Executive Manager: Jan-Robert Riise
Director of Corporate Services: Christine Ferguson

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If calling please ask for
Louise Adamson
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Dear Sir/Madam

Date: 30 November 2017

You are invited to the following meeting:

Pension Fund Committee / Pension Board
Council Chamber, Town Hall, Lerwick
Wednesday 6 December 2017 at 11.30am

Please note that in accordance with the agreed terms of reference, this is a concurrent meeting of both the Pension Fund Committee and the Pension Board - SEE MEMBERSHIP OF BOTH BODIES OVERLEAF

Apologies for absence should be notified to Louise Adamson at the above number.

Yours faithfully

Executive Manager – Governance and Law
[and Joint Secretary to the Pension Board]

Chair: Cecil Smith
Vice-Chair: Steven Coutts

AGENDA

(a) Hold circular calling the meeting as read.

(b) Apologies for absence, if any.

(c) Declarations of Interest - Members are asked to consider whether they have an interest to declare in relation to any item on the agenda for this meeting. Any Member making a declaration of interest should indicate whether it is a financial or non-financial interest and include some information on the nature of the interest. Advice may be sought from Officers prior to the meeting taking place.

(d) Confirm the minutes of the meeting held on (i) 29 August 2017, and (ii) 20 September 2017 (enclosed).

Items

1. Presentation from Schroders Investment Management
F-095

2. Management Accounts for Pension Fund Committee: 2017/18 Projected Outturn at Quarter 2
F-090

3. 2017/18 Mid Year Performance Review Report
F-094

4. Formal Pension Fund Valuation 2017 – Whole Fund Initial Results & Draft Funding Strategy Statement (FSS)
F-097

5. Implementation of MIFID 11 (Markets in Financial Instruments Directive)
F-092-17

Pension Fund Committee
M Burgess A Cooper S Coutts A Duncan S Leask R McGregor C Smith G Smith T Smith R Thomson

Pension Board	
Employers Representatives: M Bell, SIC E Macdonald, SIC I Scott, SIC J Johnston, SRT Joint Secretary J Riise, Executive Manager – Governance and Law	**Trade Union Representatives**: David Marsh, Unison Alan Goudie, Unite Robert Williamson, GMB Austin Taylor, Unison *Substitutes*: *C Wiseman, Unison* Joint Secretary C Wiseman, Unison

Shetland Islands Council

Agenda Item

1

Meeting(s):	Pension Fund Committee Pension Board	6 December 2017 6 December 2017
Report Title:	Presentation from Schroders Investment Management	
Reference Number:	F-095-F	
Author / Job Title:	Jonathan Belford Executive Manager - Finance	

1.0 Decisions / Action required:

1.1 The Pension Fund Committee and Pension Board are asked to NOTE the presentation.

2.0 High Level Summary:

2.1 As part of the Pension Fund's governance arrangements to receive fund manager presentations at the quarterly meetings, representatives of Schroder Investment Management will attend the meeting and give a presentation to the Pension Fund Committee and Pension Board regarding their mandate.

2.2 Schroders manage a property fund on behalf of the Pension Fund and were awarded this property mandate in March 2007, with management of that mandate commencing in July 2007.

2.3 Schroders are a large global fund management company and a FTSE 100 member. Asset management is their only business with 41 offices in 27 different countries.

2.4 Representatives from Schroders will attend the meeting and give a presentation explaining how Schroders invest, along with a review of their performance. Schroders will give out handouts at the meeting to go along with their presentation. Information on Schroders and the fund's investment performance is in the Pension Fund Report covering the six month period from April to September 2017, which is included at item 3 on the agenda for this meeting.

2.5 The presentation from Schroders along with this report is intended to inform the members and employers about the Pension Fund's property investment and its investment performance. It is envisaged that all of the Pension Fund Managers will over future meetings be invited to give similar types of presentations.

3.0 Corporate Priorities and Joint Working:

3.1 The report links to the Council's corporate priorities, defined in its Corporate Plan, specifically in relation to assisting the Pension Fund in ensuring that financial resources are managed effectively.

4.0 Key Issues:

4.1	The presentation from Schroders forms part of the governance arrangements in regard to the investments, to allow the Pension Fund Committee and Pension Board the opportunity to meet and hear directly from a fund manager that is investing on behalf of the Pension Fund. This also provides an opportunity to question the fund manager on any aspect of the fund and its performance.
5.0	**Exempt and/or confidential information:**
5.1	None

6.0 Implications :	
6.1 Service Users, Patients and Communities:	The Fund Manager presentation forms part of the monitoring of the Pension Fund's investments, to assist in providing reassurance to members and employers that the fund is being managed appropriately for the long term sustainability objectives, and to ensure that monies will be available to fund future pension benefits for members.
6.2 Human Resources and Organisational Development:	None.
6.3 Equality, Diversity and Human Rights:	None.
6.4 Legal:	As required by The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010, where investment managers have been appointed their performance must be kept under review.
6.5 Finance:	The long term investments and their performance are important to the Pension Fund and the achievements of its outcomes and objectives. It is recognised that the actual investment performance each year will be different to what is expected or required however over the long term this will be monitored and reviewed to ensure that the Pension Fund is working towards meeting its long term investment objectives. It is not likely that the Pension Fund can expect a positive investment return from its investments every year but having robust governance and monitoring in place, alongside a diversified investment strategy mitigates the financial risks and enables the Pension Fund to take action at appropriate times to address poor performance by the fund managers. This report is part of that governance and monitoring framework.

6.6 **Assets and Property:**	Long term investments are assets of the Pension Fund and represent money given to fund managers to manage on its behalf for long term benefit. The Pension Fund relies upon each fund manager's fiduciary duty and to buy and sell appropriate assets in accordance with the mandate awarded to them and to report regularly on the value and performance of the fund in which Pension Fund money is invested. The value of long term investments under these mandates can go down as well as up.
6.7 **ICT and new technologies:**	None.
6.8 **Environmental:**	Whilst the fund managers have delegated powers for the acquisition and realisation of investments, fund managers are expected as part of their investment process to consider all factors, including the social, environmental and ethical policies of companies in which they may invest, to the extent that these may materially affect the long term prospects of such companies. The fund managers will also be expected to enter into dialogue with companies in which they invest, in relation to the pursuance of socially responsible business practices, and report on these activities. Corporate Governance is a key responsibility for institutional shareholders and as a matter of principle the Pension Fund will seek to exercise all of its voting rights in respect of its shareholdings. It is recognised however that in practical terms this may not always be possible for overseas holdings. However for UK stocks all voting rights will be exercised in a positive fashion, i.e. no abstentions. The fund managers, who will act in accordance with this policy, will exercise voting. Schroders have signed up to the United Nations Principles on Responsible Investment. The principles reflect the view that environmental, social and corporate governance (ESG) issues can affect the performance of investment portfolios, and therefore must be given appropriate consideration by investors, if they are to fulfil their fiduciary (or equivalent) duty. The Principles provide a voluntary framework by which all investors can incorporate ESG issues into their decision-making and ownership practices, and so better align their objectives with those of society at large.
6.9 **Risk Management:**	All investments carry risk. Risks, such as market risk are mitigated and actively managed through diversification of fund managers, asset classes, markets, size of holdings and through performance monitoring against benchmarks. Going forward, as the fund reaches maturity, there could be a risk where contributions receivable are less than benefits payable.

	To mitigate this risk an investment strategy was approved with the aim to become fully funded by 2027, when the Fund is expected to mature. This strategy of diversification of fund managers is a significant element of mitigating the risk of investing for growth and income.	
6.10 Policy and Delegated Authority:	The Pension Fund Committee has delegated authority to discharge all functions and responsibilities relating to the Council's role as administering authority for the Shetland Islands Council Pension Fund (the Pension Fund) in terms of the Local Government (Scotland) Act 1994, the Superannuation Act 1972 and the Public Service Pensions Act 2013. The Pension Board is the body responsible for assisting the Scheme Manager in relation to compliance with scheme regulations and the requirements of the Pension Regulator. The Pension Board will determine the areas they wish to consider.	
6.11 Previously considered by:	This report has not been presented at any formal meeting.	

Contact Details:

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Appendices:
None

Background Documents:
None

Shetland Islands Council	Agenda Item **2**

Meeting(s):	Pension Fund Committee Pension Board	6 December 2017
Report Title:	Management Accounts for Pension Fund Committee: 2017/18 – Projected Outturn at Quarter 2	
Reference Number:	F-090-F	
Author / Job Title:	Jonathan Belford, Executive Manager - Finance	

1.0 Decisions / Action required:

1.1 That the Pension Fund Committee and Pension Board RESOLVE to review the Management Accounts showing the projected outturn position at Quarter 2.

2.0 High Level Summary:

2.1 The purpose of this report is to enable the Pension Fund Committee and Pension Board to monitor the financial performance of the Pension Fund to ensure that Members are aware of the forecast income and expenditure position and its impact on delivery of the approved budget.

2.2 This report presents the projected outturn position for 2017/18 as at the end of the second quarter. The forecasts have been determined by Finance Services in conjunction with the relevant budget responsible officers.

2.3 The projected revenue outturn position for the Pension Fund is an over-achievement of £273k (4.3%), which means that the Pension Fund is projected to receive more net income than the approved budget.

2.4 Further detail on the projected outturn position can be found at Appendix 1.

3.0 Corporate Priorities and Joint Working:

3.1 There is a specific objective in the Corporate Plan that the Council will have excellent financial management arrangements to ensure that it maintains a balanced and sustainable budget and lives within its means; and that it continues to pursue a range of measures that enable effective and successful management of its finances over the medium to long term.

3.2 By 2027, the investment strategy of the Pension Fund is targeted with achieving a 100% funding position in order to ensure that the scheme remains affordable and sustainable in the future.

4.0 Key Issues:

4.1 On 7 December 2016 (Min Ref 21/16) the Pension Fund Committee approved the 2017/18 Pension Fund Budget. It is vital to the economic wellbeing of the Pension Fund that its financial resources are managed effectively and that net income is delivered in line with the budget, as any overspends or under-achievements of income could result in a reduction in the net contribution to the Pension Fund.

4.2 This report forms part of the financial governance and stewardship framework, which ensures that the financial position of the Pension Fund is acknowledged, understood and quantified on a regular basis. It provides assurance to the Corporate Management Team and the Committee/Board that resources are being managed effectively and it allows corrective action to be taken, where applicable.

4.3 At Quarter 2, the Pension Fund is projected to have a year-end over-achievement of net income of £273k.

5.0 Exempt and/or confidential information:

5.1 None.

6.0 Implications :	
6.1 Service Users, Patients and Communities:	There are no implications arising from this report.
6.2 Human Resources and Organisational Development:	There are no implications arising from this report.
6.3 Equality, Diversity and Human Rights:	There are no implications arising from this report.
6.4 Legal:	There are no implications arising from this report.
6.5 Finance:	The Pension Fund Investment Strategy, approved in 2015/16, seeks to address the prospect of falling income and rising expenditure projections over the longer term. The aim of the strategy is to ensure that the Pension Fund is 100% funded by 2027. It is vital that the Pension Fund continues to receive a surplus of income over expenditure as it is a component of the strategy to become fully funded by 2027. However, there are many factors within the Pension Fund transactions that can cause the actual outturn to differ significantly from the budget. Should the Pension Fund consistently under-achieve its net income budget, employer contributions may have to significantly increase in order to meet any shortfall. The success of the investment strategy, the performance of the fund managers and the cost of future liabilities, all of which are considered as part of the triennial fund valuation, are also factors that could have an effect on employer contributions.
6.6 Assets and Property:	There are no implications arising from this report.
6.7 ICT and new technologies:	There are no implications arising from this report.
6.8 Environmental:	There are no implications arising from this report.

6.9 Risk Management:	There are numerous risks involved in the delivery of the Pension Fund and awareness of these risks is critical to successful financial management. From a financial perspective, risks are an integral part of planning for the future, as assumptions and estimates are involved. These assumptions can be affected by many internal and external factors, such as supply and demand, which could have an adverse impact. The main financial risks for the Pension Fund are: • That the Fund's investments fail to deliver returns in line with those required to meet the valuation of long-term liabilities; • That bond yields fall, leading to a rise in value placed on liabilities; • That employers leave the scheme or the scheme closes to new members, which could be attributed to factors such as cost, liquidation or bankruptcy; • That a failure to recover unfunded payments from employers occurs, potentially leading to other employers having to increase their employer contributions to subsidise; • That a global stock market failure occurs; • That active fund managers under-perform against expectations.	
6.10 Policy and Delegated Authority:	The Pension Fund Committee has been delegated authority to discharge all functions and responsibilities relating to the Council's role as administering authority for the Shetland Islands Council Pension Fund in terms of the Local Government (Scotland) Act 1994, the Superannuation Act 1972 and the Public Service Pensions Act 2013. The Pension Board is the body responsible for assisting the Scheme Manager in relation to compliance with scheme regulations and the requirements of the Pension Regulator.	
6.11 Previously considered by:	n/a	n/a

Contact Details:
Jacqueline Johnson, Senior Assistant Accountant, 01595 744625.
jacqueline.johnson@shetland.gov.uk

Appendices:
Appendix 1 – Projected Revenue Outturn Position 2017/18

Background Documents:
Pension Fund Budget Proposals 2017/18, Pension Fund Committee/Pension Board, 7 December 2016
http://www.shetland.gov.uk/coins/submissiondocuments.asp?submissionid=20199

F-090 Appendix 1

Pension Fund Committee / Pension Board

1. Revenue Outturn Position 2017/18 (Quarter 2)

Budget v Projected Outturn variance at Q1 (Adv) / Pos £000	Pension Fund	Revised Annual Budget £000	Projected Annual Outturn £000	Budget v Projected Outturn at Q2 (Adv) / Pos £000	Year to date expenditure and income to 30 September 2017 £000
30	Employee Costs	280	236	44	94
0	Operating Costs	152	148	4	86
0	Investment Expenses	1,644	1,549	95	418
(4)	Benefits Payable	9,565	9,700	(135)	4,151
0	Transfers Out	296	465	(169)	360
(39)	Lump Sums	1,695	2,054	(359)	1,479
(15)	AVC Out	225	349	(124)	349
(28)	**Total Expenditure**	**13,857**	**14,501**	**(644)**	**6,937**
55	Contributions Received	(16,585)	(16,723)	138	(6,975)
(13)	Other Income	(55)	(35)	(20)	(11)
(1)	Investment Income	(3,213)	(3,540)	327	(1,584)
7	Transfers In	(200)	(358)	158	(282)
221	AVC In	(225)	(539)	314	(539)
269	**Total Income**	**(20,278)**	**(21,195)**	**917**	**(9,391)**
					-
241	**Net Income**	**(6,421)**	**(6,694)**	**273**	**(2,454)**

An explanation of the significant variances to budget for the Pension Fund at Quarter 2 is set out below.

1.1 Employee Costs – underspend of £44k (15.7%)

This underspend relates to two vacancies. The Systems Administrator & Development post will shortly be re-advertised. This post, along with the recently advertised Pension Assistant post, is expected to be filled by January 2018.

The year-to-date employee costs figure represents ongoing salary costs for existing staff. There is an additional recharge of Council Finance staff time at the year-end.

1.2 Investment Expenses – underspend of £95k (5.8%)

This underspend relates to a reduction in fees for one of the Fund Managers and a saving in relation to fund performance monitoring being conducted in-house by the fund managers, rather than by a third party.

1.3 Benefits Payable – overspend of (£135k) (1.4%)

This overspend is due to more retirements in 2017/18 than anticipated when the budget was set. Members now have the option to retire between the ages of 55 and 75, and this age range is prevalent in the demographic of the Council's pension fund.

1.4 Transfers Out – overspend of (£169k) (57.1%)

This overspend relates to the transfer of employees' pensions to other Pension Funds. The value of the transfer depends on a number of factors, including salary and length of service. The budget is based on a five-year rolling average of eight transfers at £37k each and the year-to-date position consists of five transfers out at an average of £72k.

1.5 Lump Sums – overspend of (£359k) (21.2%)

The value of lump sums payable to retirees varies greatly depending on a number of factors including length of service, salary, additional voluntary contribution (AVC) portion and whether there is automatic entitlement to a lump sum. The year-to-date position represents 65 retirees, analysed as follows:

- 11 ill health retirements (£223k);
- 24 late retirements (over 65) (£556k);
- 30 normal retirements (£540k).

There were also five lump sum payments amounting to £78k that relate to flexible or phased retirements, this is where the employee accesses their retirement benefits and is still employed on reduced hours or reduced grade.

Death-in-Service benefit lump sums are paid out at the rate of three times salary. Two payments in this regard have been made so far this year. The budget is expected to underspend by £115k at the end of the financial year.

1.6 AVC Out – overspend of £124k (55.1%)

This cost varies, depending on the extent of AVCs built up during a retiree's career. The year-to-date position represents 10 retirees that have taken AVC lump sums, analysed as follows:

- 1 efficiency retirement;
- 4 late retirements;
- 4 normal retirements;
- 1 flexible retirement.

1.7 Investment Income – over-achievement of £327k (10.2%)

This additional income relates to a Schroders European property investment fund that is due to close in 2018. Its winding down means that some of the fund's underlying assets are being sold off, generating capital receipts into the Pension Fund.

1.8 Transfers in – over-achievement of £158k (79.0%)

This is due to more, higher value transfers being received than budgeted. Income from transfers into the Pension Fund is based on the value of a new employee's previous pension benefits; transfers in from other local authority Pension Funds are often higher value than those from private Pension Funds. The budget is based on a five-year rolling average of 10 transfers at £20k each. The year-to-date position consists of 13 transfers in at an average of £27k.

1.9 AVC In – over-achievement of £314k (139.6%)

The budget here is set to match the AVCs Out budget, however transfers into the Pension Fund for AVCs upon retirement is of significantly higher value than the AVC lump sums paid out. The balance of AVCs not used for lump sums is converted to LGPS pension. This will increase ongoing benefits payable.

Shetland Islands Council

Agenda Item

3

Meeting(s):	**Pension Fund Committee** **Pension Board**	**6 December 2017** **6 December 2017**
Report Title:	**Pension Fund – 2017/18 Mid Year Performance Review Report**	
Reference Number:	**F-094-F**	
Author / Job Title:	**Jonathan Belford, Executive Manager - Finance**	

1.0 Decisions / Action required:

1.1 This report is a review of the Pension Fund's external investments over the first six months of the 2017/18 financial year, and as such the Pension Fund Committee and Pension Board should consider the outcome of this Mid Year review and provide comments accordingly.

2.0 High Level Summary:

2.1 This report will allow the Pension Fund Committee and Board to review the mid year investment position and performance of the Pension Fund's external investments, managed on their behalf by fund managers.

2.2 The Pension Fund's investments increased in value by £10 million over the first six months of the 2017/18 financial year and now have an overall value at the end of September of £460 million.

2.3 Over the first six months of the 2017/18 financial year BlackRock were close to their benchmark aim, while the four active fund managers saw mixed performance results with Schroders and M&G outperforming while KBI and Newton underperformed their respective benchmarks. The combined investment return for the Pension Fund over the six month period was 2.2%. See additional information in Appendix 1. Two representatives from Schroders will also be attending the meeting to give a presentation on their property fund and its performance.

2.4 The conclusion of the Mid Year review is that Fund Manager performance has been mixed individually but in absolute terms positive overall. Performance of the Fund investments, as indicated by relevant benchmarks, show that investment returns overall could have been better but there is no immediate reason to investigate further the Pension Fund making changes. Once the outcome of the Pension Fund Triennial Valuation is known an interim review of the investment strategy will be undertaken thereafter.

3.0 Corporate Priorities and Joint Working:

3.1 One of the reporting requirements of the CIPFA Code of Treasury Management is to formally give a Mid Year review report. This report fulfils that requirement, in relation to the Pension Fund Committee and Board while also assisting the Council in ensuring that financial resources are managed.

4.0	Key Issues:
4.1	This report is only a six month snapshot of how the markets and fund managers have performed. Over the remainder of the financial year the performance of the Pension Fund's investments could quickly and unpredictably increase or decrease depending on economic and investment circumstances.

5.0	Exempt and/or confidential information:
5.1	*None*

6.0 Implications :	
6.1 Service Users, Patients and Communities:	The monitoring of fund Manager performance is a means of providing reassurance to members and employers that the fund is being managed appropriately for the long term sustainability objectives and to ensure that monies will be available to fund future pension benefits.
6.2 Human Resources and Organisational Development:	*None*
6.3 Equality, Diversity and Human Rights:	*None*
6.4 Legal:	As required by The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010, where investment managers have been appointed their performance must be kept under review.
6.5 Finance:	The long term investments and their performance are important to the Pension Fund and the achievements of its outcomes and objectives. It is recognised that the actual investment performance each year will be different to what is expected or required however over the long term this will be monitored and reviewed to ensure that the Pension Fund is working towards meeting its long term investment objectives. It is not likely that the Pension Fund can expect a positive investment return from its investments every year but having robust governance and monitoring in place, alongside a diversified investment strategy, mitigates the financial risks and enables the Pension Fund to take action at appropriate times to address poor performance by the fund managers. This report is part of that governance and monitoring framework.

