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If calling please ask for
Louise Adamson
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Dear Sir/Madam

Date: 27 February 2018

You are invited to the following meeting:

Pension Fund Committee / Pension Board
Council Chamber, Town Hall, Lerwick
Tuesday 6 March 2018 at 2pm

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 6 December 2017 (enclosed).

Items

1. Management Accounts for Pension Fund Committee: 2017/18 Projected Outturn at Quarter 3
F-003

2. Formal Triennial Pension Fund Valuation as at 31 March 2017 and Funding Strategy Statement (FSS)
F-028

3. 2018/19 Budget Proposal – Pension Fund
F-005

4. Pension Fund - Quarter to December 2017 Investment Review Report
F-024

5. Annual Audit Plan 2017/18
F-002

6. General Data Protection Regulation (GDPR) – Impact on Pension Funds
F-030

Pension Fund Committee
A Cooper S Coutts A Duncan S Leask E Macdonald R McGregor I Scott C Smith G Smith T Smith R Thomson

Pension Board	
Employers Representatives: M Bell, SIC J Fraser, SIC A Westlake, 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 March 2018
Report Title:	Management Accounts for Pension Fund Committee: 2017/18 – Projected Outturn at Quarter 3	
Reference Number:	F-003-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 3.

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 31 December 2017. The forecasts have been determined by the relevant budget responsible officers in conjunction with Finance Services.

2.3 The projected revenue outturn position for the Pension Fund is an under-achievement of £140k (2.2%), which means that the Pension Fund is projected to spend more than the approved budget.

2.4 Further detail on the projected outturn position can be found in 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 3, the Pension Fund is projected to have a year-end under-achievement of net income of £140k (2.2%).

5.0 Exempt and/or confidential information:

5.1 None.

6.0 Implications :

6.1 Service Users, Patients and Communities:	None arising from this report.
6.2 Human Resources and Organisational Development:	None arising from this report.
6.3 Equality, Diversity and Human Rights:	None arising from this report.
6.4 Legal:	None 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:	None arising from this report.
6.7 ICT and new technologies:	None arising from this report.
6.8 Environmental:	None 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-003 Appendix 1

Pension Fund Committee / Pension Board

1. Revenue Outturn Position 2017/18 (Quarter 3)

Budget v Projected Outturn variance at Q2 (Adv) / Pos £000	Pension Fund	Revised Annual Budget £000	Projected Annual Outturn £000	Budget v Projected Outturn at Q3 (Adv) / Pos £000	Expenditure and income to 31 December 2017 £000
44	Employee Costs	280	226	54	140
4	Operating Costs	152	158	(6)	98
95	Investment Expenses	1,644	1,520	124	794
(135)	Benefits Payable	9,565	9,895	(330)	6,638
(169)	Transfers Out	296	498	(202)	498
(359)	Lump Sums	1,695	2,307	(612)	1,924
(124)	AVC Out	225	349	(124)	349
(644)	**Total Expenditure**	**13,857**	**14,953**	**(1,096)**	**10,441**
138	Contributions Received	(16,585)	(16,794)	209	(11,154)
(20)	Other Income	(55)	(29)	(26)	(18)
327	Investment Income	(3,213)	(3,368)	155	(2,197)
158	Transfers In	(200)	(494)	293	(494)
314	AVC In	(225)	(550)	325	(550)
917	**Total Income**	**(20,278)**	**(21,235)**	**956**	**(14,413)**
					-
273	**Net Income**	**(6,421)**	**(6,282)**	**(140)**	**(3,972)**

An explanation of the significant variances to budget for the Pension Fund at Quarter 3 is set out below.

1.1 Employee Costs – underspend of £54k (19.3%)

This underspend relates to two in-year vacancies. The ICT Systems Development Officer post was recently re-advertised and will hopefully be filled before the year-end. The Pension Assistant post was filled during 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 £124k (7.5%)

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 bought in.

1.3 Benefits Payable – overspend of £330k (3.5%)

This overspend is due to more retirements in 2017/18 than was 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 this Pension Fund.

1.4 Transfers Out – overspend of £202k (68.2%)

This cost 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 eight transfers out at an average of £62k.

1.5 Lump Sums – overspend of £612k (36.1%)

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 93 retirees, analysed as follows:

- 12 ill health retirements (£258k);
- 29 late retirements (over 65) (£640k);
- 46 normal retirements (£773k);
- 6 flexible / phased retirement lump sums (£62k).

A flexible or phased retirement 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. Five payments in this regard have been made so far this year. The budget is expected to underspend by £108k 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 £155k (4.8%)

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 £293k (146.5%)

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 22 transfers in at an average of £26k.

1.9 AVC In – over-achievement of £325k (144.4%)

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 in excess of the lump sum permitted is converted to LGPS pension. This will increase ongoing benefits payable, but at no cost to the Pension Fund.

Shetland Islands Council

Agenda Item
2

Meeting(s):	Pension Fund Committee Pension Board	6 March 2018
Report Title:	Final Draft Formal Triennial Pension Fund Valuation as at 31 March 2017 & Final Funding Strategy Statement (FSS)	
Reference Number:	F-028-F	
Author / Job Title:	Jonathan Belford, Executive Manager - Finance	

1.0 Decisions / Action required:

1.1 The Pension Fund Committee RESOLVE to:

APPROVE Hymans Robertson LLP final draft Actuarial Valuation Report as at 31 March 2017 and the final Funding Strategy Statement (FSS).

1.2 The Pension Board NOTE the report

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 final draft 2017 Actuarial Valuation Report and the final Funding Strategy Statement (FSS).

2.2 The Council, as the Pension Fund Administering Authority, is required by the regulations governing the Local Government Pension Scheme to have a formal valuation carried out by the scheme 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 final draft Valuation Report is attached as Appendix 1.

2.4 The Council, as the Pension Fund Administering Authority, is required by the regulations governing the Local Government Pension Scheme to also maintain and publish a FSS. A copy of the final 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 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 scheme members are funded over the long-term. The Pension Fund Investment Strategy approved in 2015/16, seeks to ensure the Pension Fund is 100% funded by 2027.

4.0	**Key Issues:**
4.1	The Fund was 92% funded at the 31 March 2014 valuation. The results of the 31 March 2017 valuation are showing the funding level has reduced to 90%.
4.2	The main reason for the change is 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 assets has been greater than had been assumed at the 2014 Valuation therefore this offsets a part of the increase in valuation of the liabilities.
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 initial employer contribution rates were discussed with employers at the Employer Pension Fund Forum held on 23 January 2018 and are in the process of being finalised.
4.6	The draft FSS was put out to consultation with only one response being received from Lerwick Port Authority. At the time of preparing this report we are formulating a response, taking advice from our actuaries who have advised that the comments made does not affect the revised FSS.
.	
4.7	The attached final draft valuation report and FSS are important documents in the administration of the Fund and are the basis upon which the employer contribution rates will be set for the financial years 2018/19, 2019/20 and 2020/21. Whilst all the assumptions within the final draft valuation report have been agreed, the report is still at the final draft stage as Employer Rates have not been agreed with all the Employers as yet.

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	There are no implications arising from this report.

Human Resources and Organisational Development:	
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. 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. Following on from determining the whole Fund results, Hymans Robertson LLP are now in the final stages of preparing the individual employer contribution rates for all employers participating in the Fund for the financial years 2018/19, 2019/20 and 2020/21.
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 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:
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Appendices:
Appendix 1 – 2017 Final Draft Formal Funding Valuation 2017, prepared by Hymans Robertson LLP
Appendix 2 –Final Funding Strategy Statement, prepared in collaboration with Hymans Robertson LLP

Shetland Islands Council Pension Fund

DRAFT - 2017 Actuarial Valuation Report

February 2018

Douglas Green

Fellow of the Institute and Faculty of Actuaries
For and on behalf of Hymans Robertson LLP

Contents

Executive summary

We have carried out an actuarial valuation of the Shetland Islands Council Pension Fund as at 31 March 2017. The results are presented in this report and are briefly summarised below.

Funding position

The table below summarises the funding position of the Fund as at 31 March 2014 and 31 March 2017:

Past Service Position	31 March 2014 (£m)	31 March 2017 (£m)
Past Service Liabilities	363	502
Market Value of Assets	333	450
Surplus / (Deficit)	(30)	(52)
Funding Level	**92%**	**90%**

The funding level has fallen due to the reduction in future expected investment returns (i.e. a fall in real gilt yields). Better than expected asset returns over the period, and lower actual and expected future pay growth, have partially offset the effect of this. Further details are set out in **Section 5**.

Contribution rates

The table below summarises the whole fund Primary and Secondary Contribution rates at this triennial valuation:

Primary Rate (% of pay)	Secondary Rate (% of pay)		
1 April 2018 - 31 March 2021	2018/19	2019/20	2020/21
22.1%	-1.5%	-1.5%	-1.5%

At the previous formal valuation at 31 March 2014, a different regulatory regime was in force. Therefore a contribution rate that is directly comparative to the rates above is not provided.

The average employer contribution rate has remained broadly stable compared to the 2014 valuation of the Fund. However, it should be noted that changes to contribution rates at employer level have been variable.

The minimum contributions to be paid by each employer from 1 April 2018 to 31 March 2021 are shown in the Rates and Adjustment Certificate in **Appendix F.**

1 Introduction

Shetland Islands Council (“the Administering Authority”) has commissioned us to carry out a formal actuarial valuation of the Shetland Islands Council Pension Fund (“the Fund”) as at 31 March 2017 to fulfil their obligations under Regulation 60 of The Local Government Pension Scheme (Scotland) Regulations 2014 (“the Regulations”). Therefore, the totality of our advice in relation to this formal valuation has been addressed to the Administering Authority and they are the only intended users of this advice. All reliances, limitations and caveats, including 3rd party exclusions are set out in Section 7 of this report.

The purpose of the actuarial valuation is to assess the value of the assets and liabilities of the Fund as at 31 March 2017 and to calculate the required rate of employers’ contributions to the Fund for the period from 1 April 2018 to 31 March 2021. This report summarises the results of the valuation and the underlying advice provided to the Administering Authority throughout the valuation process.

This report is the culmination of various other communications which set out our advice in relation to the valuation, in particular:

- Our 2017 valuation toolkit which set out our proposed valuation methodology;
- Our 22 September 2017 paper “2017 valuation – pay growth assumption” which set out the factors influencing the choice of salary increase assumption;
- Our 22 September 2017 paper “2017 valuation - Asset Outperformance Assumption” which summarises modelling testing the appropriateness of the Asset Outperformance Assumption (AOA);
- Correspondence relating to data including the Data Report dated TBC;
- Correspondence relating to financial and demographic assumptions, dated 8 November 2017;
- The Initial Results report dated 27 November 2017 which outlined the whole fund results and proposed valuation assumptions;
- The Employer Results Schedules and Employer Results Report, all dated January 2018 (some revised February 2018), which set out our recommended employer contribution rates; and
- The Funding Strategy Statement, confirming the different contribution rate setting approaches for different types of employer or in different circumstances.

2 Valuation Approach

The valuation is a planning exercise for the Fund, to assess the monies needed to meet the benefits owed to its members as they fall due. As part of the valuation process the Fund reviews its funding strategy to ensure that an appropriate contribution plan and investment strategy is in place.

It is important to realise that the actual cost of the pension fund (i.e. how much money it will ultimately have to pay out to its members in the form of benefits) is unknown. This cost will not be known with certainty until the last benefit is paid to the last pensioner. The purpose of this valuation is to estimate what this cost will be, so that the Fund can then develop a funding strategy to meet it.

Setting the funding strategy for an open defined benefit pension fund such as the Shetland Islands Council Pension Fund is complex. Firstly, the time period is very long; benefits earned in the LGPS today will be paid out over a period of the next 80 years or more and it remains open to new joiners and accrual of benefits. Secondly, the LGPS remains a defined benefit scheme so there are significant uncertainties in the final cost of the benefits to be paid. Finally, in order to reduce employer costs, the Shetland Islands Council Pension Fund invests in a return seeking investment strategy which can result in high levels of asset volatility.

Such a valuation can only ever be an estimate as the future cannot be predicted with certainty. However, as actuaries, we can use our understanding of the Fund and the factors that affect it to set the pace of funding in conjunction with the Administering Authority. The pace of this funding can vary according to the level of prudence that is built into the valuation method and assumptions.

The valuation approach adopted recognises the uncertainties and risks posed to funding by the factors discussed above and follows the process outlined below.

Step 1: The Fund sets a funding target (or funding basis) which defines the target amount of assets to be held to meet the future cashflows. The assumptions underlying the funding target are discussed further in the next section. A measurement is made at the valuation date to compare the assets held with the funding target.

Step 2: The Fund sets the time horizon over which the funding target is to be reached

Step 3: The Fund sets contributions that give a sufficiently high likelihood of meeting the funding target over the set time horizon. More detail on this risk based approach to setting contribution rates can be found in **Appendix A**.

For this valuation, as for the previous valuation, our calculations identify separately the expected cost of members' benefits in respect of scheme membership completed before the valuation date ("past service") and that which is expected to be completed after the valuation date ("future service").

Past service

The principal measurement here is the comparison of the funding position at the valuation date against the funding target. The market value of the Fund's assets as at the valuation date are compared against the value placed on the Fund's liabilities in today's terms (calculated using a market-based approach). By maintaining a link to the market in both cases, this helps ensure that the assets and liabilities are valued in a consistent manner. Our calculation of the Fund's liabilities also explicitly allows for expected future pay and pension increases. The assumptions used in the assessment of the funding position at the valuation date are detailed in the next section.

The funding level is the ratio of assets to liabilities at the valuation date. A funding level of less/more than 100% implies that there is a deficit/surplus in the Fund at the valuation date against the funding target.

Funding plans are set to eliminate any deficit (or surplus) over the set time horizon and therefore get back to a funding level of 100%. To do so, additional contributions may be required to be paid into the Fund; these contributions are known as the "secondary rate".

Future service

In addition to benefits that have already been earned by members prior to the valuation date, employee members will continue to earn new benefits in the future. The cost of these new benefits must be met by both employers and employees. The employers' share of this cost is known as the "primary rate".

The primary rates for employers are determined with the aim of meeting the funding target in respect of these new benefits at the end of the set time horizon with an appropriate likelihood of success. The primary rate will depend on the profile of the membership (amongst other factors). For example, the rate is higher for older members as there is less time to earn investment returns before the member's pension comes into payment.

The methodology for calculating the primary rate will also depend on whether an employer is open or closed to new entrants. A closed employer will have a higher rate as we must allow for the consequent gradual ageing of the workforce.

