

HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Pension Fund Panel
Date:	17 June 2011
Title:	Funding Strategy Statement
Reference:	3029
Report From:	County Treasurer

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1. Executive Summary

2.2 The purpose of this report is to provide for the Panel's approval the updated Funding Strategy Statement which was developed as part of the 2010 actuarial valuation.

2. Funding Strategy Statement

2.2 As part of the 2010 actuarial valuation prepared by the Fund actuary Aon Hewitt, the Funding Strategy Statement has been updated. The Funding Strategy Statement was circulated to all employers in the Fund for their review in February 2011, and following no adverse comments this version has now been finalised. It was used by Aon Hewitt to underpin their work on finalising the actuarial valuation at 31 March 2010.

2.2 The updated Funding Strategy Statement has been attached to this report as Appendix 1, for the Panel's information. The Statement of Investment Principles is included within the Funding Strategy Statement. This version of the Statement of Investment Principles is unchanged from the one approved by the Panel on 15 December 2010.

3. Recommendation

3.1. That the Panel approve the updated Funding Strategy Statement.

CORPORATE OR LEGAL INFORMATION:**Links to the Corporate Strategy**

This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision because actions are required to approve the Pension Fund's Funding Strategy Statement.
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Other Significant Links

Links to previous Member decisions:		
<u>Title</u>	<u>Reference</u>	<u>Date</u>
Direct links to specific legislation or Government Directives		
<u>Title</u>	<u>Date</u>	

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

<u>Document</u>	<u>Location</u>
None	

IMPACT ASSESSMENTS:

1. Equalities Impact Assessment:

- 1.1. Equality objectives are not considered to be adversely affected by the proposals in this report.

2. Impact on Crime and Disorder:

- 2.1. The proposals in this report are not considered to have any direct impact on the prevention of crime.

3. Climate Change:

- a) How does what is being proposed impact on our carbon footprint / energy consumption?

No specific impact.

- b) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.

Funding Strategy Statement

The Fund's Pension Fund Panel undertook its latest substantive review of the Funding Strategy Statement (FSS) in February 2011. The FSS will next be revised and published while the actuarial valuation is being prepared as at 31 March 2013, unless circumstances are such, that an earlier review becomes necessary.

Introduction

The Local Government Pension Scheme (Administration) Regulations 2008 require the Hampshire Pension Fund to prepare and publish a Funding Strategy Statement (FSS). The Fund's Actuary must take this statement into account when setting employers' contribution rates.

The Chartered Institute of Public Finance and Accountancy (CIPFA) issued detailed guidance on the content and format of an FSS. This guidance was followed in preparing this document.

This FSS should be read in the context of the Fund's Statement of Investment Principles (SIP), which sets out in detail the Fund's investment arrangements and strategy. The current version of this is attached for information on pages 16 to 23.

Purpose of the Funding Strategy Statement

The FSS has two main purposes:

- To set out clearly the Fund's strategy for how it intends to meet its liabilities over the long term.
- To explain how the Fund will try to maintain stable contribution rates from employers.

Aims of the Fund

The Fund has four main aims:

- To make sure the Fund can always meet its liabilities.
- To enable employers' contribution rates to be kept as stable as possible and affordable for the Fund's employers.
- To manage the employers' liabilities effectively.
- To maximise the income from investments within reasonable risk parameters.

The main aims of the Fund are explained in more detail below.

To make sure the Fund can always meet its liabilities

The Fund's primary aim is long-term solvency. Accordingly, employers' contributions will be set to ensure that 100% of the liabilities can be met over the long term.

The Fund is deemed to be solvent when the assets held are equal to 100% of the Funding Target.

Hampshire County Council as Administering Authority will make sure that the Fund always has enough cash available to pay pensions, transfer values to other pension funds, and other costs and expenses. Such expenditure will normally be met from incoming contributions from employees and employers and investment income, to avoid the cost of selling any of the Fund's investments. The position is reviewed every three months to make sure enough cash is available to meet the Fund's obligations.

To enable employers' contribution rates to be kept as stable as possible and affordable for the Fund's employers

Achieving stability in employers' contribution rates requires investment in assets that 'match' the Fund's liabilities. In this context, 'match' means behaving in a similar way to the liabilities as economic conditions alter. Of the main strategic asset classes, index-linked and fixed-interest investments are the best match for the Fund's liabilities.

Other asset classes, such as shares and property, offer the potential for higher long-term rates of return. A substantial proportion of the Fund's investments are held in these asset classes with the aim of increasing investment returns. However, these asset classes are more risky and can lead to volatile returns over short-term periods.

This short-term volatility in investment returns can lead to similar volatility in the Fund's solvency level in successive actuarial valuations, which in turn can mean volatility in employers' contribution rates. Such volatility can be reduced by using smoothing adjustments as advised by the actuary.

Maintaining stability in employers' contribution rates can run counter to the main aim of ensuring solvency. There is a need to strike a balance between the investment policy, smoothing adjustments used when carrying out actuarial valuations, and the stability of employers' contribution rates from one valuation period to the next.

