Appendix 2

WEST MIDLANDS
COMBINED AUTHORITY

West Midlands Integrated Transport Authority (ITA) Pension Fund

Funding Strategy Statement 2017

March 2017

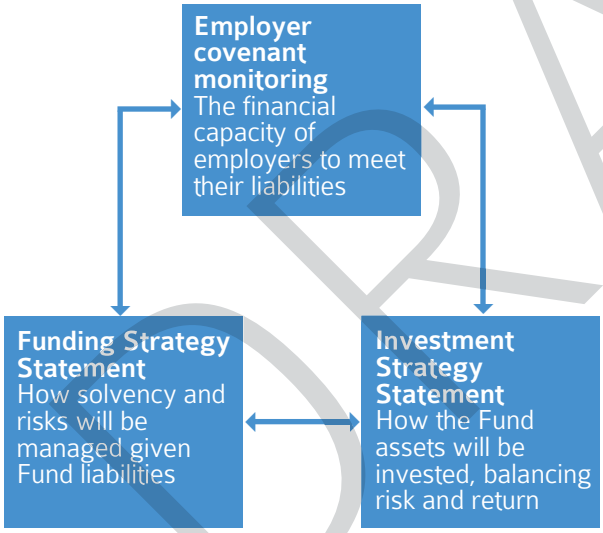
Funding Strategy Statement 2017

1) Introduction

1.1 The LGPS regulations require administering authorities to produce a Funding Strategy Statement (FSS) having regard to the guidance produced by The Chartered Institute of Public Finance and Accountancy (CIPFA). Revised regulations came into effect in 2013 and revised CIPFA guidance was issued in September 2016. This statement has been prepared in accordance with the regulations and following consultation with appropriate persons. It reflects the shift in focus towards the regulatory requirement for administering authorities to ensure contributions are set at a level to achieve Fund solvency and long-term cost efficiency.

1.2 The FSS is supported by the Investment Strategy Statement (ISS), which replaces the SIP from April 2017, and the Fund's approach to employer covenant monitoring. Together these ensure an integrated approach to funding strategy and risk management.

1.3 The statements relate as follows:



1.4 The Fund's actuary takes account of the FSS in his actuarial work for the Fund, most notably the actuarial valuation process. The FSS summarises the Fund's approach ensuring contributions are sufficient to meet its liabilities.

1.5 The FSS reflects the statutory nature of the Local Government Pension Scheme (LGPS), particularly the defined benefit nature and the benefit payable guarantee. The FSS sets out how benefits will be funded over the long-term through an accountable, transparent process with full disclosure of relevant details and assumptions.

1.6 The scheme is a defined benefit arrangement with principally final salary-related benefits from contributing members up to 1 April 2014 and career-averaged revalued earnings (CARE) benefits earned thereafter. There is also the introduction of a '50/50 scheme option', where members can elect to accrue 50% of the full scheme benefits and pay 50% of the normal member contribution.

1.7 Against this background, the key considerations in determining the funding strategy, taking advice from the actuary, are:

a) the appropriate time period for targeting funding recovery taking into account the closed nature of the scheme, but also the ongoing nature of the sponsoring organisations; and

b) the strength of covenant of the sponsoring organisations, their funding sources, and any guarantee arrangements in place.

1.8 The Fund, like many other similar public and private sector funded schemes, has a gap between its assets and pension liabilities (a funding shortfall). A number of factors have contributed to the development of the funding gap and increases in contribution rates for employers most notably:

- increases in life expectancy and pensions longevity; and
- falling long-term interest rates and the expectations for future investment returns.

This strategy addresses the recovery of the funding shortfall in addition to setting future contributions to cover the ongoing cost of benefit accrual.

Employer Contributions
The required levels of employee contributions are specified in the regulations. Employer contributions are determined in accordance with the regulations (which require that an actuarial valuation is completed every three years by the actuary and production of a rates and adjustments actuarial certificate specifying the 'primary' and 'secondary' rate of the employer's contribution).

