North East Scotland
PENSION FUND

North East Scotland Pension Fund (NESPF)
2014 Funding Strategy Statement (FSS)

This Statement has been prepared by Aberdeen City Council (the Administering Authority) to set out the funding strategy for the North East Scotland Pension Fund (the NESPF), in accordance with Regulation 31 of the Local Government Pension Scheme (Administration) (Scotland) Regulations 2008 (as amended) and the guidance paper issued by the Chartered Institute of Public Finance and Accountancy (CIPFA) Pensions Panel.

1. INTRODUCTION

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

- After consultation with all relevant interested parties involved with the Fund, the Administering Authority will prepare and publish their funding strategy.
- In preparing the FSS, the Administering Authority must have regard to :-
  - the guidance issued by CIPFA for this purpose; and
  - the Statement of Investment Principles (SIP) for the NESPF published under Regulation 12 of the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010;
- 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 NESPF 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 arrangement with principally final salary related benefits from contributing members up to 1 April 2015 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.

The benefits provided by the NESPF are specified in the governing legislation (the Local Government Pension Scheme (Benefits, Membership and Contributions) (Scotland) Regulations 2008 (as amended) ("the BMC Regulations") and the Administration Regulations referred to above. New legislation contained in the Local Government Pension Scheme (Scotland) Regulations 2014 ("the 2014 Regulations") and the Local Government Pension Scheme (Transitional Provisions and Savings) (Scotland) Regulations 2014 governs the NESPF from 1 April 2015. The required levels of employee contributions from 1 April 2015 are also specified in the 2014 Regulations.

Employer contributions are determined in accordance with the Administration Regulations which require that an actuarial valuation is completed every three years by the actuary, including a rates and adjustments certificate. Contributions to the NESPF 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 Common 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 Regulations specify the fundamental principles on which funding contributions should be assessed, implementation of the funding strategy is the responsibility of the Administering Authority.

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

3. AIMS AND PURPOSE OF THE NESPF

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
- maximise the returns from investments within reasonable 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 Local Government Pension Scheme (Administration) (Scotland) Regulations 2008 (as amended), the Local Government Pension Scheme (Benefits, Membership and Contributions) (Scotland) Regulations 2008 (as amended), the 2014 Regulations and in the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010.

4. RESPONSIBILITIES OF THE KEY PARTIES

The Administering Authority should:

- collect employer and employee contributions
- invest surplus monies in accordance with the Regulations
- ensure that cash is available to meet liabilities as and when they fall due
- manage the valuation process in consultation with the NESPF's actuary
- prepare and maintain an FSS and a SIP, both after due consultation with interested parties, and
- monitor all aspects of the NESPF's performance and funding and amend FSS/SIP.

The Individual Employer should:

- deduct contributions from employees' pay correctly after determining the appropriate employee contribution rate (in accordance with the Regulations)
- pay all contributions, including their own as determined by the actuary, promptly by the due date
- exercise discretions within the regulatory framework
- make additional contributions in accordance with agreed arrangements in respect of, for example, augmentation of scheme benefits, early retirement strain, and
- notify the Administering 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 Administering Authority and having regard to the FSS
- prepare advice and calculations in connection with bulk transfers and individual benefit-related matters,
- prepare advice and valuations on the termination of admission agreements
- provide advice to the administering authority on bonds or other forms of security against the financial effect fo the fund of employer default
- assist the administering authority in assessing whether employer contributions need to be revised between valuations as required by regulations
- 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
- 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

Funding Objective

To meet the requirements of the Administration Regulations the Administering Authority's long term funding objective is for the Fund to achieve and then maintain sufficient assets to cover 100% of projected accrued liabilities (the "**funding target**") assessed on an ongoing past service basis including allowance for projected final pay. In the long term, the employer rate would ultimately revert to the Future Service Contribution Rate.

Determination of the Funding Target and Recovery Period

The principal method and assumptions to be used in the calculation of the funding target are set out in Appendix 1.

Underlying these assumptions are the following two tenets:

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

As part of each valuation separate employer contribution rates are assessed by the actuary for each participating employer or group of employers. Separate contribution rates have applied for all new employers admitted to the Fund with effect from 1 April 2008. [*As part of the 2014 valuation, following consultation with the employers, separate contribution rates will be assessed for the following defined groups of employers:*

i) Councils and Joint Valuation Board Group
ii) Colleges Group
iii) Other Pre-2008 Employers Group

Details of the employers who fall into these groupings are set out in the actuarial valuation report.

All other employers will pay their own bespoke rate of contribution.

These rates are assessed taking into account the experience and circumstances of each employer / grouping, following a principle of no cross-subsidy between the distinct employers / employer groupings in the Scheme. In attributing the overall investment performance obtained on the assets of the Scheme to each employer a pro-rata principle is adopted. This approach is effectively one of applying a notional individual employer investment strategy identical to that adopted for the Scheme as a whole. *The Administering Authority reserves the right to amend this approach for certain employers based on their covenant risk profile and/or appetite for risk.*

The Administering Authority, following consultation with the participating employers, has adopted the following objectives for setting the individual employer contribution rates arising from the 2014 actuarial valuation:

- In the current circumstances, as a general rule, the Fund does not believe it appropriate for deficit contribution reductions to apply compared to the 2011 funding plan where substantial deficits remain.

- In addition, a **maximum** deficit recovery period of 19 years will apply. Employers will have the freedom to adopt a recovery plan on the basis of a shorter period if they so wish. A shorter period may be applied in respect of particular employers where the Administering Authority considers this to be warranted (see Deficit Recovery Plan below).

- For any employers assessed to be in surplus, their individual contribution requirements will be adjusted to such an extent that any surplus is used (ie run-off) over a 19 year period (if

surpluses are sufficiently large, contribution requirements will be set to a minimum nil total amount). The current level of contributions will be phased down as appropriate. The Administering Authority reserves to the right to adjust this on a case by case base if circumstances support it.

- The employer contributions will be expressed and certified as a percentage of pensionable payroll (unless agreed otherwise with the Administering Authority).

- Where increases in employer contributions are required from 1 April 2015, following completion of the 2014 actuarial valuation, the increase from the rates of contribution payable in the year 2014/15 may be implemented in steps, over a maximum period of 3 years (subject to the agreement of the Administering Authority).

- On the cessation of an employer's participation in the Scheme, the actuary will be asked to make a termination assessment. Any deficit in the Scheme in respect of the employer will be due to the Scheme as a termination contribution, unless it is agreed by the Administering Authority and the other parties involved that the assets and liabilities relating to the employer will transfer within the Scheme to another participating employer. The full termination policy is set out in Appendix 3.

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

- the responses made to the consultation with employers on the FSS principles
- relevant guidance issued by the CIPFA Pensions Panel
- the need to balance a desire to attain the target as soon as possible against the short-term cash requirements which a shorter period would impose, and
- the Administering Authority's views on the strength of the participating employers' covenants in achieving the objective. The Administering Authority will regularly review employer covenant for employers participating in the Fund in line with the framework detailed in the employer covenant / risk policy set out in Appendix 4.

Deficit Recovery Plan

If the assets of the scheme relating to an employer are less than the funding target at the effective date of any actuarial valuation, a recovery plan will be put in place, which requires additional contributions from the employer to meet the shortfall.

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

- the size of the funding shortfall;
- the business plans of the employer;
- the assessment of the financial covenant of the Employer; and the security of future income streams
- any contingent security available to the Fund or offered by the Employer such as guarantor or bond arrangements, charge over assets, etc.
- length of expected period of participation in the Fund.