The position can be even more volatile for admission bodies which participate in the Fund for a fixed period (for example, non-local authority employers awarded contracts to provide local authority services), where use of smoothing adjustments is less appropriate.

The Administering Authority recognises that a balance needs to be struck regarding the financial demands made of community admission bodies. On the one hand, the Administering Authority requires all admission bodies to be fully self funding (either on a grouped or an individual basis), such that other employers in the Fund are not subject to expense as a consequence of the participation of those admission bodies. On the other hand, requiring contributions to target full funding at all times, without further smoothing, may cause failure of the body in question in periods of extreme economic conditions, leading to significant costs for other participating employers.

Under economic circumstances which the Administering Authority judges to be extreme, the Administering Authority may determine that the contribution pattern required to target full funding can be temporarily relaxed for community admission bodies to enable contributions to remain affordable in the short term. Effectively the contribution pattern can be back-end loaded to a greater extent than would otherwise be permitted. Additionally, the Administering Authority may direct that, should a community admission body leave the Fund during the relaxation period, the Scheduled Bodies funding group would provide future funding for any deficiency developing in respect of former liabilities of the community admission body (this process is called 'subsumption' for the purposes of this document).

Such action has four implications:

- During the period of relaxation, contribution rates for community admission bodies can be set at a lower level in the short term than would otherwise be required.
- Should a community admission body leave the Fund during such a period, the cessation funding requirement can be reduced to reflect the Fund's continuing access to funding, should a deficiency emerge in the future in respect of those liabilities. i.e. the funding requirement is based on the liabilities being subsumed (see '*Cessation of participation - valuations*' below), and any future deficit in respect of those liabilities is met by the Scheduled Bodies funding group as a whole.
- Should a community admission body leave the Fund during such a period when short term contribution rate requirements have been relaxed, the funding requirement in any cessation valuation carried out under Regulation 38 of the Local Government Pension Scheme (Administration) Regulations 2008 will be reduced to the extent that contributions, on a cumulative basis, have fallen short of what continued targeting of full funding without any smoothing would require. i.e. this part of the deficit will effectively be paid for by the Scheduled Bodies funding group and the shortfall in contributions has been underwritten.

At subsequent valuations the position will be reassessed with a view to returning admission bodies to paying contributions which target full funding.

To manage the employers' liabilities effectively

The County Council as Administering Authority makes sure that the Fund's liabilities are managed effectively. This is achieved by commissioning actuarial valuations every three years as required by law. These determine the employers' contribution rates required to make sure liabilities can be managed effectively. The Administering Authority also commissions additional work in relation to the specific issues described below:

Cessation of participation - Subsumed liabilities

Where an employer is leaving the Fund and will no longer have any contributing members, another employer in the Fund may agree to provide future funding in respect of any emerging deficiencies.

In such circumstances the liabilities are known as subsumed liabilities, as responsibility for them is subsumed by the accepting employer. The Administering Authority will assume that the investments held in respect of those liabilities will be the same as those held for the rest of the liabilities of the accepting employer. Generally this will mean assuming continued investment in more risky investments than Government bonds.

Cessation of participation - Orphan Liabilities

Where an employer is leaving the Fund and will no longer have any contributing members, and the residual liabilities are not subsumed, the Administering Authority will act on the basis that it will have no further access for funding from that employer once any cessation valuation, carried out in accordance with Regulation 38, has been completed and any sums due have been paid. Residual liabilities of employers from whom no further funding can be obtained are known as orphan liabilities.

The Administering Authority will seek to minimise the risk to other employers in the Fund of having to make good any deficiency arising on the orphan liabilities. To achieve this, the Administering Authority will seek sufficient funding from the outgoing employer to match the liabilities with low risk investments, generally Government fixed interest and index linked bonds.

Cessation of participation – valuations

Where an admission body ceases participation, a cessation valuation will be carried out in accordance with regulation 38 of the Local Government Pension Scheme (Administration) Regulations 2008. That valuation will take account of any activity as a consequence of cessation of participation regarding any existing contributing members (for example any bulk transfer payments due) and the status of any liabilities that will remain in the Fund.

In particular, the cessation valuation will distinguish between residual liabilities which will become orphan liabilities, and liabilities which will be subsumed by other employers. For orphan liabilities the funding target in the cessation valuation will anticipate investment in low risk investments such as Government bonds. For subsumed liabilities the cessation valuation will anticipate continued investment in assets similar to those held in respect of the subsuming employer's (or group of employers') liabilities.

Regardless of whether the residual liabilities are orphan liabilities or subsumed liabilities, the departing employer will be expected to make good the funding obligation revealed in the cessation valuation. In other words, the fact that liabilities may become subsumed liabilities does not necessarily remove the possibility of a cessation payment being required.

For those employers subject to the grouped funding arrangements, the cessation valuation may also include allowance for any cross subsidies anticipated from other employers with which it is grouped. This would allow the employer to take immediate credit for the contributions expected to be paid over the long term from

other group employers in respect of the outgoing employer's share of the group deficit.

