Essex Pension Fund Board	EPB/10/10
date: 25 August 2010	

Funding Strategy

Report by the Head of Investments

Enquiries to Martin Quinn on 01245 431412

1. Purpose of the Report

1.1 To review the existing Essex Pension Fund Funding Strategy, approved in 2008, and consider proposals for a revised Funding Strategy Statement and consultation process.

2. Recommendation.

2.1 It is recommended that:

2.2 The draft Funding Strategy Statement attached at Annex E be approved for consultation

2.3 The proposed consultation process set out in the report be approved

2.4 The draft consultation letter, attached at Annex F, be approved

2.5 The proposed list of those to be consulted, attached at Annex D, be approved

3. Background

3.1 Essex County Council, as administering authority of the Essex Pension Fund (the Fund), is required under the Local Government Pension Scheme (LGPS) Regulations to prepare and publish a Funding Strategy Statement (FSS) and keep the statement under review; making appropriate revisions following any material change in its policy on the matters set out in the statement, or in its statement of investment principles. If revisions are made to the FSS it has to publish the statement as revised. In reviewing and making revisions to the statement, the authority must have regard to the guidance produced by the Chartered Institute of Public Finance and Accountancy and consult such persons as it considers appropriate.

3.2 The current FSS was produced in 2007/08, following a major review in conjunction with the triennial valuation of the Fund as at 31 March 2007. The strategy set out in the FSS has been kept under review in the years since its publication alongside interim reviews of the Fund conducted by the Actuary but no revisions have been considered necessary.

3.3 However as a further triennial review of the Fund as at 31 March 2010 is being undertaken and as there have been material changes in some of the factors taken into account in formulating the strategy it is now appropriate to undertake a comprehensive review.

3.4 The triennial valuation is taking place against a political and economic backdrop that cannot be ignored. Public sector pensions have been under intense scrutiny for some time and there is growing pressure for action to be taken to both reduce the cost burden falling on the public purse and to equalise pension provision between the public sector and the private sector by reining back what is characterised as gold-plated public sector pension provision. In addition most, if not all, of the employers in the Fund will be directly affected by the financial pressures resulting from the political imperative to reduce public sector expenditure in order to reduce our economic deficit. The Fund is of course much constrained by what it can do to reduce its costs by the statutory nature of the LGPS but within its statutory obligations can influence and vary the effects on employer contributions, for example by varying the pace of funding, in order to avoid the worst short and medium term impacts and, by its investment policies, assist with long term affordability.

3.5 In 2009 Communities and Local Government (CLG), the government department that oversees the LGPS and acts as sponsor, consulted with LGPS stakeholders on ways in which the continuing affordability, viability and fairness of the LGPS could be ensured. This consultation, which put forward for consideration suggestions on financing plans, local funding targets and revised employee contributions, ended on 30 September 2009 and to date, has had no apparent outcome. However it drew to stakeholders' attention that there was a case for making use of the flexibility available to funds and the long term nature of their operations in order to minimise the impact of the short term adverse impacts of the current economic conditions on employers and tax-payers. The considerations discussed in this report have regard to that point.

4. Solvency issues and target funding levels

4.1 The policy that the Fund has followed to date and which is embedded in its current FSS has been determined in accordance with the following 6 principles detailed below. A first step in agreeing the funding strategy going forward is to consider to what extent those principles remain valid.
Comments on each principle are set out below in italics for consideration.

a. **our long-term aim is to achieve 100% funding of pension liabilities**;
In view of the CLG consultation on financing plans and local funding targets it seems appropriate to consider whether this is still appropriate. In responding to the CLG consultation in September 2009 on a move away from a funding target of less than 100% funding, the Council argued against the idea. The response is set out in full at Annex A. If the Pension Board is still of a similar conviction then it would seem that the principle of the target should remain unchanged and the draft FSS has been prepared on that basis.

b. **the Scheme is expected to continue for the foreseeable future**;
The establishment of the independent Public Service Pensions Commission to undertake a fundamental structural review of public service pension provision, including the LGPS, by Budget 2011 must raise a question mark against the above principle. However the terms of reference of the Commission (set out in full at Annex B) do include making recommendations on how public service pensions can be made sustainable and affordable in the long-term and include the proviso that existing accrued pension rights will be protected. At present there remains a statutory obligation on the administering authority to continue to maintain the Fund. The draft FSS has therefore been prepared on the basis that the scheme will continue for the foreseeable future. The Commission is due to produce an interim report by the end of September 2010. Any information flowing from that report relevant to the future of the LGPS will be able to be reflected in the next draft of the FSS post consultation.

