Croydon Council

REPORT TO:	**Pension Committee** **21 November 2018**
AGENDA ITEM:	
SUBJECT:	**London Borough of Croydon Pension Fund: Property Transfer Proposal**
LEAD OFFICER:	**Richard Simpson, Executive Director Resources and Section 151 Officer**
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 implications for the Council and the Pension Fund and will impact on the level of contributions required of the Council.

FORWARD PLAN KEY DECISION REFERENCE NO.: N/A

1. RECOMMENDATIONS

1.1 The Committee is asked to agree to receive into the Pension Fund, the 346 housing properties as set out in paragraph 3.1, from Croydon Council, between November 2057 and April 2059.

1.2 As a consequence of recommendation 1.1 the Committee is further asked to agree the proposal to adjust Croydon Council's employer contribution rates to take account of the future transfer of properties. This would be based on assumed growth of CPI + 1.7% in the properties, which would result in a reduction of approx. 2.5% in the council's employer deficit contributions. This would be reviewed and adjusted if required in the tri-annual valuation.

1.3 The Committee should note that this proposal to transfer these assets from the Council's General Fund to the Pension fund in 40 years needs to be agreed by a future meeting of the full Council and so the Committee is further asked to delegate to the Council's s151 Officer in consultation with the Chairman of the Pension Committee to agree the appropriate wording of such a recommendation to ensure that all necessary protections for the

Council both generally and as Administering Authority are included..

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 in the future and reduce Croydon Council's employer contributions as a result.

3 DETAIL

3.1 This report provides the Committee with an update on progress to deliver the proposal to transfer 96 properties, purchased by the Council in 2013 and 2014, plus additional properties currently being acquired to bring the total to 346 properties, in total currently valued in excess of £100 million, into the Pension Fund. The Pension Committee received an earlier report at its meeting of 5th June 2018, which is Appendix A to this report, and delegated to the Executive Director of Resources authority 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.

3.2 This report sets out this updated proposal with comments on the relevant legal issues relating to the proposal. The Scheme Actuary has been consulted at each stage as to how this might work and the impact upon the Fund valuation and contribution rates and their original thinking is reflected in a report considered by the Pension Committee at its meeting of 5th June, 2018 and this paper is appended to this report together with the paper, dated January 2018, that Hymans Robertson drafted.

3.3 As stated earlier, the purpose of this exercise is to more effectively deploy the assets of the Council to manage contribution rates. In return for the transfer of property assets in 40 years' time, the Council has requested a reduction in its total contribution rate of between 1% and 3% of pay. The Actuary has calculated what annual growth in property value would be required to support these reductions without leaving the Fund worse off after 40 years. The required annual property growth rates in Table 1 below are based on the provided property portfolio value in excess of £100m, and use the data, methodology and assumptions outlined in the Actuary's paper dated 5 January 2018, Appendix B.

3.4 All of the calculations assume that the arrangements begin on 31 March 2016 (i.e. the assumptions are based on market conditions at that date, the Council payroll is assumed to be £120m as it was at that date, and the assumed transfer of property assets is assumed to happen on 31 March 2056, etc.). However, as all assumptions are inflation-linked the results will likely stay relatively stable with changing market conditions. Aside from the calculations, there are two separate leases, with two separate sets of dates and this will need to be reflected in the decision required to execute this proposal. For the sake of clarity the first lease runs from 1 November 2017 from the break option from November 2057. The second lease will run from March / April 2019 with the break option available in 2059.

Table 1 Contribution Reduction

Reduction in Croydon Council contribution rate (% of pay)	Required annual growth in value of property portfolio (% p.a. in excess of expected CPI inflation)
1%	(0.7%)
2%	1.0%
3%	2.0%

3.5 The Pension Fund and Council will take advice in order to ensure that the required annual growth rate for any agreed contribution rate reduction is suitably prudent and appropriate for the property portfolio in question. For comparison, the 'best estimate' investment return for the Fund's invested assets over 20 years (as used in the modelling carried out for the 2016 valuation) was CPI + 3.5% pa. Within this assumption the 'best estimate' return over 20 years for the diversified property assets held by the Fund was CPI + 1.7% pa. Further details are given on page 14 of the attached 5 January 2018 paper (Appendix B).

3.6 From the Actuary's perspective, although the property portfolio to be transferred to the Fund is very specific, their view is that none of the required annual property growth values seem imprudent. Therefore, provided the assumption was part of an overall agreement that was satisfactory to the Fund, the Scheme Actuary would have no objection to a reduction in contribution rates in the range 1% to 3%. However, the higher the assumed rate of property growth the greater the risk borne by the Fund, and the greater the risk that an adjustment to contributions may be required from the Council if the property portfolio does not grow in value as expected over the forty year period.

