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AUDIT AND PENSIONS COMMITTEE

17th February 2011

CONTRIBUTORS	FUNDING STRATEGY STATEMENT	WARDS
DF	This report seeks approval of the Funding Strategy Statement, prior to consultation with all participating employers in the Fund. The Statement has been revised to take account of the actuarial valuation as at 31st March 2010	**All**

RECOMMENDATION:

1. To agree the Funding Strategy Statement, prior to consultation with all participating employers in the Fund.

2. To delegate the finalisation of the Statement to the Director of Finance and Corporate Services.

1. INTRODUCTION

1.1 Regulation 76A of the Local Government Pension Scheme Regulations 1997 (the LGPS Regulations) and Regulation 35 of the Local Government Pension Scheme (Administration) Regulations 2008 require administering authorities to prepare, maintain and publish a Funding Strategy Statement. The Statement describes the London Borough of Hammersmith & Fulham's strategy, in its capacity as Administering Authority, for the funding of the London Borough of Hammersmith & Fulham Pension Fund (the Fund).

1.2 As required by Regulation 76A(2)(a) the Statement has been prepared having regard to guidance published by CIPFA in March 2004 and in accordance with Regulation 76A(1), all employers participating within the London Borough of Hammersmith & Fulham Pension Fund will be consulted on the contents of this Statement and their views will be taken into account in finalising the Statement.

1.3 The regulations require authorities to review and revise the Statement on a regular basis particularly following any material change in the Council's policy. The Statement which has been prepared in conjunction with Barnett Waddingham, the Fund's actuary, has been revised now as the last stage of the actuarial valuation process and includes the assumptions made by the actuary at the 31st March 2010 actuarial valuation. This is in accordance with Regulation 36(6)(c) of the Local Government Pension Scheme (Administration) Regulations 2008 which states that the actuary at the actuarial valuation must have regard to the current version of the Administering authority's Funding Strategy Statement mentioned in Regulation 35. Minor amendments have also been made to update the Statement.

2. RECOMMENDATION

2.1 Approval of the statement is now recommended prior to consultation with all participating employers in the Fund and delegated authority is recommended to be given to the Director of Finance and Corporate Services to finalise and publish the statement following such consultation. The statement will be published on the Council's website and included in the Pension Fund Annual Report.

LOCAL GOVERNMENT ACT 2000 LIST OF BACKGROUND PAPERS

No.	Description of Background Papers	Name/Ext. of Holder of File/Copy	Department/ Location
1	Funding Strategy Statement File	P. Gough Extension 2542	Room 42, Town Hall

Overview

This Statement has been prepared in accordance with Regulation 76A of the Local Government Pension Scheme Regulations 1997 (the LGPS Regulations) and Regulation 35 of the Local Government Pension Scheme (Administration) Regulations 2008 (the LGPS Regulations). The Statement describes the London Borough of Hammersmith & Fulham's strategy, in its capacity as Administering Authority, for the funding of the London Borough of Hammersmith & Fulham Pension Fund (the Fund).

As required by Regulation 76A(2)(a) the Statement has been prepared having regard to guidance published by CIPFA in March 2004.

Consultation

In accordance with Regulation 76A(1), all employers participating within the London Borough of Hammersmith & Fulham Pension Fund will be consulted on the contents of this Statement and their views will be taken into account in finalising the Statement. However, the Statement describes a single strategy for the Fund as a whole.

In addition, as required by Regulation 76A(2)(b), the Administering Authority has had regard to the Fund's Statement of Investment Principles published under Regulation 12 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (the Investment Regulations).

The Fund Actuary, Barnett Waddingham has been consulted on the contents of this Statement.

Policy Purpose

The three main purposes of this Funding Strategy Statement are:

- To establish a clear and transparent strategy, specific to the Fund, which will identify how employers' pension liabilities are best met going forward.
- To support the regulatory requirement in relation to the desirability of maintaining as nearly constant employer contribution rates as possible.
- To take a prudent longer-term view of funding the Fund's liabilities.

