Welcome to the CWPF valuation workshop

THE CHURCH OF ENGLAND
PENSIONS BOARD

Housekeeping

- Please mute your microphone during the presentations
- Please turn off your video – it will ensure the best connection possible for the presentation
- Please do use the chat window to raise any questions that you have
    - we'll weave in responses if we can
    - there will be a further opportunity to address questions after each item
    - a FAQ will be produced to accompany the slides

Agenda

1. **10.30 Welcome and overview**
   John Ball and Peter Dickinson

2. **10.40 Employer covenant update for this valuation**
   David Bailey

3. **10.50 Investment strategy – reaching the “end game”**
   LCP

4. **11.35 Break**

5. **11.40 Setting the assumptions**
   LCP

6. **12.25 Close**
   John Ball and Peter Dickinson

Introduction to today’s workshop

Format for today

Covid-19

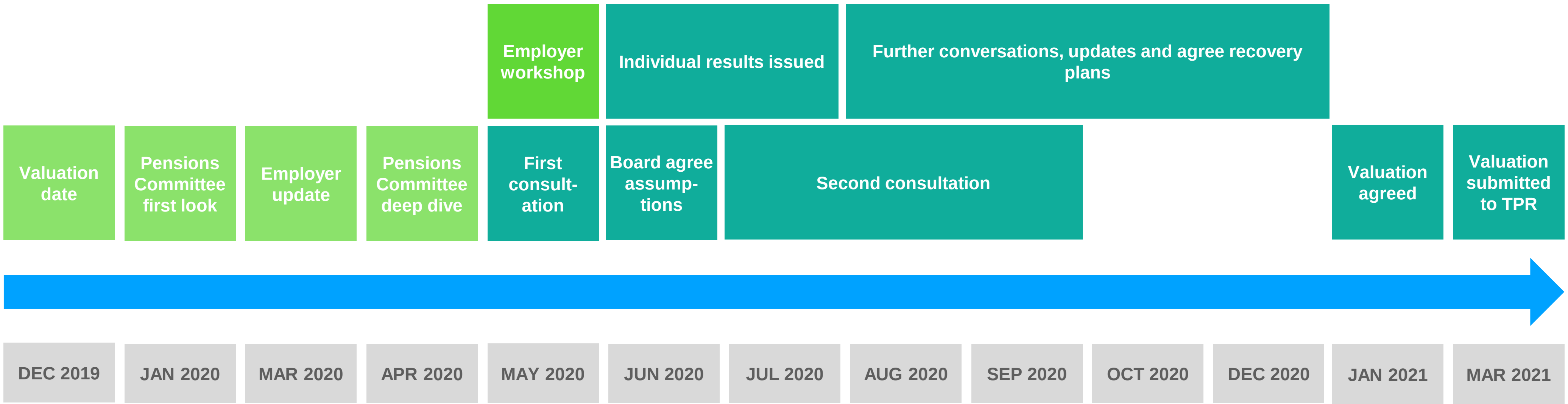
Survey and recordings

How to ask questions

2 step consultation

Continuing conversations

Valuation timeline



First stage consultation – key questions

Discount rate

Salary increases

Mortality

De-risking LRS

We will follow today's session with:

- **Recordings of the investment and assumptions sessions**
- **A consultation survey where you can give your formal feedback**

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Employer covenant

Peter Dickinson and David Bailey

Covenant rating scale

We have adopted an objective, four point rating scale, tailored to the particular circumstances of the Participating Employers and consistent with our methodology for the Clergy Scheme and the CAPF

WEAK	FAIRLY WEAK	FAIRLY STRONG	STRONG
• The Participating Employer has significant operational problems and is unlikely to be able to meet levied contributions from operations • The Participating Employer has limited non-restricted assets and may struggle to support operational shortfalls or VaR from its own assets • The Participating Employer is likely to be unable to support more than a minimal level of investment risk	• The Participating Employer demonstrates operational issues and may be unable to meet levied contributions from operations • The Participating Employer may have material non-restricted assets but may struggle to meet its portion of VaR from its own assets • The Participating Employer can support only a low level of investment risk	• The Participating Employer demonstrates positive operational performance and is likely to be able to meet levied contributions from operations • The Participating Employer is likely to have material non-restricted assets with which to support operations or additional liabilities arising from VaR • The Participating Employer can underwrite moderate levels of investment risk	• The Participating Employer demonstrates strong operational performance and there is a substantial likelihood that levied contributions can be met from operations • The Participating Employer has material assets and it is likely that it can meet any additional liabilities arising from VaR • The Participating Employer can underwrite substantial investment risk

GREATER VOLATILITY CAN BE TOLERATED IN INVESTMENT STRATEGY (APPROACH GUIDED BY INVESTMENT CONSULTANT)

APPROPRIATE VALUATION OF LIABILITIES / TECHNICAL PROVISIONS (BASIS ADVISED BY CWPF ACTUARY)

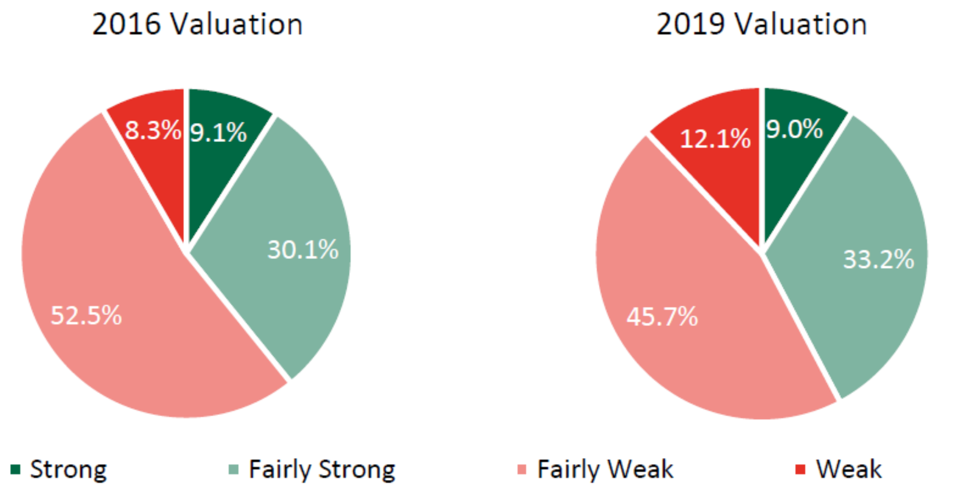
THE WEAKER THE VIEW OF THE EMPLOYER COVENANT, THE MORE PRUDENT THE TRUSTEES ARE LIKELY TO WANT TO BE IN SETTING TECHNICAL PROVISIONS, AND THE LESS RISK THE TRUSTEES ARE LIKELY TO WANT TO TAKE WITH THEIR INVESTMENT STRATEGY

Lincoln's covenant findings

Sponsor Covenant Movement since 2016 Valuation

		To			
		Weak	Fairly weak	Fairly strong	Strong
From	Weak	-	3	-	-
	Fairly weak	2	-	2	-
	Fairly strong	-	2	-	1
	Strong	-	-	2	-
	Total	**4**	**24**	**13**	**5**
	Change from 2017	(1)	1	1	(1)

Sponsor Covenant Results – DB Section Cessation liability by strength



Key points:

Lincoln assess 46 participating employers (88% of liabilities)

Results do not allow for Covid-19 impact

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Investment strategy

LCP

Mary Spencer, FIA
LCP Partner

Contents

Setting a long-term strategy

Why is the Board setting a long-term target?

