Environment Agency
Pension Fund

March 2017

# Closed Fund Funding Strategy Statement

# Contents

## Introduction

This is the Funding Strategy Statement (FSS) of the Environment Agency Closed Pension Fund ("the Fund"), which is administered by the Environment Agency on behalf of the Environment Agency Pensions Committee ("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 Department for the Environment, Food and Rural Affairs (Defra - "the Guarantor") and the Fund's investment adviser. It is effective from 23 March 2017.

### Fund history

The Fund is part of the national 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 of the UK.

The Fund is the vehicle used to pay the pensions and related benefits of certain former employees in the water industry in England and Wales prior to its privatisation. The Fund was created by the Water Act 1989 and has always been closed to new entrants and accruals of future service. The Fund's liabilities are statutorily guaranteed by the Department for the Environment, Food and Rural Affairs under section 173 of the Water Act 1989 and it is unique in this respect in the family of Local Government pension funds. The Memorandum of Understanding between the Secretary of State for Environment, Food and Rural Affairs and the Environment Agency – Pensions Committee sets out the mechanism whereby the Guarantor makes Grant-in-Aid (GiA) payments to the Fund to cover the cost of benefits in payment.

The Fund provides a convenient and efficient vehicle to deliver scheme benefits, in particular by

- Receiving GiA payments and investment income, and
- Paying scheme benefits, transfer values and administration costs.

### Profile of liabilities

As at 31 March 2016, the Fund's membership consisted of 13,511 pensioners and 2,139 deferred pension members whose benefits have yet to come into payment. The average age of members in receipt of pensions in payment was around 77 years, and 57 years for deferred pensioners.

Around 50% of the liabilities are expected to be discharged over the next 6-7 years, but the remaining liabilities could take a further 40-50 years to come close to being extinguished. The final payment from the Fund may not be paid until the end of the 21st century.

The Fund's assets are expected to be sufficient to meet the outstanding benefit and expense outgo by 2029.

The discounted mean term of the liabilities – a measurement of duration that can be useful in matching liabilities to bond durations – was 9.2 years as at 31 March 2016 and will fall only gradually over time.

As at 31 March 2016, the Fund's assets were £219m (£166m at 31 March 2013) and the value placed on the liabilities (discounted in line with the minimum risk return available on UK government bonds) was £711m (£860m) resulting in a funding level of 31% (19%) and a deficit of £492m (£694m). Benefit expenditure flowing out of the Fund is running at around £66m per annum.

All these figures exclude the additional 'unfunded' pension payments of around £10m per annum which are paid to Fund members for added years awarded on retirement.  The Administering Authority receives Grant-in-Aid payments covering funded and unfunded benefit payments.

### Regulatory framework

The FSS forms part of a framework which includes:

- the LGPS Regulations;
- the Fund's Statement of Investment Principles / Investment Strategy Statement (see Section 3)

The FSS has been prepared by the Administering Authority in collaboration with the Fund's actuary, Richard Warden, and its investment consultant, Paul Potter, both of Hymans Robertson. It has been consulted on with the Guarantor, Defra.

### Reviews of FSS

The FSS applies with effect from 31 March 2017 for lump sum contributions payable in the Fund's financial year 2017/18 and thereafter.  The principles documented herein have been used for the actuarial valuation as at 31 March 2016.

The FSS is reviewed in detail at least every three years alongside the triennial valuation being carried out, with the next valuation as at 31 March 2019 due to be completed by 31 March 2020.  The FSS is a summary of the Fund's approach to funding liabilities.  It is not an exhaustive statement of policy on all issues.

### Funding strategy objective

The FSS sets out the objectives of the Fund's funding strategy, which is 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.

### How do I find my way around this document?

In Section 3 we show how the funding strategy is linked with the Fund's investment strategy.

In the Appendices we cover various issues in more detail:

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

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

For any queries please contact David Williams, Engagement Manager on info@eapf.org.uk.

## Determining the solvency target and funding position

### Reviews of funding position and Guarantor payments

The Fund's actuary is required by LGPS Regulations to report the funding position (or 'solvency') of the Fund relative to its solvency target at least every three years. Unlike other LGPS funds there is no requirement to certify contribution rates as the Fund has no contributing employers.

At each triennial valuation the Administering Authority also works with the Fund's actuary to review the cash flow position of the Fund and the expected benefit expenditure for the following years. This is used to forecast the GiA payments required from the Guarantor.

