Church Workers Pension Fund (CWPF) – Defined Benefit Scheme

Actuarial valuation at 31 December 2019

First stage consultation FAQs

THE CHURCH OF ENGLAND PENSIONS BOARD

Introduction

Thank you to all who attended the virtual workshop. These questions and answers address the key points raised. We will also share this with employers who could not attend.

There are three sections which cover covenant, investment and actuarial assumptions. The last section covers the valuation timeline. We are currently on course to complete the valuation on time.

This note and the supporting materials form the first stage consultation for this valuation. We will run a second stage consultation once your individual employer results are ready.

Please continue to raise any further questions or issues you have.

Peter Dickinson
Pensions Manager
On behalf of the Church of England Pensions Board
May 2020

Section 1
Covenant assessment

The first stage of each valuation is to assess the strength of the employer covenant. Covenant is understanding the employers' legal duty and financial ability to support the Defined Benefit Scheme (DBS) now and in the future. A full understanding of covenant is also essential to the investment risk employers can underwrite.

Lincoln Pensions are our covenant advisers and carry out a detailed analysis at each valuation. The aggregate covenant rating of the employers for this valuation is 'fairly weak' and is broadly the same as for the last valuation in 2016.

What do Lincoln assess during their analysis?

Lincoln consider 3 key aspects when setting individual employer covenant ratings. These are:

- **Cash flow** – can the employer pay contributions when required
- **Available assets** – both to support the employer's operations and, if necessary, to support longer recovery plans
- **Ability to underwrite risk** – can the employer bear funding shocks if experience is unfavourable

Does Lincoln's assessment take Covid-19 into account?

No, Lincoln's assessment was before the pandemic took hold. We believe positions of individual employers, and the Church as a whole, is likely to have worsened since.

Lincoln will carry out further work this summer, with the Church House finance team (where appropriate), to assess the impact of Covid-19 both on employer financial strength and recovery plan affordability. This will include looking at help employers have received from the government or (where relevant) the national Church.

We would like to take this opportunity to remind employers of their responsibility to keep us informed about their financial position. If something happens which is likely to be of 'material significance' you have a legal requirement to tell us, or our advisers, **within one month**. Examples include:

- the employer acquiring, or being acquired by, another employer
- a major redundancy programme involving members taking early retirement
- a restructure which may have a materially detrimental effect on the pension scheme

We, and our advisors, will treat the information as confidential. We can put in place confidentiality agreements if necessary.

Section 2
Long-term funding target and investment strategy

The next step is to set a long-term funding target that reflects DBS' circumstances. Once we set a target, we can plan how we get there by setting an investment strategy, which considers the employer covenant.

As the DBS is largely closed to future accrual it is maturing quite quickly. By the time the DBS is very mature, we want to have a 'low dependency' on the employer covenant and a low risk of needing to ask employers for significant deficit contributions. Therefore, we are proposing a 'low dependency' funding target.

What is maturity?

A mature pension scheme is one that is increasingly paying out benefits to retired members as the number of members yet to retire reduces. We forecast by 2034 the DBS will be very mature, with about 80% of the liabilities for pensioners. 2034 is our proposed timescale for meeting our 'low dependency' target.

How will we reach this?

We plan to gradually de-risk the LRS between now and 2034, taking small steps each year and taking opportunities to accelerate as and when they occur. These steps involve selling riskier assets (such as equities) and buying more assets whose value is expected to move in line with the value of the liabilities. Meanwhile we propose to use leveraged 'liability driven investments' to hedge interest rate and inflation risk. Overall, this strategy should provide extra returns but also reduce volatility.

Does this mean LRS deficits will reduce or become less likely in future?

Yes, they should but investment risk is reduced rather than removed (there are also other risks such as mortality). It will also vary between employers. For instance, employers with significant numbers of unretired members are at greater risk than employer's whose members have retired. We expect to pay pensions for many decades to come, so deficits can occur until the last member or beneficiary dies, or we can buy-out benefits with an insurer.

What is Value at Risk, and how much is at risk?

Value at risk (VaR) is a 'model-dependant' measure used to estimate how much a pension scheme's funding position could increase or decrease over a set period.

Our VaR model at the valuation date shows a 1 year, 95% VaR estimate of £64m. This means there is a 1 in 20 chance (i.e. 5% chance) the DBS deficit could increase by £64m or more this year.