The assumptions to be used in these Recovery Plan calculations are set out in Appendix 2.

It is acknowledged by the Administering Authority that, whilst posing a relatively low risk to the Fund as a whole, a number of smaller employers may be faced with significant contribution increases that could seriously affect their ability to function in the future. The Administering Authority would in specific circumstances be willing to use its discretion to negotiate an **evidence based** affordable level of contributions for the organisation for the three years 2015/18. Any

application of this option is at the ultimate discretion of the Administering Authority and will only be considered after the provision of the appropriate evidence.

The Normal Cost of the Scheme (Future Service Contribution Rate)
In addition to any contributions required to rectify a shortfall of assets below the funding target, contributions will be required to meet the cost of future accrual of benefits for members after the valuation date (the "normal cost"). The method and assumptions for assessing these contributions are also set out in Appendix 1.

6. LINK TO INVESTMENT POLICY SET OUT IN THE STATEMENT OF INVESTMENT PRINCIPLES

The results of the 2014 valuation show the liabilities at 31 March 2014 to be 94% covered by the current assets, with the funding deficit of 6% being covered by future deficit contributions.

In assessing the value of the NESPF's liabilities in the valuation, allowance has been made for asset out-performance as described in Appendix 1, taking into account the investment strategy adopted by the NESPF, 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. Investment of the NESPF's assets in line with the least risk portfolio would minimise fluctuations in the NESPF's ongoing funding level between successive actuarial valuations.

Departure from a least risk investment strategy, in particular to include equity type 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.

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

Asset Class (Summary)		**%**
	Equities	65
	Bond	10
	Property	10
	Alternative Assets (incl. Private Equity)	15
	TOTAL	**100**

The funding strategy adopted for the 2014 valuation is based on an assumed asset out-performance of 1.4% per annum.

7. IDENTIFICATION OF RISKS AND COUNTER MEASURES

The funding of defined benefits is by its nature uncertain. Funding of the NESPF is based on both financial and demographic assumptions. These assumptions are specified in the Appendices and 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 Administering Authority has been advised by the actuary that the greatest risk to the NESPF's funding is the investment risk inherent in the predominantly equity (or return seeking) based strategy, so that actual asset out-performance between successive valuations could diverge significantly from the overall out performance assumed in the long term.

What are the 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

The Administering Authority's policy will be to regularly review such aspects to ensure that all the assumptions used are still justified and that the appropriate action is taken where possible to mitigate such risks.

Demographic

- Longevity horizon continues to expand
- Deteriorating pattern of early retirements (including those granted on the grounds of ill health)
- The level of take-up of the 50:50 option at a higher or lower level than built into the actuarial assumptions.

The Administering Authority will ensure that the Fund actuary investigates these matters at each valuation and reports on developments. The Administering Authority will agree with the Fund actuary any changes which are necessary to the assumptions.

Regulatory

- Further 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

The Administering Authority will keep abreast of all proposed changes and, where possible, express their opinion during consultation periods after careful consideration

Governance

- Administering Authority unaware of structural changes in employer's membership (e.g. large fall in employee numbers, large number of retirements)
- Administering Authority not advised of an employer closing to new entrants
- An employer ceasing to exist with insufficient funding or adequacy of a bond.
- Inadequate, inappropriate or incomplete investment and actuarial advice is taken and acted upon

The Administering Authority's policy is to require regular communication between itself and employers, and to ensure regular reviews of those items identified above and will consider and monitor the employer related risks as set out in Appendix 4.

8. MONITORING AND REVIEW

In preparing this FSS the administering authority has consulted with such persons as the authority considers appropriate.

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

- if there has been a significant change in market conditions, and/or deviation in the progress of the funding strategy;
- if there have been significant changes to the NESPF membership, or LGPS benefits;
- if there have been changes to the circumstances of any of the employing authorities to such an extent that they impact on or warrant a change in the funding strategy e.g. closure to new entrants;
- whether there have been any significant changes in the employer risk profiles as set out in Appendix 4;and
- if there have been any significant special contributions paid into the NESPF.

Steven Whyte
Head of Finance
Aberdeen City Council as Administering Authority for the North East Scotland Pension Fund

APPENDIX 1

ACTUARIAL VALUATION AS AT 31 MARCH 2014

Method and assumptions used in calculating the funding target

Method

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

Financial assumptions

Investment return (discount rate)

A yield based on market returns on UK Government gilt stocks and other instruments which reflects a market consistent discount rate for the profile and duration of the Scheme's accrued liabilities, plus an Asset Out-performance Assumption ("AOA") 1.4% per annum .

The asset out-performance assumptions represent the allowance made, in calculating the funding target, for the long term additional investment performance on the assets of the Fund relative to the yields available on long dated gilt stocks as at the valuation date.

Inflation (Consumer Prices Index)

The inflation assumption will be taken to be the investment market's expectation for RPI inflation as indicated by the difference between yields derived from market instruments, principally conventional and index-linked UK Government gilts as at the valuation date, reflecting the profile and duration of the Scheme's accrued liabilities, but subject to the following two adjustments:

- an allowance for supply/demand distortions in the bond market is incorporated, and
- an adjustment due to retirement pensions being increased annually by the change in the Consumer Price Index rather than the Retail Price Index

The overall reduction to RPI inflation at the valuation date is 1.0% per annum.

Salary increases

The assumption for real salary increases (salary increases in excess of price inflation) will be determined by an allowance of 1.5% p.a. over the inflation assumption as described above. This includes allowance for promotional increases. In addition to the long term salary increase assumption allowance has been made for expected short term pay restraint for some employers as budgeted in their financial plan. This results in a total salary increase of 1% per annum for 3 years.

Pension increases/Indexation of CARE benefits

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 the RPI (e.g. Guaranteed Minimum Pensions in respect of service prior to April 1997).

Demographic assumptions

Mortality

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 and the experience of

the scheme. The mortality tables used are set out below, with a loading reflecting NESPF specific experience. The derivation of the mortality assumption is set out in a separate paper as supplied by the Actuary. Current members who retire on the grounds of ill health are assumed to exhibit average mortality equivalent to that for a good health retiree at an age 4 years older whereas for existing ill health retirees we assume this is at an age 3 years older. 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.

The mortality before retirement has also been adjusted based on LGPS wide experience.

Commutation

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

Other Demographics

Following an analysis of Fund experience carried out by the Actuary, the incidence of death before retirement, retirement in normal health and retirement in ill-health have been modified from the last valuation. Other assumptions are as per the last valuation.

Expenses

Expenses are met out the Fund, in accordance with the Regulations. This is allowed for by adding 0.4% of pensionable pay to the contributions as required from participating employers. This addition is 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

Method and assumptions used in calculating the cost of future accrual

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

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

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

The financial assumptions in relation to future service (i.e. the normal cost) are not specifically linked to investment conditions as at the valuation date itself, and are based on an overall assumed real return (i.e. return in excess of price inflation) of 3.0% per annum, with a long term average assumption for consumer price inflation of 2.6% per annum. These two assumptions give rise to an overall discount rate of 5.6% p.a (i.e. 3.0% plus 2.6%).

Adopting this approach the future service rate is not subject to variation solely due to different market conditions applying at each successive valuation, which reflects the requirement in the Regulations for stability in the “Common Rate” of contributions. In market conditions at the effective date of the 2014 valuation this approach gives rise to a slightly more optimistic stance (i.e. allows for a higher AOA) in relation to the cost of accrual of future benefits compared to the market related basis used for the assessment of the funding target.