c. favourable investment performance can play a valuable role in achieving adequate funding over the longer term;
At present the LGPS as a partially funded scheme and relatively immature scheme has funds available to invest. It would theoretically be possible to invest those funds on a "least risk" basis to match liabilities. However the ISC, following a detailed asset liability modelling exercise, has adopted an investment strategy which has the prospect that out-performance by its assets will over time reduce the contribution requirements or at a minimum contribute to off-setting increases in contributions arising from issues such as increased longevity. That strategy, designed to maximise returns within an acceptable risk profile, is in line with the ISC's core investment beliefs and includes a substantial allocation to asset classes such as equities which are expected to grow at levels significantly in excess of bonds (the traditional "least risk" investment) in the long term.

d. we wish to minimise fluctuations in employers' contributions in order to assist them with their financial planning and to meet their financial responsibilities to the Fund;

It remains an aim of the Fund, which is linked to the statutory requirements placed on the Actuary, to enable contribution rates to be kept as nearly constant as possible. The importance of this and of adopting a long term approach to funding, reflecting the long term nature of the LGPS, to ensure affordability for employers and the sustainability of the scheme has been highlighted by central government over recent valuations and consultation exercises. In setting this principle it is recognised that there is an essential conflict (or trade-off) between seeking certainty of cost through minimising fluctuations and the adoption of a risk based investment strategy – principle c. A comprehensive understanding of this requires analysis not just of the risk factors at play, but also of the mechanisms the Fund's actuary has to manage contribution rate volatility, as mandated by the FSS. These approaches include adoption of "long-term" non-market related approaches for setting future service contribution requirements, smoothing mechanisms, possible allowance for increased levels of investment returns, and extension of the deficit recovery period.

The draft FSS has been formulated with a view to avoiding the need for any increase in employer contributions but also not allowing any reduction in employer contributions unless a reduction would have been due under the 2007 valuation assumptions.

e. the LGPS as a whole, in comparison with other UK funded pension schemes, is relatively immature in terms of its membership profile with a high proportion of contributors. The Essex Fund is similarly positioned and we can therefore take advantage of that fact in setting our investment strategy;

This remains the case as can be seen from the cash flow modelling exercises that have been undertaken by the Fund for the Actuary. However the pace of increasing maturity does need to be monitored and of course the position can change on an individual employer level to a greater or lesser extent than for the Fund as a whole. The Actuary will be in a position to advise further on how this has moved from the 2007 valuation to 2010 once the first set of results based on the full data is available. This area should therefore be revisited when that initial analysis is available after the consultation period and any required changes reflected in a further draft of the FSS.

f. **we have a large number of employing bodies with different characteristics including size and strength of covenant.**
Again this remains the case and an exercise has been undertaken in conjunction with the Actuary to analyse the employing bodies and produce a risk profile for the Fund. This can be used to help inform decisions on various elements of our strategy such as determining deficit recovery periods, stepping arrangements, and differential investment strategies. It may also be of further help going forward if the Fund were to adopt a policy of positive engagement designed to reduce the risks borne by the Fund by seeking to strengthen employer covenants by such means of bond/indemnity insurance, parent company or local authority guarantees and charges on assets in exchange for less stringent funding requirements (e.g. extended recovery periods) while preserving and perhaps even strengthening employer protection from cross-subsidisation.

5. Funding Objectives

The aims of the Fund are to:

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

It is suggested that in the light of the comments above on the principles that the aims of the Fund are amended to the following:

- **enable employer contribution rates to be kept as stable as possible;**
- **manage employers' liabilities effectively;**
- **ensure that sufficient resources are available to meet all liabilities as they fall due; and**
- **maximise the returns from investments within reasonable risk parameters;**
- **minimise the risks to the Fund from its admission arrangements by strengthening its admission arrangements and pursuing a policy of positive engagement.**

The current long term funding objective of the Authority as set out in the FSS is: "To achieve and maintain assets equal to 100% of projected accrued liabilities (the "funding target"), assessed on an ongoing basis including allowance for projected final pay."

In order to achieve that objective, in setting its funding strategy in 2007/8, the Authority adopted a number of objectives for setting employer contribution rates in order to achieve the funding target. These are set out in full at Annex

C and are individually considered below, in the light of the revised aims set out above, with comments in italics.