Primary Rate
The 'primary rate' for an employer is the contribution rate required to meet the cost of the future accrual of benefits, ignoring any past service surplus or deficit, but allowing for any employer-specific circumstances, such as its membership profile, the funding strategy adopted for that employer, the actuarial method used and/or the employer's covenant.

Secondary Rate
The 'secondary rate' is an adjustment to the primary rate to arrive at the total rate of contribution each employer is required to pay. The secondary rate may be expressed as a percentage adjustment to the primary rate, and/or a cash adjustment in each of the three years beginning 1 April in the year following the actuarial valuation. In line with previous valuations, each employer will have a cash adjustment to the primary rate to reflect their funding level.

Secondary rates for the whole Fund in each of the three years shall also be disclosed.

2) Purpose of the Funding Strategy Statement in Policy Terms

2.1 The purpose of this FSS is:

- to establish a clear and transparent fund-specific strategy which will identify how employers' liabilities are best met going forward;
- to take a prudent longer term view of funding those liabilities;
- to ensure that the regulatory requirements to set contributions so as to ensure the solvency and long-term cost efficiency of the Fund are met; and
- to support the desirability of maintaining as nearly constant a primary contribution rate as possible, as defined in Regulation 62(5) of the LGPS Regulations 2013.

The FSS supports the process of ensuring adequate funds are put aside on a regular basis to meet future benefit payments. This framework is designed to ensure the funding strategy is both cohesive and comprehensive for the Fund as a whole, recognising that there will be conflicting objectives that need to be balanced and reconciled. Whilst the funding strategy applicable to individual employers must be reflected in the FSS, its focus should at all times be on those actions that are in the best long-term interests of the Fund. Consequently, the FSS is a single all-employer-encompassing strategy for the administering authority to implement and maintain.

3) Background

2.1 LGPS regulations require the administering authority to consult with such persons it considers appropriate in the maintenance and review of the FSS. CIPFA provides further guidance that this must include meaningful dialogue at officer and elected member level, with council tax raising authorities and with corresponding representatives of participating employers.

3.2 Employers participating in the Fund have been consulted on the principles of this FSS and consideration has been given to their views accordingly. However, the FSS represents a single strategy for the Fund as a whole, adjusted for individual employers based on the advice of the Fund actuary, Barnett Waddingham, who has also been consulted

4) Aims and Purposes of the Pension Fund

4.1 The aims of the Fund are to:

- manage employers' liabilities effectively and ensure that sufficient resources are available to meet all liabilities as they fall due;
- enable primary contribution rates to be kept as nearly constant as possible and (subject to the administering authority not taking undue risks) at reasonable cost to the taxpayers, scheduled, resolution and admitted bodies, while achieving and maintaining Fund solvency and long-term cost efficiency, which should be assessed in light of the risk profile of the Fund and employers, and the risk appetite of the administering authority and employers alike; and
- seek returns on investment within reasonable risk parameters.

4.2 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 Fund benefits, transfer values, costs, charges and expenses, as defined in the Local Government Pension Scheme Regulations and as required in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (or the equivalent in Scotland and Northern Ireland).

5) Responsibilities of the Key Parties

5.1 The LGPS regulations set out the responsibilities of the key parties which are summarised below.

The administering authority is required to:

- operate the Fund;
- collect employer and employee contributions, investment income and other amounts due to the Fund as stipulated in LGPS regulations;
- pay from the Fund the relevant entitlements as stipulated in the LGPS regulations;
- invest surplus monies in accordance with the LGPS regulations;
- ensure that cash is available to meet liabilities as and when they fall due;
- take measures as set out in the regulations to safeguard the Fund against the consequences of employer default;
- manage the valuation process in consultation with the Fund's actuary;
- prepare and maintain an FSS and an SIP/ISS, both after proper consultation with interested parties; and
- monitor all aspects of the Fund's performance and funding and amend the FSS/ISS accordingly.

The administering authority discharges its responsibilities in consultation with the two employers and through delegation to the Pensions Committee of the West Midlands Pension Fund.