For the reasons outlined above regarding the uncertainty of the future, there is no guarantee that the amount paid for the primary rate will be sufficient to meet the cost of the benefits that accrue. Similarly, there is no guarantee that the secondary contributions will result in a 100% funding level at the end of the time horizon. Further discussion of this uncertainty is set out in **Appendix A**.

Benefits

The scheme rules and benefits are set out in the Regulations. For further details, please refer to the timeline regulations on http://www.lgpsregs.org/.

3 Assumptions

Due to the long term nature of the Fund, assumptions about the future are required to place a value on the benefits earned to date and the cost of benefits that will be earned in the future. These assumptions broadly fall into two categories – financial and demographic.

Financial assumptions

Financial assumptions relate to the **size** of members' benefits. For example, how members' pensions will increase over time. In addition, the financial assumptions also help us to estimate how much members' benefits will cost the Fund in today's money by making an assumption about the return on the Fund's investments in the future.

For measuring the funding level, the liabilities of the Fund are reported on a single set of financial assumptions about the future, based on financial market data as at 31 March 2017. However, when we assess the required employer contributions to meet the funding target, we use a model that calculates the contributions required under 5,000 different possible future economic scenarios. Under these economic scenarios, key financial assumptions about benefit increases and investment returns vary across a wide range. More information about these types of assumptions is set out in **Appendix C**.

Discount rate

In order to place a current value on the future benefit payments from the Fund, an assumption about future investment returns is required in order to "discount" future benefit payments back to the valuation date.

For a funding valuation such as this, the discount rate is required by Regulations to incorporate a degree of prudence. The discount rate is set by taking into account the Fund's current and expected future investment strategy and, in particular, how this strategy is expected to outperform the returns from Government bonds over the long term. The additional margin for returns in excess of that available on Government bonds is called the Asset Outperformance Assumption (AOA).

The selection of an appropriate AOA is a matter of judgement and the degree of risk inherent in the Fund's investment strategy should always be considered as fully as possible. Following modelling, analysis and discussion reported in the paper "2017 valuation – Asset Outperformance Assumption" issued 22 September 2017, the Fund is satisfied that an AOA of 1.8% p.a. is a prudent assumption for the purposes of this valuation. An AOA of 1.7% was used at the 2014 valuation.

Price inflation / benefit increases

Benefit increases are awarded in line with the Consumer Prices Index (CPI). As there continues to be no deep market for CPI linked financial instruments, the Fund derives the expected level of future CPI with reference to the Retail Prices Index (RPI).

Similar to previous valuations, the assumption for RPI is derived as the difference between the yield on long dated fixed interest and index-linked government bonds. In line with recent experience and projections by the Bank of England, CPI is expected to be, on average, 1.0% lower than RPI over the long term (compared to 0.8% as at the 2014 valuation).

Salary increases

Due to the change to a CARE scheme from 2015, there is now a closed group of membership in the Fund with benefits linked to final salary. The run-off of this final salary linked liability was modelled, taking into account the short-term restrictions in public sector pay growth. The results of this modelling and analysis were reported in the paper "2017 valuation – Pay growth assumption" r issued 22 September 2017. . Based on the results of this modelling the Fund set a salary growth assumption of RPI minus -0.4% (compared to 1% above RPI at the 2014 valuation).

A summary of the financial assumptions underpinning the target funding basis and adopted during the assessment of the liabilities of the Fund as at 31 March 2017 (alongside those adopted at the last valuation for comparison) are shown below.

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%**

**Applied arithmetically in 2014 and geometrically in 2017*

Demographic assumptions

Longevity

The main demographic assumption to which the valuation results are most sensitive is that relating to the longevity of the Fund's members. The longevity assumptions result in the following typical future life expectancies from age 65 (figures for 2014 are 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

Further details of the longevity assumptions adopted for this valuation can be found in **Appendix C**. Note that the figures for non-pensioners assume they are aged 45 at the valuation date.

Other demographic assumptions

We are in the unique position of having a very large local authority data set from which to derive our other demographic assumptions. We have analysed the trends and patterns that are present in the membership of local authority funds and tailored our demographic assumptions to reflect LGPS experience. Details of the other demographic assumptions adopted by the Fund are set out in **Appendix C**.

Further comments on the assumptions

We are required to include a degree of prudence within the valuation. This has been achieved by explicitly allowing for a margin of prudence in the discount rate (i.e. a 2/3rd's probability the Fund's investment strategy will outperform the chosen discount rate versus a 50% chance). All other proposed assumptions represent our "best estimate" of future experience.

For the avoidance of doubt, we believe that all other proposed assumptions represent the "best estimate" of future experience. This effectively means that there is a 50% chance that future experience will be better or worse than the chosen assumption. Taken as a whole, we believe that our proposed assumptions are more prudent than the best estimate.

Assets

We have taken the assets of the Fund into account at their market value as indicated in the audited accounts for the period ended 31 March 2017. In our opinion, the basis for placing a value on members' benefits is consistent with that for valuing the assets – both are related to market conditions at the valuation date

4 Results

The Administering Authority has prepared a Funding Strategy Statement which sets out its funding objectives for the Fund. In broad terms, the main valuation objectives are to hold sufficient assets in the Fund to meet the assessed cost of members' accrued benefits on the target funding basis ("the Funding Objective") and to set employer contributions which ensure both the long term solvency and the long term cost efficiency of the Fund ("the Contribution Objective").

Funding position relative to funding target

In assessing the extent to which the Funding Objective was met at the valuation date, we have used the actuarial assumptions described in the previous section of this report for the target funding basis and the funding method also earlier described. The table below compares the value of the assets and liabilities at 31 March 2017. The 31 March 2014 results are also shown for reference.

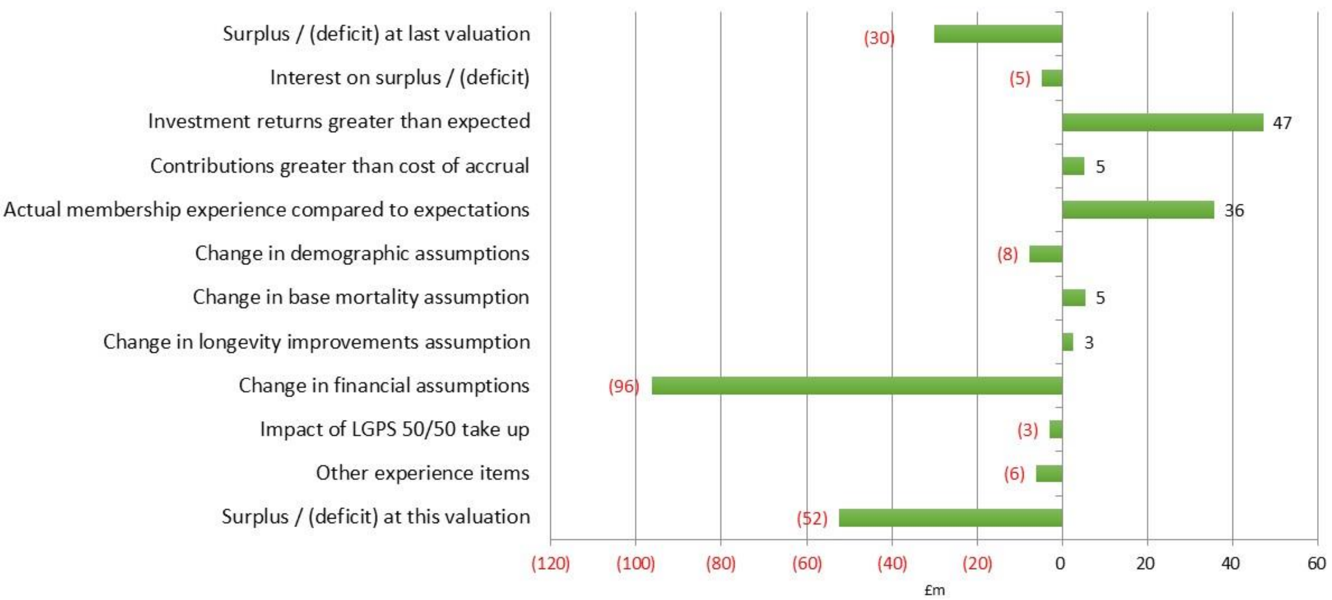
A funding level of 100% would correspond to the Funding Objective being met at the valuation date.

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%**

The Funding Objective was not met: there was a shortfall of assets relative to the assessed cost of members' benefits on the target funding basis of £52m.

Summary of changes to the funding position

The chart below illustrates the factors that caused the changes in the funding position between 31 March 2014 and 31 March 2017:



Further comments on this chart are set out below:

- 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 conditions 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 led to a gain of £36m. The most material items of membership experience have been:
    - Lower than expected salary increases leading to a gain of £16m
    - Lower than expected pension increases leading to gain of £13m
    - Higher than expected withdrawal experience leading to a gain of £7m.

Projection of the funding position

The progression of the funding position will depend on various factors including future asset performance, economic conditions and membership movements. If the financial and demographic assumptions we have made at this valuation are borne out in practice, and there are no changes to the valuation assumptions, we project that the funding level at the 2020 valuation date will be 92%. This allows for contributions to be paid as detailed below.

Employer contribution rates

The Contribution Objective is achieved by setting employer contributions which are likely to be sufficient to meet both the cost of new benefits accruing and to address any funding surplus or deficit relative to the funding target over the agreed time horizon. A secondary objective is to maintain relatively stable employer contribution rates.

In order to meet the above objectives we have used the methodology set out in **Section 2** and **Appendix A** of this report as well as the Fund's Funding Strategy Statement to set employer contributions rates from 1 April 2018. These are set out in the Rates and Adjustments Certificate as set out in **Appendix F.**

The table below summarises the whole fund Primary and Secondary Contribution rates at this valuation. The Primary rate is the payroll weighted average of the underlying individual employer primary rates and the Secondary rate is the total of the underlying individual employer secondary rates, calculated in accordance with the Regulations and CIPFA guidance.

Primary Rate (% of pay)	Secondary Rate (% of pay)		
1 April 2018 - 31 March 2021	2018/19	2019/20	2020/21
22.1%	-1.5%	-1.5%	-1.5%

The Primary rate also includes an allowance of 0.6% of pensionable pay for the Fund's expenses.

The table below shows the Fund "Common Contribution rate' as at 31 March 2014 was 20.7%. However, it should be noted that the change in regulatory regime and guidance on contribution rates means that any direct comparison between the whole fund rate at 2017 and the 2014 Common Contribution Rate is not appropriate.

Contribution Rates	31 March 2014 (% of pay)
Employer future service rate (incl. expenses)	17.8%
Past Service Adjustment	2.9%
Total employer contribution rate (incl. expenses)	**20.7%**
Employee contribution rate	6.0%
Expenses	0.4%

5 Risk Assessment

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 the Fund as it currently stands at 31 March 2017.

However, no one can predict the future with certainty and it is unlikely that future experience will exactly match the assumptions. The future therefore presents a variety of risks to the Fund and these should be considered as part of the valuation process. In particular:

- The main risks to the financial health of the Fund should be **identified**.
- Where possible, the financial significance of these risks should be **quantified**.
- Consideration should be given as to how these risks can then be **controlled** or **mitigated**.
- These risks should then be **monitored** to assess whether any mitigation is actually working.

This section investigates the potential implications of the actuarial assumptions not being borne out in practice.

Set out below is a brief assessment of the main risks and their effect on the valuation past service funding position results.

Sensitivity of past service funding position results to changes in assumptions

The table below gives an indication of the sensitivity of the funding position to small changes in two of the main financial assumptions used:

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 valuation results are also very sensitive to unexpected changes in future longevity. All else being equal, if longevity improves in the future at a faster pace than allowed for in the valuation assumptions, the funding level will decline and the required employer contribution rates will increase.

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 assumption, shown in the table below 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) Funding Level	(52) 90%	(58) 89%

This is not an exhaustive list of the assumptions used in the valuation. For example, changes to the assumed level of withdrawals and ill health retirements will also have an effect on the valuation results.

Note that the tables show the effect of changes to each assumption in isolation. In reality, it is perfectly possible for the experience of the Fund to deviate from more than one of our assumptions simultaneously and so the precise effect on the funding position is therefore more complex. Furthermore, the range of assumptions shown here is by no means exhaustive and should not be considered as the limits of how extreme experience could actually be.

Sensitivity of contribution rates to changes in assumptions

The employer contribution rates are dependent on a number of factors including the membership profile, current financial conditions, the outlook for future financial conditions, and demographic trends such as longevity. Changes in each of these factors can have a material impact on the contribution rates (both primary and secondary rates). We have not sought to quantify the impact of differences in the assumptions because of the complex interactions between them.

Funding risks

Employers participating in the Fund are exposed to a number of risks. These include, but are not limited to:

- Market risks – these include investment returns being less than anticipated or liabilities increasing more than expected due to changes in market conditions underlying the financial assumptions (e.g. inflation or pay increases above that assumed in **Section 3**).
- Demographic risks – these include anything that affects the timing or type of benefits (e.g. members living longer than anticipated, fewer members opting into the 50/50 option, etc.). In particular, early retirement on ill-health grounds can result in significant funding strains.
- Regulatory risks – changes in the Regulations could materially affect the benefits that members become entitled to. It is difficult to predict the nature of any such changes but it is not inconceivable that they could affect not just the cost of benefits earned after the change but could also have a retrospective effect on the past service position.
- Administration and Governance risks – failures in administration processes can lead to incorrect actuarial calculations. For example, where membership data is not up to date (e.g. leaver forms not being submitted in a timely matter) material inaccuracies in respect of the level of deficit and contributions may occur at future valuations
- Resource and Environmental risks – i.e. risks relating to potential resource constraints and environmental changes, and their impact on Fund employers and investments: such risks exist and may prove to be material. Given the lack of relevant quantitative information available specifically relevant to the Fund, we have not explicitly incorporated such risks in our advice on the 2017 valuation. The Administering Authority and the Employers may wish to seek direct advice on these risks.

Investment risk

The Fund holds some of its assets in return seeking assets such as equities to help reduce employers' costs. However, these types of investments can result in high levels of asset volatility. Therefore, there is a risk that future investment returns are below expectations and the funding target is not met. This will require additional contributions from employers to fund any deficit.

Whilst the Fund takes steps to ensure that the level of investment risk is managed and monitored via strategy reviews and performance monitoring, it can never be fully mitigated.

Managing the risks

Whilst there are certain things, such as the performance of investment markets or the life expectancy of members, that are not directly within the control of the pension fund, that does not mean that nothing can be done to understand them further and to mitigate their effect. Although these risks are difficult (or impossible) to eliminate, steps can be taken to manage them.

