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.

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For and on behalf of Hymans Robertson LLP
24 May 2018

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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 50th percentile portfolio return over 20 years (50th 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.