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

Summary of key whole Fund assumptions used for calculating funding target and cost of future accrual (the "normal cost") for the 2014 actuarial valuation

Long-term gilt yields	
Fixed interest	3.5% p.a.
Index linked	-0.1% p.a.
Past service Funding Target financial assumptions	
Investment return/Discount Rate	4.9% p.a.
CPI price inflation	2.6% p.a.
Long Term Salary increases	4.1% p.a.
Pension increases/indexation of CARE benefits	2.6% p.a.
Future service accrual financial assumptions	
Investment return	5.6% p.a.
CPI price inflation	2.6% p.a.
Long Term Salary increases	4.1% p.a.
Pension increases/indexation of CARE benefits	2.6% p.a.

Demographic assumptions

The post retirement mortality tables adopted for this valuation are as follows:

Life expectancy at 65 in 2013		Base table	Adjustment	Improvement model	Long term rate
CURRENT ANNUITANTS	Normal health	S1PxA	106% / 103%	CMI_2013	1.5%
	Ill health	S1PxA	Normal health + 3 years	CMI_2013	1.5%
	Dependants	S1PMA/S1DFA	175% / 121%	CMI_2013	1.5%
CURRENT ACTIVES / DEFERREDS	Actives normal health	S1PMA	107% / 97%	CMI_2013	1.5%
	Actives ill health	S1PMA	Normal health + 4 years	CMI_2013	1.5%
	Deferreds	S1PMA	133% / 114%	CMI_2013	1.5%
	Future dependants	S1PMA/S1DFA	114% / 108%	CMI_2013	1.5%

Other demographic assumptions are noted below:

Withdrawal	As for 2011 valuation
Proportions Married	As for 2011 valuation
Other demographics	Based on LG scheme specific experience.
50:50 Option	Nil

APPENDIX 2

Assumptions used in calculating contributions payable under the Deficit Recovery Plan

The contributions payable under the recovery plan are calculated using the same assumptions as those used to calculate the funding target.

Appendix 3

North East Scotland Pension Fund

Policy on Termination Funding for Employers ("Termination Policy")

1. Introduction

1.1. This document details the North East Scotland Pension Fund's (NESPF) policy on the methodology for assessment of ongoing contribution requirements and termination payments in the event of the cessation of an employer's participation in the Fund. This document also covers NESPF's policy on admissions into the Fund and sets out the considerations for current and former *admission bodies.* It supplements the general policy of the Fund as set out in the Funding Strategy Statement (FSS).

1.2. *Admission bodies* are required to have an "*admission agreement*" with the Fund. In conjunction with the Regulations, the *admission agreement* sets out the conditions of participation of the *admission body* including which employees (or categories of employees) are eligible to be members of the Fund.

1.3. *Scheme Employers* have a statutory right to participate in the LGPS and their staff therefore can become members of the LGPS at any time, although some organisations (*Part 2 Scheme Employers*) do need to designate eligibility for its staff.

1.4. A list of all current *employing bodies* participating in the NESPF is kept as a live document and will be updated by the *Administering Authority* as bodies are admitted to, or leave the NESPF.

1.5. Please see the glossary for an explanation of the terms used (in italics) throughout this Appendix.

2. Principles

Termination of an employer's participation

2.1. When an *employing body* terminates for any reason, employees may transfer to another employer, either within the Fund or elsewhere. If this is not the case the employees will retain pension rights within the Fund i.e. either deferred benefits or immediate retirement benefits.

2.2. In addition to any liabilities for current employees the Fund will also retain liability for payment of benefits to former employees, i.e. to existing deferred and pensioner members except where there is a complete transfer of responsibility to another Fund with a different *Administering Authority*.

2.3. In the event that unfunded liabilities arise that cannot be recovered from the *employing body*, these will normally fall to be met by the Fund as a whole (i.e. all employers) unless there is a guarantor or successor body within the Fund.

2.4. The NESPF's policy is that a termination assessment will be made based on *a least risk funding basis*, **unless** the *employing body* has a guarantor within the Fund or a successor body exists to take over the *employing body's* liabilities (including those for former employees). This is to protect the other employers in the Fund as, at termination,

the *employing body's* liabilities will become *orphan liabilities* within the Fund, and there will be no recourse to it if a shortfall emerges in the future (after participation has terminated).

2.5. If, instead, the *employing body* has a guarantor within the Fund or a successor body exists to take over the *employing body's* liabilities, the NESPF's policy is that the *valuation funding basis* will be used for the termination assessment unless the guarantor informs the NESPF otherwise. The guarantor or successor body will then, following any termination payment made, subsume the assets and liabilities of the *employing body* within the Fund. (For *Admission Bodies*, this process is sometimes known as the "novation" of the admission agreement.) This may, if agreed by the successor body, constitute a complete amalgamation of assets and liabilities to the successor body, including any funding deficit on closure. In these circumstances no termination payment will be required from the outgoing *employing body* itself, as the deficit would be recovered via the successor body's own deficit recovery plan.

2.6. It is possible under certain circumstances that an employer can apply to transfer all assets and current and former members' benefits to another LGPS Fund. In these cases no termination assessment is required as there will no longer be any *orphan liabilities* in the NESPF. Therefore, a separate assessment of the assets to be transferred will be required.

Funding basis

2.7. An *employing body* may choose to pre-fund for termination i.e. to amend their funding approach to a least risk methodology and assumptions. This will substantially reduce the risk of an uncertain and potentially large debt being due to the Fund at termination. However, it is also likely to give rise to a substantial increase in contribution requirements, when assessed on the least risk basis. If a grouped admission body chooses this approach they will be required to move out of the group and to a bespoke individual contribution rate unless agreed otherwise by the Administering Authority.

2.8. For any *employing bodies* funding on such a *least risk* strategy a notional investment strategy will be assumed as a match to the liabilities. In particular the *employing body's* notional asset share of the Fund will be credited with an investment return in line with the *least risk funding* assumptions adopted rather than the actual investment return generated by the actual asset portfolio of the entire Fund. The Fund reserves the right to modify this approach in any case where it might materially affect the finances of the Scheme, or depending on any case specific circumstances.

Administering Authority options relating to Admission Bodies

2.9. Prior to admission to the Fund, an *Admission Body* is required to carry out an assessment of the level of risk on premature termination of the contract to the satisfaction of the *Administering Authority*. If the risk assessment and/or bond amount is not to the satisfaction of the *Administering Authority* (as required under the LGPS Regulations) it will consider and determine whether *admission body* must pre-fund for termination with contribution requirements assessed using the least risk methodology and assumptions.

2.10. Some aspects that the *Administering Authority* may consider when deciding whether to apply a least risk methodology are:

- Uncertainty over the security of the organisation's funding sources e.g. the *admission body* relies on voluntary or charitable sources of income or has no external funding guarantee/reserves;

- If the *admission body* has an expected limited lifespan of participation in the Fund;

- The average age of employees to be admitted and whether the admission is closed to new joiners.

2.11. In order to protect other Fund employers, where it has been considered undesirable to provide a bond, a guarantee must be sought in line with the LGPS Regulations.

3. Implementation

New admissions

3.1. The NESPF will apply the above principles to the admission of new bodies into the Fund and to the methodology for assessment of a termination payment on the cessation of such an *admission body's* participation in the NESPF.