6. Funding Objective 1 – The Funding Target

6.1 The current funding target is:
"we will set employers' contribution rates to achieve 100% funding of liabilities in the long term"

This is discussed above under Paragraph 4 – Solvency issues and target funding levels.

7. Funding Objective 2 – Composition of the employer contribution rate

7.1 Currently the employer contribution rate is composed of two separate elements:

- an ongoing rate to recover the costs of future service; and
- a deficit recovery contribution to recover the shortfall revealed by the actuarial valuation

This seems to work well, is now familiar to employers and is the basis on which the draft FSS has been prepared. However these arrangements could be revised if thought desirable. For example, if it was decided to give scheduled employers greater freedom in how ill-health retirements were provided for, that element might need to be separated out from the ongoing rate. On ill health retirements there are a variety of approaches available, including direct charging (as already operated by some funds), pay as you go (PAYG) for tier 3 ill heath benefits, and insurance solutions. The Fund already operates direct charging for non-ill health early retirements and also for administration expenses (for most employers).
The essence of this issue is defining what elements are to be funded via the contribution rate, and what elements are to be met by some other mechanism (e.g. PAYG or direct charging). Broadly LGPS funds (given the regulatory requirement to operate on a funded basis) do fund for all benefits and costs through the contribution rate, other than for a few clearly identified items (i.e. early retirement costs and possibly ill health costs and expenses as noted above). Further than that we would be breaking new ground for LGPS, but there are theoretically many possibilities, such as not funding in advance for salary increases, pension increases, or longevity improvements.

8. Funding Objective 3 – Grouping of Employers

8.1 Currently for the purpose of administration, the calculation of contribution rates and for the setting of maximum deficit recovery periods the Fund deals with certain employers and types of employers in discrete groups. These are:

- town and parish councils; and
- those small admission bodies that were members of the small admission bodies group as at 1 April 2007

The small admission bodies group was closed to new members with effect from 1 April 2007 as part of the funding strategy considerations because of *concerns about growing volatility of membership of the group. That volatility has continued to grow and consideration has been given by officers and the Actuary to the idea of winding the group up and treating all the members as stand alone bodies. However, following a detailed examination of the group, it is considered that the majority of the employer's interests are best served by allowing the group to continue to operate. It is however considered that it would be good practice to include the rules under which the groups are operated in the FSS.* ***They have therefore been added as Schedule B to the draft FSS.***

9. Funding Objective 4 – Deficit Recovery Periods – Grouped Employers

9.1 We currently set deficit recovery periods for the above groups of employers. Those deficit recovery periods are set at levels that:

- are likely to reduce the level of deficit during the inter-valuation period if all of the Actuary's assumptions prove correct; and
- safeguard the interests of the Fund by having regard to the strength of covenant and the financial stability of the grouped employers.

Although it is proposed that the arrangements should continue to safeguard the interests of the Fund by having regard to the strength of covenant and the financial stability of the grouped employers any extension of the recovery plan beyond roughly 21 years will mean the level of deficit will not be reduced during the inter-valuation period. It would of course be eliminated at the end of the deficit recovery period if the Funding Strategy is successful. The proposed deficit recovery period for the town and parish councils group is proposed as 30 years while that for the small admitted bodies group will be calculated later in the valuation process and reported to the Board when it next considers the funding strategy after the consultation period. It is proposed that this funding objective is revised to reflect this change as follows:

We will set deficit recovery periods for the above groups of employers. Those deficit recovery periods will be set at levels that

- **as far as possible are likely to reduce the level of deficit during the inter-valuation period if all of the Actuary's assumptions prove correct; and**
- **safeguard the interests of the Fund by having regard to the strength of covenant and the financial stability of the grouped employers.**

10. Funding Objective 5 – Schools

10.1 Currently schools, including former grant maintained schools, are treated as part of the local education authority within whose area of responsibility they fall for the purpose of setting contribution rates and deficit recovery periods. Any discretions in respect of these matters fall to be exercised by the local education authority.

No change is proposed in regard to the above arrangements but the position in regard to academies should perhaps be clarified by adding the following: ***"Schools that opt to become academies become stand-alone employers***

in their own right but inherit responsibility for the share of scheme deficit attributable to the former school(s) from which they were formed and that share of scheme deficit will then be taken into account in calculating their separate contribution rate."

