



FUNDING STRATEGY STATEMENT FOR LONDON BOROUGH OF HOUNSLOW

1. Introduction

- 1.1 The Local Government Pension Scheme Regulations (LGPS) Regulations require funds to produce a Funding Strategy Statement (FSS) having regard to the guidance produced by CIPFA. This statement has been drawn up by the London Borough of Hounslow Pension Fund in accordance with the regulations and discussion at its Pension Fund Panel.
- 1.2 The FSS complements and adds to the Statement of Investment Principles (SIP). It is primarily based on the 2007 Actuarial Valuation, but has references to post valuation events. These relate to the recent unprecedented volatility in equity and bond markets, and to the Improvement Plan of efficiencies implemented by the London Borough of Hounslow, resulting in significant staff redundancies.
- 1.3 The statements relate as follows:



- 1.4 The FSS reflects the statutory nature of the Local Government Pension Scheme (LGPS), particularly the defined benefit nature and the benefit payable guarantee. The FSS sets out how benefits will be funded over the long term through an accountable, transparent process with full disclosure of relevant details and assumptions.
- 1.5 The LGPS is a long-established, well-managed, funded final salary scheme. Work currently being carried out by the Department for Communities and Local

Government (DCLG) on updating the Scheme to incorporate 'cost-sharing' is intended to ensure its sustainability into the longer term.

- 1.6 The Fund, like many other similar public and private sector funded schemes, has a gap between its assets and pension liabilities which this strategy addresses.
- 1.7 A number of factors have contributed to the funding gap and rise in contribution rates for many employers:
 - (a) investment returns relative to movement in liabilities;
 - (b) increases in longevity of pensioners;
 - (c) falling long-term interest rates.

There are some steps that the actuary can take to assist employing bodies. These include:

- (a) recognising the long-term nature of local government, so that deficits are recovered over time. At the 2007 valuation this period was 13 years.
- (b) phasing increases in contributions;
- (c) recognising such financial 'improvements' as a reduction in ill-health retirements and changes to the LGPS (such as retirement at aged 65, and in general no early retirements before 55 and taking of additional lump-sums);
- (d) giving weight to a balanced investment strategy.

2. Purpose of the Funding Strategy Statement in Policy Terms

- 2.1 The purpose of this FSS is:
 - To establish a clear and transparent fund-specific strategy which will identify how employers' liabilities are best met going forward.
 - To support the regulatory requirement to maintain employer contribution rates as nearly constant as possible.
 - To take a prudent longer-term view of funding those liabilities.
- 2.2 The Fund currently has a strong net cash inflow. The FSS supports the process of ensuring adequate funds are put aside on a regular basis to meet future benefit liabilities. The LGPS regulations specify the approach and requirements. The implementation of the funding strategy is the responsibility of the Fund acting on expert advice and following consultation.
- 2.3 The FSS is a comprehensive strategy for the whole Fund. It balances and reconciles the many direct interests that arise from the nature of the Scheme and funding of the benefits now and in the future.
- 2.4 The solvency of the Fund is a long term management issue. Currently, the net cash inflow is over £20m per annum, but it is essential that funds are made available to ensure all future benefits payments can be met when they become due.

3. Aims and Purposes of the Fund

3.1 The aims of the Fund are to:

- Maximise the returns from investments within reasonable risk parameters.
- Ensure that sufficient resources are available to meet all liabilities as they fall due.
- Enable employer contribution rates to be kept as nearly constant as possible and at reasonable cost to the taxpayers, scheduled and admitted bodies having regard to the liabilities.
- Manage employers' liabilities effectively through regular review of contributions and additional contributions for early retirements which lead to a strain on funding.

3.2 The purpose of the Fund is to:

- Receive and invest monies in respect of contributions, transfer values and investment income.
- Pay out monies in respect of scheme benefits, transfer values, costs, charges and expenses.

The Local Government Pension Scheme Regulations and in particular the Local Government Pension Scheme (Management and Investment of Funds) Regulations define these purposes.

4. Responsibilities of the Key Parties

4.1 The LGPS regulations set out the responsibilities of the key parties which are summarised below. Further details are available on the London Borough of Hounslow's website where operational and management arrangements are set out.

4.2 The administering authority (London Borough of Hounslow):

- Collects employer and employee contributions.
- Invests surplus monies in accordance with the regulations and agreed strategy.
- Ensures that cash is available to meet liabilities as and when they fall due.
- Manages the valuation process in consultation with the Fund's actuary.
- Prepares and maintains a Funding Strategy Statement (FSS) and a Statement of Investment Principles (SIP).
- Monitors all aspects of the Fund's performance and funding.
- Amends the FSS and SIP as appropriate.