Ways in which some of these risks can be managed could be:

- Set aside a specific reserve to act as a cushion against adverse future experience (possibly by selecting a set of actuarial assumptions that are deliberately more prudent).
- Take steps internally to monitor the decisions taken by members (e.g. 50:50 scheme take-up, commutation) and employers (e.g. relating to early / ill health retirements or salary increases) in a bid to curtail any adverse impact on the Fund.
- Pooling certain employers together at the valuation and then setting a single (pooled) contribution rate that they will all pay. This can help to stabilise contribution rates (at the expense of cross-subsidy between the employers in the pool during the period between valuations).
- Carrying out a review of the future security of the Fund's employers (i.e. assessing the strength of employer covenants) and ultimately their ability to continue to pay contributions or make good future funding deficits.
- Carry out a bespoke analysis of the longevity of Fund members and monitor how this changes over time, so that the longevity assumptions at the valuation provide as close a fit as possible to the particular experience of the Fund.
- Undertake an asset-liability modelling exercise that investigates the effect on the Fund of possible investment scenarios that may arise in the future. An assessment can then be made as to whether long term, secure employers in the Fund can stabilise their future contribution rates (thus introducing more certainty into their future budgets) without jeopardising the long-term health of the Fund.
- Purchasing ill health liability insurance to mitigate the risk of an ill health retirement impacting on solvency and funding level of an individual employer where appropriate.
- Monitoring different employer characteristics in order to build up a picture of the risks posed. Examples include membership movements, cash flow positions and employer events such as cessations.
- Regularly reviewing the Fund's membership data to ensure it is complete, up to date and accurate.

6 Related issues

The Fund's valuation operates within a broader framework, and this document should therefore be considered alongside the following:

- the Funding Strategy Statement, which in particular highlights how different types of employer in different circumstances have their contributions calculated;
- the Statement of Investment Principles (e.g. the discount rate must be consistent with the Fund's asset strategy);
- the general governance of the Fund, such as meetings of the Pensions Committee, decisions delegated to officers, the Fund's business plan, etc;
- the Fund's risk register;
- the information the Fund holds about the participating employers.

Further recommendations

Valuation frequency

Under the provisions of the LGPS regulations, the next formal valuation of the Fund is due to be carried out as at 31 March 2020. In light of the uncertainty of future financial conditions, we recommend that the financial position of the Fund (and for individual employers in some cases) is monitored by means of interim funding reviews. This will give early warning of changes to funding positions and possible revisions to funding plans.

Investment strategy and risk management

We recommend that the Administering Authority continues to regularly review its investment strategy and ongoing risk management programme.

New employers joining the Fund

Any new employers or admission bodies joining the Fund should be referred to the Fund Actuary to assess the required level of contribution. Depending on the number of transferring members the ceding employer's rate may also need to be reviewed.

Additional payments

Employers may make voluntary additional contributions to recover any funding shortfall over a shorter period, subject to agreement with the Administering Authority and after receiving the relevant actuarial advice.

Further sums should be paid to the Fund by employers to meet the capital costs of any unreduced early retirements, reduced early retirements before age 60 and/or augmentation (i.e. additional membership or additional pension) using the methods and factors issued by me from time to time or as otherwise agreed.

In addition, payments may be required to be made to the Fund by employers to meet the capital costs of any ill-health retirements that exceed those allowed for within our assumptions.

Cessations and bulk transfers

Any employer who ceases to participate in the Fund should be referred to us in accordance with Regulation 62 of the Regulations.

Any bulk movement of scheme members:

- involving 10 or more scheme members being transferred from or to another LGPS fund, or
- involving 2 or more scheme members being transferred from or to a non-LGPS pension arrangement;

should be referred to us to consider the impact on the Fund.

7 Reliances and limitations

Third parties

This document has been prepared for the sole use of Shetland Islands Council in its role as Administering Authority of the Fund and not for any other third party. Hymans Robertson LLP makes no representation or warranties to any third party as to the accuracy or completeness of this report. This report will therefore not address the particular interests or concerns of any such third party.

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The Report must not be used for any commercial purposes unless Hymans Robertson LLP agrees in advance.

Component reports

As set out in **Section 1** and **Section 6**, the totality of our advice pertaining to the valuation is set out over a number of component communications and complies with the various professional and regulatory requirements related to public sector actuarial valuations in Scotland. The reliances, limitations and caveats within this report and each component report apply equally across the totality of our advice.

Model limitations

The models used to calculate the assets, liabilities, contribution rates and the level of indemnity make some necessary simplifying assumptions. I do not consider these simplifications to be material and I am satisfied that they are appropriate for the purposes described in this report.

Limited purpose

This document has been prepared to fulfil the statutory obligations of the Administering Authority to carry out a formal actuarial valuation. 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 under Regulation 62).

Reliance on data

The results of the valuation are dependent on the quality of the data provided to us by the Administering Authority for the specific purpose of this valuation. We have previously issued a separate report confirming that the data provided is fit for the purposes of this valuation and have commented on the quality of the data provided. The data used in our calculations is as per our report of TBC.

Actuarial standards

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

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

No material deviations have been made from the above actuarial standards.

Compliance statement

The totality of our advice complies with the Regulations as they pertain to actuarial valuations.

Douglas Green

Fellow of the Institute and Faculty of Actuaries

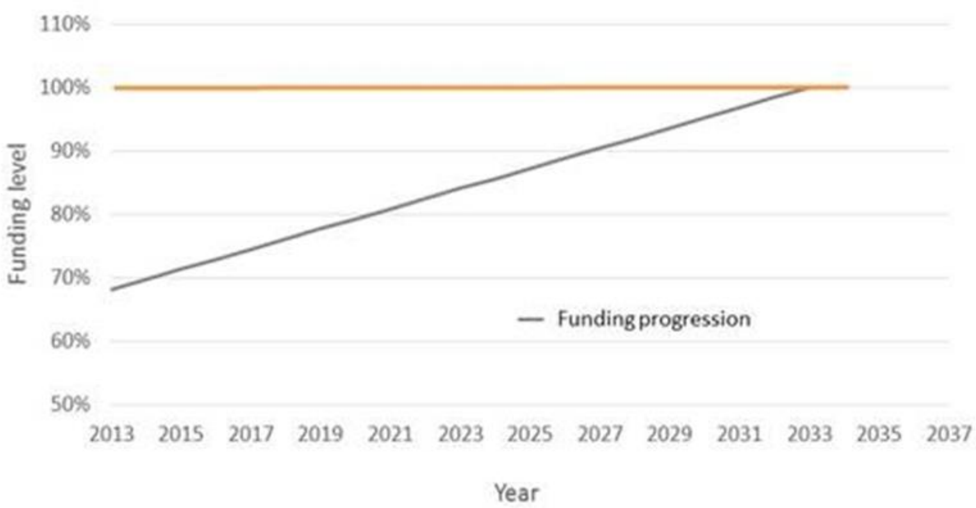
For and on behalf of Hymans Robertson LLP

XXXXXXXX

[1] Technical Actuarial Standards (TASs) are issued by the Financial Reporting Council (FRC) and set standards for certain items of actuarial work, including the information and advice contained in this report.

Appendix A: Risk based approach to setting contribution rates

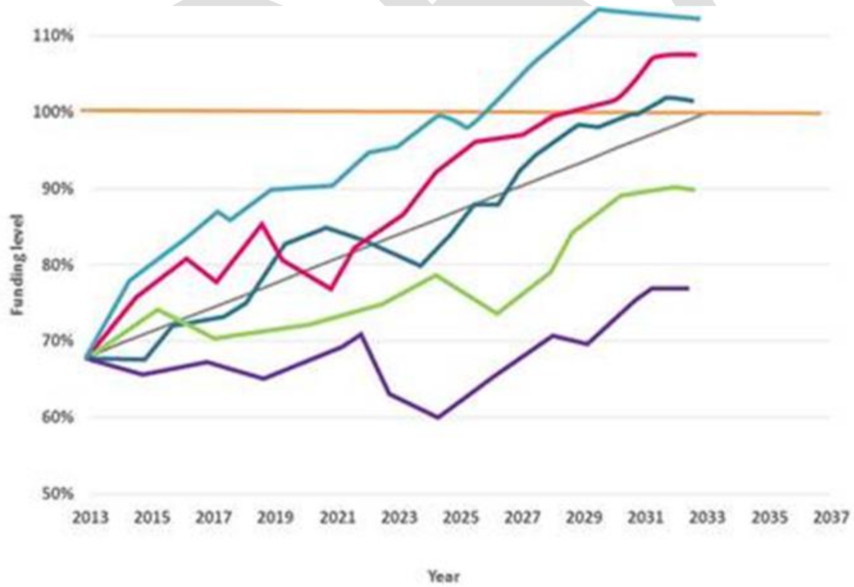
At previous valuations we have set contribution rates by calculating them using a single set of assumptions about the future economic conditions (a 'deterministic' method). By using this deterministic method, there is an implicit assumption that the future will follow expectations (i.e. the financial assumptions used in the calculation) and the employer will return to full funding via one 'journey'. This approach is summarised in the illustrative chart below.



However, pension funding is uncertain as:

- the Fund's assets are invested in volatile financial markets and therefore they go up and down in value; and
- the pension benefits are linked to inflation which again can go up and down in value over time.

One single set of assumptions are very unlikely to actually match what happens, and therefore, the funding plan originally set out will not evolve in line with the single journey shown above. The actual evolution of the funding position could be one of many different 'journeys', and a sample of these are given below.



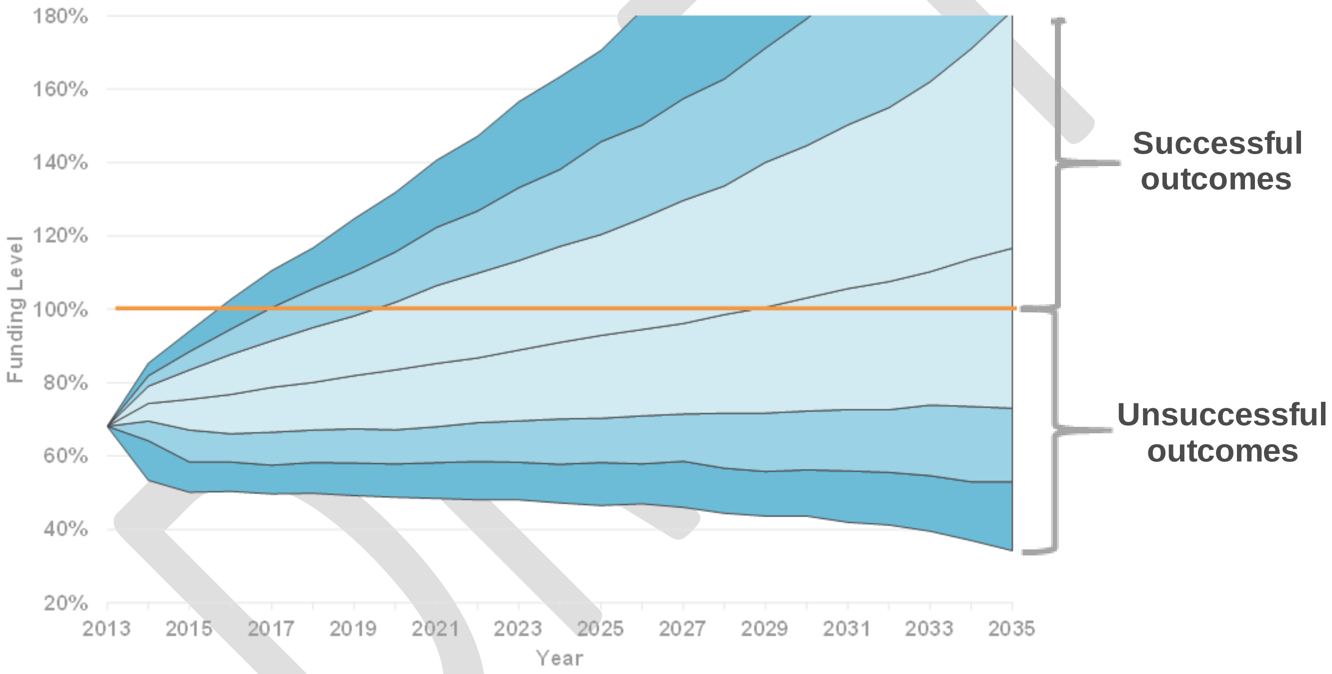
The inherent uncertainty in pension funding creates a risk that a funding plan will not be a success i.e. the funding target will not be reached over the agreed time period.

This risk can never be fully mitigated whilst invested in volatile assets and providing inflation linked benefits, however the main disadvantage of the traditional deterministic method is that it does not allow the Fund, employer, regulators or actuary to assess and understand the risk associated with the proposed funding plan and the likelihood of its success, or otherwise.

Risk Based Approach

At this valuation, we have adopted a 'risk based' approach when setting contribution rates. This approach considers thousands of simulations (or 'journeys') to be projected of how each employer's assets and liabilities may evolve over the future until we have a distribution of funding outcomes (ratio of assets to liabilities). Each simulation represents a different possible journey of how the assets and liabilities could evolve and they will vary due to assumptions about investment returns, inflation and other financial factors. Further technical detail about the methodology underlying these projections is set out in **Appendix F**.

Once we have a sufficient number of outcomes to form a statistically credible distribution (we use 5,000 outcomes), we can examine what level of contribution rate gives an appropriate likelihood of meeting an employer's funding target (usually a 100% funding level) within the agreed timeframe ('time horizon') (i.e. a sufficient number of successful outcomes). The picture below shows a sample distribution of outcomes for an employer.



Having this 'funnel' of outcomes allows the Fund to understand the likelihood of the actual outcome being higher or lower than a certain level. For example, there is 2/3rds chance the funding level will be somewhere within the light shaded area, and there is a 1 in 100 chance that the funding level will be outside the funnel altogether. Using this 'probability distribution', we then set a contribution rate that leads to a certain amount of funding outcomes being successful (e.g. 2/3rds).

Further detail on the likelihoods used in employer's funding plans is set out in the Fund's Funding Strategy Statement.

Appendix B: Data

This section contains a summary of the membership, investment and accounting data provided by the Administering Authority for the purposes of this valuation (the corresponding membership and investment data from the previous valuation is also shown for reference). For further details of the data, and the checks and amendments performed in the course of this valuation, please refer to our separate data report.

Membership data – whole fund

Employee members

	31 March 2014		31 March 2017		
	Number	Pensionable Pay* (£000)	Number	Pensionable Pay* (£000)	CARE Pot (£000)
Total employee membership	2,769	55,391	3,166	60,567	2,287

*actual pay (not full-time equivalent)

Deferred pensioners

	31 March 2014		31 March 2017	
	Number	Deferred pension (£000)	Number	Deferred pension (£000)
Total deferred membership	1,782	3,357	2,314	4,216

The figures above also include any “frozen refunds” and “undecided leavers” members at the valuation date.