3.7 Members should refer to the 5th June 2018 report for details of the development of the options considered and for a fuller treatment of the risks associated with this scheme. In broad terms four options were worked up and distilled to the recommendation presented here. For members who are interested in the development of this proposal the current recommendation possesses characteristics of options 3 and 4 in the earlier report, as outlined in paragraph 3.17 below.

3.8 Mercers, as the Pensions Fund's professional, independent investment advisors, have considered the property transfer proposal, based on their understanding of it from the Hymans Robertson note (see Appendix B to this report). Noting that there is a lot involved in this proposal, they advise that the Committee consider:

- If the calculation basis for assessing the reduction in contributions is reasonable for the risk taken by the Fund.
- That there is sufficient flexibility to review the terms of the structure as time progresses.
- The impact on the cashflow position of the Fund and if action needs to be taken to lessen the risk of the Fund being in a cashflow negative position.

3.9 The Council have discussed with their legal advisors, Eversheds Sutherland, whether the transfer of assets can be effected under the LGPS Regulations. These discussions excluded considerations of actuarial, taxation or accounting issues. The considered response is that Croydon Council can pursue this option within the remit of the current Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 and that if this transfer were to occur today the properties could be considered assets of the Pension Fund. The mechanism to check the adequacy of the Council's contributions, as proposed by the Scheme Actuary, should mitigate some of the risk relating to the future transfer of the properties. This would take the form of a specific triennial valuation of these assets, aligned with the formal triennial actuarial valuation. The existing smoothing mechanism, applied to contributions, would continue to apply.

3.10 Because the Council is both the scheme employer and the administering authority, the normal ways of securing such a proposal from a third party do not apply as the Council, as a single legal entity, cannot contract with itself or charge its own assets to itself. The Council would have to pass a resolution to agree to transfer the properties in the future. The properties proposed to transfer to the Pension Fund are being leased by the Council to an LLP for 40 years. The Council has the option to terminate the leases at the end of that period and then to transfer the properties from its general accounts to the accounts of the Pension Fund so they would then become an asset of the Pension Fund at that stage. Set out in Appendix C.

Background

3.11 Under the terms of an existing agreement, with the local charity Croydon Affordable Housing, the Council has set up a limited liability partnership Croydon Affordable Homes LLP, (CAHLLP) to lease properties to it on a long-term basis. CAHLLP manages and maintains the properties, collects rent, and pays any surplus income to the Council as rent under the lease agreement. Under the terms of this proposal, at year 40, the Council has the option to exercise a break clause in the lease agreements whereby the properties would return, fully maintained and unencumbered with debt, to the Council. The proposal is that, at that point, the Council will transfer the properties to the accounts of the Pension Fund and so at that point the properties would become assets of the Pension Fund and allocated to the Council's notional share of assets in the Pension Fund. The Pension Fund could then decide to sell the properties or it is possible that the lease to CAHLLP could continue albeit that any rental income would then be paid to the Pension Fund.

3.12 There is a local authority precedent for this proposal. The London Borough of Bromley has set up a similar arrangement with the London Borough of Bromley Pension Fund. Under this arrangement, approved in June / July 2016, a scheme of 400 properties will be transferred to the Bromley Fund after 40 years and paid into Bromley Council's notional section of the Fund (subject to certain conditions). In return, Bromley Council will see savings of up to £1.7m per year from 2017/2018 via reduced pension contributions.

3.13 The most recent formal valuation of the Croydon Fund was carried out as at 31 March 2016. At that date the Council was estimated to be in deficit by approximately £291m, as shown in the table below.

Table 2 Croydon Council Ongoing Funding Position

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

3.14 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 in approximately 3 in 4 economic scenarios modelled after a period of 22 years (based on the Fund's ongoing valuation assumptions). In other words, employer contributions are set to achieve a c.75% probability of meeting the target 100% funding level in 22 years.

