



FUNDING
STRATEGY
STATEMENT

STRATHCLYDE PENSION FUND
(NO.3 FUND)

Effective: 1st April 2006

1. Introduction

This is the Funding Strategy Statement (FSS) of the Strathclyde Pension Fund (No.3 Fund) (“the Fund”), which is administered by Glasgow City Council, (“the Administering Authority”).

It has been prepared by the Administering Authority in collaboration with the Fund’s actuary, Hymans Robertson, and after consultation with the Fund’s employer and investment adviser and is effective from 1 April 2006.

1.1 Regulatory Framework

Members’ accrued benefits are guaranteed by statute. Members’ contributions are fixed in the Regulations at a level which covers only part of the cost of accruing benefits. Employers pay the balance of the cost of delivering the benefits to members. The FSS focuses on the pace at which these liabilities are funded and, insofar as is practical, the measures to ensure that employers pay for their own liabilities.

The FSS forms part of a framework which includes:

- the Local Government Pension Scheme (Scotland) Regulations 1998 “ the Regulations” (regulations 75A and 76 are particularly relevant);
- the Rates and Adjustments Certificate, which can be found appended to the Fund actuary’s triennial valuation report;
- actuarial factors for valuing early retirement costs and the cost of buying extra service; 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.

1.2 The Fund

The No.3 Fund was established in 1993 as a sub-fund of the Strathclyde Pension Fund. It is an “admission agreement fund” as defined within regulation 74 of the Regulations. First Glasgow is the only employer in the No.3 Fund. No new entrants have been admitted since the Fund was first established. It is treated as a closed fund.

1.3 Review of FSS

The FSS is reviewed in detail at least every three years ahead of triennial valuations being carried out, with the next full review due to be completed by 31 March 2008. More frequently, Annex A is updated to reflect any changes to 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. If you have any queries please contact Richard McIndoe, Head of Pensions in the first instance at Richard.mcindoe@fs.glasgow.gov.uk or on 0141 287 7383.

2. Purpose

2.1 Purpose of FSS

The Office of the Deputy Prime Minister (ODPM) has stated that the purpose of the FSS is:

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

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

This statement sets out how the Administering Authority has balanced the conflicting aims of affordability of contributions, transparency of processes, stability of employers’ contributions, and prudence in the funding basis.

2.2 Purpose of the Fund

The Fund is a vehicle by which scheme benefits are delivered. The Fund:

- receives contributions, transfer payments and investment income;
- pays scheme benefits, transfer values and administration costs.

One of the objectives of a funded scheme is to reduce the variability of pension costs over time for employers compared with an unfunded (pay-as-you-go) alternative.

The roles and responsibilities of the key parties involved in the management of the pension scheme are summarised in Annex B.

2.3 Aims of the Funding Policy

The objectives of the Fund’s funding policy include the following:

- to ensure the long-term solvency of the Fund;
- to ensure that sufficient funds are available to meet all benefits as they fall due for payment and that this remains the case over the remaining life of the Fund;

- to complement the investment strategy of the Fund so that the Administering Authority can seek to maximise investment returns (and hence minimise the cost of the benefits) for an appropriate level of risk;
- to help the employer recognise and manage pension liabilities as they accrue;
- to inform the employer of the risks and potential costs associated with pension funding;
- to minimise the degree of short-term change in the level of the employer's contributions where the Administering Authority considers it reasonable to do so; and
- to use reasonable measures to reduce the risk to other employers and ultimately to the Council Tax payer from the employer defaulting on its pension obligations.

2.4 Funding Mechanism

There are three income streams for the Fund: employee contributions; employer contributions and investment income.

Employee contributions are fixed. Any change could only be introduced by statutory instrument over which the Fund has no control.

Investment income is semi-controllable by the Fund. The Fund controls its investment strategy but has no control over the markets. The investment strategy is dealt with in some detail in the Fund's Statement of Investment Principles, a subsidiary document to the FSS.

Employer contributions are both variable and controllable and are also in effect the "balancing item" in funding - any shortfall in funding from employee contributions and investment returns has to be met from employer contributions.

Hence employer contributions are the principal focus of the FSS.

3. Solvency Issues and Target Funding Levels

3.1 Derivation of Employer Contributions

Employer contributions are normally made up of two elements:

- a) the estimated cost of future benefits being accrued, referred to as the “*future service rate*”; plus
- b) an adjustment for the funding position (or “solvency”) of accrued benefits relative to the Fund’s solvency target, “*past service adjustment*”. If there is a surplus there may be a contribution reduction; if a deficit a contribution addition, with the surplus or deficit spread over an appropriate period.

