

Annual Report 2006



Benefits of the Scheme

As a contributing member of the SFHA Pension Scheme you benefit from the following:

- A pension payable from retirement for the rest of your life, related to your final pensionable earnings at retirement.
- Annual pension increases in retirement.
- The option to exchange some pension for a tax-free lump sum on retirement; you may choose the amount (within limits) that best suits your needs.
- Partner's and/or children's pensions if you die before or after retirement.
- Life assurance (of three times your pensionable earnings) if you die whilst contributing to the Scheme (not applicable once contributions cease).
- An immediate pension if you retire due to ill-health (in defined circumstances).
- Retirement age of 65, with the option to take early retirement.
- Lump sum payment to your nominee(s), if you die after leaving the Scheme but before you start to receive your pension.



Chairman's Statement 2006

I am pleased to present this Annual Report on behalf of the SFHA Pensions Committee.

Last year my report was concerned with two main themes:

- an explanation of the causes of the 'pensions crisis' and its effect on final salary pension schemes like our own; and
- an early indication of how your Committee would respond to this challenge by conducting a major review of the pension scheme and preparing for the triennial actuarial valuation of the scheme on 30 September 2006.

I did indicate that 'our next actuarial valuation for the three years to 30 September 2006 will heavily influence the major review process. This valuation will also have to recognise the requirements for a scheme specific funding objective that came into force on 23 September 2005. This latter requirement has the aim of taking a more prudent view of scheme funding to protect members, but may increase the cost of the scheme.'

This year's report will concentrate on the following key issues that impact on the future direction of your pension scheme:

- results of the recent valuation of the pension scheme; and
- an update on progress of the major review of the scheme.

Before turning to these issues, I will now review the performance of the scheme during the past year to 30 September 2006. Our pension scheme continued to grow and develop and produced a strong investment performance, as shown below:

- Total membership continued to increase by 5.3% to 6,924 members.

- Net assets of the scheme rose 19.3% to £268.4million.
- Annual contributions receivable increased by 14.4% to £19.2million.
- A strong investment return of 12.5%, increasing net assets by £28.1million.
- The funding rate of the scheme improved to 83% in the latest valuation at 30 September 2006.

It is pleasing to report that this has been another year of growth for our scheme. The provision of decent pensions for our members remains one of the key priorities of the SFHA Pensions Committee and with the continued support of employers our final salary scheme remains open to new members, while many other final salary schemes in the UK have closed to new members, or indeed, closed even to existing members.

Our investment performance during the year was strong and exceeded comparative market benchmarks for all categories of assets in which your money was invested. This performance mirrors the recovery of global stock markets during recent years.

Finally, it is pleasing to report that the long-term viability of the scheme, measured by the funding rate, strengthened to 83% in the latest triennial valuation at 30 September 2006, compared with a rate of 80% three years earlier at 30 September 2003. The funding rate measures how much of the pension scheme's liabilities are covered by its assets, expressed as a percentage. Although this improvement in the funding rate may appear small, it is nonetheless significant and encouraging as it marks the first time since the 'pensions crisis' beset us that we have witnessed improvement in the scheme's long-term funding position. Improvement in the funding rate is critical to ensuring the long-term viability of our scheme and the future payment of pensions.

This leads me now to issues affecting the future direction of the scheme, starting with the results of the latest actuarial valuation of the scheme covering the three years to 30 September 2006. This process involves the Committee and the scheme actuary:

- reviewing the actual performance of the scheme against key assumptions made by the actuary to determine trends;
- agreeing long-term assumptions, set within a regulatory framework with an increasing bias to prudence;
- agreeing a recovery period over which the deficit in the assets available to meet liabilities is eliminated; and
- agreeing future contribution rates for employers and employee members.

Over the last three years salary increases have exceeded the actuary's assumption. This has had a negative impact on the scheme by increasing liabilities as future pensions are linked to salaries. This was more than offset by the positive effect of investment returns also exceeding the actuary's assumed returns, due to the strong recovery in global stock markets during this period.

Looking at the long-term assumptions, we have adopted a more prudent combination of assumptions than were used at the last valuation. This recognises recent adverse experience of salary increases and lower expectations for future investment returns by fund managers. Inflationary pressures have also increased recently and this is expected to impact on future salary increases and pension payments. Critically, the long-term assumptions also recognise the adverse impact of increasing mortality – the longer people live and draw a pension then the higher the pension cost.

Adoption of prudent assumptions is driven by the regulatory process, as they are ultimately approved by the Pensions Regulator; as well as the period over which we must eliminate deficits in the scheme funding.