1. **Achieving a strong position before the Funds are too mature**
2. **Reducing reliance on the strength and future support of the employers**
3. **Aiding all decision making from this point onwards**

Paying promised benefits is the key objective of all schemes, and it is important to set clear plans for how this objective will be delivered and balance the risks that will be faced in doing this

The Pensions Regulator has issued a consultation on DB funding. The principles in that consultation are consistent with the comments on this slide, and our proposals for the long term investment strategy

Factors considered in setting a long-term target

Covenant strength	***Maturity of Fund***	***Ability to achieve target***	***Regulator guidance***
A scheme with a stronger covenant can afford to take a more aggressive investment strategy and ***target a relatively short date*** to reach its ultimate target.	A scheme that is not fully funded by the time it starts to mature has reduced ability to make good investment returns on a declining asset base and / or increase the certainty of the Sponsors having to pay in contributions – so the Board ***aims to hold a secure portfolio ahead of each Fund becoming too mature***.	We want to choose a timeframe that is ***achievable with an appropriate level of risk***, with regards to the covenant.	The Pensions Regulator accepts that schemes with different strength sponsors and different maturities will need to agree different paths to their long-term target.

The Board has considered each of these in proposing the longer-term target and is now consulting with employers ahead of its planned implementation

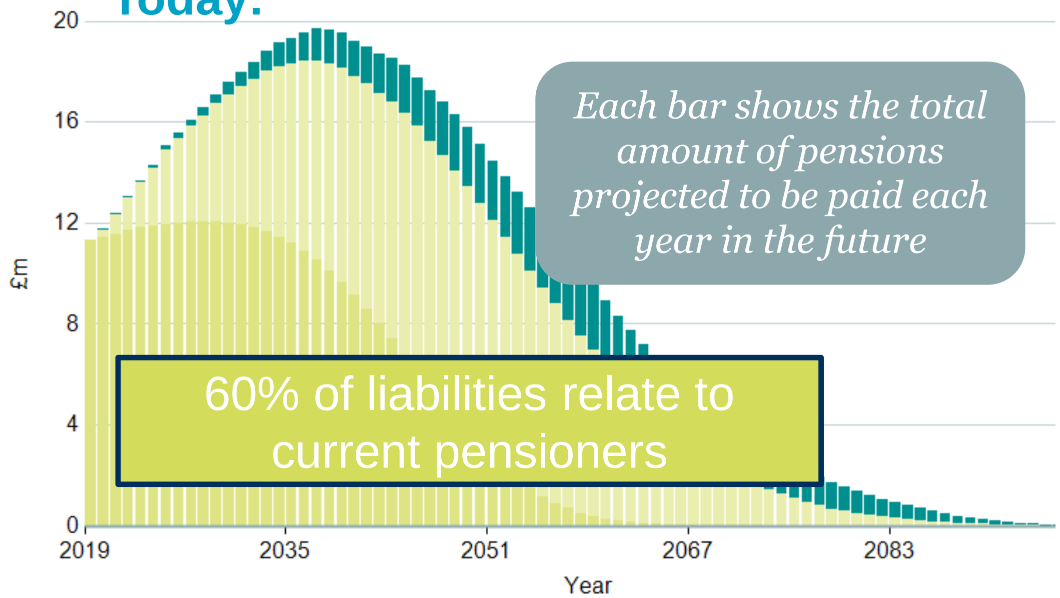
Covenant drives flexibility on the target chosen

Current assessment of the Fund's covenant

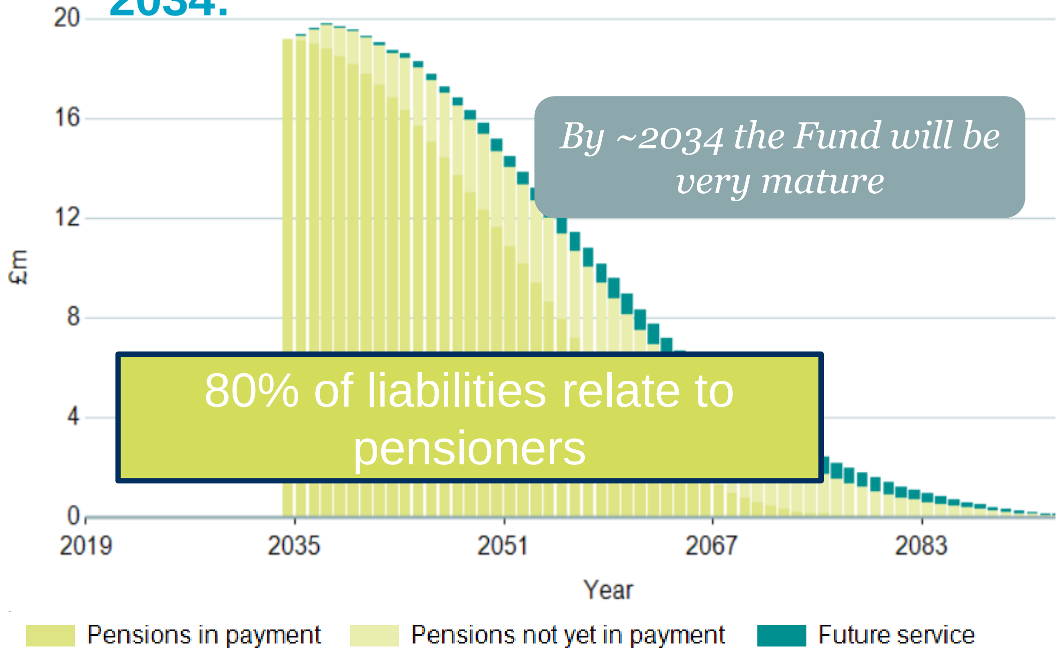
- The overall covenant was assessed as **fairly weak** as part of the 2019 Actuarial Valuation.
- This implies a **stronger long-term target**, particularly within the LRS, is required as there is less ability to rely on the employers to make good investment risk events now and in the future.
- That said, the nature of the employer covenant (many employers who are stable but cash-constrained) means the Board are comfortable to accept a long-term investment portfolio with a modest level of ongoing investment risk and to transition to a long-term target **gradually over a reasonable period**.
- The Board believes it is reasonable to adopt a target of **gilts+0.2% pa** from an investment perspective. This allows for some holdings of corporate bonds in the long term, providing a **modest return to cover uninsured risks**.
- Given the variety in individual covenants, and feedback from employers from previous workshops, the Board is comfortable to **retain a 100% return-seeking strategy within employer pools in the General Fund** and address individual covenant issues when agreeing recovery plans.