The Fund’s actuary is required by the regulations to report the *Common Contribution Rate*¹, for the employer collectively at each triennial valuation. It combines items (a) and (b) and is expressed as a percentage of pay. For the purpose of calculating the Common Contribution Rate, the surplus or deficit under (b) is currently spread over a period equivalent to the remaining working lifetime of all the employer’s scheme members.

The Fund’s actuary is also required to adjust the Common Contribution Rate for circumstances which are deemed “peculiar” to an individual employer². It is the adjusted contribution rate which the employer is actually required to pay.

Annex A contains a breakdown of the employer’s contributions following the 2005 valuation for the financial years 2006/07, 2007/08 and 2008/08. It includes a reconciliation of the employer’s rate with the *Common Contribution Rate*

Any costs of non ill-health early retirements must be paid as lump sum payments at the time of the employer’s decision in addition to the contributions described above (or by instalments shortly after the decision).

Employer’s contributions are expressed as minima, with the employer able to pay regular contributions at a higher rate. The employer should discuss with the Administering Authority before making one-off capital payments.

¹ See Regulation 76(4)

² See Regulation 76(6)

3.2 Solvency and Target Funding Levels

The Fund's actuary is required to report on the "solvency" of the whole fund at least every three years.

"Solvency" for ongoing employers is defined to be the ratio of the market value of assets to the value placed on accrued benefits on the Fund actuary's *ongoing funding basis*. This quantity is known as a funding level.

The ongoing funding basis is that used for each triennial valuation and the Fund actuary agrees the financial and demographic assumptions to be used for each such valuation with the administering authority.

The fund operates a target funding level of 100% of its accrued liabilities valued on the ongoing basis.

3.3 Ongoing Funding Basis

The demographic assumptions are intended to be best estimates of future experience in the Fund. They vary by type of member.

The key financial assumption is the anticipated return on the Fund's investments. The investment return assumption makes allowance for anticipated returns from equities in excess of bonds. There is, however, no guarantee that equities will out-perform bonds. The risk is greater when measured over short periods such as the three years between formal actuarial valuations, when the actual returns and assumed returns can deviate sharply.

It is therefore normally appropriate to restrict the degree of change to employers' contributions at triennial valuation dates.

Given the long-term nature of the liabilities, a long term view of prospective returns from equities is taken. For the 2005 valuation, it is assumed that the Fund's equity investments will deliver an average additional return of 2% a year in excess of the return available from investing in index-linked government bonds at the time of the valuation.

3.4 Future Service Contribution Rates

The future service element of the employer contribution rate is calculated on the ongoing valuation basis, with the aim of ensuring that there are sufficient assets built up to meet future benefit payments in respect of future service.

The Fund is closed to new entrants. This is expected to lead to the average age of employee members increasing over time and hence, all other things being equal, the future service rate is expected to increase as the membership ages.

To give some long term stability to the employer's contributions, the *Attained Age* funding method is adopted. This will limit the degree of future contribution rises by paying higher rates at the outset.

The funding methods is described in the Actuary's report on the valuation.

The future service rate includes expenses of administration to the extent that they are borne by the Fund and includes an allowance for benefits payable on death in service and ill health retirement.

3.5 Adjustments

The Fund is closed to new entrants. The payroll base on which the Common Contribution Rate is calculated is therefore shrinking. To address this, the actuary certifies fixed monetary payments in addition to the payroll-based rate. Full details are shown in Annex A.

3.6 Stability of Employer Contributions

3.6.1 Deficit Recovery Periods

The Administering Authority normally targets the recovery of any deficit over a period not exceeding the remaining working lifetime of the employer's active members. This *maximum* period is used in calculating the employer's *minimum* contributions. The employer may opt to pay a higher regular contribution than these minimum rates.

The deficit recovery period starts at the commencement of the revised contribution rate (1 April 2006 for 2005 valuation). The Administering Authority would normally expect the same period to be used at successive triennial valuations, but would reserve the right to propose alternative spreading periods, for example to improve the stability of contributions.

3.7.2 Phasing in of Contribution Rises

In the interests of stability the Administering Authority will normally propose that contribution rises are phased in in even steps over the 3 years of the intervaluation period.

3.8 Termination

The Admission Agreement is open-ended and is expected to continue until the last pensioner dies. Contributions, expressed as capital payments, can continue to be levied after all the employees have retired. The Admission Agreement could however be terminated at any point.

If the admission agreement is terminated, the Administering Authority will instruct the Fund actuary to carry out a special valuation in accordance with regulation 77(2) to determine whether there is any deficit.

Any deficit would be levied on the employer as a capital payment.

3.9 Early Retirement Costs

3.9.1 *Non Ill Health retirements*

The actuary's funding basis makes no allowance for premature retirement except on grounds of ill-health. The employer is required to pay additional contributions wherever an employee retires before attaining the age at which the valuation assumes that benefits are payable.

