ROYAL BOROUGH OF KENSINGTON AND CHELSEA

INVESTMENT COMMITTEE –17 NOVEMBER 2016

PENSION BOARD 16 JANUARY 2017

REPORT OF THE TOWN CLERK

FUNDING STRATEGY STATEMENT

This is the Funding Strategy Statement (FSS) for the Royal Borough of Kensington and Chelsea Pension Fund (the Fund). It has been prepared in accordance with Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (the Regulations). It should be read in conjunction with the Fund's Statement of Investment Principles (SIP) and Investment Strategy Statement (ISS).

The Funding Strategy Statement has been updated following the 2016 CIPFA advice on Preparing and Maintaining a Funding Strategy Statement. The Committee is asked to note the revised statement and approve its issuance for consultation.

FOR INFORMATION

1. Purpose of the Funding Strategy Statement

1.1 The purpose of this Funding Strategy Statement is to explain the funding objectives of the Fund and in particular:

- How the costs of the benefits provided under the Local Government Pension Scheme (the "Scheme") are met though the Fund in a prudent way;
- The objectives in setting employer contribution rates and the desirability of maintaining stability in the primary contribution rate; and
- Ensuring that the regulatory requirements to set contributions that will maintain the solvency and long term cost-efficiency of the Fund are met.

2. Aims and Purpose of the Fund

2.1 The aims of the Fund are to:

- Manage employers' liabilities effectively and ensure that sufficient resources are available to meet all liabilities as they fall due;
- Enable primary contribution rates to be kept as nearly constant as possible; and
- Seek returns on investment within reasonable risk parameters.

2.2 The purpose of the Fund is to:

- Pay pensions, lump sums and other benefits provided under the Regulations;
- Meet the costs associated in administering the Fund; and
- Receive contributions, transfer values and investment income.

3. Responsibilities of Key Parties

3.1 The key parties involved in the funding process and their responsibilities are as follows:

4. The Administering Authority

4.1 The Administering Authority for the Royal Borough's Pension Fund is the Royal Borough of Kensington and Chelsea. The main responsibilities of the Administering Authority are to:

- Operate a pension fund;
- Collect employee and employer contributions investment income and other amounts due to the Fund, as stipulated in the LGPS Regulations;
- Invest the Fund's assets in accordance with the LGPS regulations;
- Pay the benefits due to Scheme members; as stipulated by the LGPS regulations;
- Ensure that cash is available to meet liabilities as and when they fall due;
- Take measures as set out in the regulations to safeguard the Fund against the consequences of employer default;
- Manage the actuarial valuation process in conjunction with the Fund Actuary;
- Prepare and maintain this FSS, the SIP and ISS after consultation with other interested parties; and
- Monitor all aspects of the Fund's performance and funding, amending the FSS and ISS accordingly;
- Manage any potential conflicts of interest arising from the Borough''s dual role as scheme employer and fund administrator
- Enable the local pension board to review the valuation process as set out in their terms of reference.

Individual Employers

4.2 In addition to the Administering Authority, a number of scheduled and admitted bodies participate in the Fund.
The responsibilities of each individual employer that participates in the Fund, including the Administering Authority, are to:

- Deduct contributions from employees' salaries correctly and pay these, together with their own employer contributions as certified by the Fund Actuary, to the Administering Authority within the statutory timescales;
- Notify the Administering Authority of all changes in Scheme membership and any other membership changes promptly;

- Exercise any discretions permitted under the Regulations; and
- Meet the costs of any augmentations or other additional costs, such as early retirement strain, in accordance with agreed policies and procedures.

Fund Actuary

4.3 The Fund Actuary for the Royal Borough's Pension Fund is Barnett Waddingham LLP. The main responsibilities of the Fund Actuary are to:

- Prepare valuations including the setting of employers' contribution rates at a level to ensure Fund solvency and long term cost efficiency after agreeing assumptions with the administering authority and having regard to the FSS and the LGPS regulations;
- Prepare advice and calculations in connection with bulk transfers and the funding aspects of individual benefit related matters such as pension strain costs, ill health retirement costs, compensatory added years costs, etc.
- Provide advice and valuations on the exiting of employers in the Fund
- Advise the administering authority on bonds and other forms of security against the financial effect on the Fund of employer default.
- Assist the administering authority in assessing whether employer contributions need to be revised between valuations as permitted or required by the regulations.
- Ensure that the administering authority is aware of any professional guidance or other professional requirements that may be of relevance to the administrator's role in advising the fund; and
- Advise on other actuarial matters affecting the financial position of the Fund.