Transferee admission bodies (TABs)

3.2. *Transferee admission bodies* are a category of *admission body* that generally will have a guarantor in the Fund. This is due to the Regulations requiring that, in the event of any unfunded liabilities on the termination of the admission, the contribution rate for the relevant *Scheme Employer* should be revised. Accordingly, in general, the least risk approach to funding and termination will not apply for TABs.

3.3. Any risk sharing arrangements agreed between the *Scheme Employer* and the TAB will be documented in the commercial agreement between the two parties and not the admission agreement.

3.4. On termination of a TAB admission, any *orphan liabilities* in the Fund will be subsumed by the relevant *Scheme Employer*.

3.5. The *Admission Body* is required to carry out an assessment of the level of risk on premature termination of the contract to the satisfaction of the *Administering Authority*. This assessment would normally be based on advice in the form of a "risk assessment report" provided by the actuary to the NESPF. As the *Scheme Employer* is effectively the ultimate guarantor for these admissions to the NESPF it must also be satisfied (along with the *Administering Authority*) over the level (if any) of any bond requirement.

3.6. In the absence of any other specific agreement between the parties, deficit recovery periods for TABs will be set in line with the Fund's general policy as set out in the FSS.

3.7. An exception to the above policy applies if the guarantor is not a participating employer within the NESPF, including if the guarantor is a participating employer within another LGPS Fund. In order to protect other employers within the NESPF the *Administering Authority* may in this case treat the *admission body* in accordance with paragraph 2.9.

Community admission bodies (CABs)

3.8. Historically, there was no requirement to carry out an assessment of the level of risk on termination of the admission agreement for a CAB until changes were made to the Regulations via the Miscellaneous (Scotland) Regulations 2012. For bodies admitted under previous legislation, despite no requirement to do so the *Administering Authority* may nevertheless have decided to carry out such a risk assessment where appropriate. As noted in 3.5, all *Admission Bodies* are now required to carry out an assessment of the

level of risk on premature termination of the contract to the satisfaction of the *Administering Authority*.

3.9. The NESPF's policy is to consider applications on a case-by-case basis, in line with the principles set out above. In general, no CAB will be permitted to join the NESPF without having a guarantor body. If any risk assessment or determination of a bond amount is not to the satisfaction of the *Administering Authority*, or if a guarantor (of sufficient standing acceptable to the *Administering Authority*) is not forthcoming, the *admission body* will either not be approved or be required to pre-fund for termination with contribution requirements assessed using a least risk methodology and assumptions as set out in 2.9. Where bond agreements are to the satisfaction of the *Administering Authority*, the level of the bond amount will be subject to review on a regular basis.

3.10. On termination of a CAB, any unfunded liability that cannot be reclaimed from the outgoing body or bond will be underwritten by the relevant guarantor body

3.11. Following termination, any orphan liabilities in the Fund will be subsumed by the relevant guarantor body.

3.12. Deficit recovery periods will be determined consistent with the policy set out in the FSS. Alternatively, the *Administering Authority* may determine an employer specific deficit recovery period will apply.

Future Terminations

3.13. In many cases, termination of an employer's participation is an event that can be foreseen, for example, because the organisation's operations may be planned to be discontinued and/or the admission agreement is due to cease. Under the Regulations, in the event of the *Administering Authority* becoming aware of such circumstances, it can amend an employer's minimum contributions such that the value of the assets of the *employing body* is neither materially more nor materially less than its anticipated liabilities at the date it appears to the *Administering Authority* that it will cease to be a participating employer. In this case, *employing bodies* are encouraged to open a dialogue with the Fund to commence planning for the termination as early as possible. Where termination is disclosed in advance the Fund will operate procedures to reduce the sizeable volatility risks to the debt amount in the run up to actual termination of participation. The Fund reserves the right to modify the *employing body's* approach in any case, where it might materially affect the finances of the Scheme, or depending on any case specific circumstances.

Grouped Employers

3.14. The NESPF currently groups some employers for funding / contribution rate setting purposes.

3.15. The NESPF policy is that, on the termination of an employer within a group the termination assessment is based on a simplified share of deficit approach. This involves disaggregating the outgoing body from the group by calculating the notional deficit share as at the last actuarial valuation of the Fund, in proportion to the respective payrolls for the body and the group as a whole, and then adjusting to date of exit. The adjustment to date of exit will allow for key factors that affect funding position i.e. actual investment returns and changes in market yields since the last actuarial valuation.

3.16. As for stand-alone employers, the NESPF's policy is that a termination assessment will be made based on *a least risk funding basis*, **unless** the *employing body* has a

guarantor within the Fund or a successor body exists to take over the *employing body's* liabilities (including those for former employees).

Least Risk Termination basis

3.17. The least risk financial assumptions that applied at the actuarial valuation date (31 March 2014) are set out below in relation to any liability remaining in the Fund. These will be updated on a case-by-case basis, with reference to prevailing market conditions at the relevant *employing body's* cessation date.

Least risk assumptions	**31 March 2014**
Discount Rate	3.5% p.a.
CPI price inflation	2.9% p.a.
Pension increases/indexation of CARE benefits	2.9% p.a.

All demographic assumptions will be the same as those adopted for the 2014 actuarial valuation, unless agreed otherwise on a case by case basis.

Glossary

Admission bodies: A specific type of employer under the Local Government Pension Scheme (LGPS) who do not automatically qualify for participation in the Fund but are allowed to join if they satisfy the relevant criteria set out in the Regulations.

Community admission bodies: A subset of, and the traditional type of *admission bodies* – bodies who operate in and/or are connected to local government. They also include *admission bodies* that are not associated to local government, as follows:

- Bodies which provide a public service in the UK otherwise than for the purposes of gain and which have sufficient links with a *Scheme Employer* to be regarded as having a community of interest.

- Bodies which provide a public service in the UK otherwise than for the purposes of gain and which are approved by Scottish Ministers to be admitted to the LGPS. Approval may be subject to such conditions as the Scottish Ministers think fit and they may withdraw approval at any time if such conditions are not met.

- Bodies to which any *Scheme Employer* provides funding. Where at the date that the admission agreement is made with such a body the total contribution from any one or more *Scheme Employers* to its contribution income equals 50% or less of the funding contributed by third parties it must be a term of the admission agreement that the *Scheme Employer* who provides funding (and, if more than one, all of them) guarantees the liability of the *admission body* to pay all amounts due from it under the LGPS Regulations.

Employing bodies: any organisation that participates in the LGPS, including *admission bodies* and *scheme employers*.

Valuation funding basis: the financial and demographic assumptions used to determine the employer's contribution requirements. The relevant discount rate used for valuing the present value of liabilities is consistent with an expected rate of return of the Fund's investments. This includes an expected out-performance over gilts in the long-term from other asset classes, held by the Fund.

Least risk funding basis: more cautious funding basis than the existing valuation basis. The relevant discount rate used for valuing the present value of liabilities is consistent with that used under the most recent valuation but removing the allowance for asset out-performance.

Orphan liabilities: liabilities in the NESPF for which there is no sponsoring employer within the Fund. Ultimately orphan liabilities must be underwritten by all other employers in the Fund.

Part 2 Scheme Employers: employers that have the statutory right to participate in the LGPS, although these bodies (set out in Part 2 of Schedule 2 of the Administration Regulations) would need to designate an employee, or a class of employees to which he/she belonged, as being eligible for membership of the LGPS.

