contributions are required from the Guarantor. Where contributions are required the amortisation period will be determined by the LPF. The initial amortisation period is expected to be 8 years, but this may reduce in future.

Funding Scenario		Guarantor's Contributions (effective from one year after valuation date)
1.	AFL greater than or equal to TFL at current valuation date	No contributions
2.	AFL greater than or equal to TFL at previous valuation date, but less than TFL at current valuation date	Contributions are the lesser of: <ul style="list-style-type: none">• current level of contributions; or• the contributions that would result from current AFL if calculated by reference to TFL at this valuation date, as in (3) below.
3.	AFL less than TFL at previous valuation date	Shortfall relative to current target (i.e. TFL at this valuation x capitalised value of liabilities minus assets) is spread over period not exceeding 8 years ³

Whatever the outcome of the valuation as at 1 July 2005, there would be no contributions levied on the Guarantor. The 2008 valuation would be the first assessment that could lead to the Guarantor making extra contributions in the 2009/10 financial year.

The LPF will use its best endeavours to give the Guarantor at least 2 (two) months notice of any change in contributions.

A worked example illustrating how the funding objective is expected to work in practice is included in Annex A.

³ shortfall would be amortised over 8 years (or less) assuming level monthly payments starting one year after effective date of valuation.



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Investment Strategy


The investment strategy of the LPF is set by the City of Edinburgh Council, as administering authority. The LPF will consult the Guarantor on any changes to investment strategy.


Initially, the intention is to adopt an investment strategy comprising of broadly:

	Proportion of Total Assets
Global Equities	45%
Bonds	45%
Property	10%
Total	100%

It is expected that the global equities component will be reduced over time, by around five percentage points every three years. These reductions need not be linked to triennial valuations. Indeed, the desire of the Guarantor is to lock away any *surpluses* that may occur over time by accelerating the transfer of assets into bonds. Here a surplus is defined as assets in excess of the Target Funding Level as defined above.

The Administering Authority will consider how this objective may be implemented in practice.

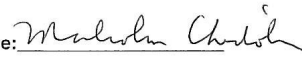

W Douglas B Anderson FIA
Actuary to the Lothian Pension Fund
For and on behalf of Hymans Robertson LLP
29 June 2005

Signed on behalf of City of Edinburgh Council: 

Name: GEIK DREUER

Position: HEAD OF INVESTMENT & PENSIONS

Date: 1 July 2005

Signed on behalf of Scottish Executive: 

Name: Malcolm Chisholm

Position: Minister for Communities

Date: 6-7-05

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Annex – Worked Example of Funding Objectives

Consider the position at the 2008 valuation. The figures used below are hypothetical and do not represent the extremes of the range of outcomes which could occur.

The Target Funding Level (TFL) would be 87.5% of the then liabilities valued on a minimum risk discount rate (i.e. based on Government bond yields of appropriate duration to the liabilities).

Suppose, for simplicity, that bond yields remain the same at around 4.7% pa. The value of the undischarged liabilities in 2008 might be around £128m.

The TFL in 2008 is therefore $£128m \times 87.5\% = £112m$

Consider these scenarios for actual assets:-

Scenario 1 (AFL > TFL in 2008)

Assets are £115m in 2008, giving an AFL of $115/128 = 89.8\%$

As this is higher than the TFL of 87.5% (£112m), no contributions are payable

Scenario 2 (AFL < TFL in 2008, but AFL > TFL in 2005)

Assets are £110m in 2008, giving an AFL of $110/128 = 85.9\%$

This is lower than the TFL at 2008, but is higher than the TFL at 2005 of 85%. There are therefore no contributions payable. This position will be reviewed at the 2011 valuation. For no contributions to continue beyond 2011/12, the AFL would have to rise to be at least 87.5%. (since 87.5% is the TFL for 2008).

Scenario 3.0 (AFL < TFL in 2008 and AFL < TFL in 2005)

Suppose assets fall to £90m by 2008, giving an AFL of $90/128 = 70.3\%$

This is less than the TFL in 2008 of 87.5% and the TFL in 2005 of 85%. Therefore contributions become payable from April 2009.

The shortfall relative to the TFL is $£112m - £90m = £22m$

The recovery of this deficit is to be targeted over 8 years. It is assumed that monthly contributions will be made and allowance is included for the "lost" investment returns on the deficit.

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Assuming bond yields of 4.7%, the monthly contributions would be calculated to be

$$\frac{£22m \times 1.047}{12 \times 6.69^4} = £287,000 \text{ per month}$$

The funding position would be reviewed again at the 2011 valuation, against a TFL of 89.5%. Thus these contributions from the Guarantor would be payable for at least 3 years (2009/10 to 2011/12), but may be reduced (or increased) following the 2011 actuarial valuation.

Scenario 3.1 (AFL < TFL in 2011 and AFL > TFL in 2008)

Suppose there is a dramatic improvement in the AFL from 2008 to 2011, but not sufficient for the AFL to exceed the TFL in 2011 (89.5%).

Suppose in 2011, that the undischarged liabilities are valued at £126m. The assets are £108m in 2011, giving an AFL of 85.7% and a deficit relative to the 2011 TFL of £4.8m.

Again, assuming that bond yields remain at 4.7%pa, the monthly contributions would be calculated to be:

$$\frac{£4.8m \times 1.047}{12 \times 6.69} = £62,600 \text{ per month payable from April 2012 for 8 years, but reviewed again at 2014 valuation}$$

Notes – these examples assume:

- (a) bond yields remain unchanged
- (b) we make no allowance for the shape of the yield curve today
- (c) demographic experience and pension increases are in line with assumptions

⁴ 6.69 is derived as the value of a level annuity payable for eight years at 4.7%pa interest. The actual annuity would be calculated at the prevailing redemption yield on bonds of appropriate duration.