5.2 The individual employer is required to:

- deduct contributions from employees' pay correctly;
- pay all ongoing contributions, including employer contributions determined by the Fund actuary and set out in the rates and adjustments certificate, promptly by the due date;
- develop a policy on certain discretions and exercise those discretions as permitted within the regulatory framework;
- make additional contributions in accordance with agreed arrangements in respect of, for example, augmentation of Fund benefits and early retirement strain;
- notify the administering authority promptly of all changes to active membership which affect future funding; and
- Pay any exit payments on ceasing participation in the Fund.

5.3 The Fund's actuary:

The Fund actuary should:

- prepare valuations including the setting of employers' contribution rates at a level to ensure Fund solvency and long-term cost efficiency after agreeing assumptions with the administering authority and having regard to the FSS and the LGPS regulations;
- prepare advice and calculations in connection with bulk transfers and the funding aspects of individual benefit-related matters such as pension strain costs, ill-health retirement costs, compensatory added years costs, etc;
- provide advice and valuations on the exiting of employers from the Fund;
- provide advice to the administering authority on bonds or other forms of security against the financial effect on the Fund of employer default;
- assist the administering authority in assessing whether employer contributions need to be revised between valuations as permitted or required by the regulations; and
- ensure that the administering authority is aware of any professional guidance or other professional requirements which may be of relevance to his or her role in advising the Fund.

6) Solvency Issues and Target Funding Levels

6.1 LGPS regulations require each administering authority to achieve Fund solvency and long-term cost efficiency by means of employer contribution rates established by triennial valuation. LGPS administering authorities prudentially seek to achieve an appropriate balance between the income stream from contributions and investments and maintaining the ability to pay pension benefits as and when they fall due over the life of the Fund.

6.2 Securing solvency and long-term cost efficiency is a regulatory requirement whereas a constant as possible a primary contribution rate remains only a desirable outcome. Administering authorities should avoid continually extending deficit recovery periods at each and subsequent actuarial valuations. Over time and given stable market conditions, administering authorities should aim to reduce deficit recovery periods.

6.3 The Fund is mature and has a funding gap. It takes an appropriate cautious view on determining employing body contribution rates to meet future liabilities through operating a fund with individual employer investment strategies that reflect this view. It aims to allow short-term investment market volatility to be managed, so as not to cause volatility in employing body contribution rates.

6.4 The LGPS regulations require the long-term funding objectives to achieve and maintain assets sufficient to meet 100% of the projected accrued liabilities. The level of assets necessary to meet this 100% funding objective is known as the funding target. The role of the actuary in performing the necessary calculations and determining the key assumptions used is an important feature in determining the funding requirements.

The Fund recognizes the different characteristics of the participating employers and their liability profiles, and will set funding strategy (including funding target and deficit recovery contributions) appropriately having regard to factors such as:

- strength of covenant, and security of future income streams;
- support or guarantee arrangements provided; and
- prospective period of participation in the Fund, and specifically the implications of the closed membership of the Fund to new employees.

Under Section 13(4)(c) of the Public Service Pensions Act 2013 the Government Actuary's Department (GAD) (as the person appointed by the responsible authority) must, following an actuarial valuation, report on whether the rate of employer contributions to the Fund are set at an appropriate level to ensure the solvency of the Fund and long-term cost efficiency of the LGPS.

6.5 In developing the funding strategy, the administering authority has had regard to the likely outcomes of the subsequent review under Section 13(4)(c) and has considered implications for its key performance indicators as determined by the Scheme Advisory Board where appropriate, ie, in England and Wales.

Determination of the Funding Target and Recovery Period

6.6 The principle method and assumptions to be used in the calculation of the funding target and cost of future accrual are set out in the Appendix.

6.7 Underlying these assumptions are the following three tenets:

- That the scheme is expected to continue for the foreseeable future over the run-off of the liabilities for current and former members.
- Favourable investment performance can play a valuable role in achieving adequate funding over the longer term.
- The contributions reflect the employers' current financial strength including any separate guarantees in place, subject to the agreement of the guarantor.