Scheme Employers: employers that have the statutory right to participate in the LGPS. These organisations (set out in Part 1 of Schedule 2 of the Administration Regulations) would not need to designate eligibility, unlike the Part 2 *Scheme Employers*.

Administering Authority: Aberdeen City Council, as the lead authority of the NESPF, responsible for all aspects of its management and operation.

Transferee admission bodies: A subset of *admission bodies* and participates in the Fund for employees involved with delivery of a specific function or service for a *Scheme Employer*. An example is where a local authority outsources a specific service (e.g. waste management) to a private sector employer. In these cases the relevant *Scheme Employer* would be a party to the admission agreement, as well as the *admission body* itself and the *administering authority*.

EMPLOYER ENGAGEMENT – RISK AND ASSESSMENT OF EMPLOYER COVENANT

Introduction

This policy sets out the Fund's approach to Employer risk management and in particular in respect of those bodies in the Fund defined as 'admission bodies'. This policy supports the Fund's Employer Engagement Strategy and Funding Strategy Statement

1.1 Admission bodies

Under the Local Government Pension Scheme (LGPS) (Scotland) Regulations, certain employers are allowed to participate in the North East Scotland Pension Fund (the Fund) if they satisfy the relevant criteria. These are known as admission bodies. An admission body is required to have an 'admission agreement' with the Fund. In conjunction with the regulations, the admission agreement sets out the conditions of participation of the admission body including which employees (or categories of employees) are eligible to be members of the Fund.

There are two types of the admission bodies:

Transferee admission bodies: these bodies generally will have a guarantor in the Fund since the regulations require that, in the event of any unfunded liabilities on termination of the admission, the contribution rate for the relevant Scheme employer should be revised.

Community admission bodies: In some cases these bodies (in particular historical cases) have no guarantor in the Fund so any unfunded liabilities on termination would be the responsibility of the whole Fund and therefore all employers.

From 1 February 2013 (The Local Government Pension Scheme (Administration) (Scotland) Regulations 2008 -as amended by SSI 2012/347) **all** new admission bodies are required to carry out, to the satisfaction of the administering authority, an assessment, taking account of actuarial advice, of the level of risk arising on premature termination of the provision of service or assets by reason of insolvency, winding up or liquidation of the admission body.

The admission body is required to enter into a bond to cover this risk but, where it is not possible for the community admission body to enter into a bond then a guarantee can be obtained from another entity provided certain conditions are met.

For transferee admission bodies it is acceptable for the original transferring employer to instruct in writing to the Administering Authority that they should waive the requirement for a bond/indemnity and/or other guarantee on the basis of the guarantee provided by the original scheme employer under the Regulations. The Administering Authority will consider if this is acceptable depending on the covenant of the original scheme employer.

1.2 Employer covenant

An employer's covenant underpins its legal obligation and ability to fund the Scheme now and in the future. The strength of covenant depends upon the robustness of the legal agreements in place and the likelihood that the employer can meet them. The covenant effectively underwrites the risks to which the Scheme is exposed, including underfunding, longevity, investment and market forces.

An Assessment of employer covenant focuses on determining the following:

- Type of body and its origins.
- Nature and enforceability of legal agreements.
- Whether there is a bond in place and the level of the bond.
- Whether a more accelerated recovery plan should be enforced.
- Whether there is an option to call in contingent assets.
- Is there a need for monitoring of ongoing and termination funding ahead of the next actuarial valuation?

The strength of employer covenant can be subject to substantial variation over relatively short periods of time and, as such, regular monitoring and assessment is vital.

2. RISK

2.1 Definition of Risk

Risk can be defined as the combination of the probability of an event and its consequences. In this instance, the probability centres around participation in the Fund coming to an end or being prematurely terminated and if employees are not transferred to another employer, pension rights will be retained within the Fund in respect of the outgoing employer These pension rights, deferred benefits, immediate retirement benefits or existing pensions in payment form the employer's liabilities. In the event that liabilities arise that cannot be recovered from the admission body, these will normally fall to be met by the original Scheme employer in the case of transferee admission bodies or the Fund as a whole in the case of community admission bodies unless there is a separate guarantor in the Fund. Therefore, the consequence is that the Fund is exposed to risk where employers are unable to meet their liabilities and there is no cover provided by a guarantor.

Risk management includes identifying and assessing risks (the 'inherent risks') and responding to them.

Response to risk, which is initiated within the organisation, is through management of risk and may involve one or more of the following:

- Tolerating risk.
- Treating risk in an appropriate way to constrain the risk to an acceptable level.
- Transferring the risk.
- Terminating the activity giving rise to the risk.

The level of risk remaining after a review is that which has been accepted (the 'residual risk") and is the exposure in respect of that risk, and should be acceptable and justifiable.

2.2 Identifying risk

The North East Scotland Pension Fund (the Fund) is exposed to a number of risks associated with admission bodies and other employers. In order to mitigate these risks, it is necessary to identify them and prescribe them certain levels so as to ascertain which are deemed tolerable and those that need to be addressed.

Broadly speaking the key risks specific to the Fund are as follows:

Financial - Market fluctuations, investment returns and pay/price inflation.

Demographic - Increased longevity and the cost of early retirements/death-in-service.

Regulatory - Changes to regulations and changes to national pension requirements and/or HMRC rules.

Governance - Administering authority unaware of structural changes in employer's membership, administering authority not advised of an employer closing to new entrants, and an employer ceasing to exist with insufficient funding or adequacy of a bond. In addition lack of quality data from the employer can impact of the risk profile.

Employers - Sustainability of an employer or their ability to meet their liabilities within the agreed funding strategy.

Clearly some of the risks identified are beyond the control of the Fund and, therefore, it is important to target those where it does have influence when mitigating risk. With this in mind, the focus of this document will be in the areas of governance and employers' activities or actions, but consideration should also be given to the cost of early retirements (including in ill health) and death in service and the potential for the transfer of such risk through appropriate insurance whether externally or internally within the Fund.

2.3 Levels of risk

The levels of risk facing the Fund can be generally classified as lower, medium and higher risk as illustrated below:

Participating Employers

Lower Risk	Medium Risk	Higher Risk
Local Authorities	Bodies which are part of a group or pooled bodies which share unfunded costs on default	Admission bodies with no guarantors and a significant deficit
Bodies with local authority guarantor	Admission bodies with small deficit or surplus of assets over liabilities	Bodies with potentially limited life span and in deficit
Bodies with long-term funding from local or central government		No active members or is closed with a significant deficit
		Relies on voluntary or charitable source of income with significant deficit

A key aspect of the risk categorisation will be the level of deficit in the Fund. This will be monitored as noted below.

The Fund will consider whether further banding of risk is required for employers and in certain cases it may be full assessment of potential risk is needed on a bespoke basis.

In addition in the context of those employers providing a guarantee to the Fund for certain employer liabilities (typically Local Authorities) the risk would be re-categorised ignoring the guarantee. This will be to show the guarantors the level of exposure in terms of their existing guarantees.

2.4 Nature of risk

The principal risk facing the North East Scotland Pension Fund is the inability of an employer to be able to meet its regular pension contributions and/or its liabilities upon termination. A deficit upon termination of an admission agreement might arise in the following scenarios:

a) Non-payment of contributions to the Fund by an employer prior to closure

b) Premature termination of a contract where market values are depressed relative to the liabilities in respect of an admission body, assessed on consistent assumptions to those adopted in the previous actuarial valuation.

c) The reality is less favourable than the assumptions used in setting contribution rates for that employer – for instance, lower than expected investment returns, higher than expected rates of early retirement or excessive pay increases.

d) Additional liabilities created as a result of the body closing, in particular the possible payment of immediate retirement benefits to all those eligible at that time.

e) A pre-existing deficit in the Fund (shortfall of attributable assets versus past service liability).

f) A change from open to closed status meaning the likelihood of automatic termination of participation when the final active member leaves the Fund.