6.6 **Assets and Property:**	Long term investments are assets of the Pension Fund and represent money given to fund managers to manage on its behalf for long term benefit. The Pension Fund relies upon each fund manager's fiduciary duty and to buy and sell appropriate assets in accordance with the mandate awarded to them and to report regularly on the value and performance of the fund in which Pension Fund money is invested. The value of long term investments under these mandates can go down as well as up.
6.7 **ICT and new technologies:**	*None*
6.8 **Environmental:**	Whilst the fund managers have delegated powers for the acquisition and realisation of investments, fund managers are expected as part of their investment process to consider all factors, including the social, environmental and ethical policies of companies in which they may invest, to the extent that these may materially affect the long term prospects of such companies. The fund managers will also be expected to enter into dialogue with companies in which they invest, in relation to the pursuance of socially responsible business practices, and report on these activities. Corporate Governance is a key responsibility for institutional shareholders and as a matter of principle the Pension Fund will seek to exercise all of its voting rights in respect of its shareholdings. It is recognised however that in practical terms this may not always be possible for overseas holdings. However for UK stocks all voting rights will be exercised in a positive fashion, i.e. no abstentions. The fund managers, who will act in accordance with this policy, will exercise voting. All of the Pension Fund managers have signed up to the United Nations Principles on Responsible Investment. The principles reflect the view that environmental, social and corporate governance (ESG) issues can affect the performance of investment portfolios, and therefore must be given appropriate consideration by investors, if they are to fulfil their fiduciary (or equivalent) duty. The Principles provide a voluntary framework by which all investors can incorporate ESG issues into their decision-making and ownership practices, and so better align their objectives with those of society at large.
6.9 **Risk Management:**	All investments carry risk. Risks, such as market risk are mitigated and actively managed through diversification of fund managers, asset classes, markets, size of holdings and through performance monitoring against benchmarks.
6.10 **Policy and Delegated Authority:**	The Pension Fund Committee has delegated authority to discharge all functions and responsibilities relating to the Council's role as administrating authority for the Shetland

	Islands Council Pension Fund (the Pension Fund) in terms of the Local Government (Scotland) Act 1994, the Superannuation Act 1972 and the Public Service Pensions Act 2013. The Pension Board is the body responsible for assisting the Scheme Manager in relation to compliance with scheme regulations and the requirements of the Pensions Regulator. The Pension Board will determine the areas they wish to consider.	
6.11 Previously considered by:	*None*	

Contact Details:
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Telephone 01595 744616
E-mail colin.bain@shetland.gov.uk

Appendices:
Appendix 1 - 2017/18 Mid Year Performance Review Report

Background Documents:
None

Appendix 1

2017/18 Mid Year Performance Review Report

1.0 Investment Position and Market Performance

1.1 This report complies with the requirements of the CIPFA Code of Practice for Treasury Management in Public Services 2011, in respect of the requirement to report the Mid Year investment position.

1.2 This report concentrates on the six-month period from April to September 2017. The report looks at the performance of the Pension Fund's managers, the overall investment performance relative to the markets, the physical movement of funds, any changes from the investment strategy, and any other relevant issues relating to the investments over the period.

1.3 The Pension Fund has five fund managers with total investments under management at the end of September 2017 of £460 million. The funds, type of mandate and market values at the end of September 2017 are as follows:

Manager	Mandate	% of Reserves	Market Value (£m)
BlackRock	Passive Equity	42%	194
KBI Global Investors	Active Equity	21%	97
Newton	Diversified Growth	17%	77
Schroders	Property	12%	53
M&G	Alternative Credit	8%	39

1.4 Individual fund manager performance is detailed later but there is the need to consider the effect of the markets themselves, and of any cash withdrawals or injections into the funds. The following table shows the effect on the overall investments of these factors during the six-month period.

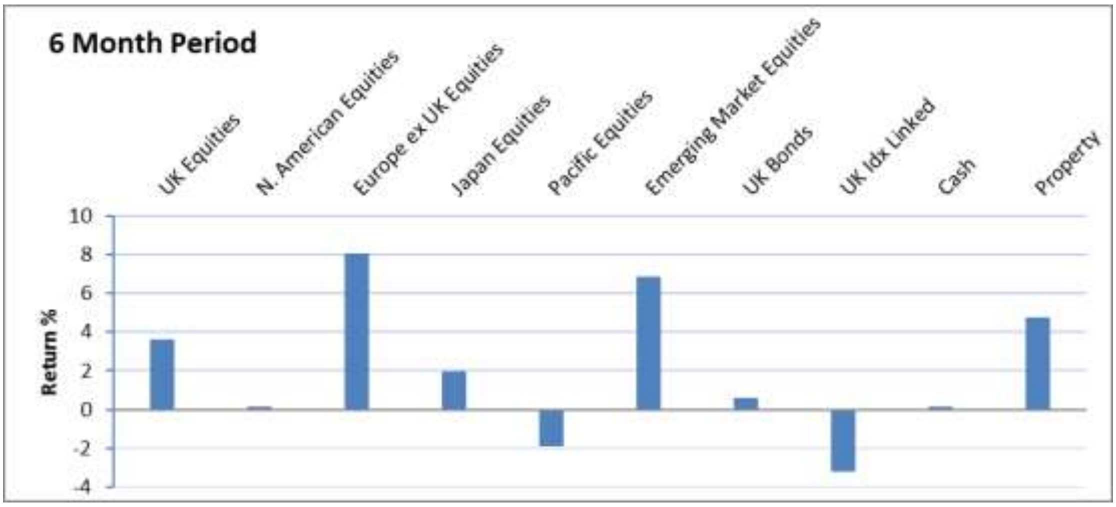
Pension Fund	£ Million
Market value as at 31/03/17	450
Additions / (Withdrawals)	1
Investment Return	9
Market value as at 30/09/17	**460**

1.5 The figures show that the Pension Fund has increased in value by £10 million over the six month period. The increase in investment returns is due to investment returns from various asset classes, with equities being the best returning asset class over the six month period.

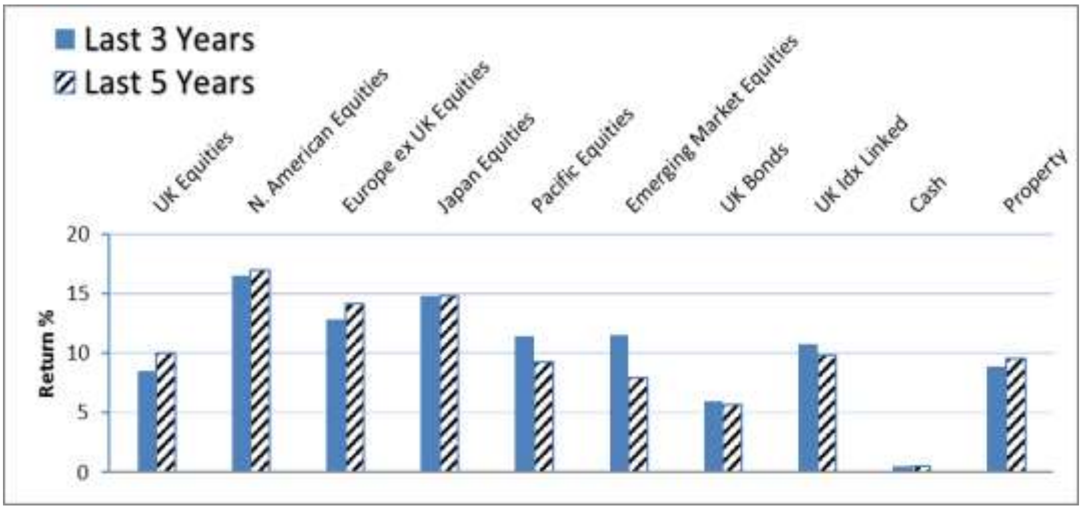
1.6 There was an injection of £1.2 million into the Pension Fund investments in June 2017. This was invested with Newton and was cash that had accumulated in the Pension bank account from excess contributions over pension payments.

1.7 The six month period to September 2017 saw major hurricanes hit North America, while tensions increased between North America and North Korea as their war of words intensified, but over the period North America increased their interest rates and the equity market posted record highs. Japan saw improving economic data while the Prime Minister's popularity increased with his handling of the North Korean situation, which benefitted their equity markets. In Europe the UK, France and Germany all had elections, while the uncertainty over the Brexit negotiations continued. Improved economic data helped European markets, and the UK gained over the quarter boosted by good retail sales and steady low unemployment figures.

1.8 The investment markets performance, over the main asset classes the Pension Fund invests into, over the six-month period looked like this:



1.9 This is only a six month snapshot of how the various investment classes and sectors have performed and it shows how, in the short term, you can have volatility that produces both positive and negative returns. History shows that investments in these asset classes over the long term are usually positive, which is the reason the investment strategy is based on a long term investment horizon. As an example of the differences in market returns over a slightly longer time period the following graph shows the same asset classes returns per annum over the last three and five years.



1.10 The fund manager has negligible influence over the market return but they may be required by the mandate agreement to invest into these markets. The main constituent of a fund's performance is the market return, where the fund is invested. A fund manager with an active mandate is asked to outperform the market return by a certain percentage, whereas a fund manager with a passive mandate is aiming to match the market return.

2 Fund Manager Performance

2.1 The Pension Fund invests in various asset classes for the long term, generally five years or more. This report looks at just the performance of the fund managers and the investment return over a six month period.

2.2 The Pension Fund's managers have, over the six month period to end September 2017, performed as follows:

Manager	Mandate	Fund Return	Benchmark Return	% Return Compared to Benchmark
BlackRock	Passive Equity	2.8%	2.7%	0.1%
KBI Global Investors	Active Equity	0.8%	1.6%	-0.8%
Newton	Diversified Growth	0.7%	2.2%	-1.5%
Schroders	Property	4.9%	4.8%	0.1%
M&G	Alternative Credit	2.1%	1.6%	0.5%

2.3 The fund with BlackRock is invested passively in equities, so the fund is aiming to equal the benchmark return. BlackRock was very close to this aim over the six month period, while producing a return of 2.8%, which is a reflection of the mixture of returns from the various markets the fund invests into.

2.4 The fund with KBI Global Investors is in active equities. Their investment strategy is based on income generating shares that pay a steady annual dividend. KBI have over the six month period underperformed the benchmark. Over this period the equity markets have produced mixed returns but the growth areas have predominately been in sectors that do not favour paying dividends. KBI have produced a positive return of 0.8% but have underperformed in a slight rising market place.

2.5 Newton has a diversified growth fund mandate which invests in various asset classes to spread risk and smooth investment returns. Newton have over the six month period underperformed the benchmark, but they did produce a positive return of 0.7%. Newton's return seeking assets, such as equities were broadly flat over the period but certain stabilising assets such as Government bonds and commodities produced negative returns.

2.6 Schroders invests into property via a fund of funds approach where they invest in various different property funds to spread investment risk. There are two main investment areas, UK and Europe. Schroders have over the six month period just outperformed the benchmark by 0.1% producing a return of 4.9%. The main contributors to Schroders performance were industrials and the underweight position to central London offices.

2.7 The fund with M&G is an alternative credit fund that invests in fixed income products such as corporate bonds, high yield bonds, asset backed securities etc. The fund outperformed the cash plus benchmark over the six month period by 0.5%. The fund's industrial and financial bonds performed well over the period. M&G are becoming more defensively positioned but ready to exploit any episodes of volatility that may occur.

2.8 The overall Pension Fund investment return for the six-month period to end September 2017 was 2.2%, which was 0.3% below the benchmark return.

3.0 After the end of September 2017

3.1 Since the end of September 2017 the financial markets have remained positive, and at the end of October 2017 the Pension Fund investments had a value of £470 million (unaudited).

	Shetland Islands Council	Agenda Item **4**

Meeting(s):	Pension Fund Committee Pension Board	6 December 2017
Report Title:	Formal Pension Fund Valuation 2017 – Whole Fund Initial Results & Draft Funding Strategy Statement (FSS)	
Reference Number:	F-097-F	
Author / Job Title:	Jonathan Belford, Executive Manager - Finance	

1.0 Decisions / Action required:

1.1 That the Pension Fund Committee DISCUSS the Hymans Robertson LLP 2017 Formal Funding Valuation Initial Results report at whole Fund level and the revised Funding Strategy Statement (FSS), and RESOLVE to:

AGREE any changes that should be applied to the Initial Results report or draft FSS; and

APPROVE the valuation assumptions (amended where necessary) as set out in section 3 of the Initial Results report at Appendix 1 and APPROVE the appropriate parameters for the calculations of employer contribution rates as described in section 5 of the Initial Results report at Appendix 1..

2.0 High Level Summary:

2.1 The purpose of this report is for the Pension Fund Committee and Board to receive Hymans Robertson LLP initial 2017 Actuarial Valuation Report, at whole Fund level along with a copy of a revised Draft Funding Strategy Statement (FSS). The Fund Actuary will be present at the meeting to guide the Committee and Board on these two subjects.

2.2 The Council, as Pension Fund Administering Authority, is required by the regulations governing the Local Government Pension Scheme to have the scheme examined by an Actuary at three yearly intervals. The Council's appointed actuaries are Hymans Robertson LLP.

2.3 In general terms the actuarial valuation is a measurement of the Pension Fund's assets against its accrued liabilities, and the determination of employer contribution rates for those employers who participate in the Fund. A copy of the initial whole Fund results is attached as Appendix 1.

2.4 The Council, as Pension Fund Administering Authority, is also required by the regulations governing the Local Government Pension Scheme to maintain and publish a FSS. In publishing the FSS the Administering Authority has to have regard to any guidance published by the Chartered Institute of Public Finance and Accountancy (CIPFA) (most recently in 2016) and to its Statement of Investment Principles. A copy of the draft FSS is attached as Appendix 2.

2.5 The purpose of the FSS 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 framework to maintain **as nearly constant employer contribution rates as possible;** and

> to take a **prudent longer-term view** of funding those liabilities.

3.0 Corporate Priorities and Joint Working:

3.1 The key aim for the Pension Fund is to remain sustainable and to ensure the future benefits due to Pension Fund members are funded over the long-term. An important component of that is the objective of achieving a 100% funding position by 2027 in order to ensure the Scheme remains affordable and sustainable over the long-term.

4.0 Key Issues:

4.1 The Fund was 92% funded at the 31 March 2014 valuation. The initial results of the 31 March 2017 valuation are showing the funding level has reduced to 90%.

4.2 The main reason for the change in funding level is due to the fall in real gilt yields over the valuation period. In 2014 interest on government bonds was 3.5% and now it is 1.7%, a reduction of 1.8%. This has a significant impact on the valuation of liabilities. The liabilities have therefore grown substantially since 2014 mainly as a result of the change in this financial assumption.

4.3 The assets have also grown substantially over the inter-valuation period. This is a result of positive investment returns during the 3 year period. The growth in the valuation of assets is greater than had been assumed in the 2014 valuation therefore this offsets a part of the increase in valuation of the liabilities. The overall result has been a slight reduction in the reported whole Fund funding level alongside an increase in the funding deficit.

4.4 A key challenge for the Council, as Administering Authority of the Pension Fund, is to balance the need for stable, affordable employer contributions with the requirement to take a prudent, longer-term view of funding to ensure the solvency of the Pension Fund.

4.5 The attached report and Funding Strategy Statement from the Fund Actuary are crucial documents in the administering of the fund and are the basis upon which the employer contributions are calculated and set.

4.6 The next stage, having approved the assumptions, will be for the Fund Actuary to carry out the employer calculations and these will be available for the Pension Fund forum, an event being organised for employers that will be held on 23 January 2018.

5.0 Exempt and/or confidential information:

5.1 None.

6.0 Implications :

6.1 Service Users, Patients and Communities:	There are no implications arising from this report.

6.2 **Human Resources and Organisational Development:**	There are no implications arising from this report.
6.3 **Equality, Diversity and Human Rights:**	There are no implications arising from this report.
6.4 **Legal:**	There are no implications arising from this report.
6.5 **Finance:**	The Pension Fund Investment Strategy, approved in 2015/16, seeks to address the prospect of falling income and rising expenditure projections over the longer term. The underlying aim of the strategy is to ensure that the Pension Fund is 100% funded by 2027. There are many factors which can cause a change in the funding level, including but not limited to: asset returns, bond yields, inflation, along with changes in life expectancy. Employer rates for Shetland Islands Council, being the largest employer who participates in the Fund, were in the last 3 years 18.7% in 2015/16, 19.8% in 2016/17 and 20.8% for this current financial year. The range of employer contributions is wide as some employers have a rate of below 20% and others over 30%. Following on from determining the whole Fund results, Hymans Robertson LLP will prepare the individual employer contribution rates for all employers participating in the Fund.
6.6 **Assets and Property:**	There are no implications arising from this report.
6.7 **ICT and new technologies:**	There are no implications arising from this report.
6.8 **Environmental:**	There are no implications arising from this report.
6.9 **Risk Management:**	There are numerous risks involved in the administration of the Pension Fund. From a financial perspective, risks are an integral part of planning for the future, as many assumptions are involved. These assumptions can be affected by many internal and external factors, such as supply and demand, which could have an adverse impact. The main financial risks for the Pension Fund are: • That the Fund's investments fail to deliver returns in line with those required to meet the valuation of long-term liabilities;

	- That bond yields fall, leading to a rise in value placed on liabilities; - That employers leave the scheme or the scheme closes to new members, which could be attributed to factors such as cost, liquidation or bankruptcy; - Change in active membership – for closed employers, a significant fall in active membership is a concern. Also for open employers, a large fall in active membership is a concern. - Percentage of total membership that are active members. In general the lower the percentage the more mature the Employer so the more risky. - That a failure to recover unfunded payments from employers occurs, potentially leading to other employers in the Fund having to increase their employer contributions to subsidise; - That a global stock market failure occurs; - That active fund managers under-perform against expectations.	
6.10 **Policy and Delegated Authority:**	The Pension Fund Committee has been delegated authority to discharge all functions and responsibilities relating to the Council's role as administering authority for the Shetland Islands Council Pension Fund in terms of the Superannuation Act 1972, the Local Government (Scotland) Act 1994 and the Public Service Pensions Act 2013. The Pension Board is the body responsible for assisting the Scheme Manager (Pension Administering Authority) in relation to compliance with scheme regulations and the requirements of the Pension Regulator.	
6.11 **Previously considered by:**	n/a	n/a

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Appendices:
Appendix 1 – 2017 Formal Funding Valuation – Whole Fund Result Report by Hymans Robertson LLP.
Appendix 2 – Draft Funding Strategy Statement, prepared in collaboration with Hymans Robertson LLP

HYMANS ROBERTSON

2017 Formal Funding Valuation Initial Results

Shetland Islands Council Pension Fund

Douglas Green FFA

Bryan Chalmers FFA

For and on behalf of Hymans Robertson LLP

27 November 2017

Executive Summary

Initial results

The initial whole fund solvency level result of the valuation is set out below based on your proposed funding basis. The result at the 2014 formal valuation is shown for comparison.

Valuation Date	31 March 2014	31 March 2017
Past Service Liabilities	**(£m)**	**(£m)**
Employees	177	241
Deferred Pensioners	53	87
Pensioners	133	174
Total Liabilities	**363**	**502**
Assets	**333**	**450**
Surplus / (Deficit)	**(30)**	**(52)**
Funding Level	**92%**	**90%**

Assumptions

The key financial and demographic assumptions used in the preparation of this report are set out below. The key assumptions at the 2014 formal valuation are shown for comparison.

	31 March 2014	31 March 2017
Financial		
Discount rate	5.2% p.a.	3.5% p.a.
Benefit increases	2.7% p.a.	2.4% p.a.
Salary increases	4.5% p.a.	3.0% p.a.
Demographic		
Baseline Longevity	Club Vita	Club Vita
Future Improvements	CMI2012, Peaked, 1.25% p.a. long term	CMI2016, Smoothed, 1.25% p.a. long term

Solvency

The whole fund solvency level on your proposed funding basis has fallen from 92% in 2014 to 90% in 2017. Additionally, the funding deficit has increased. The main reason for the change in the funding level over the period was a fall in real gilt yields which places a higher value on the pension liabilities. Better than expected asset returns over the period and lower expected future pay growth have partially offset the effect of this.

Contribution rates

Every employer has their own tailored funding plan and their valuation results will vary depending on their own membership, funding plan and experience since the last valuation (or since they joined the Fund). However, the change in the economic conditions may put an upward, but manageable, pressure on some employer contribution rates, in respect of future service.

Next steps

The next milestone in the valuation process is preparation of the draft individual employer funding results and proposed employer contribution rates. To proceed, we will seek from you:

- Agreement of the proposed valuation assumptions as outlined in Section 3 of this report, and
- Agreement of appropriate parameters for the calculation of individual employer contribution rates. Further detail on our proposed methodology is outlined in Section 5.

Contents

1 Introduction

We have been commissioned by Shetland Islands Council ("the Administering Authority") to carry out a full actuarial valuation of the Shetland Islands Council Pension Fund ("the Fund") as at 31 March 2017 as required under Regulation 60 of the Local Government Pension Scheme (Scotland) Regulations 2014 ("the Regulations").

This report is addressed to the Administering Authority. The purpose of this document is to:

- present the initial whole fund solvency level based on the proposed funding assumptions (see Section 4);
- show how the whole fund solvency level would vary under alternative key assumptions (see Section 6), and ultimately;
- confirm the funding assumptions before proceeding to the calculation of draft individual employer results.

In addition to the initial whole fund solvency level, this report sets out the key reasons for the change in solvency level from the 2014 valuation. This information is useful to understand the movement, identify any areas of potential risk that the Administering Authority may wish to consider and explore possible avenues of risk mitigation during the valuation process.

This report is addressed to Shetland Islands Council in its role as Administering Authority to the Shetland Islands Council Pension Fund. It should not be shared with any third parties without our prior written consent. Where consent is given, the report should be supplied in full including any related reliances and limitations.

Please note that Hymans Robertson LLP accept no liability to any third parties. The reliances and limitations in the body and appendices of this report apply equally to all users of this report.

2 Intervaluation Experience

Since the previous valuation, various events have taken place which affect the solvency of the Fund.