The administering authority discharges its responsibilities with the active involvement from the major employers and staff representatives combined with consultation with interested parties.

4.3 The individual employers:

- Deduct contributions from employees' pay correctly.
- Pay all contributions, including their own as determined by the actuary, promptly by the due date.
- Exercise discretions within the regulatory framework.
- Make additional contributions in accordance with agreed arrangements in respect of, for example, augmentation of Scheme benefits and early retirement strain.
- Notify the administering authority promptly of all changes to membership, or as may be proposed, which affect future funding.
- Discharge their responsibility for compensatory added years which the administering authority pays on their behalf and is subsequently recharged to them.

4.4 The Fund's actuary:

- Prepares valuations including the setting of employers' contribution rates after agreeing assumptions with the administering authority and having regard to the FSS.
- Sets employers' contribution rates in order to secure the Fund's solvency having regard to the aims of maintaining contribution rates that are as constant as possible.
- Prepares advice and calculations in connection with bulk transfers and individual benefit-related matters.

5. Solvency Issues and Target Funding Levels

5.1 The Fund currently has a strong net cash inflow and can, therefore, take a medium to long-term view on determining employing body contribution rates to meet future liabilities through operating a fund with an investment strategy that reflects this long-term view. It allows short-term investment market volatility to be managed so as not to cause volatility in employing body contribution rates.

5.2 The LGPS regulations require the long-term funding objectives to achieve and maintain assets sufficient to cover 100% of the projected accrued liabilities. The level of assets necessary to meet this 100% funding objective is known as the funding target. The role of the actuary, in performing the necessary calculations and determining the key assumptions used, is an important feature in determining the funding requirements. The approach to the actuarial valuation process and key assumptions used at each three yearly valuation are consulted upon and the valuation forms part of the remit of the FSS.

Determination of the Funding Target and Recovery Period

- 5.3 The principal method and assumptions to be used in the calculation of the funding target are set out in the Appendix.
- 5.4 Underlying these assumptions are the following two tenets:
- that the Scheme is expected to continue for the foreseeable future; and
 - favourable investment returns can play a valuable role in achieving adequate funding over the longer term.
- 5.5 As part of each valuation, separate employer contribution rates are assessed by the actuary for each participating employer or group of employers. These rates are assessed taking into account the experience and circumstances of each employer (or employer grouping), following a principle of no cross-subsidy between the various employers in the Scheme. In attributing the overall investment performance obtained on the assets of the Scheme to each employer, a pro-rata principle is adopted. The general approach is effectively one of applying a notional individual employer investment strategy identical to that adopted for the Scheme as a whole.
- 5.6 The administering authority has adopted the following objectives for setting the individual employer contribution rates:
- The 2007 actuarial valuation identified a deficit recovery period of 13 years.
 - Where increases in employer contribution rates are required from 1 April 2008, following completion of the 2007 actuarial valuation, the increase from the rates of contribution payable in the year 2007/08 may be implemented in steps, over a maximum period of six years.
 - 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. Details of the approach to be adopted for such an assessment on termination are set out in the separate admission bodies policy document.
- 5.7 In determining the above objectives the administering authority has had regard to:
- relevant guidance issued by the CIPFA Pensions Panel,
 - the need to balance a desire to attain the target as soon as possible against the short-term cash requirements which a shorter period would impose, and
 - the administering authority's views on the strength of the participating employers' covenants in achieving the objective.

Deficit Recovery Plan

- 5.8 Where the assets of the scheme relating to an employer are less than the funding target at the effective date of any actuarial valuation, a recovery plan will be put in place, which requires additional contributions from the employer to meet the shortfall. The 2007 actuarial valuation identified a deficit recovery period of 13 years.
- 5.9 Additional contributions will be expressed as a level percentage of pensionable payroll, but with any contribution amounts due in excess of 25% of payroll expressed in cash terms.

The Normal Cost of the Scheme (Future Service Contribution Rate)

- 5.10 In addition to any contributions required to rectify a shortfall of assets below the funding target, contributions will be required to meet the cost of future accrual of benefits for members after the valuation date (the 'normal cost'). The method and assumptions for assessing these contributions are also set out in the Appendix.

6. Links to Investment Policy Set Out in the Statement of Investment Principles (SIP)

- 6.1 In calculating the deficit recovery period, and affordable employer contribution rates, the actuary has taken into consideration the Fund's strategic asset allocation policy. This is detailed in the Statement of Investment Principles (SIP).