Current pensioners, spouses and children

	31 March 2014		31 March 2017	
	Number	Pension (£000)	Number	Pension (£000)
Members	1,227	7,730	1,477	8,765
Dependants	177	534	209	733
Children	24	33	29	67
Total pensioner members	**1,428**	**8,270**	**1,715**	**9,565**

Note that the membership numbers in the table above refer to the number of records provided to us and so will include an element of double-counting in respect of any members who are in receipt (or potentially in receipt of) more than one benefit.

Membership Profile	Average Age (years)		FWL (years)	
	2014	2017	2014	2017
Employees (CARE)	-	47.7	11.4	12.6
Employees (Final Salary)	50.0	50.8		
Deferred Pensioners	49.3	49.1	-	-
Pensioners	65.6	66.4	-	-

The average ages are weighted by liability.

The expected future working lifetime (FWL) indicates the anticipated length of time that the average employee member will remain as a contributor to the Fund. Note that it allows for the possibility of members leaving, retiring early or dying before retirement.

Assets at 31 March 2017

A summary of the Fund's assets provided by the Administering Authority (excluding members' money-purchase Additional Voluntary Contributions) as at 31 March 2017 and 31 March 2014 is as follows:

Asset class	31 March 2014 (Market Value) (£000)	Allocation %	31 March 2017 (Market Value) (£000)	Allocation %
UK equities	131,983	40%	81,933	18%
UK fixed interest gilts	14,930	4%	0	0%
UK corporate bonds	14,645	4%	38,019	8%
UK index-linked gilts	0	0%	0	0%
Overseas equities	135,830	41%	279,251	62%
Overseas bonds	0	0%	0	0%
Property	21,431	6%	48,112	11%
Cash and net current assets	14,080	4%	2,584	1%
Total	**332,899**	**100%**	**449,899**	**100%**

Note that, for the purposes of determining the funding position at 31 March 2017, the asset value we have used also includes the present value of expected future early retirement strain payments (amounting to £0m).

Accounting data – revenue account for the three years to 31 March 2017

Consolidated accounts (£000)	Year to			
	31 March 2015	30 March 2016	31 March 2017	Total
Income				
Employer - normal contributions	12,801	12,781	12,190	37,772
Employer - additional contributions	0	0	0	0
Employer - early retirement and augmentation strain contributions	366	186	18	570
Employee - normal contributions	3,596	3,626	3,783	11,005
Employee - additional contributions	37	34	35	106
Transfers In Received (including group and individual)	353	529	1,258	2,140
Other Income	28	886	28	942
Total Income	**17,181**	**18,042**	**17,312**	**52,535**
Expenditure				
Gross Retirement Pensions	8,430	8,920	9,312	26,662
Lump Sum Retirement Benefits	1,682	2,690	2,671	7,043
Death in Service Lump sum	231	117	612	960
Death in Deferment Lump Sum	44	11	21	76
Death in Retirement Lump Sum	302	152	169	623
Gross Refund of Contributions	36	51	31	118
Transfers out (including bulk and individual)	543	82	332	957
Fees and Expenses	446	1,240	373	2,059
Total Expenditure	**11,714**	**13,263**	**13,521**	**38,498**
Net Cashflow	**5,467**	**4,779**	**3,791**	**14,037**
Assets at start of year	**332,899**	**367,838**	**375,707**	**332,899**
Net cashflow	**5,467**	**4,779**	**3,791**	**14,037**
Change in value	**29,472**	**3,090**	**70,401**	**102,963**
Assets at end of year	**367,838**	**375,707**	**449,899**	**449,899**
Approximate rate of return on assets	**8.8%**	**0.8%**	**18.6%**	**30.1%**

Note that the figures above are based on the Fund accounts provided to us for the purposes of this valuation, which were fully audited at the time of our valuation calculations.

Appendix C: Assumptions

Financial assumptions

Financial assumptions	31 March 2014 (% p.a.)	31 March 2017 (% p.a.)
Discount rate	5.2%	3.5%
Price inflation (RPI)	3.5%	3.4%
Pay increases*	4.5%	3.0%
Pension increases:		
pension in excess of GMP	2.7%	2.4%
post-88 GMP	2.7%	2.4%
pre-88 GMP	0.0%	0.0%
Revaluation of deferred pension	2.7%	2.4%
Revaluation of accrued CARE pension	2.7%	2.4%
Expenses	0.4%	0.6%

*An allowance is also made for promotional pay increases (see table below).

Mortality assumptions

As the fund is a member of Club Vita, the baseline longevity assumptions are a bespoke set of Vita Curves that are tailored to fit the membership profile of the Fund. These curves are based on the data the Fund has provided us with for the purposes of this valuation. Full details of these are available on request.

We have also allowed for future improvements in mortality based on the CMI 2016 model with an allowance for smoothing of recent mortality experience and a long term rate of improvement of 1.25% p.a.

Other demographic valuation assumptions

Retirements in normal health	We have adopted the retirement age pattern assumption as specified by the Scheme Advisory Board in England & Wales for preparing their Key Performance Indicators. Further details about this assumption are available on request.
Retirements in ill health	Allowance has been made for ill-health retirements before Normal Pension Age (see table below).
Withdrawals	Allowance has been made for withdrawals from service (see table below).
Family details	A varying proportion of members are assumed to be married (or have an adult dependant) at retirement or on earlier death. For example, at age 60 this is assumed to be 90% for males and 85% for females. Husbands are assumed to be 3 years older than wives.

Commutation

50% of future retirements elect to exchange pension for additional tax free cash up to HMRC limits for service to 1 April 2009 (equivalent 75% for service from 1 April 2009).

50:50 option

1.0% of members (uniformly distributed across the age, service and salary range) will choose the 50:50 option.

The tables below show details of the assumptions actually used for specimen ages. The promotional pay scale is an annual average for all employees at each age. It is in addition to the allowance for general pay inflation described above. For membership movements, the percentages represent the probability that an individual at each age leaves service within the following twelve months. The abbreviations FT and PT refer to full-time and part-time respectively.

Age	Salary Scale	Incidence per 1000 active members per annum						
		Death Before Retirement	Withdrawals		Ill Health Tier 1		Ill Health Tier 2	
		FT & PT	FT	PT	FT	PT	FT	PT
20	105	0.14	76.49	129.80	0.00	0.00	0.00	0.00
25	117	0.14	51.45	87.32	0.19	0.16	0.15	0.13
30	131	0.21	43.12	73.18	0.25	0.21	0.21	0.18
35	144	0.34	37.19	63.11	0.48	0.40	0.40	0.33
40	150	0.55	30.93	52.49	0.72	0.60	0.60	0.50
45	157	0.89	25.46	43.21	0.96	0.80	0.79	0.66
50	162	1.30	19.40	32.93	1.76	1.44	1.84	1.51
55	162	1.71	18.15	30.80	6.43	5.22	3.87	3.14
60	162	2.19	14.59	24.76	13.55	10.94	3.97	3.20
65	162	0.00	0.00	0.00	0.00	0.00	0.00	0.00

Males

Age	Salary Scale	Incidence per 1000 active members per annum						
		Death Before Retirement	Withdrawals		Ill Health Tier 1		Ill Health Tier 2	
		FT & PT	FT	PT	FT	PT	FT	PT
20	105	0.27	96.58	223.33	0.00	0.00	0.00	0.00
25	117	0.27	63.79	147.52	0.14	0.02	0.13	0.02
30	131	0.32	45.25	104.64	0.25	0.03	0.23	0.03
35	144	0.38	35.35	81.74	0.49	0.16	0.46	0.15
40	150	0.64	28.44	65.77	0.74	0.26	0.69	0.24
45	157	1.07	23.28	53.82	1.17	0.52	1.09	0.49
50	162	1.72	18.03	41.69	2.20	1.23	2.59	1.45
55	162	2.68	17.32	40.05	6.91	4.60	4.67	3.11
60	162	4.83	15.43	35.67	11.75	8.04	3.87	2.65
65	162	0.00	0.00	0.00	0.00	0.00	0.00	0.00

Females

Age	Salary Scale	Incidence per 1000 active members per annum						
		Death Before Retirement	Withdrawals		Ill Health Tier 1		Ill Health Tier 2	
		FT & PT	FT	PT	FT	PT	FT	PT
20	105	0.14	76.49	129.80	0.00	0.00	0.00	0.00
25	117	0.14	51.45	87.32	0.16	0.14	0.15	0.13
30	131	0.21	43.12	73.18	0.22	0.19	0.21	0.18
35	144	0.34	37.19	63.11	0.43	0.36	0.40	0.33
40	150	0.55	30.93	52.49	0.64	0.53	0.60	0.50
45	157	0.89	25.46	43.21	0.85	0.71	0.79	0.66
50	162	1.30	19.40	32.93	1.57	1.28	1.84	1.51
55	162	1.71	18.15	30.80	5.72	4.64	3.87	3.14
60	162	2.19	14.59	24.76	12.04	9.72	3.97	3.20
65	162	0.00	0.00	0.00	0.00	0.00	0.00	0.00

Appendix D: Technical appendix for contribution rate modelling

In order to assess the likelihood of the employer's section of the Fund achieving full funding we have carried out stochastic asset liability modelling (ALM) that takes into account the main characteristics and features of each employer's share of the Fund's assets and liabilities. For all employers a simplified ALM, known as TARGET has been used.

The following sections provide more detail on the background to the modelling.

Cashflows

In projecting forward the evolution of each employer's section of the Fund, we have used anticipated future benefit cashflows. These cashflows have been generated using the membership data provided for the formal valuation as at 31 March 2017, the demographic and financial assumptions used for the valuation and make an allowance for future new joiners to the Fund (if any employer is open to new entrants).

We have estimated future service benefit cash flows and projected salary roll for new entrants (where appropriate) after the valuation date such that payroll remains constant in real time (i.e. full replacement) unless otherwise stated.. The base mortality table used for new entrants is an average of mortality across the LGPS and is not specific to the Fund. Nonetheless, we believe that these assumptions are reasonable for the purposes of the modelling given the highly significant uncertainty associated with the level of new entrants.

We do not allow for any variation in actual experience away from the demographic assumptions underlying the cashflows. Variations in demographic assumptions (and experience relative to those assumptions) can result in significant changes to the funding level and contribution rates. We allow for variations in inflation (RPI or CPI as appropriate), inflation expectations (RPI or CPI as appropriate), interest rates, yield curves and asset class returns. Cashflows into and out of the Fund are projected forward in annual increments and are assumed to occur in the middle of each financial year (April to March). Investment strategies are assumed to be rebalanced annually.

Asset liability model (TARGET)

These cash flows, and the employer's assets, are projected forward using stochastic projections of asset returns and economic factors such as inflation and bond yields. These projections are provided by the Economic Scenario Service (ESS), our (proprietary) stochastic asset model, which is discussed in more detail below. Contribution rates are inputs to the model and are assumed not to vary throughout the period of projection, with no valuation every three years or setting of 'stabilised' contribution rates.

In allowing for the simulated economic scenarios, we have used more approximate methods for updating the projected cash flows. The nature of the approximations is such that the major financial and investment risks can be broadly quantified.

When projecting forward the assets, we have modelled a proxy for the Fund's investment strategy by simplifying their current benchmark into growth (UK equity) and non-growth (index-linked gilts) allocations, and then adjusting the volatility of the resultant portfolio results to approximately reflect the diversification benefit of the Fund's investment strategy.

Economic Scenario Service

The distributions of outcomes depend significantly on the Economic Scenario Service (ESS), our (proprietary) stochastic asset model. This type of model is known as an economic scenario generator and uses probability distributions to project a range of possible outcomes for the future behaviour of asset returns and economic variables. Some of the parameters of the model are dependent on the current state of financial markets and are updated each month (for example, the current level of equity market volatility) while other more subjective parameters do not change with different calibrations of the model.

Key subjective assumptions are the average excess equity return over the risk free asset (tending to approximately 3% p.a. as the investment horizon is increased), the volatility of equity returns (approximately 18% p.a. over the long term) and the level and volatility of yields, credit spreads, inflation and expected (breakeven) inflation, which affect the projected value placed on the liabilities and bond returns. The market for CPI linked instruments is not well developed and our model for expected CPI in particular may be subject to additional model uncertainty as a consequence. The output of the model is also affected by other more subtle effects, such as the correlations between economic and financial variables.

Our expectation (i.e. the average outcome) is that long term real interest rates will gradually rise from their current low levels. Higher long-term yields in the future will mean a lower value placed on liabilities and therefore our median projection will show, all other things being equal, an improvement in the current funding position (because of the mismatch between assets and liabilities). The mean reversion in yields also affects expected bond returns.

While the model allows for the possibility of scenarios that would be extreme by historical standards, including very significant downturns in equity markets, large systemic and structural dislocations are not captured by the model. Such events are unknowable in effect, magnitude and nature, meaning that the most extreme possibilities are not necessarily captured within the distributions of results.

Expected rate of returns and volatilities

The following figures have been calculated using 5,000 simulations of the Economic Scenario Service, calibrated using market data as at 31 March 2017. All returns are shown net of fees. Percentiles refer to percentiles of the 5,000 simulations and are the annualised total returns over 5, 10 and 20 years, except for the yields which refer to the (simulated) yields in force at that time horizon. Only a subset of the asset classes are shown below.

		Annualised total returns									
		Cash	Index Linked Gilts (medium dated)	Fixed Interest Gilts (medium dated)	Corporate Bonds (medium dated)	UK Equity	Overseas Equity	Property	Inflation	17 year real yield	17 year yield
5 years	16th %'ile	-0.7%	-2.5%	-3.1%	-2.9%	-4.5%	-6.4%	-4.3%	1.5%	-2.3%	1.1%
	50th %'ile	0.4%	0.3%	0.1%	0.5%	3.6%	3.4%	1.4%	2.9%	-1.4%	2.4%
	84th %'ile	1.7%	3.0%	3.2%	3.9%	12.4%	13.7%	8.0%	4.4%	-0.5%	4.0%
10 years	16th %'ile	-0.2%	-1.6%	-1.1%	-0.7%	-1.4%	-2.7%	-2.2%	1.7%	-1.9%	1.4%
	50th %'ile	1.3%	0.1%	0.4%	1.0%	4.6%	4.3%	2.4%	3.0%	-0.7%	3.0%
	84th %'ile	3.1%	2.0%	2.0%	2.7%	10.9%	11.8%	7.3%	4.6%	0.5%	5.1%
20 years	16th %'ile	0.7%	-0.9%	0.4%	0.9%	1.3%	0.1%	0.0%	1.9%	-0.8%	2.1%
	50th %'ile	2.5%	0.5%	1.3%	2.1%	5.9%	5.5%	3.7%	3.1%	0.8%	4.0%
	84th %'ile	4.6%	2.1%	2.3%	3.3%	10.6%	11.2%	7.6%	4.6%	2.3%	6.3%
	Volatility (Disp) (1 yr)	0.5%	7%	10%	10%	16%	18%	14%	1.4%		

The current calibration of the model indicates that a period of outward yield movement is expected. For example, over the next 20 years our model expects the 17 year maturity annualised real (nominal) interest rate to rise from -1.7% (1.7%) to 0.8% (4.0%).

