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Pension Committee Agenda

To: Councillor Andrew Pelling (Chair)
Councillor Simon Hall (Vice-Chair)
Councillors Patricia Hay-Justice, Clive Fraser, Robert Canning, Luke Clancy, Simon Brew, Yvette Hopley, Gill Driver and Peter Howard

Reserve Members: Maddie Henson, Jamie Audsley, Sherwan Chowdhury, Steve Hollands, Rob Ward and Stuart Millson

A meeting of the **Pension Committee** which you are hereby summoned to attend, will be held on **Tuesday, 5 June 2018** at **10.00 am** in **Council Chamber - Town Hall**

JACQUELINE HARRIS-BAKER
Director of Law and Monitoring Officer
London Borough of Croydon
Bernard Weatherill House
8 Mint Walk, Croydon CR0 1EA

James Haywood
020 8726 6000 x63319
james.haywood@croydon.gov.uk
www.croydon.gov.uk/meetings
Friday, 25 May 2018

Members of the public are welcome to attend this meeting.
If you require any assistance, please contact the person detailed above, on the righthand side.

N.B This meeting will be paperless. The agenda can be accessed online at www.croydon.gov.uk/meetings

AGENDA – PART A

1. Apologies for Absence

To receive any apologies for absence from any members of the Committee.

2. Minutes of the Previous Meeting (Pages 5 - 10)

To approve the minutes of the meetings held on 13 March 2018 and 23 May 2018 as an accurate record.

3. Disclosure of Interests

In accordance with the Council's Code of Conduct and the statutory provisions of the Localism Act, Members and co-opted Members of the Council are reminded that it is a requirement to register disclosable pecuniary interests (DPIs) and gifts and hospitality to the value of which exceeds £50 or multiple gifts and/or instances of hospitality with a cumulative value of £50 or more when received from a single donor within a rolling twelve month period. In addition, Members and co-opted Members are reminded that unless their disclosable pecuniary interest is registered on the register of interests or is the subject of a pending notification to the Monitoring Officer, they are required to disclose those disclosable pecuniary interests at the meeting. This should be done by completing the Disclosure of Interest form and handing it to the Democratic Services representative at the start of the meeting. The Chair will then invite Members to make their disclosure orally at the commencement of Agenda item 3. Completed disclosure forms will be provided to the Monitoring Officer for inclusion on the Register of Members' Interests.

4. Urgent Business (if any)

To receive notice of any business not on the agenda which in the opinion of the Chair, by reason of special circumstances, be considered as a matter of urgency.

5. Investment Strategy Training (Pages 11 - 26)

To receive a brief initial training session

6. Grant Thornton Report - Croydon Pension Fund Audit Plan 2017/18 (Pages 27 - 42)

To receive the Croydon Pension Fund Audit Plan report for 2017/2018.

This item is for information only following its presentation at the 15 March 2018 meeting of the General Purpose Audit Committee.

7. **Progress Report Q1**

To Follow

8. **Options for Asset Transfer**

To Follow

9. **London Collective Investment Vehicle Update**

To receive an oral update and Q&A

10. **Governance Review**

To Follow

11. **Risk Register Review**

To Follow

12. **Forward Plan**

To Follow

13. **Investment Advisor Appointment**

To Follow

14. **Exclusion of the Press and Public**

The following motion is to be moved and seconded where it is proposed to exclude the press and public from the remainder of a meeting:

"That, under Section 100A(4) of the Local Government Act, 1972, the press and public be excluded from the meeting for the following items of business on the grounds that it involves the likely disclosure of exempt information falling within those paragraphs indicated in Part 1 of Schedule 12A of the Local Government Act 1972, as amended."