The Aims of the Fund

The aims of the Fund are:

1. <u>To enable employer contribution rates to be kept as nearly constant as possible and at reasonable cost to the scheduled bodies, admission bodies and to the taxpayers.</u>

   The Administering Authority recognises that the requirement to keep employer contribution rates as nearly constant as possible can run counter to the following requirements:

   - the regulatory requirement to secure solvency,

- the requirement that the costs should be reasonable, and
- maximising income from investments within reasonable cost parameters (see below)

Producing low volatility in employer contribution rates can require material investment in assets which ‘match’ the employer’s liabilities. In this context, ‘match’ means assets that behave in a similar manner to the liabilities as economic conditions alter. For the liabilities represented by benefits payable by the Local Government Pension Scheme, such assets would tend to comprise gilt-edged investments.

Other classes of assets, such as equities, are perceived to offer higher long term rates of return, on average, and consistent with the requirement to maximise the returns from investments, the Administering Authority invests a substantial proportion of the Fund in such assets. However, these assets are more risky in nature, and that risk can manifest itself in volatile returns over short-term periods.

This short-term volatility in investment returns can produce a consequent volatility in the measured funding position of the Fund at successive valuations, with knock on effects on employer contribution rates. The impact on employer rates can be mitigated by use of smoothing adjustments at each valuation within the valuation funding model.

The Administering Authority recognises that there is a balance to be struck between the investment objectives adopted, the smoothing mechanisms used at valuations, and the resultant smoothness of employer contribution rates from one valuation period to the next.

The Administering Authority also recognises that the position is potentially more volatile for Admission Bodies with short term contracts where utilisation of smoothing mechanisms is less appropriate.

2. <u>To ensure that sufficient resources are available to meet all liabilities as they fall due</u>.

   The Administering Authority recognises the need to ensure that the Fund has, at all times, sufficient liquid assets to be able to pay pensions, transfer values, costs, charges and other expenses. It is the Administering Authority’s policy that such expenditure is met, in the first instance, from incoming employer and employee contributions to avoid the expense of selling assets. The Administering Authority monitors the position on a monthly basis to ensure that all cash requirements can be met.

3. <u>To manage employers’ liabilities effectively.</u>

   The Administering Authority seeks to ensure that all employers’ liabilities are managed effectively. In a funding context, this is achieved by seeking regular actuarial advice, ensuring that employers and Audit and Pensions Committee members are properly informed, and through regular monitoring of the funding position.

4. <u>To maximise the income from investments within reasonable risk parameters.</u>

   The Administering Authority recognises the desirability of maximising investment income within reasonable risk parameters. Investment returns higher than those available on government stocks are sought through investing a substantial proportion of the Fund’s investments in other asset classes such as equities. The Administering Authority ensures that risk parameters are reasonable by:

- Restricting investment to the levels permitted by the Investment Regulations.
- Restricting investment to asset classes generally recognised as appropriate for UK pension funds.
- Analysing the potential risk represented by those asset classes in collaboration with the Fund Actuary, Investment Advisor and Fund Managers.

Purpose of the Fund

The purpose of the Fund is:

1. To pay out all scheme benefits, transfer values, costs, charges and expenses.
2. To receive contributions, transfer values and investment income.

Responsibilities of the key parties

The three parties whose responsibilities to the Fund are of particular relevance are the Administering Authority, the Individual Employers and the Fund Actuary.

Their key responsibilities are as follows:

Administering Authority

The Administering Authority's key responsibilities are:

1. Collecting employer and employee contributions and, as far as the Administering Authority is able to, ensure these contributions are paid by the due date.

   Individual employers must pay contributions in accordance with Regulations 79, 80 and 81 of the LGPS Regulations. The Administering Authority will ensure that all employers are aware of these requirements especially the requirement of the Pensions Act 1995 that members' contributions are paid by the 19th of the month following the month that it is paid by the member. If contributions are not paid on time, the Administering Authority will notify the employer that the requirements of the Pensions Act 1995 have been breached and that unless the employer pays all of the overdue contributions without any further delay, they may be reported to the Pensions Regulator.