Interim reviews for admission bodies

Regulation 38(4) of the Local Government Pension Scheme (Administration) Regulations 2008 provides the Administering Authority with the power to carry out valuations in respect of Admission Bodies, and for the Actuary to certify revised contribution rates, between triennial valuation dates.

The Administering Authority's overriding objective at all times in relation to admission bodies is that, where possible, the funding target for that body is clear, and that contribution rates payable are appropriate for that funding target. However, this is not always possible as any date of cessation may be unknown (for example, participation may be assumed at present to be indefinite), and because market conditions change daily.

The Administering Authority's general approach in this area is as follows:

- Where the date of cessation is known, and is more than 3 years away, or is unknown and assumed to be indefinite, interim valuations will generally not be required by the Administering Authority.
- For transferee admission bodies falling into the above category, the Administering Authority sees it as the responsibility of the Relevant Scheme Employer to instruct it if an interim valuation is required. Such an exercise would be at the expense of the Relevant Scheme Employer unless otherwise agreed.
- A material change in circumstances, for example the date of cessation becoming known, material membership movements or material financial information coming to light may cause the Administering Authority to review the situation informally and subsequently request a formal interim valuation.
- Where an admission body is due to leave the Fund within the next 3 years, the Administering Authority will monitor developments and may see fit to request an interim valuation at any time in order to try to effect a smoother transition to cessation.

In addition, the Administering Authority reserves the right to request an interim valuation of any admission body at any time in accordance with Regulation 38(4).

Inter-valuation funding valuations

In order to monitor developments, the Administering Authority may from time to time request informal valuations or other calculations. Generally, in such cases the calculations will be based on an approximate update of the asset and liability values, and liabilities calculated using assumptions consistent with the latest valuation. It is unlikely that the liabilities would be calculated using individual membership data, or that the assumptions would be reviewed.

Guarantors

Some admission bodies participate in the Fund by virtue of the existence of a Guarantor. The Administering Authority maintains a list of employers and their Guarantors. For any new admission body wishing to join the fund, the Administering Authority will require a Guarantor. The Administering Authority, unless notified otherwise, sees the role of a Guarantor to include the following:

- If an admission body leaves the Fund and defaults on any of its financial obligations to the Fund, the Guarantor is expected to provide the Fund with the amount certified by the Fund Actuary as due, including any interest payable.
- If the Guarantor is an employer in the Fund and is judged by the Administering Authority to have suitable financial security, the Guarantor may clear some of the financial liability by subsuming the residual liabilities into its own pool of Fund liabilities. In other words, it agrees to be a source of future funding in respect of those liabilities should future deficiencies emerge.

During the period of participation of the admission body a Guarantor may at any time agree to the future subsumption of any residual liabilities of an admission body. That action would reduce the funding target for the admission body, which would probably lead to reduced contribution requirements.

In extreme circumstances the Guarantor may be permitted to subsume all assets and liabilities of the admission body including the inheritance of any deficit. However, where the Guarantor is a grouped employer, the Administering Authority may insist upon the Guarantor meeting the contributions required to clear the deficit inherited by the Guarantor, to protect the other employers in the Guarantor's group from this element of the group's deficit.

Bonds and other securitization

Regulation 6 of the Local Government Pension Scheme (Administration) Regulations 2008 creates a requirement for risk reviews and bonds to be provided in certain circumstances. The Administering Authority's approach in this area is as follows:

- In the case of Transferee Admission Bodies admitted under Regulation 6(2)(a), so long as the Administering Authority judges the Relevant Scheme Employer to have suitable financial security any bond exists purely to protect the Relevant Scheme Employer against default of the admission body. It is entirely the responsibility of the Relevant Scheme Employer to arrange any risk assessments and decide the level of required bond. The Administering Authority can supply some standard calculations provided by the Fund Actuary to aid the Relevant Scheme Employer, but this should in no way be taken as advice on this matter. Levels of required bond cover can fluctuate and the Administering Authority recommends that Relevant Scheme Employers review required cover regularly, at least once a year.
- In the case of Transferee Admission Bodies admitted under Regulation 6(2)(a), where the Administering Authority does not judge the Relevant Scheme Employer to have suitable financial security, the Administering

Authority must be involved in assessing the required level of bond to protect the Fund. Admission can only proceed once the Administering Authority has agreed the level of bond cover. Levels of required bond cover can fluctuate and the Administering Authority will require the Relevant Scheme Employer to review required cover jointly with it regularly, at least once a year.

- In the case of Transferee Admission Bodies admitted under Regulation 6(2)(b), the Administering Authority must be involved in assessing the required level of bond to protect the Fund. Admission can only proceed once the Administering Authority has agreed the level of bond cover. Levels of required bond cover can fluctuate and the Administering Authority will review required cover regularly, at least once a year.

To maximise the income from investments within reasonable risk parameters

Returns should be higher over the long term than those from index-linked stocks by investing in other asset classes such as shares, property and alternative investments. However, investment is restricted as specified in the LGPS investment regulations.

Risk parameters are controlled by restricting investment to asset classes generally recognised as appropriate for UK pension funds. From time to time the County Council reviews the potential risks of investing in the various asset classes, with help from the Fund's Actuary and its investment managers.