A key factor in determining our scheme's funding position is the discount rate used for valuing future pension liabilities. Regulation requires that this is set by reference to the yield on government gilts (loans to the government). The problem with this approach is that because pension schemes are currently being encouraged en-masse to invest in government gilts rather than the stock market (to match long-term liabilities with 'safe' long-term investments), too much pension money is chasing a limited amount of government gilts.

During our review period it was estimated that a pension industry of around £800billion was scrambling to invest in a market of long-term government gilts valued at around £163billion. This pressure to buy government gilts has pushed prices up and yields down. This has had the effect of increasing the estimated liability of future pensions for our scheme.

Our investment performance during the year was strong and exceeded comparative market benchmarks.

The government has not relieved this pressure on final salary pension schemes by issuing sufficient long-term gilts, or changing the regulations requiring the discount rate to be linked to long-term gilts – good for Gordon Brown, the Chancellor, as the government can raise cheap loans, but at the expense of final salary schemes like our own! This adds further to the burden the Chancellor has imposed on pension schemes in recent years through 'stealth taxes'.

The Committee had its final meeting with the scheme actuary in January 2007 and agreed the valuation report for the scheme and the following matters contained within that report: the assumptions used; the period over which deficits have to be eliminated; and the future contribution rate. This report will be submitted for approval to the Pensions Regulator over the coming months.

Having provided this technical background to the valuation, I can cut to the key issue for employers and employee members – the new contribution rate required by the scheme actuary. Unfortunately, as was flagged up to employers attending the major review roadshows, the hostile environment for final salary pensions in which we operate requires the contribution rate to be increased to 23.1%, from a current level of 21%. This new rate will be implemented from 1 April 2008, to take the scheme to the next triennial valuation on 30 September 2009.

The SFHA Pensions Committee has been following a policy of splitting the contribution rate and changes in the contribution in a ratio of 2:1 between employers and employees. This would result in an employer rate of 15.4%, an increase of 1.4%, and an employee rate of 7.7%, an increase of 0.7%. We are required to implement the contribution rate agreed with the scheme actuary by 1 April 2008 and the Committee are proposing to consult on a continuation of the policy of splitting the contribution rate in the ratio 2:1 between employers and employees.

We believe that this proposal is equitable and its agreement is in the interests of both employers and members. It is important to note that this increase in the contribution rate is below that expected at the time of the employer roadshows and reflects continued improvement in the funding position of the scheme.

It is pleasing to report that the long-term viability of the scheme, measured by the funding rate, strengthened to 83% in the latest triennial valuation at 30 September 2006, compared with a rate of 80% three years earlier at 30 September 2003.

The Committee is keenly aware that the affordability of the existing final salary scheme is a key issue for employers. This concern brings me to the second main issue of this report, being an update on progress of the major review of the scheme.

Feedback from employers indicated that this proposed level for their contribution increase can be met by most employers and will allow them to continue providing the existing final salary scheme. Some employers have indicated any increase in the current contribution rate will prove unaffordable to them and for a small group of other employers the current level of contribution is causing them financial difficulties.

The Committee have decided, therefore, to consult with employers on the introduction of a range of options including:

- preserving the existing final salary scheme;
- options which broadly preserve their current contribution rate, but may also remove promotion cost risks, if based on career average earnings; and
- an option for reducing the current contribution rate and removing promotion cost risks, through being based on career average earnings.

These options, if introduced, will allow change both now and in the future. The options will allow employers to address issues of affordability and remain within the umbrella of the SFHA Pension Scheme and avoid immediately triggering 'buy-out' debts. They will also allow employers to change pension provision for existing members, or new members.

Protection of your scheme and the provision of decent pensions for our members will remain the highest priorities of the SFHA Pensions Committee.

In considering change, employers should bear in mind the following:

- the SFHA Pensions Committee would expect the member contribution to reduce, if alternative options are introduced, to reflect the scaling down of the members benefits;
- for those employers wishing to make change they will require to consult with their employees within a tight timescale if they wish to introduce change from the earliest opportunity being presented of 1 April 2008; and
- for employers to note that closing the scheme to new entrants may trigger a loading in their contribution rate and also potential future 'buy-out' debts.

Regarding the major review, your Committee was heartened by feedback from the employer roadshows indicating a high level of commitment to preserving the existing final salary scheme from most employers. Also for those employers wishing change they also continue to be committed to provide decent pensions for their staff – our members.