Appendix E: Events since valuation date

Post-valuation events

These valuation results are in effect a snapshot of the Fund as at 31 March 2017. Since that date, various events have had an effect on the financial position of the Fund. Whilst we have not explicitly altered the valuation results to allow for these events, a short discussion of these "post-valuation events" can still be beneficial in understanding the variability of pension funding.

In the period from the valuation date to early March 2018, the Fund asset returns have been lower than expected, however real gilt yields have risen (giving lower liabilities). As a result of this, the funding position is expected to have stayed broadly the same as at 31 March 2017.

Overall, employer contributions are not expected to be subject to any different pressure as a result of post-valuation events.

It should be noted that the above is for information only: the figures in this report have all been prepared using membership data, audited asset information and market-based assumptions all as at 31 March 2017. In particular, we do not propose amending any of the contribution rates listed in the Rates and Adjustments Certificate on the basis of these market changes.

Appendix F: Rates and adjustments certificate

In accordance with regulation 60(4) of the Regulations we have made an assessment of the contributions that should be paid into the Fund by participating employers for the period 1 April 2018 to 31 March 2021 in order to maintain the solvency of the Fund.

The method and assumptions used to calculate the contributions set out in the Rates and Adjustments certificate are detailed in the Funding Strategy Statement dated TBC and our report on the actuarial valuation dated TBC.

Regulation 60(8) requires a statement of the assumptions on which the certificate is given regarding the number of members, and the associated of liabilities arising, who will become entitled to payment of pensions under the regulations of the LGPS. These assumptions can be found in Appendix D of the 31 March 2017 formal valuation report dated TBC. These assumptions cover members who become entitled to payment of pension via normal retirement and ill health retirement. Further members will become entitled due to involuntary early retirement (for redundancy and efficiency reasons) for which no allowance has been made.

The required minimum contribution rates are set out below.

INSERT R&A table

Signature:

Date:	XXXXXX
Name:	Douglas Green
Qualification:	Fellow of the Institute and Faculty of Actuaries
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HYMANS ROBERTSON

Shetland Islands Council Pension Fund

FINAL Funding Strategy Statement

FEBRUARY 2018

PUBLIC SECTOR

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Appendices

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 14 February 2018.

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".

The consultation process for the FSS was as follows:

a) **A draft version of the FSS was issued to all participating employers for comment on 12 January 2018.**

b) **An Employers Forum was held on 23 January 2018 at which questions regarding the FSS was raised and answered;**

b) **Comments on the draft version of the FSS was requested to be returned by 13 February 2018;**

c) **Following the end of the consultation period the FSS was updated where required and will be 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 **[to be added upon publication]**

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 **[to be added upon publication]**

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
3

Meeting(s):	Pension Fund Committee Pension Board	6 March 2018
Report Title:	2018/19 Budget Proposal – Pension Fund	
Reference Number:	F-005-F	
Author / Job Title:	Jonathan Belford Executive Manager - Finance	

1.0 Decisions / Action required:

1.1 The Pension Fund Committee RESOLVE to approve the budget proposals for 2018/19 included within this report.

1.2 The Pension Board NOTE the report.

2.0 High Level Summary:

2.1 The proposed Pension Fund budget for 2018/19 is detailed in Appendix 1.

2.2 The net impact of the 2018/19 budget is a £6.741m contribution to the Pension Fund, an increase of £0.320m on the previous year.

2.3 The overall Pension Fund budget strategy is to return a surplus of income over expenditure, whilst delivering a high quality service to all scheme members, ensuring that pension benefits are paid accurately and on time.

2.4 The Local Government Pension Scheme (Scotland) Regulations 2014 require administering authorities to ensure strong governance arrangements, which includes budget setting.

3.0 Corporate Priorities and Joint Working:

3.1 There is a specific objective within the Corporate Plan to ensure that the Council is "living within our means". The key aim for the Pension Fund is to ensure that any deficits are recovered over less than a 20-year period. This means that the Pension Fund would be able to pay all liabilities as they fall due into the future.

4.0 Key Issues:

4.1 The following assumptions have been made in preparation of the 2018/19 budget proposals:

- That the actuarial valuation will not result in any significant changes to the employer percentage rates from 2017/18;
- That the number and values of lump sums will follow a similar trend as the previous five years;
- That the number of retirees will follow a similar trend as the previous five years;

- That the admitted bodies will continue to pay employee and employer contributions on a similar number of staff as 2017/18;
- That, in line with Shetland Islands Council, the admitted bodies will incur a pay award of 3% to staff earning less than £30,000 and 2% for all other staff, with a monetary cap of £1,600 for higher earners, increasing the employee and employer contributions received;
- That investment income and fees will be broadly in line with 2017/18 projected income and expenditure;
- That the Pensions team will be fully staffed for 2018/19.

4.2 From 2016/17 to 2017/18, expenditure has increased overall by £1.493m and income has increased overall by £1.842m; see Appendix 1 for further detail.

4.3 It should be noted that there is the potential for more uncertainty in investment markets e.g. Brexit, which may affect investment income rates of return.

5.0 Exempt and/or confidential information:

5.1 None

6.0 Implications :

6.1 **Service Users, Patients and Communities:**	Failure to set a sustainable budget could result in increased contributions for employees and employers of the scheduled and admitted bodies in order to achieve its strategy of any deficits being recovered within 20 years.
6.2 **Human Resources and Organisational Development:**	None arising from this report.
6.3 **Equality, Diversity and Human Rights:**	None arising from this report.
6.4 **Legal:**	The budget detailed in this report will allow the Council to meet its statutory and regulatory requirements in being a Pension Administering Authority.
6.5 **Finance:**	There is an estimated net income to the Pension Fund of £6.741m in 2018/19. This represents an increase in net income of £0.320m over the 2017/18 budget.
6.6 **Assets and Property:**	None arising from this report.
6.7 **ICT and new technologies:**	None arising from this report.

6.8 **Environmental:**	None arising from this report.
6.9 **Risk Management:**	There are numerous risks involved in the operation of the Pension Fund. From a financial perspective, risks are an integral part of planning for the future, as assumptions are made, internal and external factors and demand and supply all have an impact throughout the financial year. These can lead to unplanned or unexpected costs, and may arise without warning. Awareness of risks is critical to successful financial management. This report is part of the framework that provides assurance and provides the opportunity to correct any deviation from budget that may place the Board in a financially challenging position. Going forward, as the fund reaches maturity, there could be a risk where contributions receivable are less than benefits payable. To mitigate this risk, a new investment strategy was approved, with the aim for all deficits to be recovered within a 20-year period. 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 2014. 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:**	This report has not previously been presented to any formal meeting.

Contact Details:
Christine McCourt, christine.mccourt@shetland.gov.uk, 6 March 2018

Appendices:
Appendix 1: Proposed Pension Fund Budget 2018/19

Background Documents:
None

SHETLAND ISLANDS COUNCIL
PENSION FUND

BUDGET 2018/19

Contents

Introduction

The Shetland Islands Council Pension Fund (the Pension Fund) participates in the Local Government Pension Scheme (LGPS) and as such it is governed by the LGPS (Scot) Regs 2014 (as amended), the LGPS (Transitional Provisions and Savings) (Scot) Regs 2014 (as amended) and the LGPS (Management and Investment of Funds) (Scotland) Regulations 2010. The Shetland Islands Council is the administering authority of the Shetland Islands Council Pension Fund, and in this role the Council is required to make arrangements for the proper administration of the Fund.

Pension Fund Objectives

The Pension Fund has the following objectives

- To secure and maintain sufficient assets to meet liabilities which fall due by the Fund under the Local Government Pension Scheme;
- To minimise the risk of assets failing to meet these liabilities, through an investment strategy that is specifically tailored to the Pension Fund's requirements;
- To maximise investment returns within an acceptable level of risk whilst, at the same time, providing stability in the level of employers' contribution rates;
- To work with employers to ensure that any deficits are recovered over less than a 20-year period. This means that the Pension Fund would be able to pay all liabilities as they fall due into the future.

Investment Strategy

The current Investment Strategy 2014-2027 will be refreshed following the completion of the 2017 triennial valuation by the Pension Fund's actuaries. This is expected to be finalised in March 2018. The current strategy for the Pension Fund is investment in the following asset classes:

- Active Equities: 20%
- Passive Global Equities: 20%
- Diversified Growth Fund: 20%
- Passive UK Equity: 18%
- Active Property: 12%
- Alternative Bonds: 10%

This new investment strategy will focus on achieving a fully funded Pension Fund for the long-term benefit of its members.

Membership

The Pension Fund provides pensions and other benefits for pensionable employees of scheduled bodies and admitted bodies within Shetland, as shown below. Teachers are not included as they have a separate national pension scheme.

Employers with active members at 31 December 2017

- Shetland Islands Council
- Orkney & Shetland Valuation Joint Board
- Lerwick Port Authority
- Shetland Recreational Trust
- Shetland Fisheries Training Centre Trust
- Shetland Islands Tourism (Visit Scotland)
- Shetland Amenity Trust
- Shetland Seafood Quality Control
- Shetland Charitable Trust
- Shetland Arts Development Agency
- Shetland Care Attendant Scheme

Employers with no active members at 31 December 2017

- Shetland Enterprise Co Ltd (Highlands & Islands Enterprise)

In general, employers pay regular monthly contributions to the Pension Fund based on the salary costs of those staff who are Pension Fund members (active members). Where an employer continues to participate in the Scheme but has no active members, an annual monetary amount is calculated by the actuary to cover the cost of ongoing and future pension payments.

Members and Pensioners

Shetland Islands Council Pension Fund	31 March 2017	31 December 2017
Number of employers with active members	**11**	**11**
Number of employees in scheme:		
Shetland Islands Council*	2,957	2,910
Other employers	385	396
Total	**3,342**	**3,306**
Number of pensioners/dependants		
Shetland Islands Council	1,583	1,652
Other employers	145	148
Total	**1,728**	**1,800**
Deferred pensioners		
Shetland Islands Council	1,611	1,593
Other employers	362	302
Total	**1,973**	**1,895**
Scheme Total	**7,043**	**7,001**

*This number has reduced due to consolidation of employees with multiple jobs. The number of individual staff members has not decreased.

Budget Estimates

This estimated expenditure for 2018/19 has been arrived at by analysing rolling trends over the past five years and considering the composition of members / pensioners in the coming year. Further detail on each budgeted items is provided below the table.

Pension Fund	2016/17 Actual Outturn £000	2017/18 Projected Outturn £000	2017/18 Approved Budget £000	2018/19 Proposed Budget £000	Budget movement £000
Employee Costs	219	226	280	292	12
Operating Costs	154	158	154	145	(9)
Investment Expenses	1,487	1,520	1,644	1,573	(71)
Benefits Payable	9,312	9,895	9,565	10,557	992
Transfer Out	332	498	296	300	4
Lump Sums	3,505	2,307	1,693	2,003	310
AVC Out	0	349	225	480	255
Total Expenditure	**15,009**	**14,953**	**13,857**	**15,350**	**1,493**
Contributions Received	(16,026)	(16,794)	(16,585)	(17,569)	(984)
Other Income	(28)	(29)	(55)	(28)	27
Investment Income	(3,154)	(3,368)	(3,213)	(3,394)	(181)
Transfer In	(1,258)	(494)	(200)	(300)	(100)
AVC In	0	(550)	(225)	(800)	(575)
Total Income	**(20,466)**	**(21,235)**	**(20,278)**	**(22,120)**	**(1,842)**
Net Income	**(5,457)**	**(6,282)**	**(6,421)**	**(6,741)**	**(320)**

Employee Costs

The budget for employee costs is based on an establishment of 5.9 full time equivalent (FTE) staff. Some staff are due pay increments during 2018/19, depending on where they are on the salary scale. All staff salary budgets have been uplifted by a pay award as follows: 3% for those on salaries under £30,000 and 2% for salaries of more than £30,000.

Operating Costs

Operating costs include administration and governance costs, such as printing, computer licence fees, postage and actuarial and audit fees. The budget is based on known costs for 2018/19, such as the audit fee, and other known costs are based on actual 2016/17 spend.

Investment Expenses

The budget for investment expenses is determined by arrangements with fund managers, who manage the Pension Fund's investment portfolio on its behalf. There are five fund managers. Included here is also a budget for independent performance monitoring of the fund managers, which amounts to £15k.

Benefits Payable

This budget relates to pension benefits payable when a member retires. Members have the option to retire between the ages of 55 and 75. The budget is estimated on a CPI increase on the 2017/18 projected cost, and a five-year rolling average of retirements, equating to a total of £10.557m.

Transfers Out

Transfers Out occur when a Pension Fund member transfers their value into another pension fund. The value of the transfer depends on a number of factors, including salary and length of service, which is highly variable, so the budget is based on a five-year rolling average equating to £300k.

Lump Sums

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, whether there is automatic entitlement to a lump sum and whether a member elects for commutation of pension to lump sum. The budget is estimated on a five year rolling average equating to £2.003m.

This budget also includes Death-in-Service benefits, which are paid out at the rate of three times salary. The budget is estimated on a five-year rolling average, equating to £300k. Death-in-Retirement benefits are also paid out, but are variable in nature and are dependent on the legislation at the time the member retires.

Contributions Received

This budget includes income from active members and their employers paying into the Pension Fund. Contribution rates are set following each triennial actuarial valuation, the latest of which is due to apply from 1 April 2018. They are also affected by any pay award received by active members, which will uplift the monetary value of contributions. The budget for contributions from each employer in the Pension Fund has been analysed at December 2017 and uplifted for the anticipated pay awards and contribution rate changes due to come into effect from April 2018.

Other Income

Other income includes a recharge to Shetland Islands Council for its share of the ICT Systems Development Officer post - Finance & HR.

Investment Income

This budget includes income from, for example, interest or dividends arising from the Pension Fund's investment portfolio. This is highly variable, depending on a number of market factors; therefore the budget is based on the income received during 2017/18.