Note1. Essex County Council has adopted a policy of allowing schools becoming academies to take with them any accumulated surpluses at the date of transfer. These can then be used to defray any share of scheme deficit should the academy so choose. It is expected that this will become a statutory right for new academies established under the Academies Act.
Note2. The share of scheme deficit referred to above does not include any charges in respect of compensatory added years (CAY). CAY are not fund benefits and the cost of these is charged directly to the employer responsible for the decision to award CAY. Academies will be charged the cost of CAY awarded by the former schools from which they are formed where these costs were being met by those schools.

11. Funding Objective 6 – Other employers deficit recovery periods

11.1 Currently under similar arrangements to those discussed at paragraph 10 above (re Funding Objective 4) maximum deficit recovery periods are set for the remaining employers. They, however, are given the freedom to decide to repay their share of the deficit over a shorter period should they so choose.

The above practice was adopted in order to permit employers greater flexibility to manage their own budgets and should operate to reduce fund risk. It is now proposed that this arrangement should be varied in order to give employers even greater freedom to manage the impact of their financial responsibilities to the Fund. The proposal is that the Fund should set standard deficit recovery periods (which would in standard circumstances apply to the various classes of employer) and maximum deficit recovery periods. Individual employers would be enabled to agree with the Fund an increase in their deficit recovery period up to the maximum, subject to providing proof of a strengthened covenant. The sort of proofs that might be considered acceptable would be transfer Scheme employer consent, provision of a bond, parent company guarantee, deposits or other sureties.

It is therefore proposed that this objective should be amended to the following:

We will set standard and maximum deficit recovery periods for the remaining employers but will leave them the freedom to decide to repay their share of the deficit over a shorter period should they so choose;

- **the standard deficit recovery periods will be set at levels that safeguard the interests of the Fund by having regard to the Fund's judgement of the strength of covenant and the financial stability of individual employers;**
- **individual employers will, at the discretion of the Fund, be able to increase their deficit recovery period up to the maximum deficit recovery period subject to providing assurance of greater strength of covenant and financial stability. (e.g. transferor Scheme employer consent, provision of a bond, a deposit, a parent company guarantee or other surety);**
- **No reduction in the level of an employer's contributions will be allowed unless the deficit recovery period adopted by that**

employer is equal to or less than the standard deficit recovery period.

12. Funding Objectives 7 and 8 – Deficit recovery periods

12.1 The Fund sets maximum deficit recovery periods for grouped employers and other employers in accordance with the criteria set out at Funding Objective 4.

Set out in the tables below are the existing deficit recovery periods and those proposed for inclusion in the new FSS.

Where an extension of deficit recovery period to 30 years for some bodies is proposed it should be noted that it could potentially give rise to a reduction in contribution requirements for some employers at the 2010 valuation. It is however additionally proposed that there should be an underpinning of the current levels of contributions. e. g. no reduction in overall contribution level for an employer would be allowed unless the calculated contribution on the basis of the standard recovery period would be lower than that calculated for the previous valuation.

Deficit recovery periods for grouped employers			
Employer Category	Existing Deficit Recovery Period	**Standard Deficit Recovery Period**	***Proposed Deficit Recovery Period***
town and parish councils	20 years	20 years (applicable for the purpose of any possible reduction in contributions – see 12.1 above)	***30 years***
small admission bodies	The average remaining working life of the small admission bodies' group work-forces as at 1 April 2007	***The average remaining working life of the small admission bodies' group work-forces as at 1 April 2010***	***The average remaining working life of the small admission bodies' group work-forces as at 1 April 2010***

Employer Category	Existing Deficit Recovery Period	**Standard Deficit Recovery Period**	**Maximum Deficit Recovery Period**
scheme employers	20 years	**20 years**	**30 years**
arms length management organisations of scheme employers	20 years	**20 years**	**30 years**
care trusts	20 years	**20 years**	**30 years**
admission bodies working on contracts for scheme employers	Either the period that the contract still has to run or 20 years whichever is the shorter period.	**The period that the contract still has to run.**	**30 years**
other admission bodies	The average remaining working life of the employer's work-force as at 1 April 2007	**The average remaining working life of the employer's work-force as at 1 April 2010**	**30 years**

13. Funding Objective 9 – Phasing in of contributions – grouped bodies

13.1 The grouped employing bodies (small admission bodies and town & parish councils) deficit recovery contributions and ongoing rate contributions are currently phased in, in steps over the 3 year inter-valuation period.