I would like to thank all Committee Members for their support and hard work during the year. Jim Wilson resigned from the Committee in 2006, after stepping down as Chair in 2005. The scheme owes a great debt to Jim for his valued contribution to its success during 22 years of service. I will miss him – a lot. David Molyneaux and Alastair Miller also resigned from the Committee in 2006 and I wish to also thank them for their contribution to the scheme over a number of years. I would also like to welcome our three new Committee Members: Ahsan Khan; Ken Tudhope; and Glen Waddell. They bring a broad range of experience and are already making their mark.

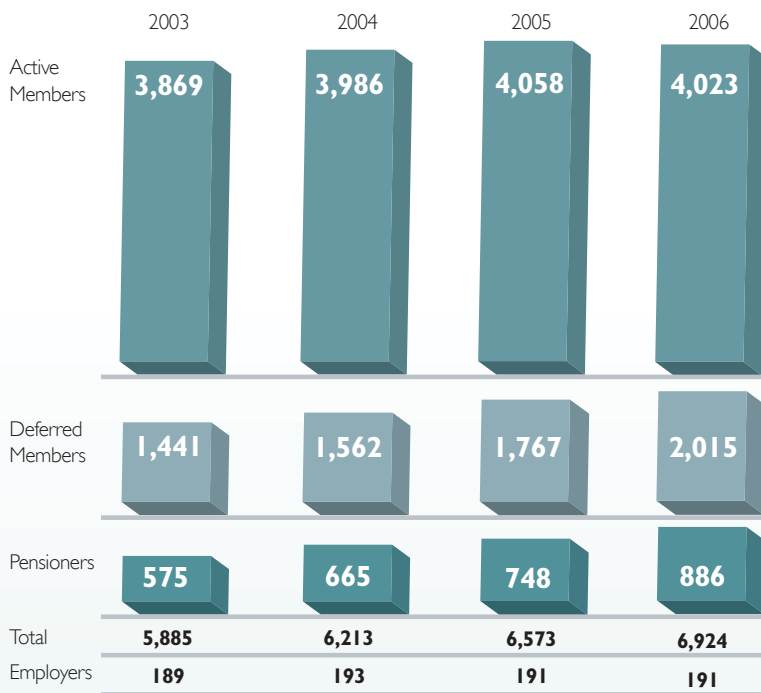
Finally, I would like to thank the staff of The Pensions Trust for the continued progress and successful growth of the scheme during the year and also our employers and members for their support. This remains a challenging time for pensions. Although difficulties lie ahead, we have made good progress over the past year, and your scheme is more favourably placed to cope with these difficulties than many other pension schemes.

Members can be assured that protection of your scheme and the provision of decent pensions for our members will remain the highest priorities of the SFHA Pensions Committee in the year ahead and beyond.



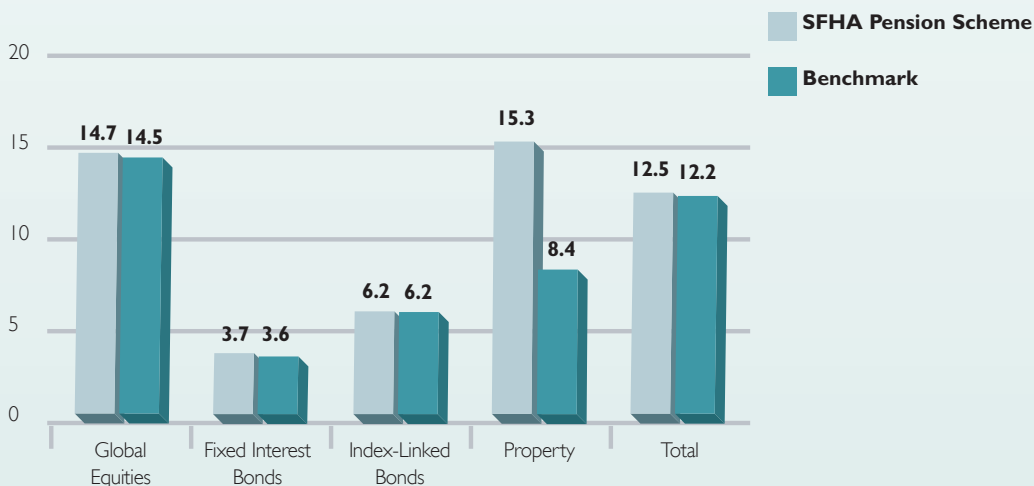
Malcolm MacDonald
Chair

Membership Growth



Total membership continues to grow steadily and has increased by 5.3% to 6,924 at 30 September 2006.