7. The Identification of Risks and Countermeasures

- 7.1 Evaluating risks that may impact on the funding strategy and expectations of future solvency is crucial to determining the appropriate measures to mitigate those risks. The FSS identifies those key risks specific to the Fund and the measures being taken or assumptions made to counter those risks.
- 7.2 Some of the key risks taken into account are:

Financial

- Unexpected market-driven events.
- Investment markets fail to perform in line with expectations.
- Market yields move at variance with assumptions.
- Investment fund managers fail to achieve performance targets over the longer term.
- Asset allocations in volatile markets may lock in past losses.
- Pay and price inflation significantly more or less than anticipated.

- The effect of a possible increase in employer's contribution rate on service delivery and employers in general.

The Fund regularly reviews its investment strategy taking into account investment risk and future benefit payments to determine a bespoke investment strategy that for a variety of future economic outcomes gives a high degree of certainty that the investment objectives will be achieved. Short-term investment management decisions to reflect anticipated market changes are strictly controlled against the investment strategy or benchmark. Further information is available in the SIP and on the Fund's website.

Demographic

- The longevity horizon of beneficiaries continues to expand.
- Cost of early retirements.

The Fund has in place policies and procedures to identify for employing bodies the impact of these factors and agrees how they will be managed in terms of annual contribution rates and/or as special additional contributions.

Regulatory

- Changes to regulations, e.g. more favourable benefits package, potential new entrants to scheme.
- Changes to national pension requirements and/or Inland Revenue rules.

These changes agreed and proposed are evaluated and taken into account in the actuarial valuation and closely monitored between valuations in case any action is required.

Major employing bodies are required to make contributions to the Fund as cases are approved for early retirement and other employing body discretions that when exercised alter future liabilities.

Governance

- Administering authority unaware of structural changes in an employer's membership (e.g. large fall in employee members, large number of retirements).
- Administering authority not advised of an employer closing to new entrants.
- An employer ceasing to exist, with insufficient funding or adequacy of a bond.

The Fund has established inter-valuation monitoring and performance methodologies. It has working relations with its employers to ensure membership changes are detected, discussed, evaluated and appropriate action agreed. This includes regular reviews of funding levels, bond arrangements where appropriate and the assessment of the financial standing of employers that are not tax-raising bodies.

Employers

- Sustainability of an employer or their ability to meet their liabilities within the agreed funding strategy.

The Fund's approach to the outcome of the 2007 valuation has had regard to balancing the needs of funding the liabilities and the cost to employers. This is reflected in the approach to the phasing of increase, the recovery period for meeting any funding gap, together with the risks associated with the investment strategy. It is considered the approach adopted represents an 'affordable' solution taking all factors into account.

A risk assessment of the sustainability of all employers has been undertaken seeking to establish the risk of an employer failing to meet their pension liabilities. The analysis identified the following levels of risk:

Low Risk

Scheduled and resolution bodies as statutory entities that are either required, or can choose to offer membership of the LGPS. This category would cover:

- A local authority, or equivalent.
- A body for which the Fund has a guarantee of liabilities from a local authority (or its equivalent).
- A body which receives funding from local or central government (e.g. colleges and universities).
- A body which has a funding deficiency guarantee from local or central government.
- A best value type body for which a local authority within the Fund effectively stands as the ultimate guarantor on the termination of the admission agreement as a result of Regulation 78(2A).

Medium Risk

Scheduled bodies not considered as low risk and admitted bodies with no statutory underpin but:

- Can provide satisfactory evidence of financial security (e.g. parent company guarantee, bond, indemnity, insurance).
- Is part of a group of related or pooled bodies which share funding on default.

High Risk

An admitted body:

- With no external funding guarantee or reserves.
- With a known limited lifespan or fixed contract term of admission to the Fund.
- Which has no active contributors and/or is closed to new joiners.
- Which relies on voluntary or charitable sources of income.

Our analysis of all of our scheduled and admitted bodies indicates the risk to the Fund's solvency and ability to meet prior liabilities to be low. The situation will, however, continue to be monitored.

8. Contributions required from employers

- 8.1 The Common Rate of Contribution payable by each employing authority, as identified by the actuary, is 13.9% of payroll. On top of this individual adjustments are made for each employing authority reflecting the individual circumstances of fund membership. The table below shows the minimum contribution rates as a percentage of payroll that are required over the next three years by each employer in order to bring the fund to an initial nil deficit position in 13 years time.

