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:

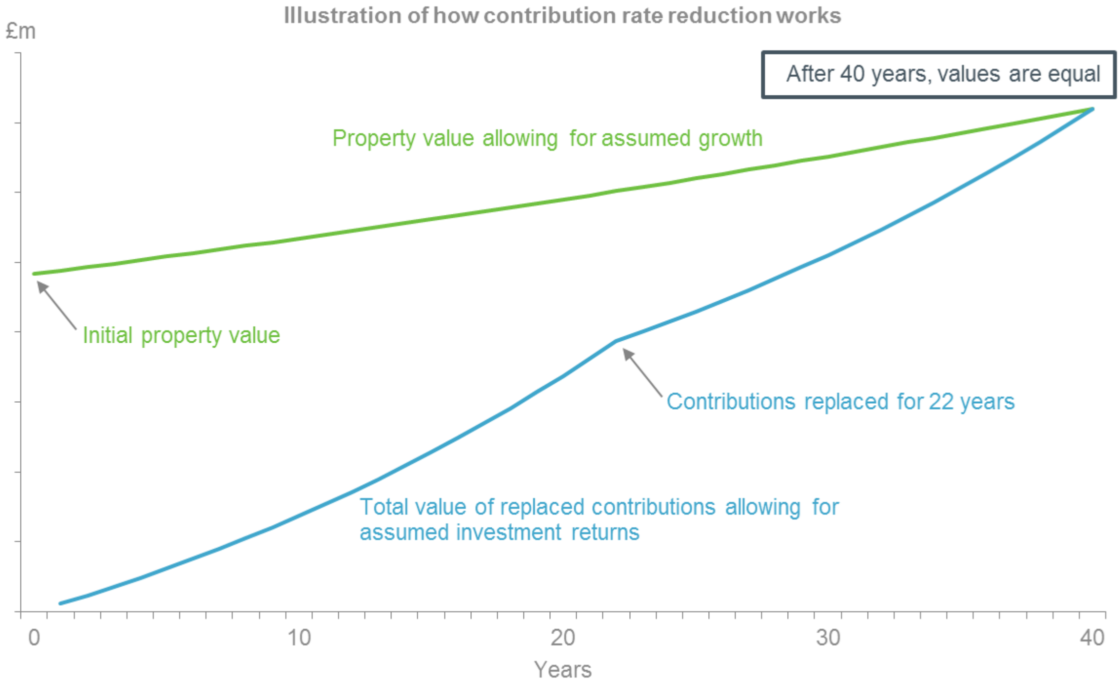
Property value today * assumed rate of property growth over 40 years

=

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:

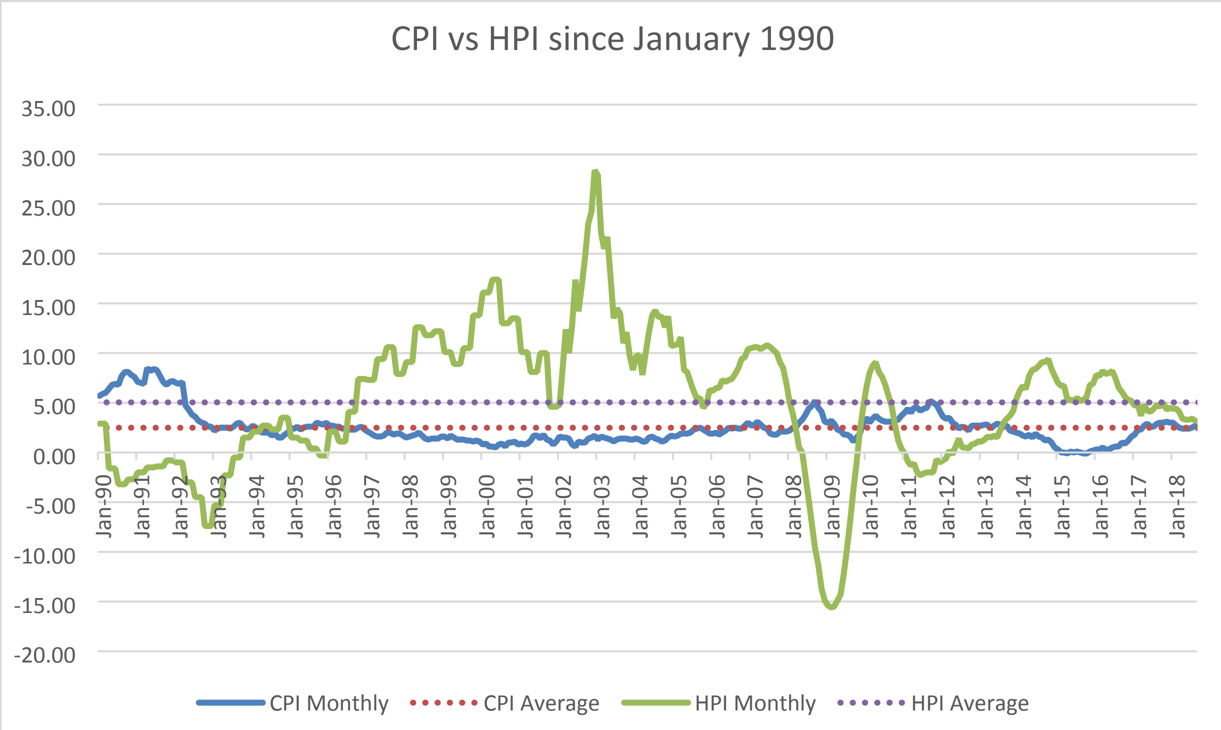
Chart 1 Contribution Rate Reduction



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.

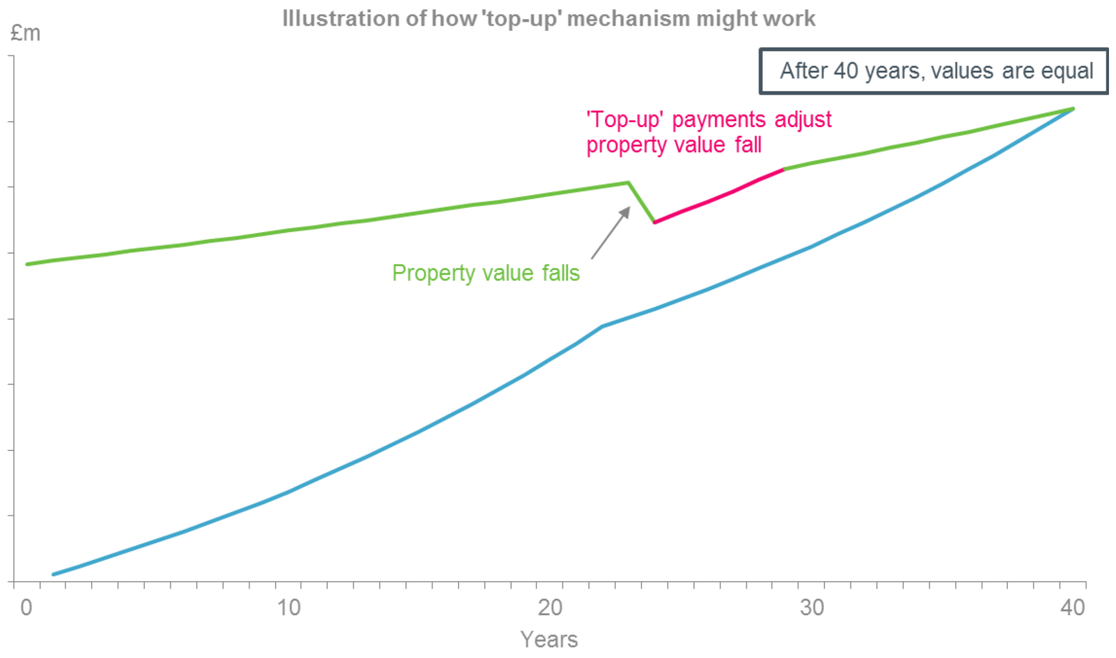
3.23 Under the proposals to transfer the properties to the Pension Fund, the Council would remain as the landlord throughout, both pre and post the transfer of the properties to the Pension Fund. The Council would therefore continue to benefit from any provisions in the lease regarding the receipt of 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,
Resources department, ext. 62552.

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.**

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Croydon Council

REPORT TO:	**Pension Committee** **5 June 2018**
AGENDA ITEM:	
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

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CONTACT OFFICER:

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

PEN 05062018

BACKGROUND DOCUMENTS:

None

Appendices

Appendix A:

Croydon Council property transfer proposal, June 2018. Hymans Robertson

London Borough of Croydon Pension Fund

Croydon Council property transfer proposal

January 2018

Robert McInroy and Richard Warden

Fellows of the Institute and Faculty of Actuaries

For and on behalf of Hymans Robertson LLP

Contents

1 Addressee and scope

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"). Please note our advice is specifically addressed to the Administering Authority, therefore we consider the proposal from the Fund's (not the Council's) point of view. This paper provides the requested information and advice regarding the proposal from the Council to transfer ownership of a specified set of property assets to the Fund in 40 years' time.