3.15 To allow greater stability and cost certainty for the Council over the 22 year period, any increases in Council contributions are limited to 1% of pay p.a. At the 2016 valuation the contribution rates payable by the Council were reviewed in line with the Fund's funding strategy. It was agreed that contributions 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. Subsequently, the Council made a £33.2m lump sum "prepayment" in March 2017 which served to reduce the contributions payable over the three year period. The final certified rates from the 2016 valuation were therefore as follows:

Table 3 Contribution Rates

Croydon Council certified contribution rates Year ending 31 March	Before prepayment (% of pay)	As certified (% of pay)
2018	25.2%	15.1%
2019	25.2%	15.1%
2020	26.2%	16.1%

3.16 In the initial work to investigate the proposal, the Fund Actuary, Hymans Robertson, described four possible methods for allowing for the property transfer in the Council's funding strategy but noted these were not the only possible ways of allowing for the transfer. These options were presented to the Committee in the agenda of the 5 June, 2018 meeting. That report is appended to this item as Appendix A.

3.17 These options have been appraised and a recommendation, based on this analysis, is presented here. A fixed reduction is applied to the Council deficit repair contribution rate. The reduction is calculated such that the value of replaced contributions is equal to the estimated value of the property assets transferring to the Pension Fund in 40 years' time, so that the Pension Fund is theoretically no worse off after 40 years than if it had continued to receive contributions. This arrangement is represented by the equation below:

Property value today * assumed rate of property growth over 40 years

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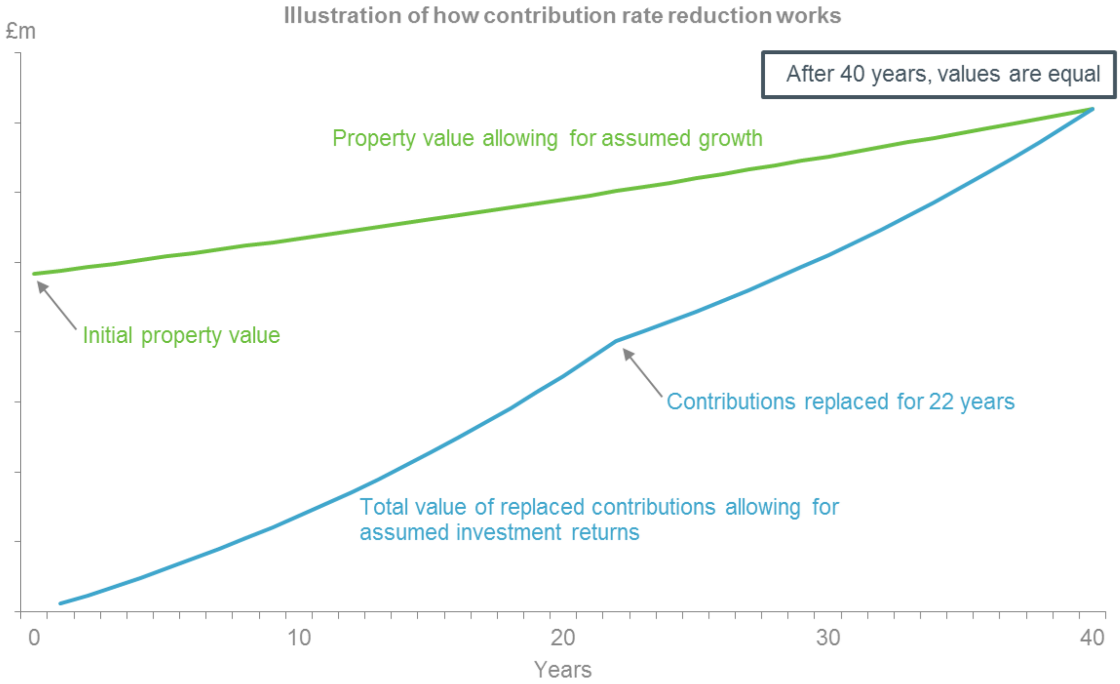
Contributions replaced (for agreed period) * assumed investment return over 40 years

3.18 As can be seen, the size of the contribution rate reduction depends on various assumptions, particularly the assumed growth in value of the property assets over the 40-year period. The Council's proposal is to assume an annual real growth rate of CPI + 1.7%. This would result in a reduction to employer contributions of an estimated 2.5% of pay per annum. Table 1, above, refers. This is illustrated in the chart below:

