HYMANS ROBERTSON

London Borough of Croydon Pension Fund

Croydon Council property transfer proposal

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Robert McInroy and Richard Warden

Fellows of the Institute and Faculty of Actuaries

For and on behalf of Hymans Robertson LLP

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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:

Robert McInroy FFA

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.