

ROYAL BOROUGH OF KENSINGTON AND CHELSEA

INVESTMENT COMMITTEE –7 NOVEMBER 2012

REPORT OF THE TOWN CLERK AND EXECUTIVE DIRECTOR OF
FINANCE

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 35 of the Local Government Pension Scheme (Administration) Regulations 2007 (the Regulations). It should be read in conjunction with the Fund's Statement of Investment Principles (SIP).

The Committee is asked to note the Fund's Funding Strategy Statement for inclusion in the Fund's 2011-12 Report and Accounts

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 (LGPS) are met through the Fund
 - The objectives in setting employer contribution rates; and
 - The funding strategy that is adopted to meet these objectives.

2. Purpose of the Fund

- 2.1 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. Funding Objectives

- 3.1 Contributions are paid to the Fund by Scheme members and the employing bodies to provide for the benefits which will become payable to Scheme members when they fall due.

- 3.2 The funding objectives are to:
- Set levels of employer contribution that will build up a Fund of assets that will be sufficient to meet all future benefit payments from the Fund.
 - Build up the required assets in such a way that employer contribution rates are kept as low and stable as possible.

4. Key Parties

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

The Administering Authority

- 4.2 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:
- Collect employee and employer contributions;
 - Invest the Fund's assets;
 - Pay the benefits due to Scheme members;
 - Manage the actuarial valuation process in conjunction with the Fund Actuary;
 - Prepare and maintain this FSS and also the SIP after consultation with other interested parties; and
 - Monitor all aspects of the Fund's performance.

Individual Employers

- 4.3 In addition to the Administering Authority, a number of scheduled and admitted bodies participate in the Fund. Those with active members are all currently open to new members, although it is anticipated that some may close to new and possibly existing members in the near future (see 6.2 below).
- The responsibilities of each individual employer that participates in the Fund, including the Administering Authority, are to: Collect employee contributions 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 any new Scheme members and any other membership changes promptly;
 - Exercise any discretions permitted under the Regulations; and
 - Meet the costs of any augmentations or other additional costs in accordance with agreed policies and procedures.

Fund Actuary

- 4.4 The Fund Actuary for the Royal Borough's Pension Fund is Barnett Waddingham LLP. The main responsibilities of the Fund Actuary are to:
- Advise interested parties on funding strategy and completion of actuarial valuations in accordance with the FSS and the Regulations; and
 - Advise on other actuarial matters affecting the financial position of the Fund.

5. Funding Strategy

- 5.1 The factors affecting the Fund's finances are constantly changing, so it is necessary for its financial position and the contributions payable to be reviewed from time to time by means of an actuarial valuation to check that the funding objectives are being met.
- 5.2 The actuarial valuation involves a projection of future cash flows to and from the Fund. The main purpose of the valuation is to determine the level of employers' contributions that should be paid to ensure that the existing assets and future contributions will be sufficient to meet all future benefit payments from the Fund.

6. Funding Method

- 6.1 The key objective in determining employer's contribution rates is to establish a funding target and then set levels of employer contribution to meet that target over an agreed period.
- 6.2 The funding target is to have sufficient assets in the Fund to meet the accrued liabilities for each employer in the Fund. The funding target may, however, depend on certain employer circumstances and in particular, whether an employer is an "open" employer – one which allows new recruits access to the Fund, or a "closed" employer which no longer permits new staff access to the Fund. The expected period of participation by an employer in the Fund may also affect the chosen funding target.
- 6.3 The last actuarial valuation was carried out as at 31 March 2010. For open employers, the actuarial funding method that was adopted is known as the Projected Unit Funding Method which considers separately the benefits in respect of service completed before the valuation date ("past service") and benefits in respect of service expected to be completed after the valuation date ("future service"). This approach focuses on:
- The past service funding level of the Fund. This is the ratio of accumulated assets to liabilities in respect of past service. It makes allowance for future increases to members' pay for pensions

in payment. A funding level in excess of 100 per cent indicates a surplus of assets over liabilities; while a funding level of less than 100 per cent indicates a deficit; and

- The future service funding rate which is. the level of contributions required from the individual employers which, in combination with employee contributions is expected to support the cost of benefits accruing in future.

6.4 The key feature of this method is that, in assessing the future service cost, the contribution rate represents the cost of one year's benefit accrual.

6.5 For closed employers, the funding method adopted is known as the Attained Age Method. The key difference between this method and the Projected Unit Method is that the Attained Age Method assesses the average cost of the benefits that will accrue over the remaining expected working lifetime of active members.

7. Valuation Assumptions and Funding Model

7.1 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.

7.2 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

7.3 The base assumption in any valuation is the future level of price inflation. This is derived by considering the average difference in yields from conventional and index linked gilts during the six months straddling the valuation date.

Future Pay Inflation

7.4 As 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 in excess of price inflation averaging between one per cent and three per cent per annum, depending on economic conditions. The assumption adopted in the valuation is that pay increases will, on average over the longer term, exceed price inflation by 1.25 per cent per annum. It was

also assumed in the valuation as at 31 March 2010 that there would be a two-year pay freeze for active members earning over £21,000 per annum.

Future Investment Returns/Discount Rate

- 7.5 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.
- 7.6 The discount rate that is adopted will depend on the funding target adopted for each employer.
- 7.7 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.
- 7.8 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.
- 7.9 The Fund Actuary will incorporate such an adjustment after consultation with the Administering Authority.
- 7.10 The adjustment to the discount rate 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

- 7.11 The market value of the accumulated Fund at the valuation date is adjusted to reflect average market conditions during the six months straddling the valuation date.

Statistical Assumptions

- 7.12 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.

8. Deficit Recovery/Surplus Amortisation Periods

- 8.1 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.
- 8.2 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.
- 8.3 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.
- 8.4 At the 2010 valuation, the period adopted to recover the deficit varied by employer, but was no more than ten years.

9. Pooling of Individual Employers

- 9.1 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.
- 9.2 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.
- 9.3 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.

10. Cessation Valuations

- 10.1 On the cessation of an employer's participation in the Scheme, the actuary will be asked to make a termination assessment. Any deficit in the Scheme in respect of the employer will be due to the Scheme 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 Scheme to another participating employer.

- 10.2 In assessing the deficit on termination, the 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.

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

- 11.1 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.
- 11.2 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.

12. Risks and Counter Measures

- 12.1 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.
- 12.2 The major risks to the funding strategy are financial, although there are other external factors including demographic risks, regulatory risks and governance risks.

13. Financial Risks

- 13.1 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.
- 13.2 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.

- 13.3 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.
- 13.4 The Committee may also seek advice from the Fund Actuary on valuation related matters.
- 13.5 In addition, the Fund Actuary provides funding updates between valuations to check whether the funding strategy continues to meet the funding objectives.

14. Demographic Risks

- 14.1 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.
- 14.2 The actual mortality of pensioners in the Fund is monitored by the Fund Actuary at each actuarial valuation and assumptions are kept under review.
- 14.3 The liabilities of the Fund can also increase by more than has been planned as a result of early retirements.
- 14.4 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.

15. Regulatory Risks

- 15.1 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.
- 15.2 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.
- 15.3 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.

16. Governance

16.1 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.

16.2 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.

16.3 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.

17. Monitoring and Review

17.1 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.

17.2 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: Draft Funding Strategy Statement prepared by Mr Graeme Muir FFA of Barnett Waddingham Public Sector Consulting, May 2011