The Church of England Funded Pension Scheme (CEFPS)

Actuarial valuation at 31 December 2018

Consultation Response

THE CHURCH OF ENGLAND
PENSIONS BOARD

Introduction

Thank you everyone who attended our valuation workshops and replied to the valuation consultation. We appreciate your time, consideration and input.

We received a range of responses to the consultation. We presented these responses along with the questions and discussion points from the workshops to our Board meeting in September. We also involved our actuarial advisers (LCP) and our covenant advisers (Lincoln Pensions) in this discussion.

This report highlights:

- the common themes we explored and reviewed,
- the professional advice we received, and,
- the final results of the valuation.

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Pensions Manager
On behalf of the Church of England Pensions Board
October 2019

Section 1
Executive summary and final results

Executive summary

In the consultation document and at the valuation workshops, we explained how we have developed a new valuation methodology which we refer to as Asset Led Funding, or "ALF". We adopted ALF to better reflect our long-term investment strategy and help limit future funding volatility.

At this valuation, the deficit reduced from £236m in 2015 to £57m, using our initial results. Following the 2015 valuation, we spread the £236m deficit over a 10 year "deficit recovery period", expecting this to be cleared by December 2025. With the initial 2018 valuation results showing a much lower deficit than in 2015, maintaining the overall contribution rate would allow the deficit to be cleared by December 2023. This is two years earlier than previously expected. While this is very positive news, the amount you need to pay for future benefits increased from 28% to 33%. Combining this with the deficit payments keeps the contribution rate at 39.9%.

Many of you asked if we could keep the deficit recovery period at December 2025 in return for a small reduction in the contribution rate. We considered how this would affect all Responsible Bodies and the long-term funding, being mindful that our key responsibility is to our members and beneficiaries.

We asked Lincoln Pensions, our covenant advisers, to help us explore the implications. Lincoln's advice is that clearing the deficit as quickly as possible is more beneficial to members and, ultimately, the Responsible Bodies. A small reduction in the contribution rate would not strengthen the overall covenant rating. There is more on this in the covenant review section.

We also wanted to gauge whether a reduced contribution rate would get regulatory approval. We asked the Pensions Regulator which is the regulatory body that supervises our work. The Regulator's team are taking a greater interest in CEFPS since the 2015 valuation when they first became actively involved. They wrote; *"Whereas we recognise that there is a significant level of support within the participating employers to see a reduction to the present 39.9% contribution level, it would be tPR's preference that the scheme continues to reduce the present deficit in as short a time period as possible. If the contribution rate were to be reduced, we would need to understand the reasons for the reduction and how the risks of the reduction would be managed or mitigated. In general, where a scheme's deficit reduces, we prefer to see deficit recovery contribution rates maintained (with consequently shorter recovery periods) rather than lower deficit contribution rates paid over the same period."*

You also asked us to look at the assumptions again with LCP. This has led us to change one assumption which **allows us to reduce the deficit further to £50m and clear it one year earlier by 31 December 2022**. If experience is as we expect based on December 2018 conditions, the contribution rate from 1 January 2023 will reduce to 32.8%. There is more on this in the final results section.

Since CEFPS started in 1998 the contribution rate has either increased or stayed level at each valuation. We now have the prospect of **reducing the contribution rate in 2023 to the future service rate level**. However, we are still in turbulent financial times and we do not know what Brexit will mean for pensions and wider economic conditions. We will keep a close eye on how this affects pensions and our investments and we will continue to talk to you as we progress to the next valuation at the end of 2021.

Final results

A common view from the consultation and workshops is that we could be less prudent and Responsible Bodies would appreciate us taking more risk.

Whilst all of the assumptions used in the valuation have an impact, the two main areas where prudence has a material effect are:

1. our assumed investment returns
2. how long we expect members to live

We reviewed the initial assumptions with LCP. One assumption where we felt we could take a different approach concerned how much pension members give up at retirement for extra tax-free cash. Members are exchanging about 6% of their pension for an extra lump sum. Assuming this continues, updating this assumption reduces the deficit by £7m and the future service contribution rate by 0.2%.