If we reach our long-term funding target by 2034, we expect the VaR to be significantly lower. By this point we expect the assets and liabilities to be moving closely in sync.

What about future buy-ins?

We will look at further buy-in opportunities when we have enough pensioner liabilities to make it cost effective. A buy-in reduces risk as an insurance company takes on the cost of paying pensions instead of us.

What about the General Fund?

The General Fund is all the individual employer pools which hold assets for your members before they retire and move to the LRS.

We are not proposing to de-risk the General Fund at this time. It will remain invested in 100% return seeking assets, but we will review this regularly. We will also monitor liquidity and hold enough liquid assets so we can pay benefits and transfer assets to the LRS as members retire.

The retirement process provides de-risking over time. As members retire, we exchange investments in the General Fund (100% return seeking assets) for the less-risky investments held in the LRS.

Has Covid-19 affected our general investment strategy?

No, Covid-19 does not change our proposed long-term investment strategy. We remain a long-term investor with a well-diversified portfolio.

Who decides what assets the DBS section holds?

The decision on the assets we hold lies with the Board as trustee, but we welcome the views of employers. The recording on the de-risking strategy explains our asset allocation, and you can also see more on this in the presentation.

We will consult with you as we develop our strategy in future. The last consultation on our Statement of Investment Principles (SIP) took place in 2019 and we will consult again when the SIP is updated as part of this valuation.

Section 3
Setting the preliminary assumptions

The next stage of a valuation is to set the preliminary assumptions. There are a wide range of factors, but the main ones are:

- how much we expect our investments to return in the long-term
- how long we think our members will live for
- what long-term inflation will be

Why do we need to be prudent?

The legislation for actuarial valuations requires us to set prudent assumptions. There is no specific definition of prudence. The trustee must use their judgement.

We take prudence to mean we have a better than 50/50 (50%) chance our assumptions will be borne out.

What are the key assumptions?

The key assumptions are:

Mortality

This is how long we expect our members to live for, i.e. life expectancy. This is one of the most important assumptions as it determines how long we expect to pay pensions. The longer people live, the more money we need to continue paying their pension.

People are still living longer than they have in the past, but the rate of increase has slowed since the last valuation in 2016. This slow-down in the rate of improvement since 2016 has improved the DBS's funding level by about £16m.

Salary increases and inflation

Salary increases are only important for employers who still have active members. In the short-term, contribution rates are a percentage of their pay. In the long-term, it is their final salary that determines their pension and the liability the employer needs to fund.

We have looked at experience across DBS and listened to you. We intend to reduce the long-term assumption for salary annual increases from CPI +1.2% pa down to CPI + 0.5% pa. This is in line with the experience since the 2016 valuation.

When a member retires or leaves before they retire, their pension increases in line with inflation. We need to make a long-term assumption for how much we think this will be. We use our current long-term expectation of RPI for pensions in payment and CPI for increases to pensions not yet in payment. In both cases, caps apply.

Discount rate

This is the long-term investment return we expect. Gilts are the safest form of investment return available, so they are a good reference point for expected returns (whether or not we hold gilts).

In previous valuations we have set an assumption for:

- **return-seeking assets** of gilts plus a margin of generally between 2% pa and 2.5% pa, and,
- **matching assets** of gilts flat.

We have changed the investment pooling arrangements of the common investment fund (which includes assets for all our pension schemes).

For this valuation we have set 'best-estimate' assumptions for each investment pool, then reduced each by a 'haircut' to be prudent. The haircuts have been calculated based on an average period of exposure of 15 years and a broadly 65% to 70% likelihood that the resulting discount rate will be achieved.

Investment pool	Best estimate return (in excess of gilts) at 31 December 2019	Return haircut	Reason for haircut	Discount rate in excess of gilts at 31 December 2019
Equity	4.7% pa	(2.0%)	High price volatility	2.7% pa
Diversified Growth	3.3% pa	(1.4%)	High price volatility, income not secure	1.9% pa
Diversified Income	3.3% pa	(1.1%)	Reinvestment and default risk	2.2% pa
Traditional credit	0.9% pa	(0.3%)	Default and downgrade risk	0.6% pa
Gilts and LDI	0.0% pa	Nil	None	0.0% pa

The final discount rates are then calculated from the above returns and the proposed asset allocation set out in the table below, a linear transition from the current LRS allocation to the long-term one being allowed for over a period of 15 years:

General Fund	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%

Do we need to consider the impact Covid-19 has had?