We understand that there is a possibility in the future that additional assets may be transferred to the Fund under similar arrangements. For the avoidance of doubt, the information and advice contained within this paper relates only to the possible options to allow for the asset transfer detailed in section 2.1 below. Any additional asset transfer proposal should be considered separately.

This paper may be shared with Jonathan Bunt, of JB Financial Consulting, in his role as special advisor to the Council. It may not be shared with any other party except with our prior written approval, in which case it must be shared in full.

As agreed and set out in our email of 9 November 2017, detailed comments and observations on the practical implementation of the arrangement and the key actuarial risks to the Fund are outside the scope of the requested advice in this paper.

2 Background

2.1 Property transfer arrangement

We understand that the Council is currently considering the following arrangement, involving 96 properties it purchased in 2013 and 2014:

1. In conjunction with a local charity, the Council sets up Croydon Regeneration LLP (CRLLP) and leases the properties to it on a long-term basis in exchange for an agreed payment stream.
2. CRLLP manages and maintains the properties, collects rent, and pays the agreed amounts to the Council.
3. At year 40, the 96 properties return, fully maintained and unencumbered with debt, to the Council.
4. At this time the Council immediately transfers ownership of the properties to the Fund.

We have been provided with an independent valuation for the properties, carried out by GVA, which estimates the current market value of the properties to be £21,700,000 (see letter "Multi Asset Housing Disposal – Best Consideration Assessment", dated 26 June 2017, to Richard Simpson, Executive Director of Resources).

We have been asked to provide advice on this proposal from the Fund's point of view, in particular how it might affect the contribution strategy for the Council and possible options for allowing for the proposal with this strategy.

If the Fund disagrees with any of the above, in particular the market value of the properties, then please contact us to review the information and advice contained in this paper.

2.2 Croydon Council – funding position and current 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. For details of the data and assumptions used to calculate these figures please see Appendix A.

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

As set out in the Fund's Funding Strategy Statement (FSS), dated February 2017, the Council's contribution strategy makes use of a "contribution stabilisation mechanism" (CSM). This mechanism allows annual changes to the total employer contribution rate to be limited to 1% of pay p.a..

At the 2016 valuation the Council contribution strategy was reviewed. It was agreed that the 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. The contribution rate would also not be reduced below 26.2% of pay for the remaining 19 year time horizon of the Council's current contribution strategy.

In addition, the Council 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.

Allowing for the CSM and the lump sum prepayment, the certified Council contribution rates from the 2016 valuation were as follows:

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%

As set out in the Fund's Funding Strategy Statement, these contributions target full funding on the "ongoing valuation" assumptions (as set out in Appendix A) over a time horizon of 22 years. The probability of achieving this objective under the agreed CSM was estimated to be 73%.

3 Possible options for Council contribution rate reduction

We set out below four options for how the transfer could be allowed for in the Council's contribution rate and funding position. For each one we have considered the main components and include a comment on how the option would affect the funding strategy. In particular, we consider how it would affect the probability of the Council reaching its full funding target over its agreed recovery period of 22 years.

For the avoidance of doubt we have not provided any steer or opinion on whether any of the options included would be preferable. Options 1 to 3 are ordered in decreasing order of prudence (from the Fund's perspective). Option 4 includes an additional arrangement which reduces some of the risks inherent within option 3.

There are several other risks and considerations not directly connected to the effect on contributions that should also be considered, these are summarised briefly in section 5.

3.1 Option 1 – no allowance for property transfer

The most prudent approach to allowing for the property transfer agreement 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 in section 5 are considered to be so significant that it is undesirable or imprudent to allow for it 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 CSM. For this reason the probability of meeting the funding target would be unchanged. However, it could be argued that this approach is excessively prudent and hence leads to opportunity costs for the Council.

3.2 Option 2 – allow for property transfer at future valuations within the existing CSM

Under this option the existing funding strategy and CSM are 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 expert. 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 2% 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).

3.3 Option 3 – Agreed reduction in contributions alongside current CRM

Under this option the Council's contribution rate would be reduced immediately (perhaps using one of the reductions quoted in section 4.2 below). 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 CSM is reviewed triennially at each formal valuation in any case.

Strictly speaking, the current funding strategy for the Council does not allow for any form of contribution reduction. Special dispensation would therefore be required if option 3 was pursued.