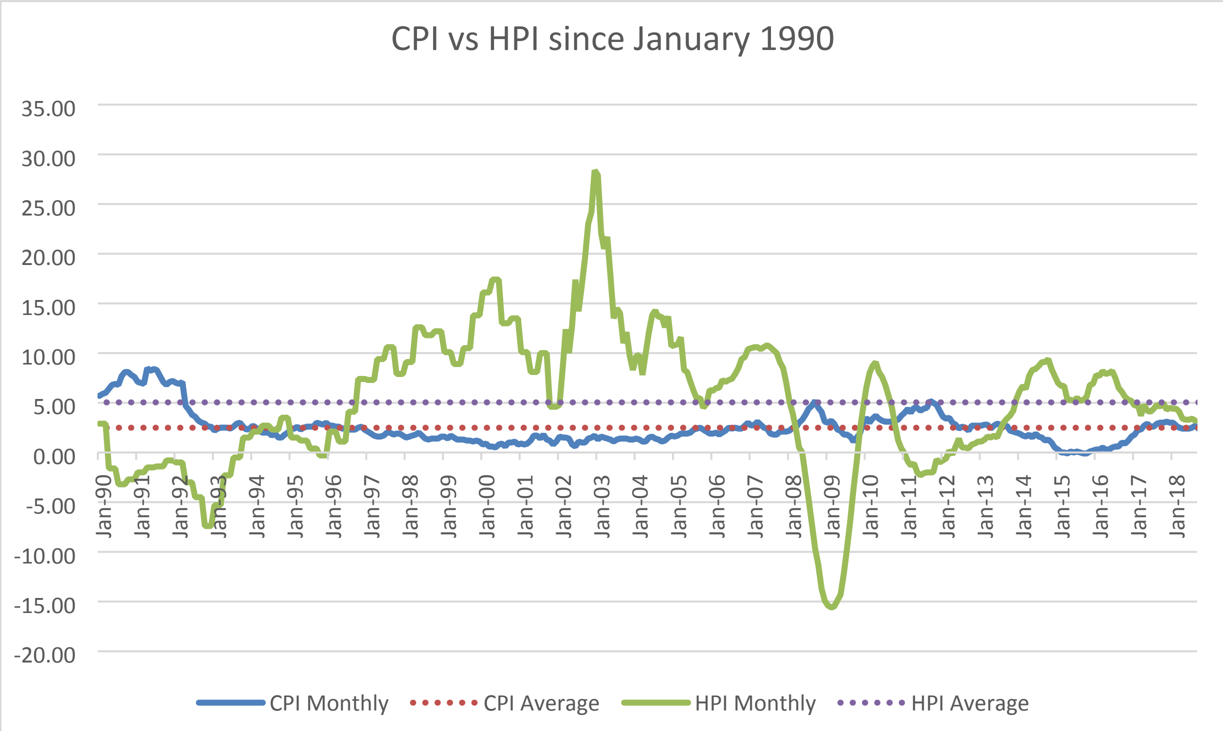
Chart 1 Contribution Rate Reduction



3.19 This proposal implicitly involves the risk of a shortfall caused through the property portfolio growing at a lower rate than the assumed amount, equivalent to CPI + 1.7.

3.20 Historically, the increase in the value of houses, known as the Housing Price Index (HPI), has been substantially higher than CPI. This is shown in the chart below.

Chart 2 Comparison of CPI with HPI



3.21 Since 1990, whilst more volatile than CPI, HPI has averaged 5.04% compared to CPI at 2.49%. This is a margin of 2.55% above CPI compared to the proposed assumption of CPI +1.7%.

3.22 It is important to clarify that there are a number of different measures for HPI. The data used above is sourced from the Land Registry All Dwellings Index and considers the entire United Kingdom. Over the same period, the London only housing price index averages at 8.41%. There is clearly risk in estimating HPI in to the future, however, in the context of the Bank of England's long term target for CPI of 2%, the relative historic performance of house prices means an assumption of CPI + 1.7% is recommended to the Committee.

