Church of England Funded Pensions Scheme (CEFPS)

Preparation for the Actuarial Valuation at 31 December 2021

April 2021 update

Introduction

The next statutory valuation of the Church of England Funded Pensions Scheme (CEFPS) is due as at 31 December 2021. While the valuation is still some way off, this document provides an update and an invitation to join us for pre-valuation workshops ahead of the valuation.

We hope that you find it useful. If you have any further questions, please contact us.

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Section 1

Executive summary and the valuation timetable for 2021.

Section 2

An update on what has happened since the last valuation.

Section 3

A reminder of how the pension scheme works and our Asset Led Funding methodology (ALF).

Section 4

Regulatory and other developments.

Section 1
Executive summary and valuation timeline

Executive summary

When we completed the 2018 valuation, in December 2019, no one could have foreseen the coming pandemic or the effect that Covid-19 would have. Covid-19 will continue to have a profound effect on individuals, communities, the economy and the Church, in the months and years to come. Inevitably the pandemic shapes the context for the forthcoming valuation, due as at 31 December 2021.

The last valuation, as at 31 December 2018, showed a reduced deficit of £50m (on a technical provisions basis), and a combined future service and deficit recovery contribution rate of 39.9% of the previous year's National Minimum Stipend, with the deficit due to be cleared by December 2022.

Draft results of the 2021 valuation will be available around April next year. It is too early to say what the outcome will be, particularly as there are material uncertainties, including the effect of the pandemic on global markets. However, this note provides an update, an invitation to the pre-valuation workshops, a reminder of how the scheme works, and a brief update on other matters.

- The lasting impact to the Church economy of the pandemic needs to be carefully considered in terms of the strength of the **covenant** (the Responsible Bodies' ability to financially back the pension scheme and the level of investment risk within the scheme). While initial indications from our covenant advisers suggest the overall covenant is in the same 'fairly strong' bracket as it was at the last valuation, there are clearly increased pressures on many Responsible Bodies relevant to both the covenant and affordability.
- The **funding level** – the gap between the estimated costs of meeting pension promises and the scheme assets – has improved, overall, since the last valuation. As the impact of the pandemic was felt in financial markets last year, the estimated deficit worsened. Strong investment performance since then has improved the funding level to recover the notional surplus, on a technical provisions basis, that we reported in the 2019 update. The estimated funding level is volatile but lying within the 95% confidence level projected at the last valuation.
- Increasing asset values helps the funding level because investments backing current liabilities have done well. But it also means that the cost of buying new assets to set against future liabilities has increased. To put it another way, the cost of buying the same yield in £ terms is higher than it was in 2018. For example, at the end of 2020, gilt yields (ie long-term interest rates) were just a third of the level they were in 2018. This puts downward pressure on the discount rate and upward pressure on **cost of future service benefits**. We will look closely at this ahead of, and through, the valuation.

It is important to re-emphasise that this is just an early indication and outline of the topics that affect the valuation. As always, we value your input and thoughts, so if you have any questions please get in touch.

Valuation timeline

The Trustees, Pensions Board team and our advisers are preparing for the valuation. We are conscious of the importance and weight of expectations on this valuation, particularly in the light of the pandemic. We will update you as this work progresses through the year.

What is happening?	Date
Our Pensions Committee took an early look at the funding level, and how the covenant may have been affected by Covid-19 so far.	**March 2021**
Once the scheme's annual accounts have been audited and signed, we will send all Responsible Bodies a formal update from LCP on how the funding position has developed between 31 December 2018 and 31 December 2020. This is called the Annual Actuarial Report.	**August 2021**
First online **workshop**, looking at how the scheme works, our Asset Led Funding (ALF) methodology, our investment strategy and how the covenant has changed since the last valuation.	**14 September 2021** ***(2pm to 4pm)***
Second online **workshop**, looking at the valuation prospects and asking for your early thoughts on the key assumptions.	**2 November 2021** ***(10am to midday)***
Our Pension Committee will review how the funding level has developed during 2021. We will update our Pensions Committee on your feedback from the workshops.	**4 November 2021**
Valuation date	**31 December 2021**
We will share the provisional results with you when available and schedule further workshops to discuss them as part of the consultation.	**Approx. April 2022**
Further workshops on the valuation and the assumptions that drive it, and a formal consultation period.	**Q2-Q3 2022**
The Board will carefully consider consultation responses and look to finalise the valuation or commission additional work.	**December 2022**
Statutory deadline for completing the valuation	**31 March 2023**

Invitation to join our workshops in September and November

Please join us for our two workshops in September and November. We will hold these virtually using Microsoft Teams. The workshops will give you a great opportunity to refresh your understanding of the valuation process, review the prospects for the valuation, and hear our expectations for the valuation. We always welcome your feedback and input into the valuation process which is vital and helps shape our decision making.