	% of payroll		
	Total Contribution for the Year Beginning		
	1 Apr 2008	01-Apr- 09	1 Apr 2010
London Borough of Hounslow	21.4%	21.3%	21.2%
West Thames College	17.5%	17.9%	18.3%
Hounslow Homes	19.4%	19.4%	19.4%
Hounslow Racial Equality Council	12.6%	12.8%	13.1%
Age Concern Feltham	12.6%	12.8%	13.1%
New bodies admitted since valuation:-			
Appetito *	17.2%	17.2%	17.2%
Fusion *	15.3%	15.3%	15.3%
John Laing Integrated Services *	15.9%	15.9%	15.9%
Continental Landscapes *	16.9%	16.9%	16.9%
Hounslow Community Services (libs)	18.5%	18.5%	18.5%
SITA *	22.1%	22.1%	22.1%
SCOPE *	18.5%	18.5%	18.5%

* closed to new members

- 8.2 Further sums will need to be paid to the Fund to meet the costs of any early retirements using methods and assumptions issued by the actuary from time to time. The assumptions underlying the number of members who will become entitled to pensions under the provisions of the scheme and the liabilities arising in respect of such members are set out in the Appendix.

9. Post 2007 Valuation Events

9.1 Economic

Since the 2007 actuarial valuation there has been considerable volatility in both bond and equity markets. Current asset values are significantly below what was assumed at the valuation date. Current liability values are also likely to be very different to what was projected/assumed. The actuary updated the model at March 2008. At that date they estimated the funding level to be relatively unchanged, since the underperformance of assets was offset by the reduction in value of liabilities. At March 2008 the value of the Fund was £461m. The current valuation at February 2009 is £383m, a fall of 17%. A full revaluation will take place in March 2010, when an updated projection of the funding gap will be estimated, with its implications for employer contributions.

9.2 Organisational - Improvement Plan

The new administration of the London Borough of Hounslow, elected in May 2006, agreed an extensive Improvement Plan to improve efficiency within the local authority. This was to finance the policy aim of zero increases in LBH council tax for the period 2007/08 -2010/11 and also the allocation of resources to key policy commitments. The Improvement Plan has resulted in significant redundancies. Pension Fund strain arises for those aged over 50¹ who are eligible for immediate payment of their pension, based on accrued pensionable service. An option appraisal was undertaken evaluating different methods for paying these costs. After discussion with the actuary and the council's auditor it was agreed to finance by extending the deficit recovery period by an additional 1 year to 1.5 years.

9.3 Organisational - new employing entrants to scheme

The Council retendered its leisure contracts in 2008 and John Laing/Fusion/Continental Landscapes won the tender. The new contracts started on 1st July 2008, when the CIP group of companies ceased to exist. The Table in para 8.1 recognises the new employing entrants to the scheme. Detailed advice has been provided by the actuary on the contribution rates. In addition Appetito has joined the scheme, as it has taken over the Meals on Wheels Service. Scope has also replaced Barnardos as a provider of services.

¹ Age rises to 55 by 2010.

Appendix

Actuarial Valuation as at 31 March 2007 Method and Assumptions Used in Calculating the Funding Target

The valuation process is essentially a projection of future cashflows into and out of the Fund. The amount of future cashflows out of the Fund i.e. benefits provided will depend on rates of future pay increases and price inflation. The timing of the cashflows will depend upon future rates of retirement, mortality etc. As money is being set aside now to provide for benefits payable in the future then part of the cost of providing the benefits can be met from investment returns achieved by the Fund's assets which then build up. The higher the rate of return achieved by the assets the lower the contribution requirement that has to be paid in future to meet the cost of the benefits.

Financial Assumptions

The principal financial assumptions adopted in the valuation are as follows:-

Price Inflation

- Future levels of price inflation are derived by considering the difference in yields between index-linked gilts and traditional fixed interest gilts at the valuation date. The following table shows smoothed bond yields at both the 2004 and the 2007 valuation dates. This effectively determines what the market's expectations are for long-term inflation.

Smoothed Yields	March 2007 % p.a.	March 2004 % p.a.
Corporate Bonds	5.4	5.6
Conventional gilt yields	4.7	4.8
Index linked gilt yields	1.3	2.0
implied inflation	3.4	2.8

Pay Increases

- Pay increases are assumed to exceed future price inflation. As benefits are linked to pay levels at retirement, an assumption has to be made about 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 out at between 1% and 3% per annum depending on economic conditions. At the previous valuation 1.75% above price inflation was used. The current valuation uses 1.50% . This is based on a more detailed method of calculation taking into account the difference between full and part time staff and the reduced scope for promotion open to part time staff. Overall the change to the salary increase assumptions is broadly cost neutral.