We asked the Regulator for their view on this, and their response was "*We are comfortable with this sort of change provided there is good evidence to support it.*"

The final deficit is now £50m and if our future experience is in line with the assumptions, we will pay off the deficit by 31 December 2022. This table explains the final results.

	Results in 2015	**Proposed results in the consultation**	**Final results**
Future service	**28.0%**	**33.0%**	**32.8%**
Deficit recovery	**11.9%**	**6.9%**	**7.1%**
Total	**39.9%**	**39.9%**	**39.9%**
Deficit	**£236m**	**£57m**	**£50m**
Deficit paid off by	**December 2025**	**December 2023**	**December 2022**

If our assumptions are borne out, this table shows that the contribution rate will drop from 39.9% to **32.8%**.

A future service contribution of 32.8% is based on prudent assumptions that we chose in the expectation that this provides a 2 in 3 chance that the contribution rate is enough, but a 1 in 3 chance it is not.

LCP calculated the future service rate using "best-estimate" assumptions (i.e. a 50/50 chance). Based on these assumptions, there is a 50/50 chance that **the future service rate will reduce to 26% in the long term.**

Under the previous valuation methodology, the contribution rate for both deficit and future service contributions would have been much higher.

Section 2
Covenant review – benefit of clearing the deficit

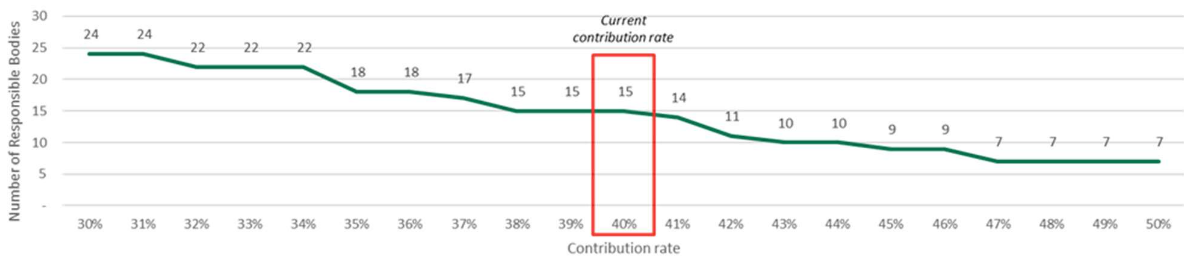
"Could we have a token reduction in the contribution rate?"

This question came out strongly both at the workshops and in the formal consultation responses. One of our biggest challenges is securing the interests of our members without over-burdening Responsible Bodies with the cost.

When responding to the consultation, some of you shared detailed analysis of how a small reduction in the contribution rate now would help ease financial burdens or enable you to spend on other areas such as increased curacy placements. A small number of respondents argued against this, preferring that eliminating the deficit is the priority and that the contribution rate should not decrease until there is significant evidence of sustained improvement.

We asked Lincoln Pensions, our Covenant advisers to estimate what different levels of contribution rates would mean for operating cashflows. Lincoln only looked at the dioceses rather than all Responsible Bodies. The chart below shows the results.

Contribution rate sensitivity (based on FY15-FY17 average operating cash flow)



This chart shows the effect of different contribution rates on diocesan operating cashflows. It uses financial years 2015-17 as a baseline and shows the number of dioceses more or less able to meet different contribution rates from operating income during that period. Dioceses with improved operating cashflows would have needed to make less use of other assets to support their operations. Dioceses with worsened cashflows would have needed to dispose of other assets to support expenditures. Analysing operating cashflows helps assess the strength of covenant.