If you are free and would like to join, please email joel.ryan@churchofengland.org with your name and organisation. The workshops will run for no longer than two hours. To keep these meetings manageable, ideally we would prefer only one person per organisation.

What could Responsible Bodies be doing before the valuation?

- Book onto the workshops scheduled for September and November (as above).
- Inform us if you are planning changes that might affect your covenant rating (see next section).
- Contact us if you have specific questions about anything in this note, or matters you would like us to address in the workshops or at the valuation.
- Engage with the Clergy Remuneration Review (led by the Archbishops' Council) when it reports to Synod, as the outputs of that work may have implications for the assumptions we use in the valuation.

Section 2
What has happened since the last valuation?

Covenant assessment

The first stage of each valuation is to assess the strength of the covenant. Covenant is understanding the sponsors' legal duty and financial ability to support the pension scheme now and in the future. A full understanding of covenant is essential to the level of investment risk that you as Responsible Bodies can underwrite.

How do you form a view on the strength of the employer covenant?
We receive covenant advice from Lincoln Pensions who assess the financial strength of a sample of about 44 Responsible Bodies. This includes dioceses plus other major funders, including the Church Commissioners.

In line with the Regulator's framework, all 44 Responsible Bodies are given a rating on a scale of 'strong', 'fairly strong', 'fairly weak' or 'weak'. From this Lincoln Pensions provide an overall covenant rating. The overall rating in 2018 was 'fairly strong'. Lincoln Pensions will review this again for 2021.

What do Lincoln Pensions look at?
Lincoln Pensions look at the financial accounts for the last 3 years, and in particular, expenditure, income (including donations), assets (including how readily they could be realised or sold), and liabilities (including these and other pension liabilities).

Has the covenant rating changed since the last valuation?
The initial work from Lincoln confirms that Responsible Body operations generally continued as expected in FY2018 and FY2019. FY2020 saw a financial shock to the Church economy from the pandemic, with many church bodies reporting falls in income and some projecting pressures on cashflows. However, dioceses and larger Responsible Bodies continue to hold material assets, particularly residential property, which may have increased in value in the last year. Taking this information together suggests the overall covenant remaining in the 'fairly strong' bracket at present but weakening compared to the last valuation. Some Responsible Bodies are more strained than others, and there is much uncertainty around the lasting effect.

What happens next?
Lincoln will continue to work with the Church House Finance team to assess the effect of Covid-19 both on Responsible Body financial strength and recovery plan affordability.

Please don't forget that you have a legal duty to keep pension provider(s) informed about your financial position. If something happens which is likely to be of 'material significance' to your organisation, you should tell us or our advisers, within one month. We, and our advisors, will treat the information as confidential. We can put in place confidentiality agreements if necessary. Examples cited by the Regulator include:

- a major redundancy programme involving members taking early retirement
- a restructure which may have a materially detrimental effect on the pension scheme
- material changes in current and future affordability of pension contributions

Funding position since 31 December 2018

The funding surplus (or deficit) is the difference between the scheme's asset value and estimated value of liabilities as at a given date. This is formally assessed at each valuation and tracked between valuations to give a notional or estimated funding position.

The chart on the right shows the estimated progress in three key measures since the last valuation. The top (orange) line estimates the funding surplus or 'technical provisions' rolling forward the methodology used at the last valuation and described below. The middle (blue) line estimates the position on assumptions that might be appropriate in the long term in the event the scheme were ever closed to accrual (with a "low dependency" on the Responsible Bodies). The lower (pink) line – for reference – shows the estimated deficit against the costs of transferring all the scheme liabilities to an insurer if the scheme wound up.

Note: this chart shows an estimate of the difference between assets and liabilities on different measures since the last valuation. Estimates are based on daily pricing information for financial instruments where available. However, it does not account for movements in factors which are only assessed at the valuation including member experience (eg transfers), expectations of future mortality and pension increases, prices of some illiquid assets and the ALF discount rate. As such it only gives an indication and cannot be relied upon.

The last valuation showed a deficit of £50m on a technical provisions basis. There was a sharp dip around March 2020 following the first 'lockdown' at which point the deficit is estimated to have materially worsened. Since then, the funding position has recovered markedly, implying a notional surplus on a technical provisions basis. (There remains a substantial deficit against the notional costs of transferring the liabilities to an insurer.) The presence of a surplus, or deficit, is only confirmed at the valuation when the Trustees fully considers all the relevant factors, taking advice from LCP and consulting the Responsible Bodies.