Maturity provides a "backstop" on timeframe

Today:



2034:



The Pensions Regulator defines a Fund as "very mature" by the time the duration of the liabilities falls to 12 to 14 years – in the case of the DBS, this is projected to be around 2034

The Board considers December 2034 as a hard backstop for achieving the long-term target

The ability to achieve the target

- The Board proposes to incorporate the long-term funding target into the technical provisions as part of the actuarial valuation at 31 December 2019.
- This is captured in the planned de-risking within the LRS, alongside the movement from the General Fund to the LRS as members retire.
- At the valuation date, this de-risking, alongside recovery of the funding deficit, resulted in an expected investment strategy **projected to achieve the long-term target by 2034**.

- *Since 31 December 2019, the funding position has deteriorated and the biggest impact will have been on the employer pools within the General Fund.*
- *To date, feedback from employers has been against de-risking the General Fund assets.*
- *At the present time, the Board does not propose to take immediate action, eg to de-risk the General Fund assets, or to request additional contributions to cover the increased shortfall.*
- *Instead, the Board proposes to **review the investment strategy on an ongoing basis** and it may propose de-risking of the General Fund in the future.*

Where is legislation heading?

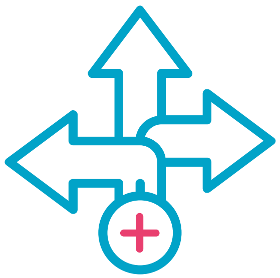
Eight principles outlining TPR direction of travel in DB funding consultation

1. Demonstrating compliance and risk management – **“IRM” and Chair’s Statement**
2. Achieving **long-term objective**:
   - By the time “significantly mature”
   - With low dependency on employer
   - And taking little investment risk
3. Developing a journey plan which is **explicitly linked to technical provisions**
4. **Aligning investment strategy** to funding strategy – reducing risk
5. Using **covenant rating to determine risk** today, and reducing reliance on covenant over time
6. Additional support can work in a bespoke world
7. Deficits to be recovered “as quickly as affordable”
8. **Open schemes** to be treated “the same” as closed schemes

The framework for setting long-term investment strategy

Step 1:
Define the target

What is our ultimate target and **when** should we aim to reach it

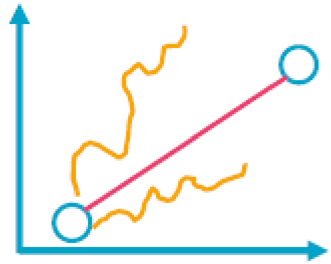


Step 2:
Avoid being thrown off course

Understand the risks that could set you back and mitigate these as far as practical

Step 3:
Invest for success

Set an investment strategy today that can **generate the returns required**, whilst **managing risk**



Step 4:
Manage the journey

Evolve your investment strategy over time, reacting to actual experience and **keeping you "on track"**

The Board's proposed investment strategy

The Board's proposed investment strategy

High level overview of the Board's proposals

General Fund (Employer non-pensioner pools)	Life Risk Section (Pensioner pool)

Long-term LRS funding target of Gilts +0.2%, target by 31 December 2034
No changes at this time to General Fund's 100% return-seeking strategy

Retain 100% allocation to return-seeking assets in the General Fund but manage the exposure to less liquid return-seeking asset pools

Increase interest rate and inflation hedging by leveraging the gilts held

Switch return-seeking holdings to credit pool assets by 31 December 2034

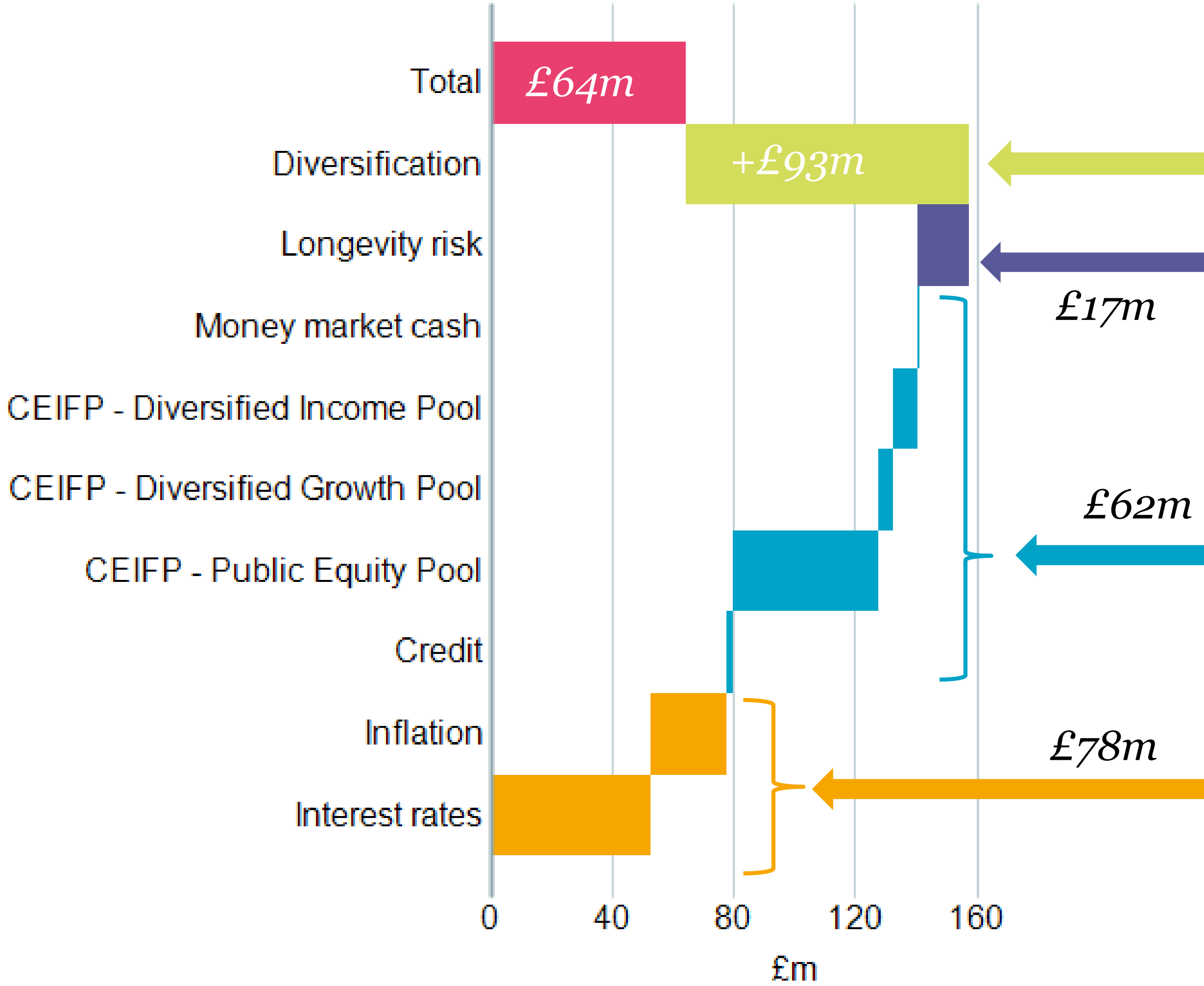
Continued switches from General Fund to LRS as members retire
Look to reduce illiquid assets in the General Fund over time
Time-based de-risking of the LRS to switch all return-seeking assets to credit assets by 31 December 2034

The impact on investment risk

Understanding the impact on investment risk

Sources of risk in the current strategy

As far as possible, only take risk if you expect it to be well rewarded. Other risks should be removed, reduced or mitigated, where possible.