Investment returns	Expected	Actual	Difference	Impact
Over 3 year period	16.4%	30.9%	14.5%	Positive
Annual	5.2%	9.4%	4.2%	Positive

Assumption/measure	2014	2017	Difference	Impact
Long-dated gilt yields (p.a.)	3.5%	1.7%	(1.8%)	Negative
Expected RPI inflation (p.a.)	3.5%	3.4%	(0.1%)	Positive

Investment returns

The Fund has experienced better than anticipated investment returns. The return in excess of the 2014 valuation discount rate serves to 'pay back' a greater portion of the deficit than expected (all other things being equal). Therefore, all other things being equal, this improves the funding position and reduces the reliance on contributions to repair funding deficits.

Gilts and inflation

There has been a significant drop in gilt yields over the inter-valuation period which reflects a general reduction in anticipated investment returns and therefore a reduction in the discount rate used to place a value on the liabilities. This increases the liabilities and puts upwards pressure on employer contribution rates.

Long term expectations for Retail Prices Inflation (RPI) have fallen slightly since 2014. This will offset some of the increases caused by the fall in gilt yields.

Fund expenses

The Fund's expenses (in relation to non-investment activities) over the last 3 years have totalled £1.1m. This figure is equivalent to 0.6% when expressed as a percentage of pensionable pay which is higher than the expense figure of 0.4% of pensionable pay as at the last valuation. Unless otherwise instructed, we propose to make allowance for the Fund's expenses by including an allowance of 0.6% of pay in employer contribution rates payable from 1 April 2018.

Membership experience

The areas of membership experience that have had the greatest effect on the results of the valuation are set out below:

	Expected	Actual	Difference	Impact
Pre-retirement experience				
Early leavers (no.of lives)	527	1,194	667	Positive
Ill-health retirements (no.of lives)	34	39	5	Negative
Salary increases (p.a.)*	5.2%	2.2%	(3.0%)	Positive
Post-retirement experience				
Benefit increases (p.a.)	2.7%	0.7%	(2.0%)	Positive
Pensions ceasing (£m)	0.5	0.7	0.2	Positive

**including promotional increases*

The pensioner mortality experience has been very close to expectations which justifies the Fund's use of Club Vita to inform the longevity assumption. Membership experience overall has been positive over the intervaluation period. The most significant items of membership experience to note are:

- Salary increases have been less than assumed, which places a lower value on the liabilities (all else being equal);
- Pension Increases have been less than assumed, which places a lower value on the liabilities (all else being equal);

- The number of members withdrawing was greater than expected, which places a lower value on the liabilities (all else being equal).

Regulatory experience

The Fund is subject to risks beyond its control. In particular, since 2014:

- A new benefit structure has come into force;
- Funds have come under greater scrutiny from the Government Actuary's Department, the Scottish Scheme Advisory Board and the Scottish Public Pensions Agency (SPPA); and
- Cost controls may alter member benefits (but will have no effect on the 2017 valuation).

3 Data and Assumptions

Data

We have relied on the following items of data provided by the Administering Authority when carrying out our calculations:

- Membership data uploaded to the Data Portal on 24 October 2017;
- Cashflow and investment data uploaded to submitted by email on 30 October 2017.

The accuracy of our results is limited by the quality of the data provided. We have carried out validations on the data provided to ensure it is fit for the purpose of the valuation. Further details can be found in our paper entitled "Data report for 2017 valuation", which will follow in due course. We believe the membership data is of a good standard and is fit for the purposes of this valuation.

Financial assumptions

Your proposed financial assumptions are set out below, along with the assumptions adopted for the 2014 formal valuation:

Financial assumptions	31 March 2014	31 March 2017
Discount rate (p.a.)		
Return on long-dated gilts	3.5%	1.7%
Asset Outperformance Assumption*	1.7%	1.8%
Discount rate	**5.2%**	**3.5%**
Benefit increases (p.a.)		
Retail Prices Inflation (RPI)	3.5%	3.4%
Assumed RPI/CPI† gap*	(0.8%)	(1.0%)
Benefit increase assumption (CPI)	**2.7%**	**2.4%**
Salary increases (p.a.)		
Retail Prices Inflation (RPI)	3.5%	3.4%
Increases in excess of RPI*	1.0%	(0.4%)
Salary increase assumption	**4.5%**	**3.0%**

† Consumer Prices Index

** Applied arithmetically for the 2014 valuation and geometrically for the 2017 valuation*

Further detail on the financial assumptions required to carry out the formal valuation is included in our 2017 Valuation Toolkits 03: Measuring Your Funding Level and 07: Setting Assumptions.

We have discussed and agreed with the Administering Authority to prepare initial whole fund valuation results using the financial assumptions shown above. The Administering Authority commissioned the following actuarial advice to assist its assumption setting, both issued September 2017:

- Our paper "2017 valuation – pay growth assumption" which set out the factors influencing the choice of salary increase assumption and commented on some possible choices.
- Our paper "2017 valuation - Asset Outperformance Assumption" which summarises modelling testing the appropriateness of possible choices of Asset Outperformance Assumption (AOA). This modelling allowed for the Fund's long term investment strategy as outlined in the Statement of Investment Principles.

We believe the proposed discount rate of 3.5% p.a. is a sufficiently prudent estimate of the return that can be expected from the Fund's assets in the long term. All other assumptions are intended to represent our best estimate of future experience. Taken in aggregate, the proposed funding basis results in a prudent estimate of the Fund's pension liabilities.

It is our opinion that there has been no material change to the level of prudence between the 2014 and proposed 2017 funding assumptions.

Demographic assumptions

Longevity

Your proposed longevity assumptions are set out below, along with the assumptions adopted for the 2014 formal valuation:

Longevity Assumptions	31 March 2014	31 March 2017
Baseline Longevity	Club Vita	Club Vita
Future Improvements	CMI2012, Peaked, 1.25% p.a. long term	CMI2016, Smoothed, 1.25% p.a. long term

Further detail on your proposed longevity assumptions are set out in our Valuation Toolkit 08: Longevity.

Your proposed longevity assumptions result in the following typical future life expectancies from age 65 (figures for 2014 shown for comparison):

	31 March 2014	31 March 2017
Male		
Pensioners	22.8 years	22.1 years
Non-pensioners	24.9 years	23.9 years
Female		
Pensioners	23.8 years	24.0 years
Non-pensioners	26.7 years	26.1 years

Non-pensioners are assumed to be aged 45 at 31 March 2017

Retirement age pattern

We have adopted the retirement age pattern assumption as specified by the England and Wales Scheme Advisory Board for preparing Key Performance Indicators. Further details about this assumption are available on request.

50/50 option

Following analysis of both the Fund's actual take up rate, and national statistics, the Fund has assumed that 1% of members will take up the 50/50 option in the future. (The assumed take up was 10% at the 2014 valuation).

Other demographic assumptions

All other assumptions have been updated to reflect the latest experience of LGPS funds in Scotland. Further details regarding the assumptions adopted can be found in our 2017 Valuation Toolkit 07: Setting Assumptions.

All the key financial and demographic assumptions were discussed with Fund Officers on the 10 October 2017 and by follow up email.

4 Initial Results - Solvency

The solvency of the Fund as at 31 March 2017 based on your proposed assumptions is set out below. The results at the 2014 formal valuation are shown for comparison.

Valuation Date	31 March 2014	31 March 2017
Past Service Liabilities	**(£m)**	**(£m)**
Employees	177	241
Deferred Pensioners	53	87
Pensioners	133	174
Total Liabilities	**363**	**502**
Assets	**333**	**450**
Surplus / (Deficit)	**(30)**	**(52)**
Funding Level	**92%**	**90%**

We have valued the benefits defined under the Regulations based on the assumptions outlined in Section 3. These results are sensitive to the underlying financial and demographic assumptions as well as the quality of the underlying data.

Liabilities

The liabilities have grown substantially since 2014 mainly as a result of the change in the financial assumptions. The change in the net discount rate (the difference between the discount rate and the assumed rates of increase of salaries, deferred pension revaluation or pensions in payment) results in a higher value being placed on the liabilities.

Assets

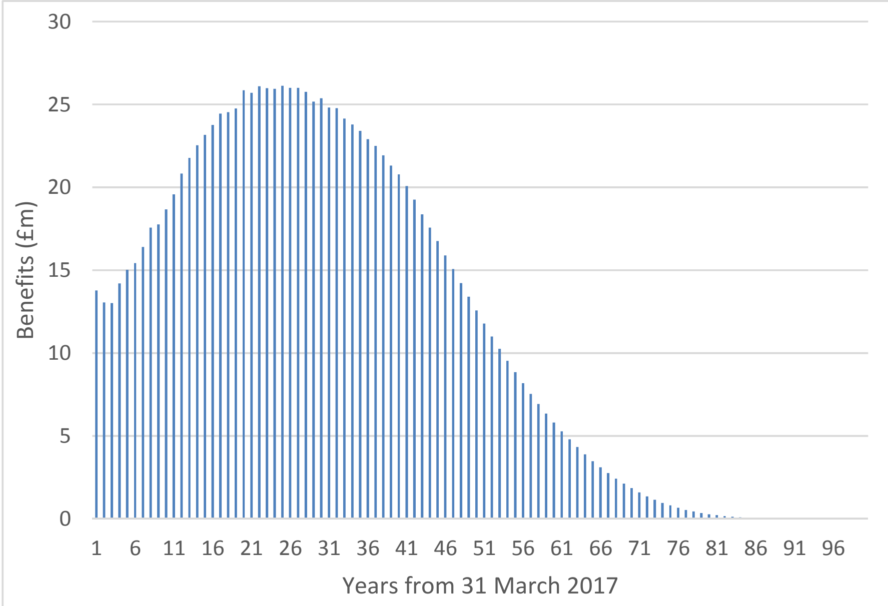
The assets have also grown substantially over the inter-valuation period. This is a result of much better than assumed asset returns. This strong investment return has only partially offset the increase in liabilities.

Funding level/deficit

The overall result has been a deterioration in the reported funding level of the Fund alongside an increase in the funding deficit.

Projected benefit payments

The liability figure is the value in today's money of all the future projected benefit payments from the Fund based on all benefits accrued up to 31 March 2017 and assumptions outlined in Section 3. The chart below details these future projected benefit payments to help understand the size and timing of the payments.



Analysis of change in solvency

The table below illustrates the various factors that have led to the change in the solvency position between the 2014 and 2017 valuations.

Analysis		(£m)
Surplus / (deficit) at 31 March 2014		**(30)**
Interest on surplus / (deficit)	(5)	
Investment returns greater than expected	47	
Contributions greater than cost of accrual	5	
Membership experience over the period	36	
Change in demographic assumptions	(8)	
Change in base mortality assumption	5	
Change in longevity improvements assumption	3	
Change in financial assumptions	(96)	
Impact of LGPS 50/50 take up	(3)	
Other experience items	(6)	
Surplus / (deficit) at 31 March 2017		**(52)**

Further comments on some of the items in this chart:

- There is an interest cost of £5m. This is broadly three years of compound interest at 5.2% p.a. applied to the previous valuation deficit of £30m (and can be thought of as the investment return that would have been achieved on the extra assets the Fund would have held if fully funded).
- Investment returns being higher than expected since 2014 lead to a gain of £47m. This is roughly the difference between the actual three-year return (30.9%) and expected three-year return (16.4%) applied to the whole fund assets from the previous valuation of £333m, with a further allowance made for cashflows during the period.
- The impact of the change in demographic assumptions has been a loss of around £8m.
- The change in mortality assumptions (baseline and improvements) has given rise to a gain of £8m. .
- The change in financial assumptions since the previous valuation has led to a loss of £96m. This is due to a decrease in the real discount rate between 2014 and 2017. This has partially been offset by the increase to 1.0% p.a. of the assumed gap between RPI and CPI and a reduction in the expected future salary growth for benefits linked to final salary.
- Membership experience over the 3 years has lef to a gain of £36m. The most material items of membership experience have been:
    - o Lower than expected salary in creases leading to a gain of £16m.
    - o Lower than expected pension increases leading to a gain of £13m
    - o Higher than expected withdrawal experience leading to a gain of £7m.
- Other experience items, such as changes in the membership data, have served to increase the deficit at this valuation by around £6m.

Comment on employers

Every employer is valued separately based on their own membership data as a part of the valuation and their change in funding position will therefore vary compared to that of the whole fund based on their individual experience. This information will be available later in the valuation process.

5 Initial Results – Contributions

Changes to terminology

The Regulations have introduced new terminology in respect of contribution rates. We have set out our interpretation of these terms below based on CIPFA guidance on preparing a Funding Strategy Statement.

Primary Contribution Rate

The actuarially calculated cost of each year's build-up of pension by current active members, excluding members' contributions but including Fund administrative expenses. This was previously referred to as the Future Service Rate.

Secondary Contribution Rate

The part of the employer's annual contribution which relates to past service deficit repair or surplus refund. This was previously referred to as Deficit Recovery Contributions.

Common Contribution Rate

The Regulations no longer require the reporting of the Common (Whole Fund) Contribution Rate. This has been replaced by Whole Fund Primary and Secondary Contribution Rates calculated as the payroll weighted average of the Primary and Secondary Contribution Rates for each employer. These rates will be calculated and disclosed in the final valuation report.

Typical employer results

The fall in the net discount rate will place upwards pressure on primary contribution rates. Employer deficit results are more difficult to predict due to the variable changes in solvency levels. Therefore, we anticipate for some employers that there may be an upward but manageable pressure on contribution rates.

Employer categorisation

Every employer in the Fund is different. For instance, they have different solvency levels, sources of funds for paying contributions, covenants, maturity profiles, and timeframes for their participation in the Fund.

As a result, when setting contribution rates, employers are categorised based on their individual characteristics in order to build a credible funding plan that fits their own needs while recognising the risk they pose to the Fund and other participating employers.

Setting credible funding plans

Information on our proposed approach to setting individual employer contribution rates is set out in our 2017 Valuation Toolkit 04: Employer Risk Based Funding.

Set a funding target

For the vast majority of employers, the target is to be fully funded on the Fund's ongoing funding assumptions. There may be instances where alternative assumptions are used such as where an employer is approaching cessation.

Choosing an appropriate time horizon

Once a target has been chosen, the time employers are given to reach that target needs to be determined. For long-term secure employers, this may be a long term horizon of up to, say, 20 years. For employers that pose a greater risk to the Fund or have different circumstances, this may be much shorter. In general, a shorter time horizon results in more volatile contributions compared to employers with longer time horizons.

Likelihood of reaching the target

The final stage involves determining the likelihood required for each employer to reach its funding target within its time horizon. In general, higher likelihoods of success are achieved by paying higher contributions and relying less on volatile investment returns. The likelihood required of each employer is largely based on each employer's assessed covenant. For instance, a lower probability of success (e.g. 66%) may be set for a secure body as they may be considered to be able to pay higher contributions (or current rates for longer) should they not reach their funding target over their time horizon.

Before we calculate individual employer results, we will agree with you an appropriate funding target, time horizon and likelihood of reaching the target for each employer in the Fund.

6 Risk Analysis

The valuation results depend critically on the actuarial assumptions that are made about the future of the Fund. If all of the assumptions made at this valuation were exactly borne out in practice then the results presented in this document would represent the true cost of providing benefits from the Fund as it currently stands at 31 March 2017.

However, no one can predict the future with certainty and future experience will not exactly match all of our assumptions. The future therefore presents a variety of risks to the Fund which should be **identified** and, where possible, the financial significance should be **quantified**. Thereafter the Fund can assess how (or if) these risks can then be **controlled** or **mitigated** and put in place **monitoring** to assess whether any mitigation is actually working.

Financial risks

The two main areas of financial risk of interest to your Fund are the investment performance and level of benefit increases. To help understand the impact of these two factors being different from assumed, we have shown the effects on the solvency level of varying the discount rate (investment performance) and benefit increase assumptions below.

Discount Rates (p.a.)	Benefit Increases (p.a.) 2.2%	2.4%	2.6%	
3.7%	(22) 95%	(37) 92%	(53) 90%	(Deficit) Funding Level
3.5%	(37) 92%	(52) 90%	(68) 87%	(Deficit) Funding Level
3.3%	(52) 90%	(68) 87%	(85) 84%	(Deficit) Funding Level

The above analysis focuses on financial risk to the solvency level. Our approach to setting contribution rates at the 2017 valuation seeks to recognise the uncertainty around future investment returns and benefit increases.

Further information about this method will be included with the employer results.

Demographic assumptions

The main area of demographic risk is people living longer than expected. We have shown below the high level impact of people living longer than currently expected by using a more prudent assumption for future longevity improvements. The proposed valuation assumption assumes that in the longer term mortality rates will fall at a rate of 1.25% each year. The more prudent assumptions shown for sensitivity analysis assumes that mortality rates will fall at a rate of 1.5% each year in the longer term.

	1.25% long term rate of improvement	1.5% long term rate of improvement
(Deficit)	(52)	(58)
Funding Level	90%	89%

Other demographic risks to consider

There are other risk factors which would have an impact on the solvency position. Examples of these include the level of ill health retirements, withdrawals from the scheme and take up of the 50:50 option. These are probably unlikely to change in such a way that would rank them as amongst the highest risks facing the Fund and therefore we have not sought to provide further quantification of their risk.

Other risks

As well as financial and demographic risks, the Fund also faces: Regulatory risks – central government legislation could significantly change the cost of the scheme in the future; and: Administration and governance risk – failures in administration proceeses could lead to incorrect data and inaccuracies in the actuarial calculations. The risks should be considered and monitored by the Fund as part of its ongoing risk management framework.

7 Next Steps

The purpose of this report is to present the initial whole fund solvency level, confirm the funding assumptions and to allow us to proceed with the calculation of individual employer results. The membership and other experience analysis is also useful to identify any areas of potential risk that the Fund may want to consider and explore possible avenues of risk mitigation during the valuation process.

The next steps in the process are as follows.

- Fund officers and Pension Committee to ***understand the whole fund solvency level result*** and agree the assumptions on which it is based, discuss any questions or issues before moving on to the next stage of the valuation process. This includes the Fund ***identifying any areas of risk*** that it is concerned about and wishes to explore further and understand how the risk can be identified, quantified, mitigated and monitored.
- Once the officers and Pension Committee are happy with these results, we will quantify the ***valuation solvency levels for each individual employer*** that participates in the Fund.
- We will also agree with you parameters (funding target, time horizon, probability of reaching target) for the ***assessment of each employer's proposed contribution rate.*** When we present you with these results, we will set out the contribution rates that each employer should pay for the next three years from 1 April 2018 based on these parameters.
- For some employers, the contribution rate that they should pay in principle may be different to what they will actually pay in practice. Any deviation will be based on their own circumstances and a range of factors including (amongst other things) their perceived security, whether they are going to be pooled with other employers or any budgetary constraints that they may be bound by. We expect there to be a consultation period where you gather together all of these issues and ***come back to us with a set of final agreed contribution rates for each employer.***
- We understand that you may require additional input from us before agreeing the final contribution rates. Some employers may accept their proposed contribution rates quite readily whilst others may want to explore their options. You may want us to look at the viability of ***different contribution strategies*** that are proposed by individual employers.
- Once a set of final contribution rates have been agreed for all employers, we will provide you with a ***final valuation report*** which will clearly set out the final valuation results and will meet all the relevant regulatory requirements. Included in this report will be the Certificate of Rates and Adjustments, which will certify the minimum contribution rates to be paid by each employer for the three year period beginning on 1 April 2018. This final valuation report must be provided to you no later than 31 March 2018.

Appendix – Reliances and limitations

This document has been requested by and is provided to Shetland Islands Council in its capacity as Administering Authority to the . It has been prepared by Hymans Robertson LLP to support a discussion on funding strategy with the Fund as part of the 2017 funding valuation.

This document should not be released or otherwise disclosed to any third party (including Fund employers) without our prior written consent, in which case it should be released in its entirety. Hymans Robertson LLP accepts no liability to any other party unless we have expressly accepted such liability

Reliances and limitations

This document has been prepared for the purpose of communicating the initial whole fund solvency level of the 2017 valuation to the Administering Authority and confirm the funding assumptions. Nothing contained in this report affects any member's benefits. Furthermore, none of the figures should be used for accounting purposes (e.g. under FRS102 or IAS19) or for any other purpose (e.g. a termination valuation).

The valuation results are wholly dependent on the data provided to us and the assumptions that we use in our calculations. We have previously issued a separate report confirming that the data provided is fit for the purposes of this valuation and have commented on our perception of the quality of the data provided. The data used in our calculations is as per our report which will follow in due course.

It is possible that as part of our ongoing discussions you may find that there is additional information you should provide us with. In a similar way, you may feel that one or more of the assumptions is no longer not suitable for the Fund and you may wish to explore the use of alternatives. Until both of these areas are definitively agreed by all relevant parties, the results in this document will remain "initial" and could be subject to change before the final valuation report is signed off.

The results contained in this document are for the Fund as a whole. It does not set out the valuation results for individual employers, which will be derived at a later date. Employers come in different shapes and sizes and their valuation results are not uniform. We would advise against extrapolating the results contained in this document to predict possible contribution rates for employers at this stage.

The figures in this report are based on our understanding of the benefit structure of the LGPS in Scotland as at 31 March 2017.

Actuarial Standards

The following Technical Actuarial Standards[1] are applicable in relation to this report and have been complied with where material:

- TAS 100 – Principles for technical actuarial work;
- TAS 300 – Pensions.

However, it should be noted that this report does not comply with paragraph 12 b) or c) of TAS 300.The figures in this report provide a notification of the whole fund solvency level. This report is not proposing individual employer contributions. Therefore we do not believe the exclusion of the information required under these paragraphs are material.

[1] Technical Actuarial Standards (TASs) are issued by the Financial Reporting Council (FRC) and set standards for certain items of actuarial work.

HYMANS ROBERTSON

Shetland Island Council Pension Fund

DRAFT Funding Strategy Statement

November 2017

PUBLIC SECTOR

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1 Introduction

1.1 What is this document?

This is the Funding Strategy Statement (FSS) of the Shetland Islands Council Pension Fund ("the Fund"), which is administered by Shetland Islands Council, ("the Administering Authority").