Does this mean we will see a surplus at the next valuation?

Maybe. It depends on what happens between now and the end of the year, and also the final assumptions adopted for the 2021 valuation, including the updated ALF discount rate.

We use 'value at risk' (VaR) as one measure of investment risk. VaR is an estimate of how much CEFPS's funding level may change in value over a set period. This is usually described in terms of the 1 in 20 probability range of what the funding level could do. At the last valuation, LCP estimated a 1 in 20 chance of a deficit of more than £400m or a surplus of more than £600m at the December 2021 valuation on a technical provisions basis. The estimated position since the last valuation has been within this range.

What are the main drivers behind the funding level?
One key driver is our asset performance and the future yield we can expect on key assets such as equities and index-linked gilts. The scheme has a well-diversified asset portfolio but is still susceptible to market volatility. Other drivers are:

- how the assets have performed relative to the liabilities
- stipend growth and pension increases
- membership experience (leavers, joiners, retirements, ill health retirements, and deaths)

What might happen if we see a surplus at the valuation date?
There is no guarantee of a surplus at the valuation date. However, if it looks likely as we approach the year end, we will discuss the options with you at the workshops. As part of our preparation for the valuation we are exploring the options to manage risks to the funding level and the potential options to use any surplus to provide some flexibility around future contributions, alongside measures to provide additional security for members' benefits through risk reduction.

Future service contribution rate

The contribution rate covers an amount to clear the deficit (on a technical provisions basis) from the last valuation, plus the amount needed to provide future benefits being accrued. The current contribution rate is 39.9% of the previous year's national minimum stipend, and this comprises:

- Deficit contributions – 7.1% (to December 2022)
- Future service rate – 32.8%

If the deficit clears at the next valuation, deficit contributions would no longer be payable.

What about the future service contribution rate?
It is too early to say. One of the biggest factors in setting the future service contribution rate is the investment return assumption. This is how much we expect to earn on investments, including the margin for prudence required by the Regulator. Since the last valuation, asset prices across most asset classes have risen, while yields have fallen. This is especially true for gilts (government debt), where the combined yield at the end of 2020 was 0.6%, just a third of the 1.8% level at the previous valuation date (there has been a small recovery since).

Reduced expectations of future returns mean that the discount rate used to value future liabilities will be lower, and therefore the 'cost' of buying assets to meet those liabilities is higher. All other things being equal, this implies an increase in the future service rate.

For the purposes of financial forecasts, Responsible Bodies may wish to consider a range of scenarios for the future service rate beyond 2022. On a like-for-like basis, based on current information, the future service rate after 2022 would be higher than the 32.8% calculated at the last valuation. However, if there is a material surplus at the valuation date, this may offer some flexibility around the total contributions payable. We can explore this further with you in the workshops.

How prudent is the investment return assumption?

We set our investment return assumptions anticipating we achieve our expected investment return broadly two times out of three. This level of prudence is consistent with a 'fairly strong' covenant. We will revisit this assumption as part of the valuation.

Other key assumptions

Stipend increases

The contribution rate is linked to the National Minimum Stipend, and the policy for increases is set by Synod. The current Synod policy is that stipends will increase in line with the Retail Prices Index each year. In practice the actual increases have been lower for several years.

Although this means that increases in pension contributions will not have increased as much as expected, overall the experience should have a small positive effect at the valuation. Any change in the Synod policy will be reflected at the valuation.

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 living longer than they have in the past, but the rate of increase has slowed in recent years. Adjusting for the slow down at the last valuation improved the funding level considerably. We will keep looking at this as part of the next valuation, in conjunction with our advisers and industry views on how to reflect the horrific death toll of the pandemic and its possible future impact in future valuations.

Inflation

When a member retires or leaves pensionable service 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 base this on our current long-term expectation of RPI for pensions in payment, and the expected increase in the National Minimum Stipend for increases to pensions not yet in payment. The government announcement that the RPI methodology will align to the CPIH methodology from 2030 will have to be factored in, to the extent it has not already been priced in by markets.

Section 3
How the pension scheme works, and Asset Led Funding methodology (ALF)

How the pension scheme works

What benefits do members build up?

The scheme is a defined benefit pension scheme. It is not a pure 'final salary' pension scheme, as pensions are linked to the National Minimum Stipend instead of actual stipends or salaries. Benefits are determined according to the Rules of the scheme which are set by General Synod.

While there have been changes to benefits in 2008 and 2011, currently members accrue benefits at 1/83rd of the previous year's National Minimum Stipend for each year of pensionable service. More simply, a member completing 41.5 years pensionable service would receive a pension of half the previous year's National Minimum Stipend from normal retirement date. Members also receive a tax-free lump sum at retirement, and a pension of two-thirds continues to their spouse or civil partner when they die.