5. Solvency Issues and Target Funding Levels

5.1 Given the statutory position of the LGPS administering authorities and the tax-backed nature of employing authorities who make up the core of the scheme and the statutory basis of the scheme, the LGPS remains outside the solvency arrangements established for private sector occupational pension schemes.

5.2 LGPS regulations require each administering authority to secure fund solvency and long-term cost efficiency by means of employer contribution rates established by mandatory valuation exercises.

5.3 Maintaining as nearly a constant a primary employer contribution rate is a desirable outcome, but not a regulatory requirement. It is for LGPS administering authorities to seek to achieve a balance between the objectives in a prudent manner.

5.4 Solvency is defined as meaning that the rate of employer contributions should be set at such a level as to ensure that the scheme's liabilities can be met as they arise. This does not mean that the Fund should be 100 per cent funded at all times, but that the rate of employer contributions should be set to target a funding level for the whole fund of 100 per cent over an appropriate time period and using an appropriate set of actuarial assumptions.

5.5 Employers should collectively have the financial capacity to increase employer contributions and/or the Fund should be able to realise contingent assets if future circumstances require, in order to continue to target a funding level of 100 per cent. If these conditions are met, it is anticipated that the Fund will be able to pay scheme benefits as they fall due.

5.6 The rate of employer contributions shall be deemed to be set at an appropriate level to ensure long-term cost efficiencyif the rate of employer contributions is sufficient to make provision for the cost of current benefit accrual, with an appropriate adjustment to the rate for any surplus or deficit in the Fund. The Government Actuary's Department (GAD) will assess whether this condition is met.

6. Primary rate of the employers' contribution

6.1 The primary rate for each employer is that employer's future service contribution rate which is the contribution rate required to meet the cost of the future accrual of benefits, expressed as a percentage of pensionable pay, ignoring any past service surplus or deficit, but allowing for any specific employer circumstances.

6.2 The primary rate for the whole Fund is the weighted average, by payroll, of the individual employers' primary rates.

6.3 The secondary rate of the employer's contribution is an adjustment to the primary rate to arrive at the rate each employer is required to pay. It may be expressed either as a percentage adjustment to the primary rate and/or as a cash adjustment for each of the three years of the inter-valuation period. This will be set out in the rates and adjustments certificate. For any employer, the rate they are actually required to pay is the sum of the primary and secondary rates.

6.4 The actuary should disclose the secondary rates for the whole scheme in each of the three inter-valuation years. These should be calculated as a weighted average based on the whole scheme payroll. The purpose of this is to facilitate a single net rate of contributions expected to be received over each of the three years that can be readily compared with other rates and reconciled with actual receipts.

7 Solvency Issues and Non Local Authority Employers

7.1 The number and type of non local government bodies operating within the LGPS has grown considerably since 2004, when Funding Strategy Statements were first introduced. There are now many more private sector contractors, companies spun off from local authorities and academies which have employees who continue to qualify for membership by dint of transferred rights under the TUPE regulations. Employees in academies qualify for the scheme because of academies' scheduled body status. Key issues are:

- The need to set appropriate employer contribution levels and deficit recovery periods for these employers which do not have tax-raising powers and therefore have weaker covenants than local authorities;
- The underlying investment strategy of the assets backing the liabilities of these employers;
- The financial standing of those employers (or their parent companies or guarantors) and their ability to meet the cost of current membership, fund any deficit and ability to ensure against default.
- The long and short term effects of high contribution rates on non local authority employers in terms of their financial viability.

7.2 In the interests of transparency, the FSS should clearly set out the risk assessment methodology to assess the long term financial health of employers and how this will be monitored. **This will be included when the actuarial valuation results are known, along with any issues regarding the increasing maturity of the Fund**.

8. Valuation Assumptions and Funding Model

8.1 In completing the actuarial valuation it is necessary to formulate assumptions about the factors affecting the Fund's future finances such as inflation, pay increases, investment returns, rates of mortality, early retirement and staff turnover etc.

8.2 The assumptions adopted at the valuation can therefore be considered as:

- The statistical assumptions which are essentially estimates of the likelihood of benefits and contributions being paid, and
- The financial assumptions which will determine the estimates of the amount of benefits and contributions payable and their current or present value.

