Nottinghamshire County Council Pension Funds
Funding Strategy Statement

March 2008

This Statement has been prepared by Nottinghamshire County Council (the Administering Authority) to set out the funding strategy for the Nottinghamshire County Council Pension Fund and the Nottinghamshire Admission Agreement Etc. Pension Fund (the Schemes), in accordance with Regulation 76A of the Local Government Pension Scheme Regulations 1997 (as amended) and the guidance paper issued in March 2004 by the Chartered Institute of Public Finance and Accountancy (CIPFA) Pensions Panel.

1. Introduction

1.1 The Local Government Pension Scheme Regulations 1997, as amended ("the Regulations"), provide the statutory framework under which the Administering Authority is required to prepare a Funding Strategy Statement (FSS). The key requirements for preparing the FSS can be summarised as follows:

- After consultation with all relevant interested parties involved with the Schemes the Administering Authority will prepare and publish their funding strategy
- In preparing the FSS, the Administering Authority must have regard to:
    - the guidance issued by CIPFA for this purpose, and
    - the Statement of Investment Principles (SIP) for the Schemes published under Regulation 9A of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended)
- The FSS must be revised and published whenever there is a material change in either the policy on the matters set out in the FSS or the Statement of Investment Principles

1.2 Benefits payable under the Schemes are guaranteed by statute and thereby the pensions promise is secure. The FSS addresses the issue of managing the need to fund those benefits over the long term, whilst at the same time facilitating scrutiny and accountability through improved transparency and disclosure. The Schemes are defined benefit final salary schemes under which the benefits are specified in the Regulations. The required levels of employee contributions are also specified in the Regulations.

1.3 Employer contributions are determined in accordance with the Regulations (principally Regulation 77) which require that an actuarial valuation is completed every three years by the actuary, including provision of a rates and adjustments certificate. Contributions to each Scheme should be set so as to "secure its solvency", whilst the actuary must also have regard to the desirability of maintaining as nearly constant a rate of contribution as possible. The actuary must have regard to the FSS in carrying out the valuation.

2. Purpose of the FSS in Policy Terms

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

2.2 **The purpose of this Funding Strategy Statement is:**

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

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

3. Aims and Purpose of the Pension Funds

3.1 **The aims of the funds are to:**

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

3.2 **The purpose of the funds is to:**

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

as defined in the Local Government Pension Scheme Regulations 1997 (as amended) and in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 (as amended).

4. Responsibilities of the Key Parties

4.1 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 actuary
- prepare and maintain an FSS and SIP, both after due consultation with interested parties
- monitor all aspects of the Schemes' performance and funding and amend FSS/SIP.

4.2 The Individual Employer should:

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

4.3 The Fund actuary should:

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

5. Solvency Issues and Target Funding Levels

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

5.2 The principal method and assumptions to be used in the calculation of the funding target are set out in Appendix A. Underlying these assumptions are the following two tenets:

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

5.3 As part of each valuation separate employer contribution rates are assessed by the actuary for each participating employer or group of employers. These rates are assessed taking into account the experience and circumstances of each employer (or employer grouping), following a principle of no cross-subsidy between the various employers in each of the Schemes.

5.4 In attributing the overall investment performances obtained on the assets of each Scheme to each employer, a pro-rata principle is adopted. This approach is effectively one of applying a notional individual employer investment strategy identical to that adopted for the Schemes as a whole. However, under exceptional circumstances the Administering Authority may agree an alternative approach with a particular employer.

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

a. Employer groupings will be adopted for certain employers with small numbers of members in the Funds, specifically Small Scheduled Bodies (within the Nottinghamshire County Council Pension Fund) and the Grouped Admission Bodies (within the Nottinghamshire Admission Agreement Etc Pension Fund).

b. A maximum deficit recovery period of 20 years will apply (17 years for employers within the Nottinghamshire Admission Agreement Etc Pension Fund). Employers will have the freedom to adopt a recovery plan on the basis of a shorter period if they so wish. A shorter period may be applied in respect of particular employers where the Administering Authority considers this to be warranted (see Deficit Recovery Plan below).

c. In the Nottinghamshire County Council Pension Fund employer contribution rates for 2008/09 will be as determined as part of the agreement on stepping of increases at the 2004 actuarial valuation. Following completion of the 2007 actuarial valuation, where increases in Nottinghamshire County Council Pension Fund employer contribution rates are required from 1 April 2009, any increase from the rates of contribution payable in the year 2008/09 may be implemented in steps, over a period of 2 or 4 years.