Diversification benefits
In normal market conditions not all downside risks are expected to materialise at the same time (providing a +£93m 'diversification benefit')

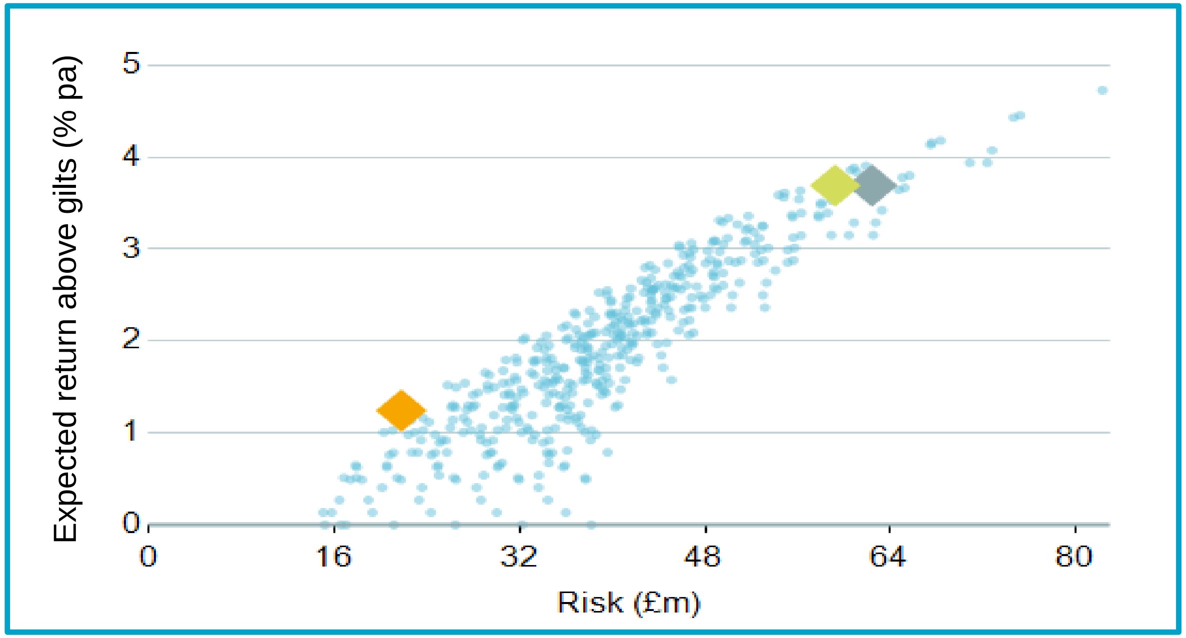
Longevity risk
The Fund remains exposed to longevity risk (members living longer than anticipated). This can only be directly hedged with a further buy-in or a 'longevity swap'.

Return-seeking investment risk
The Board expects to be rewarded over the long-term by assuming these risks but will consider the proportions held in each pool as the Fund matures.

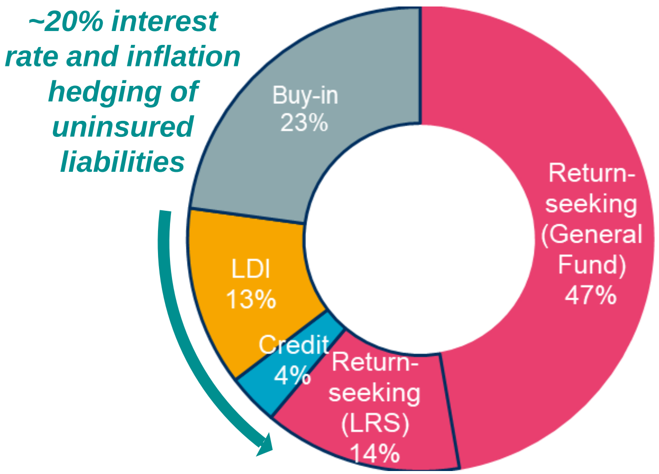
Interest rate / inflation risk
Represents around half of the gross VaR. This risk is material and in the Board's view it is unrewarded over the long-term and could be reduced by increasing interest rate and inflation hedging through liability matching assets.

Source: LCP Visualise as at 31 December 2019. Risk is measured by a 1-year 95% VaR of £Xm, which means that there is a 1 in 20 chance (or a 5% probability) that the funding position could worsen by £Xm or more, compared to the expected position, in any 12 month period, due to investment risk and longevity risk.

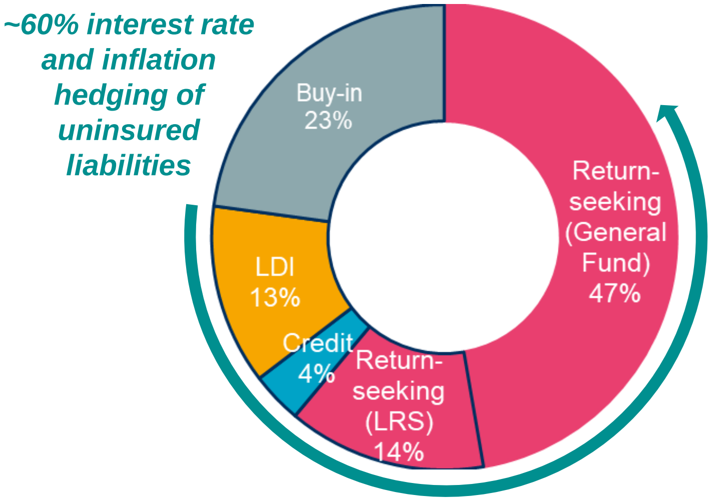
Implications of proposed changes on overall risk and return