3. ASSESSMENT OF RISK

3.1 Risk criteria

The Pensions Regulator has set out prescribed guidelines detailing the assessment criteria upon which an employer should be reviewed:

- Nature and prospects of the employer's industry.
- Employer's competitive position and relative size.
- Management ability and track record.
- Financial policy of the employer.
- Profitability, capital structure, cashflow and financial flexibility.
- Employer's credit rating.
- Position of the economy as a whole.

CIPFA also include information on how covenant and risk should be considered in their guidance *Preparing and Maintaining a Funding Strategy Statement in the Local Government Pension Scheme 2012*

Not all of the above would be applicable to assessing employer risk within the North East Scotland Pension Fund rather a balanced approach to consideration of the above criteria would be made, with further consideration given to the following:

- The scale of obligations to the pension scheme relative to the size of the employer's operating cashflow.
- The relative priority placed on the pension scheme compared to corporate finances.
- An estimate of the amount which might be available to the scheme on insolvency of the employer as well as the likelihood of that eventuality.

3.2 Risk Parameters

For the North East Scotland Pension Fund, the risk a particular employer represents will be quantified using a five pronged approach, governed by the assessment criteria or triggers outlined

below. Where one or more of these triggers is engaged, such employers will be subject to a more detailed review by the Fund. These criteria, when analysed in conjunction with the strength of the employer covenant (Section 5), will provide the basis for the framework upon which risk will be continually assessed and employer stability monitored.

1. **Employer with less than five active members**

2. **Employer where significant member movements are imminent**

3. **Employer with a known participation length of 18 months or less**

4. **Employer with a known deficit of a significant level, relative to size of its financial metrics**

5. **Employer with a funding level identified at the last review of less than 80% or a deficit greater than £0.5m**

4. MONITORING/SCREENING OF THE EMPLOYER COVENANT

4.1 Assessing the employer covenant

The employer covenant should be assessed objectively and the ability of employers or guarantors to meet their obligations should be viewed in the context of the Fund's exposure to risk and volatility, while preserving the interests of other employers within the Fund. The monitoring of covenant strength by itself does not strengthen the Fund's security; however, it does enable the Fund to anticipate and pre-empt employer funding issues and thus adopt a proactive approach with a view to reminding employers of their obligations and managing their expectations. In order to objectively monitor the strength of an employer's covenant, adjacent to the risk posed to the Fund, the proposal is for a number of fundamental financial metrics to be appraised to develop an overview of the employer's stability. These financial metrics center around the following:

- Does the employer have a guarantor within the Fund or corporate structure?
- The employer's funding source and length (if known).
- The employer's cashflow forecast, ideally over the next three to five years.
- If the employer has any contingent assets which can be used by the Fund to provide security.

In order to accurately monitor employer covenant, it will be necessary for research to be carried out into employers' backgrounds and, in addition, for those employers to be contacted sensitively to gather as much information as possible. Focus will be placed on the continual monitoring of employers with a proactive rather than reactive view to mitigating risk.

An overview of the framework upon which an employer's covenant will be monitored is detailed in the diagram on page 8 (4.4). It is considered that this will provide the basis for actions to be taken and ultimately the management of risk, covered in the next section.

4.2 Frequency of monitoring

The funding position and contribution rate for each employer participating in the Fund will be reviewed as a matter of course with each triennial actuarial valuation. However, it is important that the relative financial strength of employers is reviewed regularly to allow for a thorough assessment of the financial metrics. There will be instances where known 'events' or individual employer circumstances are to be taken into consideration, and they will be incorporated into the monitoring framework.

Employers subject to a more detailed review, where a risk criterion is triggered, will be reviewed at least every six months, but more realistically with a quarterly focus. In such cases a more in depth

analysis will be carried out taking into consideration all of the financial metrics and extenuating circumstances.

Separately the funding position will be monitored in conjunction with the Actuary to consider the potential exposure of the Fund in light of the covenant strength.

