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