It is assumed that members' benefits on age retirement are payable from the earliest age that the employee could retire without incurring a reduction to their benefit and without requiring their employer's consent to retire.

The additional costs of premature retirement are calculated by reference to these ages.

3.9.2 *Ill health monitoring*

The Fund monitors the employer's ill health experience on an ongoing basis but does not currently levy additional contributions in respect of ill health retirements.

4. Links to Investment Strategy

Funding and investment strategy are inextricably linked. Investment strategy is set by the administering authority, after consultation with the employers and after taking investment advice.

4.1 Investment Strategy

The investment strategy currently being pursued is described in the Fund's Statement of Investment Principles.

The investment strategy is set for the long-term, but is reviewed from time to time, normally every three years, to ensure that it remains appropriate to the Fund's liability profile. The Administering Authority has adopted a benchmark, which sets the proportion of assets to be invested in key asset classes such as equities, bonds and property. As at 31 March 2005, the proportion held in equities and property was 75% of the total Fund assets.

The investment strategy of lowest risk – but not necessarily the most cost-effective in the long-term – would be 100% investment in index-linked government bonds.

The Fund's benchmark includes a significant holding in equities in the pursuit of long-term higher returns than from index-linked bonds. It is anticipated that this will be reduced as the Fund matures.

4.2 Consistency with Funding Basis

The Fund's investment adviser's current *best estimate* of the long-term return from equities is around 3% a year in excess of the return available from investing in index-linked government bonds.

In order to reduce the volatility of employers' contributions, the funding policy currently anticipates returns of 2% a year, that is 1% a year less than the *best estimate* return.

The anticipated future returns from equities used to place a value on employers' liabilities only relate to the part of the Fund's assets invested in equities (or equity type investments), currently around 60% of all the Fund's assets.

The policy also allows for additional returns of 1% per annum on property which currently represents around 15% of the Fund's total assets, and 0.5% p.a. on corporate bonds which represent around 10% of the Fund.

The remaining 15% of the Fund is invested in a mixture of bonds and cash. Non equity assets invested in bonds and cash are assumed to deliver long-term returns of 0.25%pa more than the prevailing redemption yield on Government bonds.

In this way, the employer contributions anticipate returns from Fund assets which in the Fund actuary's opinion there is a better than 50:50 chance of delivering over the long-term (measured over periods in excess of 20 years).

However, in the short term – such as the three yearly assessments at formal valuations – there is the scope for considerable volatility and there is a material chance that in the short-term and even medium term, asset returns will fall short of this target. The stability measures described in Section 5 will damp down, but not remove, the effect on employer's contributions.

The Fund does not hold a contingency reserve to protect it against the volatility of equity investments.

4.3 Balance between risk and reward

Prior to implementing its current investment strategy, the Administering Authority considered the balance between risk and reward by altering the level of investment in potentially higher yielding, but more volatile, asset classes like equities. This process was informed by the use of Asset-Liability techniques to model the range of potential future solvency levels and contribution rates.

4.4 Intervaluation Monitoring of Funding Position

The Administering Authority carries out detailed monitoring of investment performance on a quarterly and annual basis. This includes some comparison of investment returns relative to the assumed growth in the liabilities. Monitoring reports are considered by the Strathclyde Pension Fund Representative Forum and the Strathclyde Pension Fund Subcommittee and are publicly available via the Fund's (www.spfo.org.uk) and the Council's (www.glasgow.gov.uk) websites. Performance is also reported at the Fund's Annual Meeting.

5. Key Risks & Controls

5.1 Types of Risk

The Administering Authority's has an active risk management programme in place. The measures that the Administering Authority has in place to control key risks are summarised below under the following headings:

- financial;
- demographic;
- regulatory; and
- governance.

5.2 Financial Risks

Risk	Summary of Control Mechanisms
Fund assets fail to deliver returns in line with the anticipated returns underpinning valuation of liabilities over the long-term	<p><i>Only anticipate long-term return on a relatively prudent basis to reduce risk of under-performing.</i></p> <p><i>Analyse progress at three yearly valuations.</i></p> <p><i>Will implement Inter-valuation roll-forward of liabilities between formal valuations at whole fund level, provided on at least an annual basis.</i></p>
Inappropriate long-term investment strategy	<p><i>Since 2001 have set Fund-specific benchmark, informed by Asset-Liability modelling of liabilities.</i></p> <p><i>Benchmark is reviewed at least every 3 years. Will review investment strategy in light of current valuation results and consider measuring performance and setting manager's target relative to bond based target, absolute returns or a Liability Benchmark Portfolio and not relative to indices.</i></p>
Fall in risk-free returns on Government bonds, leading to rise in value placed on liabilities	<p><i>Inter-valuation monitoring, as above.</i></p> <p><i>Some investment in bonds helps to mitigate this risk.</i></p>
Active investment manager under-performance relative to benchmark	<p><i>Short term (quarterly) investment monitoring analyses market performance and active management relative to</i></p>

