SCOTTISH BORDERS COUNCIL PENSION FUND

FUNDING STRATEGY STATEMENT

2019

Finance

Chief Executive
Approved – Pension Fund Committee 13 June 2019

Introduction

This is the Funding Strategy Statement (the FSS) for the Scottish Borders Council Pension Fund (the Fund) which is administered by Scottish Borders Council (the Administering Authority). It has been prepared in accordance with Regulation 56 of the Local Government Pension Scheme (Administration) (Scotland) Regulations 2014 (the Regulations).

It should be read in conjunction with the Fund's Statement of Investment Principles (the SIP).

This version of the FSS was agreed by the Pension Fund Committee (the Committee) on 13 June 2019.

1. Purpose of the Funding Strategy Statement

1.1 The purpose of the FSS is to explain the Fund's approach to meeting the pension scheme's liabilities and in particular:

- to establish a clear and transparent Fund-specific strategy which will identify how employers' pension liabilities are best met going forward;
- to take a prudent longer-term view of funding those liabilities;
- to ensure that the regulatory requirements to set contributions to meet the future liability to provide scheme member benefits in a way that secures the solvency of the Fund and the long term cost efficiency of the Scheme; and
- to support the regulatory framework to maintain as nearly constant employer contribution rates as possible.

Aims and purposes of the Fund

1.2 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 (subject to the Administering Authority not taking undue risks) at reasonable cost to all relevant parties (such as the taxpayers, scheduled and admitted bodies), while achieving and maintaining Fund solvency and long-term cost efficiency, which should be assessed in light of the risk profile of the fund and employers, and the risk appetite of the administering authority and employers alike; and
- seek returns on investment within reasonable risk parameters.

1.3 The purposes of the Fund are to:

- pay pensions, lump sums and other benefits to scheme members as provided for under the Regulations;
- meet the costs associated in administering the Fund; and
- receive contributions, transfer values and investment income.

Funding Objectives

1.4 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.

1.5 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 produces levels of employer contribution that are as stable as possible, with consideration of the long-term cost efficiency objective;
- ensure effective and efficient management of employers' liabilities; and
- allow the return from investments to be maximised within reasonable risk parameters.

2 Consultation

2.1 In accordance with Regulation 56(3), all employers participating within the Fund have been consulted on the contents of this Statement and their views have been taken into account in formulating the Statement. However, the Statement describes a single strategy for the Fund as a whole.

2.2 In addition, 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 2010 (the Investment Regulations), as required by Regulation 56(4)(b)

2.3 The Fund Actuary, Hyman Robertson, has also been consulted on the contents of this Statement.

3 Key Parties

3.1 The parties directly concerned with the funding aspect of the Pension Fund are noted below. A number of other parties, including investment managers and external auditors, also have responsibilities to the Fund, but are not key parties in determining funding strategy.

The Administering Authority

3.2 The Administering Authority for the Scottish Borders Council Pension Fund is Scottish Borders Council. The main responsibilities of the Administering Authority are as follows:

- collect and account for employee and employer contributions;
- pay the benefits to Scheme members as they fall due;
- invest the Fund's assets ensuring sufficient cash is available to meet liabilities as and when they become due;
- manage the Actuarial Valuation process in conjunction with the Fund Actuary;
- effectively manage any potential conflicts of interest arising from its dual role as both Fund administrator and Scheme Employer;
- prepare and maintain this FSS and also the SIP after consultation with other interested parties; and

- monitor all aspects of the Fund's performance and funding and ensure that the FSS and SIP are updated as necessary.

Individual Employers

3.3 The responsibilities of each individual employer which participates in the Fund, including the Administering Authority are as follows:

- 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;
- promptly notify the Administering Authority of any new Scheme members and any other membership changes;
- exercise any discretions permitted under the Regulations;
- meet the costs of any augmentations or other additional costs in accordance with agreed policies and procedures;
- pay any exit payments due on ceasing participation in the Fund; and
- provision of relevant information and data in order for the Fund Actuary facilitate the Valuation process, .

Scheme members

3.4 Active scheme members are required to make contributions into the Fund as set out in the Regulations.

Fund Actuary

3.5 The Fund Actuary for the Scottish Borders Council Pension Fund is Hyman Robertson. The main responsibilities of the Fund Actuary are to:

- prepare the Actuarial Valuation including setting employers' contribution rates at a level to help secure Fund solvency and long-term cost efficiency of the Scheme, after agreeing assumptions with the Administering Authority and having regard to the FSS and the 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 from the Fund;
- provide advice to the Administering Authority on bonds or 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 which may be of relevance to his or her role in advising the Fund; and
- advise on other actuarial matters affecting the financial position of the Fund.

4 Solvency and Maturity

4.1 The Administering Authority will prudentially 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 in respect of service prior to the measurement date when measured using 'ongoing' actuarial methods and assumptions.

4.2 Ongoing actuarial methods and assumptions are taken to be measured 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.