PART B

15. **Minutes of the Previous Meeting** (Pages 43 - 44)

16. **Progress Report B**

To Follow

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Croydon Council

REPORT TO:	**Pension Committee** **5 June 2018**
SUBJECT:	**London Borough of Croydon Pension Fund: Property Transfer Proposal**
LEAD OFFICER:	**Nigel Cook Head of Pensions and Treasury**
CABINET MEMBER	**Councillor Simon Hall** **Cabinet Member for Finance and Resources**
WARDS:	**All**
CORPORATE PRIORITY/POLICY CONTEXT: **Sound Financial Management**: The Pension Committee is responsible for the investment strategy for the Pension Fund and ultimately for ensuring sufficient assets are available to meet the liabilities of the Local Government Pension Scheme.	
FINANCIAL SUMMARY: This proposal has significant implications for the Council and the Pension Fund and will impact on the level of contributions required of the Council and other scheme employers. The proposal will also impact on the current and future funding level for the Council.	
FORWARD PLAN KEY DECISION REFERENCE NO.: N/A	

1. RECOMMENDATIONS

1.1 Note the detail contained within the report and

1.2 Delegate authority to the Executive Director of Resources to obtain specialist advice, including in relation to the legal implications and risks, and develop appropriate proposals regarding the asset transfer initiative with a view to providing a comprehensive report to a later meeting for consideration.

2. EXECUTIVE SUMMARY

2.1 This report provides the context for the work that has been undertaken to appraise the proposal to transfer certain property assets into the Pension Fund and reduce contributions as a result.

3 DETAIL

3.1 This report introduces the Pensions Committee to a proposal to transfer property assets to the Pension Fund. This idea has been developed over a period of time; an initial proposal was set out in a paper drafted by the Fund's Actuary, Hymans Robertson, in January 2018, and has subsequently been refined. This project is aligned with the Council's ambition to identify how the Pension scheme could contribute to and invest in the borough. The Scheme Actuary has drafted a note setting out how this might work and the impact upon the Fund valuation and contribution rates and this note is appended to this report.

3.2 In conjunction with a local charity, the Council sets up a partnership - Croydon Affordable Homes LLP (CAHLLP) - and leases the properties to it on a long-term basis in exchange for an agreed payment stream. CAHLLP manages and maintains the properties, collects rent, and pays the agreed amounts to the Council. At year 40, the properties return, fully maintained and unencumbered with debt, to the Council. The proposal is that, at that point the Council would immediately transfer ownership of the properties to the Pension Fund.

3.3 The current proposal concerns 346 properties, currently valued at £96.7 million, although other similar assets may be considered in due course.

3.4 The initial work on this exercise considered four options whilst noting that there might be other alternatives.

3.5 Option 1 reflected the most prudent approach to allowing for the property transfer agreement which would be to allow no contribution reduction until the property transfer is completed in year 40. This could be justified on the basis that the risks described below are considered to be so significant that it is undesirable or imprudent to allow for it, i.e. the contribution reduction, to happen now. This position could be revisited nearer to the transfer date when the terms and value of the transfer are more certain. This option has the benefits of simplicity and prudence, and would be consistent with the existing funding strategy because it would involve no change to the existing funding position, certified contributions or contribution stabilisation mechanism. For this reason the probability of meeting the funding target would be unchanged. However, it could be argued that this approach is excessively prudent.

3.6 Option 2 suggests that the existing funding strategy and contribution stabilisation mechanism should be left unchanged. The Fund allows for the property assets in the Council's funding position at future valuations (i.e. they are included in the property allocation of the Council's assets share) and hence in its contribution rates. The market value of the assets would need to be determined at each valuation date by an independent valuer. The additional assets may be enough to affect the stabilised contribution rate set at each subsequent valuation depending on the funding position and market conditions at the time. This process would be repeated at each future valuation when the contribution strategy is reviewed. It is unlikely that this approach would result in a material contribution saving for the Council due to the size of the transfer compared to the Council's assets and liabilities (the market value is equal to about 9% of the Council's liabilities) and the growth seeking nature of the Fund's investment strategy. This method has the advantage of requiring little additional actuarial work and of being consistent with the existing funding strategy. The probability of meeting the funding target at the end of the 22 year time horizon would be largely unchanged (there might be a slight improvement given the increased asset share).

3.7 For Option 3 the Council's contribution rate would be reduced immediately. In effect, the Fund would be 'banking' the value of the property assets now and, in return, reducing the future contributions required by the Council. At each subsequent valuation the reduction applied to the Council's contribution rate would be revisited. This would be practical as the Council's contribution strategy and contribution stabilisation mechanism is reviewed triennially at each formal valuation in any case. The current funding strategy for the Council does not allow for any form of contribution reduction and so special dispensation would therefore be required if this option was pursued. This would mean that any reduction in the estimated residual value of these assets would have an impact on future cash contributions.