It has been prepared by the Administering Authority in collaboration with the Fund's actuary, Hymans Robertson LLP, and after consultation with the Fund's employers and investment adviser. It is effective from [DATE POST CONSULTATION].

1.2 What is the Shetland Islands Council Pension Fund?

The Fund is part of the Scottish Local Government Pension Scheme (LGPS). The LGPS was set up by the UK Government to provide retirement and death benefits for local government employees, and those employed in similar or related bodies, across the whole country. The Administering Authority runs the Shetlands Islands Council Pension Fund, in effect the LGPS for the Shetland Islands area, to make sure it:

- receives the proper amount of contributions from employees and employers, and any transfer payments;
- invests the contributions appropriately, with the aim that the Fund's assets grow over time with investment income and capital growth; and
- uses the assets to pay Fund benefits to the members (as and when they retire, for the rest of their lives), and to their dependants (as and when members die), as defined in the various LGPS Regulations applicable to Scotland. Assets are also used to pay transfer values and administration costs.

The roles and responsibilities of the key parties involved in the management of the Fund are summarised in Appendix B.

1.3 Why does the Fund need a Funding Strategy Statement?

Employees' benefits are guaranteed by the LGPS Regulations and do not change with market values or employer contributions. Investment returns will help pay for some of the benefits, but probably not all, and certainly with no guarantee. Employees' contributions are fixed in those Regulations also, at a level which covers only part of the cost of the benefits.

Therefore, employers need to pay the balance of the cost of delivering the benefits to members and their dependants.

The FSS focuses on how employer liabilities are measured, the pace at which these liabilities are funded, and how employers or pools of employers pay for their own liabilities. This statement sets out how the Administering Authority has balanced the conflicting aims of:

- affordability of employer contributions,
- transparency of processes,
- stability of employers' contributions, and
- prudence in the funding basis.

There are also regulatory requirements for an FSS, as given in Appendix A.

The FSS is a summary of the Fund's approach to funding its liabilities, and this includes reference to the Fund's other policies; it is not an exhaustive statement of policy on all issues. The FSS forms part of a framework which includes:

- the LGPS Regulations applicable in Scotland;
- the Rates and Adjustments Certificate (confirming employer contribution rates for the next three years) which can be found in an appendix to the formal valuation report;
- actuarial factors for valuing individual transfers, early retirement costs and the costs of buying added service; and
- the Fund's Statement of Investment Principles (see Section 4)

1.4 How does the Fund and this FSS affect me?

This depends on who you are:

- a member of the Fund, i.e. a current or former employee, or a dependant: the Fund needs to be sure it is collecting and holding enough money so that your benefits are always paid in full;
- an employer in the Fund (or which is considering joining the Fund): you will want to know how your contributions are calculated from time to time, that these are fair by comparison to other employers in the Fund, and in what circumstances you might need to pay more. Note that the FSS applies to all employers participating in the Fund;
- an Elected Member whose council participates in the Fund: you will want to be sure that the council balances the need to hold prudent reserves for members' retirement and death benefits, with the other competing demands for council money;
- a Council Tax payer: you will want to know how your council seeks to strike the balance above, and also to minimise cross-subsidies between different generations of taxpayers.

1.5 What does the FSS aim to do?

The FSS sets out the objectives of the Fund's funding strategy, such as:

- to ensure the long-term solvency of the Fund, using a prudent long term view. This will ensure that sufficient funds are available to meet all members'/dependants' benefits as they fall due for payment;
- to ensure that employer contribution rates are reasonably stable where appropriate;
- to minimise the long-term cash contributions which employers need to pay to the Fund, by recognising the link between assets and liabilities and adopting an investment strategy which balances risk and return (**NB** this will also minimise the costs to be borne by Council Tax payers);
- to reflect the different characteristics of different employers in determining contribution rates. This involves the Fund having a clear and transparent funding strategy to demonstrate how each employer can best meet its own liabilities over future years; and
- to use reasonable measures to reduce the risk to other employers and ultimately to the Council Tax payer from an employer defaulting on its pension obligations.

1.6 How do I find my way around this document?

In Section 2 there is a brief introduction to some of the main principles behind funding, i.e. deciding how much an employer should contribute to the Fund from time to time.

In Section 3 we outline how the Fund calculates the contributions payable by different employers in different situations.

In Section 4 we show how the funding strategy is linked with the Fund's investment strategy.

In the Appendices we cover various issues in more detail if you are interested:

A. the regulatory background, including how and when the FSS is reviewed,

B. who is responsible for what,

C. what issues the Fund needs to monitor, and how it manages its risks,

D. some more details about the actuarial calculations required,

E. the assumptions which the Fund actuary currently makes about the future,

F. a glossary explaining the technical terms occasionally used here.

If you have any other queries please contact Mary Smith in the first instance at e-mail address **mary.smith@shetland.gov.uk** or on telephone number 01595 744669.

2 Basic Funding issues

(More detailed and extensive descriptions are given in Appendix D).

2.1 How does the actuary measure the required contribution rate?

In essence this is a three-step process:

1. Calculate the ultimate funding target for that employer, i.e. the ideal amount of assets it should hold in order to be able to pay all its members' benefits. See Appendix E for more details of what assumptions we make to determine that funding target;

2. Determine the time horizon over which the employer should aim to achieve that funding target. See the table in 3.3 and Note (b) for more details;

3. Calculate the employer contribution rate such that it has at least a given probability of achieving that funding target over that time horizon, allowing for different likelihoods of various possible economic outcomes over that time horizon. See 2.4 below, and Section 3 for more details.

2.2 What is each employer's contribution rate?

This is described in more detail in Appendix D. Employer contributions are normally made up of two elements:

a) the estimated cost of benefits being built up each year, after deducting the members' own contributions and including administration expenses. This is referred to as the "*Primary rate*", and is expressed as a percentage of members' pensionable pay; plus

b) an adjustment for the difference between the Primary rate above, and the actual contribution the employer needs to pay, referred to as the "*Secondary rate*". In broad terms, payment of the Secondary rate will aim to return the employer to full funding over an appropriate period (the "time horizon"). The Secondary rate may be expressed as a percentage of pay and/or a monetary amount in each year.

The rates for all employers are shown in the Fund's Rates and Adjustments Certificate, which forms part of the formal Actuarial Valuation Report. Employers' contributions are expressed as minima, with employers able to pay contributions at a higher rate. Account of any higher rate will be taken by the Fund actuary at subsequent valuations, i.e. will be reflected as a credit when next calculating the employer's contributions.

2.3 What different types of employer participate in the Fund?

Historically the LGPS was intended for local authority employees only. However over the years, with the diversification and changes to delivery of local services, many more types and numbers of employers now participate.

In essence, participation in the LGPS is open to public sector employers providing some form of service to the local community. Whilst the majority of members will be local authority employees (and ex-employees), the majority of participating employers are those providing services in place of (or alongside) local authority services: colleges, contractors, housing associations, charities, etc.

The LGPS Regulations define various types of employer as follows:

Scheduled bodies - councils, and other specified employers such as further education establishments. These must provide access to the LGPS in respect of their employees who are not eligible to join another public sector scheme (such as the Teachers Scheme). These employers are so-called because they are specified in a schedule to the LGPS Regulations.

Other employers are able to participate in the Fund via an admission agreement, and are referred to as 'admission bodies'. These employers are generally those with a "community of interest" with another scheme employer – **community admission bodies** ("CAB") or those providing a service on behalf of a scheme employer – **transferee admission bodies** ("TAB"). CABs will include housing associations and charities, TABs will generally be contractors. The Fund is able to set its criteria for participation by these employers and can refuse entry if the requirements as set out in the Fund's admissions policy are not met. (NB The terminology CAB and TAB has been dropped from recent LGPS Regulations, which instead combine both under the single term 'admission bodies'; however, we have retained the old terminology here as we consider it to be helpful in setting funding strategies for these different employers).

2.4 How does the measured contribution rate vary for different employers?

All three steps above are considered when setting contributions (more details are given in Section 3 and Appendix D).

1. The **funding target** is based on a set of assumptions about the future, (e.g. investment returns, inflation, pensioners' life expectancies). However, if an employer is approaching the end of its participation in the Fund then its funding target may be set on a more prudent basis, so that its liabilities are less likely to be spread among other employers after its cessation;

2. The **time horizon** required is, in broad terms, the period over which any deficit is to be recovered. A shorter period will lead to higher contributions, and vice versa (all other things being equal). Employers may be given a lower time horizon if they have a less permanent anticipated membership, or do not have tax-raising powers to increase contributions if investment returns under-perform; and

3. The **probability of achieving** the funding target over that time horizon will be dependent on the Fund's view of the strength of employer covenant and its funding profile. Where an employer is considered to be weaker, or potentially ceasing from the Fund, then the required probability will be set higher, which in turn will increase the required contributions (and vice versa).

For some employers it may be agreed to pool contributions, see 3.4.

Any costs of non ill-health early retirements must be paid by the employer, see 3.6.

Costs of ill-health early retirements are covered in 3.7.

2.5 How is a deficit (or surplus) calculated?

An employer's "funding level" is defined as the ratio of:

- the market value of the employer's share of assets (see Appendix D, section D5, for further details of how this is calculated), to
- the value placed by the actuary on the benefits built up to date for the employer's employees and ex-employees (the "liabilities"). The Fund actuary agrees with the Administering Authority the assumptions to be used in calculating this value.

If this is less than 100% then it means the employer has a shortfall, which is the employer's deficit; if it is more than 100% then the employer is said to be in surplus. The amount of deficit or shortfall is the difference between the asset value and the liabilities value.

It is important to note that the deficit/surplus and funding level are only measurements at a particular point in time, on a particular set of assumptions about the future. Whilst we recognise that various parties will take an interest in these measures, for most employers the key issue is how likely it is that their contributions will be sufficient to pay for their members' benefits (when added to their existing asset share and anticipated investment returns).

In short, deficits and funding levels are short term measures, whereas contribution-setting is a longer term issue.

2.6 How does the Fund recognise that contribution levels can affect council and employer service provision, and council tax?

The Administering Authority and the Fund actuary are acutely aware that, all other things being equal, a higher contribution required to be paid to the Fund will mean less cash available for the employer to spend on the provision of services. For instance:

- Higher pension fund contributions may result in reduced council spending, which in turn could affect the resources available for council services, and/or greater pressure on council tax levels;
- Contributions which colleges and universities pay to the Fund will therefore not be available to pay for providing education; and
- Other employers will provide various services to the local community, perhaps through housing, charitable work, or contracting council services. If they are required to pay more in pension contributions to the LGPS then this may affect their ability to provide the local services at a reasonable cost.

Whilst all this is true, it should also be borne in mind that:

- The Fund provides invaluable financial security to local families, whether to those who formerly worked in the service of the local community who have now retired, or to their families after their death;
- The Fund must have the assets available to meet these retirement and death benefits, which in turn means that the various employers must each pay their own way. Lower contributions today will mean higher contributions tomorrow: deferring payments does not alter the employer's ultimate obligation to the Fund in respect of its current and former employees;
- Each employer will generally only pay for its own employees and ex-employees (and their dependants), not for those of other employers in the Fund;

- The Fund strives to maintain reasonably stable employer contribution rates where appropriate and possible. However, a recent shift in regulatory focus means that solvency within each generation is considered by the Government to be a higher priority than stability of contribution rates;
- The Fund wishes to avoid the situation where an employer falls so far behind in managing its funding shortfall that its deficit becomes unmanageable in practice: such a situation may lead to employer insolvency and the resulting deficit falling on the other Fund employers. In that situation, those employers' services would in turn suffer as a result; and
- Council contributions to the Fund should be at a suitable level, to protect the interests of different generations of council tax payers. For instance, underpayment of contributions for some years will need to be balanced by overpayment in other years; the council will wish to minimise the extent to which council tax payers in one period are in effect benefitting at the expense of those paying in a different period.

Overall, therefore, there is clearly a balance to be struck between the Fund's need for maintaining prudent funding levels, and the employers' need to allocate their resources appropriately. The Fund achieves this through various techniques which affect contribution increases to various degrees (see 3.1). In deciding which of these techniques to apply to any given employer, the Administering Authority takes a view on the financial standing of the employer, i.e. its ability to meet its funding commitments over the relevant time horizon.

The Administering Authority will consider a risk assessment of that employer using a knowledge base which is regularly monitored and kept up-to-date. This database will include such information as the type of employer, its membership profile and funding position, any guarantors or security provision, material changes anticipated, etc.

For instance, where the Administering Authority has reasonable confidence that an employer will be able to meet its funding commitments, then the Fund will permit options such as a longer time horizon relative to other employers, and/or a lower probability of achieving their funding target. Such options will temporarily produce lower contribution levels than would otherwise have applied. This is permitted in the expectation that the employer will still be able to meet its obligations for many years to come.

On the other hand, where there is doubt that an employer will be able to meet its funding commitments or withstand a significant change in its commitments, then a higher funding target, and/or a shorter deficit recovery period relative to other employers, and/or a higher probability of achieving the target may be required.

The Fund actively seeks employer input, including to its funding arrangements, through various means: see Appendix A.

3 Calculating contributions for individual Employers

3.1 General comments

A key challenge for the Administering Authority is to balance the need for stable, affordable employer contributions with the requirement to take a prudent, longer-term view of funding and ensure the solvency of the Fund. With this in mind, the Fund's three-step process identifies the key issues:

1. What is a suitably (but not overly) prudent funding target?
2. How long should the employer be permitted to reach that target? This should be realistic but not so long that the funding target is in danger of never actually being achieved.
3. What probability is required to reach that funding target? This will always be less than 100% as we cannot be certain of future market movements. Higher probability "bars" can be used for employers where the Fund wishes to reduce the risk that the employer ceases leaving a deficit to be picked up by other employers.

These and associated issues are covered in this Section.

The Administering Authority recognises that there may occasionally be particular circumstances affecting individual employers that are not easily managed within the rules and policies set out in the Funding Strategy Statement. Therefore the Administering Authority may, at its sole discretion, direct the actuary to adopt alternative funding approaches on a case by case basis for specific employers.

3.2 The effect of paying lower contributions

In limited circumstances the Administering Authority may permit employers to pay contributions at a lower level than is assessed for the employer using the three step process above. At their absolute discretion the Administering Authority may:

- extend the time horizon for targeting full funding;
- adjust the required probability of meeting the funding target;
- permit extended phasing in of contribution rises or reductions;
- pool contributions amongst employers with similar characteristics; and/or
- accept some form of security or guarantee in lieu of a higher contribution rate than would otherwise be the case.

Employers which are permitted to use one or more of the above methods will often be paying, for a time, contributions less than required to meet their funding target, over the appropriate time horizon with the required likelihood of success. Such employers should appreciate that:

- their true long term liability (i.e. the actual eventual cost of benefits payable to their employees and ex-employees) is not affected by the pace of paying contributions;
- lower contributions in the short term will be assumed to incur a greater loss of investment returns on the deficit. Thus, deferring a certain amount of contribution may lead to higher contributions in the long-term; and
- it may take longer to reach their funding target, all other things being equal.

Overleaf (3.3) is a summary of how the main funding policies differ for different types of employer, followed by more detailed notes where necessary.

Section 3.4 onwards deals with various other funding issues which apply to all employers.

3.3 The different approaches used for different employers

Type of employer	**Scheduled Bodies**		**Community Admission Bodies**		**Transferee Admission Bodies**
Sub-type	**Local Authorities**	**Colleges**	**Open to new entrants**	**Closed to new entrants**	**(all)**
Funding Target Basis used	Ongoing, assumes long-term Fund participation (see Appendix E)		Ongoing, but may move to "gilts basis" - see Note (a)		Ongoing, assumes fixed contract term in the Fund (see Appendix E)
Primary rate approach	(see Appendix D – D.2)				
Maximum time horizon – Note (b)	20 years	20 years	20 years	Period equivalent to the expected future working lifetime of the remaining scheme members allowing for expected leavers, subject to no less than nine years	Outstanding contract term
Secondary rate – Note (c)	% of payroll	% of payroll	% of payroll	Monetary amount	% of payroll
Treatment of surplus	Preferred approach: contributions kept at Primary rate. However, reductions may be permitted by the Admin. Authority				Reduce contributions by spreading the surplus over the remaining contract term
Probability of achieving target – Note (d)	[65-70%]	[70-75%]	[75-80%]	[75-80%]	[50-70%]
Phasing of contribution changes – Note (e)	2 – 4 years				None
Review of rates – Note (f)	Administering Authority reserves the right to review contribution rates and amounts, and the level of security provided, at regular intervals between valuations				Particularly reviewed in last 3 years of contract
New employer	n/a	n/a	Note (g)		Notes (g) & (h)
Cessation of participation: cessation debt payable	Cessation is assumed not to be generally possible, as Scheduled Bodies are legally obliged to participate in the LGPS. In the rare event of cessation occurring (machinery of Government changes for example), the cessation debt principles applied would be as per Note (i).		Can be ceased subject to terms of admission agreement. Cessation debt will be calculated on a basis appropriate to the circumstances of cessation – see Note (i).		Participation is assumed to expire at the end of the contract. Cessation debt (if any) calculated on ongoing basis. Awarding Authority will be liable for future deficits and contributions arising.

Note (a) (Basis for CABs closed to new entrants)

In the circumstances where:

- the employer is an Admission Body but not a Transferee Admission Body, and
- the employer has no guarantor, and
- the admission agreement is likely to terminate, or the employer is likely to lose its last active member, within a timeframe considered appropriate by the Administering Authority to prompt a change in funding,

the Administering Authority may set a higher funding target (e.g. using a discount rate set equal to gilt yields) by the time the agreement terminates or the last active member leaves, in order to protect other employers in the Fund. This policy will increase regular contributions and reduce, but not entirely eliminate, the possibility of a final deficit payment being required from the employer when a cessation valuation is carried out.

The Administering Authority also reserves the right to adopt the above approach in respect of those Admission Bodies with no guarantor, where the strength of covenant is considered to be weak but there is no immediate expectation that the admission agreement will cease.

Note (b) (Maximum time horizon)

The maximum time horizon starts at the commencement of the revised contribution rate (1 April 2018 for the 2017 valuation). The Administering Authority would normally expect the same period to be used at successive triennial valuations, but would reserve the right to propose alternative time horizons, for example where an employer closed to new entrants over the inter-valuation period.

Note (c) (Secondary rate)

The Secondary contribution rate for each employer covering the three year period until the next valuation will often be set as a percentage of salaries. However, the Administering Authority reserves the right to amend these rates between valuations and/or to require these payments in monetary terms instead, for instance where:

- the employer is relatively mature, i.e. has a large Secondary contribution rate (e.g. above 15% of payroll), or
- there has been a significant reduction in payroll due to outsourcing or redundancy exercises, or
- the employer has closed to new entrants.

Note (d) (Probability of achieving funding target)

Each employer has its funding target calculated, and a relevant time horizon over which to reach that target. Contributions are set such that, combined with the employer's current asset share and anticipated market movements over the time horizon, the funding target is achieved with a given minimum probability. A higher required probability bar will give rise to higher required contributions, and vice versa.

The way in which contributions are set using these three steps, and relevant economic projections, is described in further detail in Appendix D.

Different probabilities are set for different employers depending on their nature and circumstances: in broad terms, a higher probability will apply due to one or more of the following:

- the Fund believes the employer poses a greater funding risk than other employers;
- the employer does not have tax-raising powers;

- the employer does not have a guarantor or other sufficient security backing its funding position; and/or
- the employer is likely to cease participation in the Fund in the short or medium term.

Note (e) (Phasing of contribution changes)

The Administering Authority may agree with employers that any increases in employer contribution be phased in over an agreed period.

Transferee Admission Bodies are not eligible for phasing in of contributions rises. Other employers may opt to phase in contribution rises as follows:

- For employers contributing at or above its future service rate in 2016/17, phasing in the rise in employer contributions over a period of four years;
- For employers contributing at less than its future service rate in 2016/17, phasing in the rise in contribution rises over a period of two years.

In exceptional circumstances the Administering Authority, following discussion with the Fund actuary, may agree to extend the phasing period for an employer beyond those stated above.

Note (f) (Regular Reviews)

Such reviews may be triggered by significant events including but not limited to: significant reductions in payroll, altered employer circumstances, Government restructuring affecting the employer's business, or failure to pay contributions or arrange appropriate security as required by the Administering Authority.

The result of a review may be to require increased contributions (by strengthening the actuarial assumptions adopted which will increase the funding target and/or moving to monetary levels of deficit recovery contributions), and/or an increased level of security or guarantee.

Note (g) (New Admission Bodies)

All new Admission Bodies will be required to provide some form of security, such as a guarantee from the letting employer, an indemnity or a bond, as set out in the LGPS Regulations. The security is required to cover some or all of the following:

- the strain cost of any redundancy early retirements resulting from the premature termination of the contract;
- allowance for the risk of asset underperformance;
- allowance for the risk of a fall in gilt yields;
- allowance for the possible non-payment of employer and member contributions to the Fund; and/or
- the current deficit.

Transferee Admission Bodies: For all TABs, the security must be to the satisfaction of the Administering Authority as well as the letting employer, and will be reassessed on an annual basis. See also Note (h) below.

Community Admission Bodies: The Administering Authority will only consider requests from CABs (or other similar bodies) to join the Fund if they are sponsored by a Scheduled Body with tax raising powers, or the Scottish or UK Government, guaranteeing their liabilities and also providing a form of security as above.

The above approaches reduce the risk, to other employers in the Fund, of potentially having to pick up any shortfall in respect of Admission Bodies ceasing with an unpaid deficit.