4.3 The financial assumptions used to assess the financial position will have regard to the yields available on long-term fixed interest and index linked gilt-edged investments and an allowance for the higher long-term returns that are expected from equity type investments based on the Fund's long-term investment strategy. The Administering Authority understands the risks of such an approach if those additional returns fail to materialise.

4.4 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.

4.5 The Fund is mature such that new contributions from employers and employees are not sufficient to meet all benefit payments falling due. In order to meet the short term cashflow requirements the income generated by some investments will be realised.

5 Funding Strategy

5.1 The funding strategy seeks to achieve (via employee and employer contributions and investment income) **three key objectives**:

- **A funding level of 100%, as assessed by the Fund's appointed actuary, triennially, in accordance with the Regulations;**
- **Ensuring the solvency of the Fund and the long-term cost efficiency of the Scheme; and**
- **As stable an employer contribution rate as is practical**.

5.2 The funding strategy recognises that the funding level will fluctuate with changing levels of employment, retirements and investment income, and the employer contribution has to be adjusted to a level sufficient to maintain the pension scheme's solvency and to achieve a funding level of 100% over the longer term.

5.3 The Actuarial Valuation process is essentially a projection of future cashflows to and from the Fund. The main purpose of the Valuation is to determine the level of employers' contributions that should be paid over an agreed period to ensure that the existing assets and future contributions will be sufficient to meet all future benefit payments from the Fund.

5.4 The last Actuarial Valuation was carried out as at 31 March 2017 with the **assets of the Fund found to represent 114% of the accrued liabilities for the Fund**; this compares with 101% at the 2014 Actuarial Valuation. The primary rate required to cover the employer cost of future benefit accrual was 20.6% of payroll p.a.

Funding Method

5.5 The key objective in determining employers’ contribution rates is to establish a funding target and then set levels of employer contribution to meet that target over an agreed period.

5.6 The funding target is to have sufficient assets to meet the accrued liabilities for each employer in the Fund. The funding target may, however, also depend on certain employer circumstances and will, in particular, have regard to whether an employer is an “open” employer (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.

5.7 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 after making allowance for future increases to members’ pay and pensions in payment. A funding level in excess of 100% indicates a surplus of assets over liabilities; a funding level of less than 100% indicates a deficit.

- The future service funding rate (also referred to as primary rate as defined in Regulation 60(5) of the Regulations) i.e. the level of contributions required from the individual employers which together with employee contributions are expected to support the cost of benefits accruing in future.

5.8 The key feature of this method is that in assessing the future service cost the primary contribution rate represents the cost of one year’s benefit accrual.

5.9 For **closed employers** an alternative funding method that may be adopted is known as the Attained Age Method. The key difference with 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.

5.10 For **closed limited-term employers** such as some Transferee Admission Bodies, a modified version of the Projected Unit Method with a control period equal to the remaining term of the contract may be used and this usually gives results between the pure Projected Unit Method and the Attained Age Method.

Valuation Assumptions and Funding Model

5.11 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.

5.12 The assumptions adopted at the Valuation can therefore be considered as:-

- the statistical assumptions which generally speaking are estimates of the likelihood of benefits and contributions being paid; and,

- the financial assumptions which generally speaking will determine the estimates of the amount of benefits and contributions payable and their current or present value.

5.13 Future Price Inflation

The base assumption in any Valuation is the future level of Retail Price Inflation (RPI). This is derived by considering the average difference in yields from conventional and index linked gilts during the 6 months straddling the Valuation date using the Bank of England Inflation Curves. The resultant RPI increase assumption used in the 2017 valuation is 3.7% per annum.

5.14 Future Pay Inflation

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 in the longer term. The long-term pay increase assumption adopted for the 2017 valuation was CPI plus 1% per annum.

5.15 Future Pension Increases

The pension increase orders are linked to changes in the level of the Consumer Price Index (CPI) rather than RPI. Inflation as measured by the CPI has historically been less than RPI due mainly to different calculation methods. It was therefore assumed for the 2017 valuation that CPI increases will be 0.9% less than the RPI increase assumption.

5.16 Future Investment Returns/Discount Rate

i. 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.

ii. The discount rate adopted depends on the funding target adopted for each employer.

iii. For open employers, the discount rate 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 6 months straddling the Valuation date. The discount rate so determined may be referred to as the "ongoing" discount rate. At the 2017 Valuation the ongoing discount rate was 5.0% per annum.

iv. For closed employers, with no individual active membership, 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 requires it.

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

vi. The adjustment to the discount rate is essentially 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 to minimise the risk of deficits arising after the termination date.

Asset Valuation

5.17 For the purposes of the valuation the asset valuation is based on the market value of the accumulated Fund at the Valuation date adjusted to reflect average market conditions during the 6 months straddling the Valuation date.

Statistical Assumptions

5.18 The statistical assumptions incorporated into the Valuation such as future rates of mortality etc are based on national statistics but then adjusted where deemed appropriate to reflect the individual circumstances of the Fund and/or individual employers.