Transfers In

The value of a transfer into the Pension Fund is determined by the previous pension benefits of a new member that have been accrued before joining the Pension Fund. Transfers in from other local authority Pension Funds are often higher value than those from private Pension Funds. The highly variable budget is based on a five-year rolling average equating to £300k.

AVCs In/Out

AVCs are Additional Voluntary Contributions that an active member of the Pension Fund chooses to contribute towards their retirement over and above their regular LGPS contributions. The value of AVCs In and Out varies year-on-year depending on members making such choices. The budget is based on a five-year rolling average.

Performance

Financial

In 2016/17 (the last full financial year), the Pension Fund received £1.3m income over the budgeted level. This was due mainly to employee transfers in to the Pension Fund being a higher value than was originally anticipated. However, this was offset by additional costs of £2.6m, largely due to a higher value of lump sums and retirement benefits paid than those originally estimated. The budgeted target for 2018/19 is a surplus of £6.8m.

Administration

The Pension Fund is committed to providing a high quality pension service to both members and employers and to ensuring that members receive their correct pension benefit entitlement. To ensure excellent customer care is provided, retiring members and employers are requested to complete a customer satisfaction survey.

In 2016/17, 71% of members rated the service as 'Excellent'. The equivalent figure for employers was 67%.

One further indicator of service quality and efficiency is the ratio of staff to pension membership, which was 1 Full Time Equivalent (FTE) for every 1,335 members in 2016/17 for the Shetland Islands Pension Fund. The Scottish average is 1 FTE for every 3,172 members.

Also, in 2016/17, the unit cost of administering the Pension Fund per member was £46.45, while the Scottish average was £21.27.

Investments

The focus of the Pension Fund's investment strategy is on achieving a 100% funding level, where the Pension Fund's contributions equal the benefits payable; deficits should be recovered over a period no longer than 20 years in line with the Pension Fund's Funding Strategy Statement (FSS).

The Pension Fund Committee was advised in December 2017 that the Pension Fund's investments increased in value by £10 million over the first six months of 2017/18 and had an overall value of £460 million at 30 September 2017. 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.

Shetland Islands Council

Agenda Item

4

Meeting(s):	**Pension Fund Committee** **Pension Board**	**6 March 2018** **6 March 2018**
Report Title:	**Pension Fund - Quarter to December 2017 Investment Review Report**	
Reference Number:	**F-024-F**	
Author / Job Title:	**Jonathan Belford, Executive Manager - Finance**	

1.0 Decisions / Action required:

1.1 The Pension Fund Committee and Pension Board should consider the outcome of this quarterly 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 investment position and performance of the Pension Fund's external investments, managed on their behalf by fund managers, for the quarter to December 2017.

2.2 The Pension Fund's investments increased in value by £18 million over the quarter and now have an overall value at the end of December of £478 million.

2.3 Over the quarter to December 2017 KBI Global Investors and Schroders outperformed their benchmarks, BlackRock achieved their aim of equalling their benchmark, while Newton and M&G underperformed their benchmarks. The combined investment return for the Pension Fund over the three month period was 3.8% which was 0.1% above the benchmark return. See additional information in Appendix 1.

2.4 The conclusion of the quarterly 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. An interim review of the investment strategy will be undertaken during 2018/19.

2.5 During the Pension Committee and Pension Board meeting on the 6th December 2017 there was a discussion about the benchmarks used in the monitoring of the investments. An explanation about benchmarks was requested and this is included with this report at Appendix 2.

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 Council in ensuring that financial resources are managed.

4.0 Key Issues:	
4.1	This report is only a three month snapshot of how the markets and fund managers have performed. Over the remainder of the financial year the performance of the Council's investments could easily 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	Long term investments are assets of the Pension Fund and

Assets and Property:	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*	

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Appendices:
Appendix 1 - Quarter to June 2017 Performance Review

Background Documents:
None

Appendix 1

Quarter to December 2017 Performance Review

1.0 Investment Position and Market Performance

1.1 This quarterly report forms part of the Pension Fund's governance arrangements where the Pension Fund Committee and Board receive a quarterly investment report on the external investments.

1.2 This report concentrates on the three month period from October to December 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 December 2017 of £478 million. The funds, type of mandate and market values at the end of December 2017 are as follows:

Manager	Mandate	% of Reserves	Market Value (£m)
BlackRock	Passive Equity	43%	204
KBI Global Investors	Active Equity	21%	103
Newton	Diversified Growth	16%	77
Schroders	Property	12%	55
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 three month period. For comparison the nine month figures from the start of the 2017/18 financial year are shown.

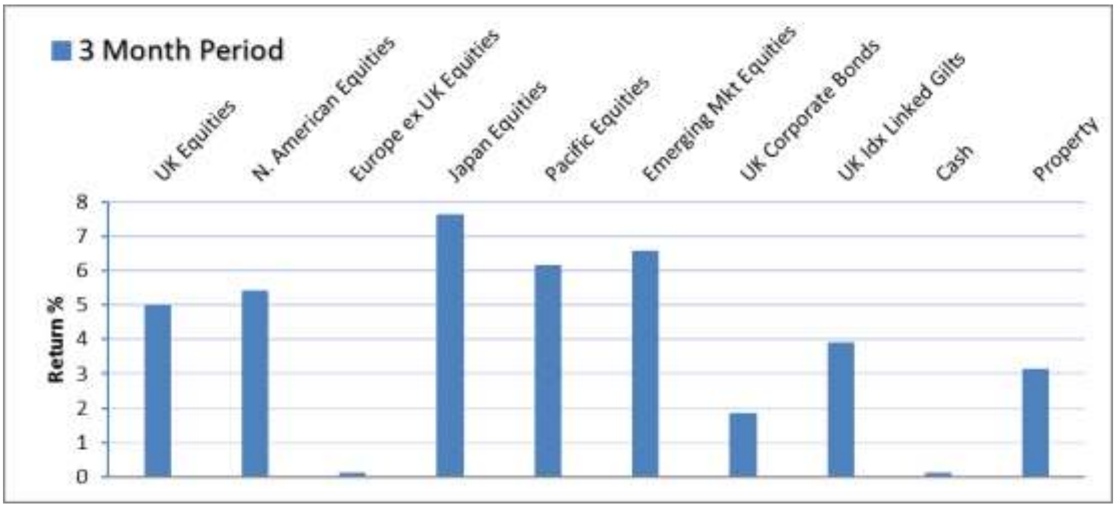
	3 Months Oct – Dec £m	9 Months Apr – Dec £m
Opening Market Value	460	450
Additions / (Withdrawals)	0	1
Investment Return	18	27
Market Value Dec 2017	**478**	**478**

1.5 The figures show an £18 million positive investment return over the three month period. The increase in investment returns is a combination of returns from property, bonds and equity investments over the period.

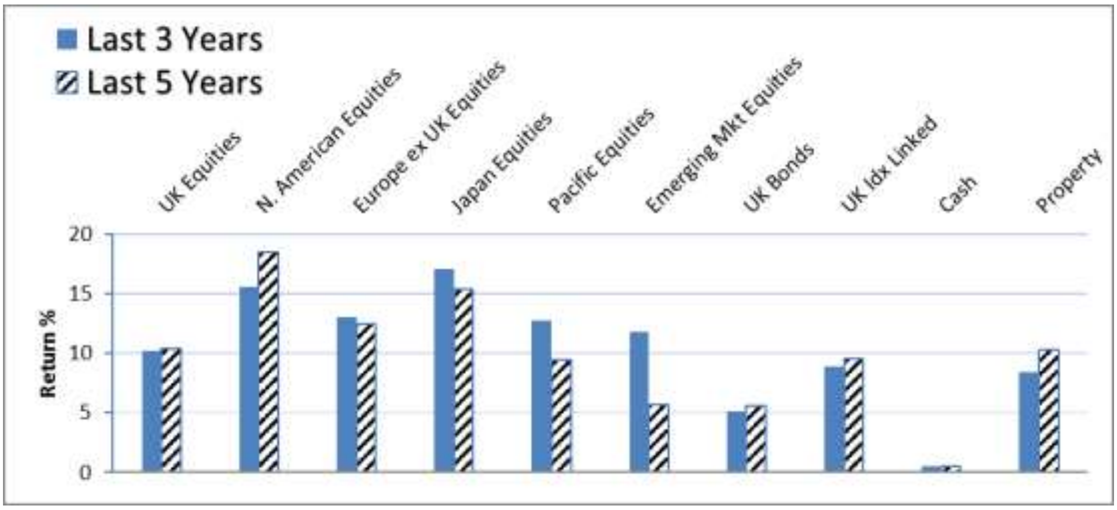
1.6 Over the three month period to December 2017 almost all major economies saw strong economic growth. The US President passed a tax bill into law which saw a substantial corporate tax cut in the US. In Japan Prime Minister Abe scored a strong victory following his decision to call a snap election, and the Japanese market delivered impressive gains. Europe though was plagued by uncertainty; in Germany Angela Merkel struggled to form a new coalition government, while in Spain the region of Catalonia attempted to gain independence after its referendum. The UK market was helped by the long awaited breakthrough in the first phase of the Brexit negotiations with the European Union.

1.7 Looking from the start of the financial year at the nine month period to December 2017 the Pension Fund's investments have returned £27 million, which is a return of 6.0% over the period. This was during a period where the UK, France and Germany all had elections. North America and the UK have increased their interest rates. A war of words between North America and North Korea increased the tension between the two countries and the uncertainty over the Brexit negotiations continued. The markets have shrugged off most of these events, and the nine month period has seen most investments rise.

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



1.9 This is only a three month snapshot of how the various investment classes and sectors have performed and unusually it shows a period of positive return for all asset classes, but over 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 but with 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. .

2.0 Fund Manager Performance

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

2.2 In this environment the Pension Fund's managers have, over the three month period to end December 2017, performed as follows:

Manager	Mandate	Fund Return	Benchmark Return	% Return Compared to Benchmark
BlackRock	Passive Equity	4.9%	4.9%	0.0%
KBI Global Investors	Active Equity	5.4%	4.6%	0.8%
Newton	Diversified Growth	0.4%	1.1%	-0.7%
Schroders	Property	3.3%	3.1%	0.2%
M&G	Alternative Credit	0.7%	0.9%	-0.2%

2.3 The fund with BlackRock is invested passively in equities, so the fund is aiming to equal the benchmark return. BlackRock achieved this aim over the three month period with a return of 4.9%.

2.4 The fund with BlackRock is split between UK equities 45% and global ex UK equities 55%. Both UK and global ex UK investments produced returns close to 4.9% as the quarter was generally positive for equities with the markets moving upwards to new highs. The investment return is a reflection of the mixture of returns from the various markets the fund invests into.

2.5 The fund with KBI Global Investors is in active global equities. They invest using a strategy based on selecting income generating shares. Over the three month period the fund outperformed the benchmark in a rising equity market and produced a return of 5.4%. The main equity investment sectors which contributed to performance were energy, retailing and software, whereas healthcare was a drag on performance.

2.6 Newton has a diversified growth fund mandate, which over the three month period retuned 0.4% which was 0.7% below the cash plus benchmark return. The diversified growth fund invests in various asset classes to spread risk and smooth returns. The main positive contributors to the investment return were equities, currency and government bonds. Newton continue to take a cautious view of the markets with an eye firmly fixed on capital preservation.

2.7 Newton continues to believe that a determined focus on the longer-term trends, rather than short-term market news, is in the best interests of their clients. The portfolio is therefore maintaining a cautious investment position.

2.8 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. Over the three month period Schroders were just above the benchmark with a return of 3.3%. The UK investment outperformed the benchmark return whereas the European investment underperformed.

2.9 Schroders currently has an underweight position in the retail sector and London offices, and an overweight position in industrials and alternatives. Schroders have made a few disinvestments from central London offices, which incurs costs and impacts on short term performance but it has proved to be a good decision, as investments were made into industrials, alternatives and regional offices which have all performed strongly.

2.10 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 underperformed the cash plus benchmark over the three month period but produced a return of 0.7%. The fund's industrial and financial holdings performed well. The fund manager continued to build the level of safer more defensive assets in the portfolio as they believe that valuations are high.

2.11 The overall Pension Fund investment return for the three month period to the end of December 2017 was 3.8%, which was 0.1% above the benchmark return. The best investment returns over the quarter came from equities with KBI's equity fund producing the best investment return at 5.4%.

3.0 After the end of December 2017

3.1 The most up to date Pension Fund investment value is £478 million (unaudited) at the end of January 2018.

3.2 The month of February 2018 has seen a lot of volatility in global financial markets. This originated in North America on concerns about inflation and the Central Bank stating that they may have to raise interest rates faster than initially thought.

Appendix 2

A Guide to Benchmarks – A Way to Measure Investment Performance

1.0 Introduction

1.1 All of the long term Pension Fund investments are held for the purpose of achieving an investment return. To this end all investments are managed in a way that aims to control the risks to the capital sum and optimises the return on the investment consistent with those risks. Benchmarks play an important role in monitoring and evaluating the performance of these investments.

1.2 Monitoring of the Pension Fund investments is essential, and one of the main tools that can be used to assist with this is to allocate each investment a benchmark. A benchmark is basically a standard or point of reference against which the performance of a Pension Fund investment can be compared. Benchmarks are set and agreed with the fund manager for each fund and for each product within the fund.

1.3 Benchmarks have a dual role:

- To aid the monitoring and governance of fund managers, so they invest in the stated asset class and investment area as per the agreement, through review and questioning of deviations away from the benchmark.

- To evaluate the performance of investments and fund managers against agreed benchmarks, i.e. is the fund manager out or underperforming the market they are investing in.

1.4 There are various types of investment benchmarks but the most common is a market benchmark. For instance the UK equity market is made up of about 640 companies and their values change daily. It is their values that are combined to compile a UK equity index. This index can be used to see if the UK market value is increasing or decreasing in value each day. This index can then be used as the benchmark to evaluate the performance of a fund manager investing in the UK market, to see if their expertise and skill can better the ups and downs of the overall market.

2.0 Investing

2.1 A mandate is awarded to a fund manager to invest on behalf of the Pension Fund. This mandate requires monitoring and appropriate governance; in the first instance a contract between the Pension Fund and the fund manager is agreed. This is called an Investment Management Agreement (IMA), which includes such items as where the investment should be invested, the benchmark, fees, authorised signatures etc.

2.2 The detail behind the agreed benchmark in the IMA will not only show the fund manager what market they will invest into but also the market benchmark against which their performance will be monitored. For instance if the fund manager was asked to invest in say US equities then a benchmark which gives the market return of US equities would be used to compare against their performance. If the fund manager's performance was consequently seen to be very different to the US equity market performance then that manager would be asked to explain why.