Who is responsible for the scheme?

There are two parts to pensions payable to Clergy, together commonly known as the Clergy pension schemes:

1. **The Church of England Pension Measures** (for service until 31 December 1997) – the costs of which are met in full by the Church Commissioners.
2. **The Church of England Funded Pensions Scheme** (for service since 1 January 1998) – this is funded by the Responsible Bodies who sponsor the scheme. CEFPS funds are ring-fenced.

The Pensions Board administers both schemes but is only the Trustee for the Funded Pensions Scheme. We have the power to make investment and funding decisions for this section only. The valuation covers CEFPS only.

Asset Led Funding (ALF) methodology

Asset Led Funding, or ALF, is the methodology we use in the valuation. It was used for the first time in the 2018 valuation following development between the Pensions Board, our advisers, and a group of Responsible Bodies. The following gives an outline of how ALF works. We will cover this in more detail at our workshop in September.

How do regulations say pension liabilities should be valued?

The regulations lay out two methods of valuing a pension scheme's liabilities against its assets. It says:

"The rate of interest used to discount future payments must be chosen prudently taking into account either or both:
(i) The yield on assets held by the scheme to fund future benefits and the anticipated future investment returns, and,
(ii) The market redemption yields on government or other high-quality bonds."

Which method do we use for CEFPS?

At the last valuation in 2018 we adopted method one ie using anticipated returns based directly on the assets assumed to be held over the long term. (Previously, in common with almost all other pension schemes, we used method two, with anticipated returns on all assets set relative to gilt returns).

Method two involves assessing how much we need to reserve for the promised benefits based on all asset returns being set relative to gilt yields. We expect a return on our investments, so LCP calculates the value of the assets that we should hold to meet future liabilities. The resulting contribution rate therefore is directly linked to gilt yields. Broadly speaking, when yields go up, lower reserves (ie lower assets) are needed, and vice versa.

Why did we move to method one/ALF?

Method one, or ALF as we call it, allows LCP to look at our assets and investment strategy and project the discount rate based on expected returns from how we actually plan to invest rather than assuming that all assets move in line with gilts.

This has the effect of reducing the high levels of volatility in the funding level. You can see this in the chart on page 5 where the top line based on ALF shows less volatility than the other two lines based on gilts. As the projected investment return assumptions are set on a prudent basis, over the long term and on average, investments should outperform the assumptions, improving the funding level.

We can use ALF for CEFPS because it is a relatively ‘immature’ scheme, meaning more money is coming in than we are paying out, and because the scheme is also open for new Clergy to join. This gives us a much longer-term view than most pension schemes in the UK which have closed to new entrants. If CEFPS were to close to new entrants at some point in the future, we would probably have to revert back to method two because the scheme would mature rapidly. This would likely result in a more volatile funding position, and further consideration would be needed regarding the appropriate assumed investment strategy, but at present such a change would be likely to result in an increase in the technical provisions required.

Section 4
Regulatory and other developments

The Pension Schemes Act 2021

This new Act introduces new requirements on pension schemes and employers and updates the law in a number of areas. Key changes include:

- Increased disclosures in relation to climate change. Our disclosures are set out in our new Stewardship Report, available at www.churchofengland.org/cepb
- Additional obligations on schemes to set out and report on the scheme's funding and investment strategies
- Strengthening the Regulator's powers in a number of areas
- New criminal sanctions for employers who deliberately seek to avoid an employer debt due to a pension scheme or who act in a way that 'detrimentally affects in a material way the likelihood of accrued scheme benefits being received'

The Pensions Regulator's funding Code of Practice

The Regulator is currently consulting on a new Code of Practice for pension scheme funding. We have seen high-profile companies failing with significant pension deficits. Changes in pension regulation can have a material effect on how we need to operate.

The Regulator is still consulting on the Code of Practice so we do not know the full implications of this new regime for CEFPS. The new regime is not expected to come into force until early 2023 at the earliest. This means that it will not apply to CEFPS at the 31 December 2021 valuation. Even so, we are engaging with the Code of Practice consultation and assessing the implications, for example the risk to continued use of the ALF approach.

Clergy Remuneration Review

The Archbishops' Council's Remuneration and Conditions of Service Committee (RACSC) is undertaking a review of the adequacy, affordability and appropriateness of clergy remuneration. This is in response to a request by the House of Clergy at General Synod in July 2018. The findings from the review are expected to be presented to Synod in July 2021. This may influence various parts of the pension and retirement package, and subsequently, pension costs.