6.8 As part of each valuation, separate employer contribution rates are assessed by the actuary for each participating employer. These rates are assessed, taking into account the experience and circumstances of each employer, following a principle of no cross-subsidy between the employers in the scheme. Fund assets have been unitised, with units allocated to each employer and the two employers have different underlying investment strategies.

The period over which an employer's past service deficit is to be recovered will be dependent on a number of factors, including the nature of the employer, any supporting guarantee or other forms of security.

The administering authority, following consultation with the participating employers as part of the 2016 actuarial valuation, has adopted the following principles.

- The deficit recovery plan for Preston Bus will be based on an overall recovery period of around three years. This reflects an acceleration of the funding plan agreed in 2013, following an improvement in the funding level for this employer.
- The deficit recovery plan for West Midlands Travel Limited (WMTL) will extend over 15 years to 31 March 2032, as long as a suitable financial guarantee remains in place to the satisfaction of the administering authority.
- All early retirements (including those on the grounds of ill health) from the Fund will give rise to an additional charge to the employer, calculated on a case-by-case basis for each retirement.
- Employer contributions payable to the Fund include an element to cover the expected administrative costs involved, incurred by the administering authority. This expenses allowance will be expressed as annual £s amounts, allocated to each employer by reference to total membership.
- Deficit contributions will continue to be assessed and expressed as annual £s amounts.
- In addition to any deficit contributions required to rectify a shortfall of assets below the funding target, contributions will be required to meet the cost of future accrual of benefits for members after the valuation date (the 'primary' rate).

In determining the above objectives, the administering authority has had regard to:

- the responses made to the consultation with employers on the valuation;
- relevant guidance issued by the CIPFA Pensions Panel;
- the administering authority's views on the strength of the participating employers' covenants in achieving the objective.

Employer contributions will be expressed and certified as two separate elements:

- The **primary rate**: a percentage of pensionable payroll in respect of the cost of the future accrual of benefits.
- The **secondary rate**: a schedule of annual lump-sum amounts, payable over the three years to 2019/20. For WMTL these amounts (together with the amount due to cover expected administration costs) will increase annually in line with the valuation funding assumption for long-term pay growth (2.3% pa).

Both elements are subject to review from April 2020 based on the results of the 2019 actuarial valuation.

7) Links to Investment Policy Set Out in the Statement of Investment Principles (SIP)

7.1 The Fund's investment strategy has been considered and reviewed in conjunction with the valuation and the FSS. In particular, the future return expectations of the main asset classes in which the Fund invests have been considered in determining the prudent allowance for future investment returns and extent of reliance on these by employers is outlined in this FSS. It will continue to be monitored by the Investment and Funding Strategy Panel which includes representatives from the authority and employers.

8) The Identification of Risks and Countermeasures

8.1 Evaluating risks that may impact on the funding strategy and expectations of future solvency is crucial to determining the appropriate measures to mitigate those risks. The FSS identifies those key risks specific to the Fund and the measures being taken or assumptions made to counter those risks.

8.2 Some of the key risks taken into account and responses are:

Financial

- Changes to the employers' ability to make pension contributions to the Fund.
- Investment markets fail to perform in line with expectations.
- Investment fund managers fail to achieve performance targets over the longer term.
- Pay and price inflation significantly more or less than anticipated.
- The effect of a possible increase in employer's contribution rate on the employers' business outlook.
- Failure of Prudential to fulfil obligations under the buy-in policy.

Employer covenant is monitored and formally independently assessed as part of each triennial actuarial valuation. The Fund undertakes a three-yearly review of its investment strategy taking into account investment risk and future benefit payments to determine a bespoke investment strategy that for a variety of future economic outcomes gives a higher degree of certainty that the investment objectives will be achieved. Investment strategy and beliefs are set out in the ISS, with managers and their benchmarks chosen to reflect and implement the ISS. Investment management briefs reflect the importance of capturing at least a market rate of return and minimising the risk of significantly underperforming an investment market.

Demographic

- The longevity horizon of beneficiaries continues to expand.
- Cost of early retirements.

The Fund has in place policies and procedures to identify for employing bodies the impact of these factors and agrees how they will be managed in terms of annual contribution rates and/or as special additional contributions.