Future Price Inflation

8.3 The base assumption in any valuation is the future level of price inflation over a period commensurate with the duration of the liabilities. This is derived by considering the average difference in yields over the appropriate period from conventional and index linked gilts during the six months straddling the valuation date to provide an estimate of future price inflation as measured by the Retail Price Index (or "RPI").

Future Pay Inflation

8.4 As some of the benefits are linked to pay levels at retirement, it is necessary to make an assumption as to future levels of pay inflation. Historically, there has been a close link between price and pay inflation with pay increases exceeding price inflation in the longer term. However, in recent years, this model has broken down due to pay freezes in the public sector and continuing restraint to restrict salary growth across many sectors.

Future Pension Increases

8.5 Pension increases are linked to changes in the level of the Consumer Price Index (or "CPI"). Inflation as measured by the CPI has historically been less then RPI due mainly to different calculation methods. An adjustment is therefore made to the RPI assumption to derive the CPI assumption.

Future Investment Returns/Discount Rate

8.6 To determine the value of accrued liabilities and derive future contribution requirements it is necessary to discount future payments to and from the Fund to present day values.

8.7 The discount rate that is adopted will depend on the funding target adopted for each employer.

8.8 For open employers, the discount rate that is applied to all projected liabilities reflects a prudent estimate of the rate of investment return that is expected to be earned from the underlying investment strategy by considering average market yields in the six months straddling the valuation date. The discount rate so determined may be referred to as the "ongoing" discount rate.

8.9 For closed employers, an adjustment may be made to the discount rate in relation to the remaining liabilities, once all active members are assumed to have retired if at that time (the projected "termination date"), the employer either wishes to leave the Fund, or the terms of their admission require it.

8.10 The Fund Actuary will incorporate such an adjustment after consultation with the Administering Authority.

8.11 The adjustment to the discount rate for closed employers is to set a higher funding target at the projected termination date, so that there are sufficient assets to fund the remaining liabilities on a "minimum risk" rather than on an ongoing basis. The aim is to minimise the risk of deficits arising after the termination date.

Asset Valuation

8.12 For the purposes of the valuation, the asset value used is the market value of the accumulated Fund at the valuation date adjusted to reflect average market conditions during the six months straddling the valuation date.

Statistical Assumptions

8.13 The statistical assumptions incorporated into the valuation, such as future mortality rates, are based on national statistics. These are adjusted as appropriate to reflect the individual circumstances of the Fund and/or individual employers.

9. Deficit Recovery/Surplus Amortisation Periods

9.1 Whilst one of the funding objectives is to build up sufficient assets to meet the cost of benefits as they accrue, it is recognised that at any particular point in time, the value of the accumulated assets will be different to the value of accrued liabilities, depending on how the actual experience of the Fund differs to the actuarial assumptions. Accordingly the Fund will normally either be in surplus or in deficit.

9.2 Where the actuarial valuation discloses a significant surplus or deficit then the levels of required employers' contributions will include an adjustment to either amortise the surplus or fund the deficit over a period of years.

9.3 The period that is adopted for any particular employer will depend on:

- The significance of the surplus or deficit relative to that employer's liabilities;
- The covenant of the individual employer and any limited period of participation in the Fund; and
- The implications in terms of stability of future levels of employers' contribution.

10. Pooling of Individual Employers

10.1 The policy of the Fund is that each individual employer should be responsible for the costs of providing pensions for its own employees who participate in the Fund. Accordingly, contribution rates are set for individual employers to reflect their own particular circumstances.

10.2 However, certain groups of individual employers are pooled for the purposes of determining contribution rates to recognise common characteristics or where the number of Scheme members is small. This is the reason for pooling academies within the Fund.

10.3 The main purpose of pooling is to produce more stable employer contribution levels in the longer term whilst, recognising that ultimately there will be some level of cross-subsidy of pension cost amongst pooled employers.

11. Cessation Valuations

11.1 On the cessation of an employer's participation in the Scheme, the Fund Actuary will be asked to make a termination assessment. Any deficit in the Fund in respect of the employer will be due to the Fund as a termination contribution, unless it is agreed by the Administering Authority and the other parties involved that the assets and liabilities relating to the employer will transfer within the Fund to another participating employer.