Investment Returns

- In a market related valuation it is necessary to assess future average levels of return in current market conditions. Redemption yields from gilts give an indication of the market's expectations of long-term interest rates and so some indication about future risk free rates of return. There is however no comparable market indicator to derive the market's expected future return from investing in equities at any particular point in time. It is generally accepted however that the expected future return from investing in equities should exceed that available from investing in gilts. This extra expected return is known as the equity risk premium. By comparing yields from gilts and equities it is possible to derive the equity risk premium. The real return to be earned in future from equities from current market levels will be the current net dividend yield plus future real growth in share values. For the purposes of the valuation the actuary has assumed real capital returns will be 1.5% pa. That was based on the long-term capital return in real terms over the 35 years to 2007 averaging out at 2% p.a. The table below summarises the actuary's assumptions regarding future equity returns.

Smoothed Equity Returns	March	March
	2007	2004
	% p.a.	% p.a.
Equity Risk Premium		
Net Equity Yield	2.8	3.1
plus assumed real capital return	1.5	1.5
less real risk free premium	1.3	2.0
Equity Risk Premium	3.0	2.6
Equity Return		
Inflation	3.4	2.8
plus risk free real return	1.3	2.0
plus equity risk premium	3.0	2.6
Equity Return	7.6	7.4

- For property the actuary has assumed that the return will be the same as for corporate bonds.
- The discount rate is then the weighted average of future expected returns from the various asset classes based on the overall asset strategy adopted by the Fund. In summary therefore the actuary has adopted the following financial assumptions:

Financial Assumptions	March 2007		March 2004	
	% p.a.	Real % p.a.	% p.a.	Real % p.a.
Investment Return				
Equities	7.6	4.3	7.4	4.6
Gilts	4.7	1.3	4.8	2.0
Bonds & Property	5.4	2.0	5.6	2.8
Discount Rate	6.9	3.5	6.7	3.9
Pay Increases	4.9	1.5	4.6	1.8
Price Inflation/Pension Increases	3.4		2.8	

Statistical Assumptions

The statistical assumptions that have been adopted are based on an analysis of the incidence of retirement and withdrawal of the actuary's Local Authority clients. The mortality assumptions are based on national mortality tables.

Age	Incidence per 1000 active members per annum								Salary Scales			
	Death	Males		Withdrawal	Death	Females		Withdrawal	Males		Females	
		Ill Health	PT			Ill Health	PT		FT	PT	FT	PT
20	0.50	0.00	0.10	400	0.20	0.10	0.10	400	100	100	100	100
25	0.40	0.10	0.60	360	0.20	0.10	0.43	360	123	100	114	100
30	0.30	0.10	1.50	264	0.30	0.30	0.80	264	146	100	126	100
35	0.50	0.30	2.40	184	0.50	0.50	1.18	184	166	100	134	100
40	0.90	0.50	3.30	108	0.60	0.80	1.63	108	183	100	137	100
45	1.30	0.90	4.50	48	0.80	1.20	2.28	48	194	100	137	100
50	2.50	1.60	6.00	0	1.40	2.20	4.05	0	199	100	137	100
55	4.30	3.50	9.00	0	2.20	4.20	7.55	0	199	100	137	100
60	6.90	7.40	14.40	0	3.10	8.50	12.23	0	199	100	137	100
64	11.10	13.20	21.90	0	4.00	11.50	13.98	0	199	100	137	100

Other assumptions

Benefits accrued prior to 1 April 2008: It is assumed that active members will retire at age 60 or when they would first satisfy the rule of 85 if later, no later than 65

Benefits accrued after 31 March 2008: It is assumed that active members will retire at age 65 or if they would reach 60 by 2016 then as for benefits accrued prior to 1 April 2008.

Probability of partners pension coming into payment (including a loading for dependants benefits) 90%

Partner Age Difference Males are assumed to be 3 years older than their partners

Commutation It is assumed that members at retirement will commute pension to provide a lump sum of 50% * (3/80ths lump sum + HMRC maximum lump sum) at a rate of £12 of lump sum for £1 of pension.

Ill health tiers It is assumed that 15% of ill health retirements will be eligible for benefits based on full prospective service and 85% will qualify for a service enhancement of 25% of prospective service.