In addition if a deficit was to occur in the future as a result of the Fund "missing out" on returns it would otherwise have achieved on the "replaced" cash contributions, it would result in an increase to the future contributions required from the Council. This continuous reliance on making up any potential shortfall through future contributions could be regarded as imprudent and inter-generationally unfair.

Nevertheless, perhaps this approach would 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.

3.4 Option 4 - Agreed reduction in contributions alongside current CRM and include a retrospective 'top-up' mechanism

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:

- how the market value of the property portfolio should be determined (e.g. by whom and how frequently)
- how to determine the 'expected' value of:
  - The property assets (e.g. by reference to a fixed assumption made at the outset or by reference to something else such as an index); and
  - the contributions that would have otherwise been received (e.g. by reference to an assumption at the outset, an assumption that is market-related or the actual fund returns received over the period)
- how any 'top-up' payments should be made (e.g. in what timescales)
- 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)

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.

3.5 Other options

The four options above are not intended to represent an exhaustive list of all the approaches that could be considered. They do, however, represent the four approaches we believe are most likely to satisfy both the Fund and the Council. We would be happy to consider alternative options beyond these.

4 Possible impact of property transfer on contribution strategy

Under the proposed agreement the Council will transfer ownership of property assets to the Fund in 40 years' time. Given that this is so far in the future, its impact on the Council's contributions today is difficult to quantify and depends strongly on how the reduction is allowed for and what assumptions are made about the growth in value of the property over the time (among other things). This section considers the scale of any reduction to the Council's contribution rate that could be made under option 3 or 4 (as described above).

In simple terms, the property assets received in 40 years' time could serve to reduce the contributions payable now. In order for the Fund to be no worse off versus the existing certified contributions due, the reduction to the contribution rate should be equivalent to the value of the property transfer.

There are a number of key assumptions which will impact on the contribution reduction, including:

- How will the property portfolio change in value over the 40 years?
- What investment return would the replaced cash contributions otherwise have benefited from?

4.1 Value of property portfolio at transfer date

Any value placed on an asset in 40 years' time is very uncertain and very sensitive to the assumed growth in value over that time. To illustrate this, the table below shows how the value of the transferring property assets depends on the assumed rate of growth.

The figures are based on a current value of £21.7m. The growth rates shown are 'real' growth rates, i.e. growth in excess of long-term assumed CPI inflation. This means that the values after 40 years are more comparable with the current value because the effect of general price increases is stripped out. We have assumed that the same growth rate applies uniformly over the 40 year period, whereas in practice the value of the portfolio would be expected to change by a different amount every year. The rates shown should therefore be regarded as 'average' rates over the 40 year period.

Assumed real growth in property portfolio value (% p.a. in excess of CPI)	Portfolio value after 40 years (£m, 2016 prices)
-3%	6.4
-2%	9.7
-1%	14.5
0%	21.7
+1%	32.3
+2%	47.9
+3%	70.8
+4%	104.2
+5%	152.8

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.

4.2 Equivalent value of contributions

To calculate the size of any reduction in contributions, we must calculate what level of contributions can be 'replaced' by the transfer of property assets in 40 years' time. To do this we calculate what level of contributions has the same value after 40 years as the value of the property assets transferring at that time. We have assumed that the contribution reduction will apply for 22 years from the 2016 valuation date, in line with the time horizon within the Council's contribution strategy.

To calculate the value of these 22 years of contributions at year 40, we rely on an assumption for the investment return achieved on the contributions over the period. For consistency with the modelling that underpins the CSM, 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 (see the appendix for further details).

By equating the value of the property assets after 40 years with the value of contributions after 40 years, we can calculate the level of contributions that could be 'replaced' by the property transfer. The table below shows the results of the analysis in cash terms and as a percentage of pay.

Assumed real growth in property portfolio value (% p.a. in excess of CPI)	Portfolio value after 40 years (£m, 2016 prices)	Potential contribution reduction	
		(£m, 2016 prices)[1]	(% of pay)
-3%	6.4	0.1	0.1%
-2%	9.7	0.2	0.1%
-1%	14.5	0.2	0.2%
0%	21.7	0.3	0.3%
+1%	32.3	0.5	0.4%
+2%	47.9	0.7	0.6%
+3%	70.8	1.1	0.9%
+4%	104.2	1.6	1.3%
+5%	152.8	2.4	2.0%

[1] These contributions are assumed to increase each year in line with the assumed rate of salary increases at the 2016 valuation. The monetary values shown are for the first year.