Note (h) (New Transferee Admission Bodies)

A new TAB usually joins the Fund as a result of the letting/outsourcing of some services from an existing employer (normally a Scheduled Body such as a council) to another organisation (a "contractor"). This involves the TUPE transfer of some staff from the letting employer to the contractor. Consequently, for the duration of the contract, the contractor is a new participating employer in the Fund so that the transferring employees maintain their eligibility for LGPS membership. At the end of the contract the employees revert to the letting employer or to a replacement contractor.

Ordinarily, the TAB would be set up in the Fund as a new employer with responsibility for all the accrued benefits of the transferring employees; in this case, the contractor would usually be assigned an initial asset allocation equal to the past service liability value of the employees' Fund benefits. The quid pro quo is that the contractor is then expected to ensure that its share of the Fund is also fully funded at the end of the contract: see Note (i).

Employers which "outsource" have flexibility in the way that they can deal with the pension risk potentially taken on by the contractor. In particular there are three different routes that such employers may wish to adopt. Clearly as the risk ultimately resides with the employer letting the contract, it is for them to agree the appropriate route with the contractor:

i) Pooling

Under this option, the contractor is pooled with the letting employer. In this case, the contractor pays the same rate as the letting employer.

ii) Letting employer retains pre-contract risks

Under this option the letting employer would retain responsibility for assets and liabilities in respect of service accrued prior to the contract commencement date. The contractor would be responsible for the future liabilities that accrue in respect of transferred staff. The contractor's contribution rate could vary from one valuation to the next. It would be liable for any deficit at the end of the contract term in respect of assets and liabilities attributable to service accrued during the contract term.

iii) Fixed contribution rate agreed

Under this option the contractor pays a fixed contribution rate and does not pay any cessation deficit.

The Administering Authority is willing to administer any of the above options as long as the approach is documented in the Admission Agreement as well as the transfer agreement. The Admission Agreement should ensure that some element of risk transfers to the contractor where it relates to its own decisions and it is unfair to burden the letting employer with that risk. For example the contractor should typically be responsible for pension costs that arise from:

- above average pay increases, including the effect in respect of service prior to contract commencement even if the letting employer takes on responsibility for the latter under (ii) above; and
- redundancy and early retirement decisions.

Note (i) (Admission Bodies Ceasing)

Admission Agreements for Transferee Admission Bodies are assumed to expire at the end of the contract.

Admission Agreements for other employers are generally assumed to be open-ended until all benefits have been paid out in full. Admission Agreements can be terminated at any point subject to the terms of the Agreement. Notwithstanding the provisions of the Admission Agreement, the Administering Authority may consider any of the following as triggers for the cessation of an admission agreement with any type of body:

- Last active member ceasing participation in the Fund (NB recent LGPS Regulation changes mean that the Administering Authority has the discretion to defer taking action for up to three years, so that if the employer acquires one or more active Fund members during that period then cessation is not triggered. The current Fund approach is that this is left as a discretion and may or may not be applied in any given case;
- The insolvency, winding up or liquidation of the Admission Body;
- Any breach by the Admission Body of any of its obligations under the Agreement that they have failed to remedy to the satisfaction of the Fund;
- A failure by the Admission Body to pay any sums due to the Fund within the period required by the Fund; or
- The failure by the Admission Body to renew or adjust the level of the bond or indemnity, or to confirm an appropriate alternative guarantor, as required by the Fund.

In addition either party can voluntarily terminate the Admission Agreement by giving the appropriate period of notice as set out in the admission agreement to the other party (or parties in the case of a TAB).

On cessation, the Administering Authority will instruct the Fund actuary to carry out a cessation valuation to determine whether there is any deficit or surplus. Where there is a deficit, payment of this amount in full would normally be sought from the Admission Body; where there is a surplus it should be noted that current legislation does not permit a refund payment to the Admission Body.

For non-Transferee Admission Bodies whose participation is voluntarily ended either by themselves or the Fund, or where a cessation event has been triggered, the Administering Authority must look to protect the interests of other ongoing employers. The actuary will therefore adopt an approach which, to the extent reasonably practicable, protects the other employers from the likelihood of any material loss emerging in future:

(a) Where a guarantor does not exist then, in order to protect other employers in the Fund, the cessation liabilities and final deficit will normally be calculated using a "gilts cessation basis", which is more prudent than the ongoing basis. This has no allowance for potential future investment outperformance above gilt yields, and has added allowance for future improvements in life expectancy. This could give rise to significant cessation debts being required;

(b) Where there is a guarantor for future deficits and contributions, the details of the guarantee will be considered prior to the cessation valuation being carried out. In some cases the guarantor is simply guarantor of last resort and therefore the cessation valuation will be carried out consistently with the approach taken had there been no guarantor in place. Alternatively, where the guarantor is not simply guarantor of last resort, the cessation may be calculated using the ongoing basis as described in Appendix E; or

(c) Again, depending on the nature of the guarantee, it may be possible to simply pool the former Admission Body's liabilities and assets with the guarantor, without needing to crystallise any deficit. This approach may be adopted where the employer cannot pay the contributions due, and this is within the terms of the guarantee.

Under (a) and (b), any shortfall would usually be levied on the departing Admission Body as a single lump sum payment. If this is not possible, then the Fund would spread the payment subject to there being some security in place for the employer such as a bond indemnity or guarantee.

In the event that the Fund is not able to recover the required payment in full, then:

(a) In the case of TABs the Awarding Authority will be liable. At its absolute discretion the Awarding Authority may agree to recover any outstanding amounts via an increase in the Awarding Authority's contribution rate over an agreed period.

(b) In the case of Admission Bodies that are not TABs and have no guarantor, the unpaid amounts fall to be shared amongst all of the other employers in the Fund. This may require an immediate revision to the Rates and Adjustments Certificate affecting other employers in the Fund, or instead be reflected in the contribution rates set at the next formal valuation following the cessation date.

As an alternative, where the ceasing Admission Body is continuing in business, the Fund at its absolute discretion reserves the right to enter into an agreement with the ceasing Admission Body. Under this agreement the Fund would accept an appropriate alternative security to be held against any deficit, and would carry out the cessation valuation on an ongoing basis: deficit recovery payments would be derived from this cessation debt. This approach would be monitored as part of each triennial valuation: the Fund reserves the right to revert to a "gilts cessation basis" and seek immediate payment of any funding shortfall identified. The Administering Authority may need to seek legal advice in such cases.

3.4 Pooled contributions

From time to time, with the advice of the Actuary, the Administering Authority may set up pools for employers with similar or complementary characteristics. This will always be in line with its broader funding strategy. Currently the pools in place within the Fund are as follows:

- Some Admission Bodies are with guarantors are pooled with the Council
- Some bodies are pooled with the Shetlands Charitable Trust

Those employers which have been pooled are identified in the Rates and Adjustments Certificate.

Employers who are permitted to enter (or remain in) a pool at the 2017 valuation will not normally be advised of their individual contribution rate unless agreed by the Administering Authority.

Community Admission Bodies that are deemed by the Administering Authority to have closed to new entrants and Transferee Admission Bodies are not usually permitted to participate in a pool.

3.5 Additional flexibility in return for added security

The Administering Authority may permit greater flexibility to the employer's contributions if the employer provides added security to the satisfaction of the Administering Authority.

Such flexibility includes a reduced rate of contribution, an extended time horizon, or permission to join a pool with another body (e.g. the Local Authority).

Such security may include, but is not limited to, a suitable bond, a legally-binding guarantee from an appropriate third party, or security over an employer asset of sufficient value.

The degree of flexibility given may take into account factors such as:

- the extent of the employer's deficit;
- the amount and quality of the security offered;
- the employer's financial security and business plan; and
- whether the admission agreement is likely to be open or closed to new entrants.

3.6 Non ill health early retirement costs

It is assumed that members' benefits are payable from the earliest age that the employee could retire without incurring a reduction to their benefit (and without requiring their employer's consent to retire). (**NB** the relevant age may be different for different periods of service, following the benefit changes from April 2009 and April 2015). Employers are required to pay additional contributions ('strain') wherever an employee retires before attaining this age. The actuary's funding basis makes no allowance for premature retirement except on grounds of ill-health.

Employers must make these additional contributions as a one off payment to the Fund immediately on awarding the early retirement. The exception to this is statutory bodies with tax raising powers who are able to spread the payment over a period not exceeding 5 years. In any event the spread period cannot exceed the period to the member's normal retirement date if this is shorter than 5 years.

3.7 Ill health early retirement costs

In the event of a member's early retirement on the grounds of ill-health, a funding strain will usually arise, which can be very large. Such strains are currently met by each employer. The Fund monitors each employer's, or pool of employers, ill health experience on an ongoing basis. If the cumulative number of ill health retirement in any financial year exceeds the allowance at the previous valuation, the employer will be charged additional contributions on the same basis as apply for non-ill health cases.

Alternatively where an employer as entered into an agreement to take out insurance on ill health costs, the Fund, together with the Fund actuary, will liaise with the insurer to ensure appropriate premiums are set for the employers in the Fund. Employers will be charged additional contributions for each ill health retirement (as for non-ill health cases) and it will be expected that the employer will make a claim for an amount equal to the strain amount identified, which will then be reimbursed to the Fund.

3.8 Employers with no remaining active members

In general an employer ceasing in the Fund, due to the departure of the last active member, will pay a cessation debt on an appropriate basis (see 3.3, Note (i)) and consequently have no further obligation to the Fund. Thereafter it is expected that one of two situations will eventually arise:

a) The employer's asset share runs out before all its ex-employees' benefits have been paid. In this situation the other Fund employers will be required to contribute to pay all remaining benefits: this will be done by the Fund actuary apportioning the remaining liabilities on a pro-rata basis at successive formal valuations;

b) The last ex-employee or dependant dies before the employer's asset share has been fully utilised. In this situation the remaining assets would be apportioned pro-rata by the Fund's actuary to the other Fund employers.

In exceptional circumstances the Fund may permit an employer with no remaining active members to continue contributing to the Fund. This would require the provision of a suitable security or guarantee, as well as a written ongoing commitment to fund the remainder of the employer's obligations over an appropriate period. The Fund would reserve the right to invoke the cessation requirements in the future, however. The Administering Authority may need to seek legal advice in such cases.

3.9 Policies on bulk transfers

Each case will be treated on its own merits, but in general:

- Where only active members transfer out, the Fund will not pay bulk transfers greater than the value of the members' liabilities had they opted to transfer on an individual basis (i.e. Cash Equivalent Transfer Values);
- Where the entire membership of the employer (i.e. active, deferred and pensioner members) transfers out, the Fund will not pay a bulk transfer greater than the asset share of the transferring employer;
- The Fund will not grant added benefits to members bringing in entitlements from another Fund unless the asset transfer is sufficient to meet the added liabilities; and
- The Fund may permit shortfalls to arise on bulk transfers if the Fund employer has suitable strength of covenant and commits to meeting that shortfall in an appropriate period. This may require the employer's Fund contributions to increase between valuations.

4 Funding strategy and links to investment strategy

4.1 What is the Fund's investment strategy?

The Fund has built up assets over the years, and continues to receive contribution and other income. All of this must be invested in a suitable manner, which is the investment strategy.

Investment strategy is set by the administering authority, after consultation with the employers and after taking investment advice. The precise mix, manager make up and target returns are set out in the Statement of Investment Principles, which is available to members and employers.

The investment strategy is set for the long-term, but is reviewed from time to time. Normally a full review is carried out as part of each actuarial valuation, and is kept under review annually between actuarial valuations to ensure that it remains appropriate to the Fund's liability profile.

The same investment strategy is currently followed for all employers.

4.2 What is the link between funding strategy and investment strategy?

The Fund must be able to meet all benefit payments as and when they fall due. These payments will be met by contributions (resulting from the funding strategy) or asset returns and income (resulting from the investment strategy). To the extent that investment returns or income fall short, then higher cash contributions are required from employers, and vice versa

Therefore, the funding and investment strategies are inextricably linked.

4.3 How does the funding strategy reflect the Fund's investment strategy?

In the opinion of the Fund actuary, the current funding policy is consistent with the current investment strategy of the Fund. The asset outperformance assumption contained in the discount rate (see Appendix E3) is within a range that would be considered acceptable for funding purposes; it is also considered to be consistent with the requirement to take a "prudent longer-term view" of the funding of liabilities as required by the Government (see Appendix A1).

However, in the short term – such as the three yearly assessments at formal valuations – there is the scope for considerable volatility and there is a material chance that in the short-term and even medium term, asset returns will fall short of this target. The stability measures described in Section 3 will damp down, but not remove, the effect on employers' contributions.

The Fund does not hold a contingency reserve to protect it against the volatility of equity investments.

4.4 Does the Fund monitor its overall funding position?

The Administering Authority monitors the relative funding position, i.e. changes in the relationship between asset values and the liabilities value by means of a Triennial Valuation report. It reports the result of this report back to the Pensions Committee and employers.

5 Statutory reporting and comparison to other LGPS Funds

5.1 Purpose

Under Section 13(4)(c) of the Public Service Pensions Act 2013 ("Section 13"), the Government Actuary's Department must, following each triennial actuarial valuation, report to the Scottish Public Pensions Agency (SPPA) acting on behalf of Scottish Ministers, on each of the LGPS Funds in Scotland. This report will cover whether, for each Fund, the rate of employer contributions are set at an appropriate level to ensure both the solvency and the long term cost efficiency of the Fund.

This additional SPPA oversight may have an impact on the strategy for setting contribution rates at future valuations.

5.2 Solvency

For the purposes of Section 13, the rate of employer contributions shall be deemed to have been set at an appropriate level to ensure solvency if:

(a) the rate of employer contributions is set to target a funding level for the Fund of 100%, over an appropriate time period and using appropriate actuarial assumptions (where appropriateness is considered in both absolute and relative terms in comparison with other funds); and either

(b) employers collectively have the financial capacity to increase employer contributions, and/or the Fund is able to realise contingent assets should future circumstances require, in order to continue to target a funding level of 100%; or

(c) there is an appropriate plan in place should there be, or if there is expected in future to be, a material reduction in the capacity of fund employers to increase contributions as might be needed.

5.3 Long Term Cost Efficiency

The rate of employer contributions shall be deemed to have been set at an appropriate level to ensure long term cost efficiency if:

i. the rate of employer contributions is sufficient to make provision for the cost of current benefit accrual,

ii. with an appropriate adjustment to that rate for any surplus or deficit in the Fund.

In assessing whether the above condition is met, SPPA may have regard to various absolute and relative considerations. A relative consideration is primarily concerned with comparing LGPS pension funds with other LGPS pension funds. An absolute consideration is primarily concerned with comparing Funds with a given objective benchmark.

Relative considerations include:

1. the implied deficit recovery period; and
2. the investment return required to achieve full funding after 20 years.

Absolute considerations include:

1. the extent to which the contributions payable are sufficient to cover the cost of current benefit accrual and the interest cost on any deficit;
2. how the required investment return under “relative considerations” above compares to the estimated future return being targeted by the Fund’s current investment strategy; and
3. the extent to which any new deficit recovery plan can be directly reconciled with, and can be demonstrated to be a continuation of, any previous deficit recovery plan, after allowing for actual Fund experience.

SPPA may assess and compare these and other metrics on a suitable standardised market-related basis, for example where the local funds’ actuarial bases do not make comparisons straightforward.

Appendix A – Regulatory framework

A1 Why does the Fund need an FSS?

The purpose of the FSS 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 framework to maintain **as nearly constant employer contribution rates as possible**; and*

*to take a **prudent longer-term view** of funding those liabilities."*

These objectives are desirable individually, but may be mutually conflicting.

The requirement to maintain and publish an FSS is contained in LGPS Regulations which are updated from time to time. In publishing the FSS the Administering Authority has to have regard to any guidance published by Chartered Institute of Public Finance and Accountancy (CIPFA) (most recently in 2016) and to its Statement of Investment Principles.

This is the framework within which the Fund's actuary carries out triennial valuations to set employers' contributions and provides recommendations to the Administering Authority when other funding decisions are required, such as when employers join or leave the Fund. The FSS applies to all employers participating in the Fund.

A2 Does the Administering Authority consult anyone on the FSS?

Yes. This is required by LGPS Regulations. It is covered in more detail by the most recent CIPFA guidance, which states that the FSS must first be subject to "consultation with such persons as the authority considers appropriate", and should include "a meaningful dialogue at officer and elected member level with council tax raising authorities and with corresponding representatives of other participating employers".

In practice, for the Fund, the consultation process for this FSS was as follows:

a) **A draft version of the FSS will be issued to all participating employers for comment following the Committee meeting on the 6 December 2017.**

b) **There will be an Employers Forum on 23 January 2018 at which questions regarding the FSS could be raised and answered;**

b) **Comments on the draft version of the FSS will be requested within 14 days of the Employer consultation forum;**

c) **Following the end of the consultation period the FSS will be updated where required and then published, in March 2018.**

A3 How is the FSS published?

The FSS is made available through the following routes:

Published on the Shetland Islands Council website at CLIENT URL

A copy sent by email to each participating employer in the Fund;

A full copy included in the annual report and accounts of the Fund;

Copies sent to investment managers and independent advisers;

Copies made available on request.

A4 How often is the FSS reviewed?

The FSS is reviewed in detail at least every three years as part of the triennial valuation. This version is expected to remain unaltered until it is consulted upon as part of the formal process for the next valuation in 2020.

It is possible that (usually slight) amendments may be needed within the three year period. These would be needed to reflect any regulatory changes, or alterations to the way the Fund operates (e.g. to accommodate a new class of employer). Any such amendments would be consulted upon as appropriate:

- trivial amendments would be simply notified at the next round of employer communications,
- amendments affecting only one class of employer would be consulted with those employers,
- other more significant amendments would be subject to full consultation.

In any event, changes to the FSS would need agreement by the Pensions Committee and would be included in the relevant Committee Meeting minutes.

A5 How does the FSS fit into other Fund documents?

The FSS is a summary of the Fund's approach to funding liabilities. It is not an exhaustive statement of policy on all issues, for example there are a number of separate statements published by the Fund including the Statement of Investment Principles, Administration Strategy and Communications Strategy. In addition, the Fund publishes an Annual Report and Accounts with up to date information on the Fund.

These documents can be found on the Shetland Islands Council website at CLIENT URL

Appendix B – Responsibilities of key parties

The efficient and effective operation of the Fund needs various parties to each play their part.

B1 The Administering Authority should:-

1. operate the Fund as per the LGPS Regulations;
2. effectively manage any potential conflicts of interest arising from its dual role as Administering Authority and a Fund employer;
3. collect employer and employee contributions, and investment income and other amounts due to the Fund;
4. ensure that cash is available to meet benefit payments as and when they fall due;
5. pay from the Fund the relevant benefits and entitlements that are due;
6. invest surplus monies (i.e. contributions and other income which are not immediately needed to pay benefits) in accordance with the Fund's Statement of Investment Principles (SIP) and LGPS Regulations;
7. communicate appropriately with employers so that they fully understand their obligations to the Fund;
8. take appropriate measures to safeguard the Fund against the consequences of employer default;
9. manage the valuation process in consultation with the Fund's actuary;
10. provide data and information as required by the Government Actuary's Department to carry out their statutory obligations (see Section 5);
11. prepare and maintain a FSS and a SIP, after consultation;
12. notify the Fund's actuary of material changes which could affect funding (this is covered in a separate agreement with the actuary); and
13. monitor all aspects of the Fund's performance and funding and amend the FSS and SIP as necessary and appropriate.

B2 The Individual Employer should:-

1. deduct contributions from employees' pay correctly;
2. pay all contributions, including their own as determined by the actuary, promptly by the due date;
3. have a policy and exercise discretions within the regulatory framework;
4. make additional contributions in accordance with agreed arrangements in respect of, for example, augmentation of scheme benefits, early retirement strain; and
5. notify the Administering Authority promptly of all changes to its circumstances, prospects or membership, which could affect future funding.

B3 The Fund Actuary should:-

1. prepare valuations, including the setting of employers' contribution rates. This will involve agreeing assumptions with the Administering Authority, having regard to the FSS and LGPS Regulations, and targeting each employer's solvency appropriately;
2. provide data and information as required by the Government Actuary's Department to carry out their statutory obligations (see Section 5);
3. provide advice relating to new employers in the Fund, including the level and type of bonds or other forms of security (and the monitoring of these);

4. prepare advice and calculations in connection with bulk transfers and individual benefit-related matters;
5. assist the Administering Authority in considering possible changes to employer contributions between formal valuations, where circumstances suggest this may be necessary;
6. advise on the termination of employers' participation in the Fund; and
7. fully reflect actuarial professional guidance and requirements in the advice given to the Administering Authority.

B4 Other parties:-

1. investment advisers (either internal or external) should ensure the Fund's SIP remains appropriate, and consistent with this FSS;
2. investment managers, custodians and bankers should all play their part in the effective investment (and dis-investment) of Fund assets, in line with the SIP;
3. auditors should comply with their auditing standards, ensure Fund compliance with all requirements, monitor and advise on fraud detection, and sign off annual reports and financial statements as required;
4. governance advisers may be appointed to advise the Administering Authority on efficient processes and working methods in managing the Fund;
5. legal advisers (either internal or external) should ensure the Fund's operation and management remains fully compliant with all regulations and broader local government requirements, including the Administering Authority's own procedures; and
6. the SPPA/Scottish Ministers (assisted by the Government Actuary's Department) and the Scottish LGPS Scheme Advisory Board, should work with LGPS Funds to meet Section 13 requirements.

Appendix C – Key risks and controls

C1 Types of risk

The Administering Authority has an active risk management programme in place. The measures that it has in place to control key risks are summarised below under the following headings:

- financial;
- demographic;
- regulatory; and
- governance.