The Fund's funding strategy requires the assets to deliver a long-term return of 2.3% a year above a low-risk portfolio. This is defined as a portfolio invested 85% in index-linked gilts and 15% in fixed-interest gilts. An investment management structure has been developed and managers appointed to deliver this long-term return within an acceptable level of risk. Details of the structure and managers are in the Statement of Investment Principles.

Purposes of the Fund

The purposes of the Fund are:

- to pay out pensions and benefits, transfer values for fund members moving to other schemes, and other costs, charges and expenses
- to receive contributions, transfer values for Fund members moving from other schemes, and investment income.

Responsibilities of the key parties

The three main parties with obligations to the Fund are the County Council as Administering Authority, the other employers in the Fund, and the Fund's Actuary. The County Council delegates responsibility for fulfilling its obligations to the Pension Fund Panel.

The County Council's obligations as Administering Authority

- To collect employers' and employees' contributions and, as far as possible, make sure they are paid by the due date as specified in the LGPS regulations.
- To invest surplus money in accordance with the LGPS regulations relating to the investment of funds.
- To make sure that cash is always available to meet the Fund's liabilities when they are due.
- To manage the valuation process in consultation with the Fund's Actuary, agreeing appropriate timescales and providing accurate data.
- To monitor regularly the Fund's investment performance and funding level.
- To prepare and maintain a Statement of Investment Principles and a Funding Strategy Statement.

Individual employers' obligations

- To deduct contributions from employees' pay, and make employers' contributions at the rates specified by the actuary, paying both to the County Council by the due date.
- To exercise discretions allowed to employers within the LGPS regulations.
- To pay for agreed added-years arrangements.
- To keep the County Council fully informed of all changes to membership, or other changes that could affect the solvency position.

The Actuary's obligations

- To prepare actuarial valuations every three years, as required by law, or more frequently if required, and set employers' contribution rates having regard to this Funding Strategy Statement. The Actuary will prepare the valuation in accordance with the latest guidance issued by the Faculty and Institute of Actuaries and Board for Actuarial Standards, as far as it applies to the LGPS.
- To prepare advice and calculations for cessation valuations, bulk transfers and individual benefit-related matters.

Solvency

The County Council (through the Panel) will seek to ensure the Fund is solvent in the long term. Solvency is defined as being achieved when the value of the Fund's assets is greater than or equal to the value of the Fund's liabilities, based on actuarial methods and assumptions of a similar level of prudence as used for the 2007 valuation of the Fund.

The 'projected unit' method of valuation will be used when assessing solvency.

The financial assumptions used to assess the funding level will take into account the yields available on long-term fixed-interest and index-linked gilt-edged investments.

The County Council has also agreed with the actuary that explicit smoothing adjustments can be used on the asset values when measuring solvency (see also 'Smoothing' on page 14). The Fund is unlikely to extend the use of these adjustments for employers who participate for a fixed period only – for example non-local authority employers awarded contracts to provide local authority services.

Funding strategy

The Fund is financed on the principle that it seeks to provide sufficient funds to enable payment of 100% of the benefits promised.

The Funding Target is the amount of assets which the Fund needs to hold at any point in time such that the funds held, plus future anticipated investment returns on those funds, taking into account the anticipated future membership and contributions due from the membership, meet the funding principle.

The Administering Authority will generally assume indefinite investment in a broad range of assets of higher risk than risk-free assets for scheduled bodies and certain other bodies. For admission bodies the Administering Authority will take into account the potential for participation to cease, the potential timing of such cessation, and any likely change in investment strategy regarding the assets held in respect of the admission body's liabilities at the date of cessation.

The Fund is deemed to be solvent when the assets held are equal to 100% of the Funding Target.

The Fund's funding ratio at any particular valuation is the ratio of the value of the assets held to the funding target set using the assumptions used in that valuation of the Fund. When assets held are greater than this amount the Fund is deemed to be in surplus, and when assets held are less than this amount the Fund is deemed to be in deficiency.

A further Aspirational Funding Target is set using a similar basis as that used for setting the Funding Target for the 2007 valuation of the Fund, updated for changes in market conditions.

Funding success is defined as achieving the Aspirational Funding Target at the end of the recovery period.

The Administering Authority will not adopt assumptions which, in its judgement and on the basis of actuarial advice received, mean that it is less than 55% likely that the strategy will deliver funding success. Where the probability of funding success is less than 65% the Administering Authority will not adopt assumptions which lead to a material reduction in the aggregate employer contribution rate.

When an actuarial valuation shows that the Fund is in deficiency, employers' contribution rates will be adjusted to achieve a 100% funding ratio over a period of years (the recovery period), while ensuring that the probability of achieving solvency over the recovery period remains acceptable. In consultation with the

Fund's actuary, the County Council has set a common maximum recovery period of 40 years for all employers in the Fund. The actual recovery period within this maximum of 40 years is determined at each actuarial valuation by balancing the Fund's solvency requirements against the financial strength of the Fund's main scheduled employers. A recovery period of 25 years has been used in the 2007 and 2010 valuations for scheduled employers.