2.3 Benchmarks are therefore a useful tool in assessing investment performance. It should be noted that there are many different types of investments and many different types of benchmarks. It is not an exact science, often a best fit.

2.4 If you were looking for a benchmark for a UK equity fund, you could consider any of the following from the FTSE range of benchmarks depending of the type of equity fund you wished to have, e.g. large UK company equity fund, midsized UK equity fund or just a general UK equity fund.

- FTSE 100 – the top 100 companies in the UK stock market
- FTSE 250 – after the top 100 companies this index is the next 250 largest companies
- FTSE 350 – the top 350 companies in the UK stock market
- FTSE All Share – All companies that are on the main UK stock market (about 640 companies)

3.0 Suitable benchmarks for different types of investments

3.1 **Active Investment**
A fund manager with an active mandate is using their skill and expertise to actively manage the investment. They will command higher fees for this management but they are correspondingly asked to outperform the market benchmark by a certain percentage. The benchmark will generally be a comparable benchmark to the agreed asset investment class as described in 2.2 above.

3.2 **Passive Investment**
A fund manager with a passive mandate is not trying to outperform the benchmark but instead they are trying to equal the benchmark's performance. This type of investing is achieved using a computer based process, and as there is much less manager involvement the fees are considerably lower than active management. The benchmark will generally be a comparable benchmark to the agreed asset investment class as described in 2.2 above.

3.3 **Property Investing**
There are no daily market trading values for properties, so the property benchmark is basically a value weighted calculation that includes all portfolio structured and professionally managed property investments in the UK. This gives a performance figure that can be used as a benchmark, and is representative of the general property market return.

3.4 **Multi – Asset Investments**

Due to the complexity of multi asset investment funds it is not possible to have a market index benchmark. In this situation a cash plus benchmark is used, e.g. a typical cash plus benchmark would be: 3 month cash return plus 4%. This type of benchmark has no relation to the asset classes that make up the fund, and it will always produce a positive benchmark. It is up to the fund manager to manage all the asset classes available to them to consistently produce positive returns.

4.0 Summary

4.1 The following table lists the Pension Fund's investment managers, their mandate and benchmark.

Manager	Mandate	Benchmark
BlackRock	Global ex UK Passive Equity Fund (47%) UK Passive Equity Fund (53%)	FTSE All World Developed ex UK Index FTSE All Share Index
KBI Global Investors	Global Active Equity Fund	MSCI World Equity Index
Newton	Diversified Growth Fund	1 month cash +4%
Schroders	Property Fund	AREF/IPD UK quarterly property fund index weighted average
M&G	Alternative Credit Fund	1 month cash +3%

4.2 Benchmarks are an essential tool to assist in not only monitoring the performance of investments but in the governance of the fund managers. Benchmarks are used for all of the Pension Fund's investments in line with the agreed Pension Fund investment strategy.

Shetland Islands Council

Agenda Item
5

Meeting(s):	Pension Fund Committee Pension Fund Board	6 March 2018
Report Title:	Annual Audit Plan 2017/18	
Reference Number:	F-002-F	
Author / Job Title:	Executive Manager - Finance	

1.0 Decisions / Action required:

1.1 That the Committee / Board NOTES the contents of the Audit Plan 2017/18 for Shetland Islands Council Pension Fund (Appendix 1) from external auditors, Deloitte LLP.

2.0 High Level Summary:

2.1 The Annual Audit Plan detailed at Appendix 1 provides information on the work that external auditors will undertake to review and assess the governance and performance of the Pension Fund in 2017/18.

3.0 Corporate Priorities and Joint Working:

3.1 The audit process plays a key role in helping the Pension Fund to maintain good governance, accountability and provides assurance around financial stewardship.

3.2 The current strategy for the Pension Fund is to achieve a 100% funding position to ensure that the scheme remains affordable and sustainable in the future.

4.0 Key Issues:

4.1 The Annual Audit Plan presents the planned audit work for the 2017/18 financial year by the Pension Fund's external auditors, Deloitte LLP, for the 2017/18 financial year; the second year of a five-year appointment. Their core audit work includes:

- providing the **Independent Auditor's Report** on the annual accounts;
- providing the **annual report** on the audit addressed to the Audit Committee;
- communicating **audit plans** to the Audit Committee;
- providing **reports to management**, as appropriate, in respect of the auditor's corporate governance responsibilities in the Code;
- preparing and submitting **fraud returns** to Audit Scotland, where appropriate;
- identifying significant matters arising from the audit, alert the Controller of Audit and support Audit Scotland in producing statutory reports as required;
- undertaking work requested by Audit Scotland or local performance audit work.

5.0 Exempt and/or confidential information:

5.1 None.

6.0 Implications :		
6.1 Service Users, Patients and Communities:	None arising from this report.	
6.2 Human Resources and Organisational Development:	None arising from this report.	
6.3 Equality, Diversity and Human Rights:	None arising from this report.	
6.4 Legal:	The Shetland Islands Council Pension Fund is required to prepare accounts in accordance with the Local Government (Scotland) Act 1973, the Code of Practice on Local Authority Accounting 2017/18 and the Local Government Pension Scheme(Scotland) Regulations 2014 (as amended)	
6.5 Finance:	The audit fee for 2017/18 is £29,486.	
6.6 Assets and Property:	None arising from this report.	
6.7 ICT and new technologies:	None arising from this report.	
6.8 Environmental:	None arising from this report.	
6.9 Risk Management:	The annual audit work is focused on identifying and assessing the key challenges and risks to the Pension Fund in order to mitigate future risk.	
6.10 Policy and Delegated Authority:	The Pension Fund Committee has responsibility for governance arrangements including regulatory compliance and implementation of audit recommendations in respect of the Pension Fund.	
6.11 Previously considered by:	Audit Committee	7 February 2018

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6 March 2018

Appendices:
Appendix 1 – Shetland Islands Council Pension Fund Annual Audit Plan for 2017/18

Shetland Islands Council Pension Fund

Planning report to the Audit Committee on the audit for the year ended 31 March 2018

7 February 2018

Deloitte Confidential: Public Sector

Contents

Deloitte Confidential: Public Sector

Planning report

Director introduction
The key messages in this report

Audit quality is our number one priority. We plan our audit to focus on audit quality and have set the following audit quality objectives for this audit:

A robust challenge of the key judgements taken in the preparation of the financial statements.

A strong understanding of your internal control environment.

A well planned and delivered audit that raises findings early with the Audit Committee.

I have pleasure in presenting our planning report to the Audit Committee for the 2017/18 audit of the Shetland Islands Council Pension Fund ("the Fund"). I would like to draw your attention to the key messages of this paper:

Fund changes	Following discussions with the Fund's finance team we have not identified any significant changes to the Fund itself during the year, other than changes to some of the sponsoring employer contribution rates as outlined in the latest triennial valuation. We will continue to liaise with the finance team to identify any changes between the date of this report and the Fund's year end, and will update our audit plan accordingly should any occur. There have been no significant regulatory changes to the accounting of the Fund in the current year. The Code of Practice on Local Authority Accounting in the UK ("the 2017/18 Code") applies in the current year.
Significant audit risk	We have identified management override of controls as our significant audit risk. Auditing Standards require us to assume that management override of controls is an audit risk for all of our audits. Further details of this significant risk, including our proposed testing can be found on page 13.
Areas of audit focus	The following areas of focus have not been identified as significant audit risks but will be considered as part of our audit: 1. Accuracy of contributions payable to the Pension Fund; and 2. Valuation of investments. Further details of the areas of audit focus, including our proposed testing are outlined on pages 14 to 15.

Director introduction (continued)

The key messages in this report (continued)

Audit quality is our number one priority. We plan our audit to focus on audit quality and have set the following audit quality objectives for this audit:

A robust challenge of the key judgements taken in the preparation of the financial statements.

A strong understanding of your internal control environment.

A well planned and delivered audit that raises findings early with the Audit Committee.

Audit Dimensions	The 2016 Code of Audit Practice sets out four audit dimensions which set a common framework for all public sector audits in Scotland. Our audit work will consider how the Fund is addressing these and we will report our conclusions in our annual report to the Members and Controller of Audit in September 2018. In particular, our work will focus on: • ***Financial sustainability*** – we will monitor the Fund's actions in respect of its medium and longer term financial plan to assess whether short term financial balance can be achieved, whether there is a long-term financial strategy and if the investment strategy is effective. • ***Financial management*** – we will review the budget and monitoring reports of the Fund during the year to assess whether financial management and budget setting is effective. • ***Governance and transparency*** – from our review of the Fund's Audit Committee papers and attendance at Audit Committee meetings we will assess the effectiveness and scrutiny of governance arrangements. We will also share best practice examples, where it is deemed appropriate. • ***Value for money*** – we will gain an understanding of the Fund's self-evaluation arrangements to assess how it demonstrated value for money in the use of resources and the linkage between money spent and outputs and outcomes delivered.

Pat Kenny
Audit Director

Responsibilities of the Audit Committee
Helping you fulfil your responsibilities

As a result of regulatory change in recent years, the role of the Audit Committee has significantly expanded. We set out here a summary of the core areas of responsibilities, relating to the financial reporting process, to provide a reference in respect of these broader responsibilities and highlight throughout the document where there is key information which helps the Audit Committee in fulfilling their remit.

The primary purpose of the Auditor's interaction with the Audit Committee

- Provide assurance over the financial statements;
- Provide timely observations arising from the audit that are significant and relevant to the Audit Committee's responsibility for overseeing the financial reporting process; and
- In addition, we seek to provide the Audit Committee with additional information to help them fulfil their broader responsibilities.

Oversight of external audit

- At the start of each annual audit cycle, ensure the scope of the external audit and fee are appropriate.

Integrity of reporting

- Review of external audit findings, key judgements, level of misstatements.
- Assess the quality of the Fund advisers where activities have been delegated by the Audit Committee.
- Assess the completeness of disclosures, including consistency with disclosures required under the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom.

Oversight of Internal Audit

- Consider annually whether there is a need for an internal audit function and any testing to be performed over pension activities.

Internal controls and risk

- Review the internal control reports and risk management systems for Fund advisers.
- Explain what actions have been, or are being taken to remedy any significant failings or weaknesses.

Whistle- blowing and fraud

- Ensure that appropriate arrangements are in place for the proportionate and independent investigation of any concerns that are raised by staff in connection with improprieties.

Our audit explained

We tailor our audit to your business and your strategy

Identify changes in your Fund

We have not identified any significant changes to the Pension Fund during the year, with the exception of changes in the rate of employer contributions. The Code of Practice on Local Authority Accounting in the UK is still applicable in the current year.

Scoping

We have performed our initial scoping based on current requirements and Audit Scotland planning guidance.

More details are given on page 9.

In our final report

In our final report to you we will conclude on the significant audit risk and areas of audit focus identified in this report, including how we have assessed them together with any misstatements or control observations identified.

Determine materiality

Financial statement materiality will be based on 1% of net assets as at 31 March 2018.

Further information around our materiality calculation can be found on page 8.

Risk assessment

We have identified the significant audit risk and areas of audit focus based on our knowledge of the Fund.

Each of these is discussed in more detail on pages 12 to 15.

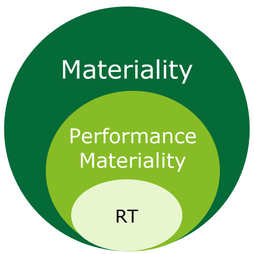
Quality and Independence

We confirm that we are independent of Shetland Islands Council Pension Fund. We take our independence and the quality of the audit work we perform very seriously. Audit quality is our number one priority.

Materiality

Approach to materiality

Basis of materiality - benchmark	We set materiality for our opinion on the financial statements at 1% of net assets of the Fund and performance materiality at 90% of materiality based on professional judgement, the requirements of auditing standards and the financial measures most relevant to users of the financial statements. As a reference our materiality and performance materiality for the 2016/17 Annual Report and Accounts was determined as £4.49m and £4.041m respectively. We will update our materiality assessment following receipt of the draft 2017-18 financial statements and will communicate this to the Audit Committee in our final report.
Reporting to the Audit Committee	We report to the Audit Committee any unadjusted misstatements greater than 5% of materiality (“reporting threshold”) and other adjustments we consider to be qualitatively material. Based on the 2016-17 Annual Report and Accounts, we determined the reporting threshold (“RT”) to be £224.5k. We will report to you misstatements below this threshold if we consider them to be material in nature.
Our audit report	The extent of our procedures is not based on materiality alone but also on the quality of systems and controls in preventing material misstatement in the financial statements, and the level at which known and likely misstatements are tolerated by you in the preparation of the financial statements.



Although materiality is the judgement of the audit director, the Audit Committee must satisfy themselves that the level of materiality chosen is appropriate for the scope of the audit.

Scoping

Our key areas of responsibility under the Code of Audit Practice

Core audit

Our core audit work as defined by Audit Scotland comprises:

- providing the **Independent Auditor's Report** on the annual accounts;
- providing the **annual report** on the audit addressed to the Pension Fund Audit Committee;
- communicating **audit plans** to the Audit Committee;
- providing **reports to management**, as appropriate, in respect of the auditor's responsibilities in the Code;
- identifying significant matters arising from the audit, alert the Controller of Audit and support Audit Scotland in producing statutory reports as required; and
- undertaking work requested by Audit Scotland or local performance audit work.

Wider scope requirements

The Code of Audit Practice sets out four audit dimensions which set a common framework for all public sector audits in Scotland:

- **Financial sustainability** – looking forward to the medium and longer term to consider whether the Fund is planning effectively to continue to deliver its services or the way in which they should be delivered.
- **Financial management –** financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.
- **Governance and transparency** – the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.
- **Value for money -** using resources effectively and continually improving services.

Wider scope requirements
Audit dimensions

The Code of Audit Practice sets out four audit dimensions which set a common framework for all public sector audits in Scotland. We will consider how the Fund addresses these areas, including any risks to their achievement, as part of our audit work as follows:

Audit dimension	Areas to be considered	Impact on the 2018 Audit
Financial sustainability looks forward to the medium and longer term to consider whether the Pension Fund is planning effectively to continue to deliver its services or the way in which they should be delivered.	• The financial planning systems in place across the shorter and longer terms. • The arrangements to address any identified funding gaps. • The affordability and effectiveness of funding and investment decisions made.	We will review the arrangements and financial planning systems in place by the Fund to ensure that its services can continue to be delivered. This will include a review of the latest actuarial valuation of the Fund and the plans in place to reduce the deficit over the shorter and medium term. In addition we will review the funding policy as set out in the Shetland Islands Council Pension Fund Investment Strategy 2014-2027, which aims to ensure the long-term solvency of the Fund, so that there are sufficient funds available to meet all benefits as they fall due.
Financial management is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.	• Systems of internal control. • Budgetary control system. • Financial capacity and skills. • Arrangements for the prevention and detection of fraud.	We will review the budget and monitoring reporting by the Fund during the year to assess whether financial management and budget setting is effective. In addition we will also ensure that there is a proper officer and fund manager who have sufficient status to be able to deliver good financial management, that monitoring reports contain information linked to performance as well as financial data, and that members have the opportunity to provide a sufficient level of challenge around variances and under-performance. Our fraud responsibilities and representations are detailed on pages 19 and 20.

