SOUTH YORKSHIRE
PENSIONS AUTHORITY

South Yorkshire Pension Fund

Funding Strategy Statement (FSS) as at March 2012

This Funding Strategy Statement (FSS) has been prepared by South Yorkshire Pensions Authority (the Authority) to set out the funding strategy for the South Yorkshire Pension Fund (the Fund), in accordance with Regulation 35 of the Local Government Pension Scheme (Administration) Regulations 2008 ("the Administration Regulations") (as amended) and the guidance papers issued in March 2004 and November 2004 by the Chartered Institute of Public Finance and Accountancy (CIPFA) Pensions Panel.

1. Introduction

The Local Government Pension Scheme (Administration) Regulations 2008 provide the statutory framework from which the Authority is required to prepare a Funding Strategy Statement. The key requirements for preparing the FSS can be summarised as follows:

- After consultation with all relevant interested parties involved with the Fund the Authority will prepare and publish their funding strategy;
- In preparing the FSS, the Authority must have regard to :-
- the guidance issued by CIPFA for this purpose; and
- their own Statement of Investment Principles (SIP) for the Fund published under Regulation 12 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (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.

Benefits payable under the Local Government Pension Scheme 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 Scheme is a defined benefit final salary scheme under which the benefits are specified in the governing legislation (the Local Government Pension Scheme (Benefits, Membership and Contributions) Regulations 2007 (as amended), "the Benefit Regulations"). Changes to the benefits under the Scheme took place from April 2008. The required levels of employee contributions are also specified in those Regulations.

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Employer contributions are determined in accordance with the Administration Regulations (principally Regulation 36) which require that an actuarial valuation is completed every three years by the actuary, including a rates and adjustments certificate. Contributions to the Fund 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

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 or pace at which this advance provision is made. Although the Administration Regulations specify the fundamental principles on which funding contributions should be assessed, implementation of the funding strategy is the responsibility of the Authority, after having taken professional advice from its advisors, including the actuary.

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; and**
- **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 Fund 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 Authority to implement and maintain.

3. Aims and purpose of the Pension Fund

The aims of the Fund 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, and

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- maximise the returns from investments within reasonable and clearly understood risk parameters.

The purpose of the Fund is to:

- receive monies in respect of contributions, transfer values and investment income, and

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

as defined in the Benefit and Administration Regulations and in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (as amended).

4. Responsibilities of the key parties

The Authority should:

- collect employer and employee contributions
- calculate benefits correctly and ensure that they are paid promptly
- 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 an FSS and a SIP, both after due consultation with interested parties
- monitor all aspects of the Fund's performance and solvency and amend FSS/SIP, and
- ensure that administration costs are kept to a minimum.

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
- maintain policies on discretions and exercise them within the regulatory framework

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- make additional contributions in accordance with agreed arrangements in respect of, for example, augmentation of scheme benefits, early retirement strain, and

- notify the Authority promptly of all changes to membership or, as may be proposed, which affect future funding.

The Fund actuary should:

- prepare valuations including the setting of employers' contribution rates after agreeing assumptions with the Authority and having regard to the FSS

- prepare advice and calculations in connection with bulk transfers and individual benefit-related matters, and

- advise on funding strategy, the preparation of the FSS, and the inter-relationship between the FSS and the SIP.

5. Solvency issues and target funding levels

To meet the requirements of the regulations the Authority's long-term funding objective is to achieve and then maintain assets equal to 100% of projected accrued liabilities, assessed on an ongoing basis including allowance for projected final pay.

The key financial assumptions making up the funding strategy and as adopted for the 2010 actuarial valuation are:

Past Service (current yields basis)	31 March 2010
Asset valuation	Market Value
Asset out-performance assumption (pre-retirement)	2.0%
Asset out-performance assumption (post-retirement)	1.0%
Discount rate (pre-retirement)	6.5%
Discount rate (post-retirement)	5.5%
Pension increases (CPI Price Inflation)	3.0%
Long-Term Earnings inflation	4.75%
Future Service (long term basis)	
Discount rate (pre-retirement)	6.7%
Discount rate (post-retirement)	6.7%
Pension increases (CPI Price Inflation)	3.0%
Earnings inflation	4.75%

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A full description and summary of the main financial and demographic assumptions adopted for the 2010 actuarial valuation are shown in the formal report produced by the Actuary for the valuation.

Underlying these assumptions are the following two tenets:

- that the Fund 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.