The Fund's liabilities mostly take the form of benefit payments over long periods of time. The main scheduled employers in the Fund are financed through central and local taxation and can be viewed as very financially secure. As these employers ultimately underwrite the Fund's finances, the County Council has agreed the current recovery period of 25 years. This is consistent with keeping employers' contribution rates as stable as possible. Were any member employers to participate in the Fund for a short period only, the County Council and actuary would be unlikely to agree to their having a recovery period longer than their remaining term of participation.

In some circumstances it is desirable to group employers within the Fund together for funding purposes (i.e. to calculate employer contribution rates). Reasons might include reducing the volatility of contribution rates for small employers, facilitating situations where employers have a common source of funding or accommodating employers who wish to share the risks related to their participation in the Fund.

Employers may be grouped entirely, such that all of the risks of participation are shared, or only partially grouped such that only specified risks are shared.

Where employers are grouped together for funding purposes, this will only occur with the consent of the employers involved.

All employers in the Fund are grouped together regarding the risks associated with payment of lump sum benefits on death in service. The cost of such benefits is shared across the employers in the Fund. This is because the Fund, in view of its size, does not see it as cost effective or necessary to insure these benefits externally.

Within the Fund there are two large groups of employers for funding purposes. Employers within these two groups share all risks of participation, with the exception of liability for lump sum benefits payable on death in service, with other employers in the group. A small number of employers sit outside of the groups.

For other benefit payments, most employers in the Fund are currently split into two groups: scheduled bodies and community admission bodies. Two common employers' contribution rates are set for each of these groups, instead of individual contribution rates for each employer. The County Council accepts that this can give rise to cross-subsidies between employers. However, employers in the Fund are required to make upfront contributions determined by the Actuary to cover the costs of early retirements, which is a major distinction between employers over time. The County Council and Actuary continually review whether separate rates for individual employers or groups of employers are required.

The two large employer groups share risk according to a set of clearly defined principles which are as follows:

- The Group exists to produce a common contribution rate for employers in the group
- Only the Group funding target is relevant when producing a common contribution rate, and
 - An employer's cash contribution depends on its level of payroll
 - While an employer has contributing members in the Fund, the employer still has a liability to clear any deficiency (where the group is in deficit)
- The employer is assumed to belong to the Group indefinitely
 - As an employer can always be called upon to pay its share of any Group deficiency, a flow of new entrants to the employer is required to finance this
 - Funding targets are set using an ongoing actuarial basis that assumes participation is indefinite
- Employers are liable to fund deficits in proportion to their own payroll
- Payroll is assumed to develop as assumed in the actuarial valuation.

Each employer in a Group is assumed to have the same funding level as the Group as a whole, based on the value of benefits accrued to date for the Group as a whole and notional assets held in respect of the Group. The funding level of the Group is expressed as a percentage and calculated as:

$$\text{notional assets held in respect of the Group} \div \text{value of benefits accrued to date for the Group as a whole}$$

Further aspects of funding strategy that may be relevant from time to time are described below:

Notional sub-funds

In order to establish contribution rates for individual employers or groups of employers it is convenient to subdivide the Fund notionally between the employers, as if each employer had its own notional sub-fund.

This subdivision is for funding purposes only. It is purely notional and does not imply any formal subdivision of assets, nor ownership of any particular assets or groups of assets by any individual employer or group.

Roll forward of sub-funds

The notional sub-fund allocated to each employer or group will be updated allowing for all cashflows associated with that employer's or group's membership, including contribution income, benefits paid, transfers in and out and investment income allocated as set out below.

In some cases there is insufficient information to complete these calculations. In these circumstances:

- Where, in the opinion of the actuary, the unavailable cashflow data is of low materiality, estimated cashflows will be used

Where, in the opinion of the actuary, the unavailable cashflow data is material, the actuary will use an analysis of gains and losses to update the notional sub-fund. This method is less precise than using cashflows, and involves calculating gains and losses to the surplus or deficiency shown at the previous valuation to determine an expected surplus or deficiency at this valuation. This is compared with the liabilities evaluated at this valuation to calculate an implied notional asset holding.

Attribution of investment income

Where the Administering Authority has agreed with a scheme employer that the scheme employer will have a tailored asset portfolio notionally allocated to it, the assets notionally allocated to that employer will be credited with a rate of return appropriate to the agreed allocation.

Where the employer has not been allocated a tailored notional portfolio of assets, the assets notionally allocated to that employer will be credited with the rate of return earned by the Fund assets as a whole, adjusted for any return credited to those employers for whom a tailored notional asset portfolio exists.

Phasing in of new contribution rates

At each actuarial valuation, the County Council will consider whether new higher employers' contribution rates should be payable immediately, or be phased in. The County Council discusses with the Actuary the risks of adopting such an approach. The current policy is to phase in over a maximum of three steps within each valuation period. However, such increases may be phased in over forthcoming and subsequent valuation periods, on a year-by-year basis, if unusual and difficult budgetary constraints make this necessary, or if other changes are expected, up to a maximum of nine steps.