C2 Financial risks

Risk	Summary of Control Mechanisms
Fund assets fail to deliver returns in line with the anticipated returns underpinning the valuation of liabilities over the long-term.	Only anticipate long-term returns on a relatively prudent basis to reduce risk of under-performing. Assets invested on the basis of specialist advice, in a suitably diversified manner across asset classes, geographies, managers, etc. Analyse progress at three yearly valuations for all employers. Inter-valuation monitoring of liabilities between valuations at whole Fund level, can be instructed at any time.
Inappropriate long-term investment strategy.	Overall investment strategy options considered as an integral part of the funding strategy. Used asset liability modelling to measure 4 key outcomes. Chosen option considered to provide the best balance; reviewed at least every three years.
Fall in risk-free returns on Government bonds, leading to rise in value placed on liabilities.	Inter-valuation monitoring, as above. Some investment in bonds helps to mitigate this risk.
Active investment manager under-performance relative to benchmark.	Quarterly investment monitoring analyses market performance and active managers relative to their index benchmark.
Pay and price inflation significantly more than anticipated.	The focus of the actuarial valuation process is on real returns on assets, net of price and pay increases. Inter-valuation monitoring, as above, gives early warning.

Risk	Summary of Control Mechanisms
	Some investment in bonds also helps to mitigate this risk. Employers pay for their own salary awards and should be mindful of the geared effect on pension liabilities of any bias in pensionable pay rises towards longer-serving employees.
Effect of possible increase in employer's contribution rate on service delivery and admission/scheduled bodies	The funding strategy includes various measures to limit sudden increases in contributions: see 3.2.
Orphaned employers give rise to added costs for the Fund	The Fund seeks a cessation debt (or security/guarantor) to minimise the risk of this happening in the future. If it occurs, the Actuary calculates the added cost spread pro-rata among all employers – (see 3.8).

C3 Demographic risks

Risk	Summary of Control Mechanisms
Pensioners living longer, thus increasing cost to Fund.	Set mortality assumptions with some allowance for future increases in life expectancy. The Fund Actuary has direct access to the experience of over 50 LGPS funds which allows early identification of changes in life expectancy that might in turn affect the assumptions underpinning the valuation.
Maturing Fund – i.e. proportion of actively contributing employees declines relative to retired employees.	Continue to monitor at each valuation, consider seeking monetary amounts rather than % of pay and consider alternative investment strategies.
Deteriorating patterns of early retirements	Employers are charged the extra cost of non ill-health retirements following each individual decision. Employer ill health retirement experience is monitored, and insurance is an option.
Reductions in payroll causing insufficient deficit recovery payments	In many cases this may not be sufficient cause for concern, and will in effect be caught at the next formal valuation. However, there are protections where there is concern, as follows: Review of contributions is permitted in general between valuations (see Note (f) to 3.3) and may

Risk	Summary of Control Mechanisms
	require a move in deficit contributions from a percentage of payroll to fixed monetary amounts.

C4 Regulatory risks

Risk	Summary of Control Mechanisms
Changes to national pension requirements and/or HMRC rules e.g. changes arising from public sector pensions reform.	The Administering Authority considers all consultation papers issued by the Government and comments where appropriate. The results of the most recent reforms were built into the 2017 valuation. Any changes to member contribution rates or benefit levels will be carefully communicated with members to minimise possible opt-outs or adverse actions.
Time, cost and/or reputational risks associated with any SPPA/Scottish Ministers intervention triggered by the Section 13 analysis (see Section 5).	Take advice from Fund Actuary on proposed valuation approach relative to anticipated Section 13 analysis.
Changes by Government to particular employer participation in LGPS Funds, leading to impacts on funding and/or investment strategies.	The Administering Authority considers all consultation papers issued by the Government and comments where appropriate. Take advice from Fund Actuary on impact of changes on the Fund and amend strategy as appropriate.

C5 Governance risks

Risk	Summary of Control Mechanisms
Administering Authority unaware of structural changes in an employer's membership (e.g. large fall in employee members, large number of retirements) or not advised of an employer closing to new entrants.	The Administering Authority has a close relationship with employing bodies and communicates required standards e.g. for submission of data. The Actuary may revise the Rates and Adjustments Certificate to increase an employer's contributions between triennial valuations Deficit contributions may be expressed as monetary amounts.
Actuarial or investment advice is not sought, or is not heeded, or proves to be insufficient in some way	The Administering Authority maintains close contact with its specialist advisers.

Risk	Summary of Control Mechanisms
	Advice is delivered via formal meetings involving Elected Members, and recorded appropriately. Actuarial advice is subject to professional requirements such as peer review.
Administering Authority failing to commission the Fund Actuary to carry out a termination valuation for a departing Admission Body.	The Administering Authority requires employers with Best Value contractors to inform it of forthcoming changes. Community Admission Bodies' memberships are monitored and, if active membership decreases, steps will be taken.
An employer ceasing to exist with insufficient funding or adequacy of a bond.	The Administering Authority believes that it would normally be too late to address the position if it was left to the time of departure. The risk is mitigated by: Seeking a funding guarantee from another scheme employer, or external body, where-ever possible (see Notes (g) and (i) to 3.3). Alerting the prospective employer to its obligations and encouraging it to take independent actuarial advice. Vetting prospective employers before admission. Where permitted under the regulations requiring a bond to protect the Fund from various risks. Requiring new Community Admission Bodies to have a guarantor. Reviewing bond or guarantor arrangements at regular intervals (see Note (f) to 3.3). Reviewing contributions well ahead of cessation if thought appropriate (see Note (a) to 3.3).

Appendix D – The calculation of Employer contributions

In Section 2 there was a broad description of the way in which contribution rates are calculated. This Appendix considers these calculations in much more detail.

All three steps above are considered when setting contributions (more details are given in Section 3 and Appendix D:

1. The **funding target** is based on a set of assumptions about the future, e.g. investment returns, inflation, pensioners' life expectancies. However, if an employer is approaching the end of its participation in the Fund then its funding target may be set on a more prudent basis, so that its liabilities are less likely to be spread among other employers after its cessation of participation;

2. The **time horizon** required is, in broad terms, the period over which any deficit is to be recovered. A shorter period will lead to higher contributions, and vice versa (all other things being equal). Employers may be given a lower time horizon if they have a less permanent anticipated membership, or do not have tax-raising powers to increase contributions if investment returns under-perform; and

3. The required **probability of achieving** the funding target over that time horizon will be dependent on the Fund's view of the strength of employer covenant and its funding profile. Where an employer is considered to be weaker, or potentially ceasing from the Fund, then the required probability will be set higher, which in turn will increase the required contributions (and vice versa).

The calculations involve actuarial assumptions about future experience, and these are described in detail in Appendix E.

D1 What is the difference between calculations across the whole Fund and calculations for an individual employer?

Employer contributions are normally made up of two elements:

a) the estimated cost of ongoing benefits being accrued, referred to as the "Primary contribution rate" (see D2 below); plus

b) an adjustment for the difference between the Primary rate above, and the actual contribution the employer needs to pay, referred to as the "Secondary contribution rate" (see D3 below).

The contribution rate for each employer is measured as above, appropriate for each employer's funding position and membership. The whole Fund position, including that used in reporting to SPPA (see section 5), is calculated in effect as the sum of all the individual employer rates. SPPA currently only regulates at whole Fund level, without monitoring individual employer positions.

D2 How is the Primary contribution rate calculated?

The Primary element of the employer contribution rate is calculated with the aim that these contributions will meet benefit payments in respect of members' **future** service in the Fund. This is based upon the cost (in excess of members' contributions) of the benefits which employee members earn from their service each year.

The Primary rate is calculated separately for all the employers, although employers within a pool will pay the Primary rate applicable to the pool as a whole. The Primary rate is calculated such that it is projected to:

1. meet the required funding target for all future years' accrual of benefits*, excluding any accrued assets,

2. within the determined time horizon (see note 3.3 Note (c) for further details), and

3. with a sufficiently high probability, as set by the Fund's strategy for the category of employer (see 3.3 Note (e) for further details).

* The projection is for the current active membership where the employer no longer admits new entrants, or additionally allows for new entrants where this is appropriate.

The projections are carried out using an economic modeller developed by the Fund's actuary Hymans Robertson: this allows for a wide range of outcomes as regards key factors such as asset returns (based on the Fund's investment strategy), inflation, and bond yields. The measured contributions are calculated such that the proportion of outcomes meeting the employer's funding target (by the end of the time horizon) is equal to the required probability.

The approach includes expenses of administration to the extent that they are borne by the Fund, and includes allowances for benefits payable on death in service and on ill health retirement.

D3 How is the Secondary contribution rate calculated?

The combined Primary and Secondary rates aim to achieve the employer's funding target, within the appropriate time horizon, with the relevant degree of probability.

For the funding target, the Fund actuary agrees the assumptions to be used with the Administering Authority – see Appendix E. These assumptions are used to calculate the present value of all benefit payments expected in the future, relating to that employer's current and former employees, based on pensionable service to the valuation date only (i.e. ignoring further benefits to be built up in the future).

The Fund operates the same target funding level for all employers of 100% of its accrued liabilities valued on the ongoing basis, unless otherwise determined (see Section 3).

The Secondary rate is calculated as the balance over and above the Primary rate, such that the total is projected to:

1. meet the required funding target relating to combined past and future service benefit accrual, including accrued asset share (see D5 below);
2. within the determined time horizon (see 3.3 Note (c) for further details); and
3. with a sufficiently high probability, as set by the Fund's strategy for the category of employer (see 3.3 Note (e) for further details).

The projections are carried out using an economic modeller developed by the Fund Actuary Hymans Robertson: this allows for a wide range of outcomes as regards key factors such as asset returns (based on the Fund's investment strategy), inflation, and bond yields. The measured contributions are calculated such that the proportion of outcomes with at least 100% solvency (by the end of the time horizon) is equal to the required probability.

D4 What affects a given employer's valuation results?

The results of these calculations for a given individual employer will be affected by:

1. past contributions relative to the cost of accruals of benefits;
2. different liability profiles of employers (e.g. mix of members by age, gender, service vs. salary);
3. the effect of any differences in the funding target, i.e. the valuation basis used to value the employer's liabilities;
4. any different time horizons;

5. the difference between actual and assumed rises in pensionable pay;
6. the difference between actual and assumed increases to pensions in payment and deferred pensions;
7. the difference between actual and assumed retirements on grounds of ill-health from active status;
8. the difference between actual and assumed amounts of pension ceasing on death;
9. the additional costs of any non ill-health retirements relative to any extra payments made; and/or
10. differences in the required probability of achieving the funding target.

D5 How is each employer's asset share calculated?

The Administering Authority does not account for each employer's assets separately. Instead, the Fund's actuary is required to apportion the assets of the whole Fund between the employers, at each triennial valuation.

This apportionment uses the income and expenditure figures provided for certain cash flows for each employer. This process adjusts for transfers of liabilities between employers participating in the Fund, but does make a number of simplifying assumptions. The split is calculated using an actuarial technique known as "analysis of surplus".

Actual investment returns achieved on the Fund between each valuation are applied proportionately across all employers, to the extent that employers in effect share the same investment strategy. Transfers of liabilities between employers within the Fund occur automatically within this process, with a sum broadly equivalent to the reserve required on the ongoing basis being exchanged between the two employers.

The Fund actuary does not allow for certain relatively minor events, including but not limited to:

1. the actual timing of regular employer contributions within any financial year;
2. the actual timing of transfers in or out of the Fund; and
3. the actual timing of changes in the benefit payments made due to retirements and deaths.

These effects are swept up within a miscellaneous item in the analysis of surplus, which is split between employers in proportion to their liabilities.

The methodology adopted means that there will inevitably be some difference between the asset shares calculated for individual employers and those that would have resulted had they participated in their own ring-fenced section of the Fund.

The asset apportionment is capable of verification but not to audit standard. The Administering Authority recognises the limitations in the process, but it considers that the Fund actuary's approach addresses the risks of employer cross-subsidisation to an acceptable degree.

Appendix E – Actuarial assumptions

E1 What are the actuarial assumptions?

These are expectations of future experience used to place a value on future benefit payments ("the liabilities"). Assumptions are made about the amount of benefit payable to members (the financial assumptions) and the likelihood or timing of payments (the demographic assumptions). For example, financial assumptions include investment returns, salary growth and pension increases; demographic assumptions include life expectancy, probabilities of ill-health early retirement, and proportions of member deaths giving rise to dependants' benefits.

Changes in assumptions will affect the measured funding target. However, different assumptions will not of course affect the actual benefits payable by the Fund in future.

The combination of all assumptions is described as the "basis". A more optimistic basis might involve higher assumed investment returns (discount rate), or lower assumed salary growth, pension increases or life expectancy; a more optimistic basis will give lower funding targets and lower employer costs. A more prudent basis will give higher funding targets and higher employer costs.

E2 What basis is used by the Fund?

The Fund's standard funding basis is described as the "ongoing basis", which applies to most employers in most circumstances. This is described in more detail below. It anticipates employers remaining in the Fund in the long term.

However, in certain circumstances, typically where the employer is not expected to remain in the Fund long term or poses an elevated risk to the Fund, a more prudent basis applies: see Note (a) to 3.3.

E3 What assumptions are made in the ongoing basis?

a) Investment return / discount rate

The key financial assumption is the anticipated return on the Fund's investments. This "discount rate" assumption makes allowance for an anticipated out-performance of Fund returns relative to long term yields on UK Government bonds ("gilts"). There is, however, no guarantee that Fund returns will out-perform gilts. The risk is greater when measured over short periods such as the three years between formal actuarial valuations, when the actual returns and assumed returns can deviate sharply.

Given the very long-term nature of the liabilities, a long term view of prospective asset returns is taken. The long term in this context would be 20 to 30 years or more.

For the purpose of the triennial funding valuation at 31 March 2017 and setting contribution rates effective from 1 April 2018, the Fund actuary has assumed that future investment returns earned by the Fund over the long term will be 1.8% per annum greater than gilt yields at the time of the valuation (this is higher than that used at the 2014 valuation, which therefore gives a lower funding target, all other things being equal). In the opinion of the Fund actuary, based on the current investment strategy of the Fund, this asset out-performance assumption is within a range that would be considered acceptable for the purposes of the funding valuation.

b) Salary growth

Pay for many public sector employees is currently subject to restriction. Although this "pay freeze" does not officially apply to local government and associated employers, it has been suggested that they are likely to show similar restraint in respect of pay awards. Based on long term historical analysis of the membership in LGPS funds, and continued austerity measures, the salary increase assumption at the 2017 valuation has been set to be a blended rate combined of:

1. 1.3% p.a. until 31 March 2020, followed by

2. The retail prices index (RPI) p.a. thereafter.

This gives a single "blended" assumption of RPI less 0.4%. This is a change from the previous valuation, which assumed a flat assumption of RPI plus 1.0% per annum. The change has led to a reduction in the funding target (all other things being equal).

c) Pension increases

Since 2011 the consumer prices index (CPI), rather than RPI, has been the basis for increases to public sector pensions in deferment and in payment. Note that the basis of such increases is set by the Government, and is not under the control of the Fund or any employers.

As at the previous valuation, we derive our assumption for RPI from market data as the difference between the yield on long-dated fixed interest and index-linked government bonds. This is then reduced to arrive at the CPI assumption, to allow for the "formula effect" of the difference between RPI and CPI. At this valuation, we have used a reduction of 1.0% per annum. This is a larger reduction than at 2014 (which was 0.8%), which will serve to reduce the funding target (all other things being equal). (Note that the reduction is applied in a geometric, not arithmetic, basis).

d) Life expectancy

The demographic assumptions are intended to be best estimates of future experience in the Fund based on past experience of LGPS funds which participate in Club Vita, the longevity analytics service used by the Fund, and endorsed by the actuary.

The longevity assumptions that have been adopted at this valuation are a bespoke set of "VitaCurves", produced by the Club Vita's detailed analysis, which are specifically tailored to fit the membership profile of the Fund. These curves are based on the data provided by the Fund for the purposes of this valuation.

It is acknowledged that future life expectancy and, in particular, the allowance for future improvements in life expectancy, is uncertain. There is a consensus amongst actuaries, demographers and medical experts that life expectancy is likely to improve in the future. Allowance has been made in the ongoing valuation basis for future improvements in line with the 2016 version of the Continuous Mortality Investigation model published by the Actuarial Profession and a 1.25% per annum minimum underpin to future reductions in mortality rates. This is a similar allowance for future improvements than was made in 2014.

The combined effect of the above changes from the 2014 valuation approach, is to reduce life expectancy by around 0.5 – 1.0 years on average, which reduces the funding target all other things being equal. The approach taken is considered reasonable in light of the long term nature of the Fund and the assumed level of security underpinning members' benefits.

e) General

The same financial assumptions are adopted for most employers, in deriving the funding target underpinning the Primary and Secondary rates: as described in (3.3), these calculated figures are translated in different ways into employer contributions, depending on the employer's circumstances.

The demographic assumptions, in particular the life expectancy assumption, in effect vary by type of member and so reflect the different membership profiles of employers.

Appendix F – Glossary

Actuarial assumptions/basis	The combined set of assumptions made by the actuary, regarding the future, to calculate the value of **the funding target**. The main assumptions will relate to the **discount rate**, salary growth, pension increases and longevity. More prudent assumptions will give a higher target value, whereas more optimistic assumptions will give a lower value.
Administering Authority	The council with statutory responsibility for running the Fund, in effect the Fund's "trustees".
Admission Bodies	Employers where there is an Admission Agreement setting out the employer's obligations. These can be Community Admission Bodies or Transferee Admission Bodies. For more details (see 2.3).
Covenant	The assessed financial strength of the employer. A strong covenant indicates a greater ability (and willingness) to pay for pension obligations in the long run. A weaker covenant means that it appears that the employer may have difficulties meeting its pension obligations in full over the longer term.
Discount rate	The annual rate at which future assumed cashflows (in and out of the Fund) are discounted to the present day. This is necessary to provide a **funding target** which is consistent with the present day value of the assets. A lower discount rate gives a higher target value, and vice versa. It is used in the calculation of the **Primary and Secondary rates**.
Employer	An individual participating body in the Fund, which employs (or used to employ) **members** of the Fund. Normally the assets and **funding target** values for each employer are individually tracked, together with its **Primary rate** at each **valuation**.
Funding target	The actuarially calculated present value of all pension entitlements of all **members** of the Fund, built up to date. This is compared with the present market value of Fund assets to derive the **deficit**. It is calculated on a chosen set of **actuarial assumptions**.
Gilt	A UK Government bond, ie a promise by the Government to pay interest and capital as per the terms of that particular gilt, in return for an initial payment of capital by the purchaser. Gilts can be "fixed interest", where the interest payments are level throughout the gilt's term, or "index-linked" where the interest payments vary each year in line with a specified index (usually RPI). Gilts can be bought as assets by the Fund, but their main use in funding is as an objective measure of solvency.
Guarantee / guarantor	A formal promise by a third party (the guarantor) that it will meet any pension obligations not met by a specified employer. The presence of a guarantor will mean, for instance, that the Fund can consider the employer's **covenant** to be as strong as its guarantor's.

Letting employer	An employer which outsources or transfers a part of its services and workforce to another employer (usually a contractor). The contractor will pay towards the LGPS benefits accrued by the transferring members, but ultimately the obligation to pay for these benefits will revert to the letting employer. A letting employer will usually be a local authority.
LGPS	The Local Government Pension Scheme, a public sector pension arrangement put in place via Government Regulations, for workers in local government. These Regulations also dictate eligibility (particularly for Scheduled Bodies), members' contribution rates, benefit calculations and certain governance requirements. The LGPS is divided into 100 Funds which map the UK. Each LGPS Fund is autonomous to the extent not dictated by Regulations, e.g. regarding investment strategy, employer contributions and choice of advisers.
Maturity	A general term to describe a Fund (or an employer's position within a Fund) where the members are closer to retirement (or more of them already retired) and the investment time horizon is shorter. This has implications for investment strategy and, consequently, funding strategy.
Members	The individuals who have built up (and may still be building up) entitlement in the Fund. They are divided into actives (current employee members), deferreds (ex-employees who have not yet retired) and pensioners (ex-employees who have now retired, and dependants of deceased ex-employees).
Primary contribution rate	The employer contribution rate required to pay for ongoing accrual of active members' benefits (including an allowance for administrative expenses). See Appendix D for further details.
Profile	The profile of an employer's membership or liability reflects various measurements of that employer's **members**, i.e. current and former employees. This includes: the proportions which are active, deferred or pensioner; the average ages of each category; the varying salary or pension levels; the lengths of service of active members vs their salary levels, etc. A membership (or liability) profile might be measured for its **maturity** also.
Rates and Adjustments Certificate	A formal document required by the LGPS Regulations, which must be updated at least every three years at the conclusion of the formal **valuation**. This is completed by the actuary and confirms the contributions to be paid by each employer (or pool of employers) in the Fund for the three year period until the next valuation is completed.
Scheduled Bodies	Types of employer explicitly defined in the LGPS Regulations, whose employers must be offered membership of their local LGPS Fund. These include Councils, colleges, some universities, police and fire authorities etc, other than employees who have entitlement to a different public sector pension scheme (e.g. teachers, police and fire officers).
Secondary contribution rate	The difference between the employer's actual and **Primary contribution rates**. In broad terms, this relates to the shortfall of its asset share to its **funding target**. See Appendix D for further details.

Valuation An actuarial investigation to calculate the liabilities, and usually individual employer Primary and Secondary contribution rates. This is normally carried out in full every three years (last done as at 31 March 2017), but can be approximately updated at other times. The assets value is based on market values at the valuation date, and the liabilities value and contribution rates are based on long term bond market yields at that date also.