The chart suggests:

- A token reduction in the contribution rate amount, say 1 or 2%, would have had little impact
- If the contribution rate fell to 33%, seven dioceses would see materially improved cashflows
- By contrast even a small increase in the overall contribution rate would worsen operating cashflows

From this there is little evidence that a token reduction in the contribution rate would materially improve the covenant.

If our assumptions are borne out and the contribution rate reduces to about 33% in January 2023, this is a level which many more Diocese can meet from operating income.

A lower contribution rate combined with reduced risk and a lower Section 75 deficit will have a positive impact on the overall Covenant rating. This is provided there are no substantial changes in the scheme sponsors' finances, pensions legislation and regulation, or economic and demographic changes.

Section 3
Next steps and further work

Signing off the valuation

We will now forward the draft valuation documents to the Pensions Regulator for their comments. We will then formally submit the valuation before the end of the year.

This will bring the 2018 valuation to a close and gives you the stability that the contribution rate will stay at 39.9% for the next 3 years, barring any exceptional negative or positive experience before then.

Further work

One of the key elements of the valuation is that it gives you, the funders, a set contribution rate for three years. The contribution rate is expected to remain the same whether there is negative or positive experience between valuations.

CEFPS has not been fully funded since it was established. Now the deficit is £50m, there is a chance that sustained positive experience could lead us into surplus. LCP use a model to help predict the chances of this happening. Using broad assumptions:

- there is a 5% chance that there could be a surplus of more than £650m at the next valuation
- there is a 5% chance there could be a deficit of more than £400m at the next valuation

We have been unable to justify reducing the contribution rate at this valuation but if we see significant positive experience before the 2021 valuation, we will talk to you to explore ways we can use that.

We might reduce the contribution rate, i.e. stop the deficit contribution of 7.1%. Alternatively, we could lock in the good experience and de-risk to give us more chance of staying fully funded.

Keep in mind that there is an estimated 1 in 3 chance the contribution level will not be sufficient. That leaves a risk that the deficit and the contribution rate will increase at the next valuation.

Integrated Risk Management

Over the next three years we will continue to monitor the interaction between funding, investment and covenant risks, which collectively make up our Integrated Risk Management framework.

Our investment strategy, the ability for employers to underwrite risk and the funding level of CEFPS, all play a part and we will continue to monitor each very closely.

We will continue to monitor the CEFPS funding level and talk with you about how this is progressing between now and the next valuation at the end of 2021.

Appendix
Response to common questions

Assumptions

Why has the future service rate increased to 32.8%? Is it too prudent?

The amount we need to cover the cost of future benefits has increased to 32.8%. When setting this rate, the regulations say we must be prudent. Prudent means there is a better than evens chance of this being enough to cover all benefits and we adjust further for the covenant rating. We have set a prudence level of about 65%, meaning there is roughly a 1 in 3 chance that 32.8% will not be enough.

The future service rate has increased from 28% to 32.8% of pensionable stipends. There are two main reasons:

1. We expect inflation to be higher than we assumed for the 2015 valuation. This is in line with market expectations.
2. We are more pessimistic about future investment conditions. We have reduced our assumption about future investment returns in line with market expectations.

While we could take a less prudent view and set a lower future service contribution rate, this significantly increases the risk that we will need to increase contributions at later valuations. With our members and beneficiaries' interests in mind, and being mindful regulations require us to set prudent assumptions, we feel a contribution rate of 32.8% is reasonably but not excessively prudent.

To set the contribution rate we also need to set a "discount rate". This is the return we expect on our investments. This is a key assumption. If the figure is relatively "high", we rely more heavily on potential investment returns and that lowers the contribution rate.

At this valuation, we assume our investments will earn broadly 3.2% p.a. in absolute terms. We believe the overall level of prudence is the same as we adopted for the 2015 valuation. If our assumption is too prudent then experience will outperform our estimate and our assets will perform better. That would clear the deficit sooner.

Is a prudence level of 65% (a 2 in 3 chance) a standard view across other pension schemes?

The trustees of each pension scheme choose their level of prudence, but they must reference the covenant rating that supports the scheme.