Regulatory

- Changes to regulations, eg, more favourable benefits package, potential new entrants to Scheme.
- Changes to national pension requirements, ie, via the national cost model and/or HMRC rules.

These changes agreed and proposed are evaluated and taken into account in the actuarial valuation and closely monitored between valuations in case any action is required.

Employers will make contributions to the Fund as cases are approved for early retirement and other employing body discretions that, when exercised, alter future liabilities.

Governance

- The administering authority is unaware of structural changes in an employer's membership (for example, large fall in employee members, large number of retirements).
- An employer ceasing to exist with insufficient funding or adequacy of a bond/guarantee.
- Changes in the level of covenant or guarantee arrangements provided by the employers to the Fund.

The Fund has established inter-valuation monitoring and working relations with its two employers to ensure changes are detected, discussed, evaluated and appropriate action agreed. This includes regular reviews of funding levels, and the assessment of the financial standing of employers and any guarantee arrangements in place.

The Fund's approach to the outcome of the 2016 valuation has had regard to balancing the needs of funding the liabilities and the cost to the employers, taking into account the following:

- provision of any financial guarantees
- financial standing of the body
- known activities and working activities
- maturity of workforce
- de-risking of liabilities through the bulk annuity policy
- risk management through changes to the investment strategy

This analysis indicates the risk to the Fund's solvency and ability to meet prior liabilities to be within acceptable bounds. It will, however, continue to be monitored.

Appendix

Actuarial Valuation as at 31 March 2016

Method and Assumptions Used in Calculating the Funding Target Method

The funding method adopted is known as the attained age method. The attained age method is consistent with the funding objective and is appropriate for the Fund given the fact that it is closed to new members and has an ageing membership profile. The salary increases assumed for each member are projected until the member is assumed to leave active service.

Financial Assumptions

Investment Return (Discount Rate)

One of the key valuation assumptions is the discount rate. The actuary estimates the future benefit cashflows which will be made to and from the Fund in the future. These cashflows are then discounted to a present day value using the discount rate. This value is essentially the estimated amount of money which, if invested now would be sufficient together with the income and growth in the accumulating assets to make these payments in future, using a prudent assumption about future investment returns (discount rate).

The discount rate assumptions for each employer have been derived using the employer's current investment strategy and a weighted set of assumed investment returns, adjusted for prudence and to reflect the employer's liability profile and employer covenant. The discount rate, in respect of buy-in pensioner members, reflects the buy-in policy backing these liabilities.

Inflation (Consumer Prices Index)

The assumption for CPI inflation is derived from the RPI assumption of 3.2% pa, which is based on information published by the Bank of England. A deduction is made to the RPI assumption due to the different ways that the indices are calculated which the Fund actuary has estimated to be 0.9% pa. In addition, the inflation risk premium (often used to reflect any long term impact of supply/demand distortions in market yields used to estimate future RPI) has been assumed to be zero. This results in a CPI inflation assumption of 2.3% pa.

Salary Increases

The assumption for salary increases including allowance for promotional increases, will be set as the CPI inflation assumption described.

Pension Increases

Increases to pensions are assumed to be in line with the inflation (CPI) assumption described above. This is modified appropriately to reflect any benefits which are not fully indexed in line with CPI (eg, guaranteed minimum pensions in respect of service prior to April 1997).

Mortality/Life Expectancy

The mortality in retirement assumptions will be based on the most up-to-date information in relation to self-administered pension schemes published by the Continuous Mortality Investigation (CMI), making allowance for future improvements in longevity.
The mortality tables used are adjusted to reflect the Fund specific experience analysis undertaken to inform current life expectancy. For all members, it is assumed that the accelerated trend in longevity seen in recent years will continue in the longer term and as such, the assumptions build in a minimum level of longevity 'improvement' year on year in the future in line with the CMI projections subject to a minimum rate of improvement of 1.5% per annum.

Commutation

It has been assumed that, on average, members will take 50% of the additional tax-free cash available to them, as well as their accrued lump-sum entitlement. The option which members have to commute part of their pension at retirement in return for a lump-sum is a rate of £12 cash for each £1 pa of pension given up.