The figures in the table demonstrate how sensitive the saving is to the assumed rate of growth in the property assets.

5 Risks and other issues to consider

Given the unconventional and long-term nature of the proposal, it is important for the Fund (and indeed the Council) to consider the risks involved and the other issues (beyond pension contributions) that should be taken into consideration.

Full consideration of the risks and other issues is outside the requested scope of this paper. High level comment is provided below:

5.1 Risks

The uncertainties involved in the proposal present many risks which can be broadly grouped into the following main categories.

1. **Legal risks -** The proposal (and any side agreement affecting contributions) will involve legal agreements between the Fund, the Council and other parties (such as CRLLP). Any such agreement carries the risk of misunderstandings that could lead to substantial problems in future. For example, lack of clarity in the agreement to transfer ownership of the property to the Fund after 40 years could lead to legal challenges in future.

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. We are aware that the 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. **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 (option 4 retrospectively mitigates this risk through a top-up payment). The Fund may also want to take investment advice about the concentration risk of investing a substantial amount in relatively non-diverse and illiquid portfolio of property assets.

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.

5. **Operation risks** – the complexity of the arrangement and the number of parties potentially involved increases operational risk e.g. fraud or mismanagement which could adversely impact the value of the property portfolio when it is transferred to the Fund.

   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.

5.2 Other issues to consider

The Fund should consider all of the issues involved in the arrangement beyond pensions costs, including (but not limited to):

A. **Conflicts of interest** – The unconventional nature of the arrangement and the fact that Croydon Council is both the Fund's Administering Authority and the employer involved in the arrangement leads to a potential conflict of interest. The Fund and the Council should take steps to ensure such a conflict is avoided, and that there is clear evidence to support this should it be questioned.

B. **Accounting and reporting** – How will the arrangement be reflected in the Fund's accounts and should it seek advice? We suggest that the Fund discusses the arrangement with its accountants and auditor.

C. **Use of the properties once transferred to the Fund** – The Fund should consider what it will do with the property assets when it receives them, taking into account its investment strategy and any limitations imposed by regulation or its membership of an LGPS investment pool.

D. **Administrative and advice costs** – The arrangement could entail upfront legal and advice costs and ongoing costs related to valuations and reporting. There could also be significant costs involved at the point the assets are transferring to the Fund, e.g. transaction costs if they are sold or management costs if they are retained. The Fund should consider if these costs should be covered as part of the arrangement.

E. **Formal approval process** – given the unconventional nature of the arrangement and the increased potential for (real or perceived) conflicts of interest and regulatory scrutiny, the Fund should ensure that the decision-making process is transparent and clearly documented.

F. **Details of 'top-up' arrangement (if applicable)** – if the Fund and the Council entered into an agreement like the one outlined in option 4 in section 3.4 above, they would need to ensure that the details were clearly defined and understood by both parties. It would also be important to ensure that such an agreement did not lead to excessive risk for either party. For example, the Fund would not be protected from falling property values under such an arrangement if the top-up requirements on the Council were unaffordable.

6 Suggested next steps

We would suggest the following next steps:

- Fund and Council to agree if and how they wish to proceed, e.g. using one of the options in this paper or an alternative.
- Both parties to seek legal advice on the contracts and agreements that would need to be in place for the arrangement to go ahead, covering the transfer of property and any additional agreements such as the 'top-up' mechanism in option 4.
- Council to finalise the details of the proposal based on agreed arrangement with the Fund
- Council to take the proposal to the Fund's Pensions Committee for approval, including consideration of:
  - Timescales of implementation – e.g. from 2019 valuation or earlier?
  - Any changes to the Funding Strategy, including (if necessary) the requirement to formally revise the Funding Strategy Statement
  - Management and documentation of how the decision was made including how potential conflicts of interest have been addressed
  - Risks involved in the arrangement and how these will be monitored and mitigated
- Inform or discuss with other interested parties e.g. the Fund's Local Pension Board, London Collective Investment Vehicle, Scheme Advisory Board, etc

We would be happy to discuss the content of this paper or provide further actuarial advice on any aspect of the transfer, including modelling alternative proposals.

Prepared by:

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Richard Warden FFA

For and on behalf of Hymans Robertson LLP

5 January 2018

Appendix A – Data, assumptions and methodology

Valuation results

The funding position and contribution rates for the Council quoted in section 2.2 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 in section 4.2 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 £21.7m, 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 tables in section 4.2.

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) and the Fund's FSS set out the aggregate of our advice.

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