3.8 Under option 3 the Fund would be giving up contributions of a known amount now in exchange for the transfer of a very uncertain value of assets in 40 years' time. To give the Fund comfort that it is not taking on excessive risk under such an arrangement, the Fund could insist on a retrospective 'top-up' arrangement whereby the Council agrees to make additional contributions to the Fund if the value of the property transfer portfolio increases by less than a specified amount over an agreed year time period (e.g. triennially). The precise details of the 'top-up' could be complex and would need to cover:

- The market value of the property portfolio;
- Determining the expected value of the property and the contributions that would have otherwise been received;
- 'Top-up' payments; and
- Whether the Council should benefit if the value of the property assets increased faster than expected (e.g. by being allowed to keep some of the proceeds after 40 years).

3.9 Provided the terms of such an agreement were acceptable to both parties, and provided the Council was able to afford any future required top-up payments, this option would reduce the risk to the Fund posed by option 3. However, it may be difficult for the Council to accept such an arrangement if it entailed a commitment to make unknown top-up payments based on the volatile valuation of the property assets. This inclusion of the retrospective 'top up' by the Council would also mean that special dispensation within the current funding strategy would not be as significant as that required in option 3. As the Council would periodically top up any shortfalls which might occur the probability of meeting the funding target at the end of the time horizon is less affected. This describes Option 4.

3.10 There are a number of risks associated with this proposal which would need to be considered and managed. The following paragraphs address these in a broad brush manner but it should be noted that the implications of adopting such an approach will require detailed specialist legal advice. The uncertainties involved in the proposal present many risks which can be broadly grouped into the following main categories.

3.10.1. **Legal risks** - The proposal (and any side agreement affecting contributions) may involve legal agreements between the Fund, the Council and other parties (such as CRLLP). Any lack of clarity within those agreements or failure to properly articulate responsibilities and risks could lead to substantial problems in future. In addition due consideration needs to be given to the appropriate nature of the delivery vehicle/mechanism for such proposals, associated governance arrangements in the context of the local government framework and restrictions whilst having due regard to the Council's duties and the potential for conflicts of interest to arise not just between the Council and the Fund but also for Members involved in the associated decision making. Such risks need to be fully assessed and articulated in order to obtain appropriate advice. At present there needs to be further work undertaken in relation to the options and their implications to assess these and other legal impacts and risks to enable informed decision making by Members.

3.10.2. **Regulatory risks** – The LGPS has experienced many regulatory changes recently and there is no reason to expect that it will not experience further change, particularly over a time period as long as 40 years. Future changes could, for example, explicitly forbid the kind of arrangement being considered here and it could be complex and costly to unwind it. The Local Government Pension Scheme Advisory Board, for example, is already discussing the use of 'asset-backed funding' which is similar in some ways to the arrangement in question here. The Fund should also consider if the long term (much longer than the Fund's recovery period) and/or unconventional nature of the arrangement might attract scrutiny from the Pensions Regulator, Scheme Advisory Board or the Government Actuary's Department, all of whom are now involved in oversight of the LGPS.

3.10.3. **Investment risks** – Some of the options discussed above involve making assumptions about the future growth in value of the property portfolio and how this compares to the value of contributions. It is very unlikely that these assumptions will be borne out in practice and the Fund must understand how it would be affected by this. For example, under options 3 and 4 the Fund will lose out if the value of the property portfolio, when transferred to the Fund, is lower than the value of contributions that would have been received from the Council instead. The Fund would have to consider this in the context of the portfolio as a whole.

3.10.4. **Political risks** – the Fund may wish to take advice on the suitability of investing in UK domestic property given that it is (and is likely to remain) a live political issue and may be subject to political action which would affect its value.

3.10.5. **Operational risks** – the complexity of the arrangement and the number of parties potentially involved increases operational risk which would have to be considered.

3.10.6 The Fund may wish to consider how it would monitor the operational side of the arrangement e.g. request the Council provides regular updates including independent valuations, uses of the property assets, rental income, insurance protection in place, major repair work, etc. There is also a likelihood that the development of the London CIV would impact on the development of any proposal. Any such monitoring should form part of the legal and governance framework put in place.