Identification of risks and counter measures

The Administering Authority recognises that future events and investment income cannot be predicted with certainty. Instead, there is a range of possible outcomes, and different assumed outcomes will lie at different places within that range.

The more optimistic the assumptions made, the more that outcome will sit towards the 'favourable' end of the range of possible outcomes, the lower will be the probability of events actually matching or being more favourable than the assumed events, and the lower will be the Funding Target calculated using those assumptions.

The Administering Authority will not adopt assumptions which, in its judgement, and on the basis of actuarial advice received, mean that it is less than 55% likely that the strategy will deliver funding success. Where the probability of funding success is less than 65% the Administering Authority will not adopt assumptions which lead to a material reduction in the aggregate employer contribution rate.

The County Council's overall policy on risk is to identify all risks to the Fund and to consider the position both in aggregate and at individual risk level. Risks to the Fund will be monitored and action taken to limit them as soon as possible. The main risks are as follows:

Demographic

Demographic risks include changing retirement patterns and increasing life expectancy. The County Council will make sure the Fund's actuary investigates these matters at each valuation, or more often if necessary. The actuary will report to the County Council as appropriate. The County Council will then agree with the actuary any necessary changes to the assumptions used in assessing solvency.

If significant demographic changes become apparent between valuations, the County Council will notify all participating employers of the likely effect on their contributions after the next full valuation, and will review the bonds that are in place for transferee admission bodies.

Regulatory

Regulatory risks relate to changes in LGPS regulations, including national pensions legislation and HM Revenue and Customs rules. The County Council will keep abreast of all proposed changes and, whenever possible, comment on the Fund's behalf during consultation periods. The County Council will ask the Fund's actuary to assess the effect of any changes on employers' contribution rates.

The County Council will then notify employers of how these rule changes are likely to affect their contribution rates at the next valuation, if they are significant.

Governance

This covers the risk of unexpected structural changes in the Fund's membership (for example, if an employer closes their scheme to new entrants or if many members withdraw or groups of staff retire), and the related risk of an employer failing to notify the County Council promptly.

To limit this risk, the County Council requires the other participating employers to communicate regularly with it on such matters.

Statistical/financial

Risks to the Fund are posed by the performance of the various investment markets, the quality of the Fund's managers, variations in pay and price inflation, and the budget constraints faced by the Fund's employers.

The County Council regularly reviews these factors with the actuary to decide whether the assumptions for assessing solvency are still appropriate.

Investment returns

The assumption that investment returns will exceed those accruing on Government bonds introduces an element of risk, in that those returns may not materialise. To make sure the funding strategy remains realistic, the County Council will monitor the underlying solvency position on the assumption that there are no such excess returns.

Smoothing

The use of a smoothing adjustment to the value of the Fund's assets introduces an element of risk, in that the smoothing adjustment may not provide a correct measure of the underlying position. Any adjustment is reviewed at the end of each valuation to ensure it remains within acceptable limits.

Recovery period

Allowing surpluses or deficiencies to be eliminated over a recovery period of up to 40 years means there is a risk that too little will be done to restore solvency between successive actuarial valuations. The associated risk is reviewed with the actuary as part of the three-yearly valuation process, to ensure as far as possible that enough is done to restore solvency. In practice, the smoothing arrangements described above deal with this.

Stepping

Increasing employers' contribution rates in annual steps rather than immediately introduces a risk that too little will be done to restore solvency in the early years of the process. The County Council's policy is to limit the number of permitted steps to three, or, in exceptional circumstances, six. In addition, it accepts that a slightly higher final rate may be necessary at the end of the stepping process to help make up the shortfall.

For admission bodies subject to an underwriting arrangement, up to nine steps will be permitted.

Links to investment policy set out in the Fund's Statement of Investment Principles

The County Council has produced this Funding Strategy Statement having taken an overall view of the level of risk in the investment policy set out in the Statement of Investment Principles (available from the Corporate Finance Section, County Treasurer's Department, Hampshire County Council) and is included in this publication on pages 16 to 23.

Both documents are subject to regular review.

Future monitoring

The County Council plans to review this Statement as part of the three-yearly actuarial valuation process unless circumstances arise that require earlier action.

The County Council and the actuary will monitor the Fund's solvency position at regular intervals between valuations. Discussions will be held with the actuary to establish whether any changes are significant enough to require further action,

such as informing employers of the need for different employers' contribution rates after the next valuation.

Statement of Investment Principles

Introduction

Hampshire County Council is the administering authority for the Hampshire Pension Fund, which covers employees of the County Council, two city (unitary) councils, 11 district councils, and 191 other scheduled and admission bodies. The total number of contributors is about 49,000 and there are about 29,000 pensioners.

The Local Government Pension Scheme (Management and Investment of Funds) (Amendment) Regulations 2009 require pension fund administering authorities to prepare and review, from time to time, a written statement setting out the investment policy for their Fund.

This SIP has been drafted to comply with these regulations.

Types of investments to be held

The Fund can be invested in shares, bonds and other investments to limits defined in Schedule 1 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009.