Current investment strategy

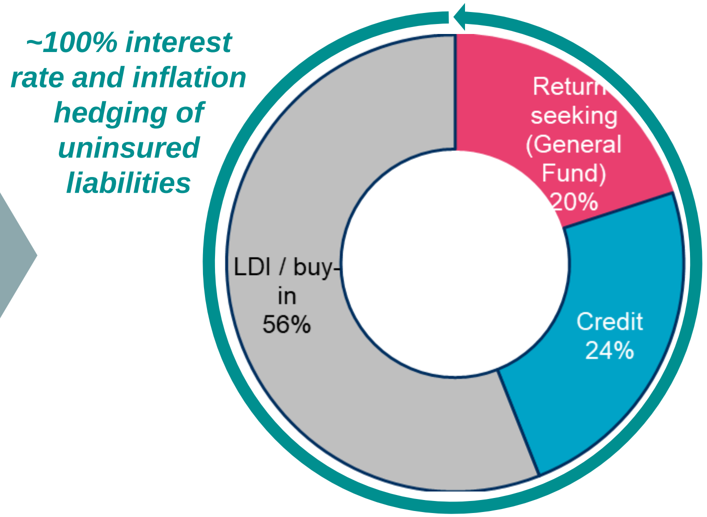


Proposed immediate investment strategy



Assets switched from GF to LRS and de-risking of LRS itself leads to the following strategy by 2034

Proposed long-term investment strategy (at 2034) *



* Allocation to General Fund at 2034 is implied by the projected proportion of liabilities relating to pensioner members. Hedge levels shown on technical provisions basis (excluding the buy-in and the insured liabilities). Risk is measured by a 1-year 95% Value at Risk with respect to the Technical Provisions funding target. A VaR of £Xm means that there is a 1 in 20 chance (or a 5% probability) that the funding position could worsen by £Xm or more, compared to the expected position, in any 12 month period, due to investment risk and longevity risk. Note that risk for the 2034 investment strategy is calculated based on the current funding position (although by this point the funding position is expected to have improved).

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Setting the assumptions

LCP

Stephen Davies, FIA
LCP Senior Partner

Paul Meredith, FIA
LCP Partner

Contents

- the regulatory framework
- the preliminary results position
- key valuation assumptions
- explanation of proposed changes

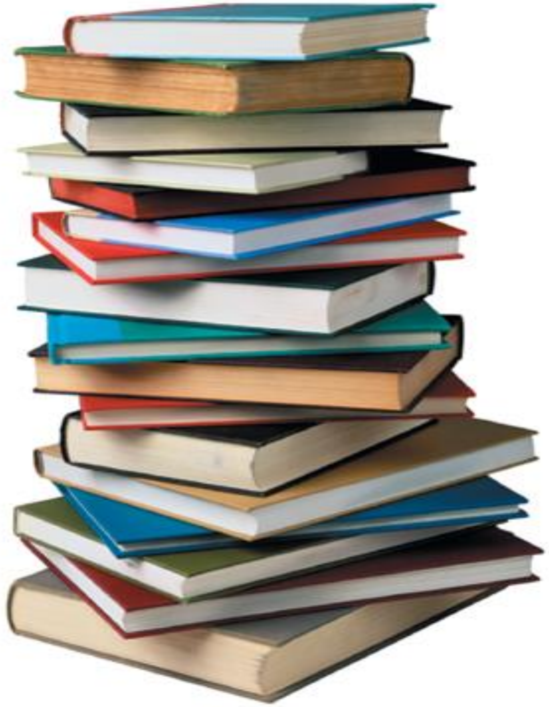
The regulatory framework

Statutory framework

Pensions Act 2004
Occupational Pension Schemes (Scheme Funding) Regulations 2005

- Perform an actuarial valuation at least every three years to set the
  - funding target ("Technical Provisions")
  - level of contributions to be paid

- Prudent actuarial assumptions
  - overall
  - discount rates
  - mortality



2019 Annual Funding Statement

Pensions Regulator to be "clearer, tougher, quicker"

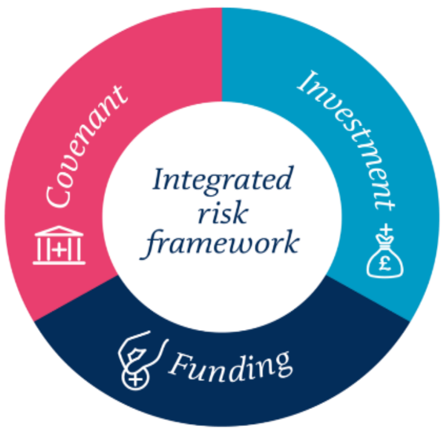
- The 2019 funding statement built on the Regulator's 2017 and 2018 funding statements and is consistent with its draft principles for the new funding framework.
- In particular the 2019 statement sets out the expectation that trustees will:
  - **set a long-term objective** for paying benefits – for example to get to self-sufficiency or buy-out
  - **set a consistent long-term funding target** (LTFT) in relation to the objective
  - **establish a journey plan** for progressing to the LTFT
  - **ensure that investment and funding strategies are aligned** with the ultimate objective and LTFT
  - **risks (particularly covenant) are monitored and managed**
- **The Regulator segmented schemes by covenant strength and funding characteristics.**
- **Deficit contributions should be "proportionate" to dividends or other "covenant leakage"**

New terminology: Long Term Funding Targets (and journey plans to get there)

Maturity matters to TPR when agreeing a plan

Is 7 years the new "long"?

Scrutiny of dividends versus deficit contributions



https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-annual-funding-statement-2019.ashx