3.11 This approach is comparatively novel; although other Boroughs have adopted this way of exploiting assets, successfully developing this project will require that officers pull in quite specialised advice. This will include a full appraisal of the four options sketched out in this report by the Scheme Actuary as well as comprehensive legal and accounting advice. The preliminary work described in this report will need to be tested to ensure that the preferred option is the most likely to provide maximum benefit to the authority and address the funding issues described above. Officers consider that the period until the December meeting of the Pensions Committee is sufficient for this work to be completed and an evidenced and comprehensive report brought to the Committee for its consideration, before settling on one of the options described, or indeed a hybrid or other option.

3.12 The Committee is asked to delegate authority to the Executive Director for Resources to work up the options to a level of completeness such that a recommendation can be put for members consideration, having due regard to the relevant considerations and risks. It is envisaged that this would happen in time for the December 2018 meeting of this Committee.

4 FINANCIAL CONSIDERATIONS

4.1 There are no further financial considerations flowing from this report.

5. OTHER CONSIDERATIONS

5.1 Other than the considerations referred to above, there are no customer Focus, Equalities, Environment and Design, Crime and Disorder or Human Rights considerations arising from this report

6. COMMENTS OF THE SOLICITOR TO THE COUNCIL

6.1 The Solicitor to the Council comments that as part of any proposed delegation to officers as per the recommendation in section 1, specialist legal advice will be required on the implications and risks, both for the Council and the Pension Fund. There is insufficient information available at present in relation to the four options referenced above to indicate the areas of risk to an appropriate degree and to allow informed decision making on the options. Accordingly the recommendation is for officers to fully explore the options detailed above and obtain relevant specialist legal and other advice to present a fully considered set of proposals for Committee consideration.

Approved by: Sandra Herbert Head of Litigation and Corporate Law for and on behalf of Jacqueline Harris-Baker, Director of Law and Monitoring Officer

CONTACT OFFICER: Nigel Cook, Head of Pensions Investment and Treasury, Resources department, ext. 62552.

BACKGROUND DOCUMENTS: None

APPENDICES: Appendix A, Croydon Council property transfer proposal, June 2018. Hymans Robertson

June 2018 Pensions Committee meeting: Croydon Council property transfer proposal

Addressee and purpose

This paper is addressed to Croydon Council ("the Council") in its role as Administering Authority to the London Borough of Croydon Pension Fund ("the Fund"). It is intended to be shared with the Fund's Pensions Committee to summarise the actuarial perspective of the Council's proposal to transfer property assets to the Fund. In particular this paper updates and summarises the paper "Croydon Council property transfer proposal" (dated 5 January 2018) which sets out more detail behind the property transfer proposal and some of the wider considerations and risks in connection with it.

The advice in this paper depends strongly on the details of the arrangement, in particular the assumed value of the property portfolio and the assumed time at which the properties will be transferred to the Fund. If the Fund disagrees with either of these assumptions then please contact us to review the information and advice contained in this paper.

Background - Council's current employer contribution strategy

The most recent formal valuation of the Fund was carried out as at 31 March 2016. The funding position for Croydon Council at 31 March 2016 is shown below (further details of the data and assumptions used are noted in Appendix A).

Croydon Council Ongoing funding position	31 March 2016 £m
Liabilities	1,038
Assets	745
Surplus/(deficit)	(291)
Funding level	72%

As set out in the Fund's Funding Strategy Statement, dated February 2017, the objective of the Council's contribution strategy is for its assets to equal its liabilities (based on the Fund's ongoing valuation assumptions) in 22 years' time in approximately 3 in 4 economic scenarios modelled. In other words, employer contributions are set to achieve a c.75% probability of meeting the target 100% funding level in 22 years. To achieve this but allow predictability of contributions over time, the Council makes use of the Fund's "contribution stabilisation mechanism". This mechanism allows annual changes to the employer contribution rate to be limited to 1% of pay p.a..

At the 2016 valuation it was therefore agreed that the Council's contribution rate would remain at 25.2% of pay for 2017/18 and 2018/19 and would increase by 1% of pay to 26.2% in 2019/20. (Please note the Council subsequently made a £33,192,000 lump sum "prepayment" in March 2017 which served to reduce the contributions payable from 1 April 2017 to 31 March 2020.)