Other Demographics

Following an analysis of Fund experience carried out by the actuary and national LGPS carried out by the Government Actuary Department, the proportions married/civil partnership assumption and allowances for withdrawals and early retirements has been modified from the last valuation. No allowance will be made for the future take-up of the 50:50 option. Where any member has actually opted for the 50:50 scheme, this will be allowed for in the assessment of the rate for the next three years.

Expenses

Expenses are met out the Fund, in accordance with the regulations. In line with the 2013 valuation, an explicit allowance and additional contributions will be made to cover expected administration expenses. This approach will be reassessed at each valuation. Investment expenses have been allowed for implicitly in determining the discount rates.

Discretionary Benefits

The costs of any discretion exercised by an employer in order to enhance benefits for a member through the Fund will be subject to additional contributions from the employer as required by the regulations as and when the event occurs. As a result, no allowance for such discretionary benefits has been made in the valuation

Full details of the assumptions adopted are set out in the actuary's formal valuation report.

Summary of Key Whole Fund Assumptions Used for Calculating Funding Target

Financial assumptions	31 March 2016
Discount rate - West Midlands Travel Ltd	
Pre-retirement (non-pensioners)	4.5% pa Derived using returns on individual asset classes combined with an allowance for prudence.
Post-retirement (non-pensioners)	As above.
Post-retirement (non-buy-in pensioners)	As above.
Post-retirement (buy-in pensioners)	Based on 13-year yield, 1.9% pa (smoothed).
Buy-in asset valuation	Based on 13-year yield,1.9% pa (smoothed).
Discount rate - Preston Bus Ltd	
Pre-retirement	2.8% pa Derived using returns on individual asset classes combined with an allowance for prudence.
Post-retirement	As above.
Retail price inflation (RPI)	Based on 18-year yield,3.2% pa (smoothed).
Consumer price inflation (CPI)	2.3% pa (deduction of 0.9% from RPI assumption).
Salary inflation	2.3% pa (in line with CPI).
Mortality assumptions	
Pre-retirement mortality - base table	Set with reference to GAD tables.
Post-retirement mortality - base table	S2PA tables with a multiplier of 110% for current pensioners (both normal and ill-health) and future dependants. 140% of the S2PMA tables for current male dependants and 120% of the S2DFA table for current female dependants.
Allowance for improvements in life expectancy	2015 CMI model with a long-term rate of improvement of 1.5% pa.
Other demographic assumptions	
Partner age difference	Males are three years older than their spouse and females are three years younger than their spouse.
Proportion married	85% of members have an eligible dependant at retirement or earlier death.
Allowance for withdrawals	Same as used by Government Actuary's Department when LGPS reforms were designed and based on analysis of incidence of death, retirement and withdrawal for local authority funds.
Promotional salary scale	Set with reference to GAD tables.
Allowance for cash commutation	Members will commute pension at retirement to provide a lump-sum of 50% of the additional maximum allowed under HMRC rules and this will be at a rate of £12 lump-sum for £1 of pension.
Allowance for expenses	Expenses of administration are allowed for by each employer paying an explicit additional contribution. Investment expenses are met by an implicit assumption made in the derivation of the discount rate assumption.

Financial assumptions	31 March 2016
Allowance for early retirements (non-ill health)	Each member retires at their weighted average 'tranche retirement age' ie, for each tranche of benefit, the earliest age they could retire with unreduced benefits plus three years for active members of WMTL and plus two years for deferred members of WMTL.
	The future service rate has been calculated using the retirement assumption above plus one year rather than three years for active members.
Allowance for early retirements (ill health)	Additional capital contributions will be paid by the employer in respect of the cost of these retirements.
Allowance for 50:50 membership	It is assumed that opted-in active members will continue to pay 50% of contributions for 50% of benefits under the new scheme.
Allowance for discretionary benefits	No allowance.

West Midlands Pension Fund
PO Box 3948
Wolverhampton
WV1 1 XP
United Kingdom