   The Administering Authority will ensure that action is taken to recover assets from Admission Bodies whose Admission Agreement has ceased by

   - Requesting that the Fund Actuary calculates the deficit at the date of the closure of the Admission Agreement
   - Notifying the Admission Body that it must meet any deficit at the cessation of the Agreement.

2. Invest surplus monies in accordance with the regulations.

   The Administering Authority will comply with Regulation 11 of the Investment Regulations.

3. Ensure that cash is available to meet liabilities as and when they fall due.

The Administering Authority recognises this duty and discharges it in the manner set out in the Aims of the Fund above.

4. Manage the valuation process in consultation with the Fund Actuary.

   The Administering Authority ensures it communicates effectively with the Fund Actuary to:

   - agree timescales for the provision of information and provision of valuation results
   - ensure provision of data of suitable accuracy
   - ensure that the Fund Actuary is clear about the Funding Strategy
   - ensure that participating employers receive appropriate communication throughout the process
   - ensure that reports are made available as required by Guidance and Regulation

5. Prepare and maintain a Statement of Investment Principles and a Funding Strategy Statement after due consultation with interested parties.

   The Administering Authority will ensure that both documents are prepared and maintained in the required manner.

6. Monitoring all aspects of the Fund's performance and funding.

   The Administering Authority monitors the funding position of the Fund on a quarterly basis, and the investment performance of the Fund on a monthly basis.

Individual Employers will:

1. Deduct contributions from employees' pay.
2. Pay all contributions, including their employer contribution as determined by the Fund Actuary, promptly by the due date.
3. Exercise discretions within the regulatory framework.
4. Pay for added years in accordance with agreed arrangements.
5. Notify the Administering Authority promptly of all changes to membership, or other changes, which affect future funding.

The Fund Actuary

It is the responsibility of the Fund Actuary to:

1. Prepare valuations including the setting of employers' contribution rates after agreeing assumptions with the Administering Authority and having regard to the Funding Strategy Statement.

   Valuations will also be prepared in accordance with generally accepted actuarial methods and reported on in accordance with Guidance Note 9 issued by the Board for Actuarial Standards, to the extent that the Guidance Note is relevant to the LGPS.

2. Prepare advice and calculations in connection with bulk transfers and

individual benefit-related matters.

Such advice will take account of the funding position and Strategy of the Fund, along with other relevant matters.

Solvency

The Administering Authority will seek to secure the solvency of the Fund. For this purpose the Administering Authority defines solvency as being achieved when the value of the Fund's assets is greater than or equal to the value of the Fund's liabilities when measured using 'ongoing' actuarial methods and assumptions. 'Ongoing' actuarial methods and assumptions are taken to be measurement by use of the projected unit method of valuation, using assumptions generally recognised as suitable for an open, ongoing UK pension fund with a sponsoring employer of sound covenant.

The financial assumptions used to assess the funding level will have regard to the yields available from the investments held by the Fund. The Administering Authority has also agreed with the Fund Actuary that these assumptions make allowance for the higher long term returns that are expected on the assets actually held by the Fund, and understands the risks of such an approach if those additional returns fail to materialise.

Consistent with the aim of enabling employer contribution rates to be kept as nearly constant as possible, and having regard to the risks inherent in such an approach, the Administering Authority has also agreed with the Fund Actuary the use of explicit smoothing adjustments in making the solvency measurement, if appropriate.

Funding Strategy

Where a valuation reveals that the Fund is in surplus or deficiency against this solvency measure, employer contribution rates will be adjusted to target restoration of the solvent position over a period of years (the recovery period). The recovery period applicable for each participating employer is set by the Administering Authority in consultation with the Fund Actuary and the employer, with a view to balancing the various funding requirements against the risks involved, due to such issues as the financial strength of the employer and the nature of its participation in the Fund.

The Administering Authority recognises that a large proportion of the Fund's liabilities are expected to arise as benefit payments over long periods of time. For employers of sound covenant, the Administering Authority is prepared to agree to recovery periods which are longer than the average future working lifetime of the membership of that employer. The Administering Authority recognises that such an approach is consistent with the aim of keeping employer contribution rates as nearly constant as possible. However, the Administering Authority also recognises the risk in relying on long recovery periods and has agreed with the Fund Actuary a period of no longer than 25 years. The Administering Authority's policy is to agree recovery periods with each employer, which are as short as possible within this framework.