Guidance from the Pensions Regulator says that we do not need to include the impact Covid-19 has had on investment markets since the valuation date when setting our assumptions. However, the guidance also states trustees should consider allowing for post valuation experience when setting recovery plans.

The funding deficit on the proposed technical provisions at the end of 2019 was about £11m. We have considered the affect Covid-19 has had on the funding position through the investment markets. We estimate the funding deficit increased to around £85m at the low point on 23 March 2020.

At the time of writing, the funding position has improved by an estimated £20m since the low point in March. These estimates are strongly influenced by return-seeking asset performance and gilt yields. They do not take account of other factors such as mortality. Volatility is expected given the extreme market conditions of late, but something we wish to reduce as the DBS matures.

Will my deficit have increased, or reappear?

The overall deficit for this valuation as at 31 December 2019 is about £11m, which is broadly on track to where we hoped to be at this time. This deficit is the aggregate across all employers. There will be some employers with a deficit in their individual employer pool and some with a surplus.

For those employers who had surplus last time, we expect you will be in surplus again this time. For those employers who had paid off their deficits at the last valuation, we expect your position to be close to neutral, with perhaps a small deficit or even a small surplus. However, this will very much depend on your own membership experience since 2016, particularly for open schemes.

Employers who are paying off deficits from 2016, we expect these payments to still be broadly sufficient, but again this will depend on your own membership experience.

We still have members earning benefits in the DBS, will the contribution rate increase?

We expect a modest overall increase in contribution rates, but it will vary between employers.

What if we make changes to our DBS before the valuation concludes?

If you are thinking about making changes to your DBS section, e.g. changing benefits or closing to future accrual, please let us know. Making changes can reduce your deficit or reduce or remove contributions for future service.

We will help you work through the process of making these changes. If you make any changes before April 2021, we can take this into account the new contribution and deficit recovery plans.

How does the CWPF valuation methodology compare to that used for the Church of England Funded Pensions Scheme (CEFPS) for Clergy?

You may be aware we changed the valuation methodology for CEFPS. We have taken a similarly detailed approach in setting the proposed discount rate for the CWPF valuation as we did for CEFPS. We considered the nature of the assets we hold in CWPF in setting the discount rate.

We used our best estimate of the returns with a reduction to allow for prudence and our assessment of the employers' covenant.

We considered the long-term state of the CWPF and it is here that the circumstances of the CWPF differ from those of the CEFPS:

- the DBS is largely closed to new entrants and eventually all members will be pensioners – we will then adopt a low risk, long-term investment strategy consisting of bonds and credit assets; whereas

- the CEFPS is fully open to new entrants so it will not become very mature (we expect the 'steady state' in 20 years or so to be around 65%-70% pensioners).

As a result, we have retained the assumption of a discount rate based on a premium in excess of gilts; having regard to the relatively short period over which the CWPF is expected to hold return-seeking assets. This differs from the CEFPS methodology where we expect to hold return-seeking assets in the longer term.

Section 4
Valuation timeline

Here is our proposed timeline to work through the valuation. We have until 31 March 2021, but we will try to complete the valuation earlier if we can.

Valuation date	31 December 2019
First consultation period *We would welcome your feedback on the preliminary assumptions and proposals as set out in the employer workshop. Please use the survey provided.*	By 30 June 2020
Pensions Board *We will review feedback before agreeing the preliminary assumptions and results.*	Mid-June 2020
Individual valuation and covenant reports *Your individual valuation report will set out your contribution rates and any proposed deficit contributions based on the preliminary assumptions. We will also include Lincoln Pensions' covenant report.*	July 2020
Second consultation and further discussions with you *We will discuss recovery plans with you, and any other actions or issues you want to raise about your section. There will also be a formal consultation stage where you can feedback on the proposed assumptions in the light of your individual results.*	August 2020 onwards
Update on progress so far *We will update you on the themes coming out of the consultation and next steps.*	October 2020

Pensions Board meeting *We will agree the final assumptions and results but may request further work by the Scheme Actuary.*	December 2020 or February 2021
Final assumptions and results communicated with employers	February 2021
Regulatory deadline for valuation to be completed	**31 March 2021**
New future service and deficit contributions start	**1 April 2021**
Possibility to delay new future service and deficit contributions where budgets have already been agreed	**1 January 2022**

The information in this document

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