For example, if a pension scheme was backed by a very weak covenant and there were concerns about the employer's long-term stability, the level of prudence would need to be very high. If the assumptions turn out to be wrong, the employer is unlikely to be able to support the losses.

If a pension scheme is backed by a very strong covenant, the employer might be willing to underwrite high levels of risk. The trustee could reduce the level of prudence to reflect this.

Our prudence level of about 65% means we have roughly a 2 in 3 chance that a contribution rate of 39.9% is enough to pay future benefits and clear the deficit by December 2022. It reflects our covenant rating, i.e. "fairly strong".

We have seen £101m of positive assumption changes between valuations. Why?

Most of this is due to our assumptions about life expectancy. The latest CMI (continuous mortality investigation) tables reflect national mortality levels. The rate of increase in life expectancy has slowed down in recent years but of course, there is a possibility that this trend may not continue.

Clergy continue to live longer than the general population, but we assume the same slowing in the rate of increase in life expectancy affects Clergy too. This means we expect to pay pensions for less time than we thought at the last valuation.

Why do we use Retail Prices Index (RPI) as our reference to inflation?

The main reason we use RPI is that our scheme rules require us to increase pensions in payment in line with RPI (up to certain caps). Unless the rules are changed, we must use RPI for pension increases.

The increase in the National Minimum Stipend is also an important assumption in the valuation. At the workshops it was noted the Archbishops' Council has talked in terms of the stipends increasing in line with the Consumer Prices Index (CPI). We checked this with the Archbishops' Council. Although there is an expectation that average stipends will increase closer to CPI, the formal policy specifically remains to look to increase them by RPI.

Both points are policy matters for the Remuneration & Conditions of Service Committee. We will write to the Chair to ensure the Committee is aware of the views expressed in this consultation.

What about the future of RPI?

On 4 September 2019, the Chancellor of the Exchequer and the UK Statistics Authority announced that RPI is to be aligned with CPIH (the CPI index that allows for owner-occupied housing) between 2025 and 2030. The Government will consult early next year on the precise timing of the proposed change. If the change happens, given pensions in payment are linked to RPI, we can expect to pay out lower pension increases from that point. The value of index-linked gilts will also fall and there is some evidence that markets have already priced this in since the announcement.

Are we seeing any effect of Renewal and Reform?

Not at present in terms which make any material difference to our calculations.

Is the change in male and female Clergy considered?

Yes. The current ratio of Clergy is about 75% male and 25% female, but the ratio for new entrants is approximately 50/50. We have taken this into account.

Contribution rate and affordability

If we still used the previous valuation method, what would the contribution rate be?

Under the previous valuation methodology, higher contributions would be needed for both future service and deficit contributions.

Do the Church Commissioners participate? What is the size of their liability? Could they fund the deficit either with cash or pledge assets?

The Commissioners are a Responsible Body and their liability is about 2% of the overall liabilities. The Commissioners have a legal responsibility to CEFPS and cannot "walk away", but we cannot use them as a guarantor. Pledging assets would need a change in legislation.

Investment

Are our investment "haircuts" too prudent?

We are required to take a prudent view on investment performance. This means we have to apply a discount or "haircut" to our investment returns to allow for risk. The biggest haircuts apply to the riskier assets.

If our haircuts are too prudent then our investment returns should be greater than we expect. At the next valuation, the funding position will improve, everything else being equal.

General

Is there a general view to change the Clergy benefits?

We were asked why CEFPS is still an open defined benefit scheme. This is something that lies with Synod and the Church and all changes need to be agreed by Synod. We are the trustee and administer the pension scheme. We are aware that the Archbishops' Council has been asked to undertake a review of the clergy remuneration package and any conclusions will be reflected in future valuations.

We have based ALF on CEFPS staying open to new members. If this changes, we will need to review ALF. The most likely outcome would be that we would revert to the previous valuation methodology with a significant increase in the contribution rate.