Background - Property transfer proposal

We understand that the Council is considering an arrangement whereby it leases a set of 346 properties to a local charity and, at the end of the lease in 40 years' time, transfers ownership of the properties to the Fund. The current value of the properties is assumed to be £96,700,000 based on information provided to us by the Council.

Following discussion with the Council and Fund, this paper sets out the Council's preferred approach to allow for the property transfer proposal within its employer contribution rates.

Proposed contribution strategy revision

Options for allowing for the property transfer

During initial discussions with the Council and Fund, various approaches to allow for the property transfer within the Council's contribution rate were considered. A key objective within each option was that the Fund would be "no worse off" than it otherwise would be if the Council had continued to make the full cash contributions.

Full details of the options considered are set out in our paper "Croydon Council property transfer proposal", dated 5 January 2018.

Proposed contribution revision approach

The proposed approach is to reduce the Council's contribution rate by an agreed amount from a suitable date (e.g. 1 April 2019). Using this approach the Fund is in effect "banking" the value of the property assets now and, in return, reducing the future contributions required by the Council. The proposal presents risks to the Council and to the Fund (for example legal, investment, operational and regulatory risks) which are considered in our paper "Croydon Council property transfer proposal", dated 5 January 2018.

To manage the risk to the Fund of allowing a contribution reduction, a retrospective top-up arrangement will be put in place. This arrangement will require that the Council make additional contributions to the Fund if the value of the property transfer portfolio increases by less than a specified amount over an agreed time period (e.g. triennially). This arrangement would mean that at the point the property is transferred to the Fund, the value of the property is equivalent to the reduction in the cash contributions over the 40 years.

The agreed contribution reduction depends on two key assumptions:

1. *How will the property portfolio change in value over the 40 years of the arrangement?*
   This is very difficult to estimate so we have provided results on a range of assumptions as shown in the table below. We have assumed that the property portfolio grows in value by a fixed percentage each year whereas in practice the value would go up and down depending on many factors including the strength of the local property market.

2. *What investment return would the replaced cash contributions otherwise have benefited from?*
   For consistency with the contribution rate modelling carried out at the 2016 valuation, we have assumed a 'best estimate' real return in excess of CPI of 3.5% p.a. based on the Fund's investment strategy at the 2016 valuation.

To agree upon the size of any contribution reduction we have calculated below what level of contributions can be 'replaced' by the value of property assets transferring in 40 years' time. For further information on the methodology, data and assumptions please see Appendix A.

Assumed real growth in property portfolio value (% p.a. in excess of CPI)	Potential contribution reduction (% of pay)
-3%	0.4%
-2%	0.6%
-1%	0.8%
0%	1.3%
+1%	1.9%
+2%	2.8%
+3%	4.1%
+4%	6.0%
+5%	8.8%

We do not make any judgement on the most appropriate value for the assumed real growth of the property assets, and the choice of values in the table above is not intended to represent what a suitable range of assumptions might be. Given the long-term nature of the arrangement and the risks involved to the Fund, we suggest that the Fund agrees an assumption with the Council with which it is comfortable, within the context of these risks. To achieve this agreement, independent expert advice might be useful.

Ultimately the Fund might consider this approach to be acceptable on the basis that the Council has a strong covenant and will always exist (in some form) to make up any future deficit caused by reducing contributions now.

Reliances, limitations and other considerations

The results in this paper are based on our previous paper “Croydon Council property transfer proposal”, dated 5 January 2018, except that they assume a larger transfer of properties and therefore a proportionally greater impact on contribution rates. Reliances and limitations are set out in appendix B.

Our previous paper set out some of the risks and other considerations related to the transfer proposal beyond the potential contribution rate reduction. We believe these other considerations are important and should be taken account of in any decision on the proposal.

Prepared by:

Robert McInroy FFA
For and on behalf of Hymans Robertson LLP
24 May 2018

Richard Warden FFA

Appendix A – Data, assumptions and methodology

Valuation results

The funding position and contribution rates for the Council are based on the results of the 2016 formal valuation for the Croydon Council pool. These results were based on the following data and assumptions.