### Solvency target

The Fund defines 'solvency' to be the ability to meet ongoing benefit expenditure. As at 31 March 2016, the assets held by the Fund were only sufficient to cover 31% of its liabilities (19% in 2013). Without the GiA payments made by the Guarantor, the Fund would expect to be exhausted by 2019.

The accrued liabilities are the future payments of pensions and lump sums, allowing for annual increases on pensions in payments in line with Consumer Prices Index (CPI) Inflation. The valuation allows for future investment returns when calculating the liabilities, which reduces the value placed on them.

### Ongoing funding basis

The Fund's actuary agrees the financial and demographic assumptions to be used for each triennial valuation with the Administering Authority.

The demographic assumptions are intended to be best estimates of future experience in the Fund. They vary by type of member.

The key financial assumption affecting the projected GiA payments is the rate of CPI inflation which will determine future benefit increases. This has been taken to be 1.8% p.a. at the 2016 valuation.

In determining the value placed on the liabilities it is also important to use a suitable discount rate. The Fund is invested almost entirely in index-linked UK government bonds, so the discount rate chosen is the expected nominal return on these assets as at the valuation date. As at 31 March 2016 this return is expected to be 2.2% p.a., leading to a real assumed return of 0.4% p.a. relative to CPI.

# Funding strategy and links to investment strategy

### What is the Fund’s investment strategy?

The Fund has built up assets over the years, and continues to receive investment 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 taking investment advice. The precise mix, manager make up and target returns are set out in the Statement of Investment Principles (being replaced by an Investment Strategy Statement under new LGPS Regulations), which is available to members.

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 Fund has a low risk investment strategy, being invested in a portfolio of index-linked UK government bonds.

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

The Fund’s funding and investment strategies are inextricably linked. However, the modest value of assets compared to liabilities and the fact that benefit payments are currently met by GiA payments from the Guarantor means that the performance of the Fund’s assets will only have a limited effect on the Fund’s finances for the time being.

### 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 discount rate assumption is consistent with the Fund’s investment strategy and is considered to be consistent with the requirement to take a “prudent longer-term view” of the funding of liabilities as required by the UK Government (see Appendix A1).

### Does the Fund monitor its overall funding position?

The Administering Authority monitors the benefit expenditure and cash flow position of the Fund on a regular basis to ensure that there are always sufficient assets to meet the benefit expenditure.

## Statutory reporting and comparison to other LGPS Funds

### 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 Department of Communities & Local Government (DCLG) on each of the LGPS Funds in England & Wales. 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.

However, given the extraordinary nature of the Environment Agency Closed Fund and its funding through Grant-in-Aid payments from Defra, it is to be excluded from most aspects of the Section 13 analysis.

# Appendix A – Regulatory framework

### A1 Why does the Fund need an FSS?

The Department for Communities and Local Government (DCLG) has stated that 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 a 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 the Chartered Institute of Public Finance and Accountancy (CIPFA) (most recently in 2016) and to its Statement of Investment Principles / Investment Strategy Statement.

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 Pensions Committee level with council tax raising authorities and with corresponding representatives of other participating employers".

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

a) A draft version of the FSS was issued to Defra on 9 March 2017 for comment;

b) Comments were requested within 14 days;

c) Following the end of the consultation period the FSS was updated where required and then published on 23 March 2017.

### A3 How is the FSS published?

The FSS is made available through the following routes:

Published on our website, at www.eapf.org.uk;

A copy sent by e-mail to Defra;

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

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 2019.

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 Fund communications,
- 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/Investment Strategy Statement, Governance 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 web at www.eapf.org.uk.

## 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. Collect GiA payments, and investment income and other amounts due to the Fund.
3. Ensure that cash is available to meet benefit payments as and when they fall due.
4. Pay from the Fund the relevant benefits and entitlements that are due.
5. 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/Investment Strategy Statement (SIP/ISS) and LGPS Regulations.
6. Manage the valuation process in consultation with the Fund's actuary.
7. Provide data and information as required by the Government Actuary's Department to carry out their statutory obligations (see Section 4).
8. Prepare and maintain a FSS and a SIP/ISS, after consultation.
9. Notify the Fund's actuary of material changes which could affect funding (this is covered in a separate agreement with the actuary).
10. Monitor all aspects of the fund's performance and funding and amend the FSS and SIP/ISS as necessary and appropriate.