It is proposed that this arrangement should be continued.

14. Funding Objective 10 – Phasing in of contributions – other employers

14.1 Currently certain individual employers, detailed in Annex C, have been given the opportunity to introduce the increase in their deficit recovery contributions and/or their ongoing rate contributions in steps over the 3 year inter-valuation period by either phasing or aggregation.

- *It is proposed that this arrangement should be continued but that a revised list of employers to whom this facility will be offered is produced using the information obtained from the employer risk analysis that has been carried out. The proposed list will be submitted for consideration when the Board next considers the FSS.*

15. Funding Objective 11 – Termination arrangements

15.1 When the funding strategy was last set it was agreed that on the cessation of an employer's participation in the Scheme, the actuary would be asked to make a termination assessment. Any deficit in the Scheme in respect of the employer would be due to the Scheme as a termination contribution, unless it was agreed by the administering authority and the other parties involved that the assets and liabilities relating to the employer would be transferred within the Scheme to another participating employer.

It is proposed that this practice should be continued but that the objective should be amended to state the basis on which termination assessments are made.
At its meeting on 31 March 2010, the Board adopted a policy in respect of admission arrangements and bulk transfers. It included the following in regard to termination arrangements :

"The "least risk" basis of assessment of a termination payment will apply for all admission bodies, except where a successor or guarantor body inherits ongoing responsibility for the orphan liabilities arising on cessation of the admission."

However the Board also agreed that, to enable proper consideration of policy on the adoption of 'least risk' terms for terminations, officers should carry out an analysis of the risk exposure for existing admissions to determine the implications of ring-fencing. This analysis should consider those bodies that have no guarantor separately from those who do. This was to help determine whether the above basis should be applied to both new and existing bodies. However it is considered that the greatest risk mitigation is obtained from implementing the above proposal for both new and existing bodies and that it is on this basis that the draft FSS should be prepared and employers be consulted. The work is being carried out and will be reported back to the Board at its December meeting at which time the Board can make a final decision I the light of employer responses. It is therefore proposed that the objective be amended to read:

On the cessation of an employer's participation in the Scheme, the actuary will be asked to make a termination assessment. Any deficit in the Scheme in respect of the employer would be due to the Scheme as a termination contribution, unless it was agreed by the administering authority and the other parties involved that the assets and liabilities relating to the employer would be transferred within the Scheme to another participating employer. The "least risk" basis of assessment of a termination payment will apply for all admission bodies, except where a successor or guarantor body inherits ongoing responsibility for the orphan liabilities arising on cessation of the admission.

16. New Objectives proposed for inclusion

16.1 In line with the aim discussed at 4.1d and to enable some employers to possibly take advantage of an increased investment return it is proposed that the following new objective is added:

"Funding Objective 12 – Increased Investment Return Allowance

In certain instances, and in particular for Fund employers who are considered by the Administering Authority to provide a high level of covenant as noted above, an allowance may be made as part of the recovery plan for investment performance at a higher level than that assumed for assessment of the long term funding target. This higher level of return assumed will, in particular, reflect the actual investment strategy of the Fund, on the basis that this is to be maintained over the entire recovery period, and will be closer to the best estimate return assumptions for the actual investment strategy. The methodology and assumptions to be used in these calculations are set out in the Appendix of the draft FSS."

Such employers will still retain the freedom to decide not to take up this option and pay a higher contribution rate.

16.2 At its meeting on 31 March 2010, the Board adopted a policy in respect of admission arrangements and bulk transfers. It is recommended that two new objectives reflecting that policy should now be included in its FSS as follows:

"Funding Objective 13 - Admission arrangements

Transferee Admission Bodies

All transferee admission bodies (i.e. "best value" contractors delivering services to scheme employers) should be accepted for admission into the Fund so long as all the necessary regulatory requirements for admission are satisfied.
No special conditions or requirements will apply for transferee admission bodies given their ultimately close links with the Scheme Employer, although the Fund retains the right to seek special terms or conditions if these are considered warranted in specific cases.
In the case of a transferee admission body, or any participating employer acting as guarantor in the case of non-transferee admission bodies, implementation of an alternative funding basis or approach (including on termination) will be subject to agreement from the relevant guarantor body/scheme employer. Any special funding arrangements between the scheme employer and transferee admission body should be covered by the commercial arrangements, i.e. outside the Fund and not part of the admission agreement.
No future transferee admission bodies will be eligible to join the Small Admitted Bodies Group.