d. For employers within the Nottinghamshire Admission Agreement Etc Pension Fund, the contribution rates payable in 2008/09 will be 1% of pensionable pay higher than in 2007/08. Any increases required from 1 April 2009 will be implemented in full, unless specific agreement is gained from the Administering Authority.

e. The Administering Authority may agree an alternative pattern of contribution rates in a particular case, where appropriate to the employer in question.

f. Nottinghamshire County Council is responsible for surpluses and deficits arising in respect of the former employees of certain bodies in the Admission Agreement Etc Fund. The treatment of such surpluses and deficits is agreed between the Administering Authority and the Fund actuary at each triennial valuation.

g. On the cessation of an employer's participation in each of the Schemes, the actuary will be asked to make a termination assessment. Any deficit in the Scheme in respect of the employer will be due to the Scheme as a termination contribution, unless it is agreed by the Administering Authority and the other parties involved that the assets and liabilities relating to the employer will transfer within the Scheme to another participating employer.

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

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

5.7 If the assets within the appropriate scheme relating to a particular employer are less than the funding target at the effective date of any actuarial valuation, a recovery plan will be put in place, which requires additional contributions from the employer to meet the shortfall. Additional contributions will be expressed as a level percentage of pensionable payroll, unless arrangements are made otherwise in relation to any particular employer(s).

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

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

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

5.10 All costs in relation to non-ill health early retirement costs will be funded as they occur. Employers may however meet the cost of the early payment strain element in 3 payments over a 2 year period from the date of retirement. These costs will be assessed on the basis of the actuary's advice.

6. Link to Investment Policy

6.1 The investment policy of the funds is set out in the Statement of Investment Principles (SIP). In assessing the value of the Schemes' liabilities in the valuation, allowance has been made for asset out-performance as described in Section 5 and Appendix A, taking into account the investment strategy adopted by the Schemes, as set out in the SIP.

6.2 The results of the 2007 valuation in respect of the Nottinghamshire County Council Pension Fund show the liabilities to be 83% covered by the current assets, with the funding deficit of 17% being covered by future deficit contributions. The results of the 2007 valuation in respect of the Nottinghamshire Admission Agreement Etc. Pension Fund show the liabilities to be 85% covered by the current assets, with the funding deficit of 15% being covered by future deficit contributions.

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

6.4 Investment of the Schemes' assets in line with the least risk portfolio would minimise fluctuations in the Schemes' ongoing funding level between successive actuarial valuations. However, if, at the valuation date, the Schemes had been invested in this portfolio, then in carrying out the valuation it would not be appropriate to make any allowance for out-performance of the investments. This would severely constrain the ability of the Fund to move back towards 100% solvency over time.

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

The current benchmark investment strategy, as set out in the SIP, is:

Equities	55% - 75%
Property	5% - 25%
Bonds	10% - 20%
Cash	0% - 10%

6.6 The Fund will be invested on a core/satellite approach, with approximately 40% of the fund managed in-house on an enhanced index-tracking basis, and the balance with specialist managers who are given targets for out-performance against benchmarks.

6.7 The funding strategy adopted for the 2007 valuation is based on an assumed asset out-performance of 2.75% in respect of liabilities pre-retirement, and 1% in respect of post-retirement liabilities. The Administering Authority believes that these are reasonable and prudent allowances for asset out-performance, based on the investment strategy adopted as set out in the SIP.