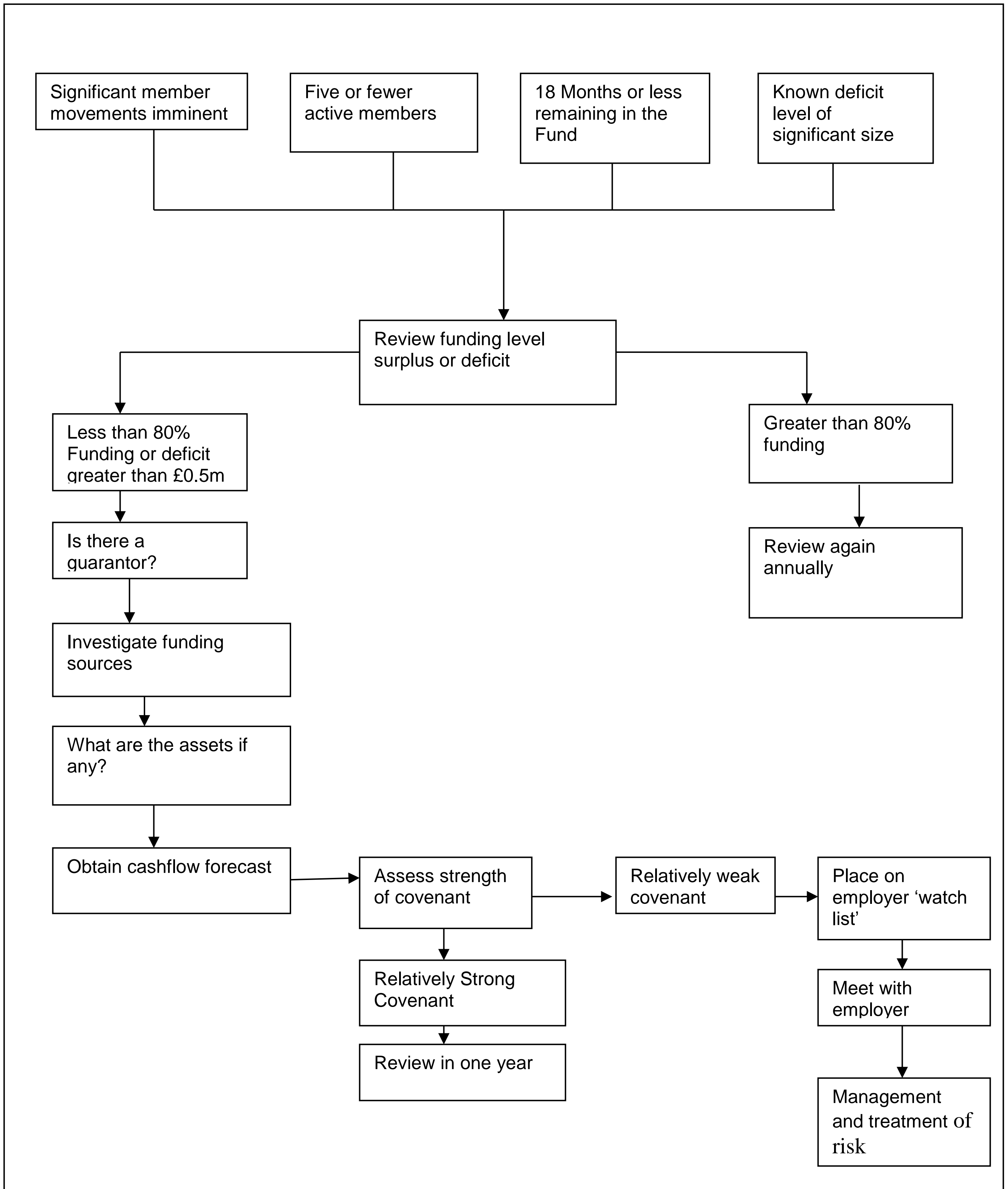
4.3 Employer meetings

As a basis for the monitoring of employers within the Fund, meetings are to be scheduled with those organisations where there is a particular concern over strength of their covenant, accrual of liabilities and future funding levels. Priority will be given to those employers requiring a more detailed review and the aim would be for meetings to be scheduled every six months for such organisations. In addition, it will also be necessary to arrange meetings with employers where there is a need to gain an understanding of their financial position with a view to assisting the monitoring process.

It is recognised that meetings will be tailored to each employer's needs, in conjunction with the Fund's assessment of that organisation; however, it is anticipated that the payment of pension liabilities on termination will feature heavily in these discussions.

There may also be a requirement for such organisations to draft a payment proposal for the Fund's consideration, along with a projection of future cash flows and income/expenditure.

4.4 Guide towards monitoring of the employer covenant



MANAGEMENT OF RISK

5.1 Management of risk

The focus of the Fund's risk management is the identification and treatment of the risks. It will be a continuous and evolving process which runs throughout the Fund's strategy. This management of risk is not a linear process; rather it is the balancing of
a number of interwoven elements which interact with each other and which have to be in balance with each other if the management is to be effective.

5.2 Initial Steps

For new bodies seeking admission to the Fund once the nature of that admission has been identified i.e. Transferee or Community Admission Body, the Pension Fund will conduct an audit to review the financial strength of the organisation, based on their accounts and other key criteria (scored out of 100).

- Regulation requires that relevant admission agreements must contain a provision requiring **all bodies** to undertake an assessment of the level of risk posed to the Fund in the event that the service contract terminates prematurely as a result of the organisation's insolvency, winding up or liquidation. Such assessments must take into account actuarial advice and must be carried out to the satisfaction of the relevant administering authority.

- In respect of outsourcing bodies, the North East Scotland Pension Fund (the Fund) will send out a risk assessment form to be completed by the outsourcing body at their expense. In order for a risk assessment to be conducted by the Fund actuary, the Scheme employer will need to provide a standard data file of the transferring staff to include names, national insurance numbers and details of current salary.

- For transferee admission bodies, upon receipt of the results of the risk assessment, which will include a calculation of the employer contribution rate, details of the contracted arrangement between the Scheme employer and organisation will be clarified. The Scheme employer will be required to confirm the responsibility for pension costs and any other contractual arrangements which may affect the participation and also whether a bond or separate guarantee is required. If there is a limit on the amount that should be reclaimed directly from the outgoing employer due to contractual arrangements then the Scheme employer must notify the Fund in writing that this needs to be taken into account. Any residual deficit (or surplus) will revert to the Scheme employer.

- On termination of the admission agreement, any contributions due will first be reclaimed from the organisation. If the organisation defaults on any payments then the bond (if a bond is in place) would be called on. Any outstanding monies would then fall back on the Scheme employer/guarantor.

The Fund will require confirmation of a suitable guarantor or indemnity for any transferee or community of interest admission body applications (see comments in 5.3 below).

5.3 Bond/Guarantee

In the event that an organisation becomes insolvent, it is unlikely to be able to meet its funding obligations to the Fund. Allowing organisations to become an admission body, therefore, creates an element of risk for the Fund, for other employers participating in the Fund and, in particular, for any outsourcing employing body.

If a risk assessment identifies a material level of risk, for an admission body, the administering authority will require the organisation to provide an indemnity or bond to protect against the identified risk or alternatively a separate guarantee.

Outsourcing employing bodies should regularly review the level of risk relating to an admission agreement, and require the admission body to put in place a revised bond or indemnity as appropriate.

The bond is the third party legal instrument required in respect of a organisation's admission to the LGPS (together with the service contract and the admission agreement). Organisations should consider employer rate and/or cost of bonds when making tender. Therefore, it is ideal these increased costs are considered early in contract/tender discussions.

Where a bond has been requested by the parent body or administering authority there will be a defined amount and timescale set. It is, therefore, important for the Fund to document the expiry date of such bonds and to monitor these closely. Bond information will be reviewed annually or when an expiry date is approaching. The aim would be to inform parent bodies where an expiry date is imminent to allow them to consider whether a revised bond is required. In cases where a revised bond is not required or cannot be obtained, it will be emphasised to the parent body that the potential for liability exists as ultimate guarantor.

As an alternative to a bond, the Fund will allow the organisation in question to set up an alternative guarantee or contingent assets e.g. an escrow account to which the Fund has direct claim upon in the event of insolvency or default, for the equivalent of the bond amount calculated by the Fund actuary. The Fund will require satisfactory evidence of such an alternative particularly on the understanding that it can only be closed or terminated via mutual consent. More detail is set out in 5.5 below.

5.4 Shortened recovery period.

The Fund actuary, in line with the Fund's Funding Strategy Statement (FSS), assumes a deficit recovery period based on the specifics of each employer group or individual employer. The Fund reserves the right to adjust this recovery period, where appropriate, dependent on the strength of an individual employer's covenant, its financial stability and future prospects.

In doing so, the Fund makes provision for any potential liability to be recouped over a shorter timescale, particularly where there is a risk the body in question may cease to exist. The shortening of the recovery period will of course increase the rates at which the employer must contribute and this needs to be weighed up in terms of its reasonable affordability vs impact on longer term covenant.

This involves a fine balancing act as it is not in the Fund's or guarantor's interest to impose an employer rate which is unaffordable and ultimately results in the premature cessation of that employer.

5.5 Contingent assets.

Contingent assets are assets which exist upon the occurrence of one or more specified future events, at the behest of the Fund – for instance, the failure to achieve a specified funding level. They are not typically included as Scheme assets, for the purpose of assessing whether a scheme meets its funding objective, until they are transferred to the scheme. Examples of contingent assets include:

- a known guarantor, which agrees to cover all liabilities, or a proportion of those liabilities, arising upon termination (the contingent event). This can take place through the absorption of

those liabilities by the guarantor to form part of its own liabilities or through the payment of a specified amount.

- security over other assets – for instance, property or securities, such that the asset is transferred to the Fund if the contingent event occurs.
- a letter of credit or a bond (see 5.3).
- sterling cash put aside in a bank account whereby some or all of the cash would be released to the Fund on the occurrence of the contingent event – for example, an escrow account.

The above list is not exhaustive and the Fund will consider alternatives as appropriate to each individual circumstance.

5.6 Phased implementation of employer contribution rate

For certain bodies, the decision may be taken for the Fund's actuary to certify an employer rate lower than the target rate calculated for that particular body. This will usually involve the certified rate being set at the same level as that from the previous actuarial valuation and is with a view to providing that employer with a period of stability to alleviate short term cash funding issues. In such cases, the Fund will look for employers to increase their contributions on a phased basis, culminating in their reaching the Fund actuary's target rate at the end of an agreed period - typically a 3 year implementation period. The underpayment would be expected to be paid as soon as practical.