The current actuarial valuation of the Scheme is effective as at 31 March 2010. The results of the valuation indicate that overall the assets of the Scheme represented 79% of projected accrued liabilities at the valuation date.

Each employer in the Fund has their own unique contribution rate. Past practice had been to express this as a percentage of their pensionable payroll, incorporating a common contribution rate for future benefit accrual adjusted by a further percentage to account for any significant demographic and/or financial variances plus any past service deficit or surplus. Traditionally this had worked well in a climate of steadily increasing employer payrolls but recent experience of changes in employers' workforces (and thus payrolls) supported the need to re-examine this approach. Accordingly, contribution rates since 2005 have been (and will continue to be) expressed in terms of a percentage of payroll for future benefit accrual plus or minus capital payments in respect of any deficit or surplus adjustments. Such an approach brings the following advantages:

- the presentational value of the transparent separation of costs between future benefit accrual and past service liabilities

- greater stability for employers in their budgeting for pension costs, and

- greater certainty of cashflow for the Authority for investment planning

However, the Authority recognises that from an operational point of view some employers may find difficulty with this approach. To alleviate any problems that might be caused the Authority modifies this approach by requiring the actuary to certify the rates in terms of minimum values. By doing so, employers are able to convert the capital payments into a percentage of their payroll thus reverting back to an all-inclusive percentage rate, if they so wish. This is on the proviso that, whatever the actual mechanics employed by individual employers, the sum paid during the Fund's financial year meets, or exceeds, the minimum value required of them. A further advantage of taking this modified line is to enable any employer to advance their return to 100% funded over a shorter period, should their finances permit them to contribute more than their minimum contribution.

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The capital payments in respect of any deficit identified by the Actuary at the valuation date (or surplus adjustments) will be subject to annual increases in line with the Consumer Prices Index i.e. the annual Pension Increase Orders. The required capital payment (or surplus adjustment) identified at the valuation date as at 31 March 2010 therefore will be increased by the 2011 Pension Increase Order of 3.1% for 2011/12. Those for 2012/13 and 2013/14 will be increased by the 2012 and 2013 Pension Increase Orders as required.

However, as part of an agreed phasing pattern, for the four district councils, the annual inflationary increase to the required capital payments identified at the valuation date will not be applied for the period 2011/14. The underpayment in deficit contributions arising as a result of the annual indexation freeze for the district councils will be identified by the actuary as part of the actuarial valuation as at 31 March 2013 and recovered by the Fund over the period 1 April 2014 to 31 March 2017 as part of the contribution requirements certified following the 2013 valuation.

With regards to costs for ill-health or voluntary early retirement, for certain employers in the Fund, the actuary has again included an allowance, based upon the employer's workforce and discretionary policies, within the certified contribution rate which is published in the valuation report and monitored by the Authority. Additionally, any "strain" costs generated on redundancy, efficiency or flexible retirements are collected by additional capital payments over a maximum of three years. For those employers for whom the certified contribution rate excludes an allowance for ill-health or voluntary early retirement costs, the Administering Authority will require the Fund's actuary to review that employer's contribution rate on all early retirements occurring during the period of the rates and adjustments certificate issued by the Actuary following the 2010 valuation..

The Authority, following consultation with interested parties, has adopted the following objectives to achieve the funding target:

- the underlying objective is to return the assets of the Fund to a position where they can meet 100% of its liabilities by March 2036

- within this overall target, scheduled and resolution bodies and those admission bodies that are backed by scheduled body guarantees are allowed to extend their recovery period up to the maximum period of recovery, or such shorter period as they may individually decide. Any extension in recovery period up to the maximum is only permissible in circumstances where stability and not a reduction in the level of deficit recovery lump sum contributions would be the outcome (compared to the levels certified at the 2007 actuarial valuation).

- those "transferor admission bodies" operating outsourced services under a contract which expires within that period are limited to the lifetime of that

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contract unless the body is in surplus at the valuation date in which case the maximum recovery period will be applied.

- due to their weaker covenant, admission bodies that are not backed by a guarantee will adopt a shorter recovery period (up to March 2031) subject to the following provisos;

- those with a defined (or expected) lifespan shorter than that period are limited to that shorter period, such known (or expected) events to be declared by the admission body as soon as practicable

- no allowance for the increased investment return allowance during the recovery period will be made (see later comments)

In determining the deficit recovery period(s) the Authority has had regard to:

- the responses made to the consultation with interested parties on the FSS principles

- the recognition that it would be impractical for each employer to have a bespoke recovery period and therefore some grouping of employer categories is appropriate

- 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, and

- the Authority's views on the strength of the participating employers' covenants in achieving the objective.