	<i>the index benchmark.</i>
Pay and price inflation significantly more than anticipated	<p><i>The focus of the actuarial valuation process is on real returns on assets, net of price and pay increases.</i></p> <p><i>Inter-valuation monitoring, as above, gives early warning.</i></p> <p><i>Some investment in bonds also helps to mitigate this risk.</i></p> <p><i>The employers pays for its own salary awards and is reminded of the geared effect on pension liabilities of any bias in pensionable pay rises towards longer-serving employees.</i></p>
Effect of possible increase in employer's contribution rate	<p><i>Seek feedback from employer on scope to absorb short-term contribution rises.</i></p> <p><i>Mitigate impact through deficit spreading and phasing in of contribution rises.</i></p>

5.3 Demographic Risks

Risk	Summary of Control Mechanisms
Pensioners living longer.	<p><i>Set mortality assumptions with some allowance for future increases in life expectancy.</i></p> <p><i>Fund actuary monitors combined experience of around 50 funds to look for early warnings of lower pension amounts ceasing than assumed in funding.</i></p> <p><i>Administering Authority encourage any employers concerned at costs to promote later retirement culture. Each 1 year rise in the average age at retirement would save roughly 5% of pension costs.</i></p>
Deteriorating patterns of early retirements	<p><i>Employer is charged the extra capital cost of non ill health retirements following each individual decision.</i></p> <p><i>Employer ill health retirement experience is monitored.</i></p>

5.4 Regulatory

Risk	Summary of Control Mechanisms
Changes to regulations, e.g. more favourable benefits package, potential new entrants to scheme, e.g. part-time employees	<p><i>The Administering Authority is alert to the potential creation of additional liabilities and administrative difficulties for employers and itself.</i></p> <p><i>It considers all consultation papers issued by the ODPM/SPPA and comments where appropriate.</i></p>
Changes to national pension requirements and/or Inland Revenue rules e.g. effect of abolition of earnings cap for post 1989 entrants from April 2006	<p><i>The Administering Authority will consult the employer where it considers that it is appropriate.</i></p> <p><i>Copies of submissions are available for employers to see at www.spfo.org.uk.</i></p>

5.5 Governance

Risk	Summary of Control Mechanisms
<p>Administering Authority unaware of structural changes in the employer's membership (e.g. large fall in employee members, large number of retirements).</p>	<p><i>The Administering Authority monitors membership movements on an ongoing basis.</i></p> <p><i>The Actuary may be instructed to consider revising the rates and Adjustments certificate to increase an employer's contributions (under Regulation 78) between triennial valuations</i></p> <p><i>Deficit contributions are expressed as monetary amounts.</i></p>
<p>Financial failure and/or default by the employer.</p>	<p><i>Continue to target 100% funding level.</i></p> <p><i>Some financial monitoring of employer.</i></p>

**Annex A – Employers’ Contributions, Spreading and Phasing
Periods**

Following the 2005 valuation, the minimum employer contributions shown in the Rates and Adjustment certificate attached to the 2005 valuation report are based on the deficit recovery periods and phasing periods shown in the table below. The table also shows the individual adjustments under Regulation 76(6) to each employer’s contributions from the ‘Common Contribution Rate’.

[Table to be inserted after valuation exercise complete].

Annex B – Responsibilities of Key Parties

The Administering Authority should:-

- collect employer and employee contributions;
- invest surplus monies in accordance with the regulations;
- ensure that cash is available to meet liabilities as and when they fall due;
- manage the valuation process in consultation with the fund's actuary;
- prepare and maintain and FSS and a SIP, both after proper consultation with interested parties; and
- monitor all aspects of the fund's performance and funding and amend FSS/SIP

The Employer should:-

- deduct contributions from employees' pay correctly;
- pay all contributions, including their own as determined by the actuary, promptly by the due date;
- exercise discretions within the regulatory framework;
- make additional contributions in accordance with agreed arrangements in respect of, for example, augmentation of scheme benefits, early retirement strain;
- notify the administering authority promptly of all actual membership changes including scheme joiners and leavers;
- provide the administering authority with accurate member data including payroll data; and
- notify the administering authority promptly of any proposed changes to membership which may affect future funding.

The Fund actuary should:-

- prepare valuations including the setting of employer's contribution rates after agreeing assumptions with the Administering Authority and having regard to the FSS; and
- prepare advice and calculations in connection with bulk transfers and individual benefit-related matters.