For employers whose participation in the fund is for a fixed period it is unlikely that the Administering Authority and Fund Actuary would agree to a recovery period longer than the remaining term of participation other than in exceptional circumstances when it may permit recovery over a period not exceeding 10 years, subject to security, e.g. an indemnity or bond or other contingent asset, of amount and form acceptable to the Administering Authority, being maintained.

Consistent with the requirement to keep employer contribution rates as nearly constant as possible, the Administering Authority permits some employers to be treated as a group for the purposes of setting contribution rates. In particular, contribution rates could be very volatile for smaller employers due to the increased likelihood that demographic movements would have a material effect. The Administering Authority recognises that grouping can give rise to cross subsidies from one employer to another over time. The Administering Authority's policy is to consider the position carefully at each valuation and to notify each employer that is grouped that this is the case, and which other employers it is grouped with. If the employer objects to this grouping, it will be offered its own contribution rate. For employers with more than 50 contributing members, the Administering Authority would look for evidence of homogeneity between employers before considering grouping. For employers whose participation is for a fixed period grouping is unlikely to be permitted.

Again, consistent with the requirement to keep employer contribution rates as nearly constant as possible, the Administering Authority will consider, at each valuation, whether new contribution rates should be payable immediately, or should be reached by a series of steps over future years. The Administering Authority will discuss with the Fund Actuary the risks inherent in such an approach, and will examine the financial impact and risks associated with each employer. The Administering Authority's policy is that in the normal course of events no more than three equal annual steps will be permitted. Further steps may be permitted in extreme cases, but the total is very unlikely to exceed six steps.

Identification of risks and counter measures

The Administering Authority's overall policy on risk is to identify all risks to the Fund and to consider the position both in aggregate and at an individual risk level. The Administering Authority will monitor the risks to the Fund, and will take appropriate action to limit the impact of these both before, and after, they emerge wherever possible. The main risks to the Fund are:

<u>Demographic</u>

The main risks include changing retirement patterns (such as early retirements), take up of the commutation option and longevity. The Administering Authority will ensure that the Fund Actuary investigates these matters at each valuation or, if appropriate, more frequently, and reports on developments. The Administering Authority will agree with the Fund Actuary any changes that are necessary to the assumptions underlying the measure of solvency to allow for observed or anticipated changes.

If significant demographic changes become apparent between valuations, the Administering Authority will notify all participating employers of the anticipated impact on costs that will emerge at the next valuation and will review the bonds that are in place for Transferee Admission Bodies.

<u>Regulatory</u>

The risks relate to changes to regulations, National pension requirements or HMRC rules. The Administering Authority will keep abreast of all proposed changes and, where possible, express their opinion during consultation periods after careful consideration. The Administering Authority's policy will be to ask the Fund Actuary to assess the impact on costs of any changes and, where these are likely to be significant, the Administering Authority will notify Employers of this likely impact and the timing of any change.

<u>Governance</u>

This covers the risk of unexpected structural changes in the Fund membership (for example the closure of an employer to new entrants or the large scale withdrawal or retirement of groups of staff), and the related risk of the Administering Authority not being made aware of such changes in a timely manner.

The Administering Authority's policy is to require regular communication between itself and employers, and to ensure regular reviews of such items as bond arrangements, financial standing of non-tax raising employers and funding levels.

<u>Statistical/Financial</u>

This covers such items as the performances of markets, movement in market yields, fund investment managers, asset reallocation in volatile markets, pay and/or price inflation varying from anticipated levels or the effect of possible increases in employer contribution rate on service delivery and on Fund employers. The Administering Authority's policy will be to ask the actuary to monitor such aspects to ensure that all assumptions used are still justified.

<u>Solvency measure</u>

The Administering Authority recognises that allowing for future investment returns in excess of those available on government bonds introduces an element of risk, in that those additional returns may not materialise. The Administering Authority's policy will be to ask the actuary to monitor the underlying position to ensure that the funding target remains realistic relative to the low risk position.