6. Link to investment policy set out in the Statement of Investment Principles

The results of the 2010 valuation show the liabilities to be 79% covered by the current assets, with the funding deficit of 21% being covered by future deficit contributions.

In assessing the value of the Fund's liabilities in the valuation, allowance has been made for asset out-performance as described in Section 5, taking into account the investment strategy adopted by the Authority, as set out in the SIP.

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 and is known as the "Least Risk Portfolio" or LRP.

Investment of the Fund's assets in line with the LRP would minimise fluctuations in the Fund's ongoing funding level between successive actuarial valuations.

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If, at the valuation date, the Fund had been invested in the LRP, then in carrying out the valuation it would not be appropriate to make any allowance for out-performance of the investments. On this basis of assessment, the assessed value of the Fund's liabilities at the 2010 valuation would have been significantly higher, by approximately 34% and the declared funding level would be correspondingly reduced to approximately 59%.

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

In order to ensure as far as possible that its investment strategy is appropriate for the Fund's liabilities the Authority has adopted a diversified asset allocation. The strategic asset allocation is adopted only after analysing the Fund's liability structure in detail. The Fund takes managed risks in order to achieve the performance it needs to meet its objectives. The Authority seeks to understand and control the risks rather than trying to eliminate them. The returns achieved from investment will, to a considerable degree, reflect the risks taken. The risks are assessed in relation to the Fund's liability structure. The adoption of a strategic asset allocation policy combined with detailed monitoring of tactical management relative to targets and constraints increases the likelihood of achieving the intended outcome. This needs to be done in such a way that allows managers sufficient flexibility to enhance returns. The Authority is well aware of this fine balance and will always have due regard to diversification, the return potential, liquidity, management costs and other impacts when determining what it regards as an appropriate level of risk. It is important to recognise that it is not possible to control the absolute return on investments. Over the longer term, however, by recognising the types of risks outlined the Authority seeks to achieve the returns required to achieve the objectives of this Statement.

The current benchmark (reproduced below) was approved in March 2011 but only adopted from October 2011. It is a natural development of the previous benchmark which arose out of the 2007 actuarial valuation. When determining and reviewing the benchmark strategy the Authority carefully considers the expected return on investments and has concluded that in the longer term the return on equities should be greater than that from other assets. The benchmark return has been comfortably ahead of both price and earnings inflation over recent periods though the Authority is aware that, over the shorter term, returns may vary significantly from one period to another. The Authority regularly reviews its policies but its long term objective is to ensure that the investment returns achieved will be at least in line with the assumptions underlying the actuarial valuations and, therefore, be appropriate to the liabilities of the Fund. An interim review following the 2010 actuarial valuation concluded that this was the case.

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Bonds	**23**		
UK Gilts	0		
UK Index Linked	12	+-3	9-15
UK Corporate Bonds	7	+-3	4-10
Emerging Market Bonds	2	+-3	0-5
High Yield Bonds	2	+-3	0-5
Quoted Equities	**60**		
UK	20	+-5	15-25
Overseas	40	+-5	35-45
NAm	11.5	+-5	6.5-16.5
Europe	9.5	+-5	4.5-14.5
Japan	3.75	+-5	0-8.75
Pacific	8.0	+-5	3-13
Other	7.25	+-5	2.25-12.25
Private Equity	**3.5**	**+-5**	**0-8.5**
Absolute Return	**3.5**	**+-5**	**0-8.5**
Property	**10**	**+-3**	**7-13**
Cash	**0**	**+10**	**0-10**

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Geographical split within overseas equities: 29% North America; 24% Western Europe; 9% Japan; 20% Pacific Basin ex Japan; 18% Emerging Markets.

The funding strategy adopted for the 2010 valuation is based on an assumed asset out-performance of 2% in respect of liabilities pre-retirement, and 1% in respect of post-retirement liabilities. Based on the liability profile of the Fund at the valuation, this equates to an overall asset out-performance allowance of 1.4% ahead of the LRP p.a. The Authority believes that this is a reasonable and prudent allowance for asset out-performance, based on the investment strategy adopted as set out in the current SIP.