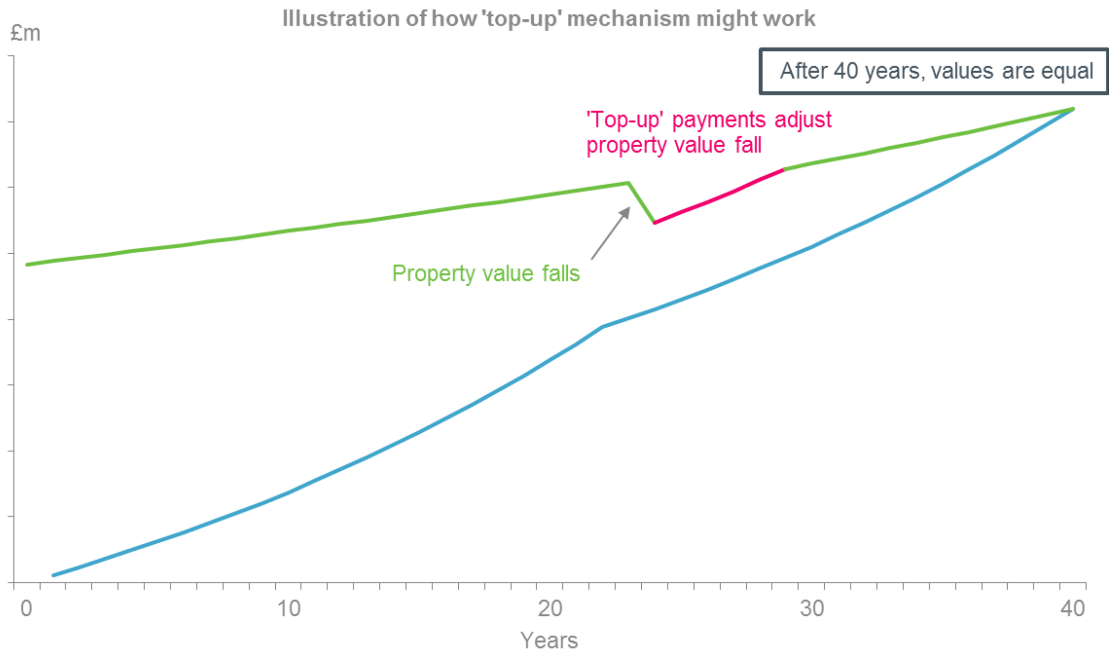
3.23 Under the proposals to transfer the properties to the Pension Fund, the Council would remain as the landlord throughout, both pre and post the transfer of the properties to the Pension Fund. The Council would therefore continue to benefit from any provisions in the lease regarding the receipt of periodic information relating to the homes to obtain assurance that they are being adequately managed and maintained by CAHLLP. This is to ensure that the value the Council expects to receive at the point of the option remains in line with the assumptions made in agreeing the reduction.

3.24 In the event that a shortfall emerges the question arises as to when that shortfall should be addressed by the Council. One option is that this should happen at the point the break clause in the lease occurs (i.e. after forty years). This has the advantage that over the forty-year period peaks and troughs may broadly cancel each other out and the overall return reflect the long-run average and hence be close to the working assumption of CPI + 1.7%. However this would appear imprudent, particularly if there is a sustained period of lower-than-expected growth. Also the government actuary or other regulatory bodies might query this arrangement, for example in the next Section 13 report.

3.25 The proposal is therefore that as part of the Tri-annual valuation the actuary would review the performance of the assets and take this into account when calculating deficit contributions required from the Council..

3.26 Chart 3 below sets out an illustration of how this could happen

Chart 3 Illustration of 'Top-Up' Mechanism



3.27 An actuarial paper would set out the agreement between the Council and the Pension Fund would stipulate how this correction would be applied. This document would include a definition of the trigger described above. At the moment the Committee is asked to agree to this proposal to adjust contribution rates *in principle*, subject to the safeguards in respect of property portfolio valuations, risks, additional contributions etc. being addressed to the satisfaction of the Fund Officers and their advisers.

3.28 The Committee should bear in mind that ultimately the Council in its capacity as an administering authority is responsible for paying Scheme members' benefits. The Council has an overarching role in ensuring the Pension Fund is sufficient to pay members their benefits as they become due. This recommendations moves the Council nearer meeting that obligation.

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 Croydon Council is the "administering authority" for the Croydon Pension Fund ('the Fund") which forms part of the Local Government Pension Scheme ("LGPS"). The Council is responsible for administering, maintaining and investing the Fund in accordance with The Local Government Pension Scheme Regulations 2013 and The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016. The Council is also a "scheme employer" in relation to the Fund.

6.2 Specialist external legal advice has been procured from Eversheds Sutherland (International) LLP in connection with the legal powers of the Council to enter into the suggested arrangement and how best this can be accomplished whilst providing the necessary protections for the Council. Any decision by both the Pension Committee and full Council will need to have full regard to this advice to be provided in Part B as an exempt item under Appendix C .

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

CONTACT OFFICER:

Nigel Cook, Head of Pensions Investment and Treasury,
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BACKGROUND DOCUMENTS:

None.

Appendices:

Appendix A:
London Borough of Croydon Pension Fund: Property Transfer Proposal. Report to the Pensions Committee, 5 June 2018.

Appendix B:
Croydon Council property transfer proposal, January 2018. Hymans Robertson

EXEMPT PAPERS

Appendix C
Advice to the Council in respect of a future transfer of assets to its Pension Fund, November 2018, Eversheds Sutherland International LLP **(exempt under Schedule 12A paragraph 5 Local Government Act 1972.**