Community Admission Bodies

Community admission bodies will be accepted for participation in the Fund, or otherwise, on a case by case consideration of the merits of

admission and the associated risks to the Fund. In general, a guarantee or alternative surety will be required for all community admission body cases, with this requirement waived at the Fund's discretion on an exceptions basis.
For community admission bodies the Fund will consider application of special conditions or requirements as deemed appropriate. Examples of such conditions are:

- **a guarantee from another Fund employer with sufficient covenant strength**
- **a surety bond or other contingent asset**
- **an independent review of covenant, including the possibility of a parent guarantee.**

All community admission bodies will be allowed flexibility to elect to adopt a funding approach prior to termination in line with the "least risk" exit debt basis, if that is their preference."

"Funding Objective 14 - Transfer arrangements

In the case where a contractor wishes to offer a broadly comparable scheme, rather than apply to become an admitted body of the Fund, standardised bulk transfer terms will be offered via the Actuary's Letter. The letter will be structured so as to target an asset transfer to the contractor's Broadly Comparable scheme such that it is equivalent to 100% of the past service liabilities reserved for by the Fund in respect of the transferring members' accrued service as at the date of transfer. The Fund will only agree to any variations in the standard in exceptional circumstances and with the prior agreement of the transferring scheme employer."

17. Investment policy

17.1 It is a requirement of the FSS that it should clearly show the link between the required investment returns to meet the funding strategy and the investment policy as set out in the SIP.

In preparation for the 2010 valuation process, the Fund's investment consultants, Hymans Robertson, were asked to update the investment expectations for the Fund. The following is a summary of their findings which will in due course be reflected in an updated version of the SIP to be considered by the ISC later in the year:

Expected strategic return on assets

At 31 March 2010, Hymans Robertson's assumptions with regard to the long term returns on asset classes were:

Asset class	20 year return (% p.a.)
UK Equity	7.9%
Overseas / Global Equity	7.6%
Private Equity	9.0%
Fixed Interest Gilts	4.7%
Index-linked Gilts	4.5%
Corporate Bonds	5.5%
LIBOR+	5.0%

Property	**5.8%**
Infrastructure	**5.8%**

Given the Fund's long term strategic allocation of assets at that time (re-weighting for Private equity) of:

%	
10.0	UK Equity
53.0	Overseas / Global Equity
6.0	Private equity (including activism)
1.2	Fixed Interest Gilts
3.8	Index-Linked Gilts
5.5	Corporate Bonds
6.0	LIBOR + (including Company Loans)
12.0	Property
2.5	Infrastructure

this would imply a long term strategic expected return of 7.0% p.a. on an arithmetic weighted average of these individual returns. This does not take account of any expected return from active management (including currency) or the benefit we might expect from diversification (which we expect to come through as 'bonuses'). Using Hymans Robertson's internal asset model (which, in this case, also does not take account of active management, but does allow for the benefits of diversification) some analysis was performed with respect to various expected returns and the probability of achieving that return. The model (based on the current structure) calculates a central expected return of 7.9% p.a. The overall expected return on a portfolio of assets does not solely reflect the arithmetic weighted average of the returns on the individual asset classes. This is due to diversification i.e. when you combine a portfolio of assets which are not fully correlated to each other the expected portfolio return is greater than the arithmetic combination of the individual returns. This reflects the lower volatility of the portfolio compared to the volatility of the sum of the parts. This is sometimes referred to as 'volatility drag'.

The probability of achieving particular levels of out-performance relative to the liabilities is as follows:

	1 year	3 years	20 years
Probability of achieving liabilities + 1.0% p.a	57%	63%	77%
Probability of achieving liabilities + 2.5% p.a	53%	56%	62%
Probability of achieving liabilities + 3.5% p.a	50%	52%	51%

The Actuary's current market related assumptions in regard to the 2010 valuation are:

	%
A liability based fixed interest gilt yield of:	*4.5*
A liability based index linked gilt real yield of:	*0.7*
Adjustment for inflation risk premium and CPI:	*0.8*
Therefore implied inflation of:	*3.0*

His asset out performance assumptions, consistent with previous actuarial valuations are:

<u>Past service liabilities</u>	
Pre-retirement =	*gilts + 2.5%*
Post – retirement =	*gilts +1%*
Total fund =	*gilts + 1.9%**
<u>Future service liabilities</u> =	*Inflation + 3.75%*