Shetland Islands Council	Agenda Item **5**

Meeting(s):	**Pension Committee** **Pension Board**	**6 December 2017** **6 December 2017**
Report Title:	**Implementation of MiFID II (Markets in Financial Instruments Directive)**	
Reference Number:	**F-092-17-F**	
Author / Job Title:	**Jonathan Belford** **Executive Manager - Finance**	

1.0 Decisions / Action required:

1.1 It is recommended that the Pension Committee and Pension Board:

NOTE the potential impact on the investment strategy from becoming a retail client with effect from 3rd January 2018.

1.2 It is also recommended that the Pension Committee RESOLVES to

ACKNOWLEDGE and AGREE, in electing for professional client status, that the Pension Fund forgo the protections available to retail clients attached as Appendix 1;

AGREE the actions taken by the Executive Manager – Finance to date, with all relevant institutions, in order to ensure it can continue to implement an effective investment strategy; and

APPROVE delegated authority to the Executive Manager – Finance to make the necessary arrangements to finalise the applications and to determine the basis for the applications as either full or single service.

2.0 High Level Summary:

2.1 This report outlines the impact of the implementation of the Markets in Financial Instrument Directive 2014/65 ("MiFID II") and in particular the risk to the administering authority of becoming a retail client on 3 January 2018 and recommends that the committee agree that elections for professional client status should be made on behalf of the authority, recognising the work already undertaken by the Executive Manager – Finance in preparing for this change.

2.2 Under the current UK regime, local authorities are automatically categorised as 'per se professional' clients in respect of non-MiFID scope business and are categorised as 'per se professional' clients for MiFID scope business if they satisfy the MiFID Large Undertakings test. Local authorities that do not satisfy the Large Undertakings test may opt up to elective professional client status if they fulfil certain 'opt-up criteria'.

2.3 Following the introduction of the Markets in Financial Instrument Directive 2014/65 ("MiFID II") from 3 January 2018, firms will no longer be able to categorise a local public authority that does not manage public debt (“local authority”) as a ’per se professional client’ or elective eligible counterparty (ECP) for both MiFID and non-MiFID scope business. Instead, all local authorities must be classified as “retail clients” unless they are opted up by firms to an ’elective professional client’ status.

2.4 Furthermore, the Financial Conduct Authority (FCA) has exercised its discretion to adopt gold-plated opt-up criteria for the purposes of the quantitative opt-up criteria, which local authority clients must satisfy in order for firms to reclassify them as an elective professional client.

3.0 Corporate Priorities and Joint Working:

3.1 This report links to the Pension Fund Investment Strategy and Funding Strategy Statement to ensure that the Council, as administering authority, carries out is duties effectively and in line with all legislative requirements.

4.0 Key Issues:

4.1 **Election for professional client status**

4.2 MiFID II allows for retail clients which meet certain conditions to elect to be treated as professional clients (to ‘opt up’). There are two tests which must be met by the client when being assessed by the financial institution: the quantitative and the qualitative test.

4.3 The Local Government Pension Scheme Advisory Board (SAB) and the Local Government Association (LGA) along with the Department of Communities and Local Government (DCLG) and the Investment Association (IA) have successfully lobbied the FCA to make the test better fitted to the unique situation of local authorities.

4.4 The new tests recognise the status of LGPS administering authorities as providing a ‘pass’ for the quantitative test while the qualitative test can now be performed on the authority as a collective rather than an individual. A summary of and extracts from the FCA policy statement which set out these new tests is attached as Appendix 2.

4.5 The election to professional status must be completed with all financial institutions prior to the change of status on 3rd January 2018. Failure to do so by local authorities would result in the financial institution having to take ‘appropriate action’ which could include a termination of the relationship at a significant financial risk to the authority.

4.6 The SAB and the LGA have worked with industry representative bodies including the IA, the British Venture Capital Association (BVCA) and others to develop a standard opt-up process with letter and information templates. This process should enable a consistent approach to assessment and prevent authorities from having to submit a variety of information in different formats.

4.7 A flowchart of the process is attached as Appendix 3 and the letter and information templates are attached as Appendices 4 and 5.

4.8 Applications can be made in respect of either all of the services offered by the institution (even if not already being accessed) or a particular service only. A local authority may wish to do the latter where the institution offers a wide range of complex instruments which the authority does not currently use and there is no intention to use the institution again once the current relationship has come to an end, for example, if the next procurement is achieved via the LGPS pool. It is recommended that officers determine the most appropriate basis of the application, either via full or single service.

4.9 Authorities are not required to renew elections on a regular basis but will be required to review the information provided in the opt-up process and notify all institutions of any changes in circumstances which could affect their status, for example, if the membership of the committee changed significantly resulting in a loss of experience, or if the relationship with the authority's investment advisor was terminated.

4.10 **Next steps**

4.11 In order to continue to effectively implement the authority's investment strategy after 3rd January 2018, applications for election to be treated as a professional clients should be submitted to all financial institutions with whom the authority has an existing or potential relationship in relation to the investment of the pension fund.

4.12 This process should commence as soon as possible in order to ensure completion in good time and avoids the need for appropriate action to be taken by institutions in relation to the authority's pension fund investments. To this end the Executive Manager – Finance has already submitted a range of applications to existing fund managers, the Pension Fund advisers and custodian. These have been made to ensure that there is no delay or 'bottleneck' due to Christmas and New Year period, immediately after which the Directive applies.

4.13 The Executive Manager - Finance should be granted the necessary delegated authority to finalise the applications on the authority's behalf and to determine the nature of the application on either full or single service basis.

5.0 Exempt and/or confidential information:

5.1 None.

6.0 Implications :

6.1 Service Users, Patients and Communities:	Employers and members of the Shetland Islands Council Pension Fund will, in opting-up to professional status, continue to benefit from the full range of investment vehicles to increase the value of the assets that the Pension Fund has.
6.2 Human Resources and Organisational Development:	There are no implications arising directly from this report.
6.3 Equality, Diversity and Human Rights:	There are no implications arising directly from this report.

6.4 **Legal:**	The impact of the implementation of The Markets in Financial Instruments Directive 2014/65 will, on 3 January 2018, result in local authorities being classified as ‘retail client’ status and therefore action requires to be taken to ensure that the Pension Fund is suitably prepared to enable it to carry out the business it requires to transact in order to deliver its Investment Strategy and to comply with its Funding Strategy Statement.
6.5 **Finance:**	A move to retail client status would mean that all financial services firms like banks, brokers, advisers and fund managers will have to treat local authorities the same way they do non-professional individuals and small businesses. That includes a raft of protections ensuring that investment products are suitable for the customer’s needs, and that all the risks and features have been fully explained. This provides a higher standard of protection for the client but it also involves more work and potential cost for both the firm and the client, for the purpose of proving to the regulator that all such requirements have been met. Such protections would come at the price of local authorities not being able to access the wide range of assets needed to implement an effective, diversified investment strategy. Retail status would significantly restrict the range of financial institutions and instruments available to authorities. Many institutions currently servicing the LGPS are not authorised to deal with retail clients and may not wish to undergo the required changes to resources and permissions in order to do so. Even if the institution secures the ability to deal with retail clients, the range of instruments it can make available to the client will be limited to those defined under Financial Conduct Authority (FCA) rules as ‘non-complex’ which would exclude many of the asset classes currently included in LGPS fund portfolios. In many cases managers will no longer be able to even discuss (‘promote’) certain asset classes and vehicles with the authority as a retail client.
6.6 **Assets and Property:**	Opting-up to ‘professional client’ status will ensure that the greatest range of asset classes and investment vehicles will be available to deliver the Pension Fund Investment Strategy.
6.7 **ICT and new technologies:**	There are no implications arising directly from this report.
6.8 **Environmental:**	There are no implications arising directly from this report.
6.9 **Risk Management:**	Investment is inherently risky and as such the MiFID II requirements offer non-professional individuals and small businesses certain protections, which are not applicable to professional clients.

	There is a risk that the Pension Fund will not have access to those protections by 'opting-up', however this is countered by the extent to which the Pension Fund is already a sophisticated, large and complex investor. It has not benefited from protections in the past. The management and governance arrangements that the Pension Fund has in place are in line with the requirements of a professional client, having for example qualified staff and advisors in place to assist the Committee and Board in understanding investment opportunities as well as helping the Committee in making decisions. With all investments there is an underlying risk that investment values will fall as well as rise.	
6.10 **Policy and Delegated Authority:**	In accordance with the Council's Scheme of Administration and Delegation, December 2016, the Pension Fund Committee has as set out in its own approved Terms of Reference, the power to discharge all functions and responsibilities relating to the Council's role as administering authority for the Shetland Islands Council Pension Fund (the Pension Fund) in terms of the Local Government (Scotland) Act 1994, the Superannuation Act 1972 and the Public Service Pensions Act 2013.	
6.11 **Previously considered by:**	None.	

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Appendices:
Appendix 1 – Summary of MiFID II protections
Appendix 2 – Summary of FCA Policy Statement
Appendix 3 – Flowchart
Appendix 4 – Letter template requesting opt-up
Appendix 5 – Assessment template to provide evidence of professional client status

Background Documents: None.

END

Appendix 1

Warnings - loss of protections as a Professional Client

Professional Clients are entitled to fewer protections under the UK and EU regulatory regimes than is otherwise the case for Retail Clients. This document contains, for information purposes only, a summary of the protections that you will lose if you request and agree to be treated as a Professional Client.

1. **Communicating with clients, including financial promotions**

   As a Professional Client the simplicity and frequency in which the firm communicates with you may be different to the way in which they would communicate with a Retail Client. They will ensure however that our communication remains fair, clear and not misleading.

2. **Information about the firm, its services and remuneration**

   The type of information that the firm provides to Retail Clients about itself, its services and its products and how it is remunerated differs to what the firm provides to Professional Clients. In particular,

   (A) The firm is obliged to provide information on these areas to all clients but the granularity, medium and timing of such provision may be less specific for clients that are not Retail Clients; and

   (B) there are particular restrictions on the remuneration structure for staff providing services to Retail Clients which may not be applicable in respect of staff providing services to Professional Clients;

   (C) the information which the firm provides in relation to costs and charges for its services and/or products may not be as comprehensive for Professional Clients as it would be for Retail Clients, for example, they are required when offering packaged products and services to provide additional information to Retail Clients on the risks and components making up that package; and

   (D) when handling orders on behalf of Retail Clients, the firm has an obligation to inform them about any material difficulties in carrying out the orders; this obligation may not apply in respect of Professional Clients.

3. **Suitability**

   In the course of providing advice or in the course of providing discretionary management services, when assessing suitability for Professional Clients, the firm is entitled to assume that in relation to the products, transactions and services for which you have been so classified, that you have the necessary level of experience and knowledge to understand the risks involved in the management of your investments. The firm will assess this information separately for Retail Clients and would be required to provide Retail Clients with a suitability report.

4. **Appropriateness**

   For transactions where the firm does not provide you with investment advice or discretionary management services (such as an execution-only trade), it may be required to assess whether the transaction is appropriate. In respect of a Retail Client, there is a specified test for ascertaining whether the client has the requisite investment knowledge and experience to understand the risks associated with the relevant transaction. However, in respect of a Professional Client, the firm is entitled to assume that they have the necessary level of experience, knowledge and expertise to understand the risks involved in a transaction in products and services for which they are classified as a Professional Client.

5. **Dealing**

A range of factors may be considered for Professional Clients in order to achieve best execution (price is an important factor but the relative importance of other different factors, such as speed, costs and fees may vary). In contrast, when undertaking transactions for Retail Clients, the total consideration, representing the price of the financial instrument and the costs relating to execution, must be the overriding factor in any execution.

6. **Reporting information to clients**

For transactions where the firm does not provide discretionary management services (such as an execution-only transactions), the timeframe for our providing confirmation that an order has been carried out is more rigorous for Retail Clients' orders than Professional Clients' orders.

7. **Client reporting**

Investment firms that hold a retail client account that includes positions in leveraged financial instruments or contingent liability transactions shall inform the Retail Client, where the initial value of each instrument depreciates by 10% and thereafter at multiples of 10%. These reports do not have to be produced for Professional Clients.

8. **Financial Ombudsman Service**

The services of the Financial Ombudsman Service may not be available to you as a Professional Client.

9. **Investor compensation**

Eligibility for compensation from the Financial Services Compensation Scheme is not contingent on your categorisation but on how your organisation is constituted. Hence, depending on how you are constituted you may not have access to the Financial Services Compensation Scheme.

10. **Exclusion of liability**

The FCA rules restrict the firm's ability to exclude or restrict any duty of liability which the firm owes to Retail Clients more strictly than in respect of Professional Clients.

11. **Trading obligation**

In respect of shares admitted to trading on a regulated market or traded on a trading venue, the firm may, in relation to the investments of Retail Clients, only arrange for such trades to be carried out on a regulated market, a multilateral trading facility, a systematic internaliser or a third-country trading venue. This is a restriction which may not apply in respect of trading carried out for Professional Clients.

12. **Transfer of financial collateral arrangements**

As a Professional Client, the firm may conclude title transfer financial collateral arrangements with you for the purpose of securing or covering your present or future, actual or contingent or prospective obligations, which would not be possible for Retail Clients.

13. **Client money**

The requirements under the client money rules in the FCA Handbook (CASS) are more prescriptive and provide more protection in respect of Retail Clients than in respect of Professional Clients.

It should be noted that at all times you will have the right to request a different client categorisation and that you will be responsible for keeping the firm informed of any change that could affect your categorisation as a Professional Client.

Appendix 2

FCA Markets in Financial Instruments Directive II Implementation – Policy Statement II

The matters relating to the reclassification of local and public authorities as retail are covered in Chapter 8 pages 64 to 74 of the full document https://www.fca.org.uk/publication/policy/ps17-14.pdf

Highlights (see highlighted sections following for context)

1. Firms may take a collective view of the expertise, experience and knowledge of committee members, taking into account any assistance from authority officers and external advisers where it contributes to the expertise, experience and knowledge of those making the decisions

2. Governance and advice arrangements supporting those individuals can inform and contribute to the firm's assessment

3. Adherence to CIPFA Codes or undertaking other relevant training or qualifications may assist in demonstrating knowledge and expertise as part of the qualitative test

4. Rules will add a fourth criterion that the client is subject to the LGPS Regulation for their pension administration business. Local authorities must continue to meet the size requirement, as well as one of the two previous criteria or the new fourth criterion

5. Compliance with the LGPS Regulations, including taking proper advice, will contribute to the assessment of knowledge and expertise of the local authority client when making decisions

6. Retain the 10 transactions on average per quarter test as one of the four available criteria for enabling a local authority body to opt up.

7. Firms may reasonably assess that a professional treasury manager has worked in the financial sector for at least one year, if their role provides knowledge of the provision of services envisaged

8. Changed the portfolio size threshold to £10m

9. Proposed transitional arrangements that would allow investment firms to re-assess the categorisation of local authority clients between the 3 July 2017 implementation deadline and 3 January 2018 are being taken forward

Page 67 Our response on the qualitative test

MiFID II requires the qualitative test to be applied to local authorities seeking to opt-up to professional client status, with the test itself unchanged from MiFID. It is important that an investment firm is confident that a client can demonstrate their expertise, experience and knowledge such that the firm has gained a reasonable assurance that the client is capable of making investment decisions and understanding the nature of risks involved in the context of the transactions or services envisioned.

COBS 3.5.4 requires that the qualitative test should be carried out for the person authorised to carry out transactions on behalf of the legal entity. 'Person' in this context may be a single person or a group of persons. We understand that the persons within a local authority who invest on behalf of pension funds are elected officials acting as part of a pensions committee. In those circumstances, firms may take a collective view of the expertise, experience and knowledge of committee members, taking into account any assistance from authority officers and external advisers where it contributes to the expertise, experience and knowledge of those making the decisions. We also understand that typically the person(s) within local authorities who invest the treasury reserves of those authorities are likely to be officers of the authorities, who are delegated authority from elected members and act under an agreed budget and strategy.

Given different governance arrangements, we cannot be prescriptive, but we would stress the importance of firms exercising judgement and ensuring that they understand the arrangements of the local authority and the clear purpose of this test. It remains a test of the individual, or respectively the individuals who are ultimately making the investment decisions, but governance and advice arrangements supporting those individuals can inform and contribute to the firm's assessment.

We agree that adherence to CIPFA Codes or undertaking other relevant training or qualifications may assist in demonstrating knowledge and expertise as part of the qualitative test.

Page 68 Our response on the quantitative test – approach for Local Government Pension Schemes (LGPS)

We recognise that local authority pension schemes are established within the framework of the LGPS Regulations and are subject to the oversight of the Pensions Regulator, as well as the broader public policy in MiFID II, such as ensuring that local authority pension schemes receive appropriate investment services, and that they understand the costs and risks involved with such service.

Some expressed concerns about interpreting the quantitative criteria in light of the common governance of local authority pension scheme administration, and recognise that the drafting of our proposed rules was not sufficient to achieve our policy intention of allowing all local authorities administering LGPS pension funds to have the ability to successfully opt up. Therefore, our rules will add a fourth criterion that the client is subject to the LGPS Regulation for their pension administration business. Local authorities must continue to meet the size requirement, as well as one of the two previous criteria or the new fourth criterion. This will assist all local authority pension fund administrators who wish to opt-up to meet the quantitative test, but maintain the need for local authorities to qualitatively demonstrate their sophistication to become professional clients. We agree with views that compliance with the LGPS Regulations, including taking proper advice, will contribute to the assessment of knowledge and expertise of the local authority client when making decisions.

Page 69 Our response on the quantitative test – undertaking 10 transactions on average per quarter

We accept that some local authorities will not be able to meet this part of the quantitative test (particularly when investing pension funds). However, it continues to be our view that regular and recent experience of carrying out relevant transactions remains a useful proxy for assessing sophistication. We have received no arguments against this view, and so confirm that we will retain this test as one of the four available criteria for enabling a local authority body to opt up.

While theoretically this criterion could be 'gamed' by firms and clients by churning portfolios, we believe it is an unlikely course of action for local authorities who are accountable to the electorate and have specific statutory duties requiring prudent management of their financial affairs. In future, we could scrutinise any firm who appeared to be recommending this course of action to its client and question whether the firm was acting in the client's best interest and whether the firm believed that an artificially higher number of trades contributed to the expertise, experience and knowledge of their client.

Page 70 Our response on the quantitative test – employment in the financial sector for at least 1 year in a professional position

We accept we could be clearer about who this test is applied to, while ensuring it can be applied flexibly to different governance arrangements. We also recognise that employment in the financial sector is a criterion that can only apply to a natural person.

In response, we have amended the proposed drafting in COBS 3.5.3BR(b)(ii) to note that 'the person authorised to carry out transactions on behalf of the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the provision of services envisaged'. This should allow local authorities to delegate authority to make investment decisions on their behalf to professional staff with at least one year's experience. We recognise that this redrafted criterion may not be useful for assessing the collective decision making involved in investing local authority pension funds. However, we think this will be less problematic given our new fourth criterion aimed at LGPS administering authorities.

We do not interpret the term ‘financial sector’ in a limited way for the purposes of COBS 3.5.3BR(2)(b)(ii), and firms may reasonably assess that a professional treasury manager has worked in the financial sector for at least one year, if their role provides knowledge of the provision of services envisaged. This meets the purpose of the test, to ensure the person acting on behalf of a client has the expertise, experience and knowledge necessary in relation to the investment or service being sold and the risks involved.

Page 71 Our response on the quantitative test – portfolio size threshold

We have changed the portfolio size threshold to £10m. This follows further data and case studies provided by local authorities, Department for Communities and Local Government (DCLG) new data, and wider CP responses.

We believe £10m is closer to our policy goal of restricting the ability of the smallest, and by implication the least sophisticated, local authorities (town and parish councils, and the smallest county and district councils) to opt-up, but giving larger ones the ability to do so more readily, (provided they meet the other criteria).

Based on the number of local authorities we estimated were investing in MiFID scope instruments and understanding the quoted portfolio size in the DCLG dataset for 2014/15, in CP16/29 we estimated that 63 additional local authorities would not be able to opt-up to professional client status for the purposes of engaging in MiFID business as a result of our consulted upon policy.

At a £15m portfolio size threshold, this increased to 78 additional local authorities which would not be able to opt-up to professional client status for the purposes of engaging in MiFID business when we used the new 2015/16 DCLG dataset.

Applying the £10m threshold to data over the following years:

2014/15 – 27 local authorities would not be able to opt-up to professional client status; and the estimated one-off costs for investment firms would decrease from £1.7m to £0.8m and on-going costs from £0.8m to £0.3m.
2015/16 – 42 local authorities would not be able to opt-up, and the one-off costs for investment firms would decrease from £2.0m to £1.1m, and on-going costs would reduce from £0.9m to £0.5m.47

While a local authority’s ability to borrow extra funds to ‘game’ this requirement may be possible, it is questionable whether local authorities would be able to justify this approach while at the same time making budgets and investment strategies available for public scrutiny.

Page 74 Our response on transitional arrangements

MiFID II gives us very limited discretion with regard to transitional arrangements for applying these rules in respect of local authorities and provides no ability to extend the deadline for compliance with this requirement beyond 3 January 2018. We consulted in CP16/43 on proposed transitional arrangements that would allow investment firms to re-assess the categorisation of local authority clients between the 3 July 2017 implementation deadline and 3 January 2018. These proposals are being taken forward (see Chapter 24). However, firms will not be expected to re-consider categorisation of existing clients other than local authorities, where MiFID II rules are the same as existing MiFID rules transposed at COBS 3.

Otherwise, we have made further consequential drafting changes to transitional provisions at COBS TP 1 that were added when MiFID was implemented in 2007, but that are no longer carried across into MiFID II.

More generally, COBS 3.5.8G notes that professional clients have the responsibility to keep investment firms informed about any changes that affect their current categorisation. Further, at COBS 3.5.9R, if the firm becomes aware that the client no longer fulfils the initial conditions that made the client eligible to be an elective professional client, it must take “appropriate action”. Neither MiFID II, nor our rules specify what ‘appropriate action’ is, which will depend on the facts of the case and what would be in the client’s best interest. Firms must exercise judgement and consider what would be in the best interests of the client. For example, if a client no longer meets the quantitative test to opt up to professional client status, a firm may decide it is appropriate to cease providing investment services but to do so in a way that minimises losses to the client.