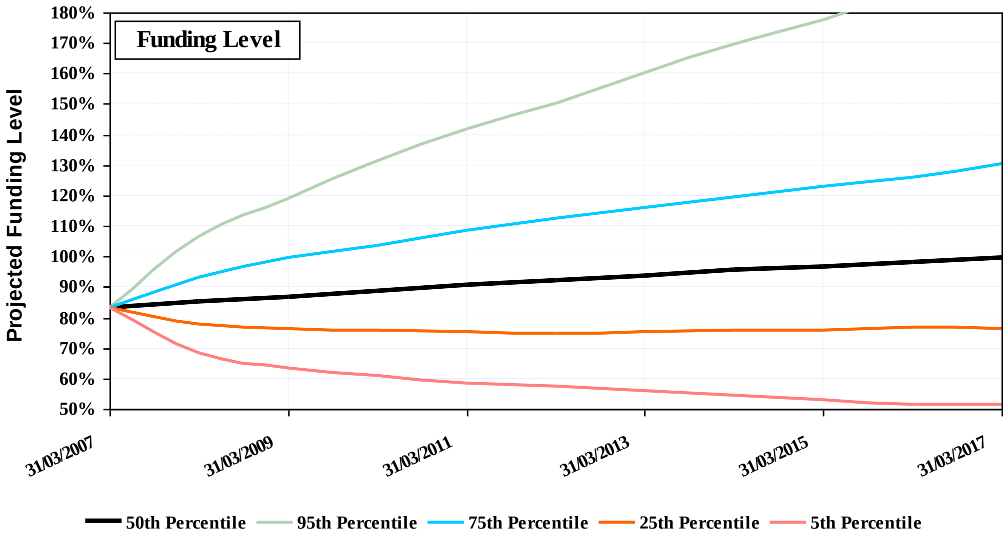
7. Identification of Risks and Counter-measures

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

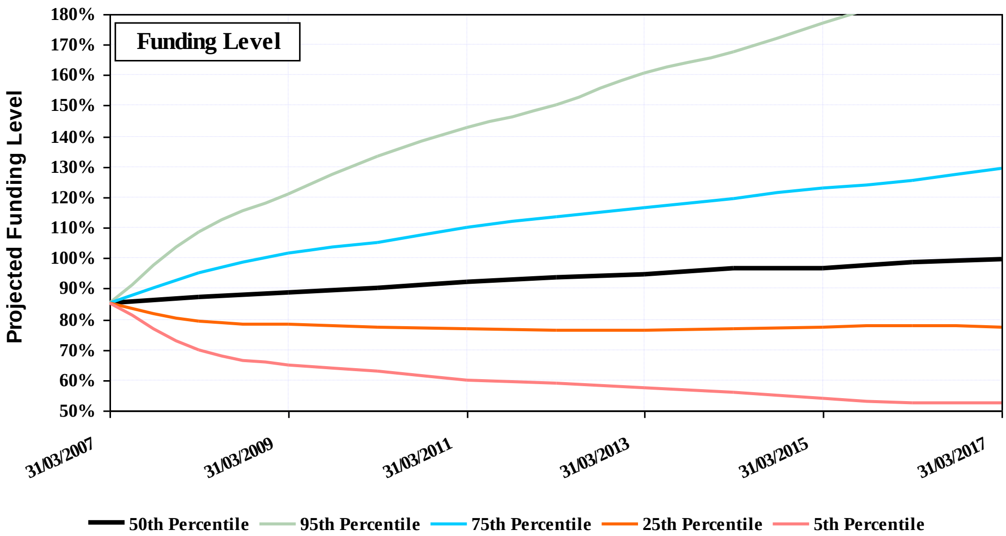
7.2 The Administering Authority has been advised by the actuary that the greatest risk to the Schemes' funding is the investment risk inherent in the predominantly equity based strategy, so that actual asset out-performance between successive valuations could diverge significantly from the overall rate per annum assumed. Based on current liability profiles this rate is 2.05% in the case of the Main Fund and 2.25% in the case of the Admitted Agreement Etc. Fund).

7.3 The following charts show the impact on projected funding levels over 10 years under differing probabilities that actual returns meet those assumed, based on the revised employer contribution rates following the 2007 valuation.

Nottinghamshire County Council Pension Fund



Nottinghamshire Admission Agreement Etc. Pension Fund



7.4 **Financial Risks**

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

7.5 **Demographic Risks**

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

7.6 **Regulatory Risk**

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

7.7 **Governance Risks**

- Administering Authority unaware of structural changes in employer's membership (e.g. large fall in employee numbers, large number of retirements)
- Administering Authority not advised of an employer closing to new entrants
- An employer ceasing to exist with insufficient funding or adequacy of a bond
- Meetings by the Administering Authority taking place infrequently
- Insufficient training being provided to members
- Inadequate procedures for taking and recording decisions
- Lack of continuity of membership of the Pensions Committee and its Sub-Committees

8. Monitoring and Review

8.1 The Administering Authority has taken advice from the actuary in preparing this Statement, and has also consulted with employing authorities.

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

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

- if there has been a significant change in market conditions, and/or deviation in the progress of the funding strategy

- if there have been significant changes to the Schemes' membership, or LGPS benefits

- if there have been changes to the circumstances of any of the employing authorities to such an extent that they impact on or warrant a change in the funding strategy

- if there have been any significant special contributions paid into the Schemes.