### B2 The Fund Actuary should:-

1. Prepare valuations, including the forecasting of GiA payments. This will involve agreeing assumptions with the Administering Authority, having regard to the FSS and LGPS Regulations.
2. Provide data and information as required by the Government Actuary's Department to carry out their statutory obligations (see Section 4).
3. Prepare advice and calculations in connection with bulk transfers and individual benefit-related matters.
4. Fully reflect actuarial professional guidance and requirements in the advice given to the Administering Authority.

### B3 Other parties:-

1. Investment advisers (either internal or external) should ensure the Fund's SIP/ISS 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/ISS.
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.

6. The Department for Communities and Local Government (assisted by the Government Actuary's Department) and the Scheme Advisory Board, should work with LGPS Funds to meet Section 13 requirements.

7. The Guarantor (the Department for the Environment, Food and Rural Affairs) should make the Grant-in-Aid payments agreed with the Administering Authority to meet the cost of benefits.

# 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
- governance

## C2 Financial risks

| Risk | Summary of Control Mechanisms |
|---|---|
| Price inflation significantly more than anticipated. | The focus of the actuarial valuation process is on real returns on assets, net of price increases.<br><br>Inter-valuation monitoring, as above, gives early warning.<br><br>Investment in index-linked bonds also helps to mitigate this risk.<br><br>The Fund holds liquid assets that can be used to pay benefits if GiA payments are inadequate in any given year |
| Effect of possible asset underperformance as a result of climate change | The EAPF has a comprehensive approach to managing this risk outlined in its Policy to Address the Risks of Climate Change. |

## 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.<br><br>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. |

## 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. |

## C5 Governance risks

| Risk | Summary of Control Mechanisms |
|---|---|
| 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.<br><br>Advice is delivered via formal meetings involving Pensions Committee Members, and recorded appropriately.<br><br>Actuarial advice is subject to professional requirements such as peer review. |

## Appendix D – Actuarial assumptions

### D1 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 and pension increases; demographic assumptions include life expectancy 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 pension increases or life expectancy; a more optimistic basis will give lower funding targets and lower GiA projections. A more prudent basis will give higher funding targets and higher GiA projections.

### D2 What assumptions are made in the Fund's standard basis?

#### a) Pension increases

The key financial assumption in determining GiA requirements is the assumed rate of pension increases. Since 2011 the consumer prices index (CPI), rather than the retail prices index (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 derived our assumption for RPI from market data as the difference between the yield on long-dated fixed interest and index-linked government bonds. An inflation risk premium was then applied to the market-implied RPI, by means of a 0.3% deduction to allow for market distortions. 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 2013 (which was 0.8%), which will serve to reduce the funding target and GiA projections (all other things being equal). (Note that the reduction is applied in a geometric, not arithmetic, basis).

#### b) Investment return / discount rate

The anticipated return on the Fund's investments is a key assumption in determining the funding position, but has no influence on the projected GiA payments required. This "discount rate" assumption is set equal to the market-implied return on long-dated UK government bonds, reflecting the Fund's low-risk investment strategy.

#### c) 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 2013 version of the Continuous Mortality Investigation model published by the Actuarial Profession and a 0.5% per annum minimum underpin to future reductions in mortality rates. This is a similar allowance for future improvements to that made in 2013.

The combined effect of the above changes from the 2013 valuation approach, is to reduce life expectancy slightly (by around 0.1-0.2 years), which reduces the funding target and GiA projections (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.

## Appendix E – Glossary

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|---|---|
| **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 body with statutory responsibility for running the Fund, in effect the Fund's "trustees". |
| **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**. |
| **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. The guarantor for the Fund is the Department for the Environment, Food and Rural Affairs (Defra). |
| **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 101 Funds which map the UK. Each LGPS Fund is autonomous to |

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|---|---|
| | 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 deferreds (ex-employees who have not yet retired) and pensioners (ex-employees who have now retired, and dependants of deceased ex-employees). |
| **Profile** | The profile of an employer's membership or liability reflects various measurements of that employer's **members**, i.e. former employees. This includes: the proportions which are deferred or pensioner; the average ages of each category; the varying pension levels, etc. A membership (or liability) profile might be measured for its **maturity** also. |
| **Valuation** | An actuarial investigation to calculate the liabilities, future service contribution rate and common contribution rate for a Fund, and usually individual employers too. This is normally carried out in full every three years (last done as at 31 March 2016), 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. |