Wider scope requirements (continued)
Audit dimensions (continued)

Audit dimension	Areas to be considered	Impact on the 2018 Audit
Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.	• Governance arrangements. • Scrutiny, challenge and transparency on decision making and financial and performance reports. • Quality and timeliness of financial and performance reporting.	We will review the Fund's papers and use our attendance at Audit Committee meetings to assess the effectiveness and scrutiny of governance arrangements. We will also review other aspects of governance around the Fund including Codes of Conduct for officers and members, fraud and corruption arrangements, and arrangements for reporting regulatory breaches to the Pensions Regulator. In addition we will review the Annual Governance Statement and Governance Compliance Statement to confirm the governance arrangements observe the guidance issued by Scottish Ministers.
Value for money is concerned with using resources effectively and continually improving services.	• Value for money in the use of resources. • Link between money spent and outputs and the outcomes delivered. • Improvement of outcomes. • Focus on and pace of improvement.	We will gain an understanding of the Fund's self-evaluation arrangements to assess how it demonstrates value for money in the use of resources and the linkage between money spent and outputs and outcomes delivered. We will also review the scrutiny that is in place to challenge the Fund's investment managers on fees and performance.

Significant Audit Risk and Areas Audit of Focus Dashboard

We welcome the Audit Committee's input into this risk assessment to ensure that any new or emerging risks or themes are considered for inclusion as a significant audit risk or area of audit focus.

Risk Area	Risk Level	Fraud Risk	Controls Approach to Testing	Level of Judgement
Management override of controls	Significant Audit Risk	Fraud Risk	D&I	Medium
Areas of audit focus				
Accuracy of Contributions	Area of Audit Focus	Not a Fraud Risk	D&I	Low
Valuation of Investments	Area of Audit Focus	Not a Fraud Risk	OE	Low

Low levels of management judgement/involvement	Not a Fraud Risk	Significant Audit Risk
Medium levels of management judgement/involvement	Fraud Risk	Area of Audit Focus
High degree of management judgement/involvement	**D & I** Design and Implementation	
	OE Operating Effectiveness	

Deloitte Confidential: Public Sector

Significant audit risk
Management override of controls

Description

In accordance with ISA 240 (UK and Ireland), management override of controls is always a significant risk for financial statement audits. The primary risk areas surrounding the management override of internal controls are over the processing of journal entries and the key assumptions and estimates made by management.

Deloitte Response

In order to address this significant audit risk, we will perform the following audit procedures:

- Make enquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
- Perform testing on the design and implementation of controls surrounding the financial reporting process and the controls over journal entries and other adjustments posted in the preparation of the financial statements;
- Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. As part of our work in this area, we will perform an analysis of journal entries which will enable us to focus on journals meeting specific pre-determined parameters determined during our audit planning;
- Review the financial statements for any accounting estimates which could contain management bias, and assess the judgements taken against supporting evidence;
- Ensure that there is an appropriate level of segregation of duties over processing journal entries to the financial statements throughout the year;
- Obtain an understanding of the rationale of any significant transactions that we become aware of that are outside the normal course of the Fund's operations or that otherwise appear to be unusual given our understanding of the Pension Fund and its environment; and
- Make enquiries of management in relation to the identification of related party transactions.

Areas of audit focus
Accuracy of contributions

Description

The correct deduction of contributions depends on systems-based processing of membership data and salary details, together with a robust internal control framework. Errors in processing contributions can lead to issues such as non-compliance with the Local Government Pension Scheme Regulations 2014 (“LGPS Regulations”) and the recommendations of the Actuary, and deducting incorrect amounts from active members' payroll which can be costly to rectify and cause reputational damage.

Due to the changes in employer contribution rates in the current year, there is a risk that contributions are not paid to the Fund accurately.

Deloitte Response

In order to address this area of audit focus we will perform the following audit procedures:

- Review the design and implementation of key controls over the contribution process;
- Perform an analytical review of the employer and employee normal contributions received in the year, basing our expectation on the prior year audited balance, adjusted for the movement in active member numbers, contribution rate changes and any average pay rise awarded in the year;
- For a sample of active members, we will recalculate individual contribution deductions to ensure that these are being calculated in accordance with the rates stipulated in the LGPS Regulations for employee contributions and the recommendations of the Actuary for employer contributions;
- Test that the correct definition of pensionable salary is being used per the LGPS Regulations to calculate contribution deductions; and
- Test the reconciliation of the total number of active members between the membership records and the employer payroll records.

Other areas of audit focus (continued)
Valuation of investments

Description	
There is a risk that investments are not valued accurately in the Fund's financial statements due to the potential levels of judgement involved in pricing such investments. The Fund holds investments primarily in pooled funds, pooled property unit trusts and fixed income unit trusts with a range of investment managers.	
Deloitte Response	In order to address this area of audit focus, we will perform the following audit procedures: • Review the design and implementation and operating effectiveness of key controls over the valuation of the investments by obtaining investment manager internal control reports and evaluating the implications for our audit of any exceptions noted; • Agree year end valuations, sales proceeds and purchases in the financial statements to the reports received directly from the investment managers; • Perform valuation testing by using a range of techniques depending on the type of investment. Where the investment held is directly quoted on an exchange, we will obtain an independent price of the investment asset using our own internal pricing systems e.g. Bloomberg. Where the investment is not directly quoted on an exchange we will confirm if it is registered on the Financial Conduct Authority website and obtain an independent price, or use sales transactions close to year end as an estimate of the price. Where none of these options are available we will obtain audited financial statements and assess the year end price against the audited accounts.

Purpose of our report and responsibility statement

Our report is designed to help you meet your governance duties

What we report

Our report is designed to establish our respective responsibilities in relation to the financial statements audit, to agree our audit plan and to take the opportunity to ask you questions at the planning stage of our audit. Our report includes:

- Our audit plan, including key audit judgements and the planned scope.

What we don't report

As you will be aware, our audit is not designed to identify all matters that may be relevant to the Audit Committee.

Also, there will be further information you need to discharge your governance responsibilities, such as matters reported on by management or by other specialist advisers.

Finally, the views on internal controls and risk assessment in our final report should not be taken as comprehensive or as an opinion on effectiveness since they will be based solely on the audit procedures performed in the audit of the financial statements and the other procedures performed in fulfilling our audit plan.

Other relevant communications

We will update you if there are any significant changes to the audit plan.

This report has been prepared for the Audit Committee, as a body, and we therefore accept responsibility to you alone for its contents. We accept no duty, responsibility or liability to any other parties, since this report has not been prepared, and is not intended, for any other purpose. Except where required by law or regulation, it should not be made available to any other parties without our prior written consent.

We welcome the opportunity to discuss our report with you and receive your feedback.

Pat Kenny, CPFA

for and on behalf of Deloitte LLP

Glasgow

23 January 2018

Appendices

Prior year audit adjustments
Uncorrected and disclosure misstatements

Uncorrected misstatements

There were no uncorrected misstatements identified during the course of our prior year audit.

Disclosure misstatements

There were no uncorrected disclosure misstatements identified during the course of our prior year audit.

Fraud responsibilities and representations

Responsibilities explained

Your Responsibilities:

The primary responsibility for the prevention and detection of fraud rests with management and the Audit Committee, including establishing and maintaining internal controls over the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

Our responsibilities:

- We are required to obtain representations from the Audit Committee regarding internal controls, assessment of risk and any known or suspected fraud or misstatement.
- As auditors, we obtain reasonable, but not absolute, assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.
- As set out in the significant risk section of this document, we have identified the risk of fraud in management override of controls as a key audit risk for your Fund.

Fraud Characteristics:

- Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.
- Two types of intentional misstatements are relevant to us as auditors – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

We will request the following to be stated in the representation letter signed on behalf of the Audit Committee:

- We acknowledge our responsibilities for the design, implementation and maintenance of internal control to prevent and detect fraud and error.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- We are not aware of any fraud or suspected fraud that affects the Fund and involves:
  - (i) management;
  - (ii) employees who have significant roles in internal control; or
  - (iii) others where the fraud could have a material effect on the financial statements.
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the Fund's financial statements communicated by employees, former employees, analysts, regulators or others.

Fraud responsibilities and representations

Inquiries

We will make the following inquiries regarding fraud:

Management:

- Management’s assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments.
- Management’s process for identifying and responding to the risks of fraud in the entity.
- Management’s communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity.
- Management’s communication, if any, to employees regarding its views on business practices and ethical behaviour.
- Whether management has knowledge of any actual, suspected or alleged fraud affecting the entity.

Those charged with governance

- How those charged with governance exercise oversight of management’s processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.
- Whether those charged with governance have knowledge of any actual, suspected or alleged fraud affecting the entity.

Independence and fees

As part of our obligations under International Standards on Auditing (UK), we are required to report to you on the matters listed below:

Independence confirmation	We confirm that we comply with APB Ethical Standards for Auditors and that, in our professional judgement, we and, where applicable, all Deloitte network firms are independent and our objectivity is not compromised.
Fees	The fee for the 2017/18 audit has been agreed as £29,486 (2016/17: £30,238).
Non-audit services	In our opinion there are no inconsistencies between APB Ethical Standards for Auditors and the Fund's policy for the supply of non-audit services or any apparent breach of that policy. We continue to review our independence and ensure that appropriate safeguards are in place in relation to any non-audit services provided including, but not limited to, the rotation of senior partners and professional staff and the involvement of additional partners and professional staff to carry out reviews of the work performed and to otherwise advise as necessary. We do not intend to perform any non-audit services during the 2017/18 audit.
Relationships	We have no other relationships with the Fund, the Audit Committee, or management, and have not supplied any services to other known connected parties.

Shetland Islands Council

Agenda Item
6

Meeting(s):	Pension Fund Committee Pension Board	6 March 2018
Report Title:	General Data Protection Regulation (GDPR) – Impact on Pension Funds	
Reference Number:	F-030-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 information contained within this report.

2.0 High Level Summary:

2.1 This report informs of the impact of the EU General Data Protection Regulation (GDPR) which replaces the existing UK data protection legislation from 25 May 2018.

2.2 Increased globalisation and technological developments have driven the need for a more consistent and robust data protection framework across the EU.

3.0 Corporate Priorities and Joint Working:

3.1 There is a specific objective within the Corporate Plan to ensure high standards of Governance. The Council, as the administering authority for the Shetland Islands Council Pension Fund is responsible for the governance and administration of the Pension Fund.

3.2 In addition to the wealth of regulation and legislation that surrounds the administration of the Fund there are key governance issues that require to be addressed in order to effectively fulfil the role to the expected and required standards.

3.3 One aspect of good governance is to ensure compliance with data protection legislation.

4.0 Key Issues:

4.1 **New & Enhanced rights for members and beneficiaries**

Under all grounds for processing regardless of the legal basis, members must be told how their data is used and shared. The GDPR says that the necessary information must be provided “in a concise, transparent, intelligible and easily accessible form, using clear and plain language”.

4.2 **Greater responsibilities for data processors and controllers**

Unlike under current rules, the new regulations make providers of third-party administration and other services (in their role as data processors) directly responsible for certain aspects of compliance. Appointed professional advisers and scheme actuaries will have a joint data controller role with scheme managers, thus division of responsibilities will need to be agreed. Such details must be made available to pension scheme members.

Contractual arrangements with service providers (in their roles as data processors and joint data controllers) require to be reviewed and updated, as the GDPR is more prescriptive about what needs to be set out in agreements.

4.3 **Increased accountability and record keeping**

Scheme Managers (as data controllers) need to be able to demonstrate how they comply with the GDPR. Furthermore, any appointed service providers (as data processors) will have to maintain records of the processing activities for which they are responsible, and will be obliged to make those records available to the Information Commissioner's Office (ICO) on request.

4.4 **Reporting Breaches**

In addition to existing requirements of reporting breaches to regulation, schemes will have to report data breaches to the ICO if there is likelihood of risk to people's rights and freedoms "without undue delay" and where feasible within 72 hours of the scheme managers becoming aware of breaches. If the breach is deemed "high risk" and is not mitigated by data encryption or other measures, the scheme manager will have to inform affected individuals without undue delay.

4.5 **Role of Data Protection Officer**

Scheme Managers are required to appoint a qualified person to fulfil the role of "data protection officer" (DPO), responsible for (amongst other things) advising, monitoring compliance and liaising with the ICO.

GDPR Project Manager

4.6 The Council has appointed a GDPR Project Manager and the preparation work for GDPR is well underway and an update to the Pension Fund Committee/Pension Board will be provided before implementation in May 2018.

4.7 **Penalties**

Under GDPR, the ICO, as the UK Data Protection Ombudsman, will continue to impose upon those who breach its requirements administrative fines that are "effective, proportionate and dissuasive".

The maximum monetary penalty that the ICO can impose under current UK legislation is £0.5m. Under GDPR, this will increase to £17million or 4% of global annual turnover.

5.0 Exempt and/or confidential information:	
5.1 None.	
6.0 Implications :	
6.1 Service Users, Patients and Communities:	By effectively implementing the new GDPR regulations ensures sound governance and that pension scheme members personal data is being safe guarded.
6.2 Human Resources and Organisational Development:	The new GDPR regulations has wide reaching implications for both HR and Payroll as well as Shetland Islands Council Pension Fund.
6.3 Equality, Diversity and Human Rights:	There are no implications arising from this report.
6.4 Legal:	The new GDPR regulations has wide reaching legal implications for Shetland Islands Council Pension Fund.
6.5 Finance:	There are no direct financial implications arising from this report. To ensure successful implementation of GDPR, temporary additional resource may be required if it is found not possible to absorb the additional work into officers current established workloads.
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 with non-compliance of GDPR being one of them. • Officers of the Council are currently taking steps now to understand and document what data is held and how it is used. • The new rules for processing by consent may prove extremely problematic. Officers are considering current processes and their basis to ascertain what changes require to be made. Current communication channels and contents also require to be analysed and reviewed to ascertain the changes required by the new regulations.
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:
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22 February 2018