** This 1.9% value was assessed at the 2007 valuation, and will be revised to take account of the liability mix at the 2010 valuation when results are available. The value represents the average required return for the current liability mix. As such the value is expected to reduce progressively over time as the scheme's membership matures.*

Given the above assumptions as to fixed interest gilt yields and inflation these give the following assumed investment return requirements for the fund relative to conditions as at 31 March 2010:

	%
Past service liabilities =4.5% + 1.9% =	*6.40*
Future service liabilities =3.0% + 3.75% =	*6.75*

Examination of the Fund Returns expected by Hymans Robertson shows a long term strategic expected return (for the individual asset classes) of 7.0% and a long term strategic expectation for the whole fund allowing for the benefit of diversification of 7.9%.

It will be seen that there is a margin between the valuation assumptions required to meet the funding target and the long term investment return expected for the Fund. This gives a degree of comfort in the funding plan, providing a buffer to assist the Fund in riding out periods of adverse experience or other events. There are, however, other potential uses to which this "buffer" could be directed. For example, a partial de-risking of the investment strategy might be considered, or an increased allowance from higher levels of investment returns could be taken to subsidise employer contribution requirements towards deficit recovery. However, any such alternative utilisation of the buffer would then reduce or remove the comfort margin, and hence impact the flexibility available for maintaining employer contribution stability (principle d above).

18. Draft FSS for 2010/11

The draft FSS for 2010/11, incorporating all of the above proposals, is attached at Annex E for members' consideration. It is proposed that it should now be sent out for consultation as described below.

19. 2010/11 FSS Consultation Process

It is proposed that the draft FSS for 2010/11 should be sent out to the various parties detailed at Annex D, accompanied by the draft covering letter attached at Annex F. This has been drafted to identify for those being consulted the changes proposed and invite them to respond both in general and to certain specific questions. Members will note that responses are requested by 26 November 2010. This gives those consulted a period of nearly 3 months to respond and should permit responses to be collated and reported back to the Board on 15 December 2010, when it is proposed that final consideration should be given to the FSS.

20. Background Papers

20.1 CIPFA Pensions Panel Guidance on Preparing and Maintaining a Funding Strategy Statement (Guidance note issue No.6).

20.2 CLG Letter of 25 June 2009 on LGPS – Delivering Affordability, Viability and Fairness.

20.3 Email from Hymans Robertson dated 13 May 2010 enclosing updated return expectations and detailed explanatory paper.

Annex A

Essex County Council
Finance Directorate
PO Box 11, County Hall
Chelmsford
Essex CM1 1LX

To: Mr Richard McDonagh 30 September 2009
Workforce, Pay and Pensions
Local Government Finance Directorate
Zone 5/F6 Eland House
Bressenden Place
London SW1E 5DU

Dear Mr McDonagh

LOCAL GOVERNMENT PENSION SCHEME DELIVERING AFFORDABILITY, VIABILITY AND FAIRNESS

I am writing in response to Mr Crossley's letter of 25 June 2009 to set out the views of Essex County Council, as the Administering Authority of the Essex Pension Fund, on the proposals put forward in that letter.

Financing Plans
Much of this proposal covers work already undertaken in the Funding Strategy Statement, the Actuarial Valuation and the details included within presentations made at employer forums. This proposal formalises these arrangements and provides a degree of greater transparency. We are therefore generally supportive of this proposal. However clarity is needed on the approach funds are expected to follow in determining the funding of each employer's liabilities.

Local Funding Targets
We believe that any move which fails to recognise 100% of liabilities should be opposed in principle. Whilst there have been subsequent developments (both in investment markets and central Government intervention) it can be argued that the overwhelming majority of LGPS Funds are still recovering from the last change in funding target when 75% funding was introduced between 1 April 1990 and 31 March 1993. For the Essex Fund, the requirement for payments in respect of deficit came in for the first time from 1 April 1994 and remains to this day.

In the past the Essex Fund, through its Funding Strategy Statement, has demonstrated flexibility in planning to reach a target of 100% funding, through the use of existing contribution strategies (i.e. deficit recovery periods and, where appropriate, phasing arrangements). It is felt that this is a more coherent and realistic approach than one which ignores a proportion of Fund liabilities. In summary therefore our view is that any reduction in funding target is financially irresponsible and is to be opposed in principle. We support flexibility in how Funds reach 100%, but cannot agree with any lowering of the target.