Appendix 3

UK Local Authority Client Opt-Up Process

STAGES	TIMELINE	GUIDANCE
Preparatory Stage **Finalise standard opt-up process**	**End July 2017**	(i) Finalise industry standard quantitative and qualitative questionnaire; (ii) Finalise request and consent letter from Local Authority to be opted-up; and (iii) Finalise response letter from investment firms agreeing to the opt-up.
Stage 1 **Local authorities to complete letter and questionnaire and send to investment firms**	**August – September 2017**	Local authorities to complete and send investment firms: (i) request and consent letter to be opted-up to professional client status; and (ii) completed quantitative and qualitative questionnaire (to allow investment firms to satisfy themselves that the local authority passes the qualitative test).
Stage 2 **Investment Firms to validate the information and run the client status assessment**	**September – October 2017**	Investment firms to validate information received from local authorities to determine information is (i) sufficient; and (ii) appropriate. Assess the information received by the local authority and confirm that it: (i) has provided the request and consent letter to be treated as a professional client; and (ii) passes (i) the quantitative test and (ii) the qualitative test Log and store the local authority information and the results of the internal assessment.
Stage 3 **Dispatch the confirmation letter to LA clients confirming professional client status**	**October 2017**	If a local authority has provided the request and consent letter and has satisfied the requirements for both: (i) the quantitative test; and (ii) the qualitative test, send a letter confirming the classification of the client as a professional client.
Stage 4 **Client re-categorisation**	**3 January 2018**	Once the steps above are complete, as of 3 January 2018, the firm may continue to treat the local authority as a professional client.

Appendix 4

Letter requesting categorisation as an elective professional client

[ON [AUTHORITY] HEADED PAPER]

[Manager name]

[Manager address]

[Date]

Dear [●]

Request to be treated as a professional investor

I am writing to you ahead of the implementation in the UK of the Markets in Financial Instruments Directive (2014/65/EU) (MiFID II). I have been authorised by NAME OF AUTHORITY (the “Local Authority”) to inform you that, in its capacity as an administering authority of a local government pension scheme, it wishes to be treated as a professional client for the purpose of:

(a) any and all investment service(s) which it receives from you (the “Services”); and/or

(b) the promotion to us of, and investment in, any and all fund(s) managed or advised by you (the “Fund Promotions/Investments”).

We understand you are required to categorise all of your clients as either professional clients or retail clients and that you currently categorise the Local Authority as a Professional Client (“Professional Client”). However as of 3 January 2018, under new rules deriving from MiFID II, you will be obliged to re-categorise the Local Authority as a Retail Client (“Retail Client”) as regards receiving Services from you and/or as regards existing fund investments and any future Fund Promotions/Investments, unless you are satisfied you can otherwise treat the Local Authority as an elective Professional Client and opt-up the Local Authority to this particular client status.

I confirm and acknowledge that the Local Authority is aware that, being categorised as a Professional Client, it will not benefit from the protections and investor compensation rights set out in more detail in Schedule 1. In doing so, I confirm that the Local Authority has reviewed and considered the loss of these protections and rights very carefully and has, if it felt so appropriate, taken advice from legal, financial or other advisors.

I wish to inform you that the Local Authority wishes to be categorised as a Professional Client for the purposes of the Services and/or Fund Promotions/Investments, as applicable in its capacity as an administrating authority of the Local Government Pension Scheme.

Prior to re-categorising the Local Authority, as a Professional Client, I understand that you will be required to assess the Local Authority on certain quantitative and qualitative grounds. In order to facilitate this assessment, please find attached a completed questionnaire for your review and consideration.

Subject to you being reasonably assured that, as of 3 January 2018, the Local Authority satisfies the necessary quantitative and qualitative grounds and may be categorised as an elective Professional Client, the Local Authority confirms the following:

(a) its request to be categorised as a Professional Client, in its capacity as an administrating authority of the Local Government Pension Scheme, in relation to the Services and/or Fund Promotions/Investments.

(b) all information provided to you by us (for the purposes of facilitating your assessment of the Local Authority’s request to be categorised as a Professional Client) is true, accurate and complete.

(c) the Local Authority understands the contents of Schedule 1 which contains summaries of the protections and investor compensation rights, if any, that the Local Authority will lose once it is categorised as a Professional Client. Please note that I can confirm that the Local Authority is fully aware of the consequences of losing such protections and still wishes to apply to be categorised as Professional Client in respect of the Services and/or Fund Promotions/Investments.

(d) the Local Authority has had sufficient time to consider the implications of categorisation as a Professional Client and has separately taken any legal, financial or other advice that it deems appropriate.

(e) the Local Authority will inform you of any change that could affect its categorisation as a Professional Client. I also confirm that the Local Authority understands its responsibility to ask you for a higher level of protection if it is unable to properly assess or manage the risks involved with the investments comprised within the portfolio management mandates which you have been appointed to manage.

(f) I acknowledge the Local Authority understands that you shall be permitted, in your sole discretion and without providing any reason, to re-categorise the client as a Retail client or cease to provide the Services or otherwise carry out any fund promotion to us or allow future investment in funds by us.

If you have any questions regarding this application please contact **[name]** on **[number]** or alternatively e-mail us at **[email address]**.

Yours sincerely,

……………………………………………

[insert name and position] [Authority]

Schedule 1

Warnings - loss of protections for the Local Authority if categorised as a Professional Client

Professional Clients are entitled to fewer protections under the UK and EU regulatory regimes than is otherwise the case for Retail Clients. This Schedule contains, for information purposes only, a summary of the protections lost when requesting and agreeing to be treated as a Professional Client.

Part 1 – Loss of protections as a Professional Client when receiving Services

1. **Communicating with clients, including financial promotions**

   As a Professional Client the simplicity and frequency in which firms communicate with you may be different to the way in which we would communicate with a Retail Client. Firms will ensure however that their communication remains fair, clear and not misleading.

2. **Information about the firm, its services and remuneration**

   The type of information that a firm provides to Retail Clients about itself, its services and products and how it is remunerated differs to what it provides to Professional Clients. In particular,

   (A) It is obliged to provide information on these areas to all clients but the granularity, medium and timing of such provision may be less specific for clients that are not Retail Clients;

   (B) the information which it provides in relation to costs and charges for its services and/or products may not be as comprehensive for Professional Clients as it would be for Retail Clients, for example, it is required when offering packaged products and services to provide additional information to Retail Clients on the risks and components making up that package; and

   (C) when handling orders on behalf of Retail Clients, it has an obligation to inform them about any material difficulties in carrying out the orders; this obligation may not apply in respect of Professional Clients.

3. **Suitability**

   In the course of providing advice or in the course of providing portfolio management services, when assessing suitability for Professional Clients, a firm is entitled to assume that, in relation to the products, transactions and services for which Professional Clients have been so classified, that they have the necessary level of experience and knowledge to understand the risks involved in the management of their investments. Firms cannot make such an assumption in the case of Retail Clients and must assess this information separately. Firms would be required to provide Retail Clients with a suitability report, where they provide investment advice.

4. **Appropriateness**

   For transactions where a firm does not provide investment advice or portfolio management services (such as an execution-only trade), a firm may be required to assess whether the transaction is appropriate for the client in question. In respect of a Retail Client, there is a specified test for ascertaining whether the client has the requisite investment knowledge and experience to understand the risks associated with the relevant transaction. However, in respect of a Professional Client, a firm is entitled to assume that they have the necessary level of experience, knowledge and expertise to understand the risks involved in a transaction in products and services for which they are classified as a Professional Client.

5. **Dealing**

A range of factors may be considered for Professional Clients in order to achieve best execution (price is an important factor but the relative importance of other different factors, such as speed, costs and fees may vary). In contrast, when undertaking transactions for Retail Clients, the total consideration, representing the price of the financial instrument and the costs relating to execution, must be the overriding factor in determining best execution.

6. **Reporting information to clients**

For transactions where a firm does not provide portfolio management services (such as an execution-only transactions), the timeframe for providing confirmation that an order has been carried out is more rigorous for Retail Clients' orders than Professional Clients' orders.

7. **Client reporting**

Firms that manage a retail portfolio that includes positions in leveraged financial instruments or contingent liability transactions shall inform the Retail Client, where the initial value of each instrument depreciates by 10% and thereafter at multiples of 10%. These reports do not have to be produced for Professional Clients.

8. **Financial Ombudsman Service**

The services of the Financial Ombudsman Service may not be available to you as a Professional Client.

9. **Investor compensation**

Eligibility for compensation from the Financial Services Compensation Scheme is not contingent on your categorisation but on how your organisation is constituted. Your rights (if any) to make a claim under the Financial Services Compensation Scheme in the UK will not be affected by being categorised as a Professional Client.

10. **Exclusion of liability**

A firms' ability to exclude or restrict any duty of liability owed to clients is narrower under the FCA rules in the case of Retail Clients than in respect of Professional Clients.

11. **Trading obligation**

In respect of shares admitted to trading on a regulated market or traded on a trading venue, a firm may, in relation to the investments of Retail Clients, only arrange for such trades to be carried out on a regulated market, a multilateral trading facility, a systematic internaliser or a third-country trading venue. This is a restriction which may not apply in respect of trading carried out for Professional Clients.

12. **Transfer of financial collateral arrangements**

As a Professional Client, a firm may conclude title transfer financial collateral arrangements for the purpose of securing or covering your present or future, actual or contingent or prospective obligations, which would not be possible for Retail Clients.

13. **Client money**

The requirements under the client money rules in the FCA Handbook (CASS) are more prescriptive and provide more protection in respect of Retail Clients than in respect of Professional Clients.

Part 2 – Loss of protections for the Local Authority as a potential investor if categorised as a Professional Client for the purposes of Fund Promotions

1. **Fund promotion**

   It is generally not permitted for firms to market alternative investment funds (AIFs) to investors who are Retail Clients (although there are certain limited exceptions to this rule). As a Professional Client, firms will (subject to complying with applicable marketing rules) be generally permitted to market shares or units in AIFs to you, without being subject to this restriction.

2. **Non-mainstream pooled investments**

   For the purposes of the UK regulatory regime, AIFs typically fall within the definition of an "unregulated collective investment scheme". The UK regulator considers unregulated collective investment schemes to be a high-risk investment, which are not generally suitable investments for Retail Clients. As such, firms are not permitted to promote investments in unregulated collective investment schemes to Retail Clients (although there are certain limited exceptions to this rule). As a Professional Client, firms will be generally permitted to promote an investment in unregulated collective investment schemes to you, without being subject to this restriction (and without making any assessment of whether the investment would be suitable or appropriate for you).

3. **Communicating with clients, including financial promotions**

   Detailed rules govern generally the form and content of financial promotions which are issued to investors who are Retail Clients. However, these detailed form and content rules apply less rigorously where a promotion is issued only to investors who are Professional Clients. As a Professional Client, firms will be generally permitted to issue promotions to you which do not satisfy the detailed form and content rules for Retail Clients. Firms must ensure however that communications remains fair, clear and not misleading.

4. **Financial Ombudsman**

   The services of the Financial Ombudsman Service may not be available to you as a Professional Client

5. **Investor compensation**

   Eligibility for compensation from the Financial Services Compensation Scheme is not contingent on your categorisation but on how your organisation is constituted. Your rights (if any) to make a claim under the Financial Services Compensation Scheme in the UK will not be affected by being categorised as a Professional Client.

Appendix 5

Elective Professional Client - Status Assessment

NAME OF LOCAL AUTHORITY:____

CAPACITY: **As administering authority of the local government pension scheme**

NAME OF OFFICIAL COMPLETING QUESTIONNAIRE:____________________________

DATE:____________________

QUANTITATIVE TEST

Answer questions (a) - (d) below. Please ensure that the detail forming the basis of the determination is recorded.

Please answer question (a) with a "Yes" / "No" answer	
(a) Does the size of the local authority's financial instruments portfolio (including both cash deposits and financial instruments) for the purposes of its administration of a local government pension scheme **exceed GBP 10,000,000**? Portfolio size_______ as at date: ………………………………………………….	☐ Yes ☐ No
(b) Is the local authority an 'administering authority' of the Local Government Pension Scheme within the meaning of the version of Schedule 3 of The Local Government Pension Scheme Regulations 2013 or, (in relation to Scotland) within the meaning of the version of Schedule 3 of The Local Government Pension Scheme (Scotland) Regulations 2014 in force at 1 January 2018, and is acting in that capacity?	☐ Yes ☐ No
If the answer is "Yes" to question (b) above, it is not necessary to carry out the assessment in question (c) or question (d) and the answer "N/A" can be given in both cases	
(c) Has the local authority carried out transactions (in significant size) on the relevant market, at an average frequency of at least **10 per quarter** for the **previous four quarters** (i.e. at least 40 investments on the relevant market in the last year)? Transaction total: ……………………………………………………………………...	☐ Yes ☐ No ☐ N/A
(d) Does the person authorised to carry out transactions on behalf of the local authority work or has that person worked in the financial sector for at least one year in a professional position, which requires knowledge of the provision of services envisaged? Details of role: ………………………………………………………………………	☐ Yes ☐ No ☐ N/A

QUALITATIVE TEST

The "qualitative test" requires a firm to undertake an assessment of the **expertise, experience and knowledge** of the local authority, in order for the firm to be reasonably assured, in light of the nature of the transactions or services envisaged, that the local authority is capable of **making its own investment decisions** and **understanding the risks involved**[1].

In order for a firm to undertake the assessment required for the purposes of the qualitative test, certain information must be received from local authorities. Local authorities should provide answers to the questions set out below in as comprehensive a fashion as possible. The responses received from the local authority client should be considered and assessed internally by the firm.

TO BE COMPLETED BY THE LOCAL AUTHORITY CLIENT

Section 1: Decision making body for pension investing within your authority

Please complete the following section in relation to the decision making body within the authority.

1.	Please indicate which one of the models below is used for investment decisions in the administering authority.

a	All decisions delegated to committee or sub-committee. (*Please tick whether you have enclosed or provided a link to the minute giving the officer completing this document the necessary authorisation to do so*)	YES NO Enclosed Link	☐ ☐ ☐ ☐
b	Decisions delegated to committee or sub- committee with partial delegation to an officer or officers. (*Please tick whether you have enclosed or provided a link to the minute giving the officer completing this application the necessary authorisation to do so*)	YES NO Enclosed Link	☐ ☐ ☐ ☐
c	All decisions delegated to an officer or officers.	YES NO	☐ ☐
d	Other	YES NO	☐ ☐

2.	Please enclose or provide a link to the relevant scheme of delegations, which confirm details of the model elected above.	Enclosed Link	☐ ☐

3.	If you have selected model "d - other" above, please use the box below to describe the composition of the decision making model giving details of the parties and their functions. Details should include information on how the decision making body is constructed, constituted and periodically reviewed.

[1] COBS 3.5.3R (1)

Section 2: Expertise, experience and knowledge

Please answer the following questions in relation to the members of the committee or sub-committee (*not officers, investment advisors or consultants*) which makes investment decisions of behalf of the authority.

If you answered (c) to Section 1 Question 1, please move to Section 3.

1	Are members provided with a written brief on joining the committee? (*Please tick whether you have enclosed or provided a link to a copy of an example of the briefing*)	YES NO Enclosed Link	☐ ☐ ☐ ☐
2	Are members provided with training on investment matters? (*Please tick whether you have enclosed or provided a link to examples of the training offered to members in the last 12 months*)	YES NO Enclosed Link	☐ ☐ ☐ ☐
	Please indicate the total number of hours of training offered and delivered to the committee over the last 12 months.	hours offered hours delivered	
3	Is the attendance of members at training monitored and recorded?	YES NO	☐ ☐
4	Please state the average number of hours of training committee members have attended over the last 12 months.	hours	
5	Please state the average number of hours at investment conferences that committee members have attended over the last 12 months.	hours	
6	Are members required to complete a self-assessment with regard to their knowledge of investments? (*Please tick whether you have enclosed or provided a link to details of the self-assessment tool used*)	YES NO Enclosed Link	☐ ☐ ☐ ☐
7	Please state the number of years served on the committee (or other such investment committees) on average for each member	years	
8	Please provide any other information which may assist with the assessment of the knowledge, experience and expertise of the committee or sub-committee - (such as the average number of years of independent investment experience by members).		

Section 3: Investment history and strategy

1	Please complete the following questions in relation to the authority's history and current strategy with regard to investments which are acquired through an investment manager's investment mandate or invested in directly (e.g. funds).

Asset class or investment vehicle	Number of years held	Currently Held
Fixed interest securities	0 ☐ 1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
Index-linked securities	0 ☐ 1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
Listed equities	0 ☐ 1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
Pooled investment vehicles (PIVs) – authorised funds (e.g. UCITS, NURS, PAIFs)	0 ☐ 1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
Pooled investment vehicles (PIVs) – unauthorised (e.g. investment trusts, close-ended real estate funds, hedge funds)	0 ☐ 1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
Property PIVs	0 ☐ 1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
Private equity funds	0 ☐ 1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
Property	0 ☐ 1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
Exchange traded derivatives (ETDs)	0 ☐ 1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
Over-the-counter derivatives (OTCs)	0 ☐ 1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
Commodities	0 ☐ 1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
Cash deposits	0 ☐ 1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
Commercial paper	0 ☐ 1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
Floating rate notes	0 ☐ 1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
Money market funds	0 ☐ 1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
Other asset classes or investment vehicles where the authority has experience (Please give details below)		
	1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
	1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
	1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐
	1-3 ☐ 4-5 ☐ 5+ ☐	YES ☐ NO ☐

2	Please tick whether you have enclosed or provided a link to the most recent version of the authority's Investment Strategy Statement (England and Wales) or Statement of Investment Principles (Scotland) .	Enclosed Link	☐ ☐
3	Has the authority taken the appropriate advice, as required by regulation, in preparing its Investment Strategy Statement?	YES NO	☐ ☐

Section 4: Understanding risks

Please answer the following questions in relation to the members of the committee or sub-committee or officers (*not investment advisors or consultants*) making investment decisions of behalf of the authority.

1	Does the authority have a risk framework and/or risk management policy in place in relation to investments? (*Please tick whether you have enclosed or provided a link to a details of the framework/policy*)	YES NO Enclosed Link	☐ ☐ ☐ ☐
2	Was external advice taken with regard to the preparation, monitoring and review of the framework/policy?	YES NO	☐ ☐
	If yes, please provide the name of the advisor:		
3	Is the risk framework/policy reviewed on a regular basis?	YES NO	☐ ☐
	If YES please state the frequency of the review.		
	(*Please tick whether you have enclosed or provided a link to details of the last review*)	Enclosed Link	☐ ☐
4	Are those directly involved in decision making provided with training on risk management, including focused training on understanding the risks involved with investments? (*Please tick whether you have enclosed or provided a link to examples of the training offered in the last 12 months*)	YES NO Enclosed Link	☐ ☐ ☐ ☐
5	Are those directly involved in decision making required to complete a self-assessment with regard to their understanding of risk management? (*Please tick whether you have enclosed or provided a link to details of the self-assessment tool used*)	YES NO Enclosed Link	☐ ☐ ☐ ☐

Section 5: Support for investment decisions taken by committee/sub-committee of the authority

Please answer the following questions in relation to those officers, advisors or consultants who directly contribute to assisting the committee/sub-committee of the authority take investment decisions or those officers who have delegated decision making powers.

In Section 1 Question 1, if you answered:

- Model a - please complete Question 1 below
- Model b - please complete Questions 1 and 2 below
- Model c - please complete Question 2 below
- Model d - please complete the below questions as appropriate

1.	For each officer providing support to the committee or sub-committee please provide the following information.

Job title	Relevant qualifications	Years experience in role[2]

2.	For each officer with delegated investment powers please provide the following information (these may be the same officers as above).

Job title	Limit on asset classes or investment vehicles	Limit on delegation (£m)

3	Does the authority have a written succession plan in place to manage key person risk in relation to the above officers? (*Please tick whether you have enclosed or provided a link to details of the succession plan*)	YES NO Enclosed Link	☐ ☐ ☐ ☐

4.	For each individual investment advisor used by the authority please provide the following information *only to be completed where these individual investment advisors are engaged on an independent basis and not acting on behalf of an entity listed in point 5 below)*.

Name	Relevant qualifications	Years experience in role[3]

[2] Or similar role which would provide knowledge of the provision of the services envisaged, which may have been carried out at a different organisation.
[3] Or similar role which would provide knowledge of the provision of the services envisaged.

5.	For each investment advisory firm used by the authority please provide the following information.

Name of firm	Details of FCA authorisation	Years employed by authority

6.	For each individual investment consultant used by the authority please provide the following information (*only to be completed where these consultants are engaged on an independent basis and not acting on behalf of an entity listed in point 7 below)*.

Name	Relevant qualifications	Years experience in role[4]

7.	For each investment consultancy firm used by the authority please provide the following information.

Name of firm	Details of FCA authorisation	Years employed by authority

8.	Please confirm whether the officer, investment advisor firm/individual, investment consultancy firm/individual, is aware of the reliance being placed on it for the purposes of the client categorisation of Local Authorities.	YES ☐ NO ☐

[4] Or similar role which would provide knowledge of the provision of the services envisaged.

Section 6 General questions

1.	In the last three years has the authority been censured for a material breach of Local Government investment regulations in force from time to time or any other related legislation governing investment? (*If yes please tick whether you have enclosed or provided a link to a details of the breach*)	YES NO Enclosed Link	☐ ☐ ☐ ☐

2.	Please use the box below to provide any further information which may be useful in the support of your application.