The main limits are:

- no more than 10% of each portfolio can be invested in any individual holding
- no more than 25% of the Fund can be invested in each manager's in-house unit trusts.

The Fund's investment management arrangements were comprehensively reviewed in October 2006, and a new specialist management structure was put in place. This took effect on 1 January 2007.

The Pension Fund Panel has agreed to increase the limit on contributions to private equity and indirect property partnerships from 5% to 10% of the total Fund with effect from 1 March 2008. This was to ensure that investment in the alternative investments of up to 10%, agreed as part of the new investment management structure, went ahead. The decision to increase the limit to 10% complies with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. The 10% limit on contributions to partnerships will apply until the Fund's overall asset allocation is reviewed following the next full actuarial valuation.

The expected return on investments

The overall objectives when investing the Fund are:

- to achieve a 100% funding level, which means that all current and future Fund liabilities (pensions and other benefits) can be met in full for the foreseeable future
- to maintain a stable employers' contribution level, with a long-term target of around 200% of employees' contributions set for the actuary.

Following an asset/liability study in 2005 by the Fund's actuary, Aon Hewitt, the Fund's target is to achieve a long-term return 2.5% a year above a low-risk portfolio. A low-risk portfolio is defined as a portfolio invested 85% in index-linked gilts and 15% in fixed-interest gilts.

Spread of investments

The Pension Fund Panel has agreed the following specialist investment management structure, which took effect on 1 January 2007. The structure is designed to achieve the overall long-term target return without exposing the Fund to excessive risk.

Investment sector	Management style	% of Fund
UK equities	Low-risk active	20
UK equities	High-performance active	9
Global equities	High-performance active	36
Global bonds	Active	5
UK index-linked bonds	Passive	20
UK property	Direct and indirect	8
European property	Indirect	2
Total		100

Nine managers have been appointed from 1 January 2007 for 11 separate mandates. Contracts are for an initial five-year period but can be extended for up to five years, subject to satisfactory performance.

The Panel also intends to invest up to 10% of the Fund in alternative investments, such as private equity and hedge funds. These investments are being funded from new cash flows, as the Fund's income will exceed its expenditure over the foreseeable future. Bramdean Asset Management were appointed from 1 August 2007 to act as an adviser on appropriate alternative investments for the Fund for an initial five-year period, with the option of an extension for a further five years.

This mandate has since been transferred to Aberdeen Asset Management on similar terms.

Projected annual investment returns on asset classes assumed by Hewitt Associates Limited in the 2005 asset/liability study are:

Asset class	Projected annual return %
UK fixed-interest stocks	5.5
UK index-linked stocks	5.25
UK equities	8.5
Global equities	8.5
Property	7.0

Realisation of investments

Managers are asked to avoid unnecessary sales and purchases of stocks, which incur transaction costs. They must regard all sales and purchases of stocks as being in the Fund's financial interests; that is, they will either improve the return or limit excessive risk.

Transaction costs are monitored closely and reported to the Pension Fund Panel once a year.

Managers of equity and bond portfolios are asked not to invest in stocks that are not readily realisable (capable of being turned into cash).

The Fund's cash can be invested for periods of up to two years in order to access higher investment returns in the current low interest rate environment.

Social, environmental and ethical considerations

The Hampshire Pension Fund has an overriding fiduciary duty in law to invest Fund monies to achieve the best possible financial return for the Fund consistent with an acceptable level of risk.

However, the Fund recognises that companies can enhance their long-term performance and increase their financial returns by adopting positive social, environmental and ethical principles in planning and running their activities.

The Fund has delegated to the external investment managers responsibility for taking social, environmental and ethical considerations into account when assessing the financial potential and suitability of investments.

Each investment manager is asked to work positively with companies to promote forward-looking social, environmental and ethical standards. This should not, however, deflect from the primary objective of achieving the best possible financial return for the Fund, in accordance with the Fund's fiduciary duty.

Exercise of rights attaching to investments

Managers have been instructed to exercise the Fund's responsibility to vote on company resolutions wherever possible.

They have also been instructed to intervene in companies that are failing and thus jeopardising the Fund's interests, by voting or by contacting company management direct.

The Fund believes that if companies comply with the principles of the combined code published by the Stock Exchange, following the Hampel report on corporate governance, this can be an important factor in helping them succeed; but the Fund also accepts the need for a flexible approach that is in the common long-term interests of shareholders, company employees and consumers. The Fund's managers should cast their votes with this in mind.

In particular, the Fund's managers should cast their votes to ensure that:

- executive directors are subject to re-election at least every three years
- executive directors' salaries are set by a remuneration committee consisting of a majority of independent non-executive directors, who should make independent reports to shareholders
- arrangements for external audit are under the control of an audit committee consisting of a majority of independent non-executive directors, with clear terms of reference – these should include a duty to ensure that managers closely control the level of non-audit work given to auditors, and should not significantly exceed their audit-related fee unless there are, in any manager's opinion, special circumstances to justify it
- in the managers' opinion, no embarrassment is caused to the Fund in relation to its beneficiaries, Hampshire residents, or the general principles of the combined code.