<u>Recovery period</u>

The Administering Authority recognises that permitting surpluses or deficiencies to be eliminated over a recovery period rather than immediately introduces a risk that action to restore solvency is insufficient between successive measurements. The Administering Authority's policy is to discuss the risks inherent in each situation with the Fund Actuary and to limit the permitted length of recovery period to no longer than 25 years.

<u>Stepping</u>

The Administering Authority recognises that permitting contribution rate changes to be introduced by annual steps rather than immediately introduces a risk that action to restore solvency is insufficient in the early years of the process. The Administering Authority's policy is to discuss the risks inherent in each situation with the Fund Actuary and to limit the number of permitted steps to three annual steps or, in exceptional circumstances, up to six annual steps.

Links to investment policy set out in the Statement of Investment Principles

The Administering Authority has produced this Funding Strategy Statement having taken an overall view of the level of risk inherent in the investment objective set out in the Statement of Investment Principles and the funding policy set out in this Statement.

The Fund's liabilities are sensitive to inflation via pension and pay increases, to interest rates and to mortality rates. The assets that would most closely match the liabilities are a combination of index-linked gilts and fixed interest gilts.

However, the Fund's asset allocation as set out in the Statement of Investment Principles invests in a broad range of asset classes which are expected but not guaranteed to produce higher returns than index-linked and fixed interest gilts and above the investment objective of the Fund over the long term albeit with greater volatility.

The Administering Authority has agreed with the Fund Actuary that the funding target on the ongoing basis will be set after making some allowance for this higher expected return. However the Administering Authority recognises that outperformance is not guaranteed and that, in the absence of any other effects, if the higher expected returns are not achieved the solvency position of the Fund will deteriorate.

Consistent with the aim of enabling employer contribution rates to be kept as stable as possible, the Administering Authority has agreed with the Fund Actuary the use of a market related funding model which uses smoothed yields and asset values.

To meet the funding plan for the Fund and to bring the funding level back to 100% an investment return as shown in the 2010 valuation report by the Fund Actuary is required over the next 25 years, the recovery period, in addition to the employers and employees contributions. This required investment return is the weighted average of future expected returns from the various asset classes based on the actual asset allocation of the Fund**.**

The Fund Actuary has derived the following key long term financial assumptions for the main asset classes held by the fund at the 31 March 2010 actuarial valuation.

Financial Assumptions	March 2010 % p.a.
Investment Return	
Equities/absolute return funds	7.3%
Gilts	4.5%
Bonds	5.6%

The Fund actuary takes a weighted average of the above assumptions to derive the discount rate used to place a current value of the liabilities at the valuation date. The weighting is the weight in each of the asset classes.

This results in the following discount rate which has been shown alongside the Fund actuary's long term assumption for pension increases, inflation and salary increases. These are the key financial assumptions used to place a current value on the liabilities, or pension promises as made by the fund.

Financial Assumptions	March 2010 % p.a.
Discount rate	6.7%
Pay Increases	5.0%
Price Inflation	3.5%
Pension Increases	3.0%

Some short term adjustments have also been allowed for as described in the 31 March 2010 actuarial valuation.

The asset allocation of the Fund consists of four portfolios, UK Equity, Global (ex UK) Equity, Dynamic Asset Allocation and a Matching Fund (to match some of the Fund's liabilities). Each portfolio represents 25% of the total Fund. The investment strategy is designed to give diversification and specialisation and achieve optimum return against acceptable risk.

Within the four portfolios the Panel has appointed external investment managers with clear strategic benchmarks which place maximum accountability for performance against that benchmark on the investment manager.

In addition, £15 million is committed to private equity, through an investment of £7.5million with each of two fund of funds managers.

Future monitoring

The Administering Authority plans to review this Statement as part of each triennial valuation process unless circumstances arise which require earlier action.

The Administering Authority will monitor the funding position of the Fund on an approximate basis at regular intervals between valuations, and will discuss with the Fund Actuary whether any significant changes have arisen that requires action.