5.19 Further details of all of the assumptions adopted are included in the latest actuarial valuation report.

Deficit Recovery/Surplus Amortisation Periods

5.20 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.

5.21 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.

5.22 The period that is adopted for any particular employer will depend upon

- 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.

5.23 At the 2017 Valuation there was no requirement for a deficit recovery period for any employer in the Fund. Although the Primary rate calculated at the 2017 valuation had increased from previous levels, due to the level of surplus revealed it was possible to apply a negative secondary rate adjustment in order to help maintain a stable level of employer contribution.

Pooling of Individual Employers

5.24 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.

5.25 However, certain groups of individual employers may be pooled for the purposes of determining contribution rates to recognise common characteristics or where the number of Scheme members is small. Employers with weak financial covenants would be liable for enhanced contributions. Currently all employers are within the main funding pool other than CGI and SBHA who are closed funds.

5.26 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

Cessation Valuations

5.27 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. It also depends on what will happen to the current active members of the Fund and whether they will continue to be active members on cessation or not.

5.28 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 to protect the other employers in the Fund from having to fund any future deficits from the liabilities that will remain in the Fund.

5.29 The basis used by the actuary to determine the cessation amount will depend on where the future responsibility will lie for the accrued liabilities. It will also depend on the market conditions at the time and as mentioned above, what will happen to the current active members.

Next Valuation

5.30 The next Actuarial Valuation is due as at 31 March 2020.

6 Links with the Statement of Investment Principles

6.1 The main link between the 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.

6.2 As explained above the ongoing discount rate adopted in the Actuarial Valuation is derived by considering the expected return from the Fund's long-term investment strategy, and so there is consistency between the funding strategy and investment strategy.

7 Risks and Counter Measures

7.1 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 a number of risks that may impact on the funding strategy and hence the ability of the strategy to meet the funding objectives.

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

Financial Risks

7.3 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 chosen fund managers who are employed to implement the chosen investment strategy failing to achieve their performance targets. The Valuation results are most sensitive to the real discount rate. Broadly speaking an increase/decrease of 0.1% per annum in the real discount rate will decrease/increase the liabilities by 2% and decrease/increase the required employer contribution by around 0.6% of payroll.

7.4 The Pension Fund Committee regularly monitor the investment returns achieved by the fund managers and seek advice from the Fund Actuary and independent advisers on investment strategy. In the inter-valuation period 2014 to 2017 such monitoring activity saw investment returns perform better than assumed in the 2014 valuation.

7.5 In addition the Fund Actuary provides funding updates between Valuations to check whether that the funding strategy continues to meet the funding objectives.

Demographic Risks

7.6 Allowance is made in the funding strategy via the actuarial assumptions of a continuing improvement in life expectancy. However the main risk to the funding strategy is that it might underestimate the continuing improvement in mortality. For example an increase of 1 year to life expectancy of all members in the Fund will reduce the funding level by around 3%.

7.7 The actual mortality of pensioners in the Fund is however monitored by the Fund Actuary at each Actuarial Valuation and assumptions kept under review.

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

7.9 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.

Regulatory Risks

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

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

7.12 The Administering Authority, however, actively participates in any consultation process of any change in Regulations and seeks advice from the Fund Actuary on the financial implications of any proposed changes.

Governance

7.13 Several different employers participate in the Fund. Accordingly it is recognised 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.

7.14 However, the Administering Authority monitors the position of employers participating in the Fund, particularly who may be susceptible to the aforementioned events and takes advice from the Fund Actuary when required.

7.15 In addition the Administering Authority keeps in close touch with all individual employers participating in the Fund and holds an annual meetings with employer to ensure that, as Administering Authority, it has the most up to date information available on individual employer situations and also to keep individual employers fully briefed on funding and related issues. Employers and Trade Union representatives are on the new Pensions Board (the Board), and participate in the joint Board/Committee meetings held by the Administering Authority and participate in discussions on all agenda items.

8 Monitoring and Review

8.1 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.

8.2 The Administering Authority will monitor the financial and funding position of the Fund on an appropriate basis at regular intervals between valuations and will discuss with the Actuary whether any significant changes have arisen that require action

VERSION CONTROL TABLE

Version	Nature of Amendment	Date of Change	Author
2015 1.0	Draft for Barnett Waddingham Review updating previous FSS for the 31 March 2014 Valuation.	1 June 2015	L Mirley
2015 2.0	Final Draft for Pension Fund Committee Approval	10 June 2015	L Mirley
2017 1.0	Final Draft for Pension Fund Committee Approval	22 June 2017	K Robb
2018.10	Final Draft for Pension Fund Committee Approval	14 June 2018	K Robb
2019.1	Final draft for Pension Fund Committee approval	13 Jun 2019	K Robb

You can get this document on tape, in Braille, large print and various computer formats by contacting the address below. Pension & Investment Team can also give information on other language translations as well as providing additional copies.

Contact us at Pension & Investment Team, Council HQ, Newtown St Boswells, TD6 0SA 01835 825016, treasuryteam@scotborders.gov.uk