Annualised Investment Return



The total benchmark shown is the weighted average return of the benchmarks of the component funds. The SFHA Pension Scheme has an investment strategy that is invested 75% in global equities, and 25% in fixed interest bonds and property.

Fund Statement for the year ended 30 September 2006

	2006	2005
	£'000	£'000
Contributions paid by members and employers	19,176	16,764
Group and individual transfers in	2,526	2,180
Total money in	21,702	18,944
Benefits paid (pensions and lump sums)	(5,184)	(3,702)
Payments to leavers	(387)	(361)
Administrative costs	(677)	(628)
Specific expenses	(101)	(106)
Pension Protection Fund	(88)	(43)
Total money out	(6,437)	(4,840)
Net new money available for investment	15,265	14,104
Return on investments		
Investment income and gains	28,638	39,127
Investment management expenses	(542)	(423)
Net returns on investments	28,096	38,704
Net increase in the fund during the year	43,361	52,808
Fund summary		
At the beginning of the Scheme year	225,057	172,249
At the end of the Scheme year	268,418	225,057

Net Asset Statement at 30 September 2006

Global Equities	198,709	167,566
Fixed Interest Bonds	48,946	40,849
Index-Linked Bonds	0	0
Property	16,649	12,949
Total Investments	264,304	221,364
Other Assets	4,114	3,693
	268,418	225,057

The SFHA Pension Scheme is part of The Pensions Trust and this statement summarises the transactions of the Scheme and its proportionate share of expenses, investment returns and investments. The figures shown in the statement have been extracted from the audited accounts of The Pensions Trust, which were approved at a meeting of the Trustee on 12 December 2006.

The summary report is not intended to be a formal financial statement according with the terms of the SORP (Statement of Recommended Practice) for Pension Schemes. The full Report & Accounts of the Trust and the Scheme are available on request.

Valuation 2006

The scheme's three-yearly valuation as at 30 September 2006 was governed by new scheme funding regulations. These regulations became effective in September 2005 as part of a drive to improve the security of members' benefits. They demand greater prudence in setting the assumptions on which the actuary's calculations are based, and they involve the Pensions Regulator in scrutinising valuation reports and schemes' plans to deal with their deficits. The regulations require annual checks on the scheme's funding in the years between full valuations. These checks will help the Pensions Committee to monitor the progress of the scheme's funding and will deliver an early warning if the funding plan is off course.

The valuation results

There is some good news at last! The scheme's funding level has strengthened to 83.4% in the latest valuation, compared with 80% three years ago. The funding level shows how much of the scheme's liabilities are covered by its assets, expressed as a percentage.

The valuation results as at 30 September 2006 were:

	£million
Market Value of Assets	268.4
Liabilities	322.0
Deficit	(53.6)
Funding Level (Assets/Liabilities)	83.4%

The Pensions Committee has agreed a 12 year 'recovery period' from 1 April 2008 to pay off this deficit. A recovery plan will be submitted to the Pensions Regulator later this year. The Regulator will monitor the progress of our recovery plan.

Future contribution rates

As expected, the difficult environment for final salary pensions requires the contribution rate to be increased to 23.1%, (from 21%). This new rate will be implemented from 1 April 2008.

At the time of writing, the SFHA Pensions Committee is consulting with employers on a continuation of the policy of splitting the contribution rate in the ratio 2:1 between employers and employees. During the summer employers will consult with employees about contribution rates.

Major Review of Scheme

The scheme review process began in 2003 in response to widespread concerns over rising costs and sustainability. The cost of providing pensions has continued to rise as people live longer. In 2005 the SFHA Pensions Committee decided to align this second phase of the Review with the scheme's full actuarial valuation as at 30 September 2006. Any changes to the scheme will be implemented from April 2008.

Last summer the Pensions Committee conducted a preliminary consultation exercise with employers; around 55% of participating employers attended meetings or responded in writing.

Current position

As expected, the scheme valuation has confirmed that the cost of providing benefits has risen. The total contribution rate needs to increase from 21.0% of pensionable earnings to 23.1% from 1 April 2008. The valuation is explained in more detail elsewhere in this document.

The Pensions Committee considered employers' responses to the preliminary consultation. Feedback indicated that many employers would be able to afford the proposed contribution increase, and would be able to continue to offer the existing 'Final Salary 60ths' benefits. However, some employers indicated they would be unable to afford the proposed level of increase, and for a small number of employers the current contribution rate is already causing financial difficulties. Given these concerns, the Pensions Committee has explored a number of options for future benefit provision.

Continued...