2020 Annual Funding statement

More of the same but…

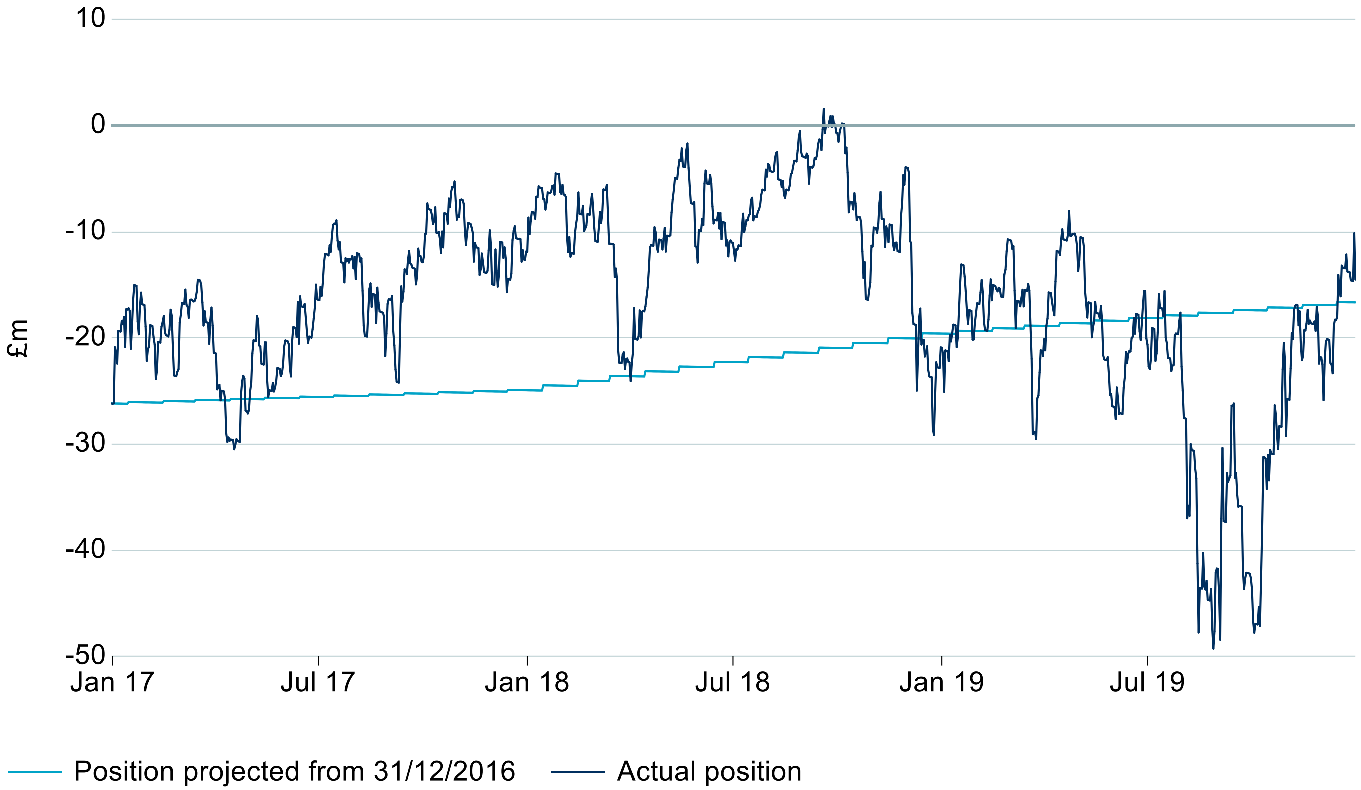
- The Pensions Regulator has on 30 April published its annual statement. This statement applies to the current valuation and built on the Regulator's recent funding statements and themes set out over recent years.
- In particular:
  - **much greater focus on the covenant aspect of integrated risk management** – perhaps inevitable given current economic conditions
  - **Trustees should consider taking post valuation experience into account**, especially the impact on the scheme's assets and liabilities of the significant changes in market conditions since the effective date of the valuation and the impact on the employer covenant
  - significantly increased expectations around the trustees **monitoring the covenant** in the current environment eg if an employer has been hit by Covid-19
  - significantly increased expectations around trustees being aware of the various forms of **covenant leakage such as dividends** and a reminder to trustees and sponsors that schemes still need to get a fair share of available cash
  - encouragement for schemes to **set long term funding targets** and having a **journey plan** to get there
- There is also a warning that the Regulator may issue further funding guidance later in the year.

Preliminary valuation position on proposed 2019 assumptions, subject to consultation with employers

2019 preliminary valuation position

Expectations based on 2016 valuation assumptions

Development of DBS position on 2016 basis

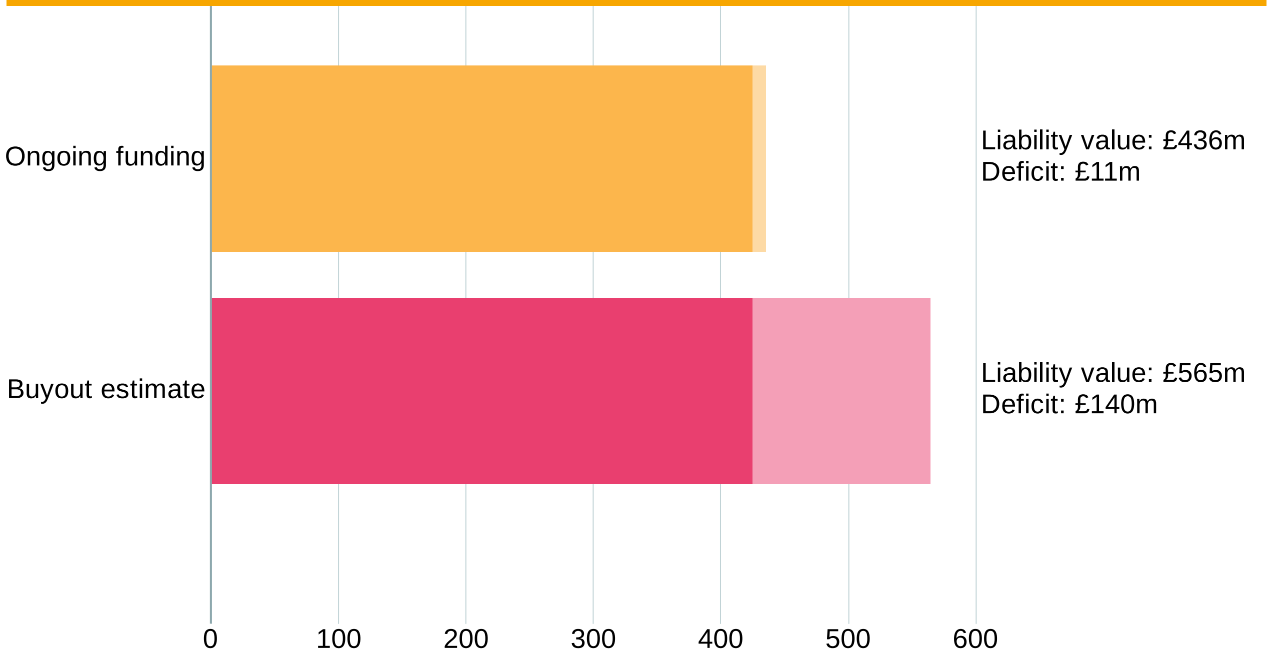


- Markets have been very volatile
- Based on the 2016 assumptions, and allowing for market experience, a deficit of about £11m was expected as at 31 December 2019, with the DBS broadly back on track despite 2019 volatility. This is BEFORE allowing for any membership changes since 2016 or any changes to the valuation assumptions

2019 preliminary valuation position

Preliminary valuation results on the proposed assumptions

Initial DBS results at 31 December 2019



The impact on individual employer pools will vary.

In terms of future service contributions, an employer with a current contribution rate of 36% might see it rise to, perhaps, 37%, although this is very sensitive to changes in the profile of members.