11.2 In assessing the deficit on termination, the Fund Actuary may adopt a discount rate based on gilt yields and adopt different assumptions to those used at the previous valuation in order to protect the other employers in the Fund from having to fund any future deficits which may arise from the liabilities that will remain in the Fund.

12. Links with the Statement of Investment Principles (SIP)

12.1 The main link between the Funding Strategy Statement (FSS) and the SIP relates to the discount rate that underlies the funding strategy as set out in the FSS, and the expected rate of investment return which is expected to be achieved by the underlying investment strategy as set out in the SIP.

12.2 As explained above, the ongoing discount rate that is adopted in the actuarial valuation is derived by considering the expected return from the underlying investment strategy. This ensures consistency between the funding strategy and investment strategy.

13. Risks and Countermeasures

13.1 Whilst the funding strategy attempts to satisfy the funding objectives of ensuring sufficient assets to meet pension liabilities and stable levels of employer contributions, it is recognised that there are risks that may impact on the funding strategy and hence the ability of the strategy to meet the funding objectives.

13.2 The major risks to the funding strategy are financial, although there are other external factors including demographic risks, regulatory risks and governance risks.

14. Financial Risks

14.1 The main financial risk is that the actual investment strategy fails to produce the expected rate of investment return (in real terms) that underlies the funding strategy. This could be due to a number of factors, including market returns being less than expected and/or the fund managers who are employed to implement the chosen investment strategy failing to achieve their performance targets.

14.2 The valuation results are most sensitive to the real discount rate. Broadly speaking an increase/decrease of 0.5 per cent per annum in the real discount rate will decrease/increase the liabilities by ten per cent, and decrease/increase the required employer contribution by around 2.5 per cent of payroll.

14.3 However, the Investment Committee regularly monitors the investment returns achieved by the fund managers and receives advice from the independent advisers and officers on investment strategy.

14.4 The Committee may also seek advice from the Fund Actuary on valuation related matters.

14.5 In addition, the Fund Actuary provides funding updates between valuations to check whether the funding strategy continues to meet the funding objectives.

15. Demographic Risks

15.1 Allowance is made in the funding strategy via the actuarial assumptions for a continuing improvement in life expectancy. However, the main demographic risk to the funding strategy is that it might underestimate the continuing improvement in longevity. For example, an increase of one year to life expectancy of all members in the Fund will reduce the funding level by between 0.5 to one per cent.

15.2 The actual mortality of pensioners in the Fund is monitored by the Fund Actuary at each actuarial valuation and assumptions are kept under review.

15.3 The liabilities of the Fund can also increase by more than has been planned as a result of early retirements.

15.4 However, the Administering Authority monitors the incidence of early retirements; and procedures are in place that require individual employers to pay additional amounts into the Fund to meet any additional costs arising from early retirements.

16. Regulatory Risks

16.1 The benefits provided by the Scheme and employee contribution levels are set out in Regulations determined by central government. The tax status of the invested assets is also determined by central government.

16.2 The funding strategy is therefore exposed to the risks of changes in the Regulations governing the Scheme and changes to the tax regime which may affect the cost to individual employers participating in the Scheme.

16.3 However, the Administering Authority participates in any consultation process of any proposed changes in Regulations and seeks advice from the Fund Actuary on the financial implications of any proposed changes.

17. Governance

17.1 Many different employers participate in the Fund. Accordingly, it is recognised that a number of employer-specific events could impact on the funding strategy including:

- Structural changes in an individual employer's membership;
- An individual employer deciding to close the Scheme to new employees; and
- An employer ceasing to exist without having fully funded their pension liabilities.

17.2 However, the Administering Authority monitors the position of employers participating in the Fund, particularly those which may be susceptible to the events outlined, and takes advice from the Fund Actuary when required.

17.3 In addition, the Administering Authority keeps in close touch with all individual employers participating in the Fund to ensure that, as Administering Authority, it has the most up to date information available on individual employer situations. It also keeps individual employers briefed on funding and related issues.

18. Monitoring and Review

18.1 This FSS is reviewed formally, in consultation with the key parties, at least every three years to tie in with the triennial actuarial valuation process.

18.2 The Administering Authority also monitors the financial position of the Fund between actuarial valuations and may review the FSS more frequently if necessary.

FOR INFORMATION

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Background Papers: 2014 Funding Strategy Statement.
CIPFA guidance on Preparing and Maintaining a Funding Strategy Statement in the LGPS. September 2016