Revised Employee Contributions
Within the wider political messages that currently frame the debate on the LGPS this proposal is not a surprise. However, it is possible to make a case that higher earners are being unfairly penalised under the proposals. Furthermore if, as has been suggested, the overall average employee rate remains broadly the same, then the Fund will not benefit from the proposal. Whilst changes in employee contributions may gain support in some quarters, the proposal doesn't guarantee increased income for the Fund and its benefit is therefore open to question.

I hope that the above comments are clear and will be helpful to you in further consideration of the proposals. If you should need any further information please do not hesitate to contact me.

Yours sincerely

Margaret Lee
Chief Financial Officer

Annex B

The independent Public Service Pensions Commission Terms of reference

To conduct a fundamental structural review of public service pension provision and to make recommendations to the Chancellor and Chief Secretary on pension arrangements that are sustainable and affordable in the long term, fair to both the public service workforce and the taxpayer and consistent with the fiscal challenges ahead, while protecting accrued rights.

In reaching its recommendations, the Commission is to have regard to:
· the growing disparity between public service and private sector pension provision, in the context of the overall reward package – including the impact on labour market mobility between public and private sectors and pensions as a barrier to greater plurality of provision of public services;
· the needs of public service employers in terms of recruitment and retention;
· the need to ensure that future provision is fair across the workforce;
· how risk should be shared between the taxpayer and employee;
· which organisations should have access to public service schemes;
· implementation and transitional arrangements for any recommendations; and
· wider Government policy to encourage adequate saving for retirement and longer working lives.

As part of the review, the Commission is invited to produce an interim report by the end of September 2010. This should consider the case for delivering savings on public service pensions within the spending review period – consistent with the Government's commitment to protect those on low incomes - to contribute towards the reduction of the structural deficit.

The commission is invited to produce the final report in time for Budget 2011.

Scheme coverage
- For civil servants:
* Principal Civil Service Pension Scheme
* Principal Civil Service Pension Scheme (Northern Ireland)
- Armed Forces Pension Scheme
- For NHS employees:
* NHS Pension Scheme
* NHS Superannuation Scheme (Scotland)
* Health and Personal Social Services Northern Ireland Superannuation Scheme
- For teachers:
* Teachers' Pension Scheme (England and Wales)
* Scottish Teachers' Superannuation Scheme
* Northern Ireland Teachers' Superannuation Scheme
- For Local Government:
* Local Government Pension Scheme (England and Wales)
* Local Government Pension Scheme (Scotland)
* Northern Ireland Local Government Pension Scheme
- Police Pension Scheme (administered locally)
- Firefighters' Pension Scheme (administered locally)
- United Kingdom Atomic Energy Authority Pension Schemes
- Judicial Pensions Scheme
- Department for international Development – Overseas Superannuation Scheme
- Research Councils' Pension Schemes

In addition to the schemes mentioned above, there are a number of smaller schemes and many established to cover only one senior appointment which do not specifically need to form part of the review but which will be required to act on the recommendations.

Annex C

Employers who will be given the opportunity to introduce the increase in their deficit recovery contributions and/or their ongoing rate contributions in steps over the 3 year period 2008/09 to 2010/11 by either phasing or aggregation;

Essex County Council
Basildon District Council
Braintree District Council
Brentwood Borough Council
Castle Point Borough Council
Chelmsford Borough Council
Colchester Borough Council
Epping Forest District Council
Harlow District Council
Maldon District Council
Rochford District Council
Southend-on-Sea Borough Council (Unitary)
Tendring District Council
Thurrock Council (Unitary)
Uttlesford District Council
Essex Fire Authority
Essex Police Authority
Essex Probation Committee
Braintree College
Chelmsford College
Colchester Institute
Colchester Sixth Form College
Epping Forest College
Harlow College
Palmers Sixth Form College
South East Essex College of Arts & Technology
South East Essex Sixth Form College
Thurrock and Basildon College
Writtle Agricultural College
Anglia Polytechnic University
University of Essex

Annex D

Suggested parties to be consulted on the draft Funding Strategy Statement:

- County Council
- District & Borough Councils
- Unitary Councils – (Including on behalf of their schools)
- Incorporated Colleges and Academic Institutions
- Other Scheduled Bodies
- Town & Parish Councils
- Small Admitted Bodies
- Transferee Admission Bodies
- Other Admission Bodies
- Fund Advisers
- Fund Actuary
- Fund Auditors
- Fund Custodian
- Fund Investment Managers