During the recovery period, an increased investment return (IIR) of 2.5% p.a. ahead of the LRP has been allowed for in the calculation of the required deficit recovery contributions for certain employers in the Fund (the asset-out performance for the remaining employers being 1.4% p.a.). The Authority believes that the additional allowance is a reasonable “best estimate” allowance for asset out-performance during the recovery period, based on the investment strategy as set out in the SIP and following analysis undertaken by the Actuary.

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The additional allowance is applied to those employers which the Authority deems to be of sufficiently high covenant to support the anticipation of investment returns during the recovery period.

7. Identification of risks and counter-measures

The funding of defined benefits is by its nature uncertain. Funding 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.

The Authority has been advised by the actuary that one of the Fund's greatest risks to its funding level 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 1.4% per annum assumed, on the basis of the current liability profile.

The chart below shows a "funnel of doubt" funding level graph, which illustrates the range and uncertainty in the future progression of the funding level, relative to the funding target adopted at the valuation. Using a simplified model, the chart shows the probability of exceeding a certain funding level over a 10 year period from the valuation date. For example, the top line shows the 95th percentile level (i.e. there is a 5% chance of the funding level at each point in time being better than the funding level shown, and a 95% chance of the funding level being lower). The graph adopts the 2010 actuarial valuation results as a starting point, and allows for the planned contributions into the Fund based on the valuation and funding strategy. The chart assumes median investment returns in line with "best estimate" market expectations and variability of those returns broadly in line with historic experience.

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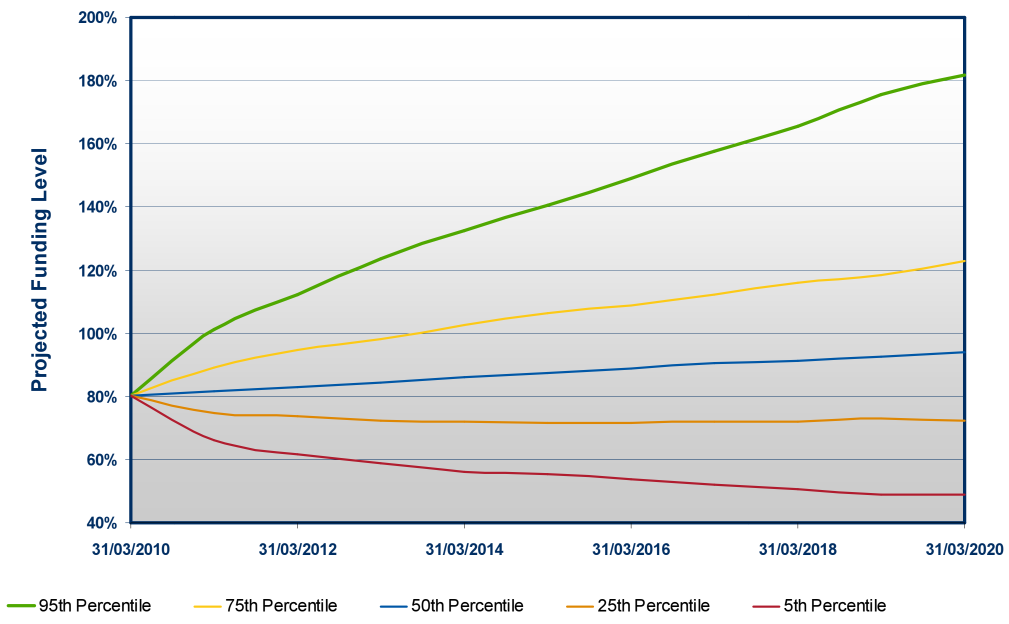

The CIPFA guidance identifies the following key risks:

Financial

- Investment markets fail to perform in line with expectations
- Market yields move at variance with assumptions
- Investment Fund Managers fail to achieve performance targets over 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

Demographic

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

Regulatory

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

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Governance

- Authority unaware of structural changes in employer's membership (e.g. large fall in employee numbers, large numbers of retirements)
- Authority not advised of an employer closing to new entrants
- An employer ceasing to exist with insufficient funding or adequacy of a bond
- In relation to the overall governance of the Fund the Authority's governance statement can be found at: http://www.sypensions.org.uk/AZ/G/tabid/282/language/en-GB/Default.aspx

8. Monitoring and Review

The Authority has taken advice from the actuary in preparing this Statement, and has also consulted with employers and trade unions representing the Fund membership.

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 then current economic conditions and will also reflect any legislative changes.

The 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 Fund membership, or LGPS benefits
- if there have been changes to the circumstances of any of the employers 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 Fund.