- 2019 proposed assumptions leave the preliminary deficit in line with expectations at £11m
  - This figure may change slightly once full data and assumptions are finalised
- The Board has reviewed the assumptions in detail
- There are a number of proposed changes, including:
  - updates to recent mortality tables
  - allowance for very gradual planned de-risking of the LRS
  - reduction in assumed salary increases

Key assumptions proposed for the 2019 valuation

Setting the assumptions

Assumptions that have been considered

- RPI and CPI inflation
- investment strategy
- pension increases
- investment returns
- retirement patterns
- age of dependants
- mortality
- expenses and GMP equalisation
- chance of having a dependant
- cash taken at retirement
- salary growth
- leavers

Key valuation assumptions

2016 assumptions shown

investment strategy	100% return-seeking pre-retirement 75% liability-matching, 25% return-seeking post-retirement	**RPI and CPI inflation**	RPI based on inflation implied by full yield curves CPI equal to RPI-1.0% pa Volatility of 1.8% pa for RPI and 1.5% pa for CPI
investment returns	Based on full yield curve Return-seeking assets yield 2.5% pa above gilts	**mortality**	95% of "S2" series tables with CMI 2015 projections and long term improvement rates of 1.5% pa
pensionable salary growth	Real salary growth assumption of 1.2% pa above CPI	**chance of having a dependant**	80% of members are married at retirement, or the date of the valuation (in the case of pensioners)

All the assumptions are set out in the current Statement of Funding Principles

2019 proposed valuation assumptions

Investment strategy

investment strategy

- Having taken feedback at previous employer workshops, the Board has concluded:
  - de-risking at the current time should be limited to considering the LRS;
  - de-risking of the LRS should be implemented over a 15 year period and this gradual de-risking should be reflected in the 2019 valuation. Although this reduces slightly the discount rate being used, this is offset by reductions in life expectancy
- In addition, the Board has made use of more granular asset pools available within the common investment fund as a result of recent restructuring

DBS	General Fund	LRS Current	LRS Long-term
Equity Pool	66%	18%	0%
Diversified Growth	11%	2%	0%
Diversified Income	23%	5%	0%
Traditional credit		6%	30%
Gilts, LDI and buy-in		69%	70%

2019 proposed valuation assumptions

Investment returns

investment returns

- The Board proposes discount rates having regard to:
  - best estimate returns on the underlying pools, less
  - a haircut for prudence
- This is consistent with the approach taken on other Church pension schemes
- The resulting proposed discount rates are set out below, with the 2016 assumptions for comparison

	DBS		
Discount rates (in excess of gilts)	General Fund	LRS Current	LRS Long-term
Best estimate	4.2% pa	1.1% pa	0.3% pa
After haircut	2.5% pa	0.65% pa	0.2% pa*
2016 assumption	*2.5% pa*	*0.65% pa*	*0.65% pa*

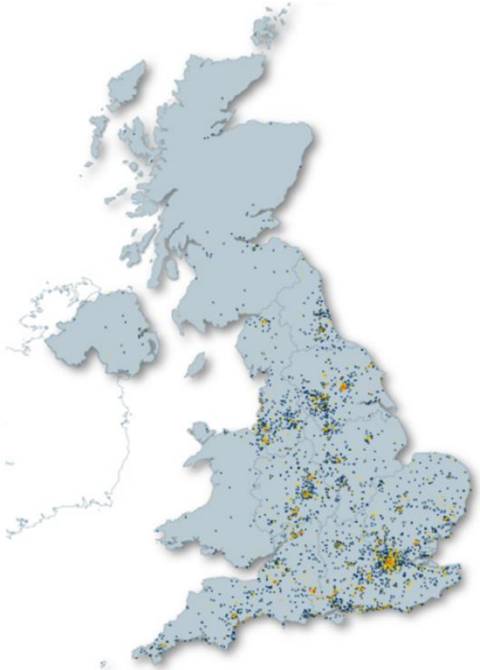
** This is equivalent to dropping the 0.65% pa assumption to 0.35% pa*

2019 proposed valuation assumptions

Life expectancies

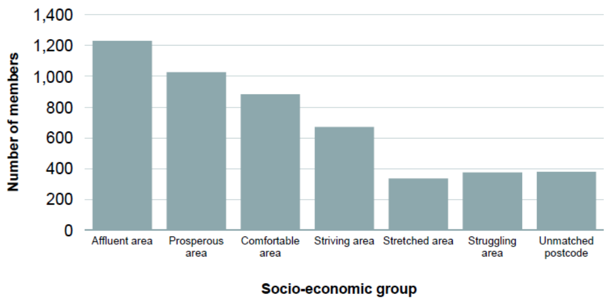
mortality

- The Board proposes updating mortality tables to adopt the most recently available tables
- There are two key aspects to the mortality assumption:
    - The “base table”, reflecting current life expectancies.
    - The allowance for future improvements in life expectancies
- As part of the valuation process, the Board has commissioned analysis of the membership profile to ensure the appropriateness of the base table
- For the 2019 valuation, the Board proposes



100% of “S3” series base tables

Future improves in line with the latest CMI 2019 projections and long term improvement rates of 1.5% pa



2019 proposed valuation assumptions

Price inflation and salary growth

- The Board proposes to adopt market implied assumptions for price inflation as measured by RPI, used for the increases to pensions in payment
- Pensions in deferment increase in line with CPI (subject to certain caps) and are set by a deduction to the RPI assumption
- Proposed changes to the RPI measure from no later than 2030 and possibly as early as 2025, have led to the Board proposing a reduction in this deduction for the 2019 valuation
- The Board also proposes to adopt a salary increase assumption in line with observed increases for DBS members over the last three years (a reduction compared to 2016)