Actuarial Valuation as at 31 March 2007

Method and assumptions used in calculating the funding target and recovery plan

Method

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

Financial assumptions

Investment return (discount rate)

A yield based on market returns on UK Government gilt stocks and other instruments which reflects a market consistent discount rate for the profile and duration of the accrued liabilities, plus an Asset Out-performance Assumption (“AOA”) of 2.75% p.a. for the period pre-retirement and 1% p.a. post-retirement.
The asset out-performance assumptions represent the allowance made, in calculating the **funding target**, for the long term additional investment performance on the assets of the Funds relative to the yields available on long dated gilt stocks as at the valuation date. The allowance for this out-performance is based on the liability profile of the Schemes, with a higher assumption in respect of the “pre-retirement” (i.e. active and deferred pensioner) liabilities than for the “post-retirement” (i.e. pensioner) liabilities. This approach thereby allows for a gradual shift in the overall equity/bond weighting of each of the Funds as the liability profile of their memberships mature over time.

Individual Employers

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

Inflation (Retail Prices Index)

The inflation assumption will be taken to be the investment market’s expectation for inflation, adjusted to reflect possible distortion in the UK government index-linked gilt market arising from supply/demand issues. This is derived by taking the difference between yields derived from market instruments, principally conventional and index-linked UK Government gilts as at the valuation date, reflecting the profile and duration of the Scheme’s accrued liabilities, and reducing it by 0.3% p.a.

Salary increases

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

Pension increases

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

Mortality

The mortality assumptions will be based on the most up-to-date information published by the Continuous Mortality Investigation Bureau, making allowance for future improvements in longevity and the experience of the schemes. The mortality tables used are PA92 Year of Birth tables with medium cohort improvements, with an age rating reflecting Scheme specific experience:
Nottinghamshire County Council Pension Fund: +2 years for males, +1 year for females
Nottinghamshire Admission Agreement Etc Pension Fund: +1 year for both males and females.
Members who retire on the grounds of ill heath are assumed to exhibit average mortality equivalent to that for a good health retiree at an age 5 years older.

Commutation

It has been assumed that, on average, 50% of retiring members will take the maximum tax-free cash available at retirement and 50% will take the standard 3/80ths cash sum. The option which members have to commute part of their pension at retirement in return for a lump sum is a rate of £12 cash for each £1 p.a. of pension given up.

Method and assumptions used in calculating the cost of future accrual

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

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

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

The financial assumptions in relation to future service (i.e. the normal cost) are not specifically linked to investment conditions as at the valuation date itself, and are based on an overall assumed real return (i.e. return in excess of assumed price inflation) of 3.7% per annum, with a long term average assumption for price inflation of 2.8% per annum. These two assumptions give rise to an overall discount rate of 6.5% p.a.

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

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

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

Long-term gilt yields and price inflation	
Fixed interest	4.4% p.a.
Index linked	1.3% p.a.
Market implied RPI price inflation	3.1% p.a.
Assumed long-term price inflation	2.8% p.a.
Past service funding target and recovery plan financial assumptions	
Investment return pre-retirement	7.15% p.a.
Investment return post-retirement	5.40% p.a.
Salary increases	4.30% p.a.
Pension increases	2.80% p.a.
Future service accrual financial assumptions	
Investment return	6.50% p.a.
Salary increases	4.30% p.a.
Pension increases	2.80% p.a.

Demographic assumptions	
Non-retired members' mortality	*Nottinghamshire County Council Pension Fund*: PA92 MC YoB tables + 2 year (males) +1 year (females) *Nottinghamshire Admission Agreement Etc Pension Fund*: PA92 MC YoB tables + 1 year (males and females) (+ additional 5 years for retirements in ill health in each case)
Retired members' mortality	*Nottinghamshire County Council Pension Fund*: PA92 MC YoB tables + 2 year (males) +1 year (females) *Nottinghamshire Admission Agreement Etc Pension Fund*: PA92 MC YoB tables + 1 year (males and females) (+ additional 5 years for retirements in ill health in each case)
Commutation	One half of members take maximum lump sum, others take 3/80ths
Withdrawal	Increased allowance compared to 2004 valuation for younger members to leave service
Other demographics	As for 2004 Valuation