If managers do not follow these guidelines, they must report to the Panel explaining why.

Custody

Northern Trust has been appointed as the Fund's independent global custodian with effect from 1 August 2006 for a seven-year period ending on 31 July 2013, subject to satisfactory performance.

Stock lending

Since 2006, the Fund has been part of Northern Trust's stock lending programme, whereby stocks (mainly equities) held by the Fund are loaned to third parties in return for a fee that helps the Fund meet its funding objectives.

In accordance with Schedule 1 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009, lending restrictions have been placed on Northern Trust to ensure that the proportion of Fund assets that are available to be lent at any time will not exceed 25% of the total market value of Fund assets.

To acknowledge the risks in stock lending, collateral is provided of at least 105% of the market value of the borrowed stock, unless the borrowed stock and collateral are denominated in the same currency, then a collateral level of 102% will apply. The collateral arrangements were tested in September 2008, when, within a few days, Northern Trust recovered stock on loan to Lehman Bros at the time of its collapse.

Although the Fund temporarily suspended stock lending in September 2008 as a result of the financial crisis, the Pension Fund Panel agreed that this should be reinstated from December 2009 as market conditions have normalised.

Overall, the Panel considers that the income from stock lending benefits the Fund and that the risks are understood and well managed. The County Treasurer will continue to monitor the risks and, as in the case of the Lehman Bros collapse, would be able to instruct Northern Trust to suspend the programme with immediate effect.

Review of the Statement of Investment Principles

This Statement of Investment Principles is subject to review at any time by the County Treasurer, who will report to the Pension Fund Panel accordingly, seeking approval for any changes.

The six principles for the management of defined benefit schemes – compliance

Effective decision-making

The County Council has delegated responsibility for managing and administering the Fund to its Pension Fund Panel through its Audit Committee.

Panel members and County Council officers can attend workshops and seminars on investment and pensions.

Detailed investment decisions are delegated to fund managers. Advice on asset allocation is sought from the actuary and other consultants as necessary.

The County Treasurer provides Panel members with full briefings on investment and pensions. The Panel also takes advice on investment from its independent adviser and sounding board, Mr Harvey Cole.

There is no power under LGPS regulations to pay Panel members for pension fund work. A business plan, which includes a training plan, has been prepared.

The Fund's contract for actuarial and other advice is open to competitive tender periodically. The contract with Aon Hewitt runs until March 2012, with an option to extend until March 2015, subject to satisfactory performance.

Investment managers are asked for advice, and new approaches are developed in partnership with them.

Little use is made of other advisers, as the County Treasurer's Department has enough expertise, so there is no separate tender process for other advice.

Clear objectives

The Fund's objectives are set out clearly in this Statement of Investment Principles.

All mandates have clear objectives and timescales for performance assessment.

Acceptable levels of risk vary according to the nature of each manager's mandate, and are effectively determined by the agreed targets and timescales for performance assessment.

There are no soft commission arrangements.

The Fund's overall target return and the managers' individual targets are set out clearly in this Statement of Investment Principles and in the Annex.

Risk and liabilities

The Fund's actuary, Aon Hewitt, carried out asset/liability studies in 1999 and 2005.

Advice from the actuary and other sources was used to determine the final strategic asset allocation to take effect from 1 January 2007, which should enable the Fund to meet its liabilities and maintain stable employers' contribution rates.

Advice was also sought to draw up the benchmarks and constraints within which (from 1 January 2007) the fund managers appointed after the review must work.

Performance assessment

Formal reviews of the managers' performance take place twice a year. Additional meetings take place between the managers and the County Treasurer each year as required.

There is no formal system for reviewing the performance of Pension Fund Panel members.

Responsible ownership

The Fund's policies on voting rights and engagement are set out clearly in this Statement of Investment Principles.

Transparency and reporting

This Statement of Investment Principles covers all areas as proposed by the Myners Committee and subsequently confirmed by the Government.

The results of the Pension Fund Panel's performance monitoring exercises are published in the annual report for the Fund.

An updated Statement of Investment Principles is published and made available to Scheme employers within three months of the Pension Fund Panel approving any significant amendment.

Annex Investment management arrangements from 1 January 2007

	Benchmark	Annual target performance gross/net of fees
Low-risk active UK equities		
Aberdeen Asset Management	FTSE All Share	+1.5% gross
Schroders Investment Management	FTSE All Share	+1.25% gross
High-performance UK equities		
GLG Partners	LIBOR	+5% gross
High-performance global equities		
Aberdeen Asset Management	MSCI World	+3% gross
AllianceBernstein	MSCI World	+3.5% gross
Newton Investment Management	MSCI World	+3% gross
Active global bonds		
Western Asset Management	Barclays Capital Global Aggregate Bonds Index	+1.5% gross
Passive index-linked bonds		
Legal & General	FT British Government over 5 years index-linked gilts index	
State Street Global Advisors	As above	
UK property		
CB Richard Ellis Investors	Retail Price Index (RPI)	+4.5% net
European property		
Aberdeen Property Investors	Eurozone Harmonised Index of Consumer Prices (HICP)	+5% net