pension increases

RPI and CPI inflation

salary growth

Assumed CPI = RPI – 0.8% pa *(-1.0% in 2016)*

Assumed salary growth = CPI + 0.5% pa *(+1.2% in 2016)*

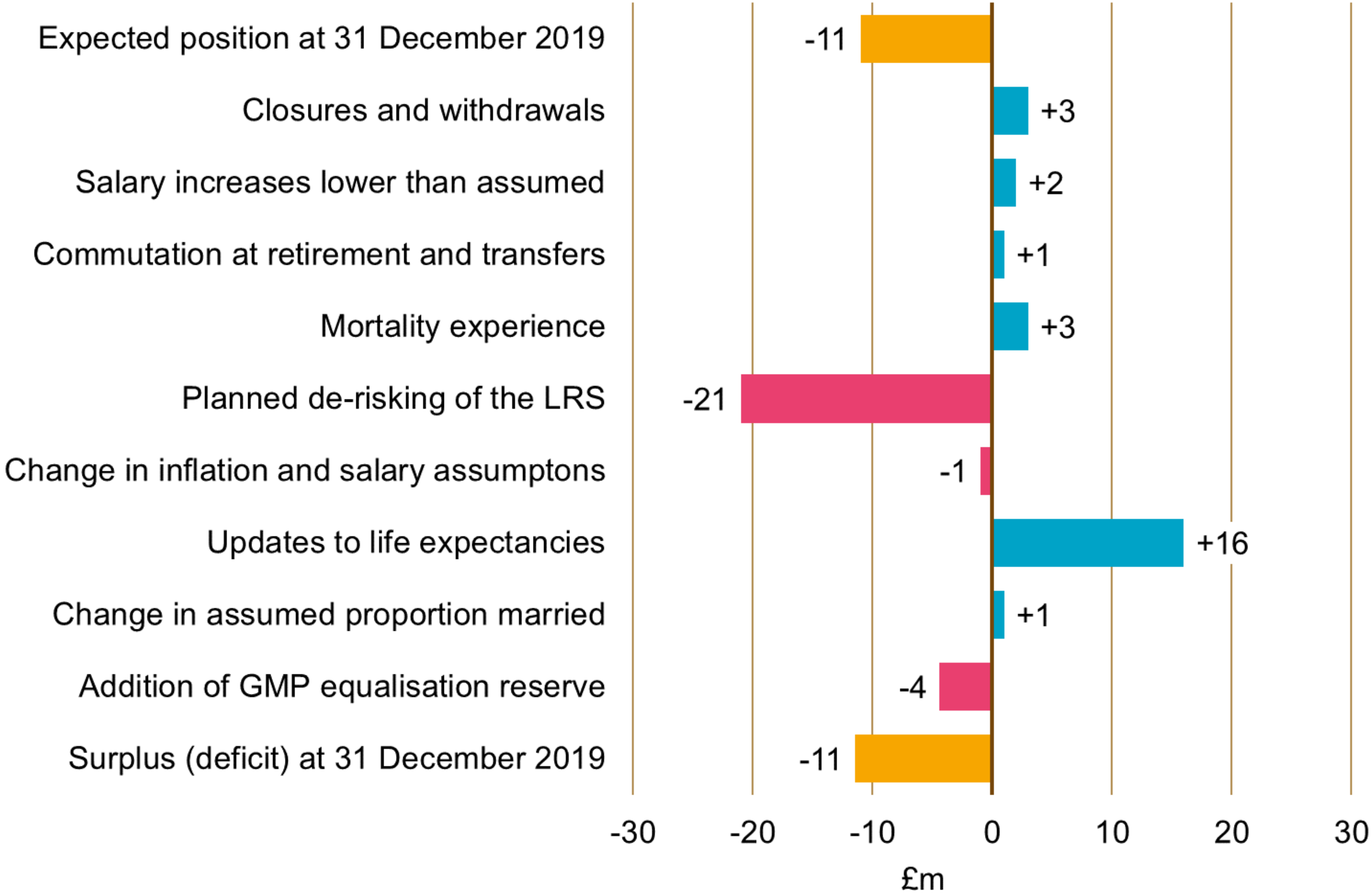
2019 proposed valuation assumptions

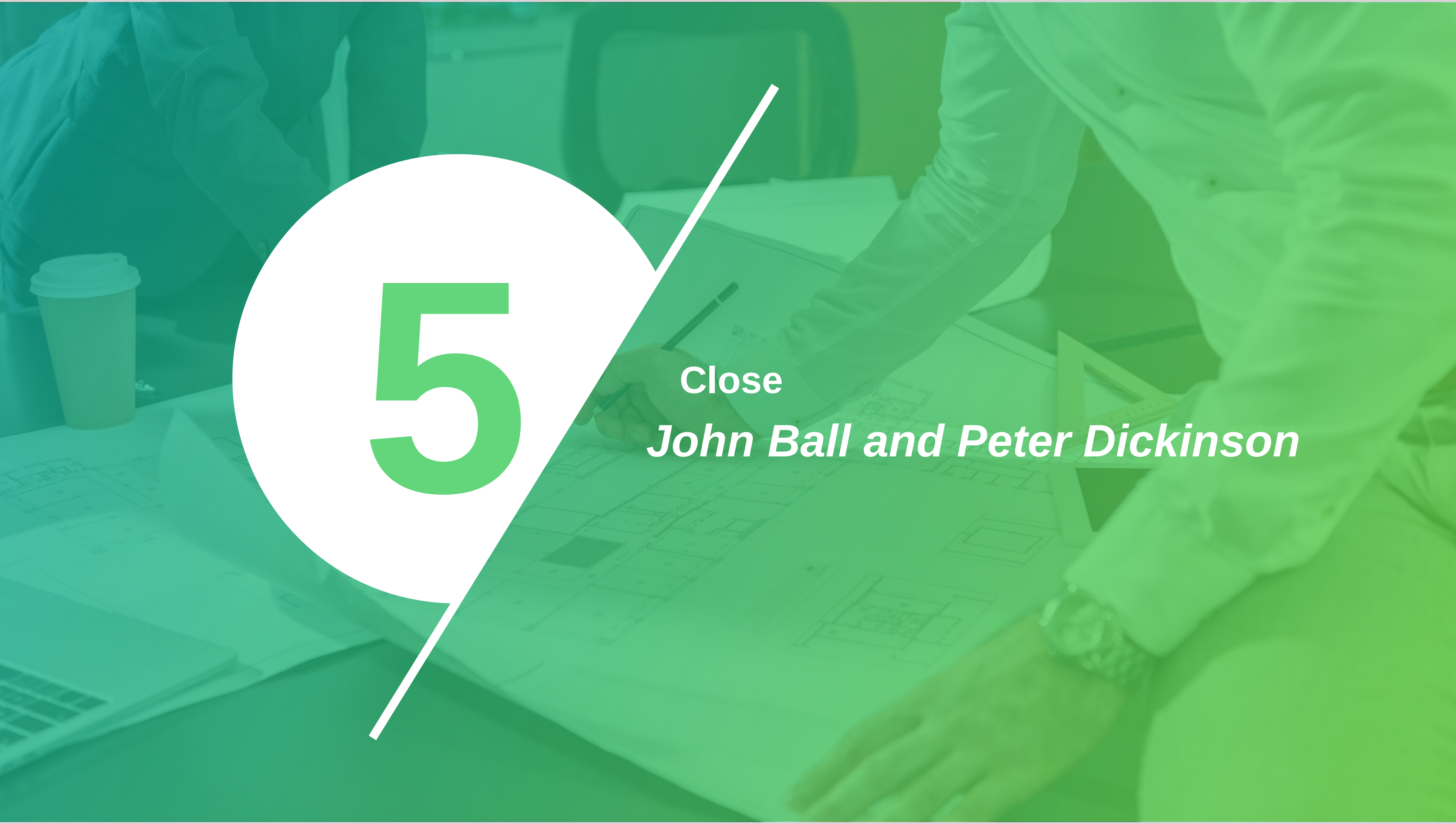
Commentary on other proposed assumptions

chance of having a dependant	80% married at retirement, or earlier death A slight reduction in the assumption for pensioners, reflecting past experience
leavers	No allowance Unchanged from 2016
retirement patterns	At earliest age at which an element of pension is payable unreduced Unchanged from 2016
age of dependants	Male members 3 years older than their dependants (females 3 years younger) Unchanged from 2016
cash taken at retirement	No allowance Individual employers will benefit from experience at retirement Unchanged from 2016
expenses and GMP equalisation	A reserve of 1% of liabilities against the cost of equalising GMP benefits Not considered in 2016

2019 proposed valuation assumptions

How the proposed assumptions affected the position





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Close

John Ball and Peter Dickinson

First stage consultation – key questions

Discount rate

Salary increases

Mortality

De-risking LRS

We will follow today's session with:

- **Recordings of the investment and assumptions sessions**
- **A consultation survey where you can give your formal feedback**

Deadline for feedback
1 June 2020

Use of our work (pages 10 to 23)

Mary Spencer FIA

Partner

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Use of our work (pages 25 to 41)

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