Major Review of Scheme – Continued

Proposals for change

Since it began in 1978 the SFHA Pension Scheme has been a 'final salary' scheme. At normal retirement age members receive a pension of 1/60th of their final pensionable earnings for each year of scheme service.

The Pensions Committee is, as we write, consulting with employers on changing the present 'one size fits all' approach to pension provision. The Pensions Committee proposes that the scheme should offer three 'defined benefit' options, from which employers can choose what their organisation will offer to current and future employees. The current 'final salary 60ths' benefit structure is included in the proposed options.

By law, benefits already built up cannot be reduced or removed without member consent. The introduction of options into the scheme would not reduce or remove the benefits members have already built up.

Consultation with employees

Under the terms of the Pensions Act 2004, employers with over 100 employees will be required to consult with employees on changes to the pension scheme. Smaller organisations may be required by their own internal procedures or governance arrangements to undertake consultation. The SFHA Pensions Committee and The Pensions Trust will be unable to carry out consultation on behalf of employers.

Consultation may be required about

- the proposed increase to the member contribution rate for the Final Salary 60ths option (where current employees will remain on that benefit structure);
- if the Pensions Committee's proposals are accepted, switching to one of the proposed alternative options for future pensionable service (where the employer believes it is not possible to continue with Final Salary 60ths for existing employees).

More information about the review will be provided to employers and members in May 2007.

Age discrimination

The Employment Equality (Age) Regulations became effective on 1 October 2006 (for employment issues) and 1 December 2006 (for issues related to occupational pension schemes). The pensions aspects were delayed slightly to allow employers and trustees more time to audit their schemes and if need be, take legal advice.

In most respects the SFHA Pension Scheme was compliant with the provisions of the regulations.

Has anything changed?

A very important new feature introduced into the scheme to ensure compliance with the regulations is:

Staying in the scheme after age 65

Members allowed to work on after age 65 will be able to continue their membership of the pension scheme if they want to. They can benefit from life cover and additional years of pensionable service up to the date they leave or, if earlier, age 75, when benefits must be taken. Pension contributions must be paid. The benefits payable will be the higher of

- (a) pension calculated at age 65, increased until the pension is drawn; plus

pension from 65 to date of leaving (or age 75 if earlier), calculated on final pensionable earnings at that date.

or

- (b) pension calculated at date of leaving (or age 75 if earlier) on total pensionable service and final pensionable earnings at that date.

The SFHA Pension Scheme Guide for Members is being amended to reflect this change – please look out for a copy on the scheme's website www.sfhaps.org.uk

Your Pensions Committee

The Pensions Committee meets at least four times a year to monitor the Scheme. It has responsibility for the successful management and operation of the Scheme in the interests of all members.

The Pensions Committee includes:

- Three individuals elected by members
- Three individuals elected by employers
- Up to three co-opted members

The Pensions Committee members are currently:

Malcolm MacDonald, Govanhill Housing Association
Christine Murphy, Elderpark Housing Association
Jim Michael, Glasgow West Housing Association
Kathryn Miller, SFHA
Sally Inkster, Orkney Housing Association
Ken Tudhope, Atrium Homes
Ahsan Khan, Loreburn Housing Association
Glen Waddell, Ark Housing Association

The Scheme Secretary is Susan Wardlaw, who is based in The Pensions Trust's Edinburgh office.

Professional Advisers & Bankers

Actuarial Consultants

HSBC Actuaries and Consultants Ltd

Scheme Actuary

Steven Robinson of HSBC Actuaries and Consultants Ltd

Auditors

KPMG LLP

Solicitors

McGrigor Donald

Mayer, Brown, Rowe & Maw LLP (to September 2006)

Linklaters (from August 2006)

Bankers

The Royal Bank of Scotland plc

Investment Managers

Legal & General Investment Management Ltd

Fidelity Pensions Management Ltd

Barclays Global Investors Ltd

Capital International Ltd

F&C Asset Management plc

Morley Fund Management Ltd

Standard Life Investments

Property Investment Managers

CB Richard Ellis Investors Ltd

Investment Consultants

Watson Wyatt Investment (to May 2006)

Mercer Investment Consulting (from June 2006)

Custodians

The Northern Trust Company (inc. Illinois)

Mayer, Brown, Rowe & Maw LLP (for property deeds)

Measurement of Investment Performance

The Northern Trust Company (inc. Illinois)

Custody Consultants

Chatham Partners

Pensions Consultants

SBJ Benefit Consultants Ltd

Trustee

Verity Trustees Ltd



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