In order to calculate the annual increments applicable, the methodology will be based on the Fund actuary's target contributions, over the current contributions payable by the employer.

It will be stressed to employers that such rates still remain subject to change at the next triennial actuarial valuation and the approach will be taken on a case by case basis, including the treatment of the underpayment.

5.7 Inflated employer contribution rate (Risk premium)

Consistent with the Funding Strategy Statement (FSS), the funding objective for triennial actuarial valuations is to achieve and then maintain assets equal to the funding target. The funding target is the present value of 100% of projected accrued liabilities, including allowance for projected final pay, on the appropriate assumptions applicable to that employer.

In practice, each new employer's position is assessed separately and their individual rates take into account the differing circumstances of each employer and the funding plan covered in the FSS.

It is an avenue open to the Fund that contributions for an admitted body, where there is a weak employer covenant and an associated concern, could be set relative to the funding target in excess of 100% of the liabilities. This higher target represents a "risk premium" against potential additional liabilities on failure of that admitted body. For example, the employer contributions could be based upon a funding target of 110% of projected accrued liabilities or set dependent upon the Fund's view towards each employer's risk.

6. TRANSFER OF RISK FOR OUTSOURCED BODIES

6.1 Transfer of risk

In order to preclude cross subsidy within the Fund between certain admitted bodies and other employers, the costs and financial effects of employers' participation in the Fund are separately identified ('separation basis'). One result of this approach is that the risks associated with a defined-benefit scheme promise in respect of the transferring staff, are transferred to the new employer. The costs relating to salary increases and early retirements also become the responsibility of the new employer. This allocation of risk to the new employer is very important to protect the position of other employers in the Fund, particularly the letting authority. There are ways in which risks can be shared with the original employer and new employer such as via the separate contractual arrangement. This can include fixing or limiting the contribution requirements on an ongoing or termination basis within certain parameters. Whilst not a direct party in these arrangements the Administering Authority would need to be notified of any such arrangements if these are to be taken into account at the termination of participation.

7. TREATMENT OF MATERIALISED RISK

7.1 Treatment of materialised risk

The Fund recognises that there will be instances where, despite the monitoring of employer covenant and steps taken to both manage and transfer risk (where practical), this risk will nevertheless materialise. As identified previously, the principal risk facing the North East Scotland Pension Fund is the inability of an employer to be able to meet its liabilities upon termination or otherwise. Therefore, a prescribed set of measures need to be agreed to respond to this eventuality, in order to minimise the impact on the Fund.

7.2 Termination of an admission agreement

In the event of termination of an admission agreement, for any one of the reasons covered in section 2.4, it will be necessary for the Fund actuary to calculate the associated deficit on a least-risk or gilts basis (unless the liabilities are to be transferred to another employer in the Fund e.g. in relation to a Transferee Admission Body where typically the assumptions would be on an ongoing actuarial valuation basis). The organisation in question will be responsible for paying the actuary's fee for this work, and the Administering Authority reserves the right to include it in the termination assessment and final contribution due from the employer or recharge it directly from the employer. The Fund will emphasise to employers their responsibility for remittance of the total deficit upon termination; however, in certain circumstances it may not be possible for an organisation to pay the total termination liabilities in one lump-sum. In this scenario, the Fund would request the organisation provides a payment plan for review and, if this is not satisfactory, consideration will be given to an independent financial and governance review (see 7.6).

Under the proposed Regulations effective 1 April 2015 employers would automatically be deemed to terminate participation when the last active member leaves service.

7.3 Closed Admission Agreement where no active members remain in the Fund.

A closed admission agreement relates only to a fixed population of employees. In the case of a transferee admission body, only those employees who transferred to the organisation from the outsourcing employing body can remain members of the LGPS through the admission agreement. Therefore, upon cessation of the last active member of a closed agreement, no further active members can be admitted and the approach for such cases would be the same as with *'Termination of an admission agreement'* detailed in section 7.2.

7.4 Open admission agreement where no active members remain in the Fund.

An open admission agreement for an admission body potentially allows further employees of the organisation to become a member of the LGPS. In some cases however the employer may not propose employees do join.

As such, upon exit of the last active member from the Fund under an open agreement, it is entirely possible that a new active member might be admitted in the future. However, as a consequence of no active members remaining in the Fund, there will be no payroll upon which to base contributions. Therefore, it will be necessary for the Fund actuary to calculate an annual lump-sum amount equivalent to that organisation's target employer contribution rate, in order to address the associated liabilities. In order to protect the Fund's interests in such cases, the suggested approach would be for this calculation to be aligned to the strength of employer covenant, whereby the recovery period and consequently the size of such lump-sum payments would be tailored with this in consideration.

Under the proposed Regulations effective 1 April 2015 employers would automatically be deemed to terminate participation when the last active member leaves service. Such cases would be dealt with as per section 7.2.

All cases will be considered on their own merits and the Fund reserves the right to request full payment of the deficit assessed by the Fund Actuary. Set out below is a rule of thumb guide to the parameters that would be considered for a target covenant based recovery period, where compliant with the parameters set out in the Funding Strategy Statement (FSS):

Weak employer covenant	A short recovery period (one or two valuation cycles i.e. 3-6 years) is preferable subject to contributions being reasonably affordable to the extent they do not impair the covenant.
Moderate employer covenant	As above but with perhaps 6-9 years being acceptable.
Strong employer covenant	As above but with perhaps 9-13 years being acceptable.

These are subject to any maximums in the FSS and are longer term "targets" to provide the balance between security for the Fund and affordability. The current maximum recovery period is [19] years other than in exceptional circumstances.

The covenant of the employer will be monitored on an ongoing basis as per section 4 above.

As with termination of an admission agreement, the costs of the Fund actuary's calculations will be the responsibility of the body in question. Agreement to the annual lump-sum payments will be required from the admitted body, in the same way that it would be sought in relation to ongoing employer rate contributions, calculated as part of the triennial actuarial valuation.

7.5 Winding-up, insolvency, or cessation of an employer

In the event an employer ceases to exist, the Fund would act as a creditor engaging with the administrator to recovery monies.

As part of the covenant assessment the Fund will consider the legal responsibility the employer has on termination in light of other legislation and priority order of other creditors.

7.6 Independent financial and governance standing review by third party auditor

In addition to the Fund taking preventative steps towards risk and responding in the appropriate fashion to address materialising risk, it may be necessary for the Fund to appoint a third party agent to conduct an independent review.

This review would be centered upon the financial measures and wider robustness of the governance of the organisation, particularly with a view to instances of substandard management or negligent practice. The appraisal also provides the Fund with an external audit of the monitoring and risk aversion process employed, which is aimed at preserving the interests of all other participating employers and/or guarantor. The key objectives of this review will be to evaluate the financial standing and underlying governance arrangements, specifically:

- an assessment of the strength of the balance sheet and, based on this, drawing conclusions on the affordability of proposed termination payments. This element of the review will include, for example, structure/liquidity ratios; and
- a high-level evaluation of the body's overall governance structures and the adequacy of management's medium-term planning arrangements in addressing weaknesses and risks; and
- to develop an assessment methodology that can be applied to bodies in assessing their capability and capacity to manage and meet pension liabilities.

The above is not an exhaustive list of criteria that will be applied and each case will be considered on its own merits by the third party agent.