Membership data	31 March 2016
Membership numbers	
Active	5,826
Deferred	7,903
Pensioner	6,439
Payroll/pensions (£000 p.a.)	
Actual pay	120,369
Accrued 80ths pension	6,166
Accrued 60ths pension	6,746
Accrued CARE pot	4,693
Deferred pensions	13,080
Pensions in payment	36,601
Average age (years)	
Active (final salary)	53
Active (CARE)	49
Deferred	53
Pensioner	68

Financial assumptions 31 March 2016	Nominal % p.a.	Real % p.a.
Discount rate	4.4%	2.2%
Salary increases[1]	2.7%	0.5%
Pension increases (= CPI inflation)[2]	2.1%	0.0%

[1] An allowance is also made for promotional pay increases (see table in valuation report).

[2] The pension increase assumption is equal to the long term assumption for inflation as measured by the Consumer Prices Index (CPI).

For the mortality and demographic assumptions used, and details on how the financial assumptions were derived, please refer to the 2016 formal valuation report for the Fund, dated 31 March 2017.

Estimates of contribution rate reductions

The figures were calculated by equating the value of the property portfolio transferred to the Fund in 40 years' time to the value of contributions that would have accumulated to the same value.

The value of the property portfolio is simply equal to the current value of £96.7m, increased for 40 years at the given growth rate. The value of contributions is based on the value of contributions paid over the next 22 years, accumulated to year 40.

The salary growth and inflation assumptions mentioned above are all equal to the assumptions set at the 2016 valuation (shown in the previous section). The assumed real investment return on the property portfolio was varied according to the table shown.

The assumed real investment return on contributions is a 'best estimate' figure based on the Fund's investment strategy and the Hymans Robertson Economic Scenario Service (ESS), a stochastic model of future potential economic scenarios. The ESS is used to project a range of possible outcomes for the future behaviour of asset returns and economic variables. Some of the parameters of the ESS are dependent on current market conditions, while other more subjective parameters do not usually change. The key subjective assumptions underlying the ESS are the average level and volatility of equity prices, bond yields, credit spreads and inflation. The model is also affected by other more subtle effects, such as the correlations between asset classes.

The following figures have been calculated using 5,000 simulations of the ESS, calibrated using market data as at 31 March 2016. All returns are shown net of fees. Percentiles refer to percentiles of the 5,000 simulations and are the annualised total returns over 5, 10 and 20 years. Only the overall portfolio returns are shown, however, similar information for separate asset classes is available on request.

	% p.a.	**Portfolio returns**	**Inflation (RPI)**
5 years	16th %'ile	-0.5%	1.2%
	50th %'ile	4.2%	2.6%
	84th %'ile	8.9%	4.2%
10 years	16th %'ile	1.2%	1.4%
	50th %'ile	4.7%	2.8%
	84th %'ile	8.2%	4.5%
20 years	16th %'ile	2.8%	1.7%
	50th %'ile	5.5%	3.0%
	84th %'ile	8.4%	4.4%
	Volatility (1 year)	10%	1.4%

Using the ESS and the Fund's investment strategy, the 'best estimate' return over 20 years is estimated to be 5.5% p.a. in nominal terms. This can be seen above as the 50^{th} percentile portfolio return over 20 years (50^{th} percentile means it is the median value, i.e. half of the modelled returns are higher than this and half are lower). The equivalent best estimate for RPI inflation is 3.0% p.a. and since the assumed gap between RPI and CPI inflation is 1% p.a., the best estimate assumption for CPI inflation is 2.0% p.a.. This leads to the best estimate assumption for the real return in excess of CPI of 3.5% p.a..

Appendix B – Reliances and limitations

This report is addressed to Croydon Council in its role as Administering Authority to the London Borough of Croydon Pension Fund. It should not be shared with any third parties without our prior written consent. Where consent is given, the report should be supplied in full including any related reliances and limitations.

Please note that Hymans Robertson LLP accept no liability to any third parties. The reliances and limitations apply equally to all users of this report.

This report complies (where relevant and to a proportional degree) with the Technical Actuarial Standards set out below:

- TAS 100; and
- TAS 300

It should be noted that this report does not comply with paragraph 12 of TAS 300. We do not believe the exclusion of the information required under this paragraph is material for the purposes of this advice.

This report together with the 2016 formal valuation report for the Fund (issued 31 March 2017), the asset-liability modelling carried out as part of the 2016 valuation (results issued September 2016), the Fund's FSS and the paper "Croydon Council property transfer proposal" (dated 5 January 2018) set out the aggregate of our advice.