London Borough of Camden – Contribution Options

We have been asked by the London Borough of Camden ("the Council") to report on the implications of pre-paying some of their next three years' contributions to the London Borough of Camden Pension Fund ("the Fund") as a single lump sum.

This report is addressed to the Fund but may be shared with the Council: see the professional notes below for further details of the reliance and limitations of this advice. This report replaces the previous version dated October 2018.

Summary of advice

- Assuming Fund investment returns are above 0%, there is an economic benefit to the Council in paying large contributions sooner;
- Such benefits must always be weighed against the potential alternative uses of the lump sum, and we have not considered these in this paper as this is ultimately a Council value judgement;
- We have been asked to calculate illustrative pre-payment amounts relating to the secondary monetary contributions for the three years beginning 1 April 2020, which have been calculated as part of the formal triennial funding valuation as at 31 March 2019;
- Assuming a payment date on or around 31 March 2020, the savings would apply from 1 April 2020 for the agreed pre-payment period (e.g. 3 years will start from 1 April 2020 and end 31 March 2023, at which point the contribution rates calculated as part of the 31 March 2022 valuation will apply);
- I have assumed that the pre-payment amount is paid in full on or around 31 March 2020 within my calculations. Any payment made significantly later than this date (e.g. beyond 30 April 2020) would impact the expected cost savings and I may need to revisit my calculations;
- Payment of a large lump sum brings certain risks, which should be appreciated and possibly the subject of independent advice. It would also require advance clearance with the Council's auditor;
- The Council should advise the Fund Actuary, via the Fund, as soon as possible of their intentions regarding pre-payments: this should be as early as possible as we need to finalise our formal certificate for the 2019 valuation by 31 March 2020. We will incorporate suitable notes in the Rates & Adjustments Certificate in the formal actuarial valuation report of the Fund (to be completed by 31 March 2020).

Background

- The Council rates have been assessed as part of the ‘contribution rate modelling’ for the formal actuarial valuation of the Fund as at 31 March 2019. These contributions (before consideration of any pre-payment lump sum) relate to the three years beginning 1 April 2020 as follows:

Proposed rates for:	2020/21	2021/22	2022/23
Primary contribution rate	19.0% of pay	19.0% of pay	19.0% of pay
Secondary contribution	0.2% plus £19,675k	0.7% plus £20,421k	1.2% plus £21,166k

- The Primary rate is the Council’s share of the cost of each year’s build-up of new benefits for current active members. The Secondary contribution is the additional employer contribution to ensure full funding in the long term for the past service benefits accrued to the valuation date.
- The Council wishes to explore the issues around possible pre-payment of the next 3 years’ secondary **monetary** contributions, payable as a single lump sum to the Fund around 31 March 2020;
- The rates from 1 April 2020 onwards will be certified as part of the ongoing 2019 formal valuation, so that any prepayment will need to be reflected in the formal valuation results certificate;
- The Fund has asked for advice on the potential level of financial benefits and also if there are any risks to this arrangement;
- Therefore, it has been agreed that the Fund will take advice on the pre-payment in principle, based on the proposed contribution pattern determined above, and its choice of potential pre-payment.
- The Fund requires advance notification of large lump sums being made around 31 March 2020.

General comments

1 Ultimately, funding for defined benefit pensions is a question of pace rather than amount: the same eventual benefit payments need to be paid, in accordance with LGPS Regulations and the Council’s particular membership in the Fund. This is regardless of when and how much contributions are paid by the Council.

2 However, on the assumption that investment returns are above 0% (i.e. they are adding to the Council’s asset share in the Fund), then it is also the case that contributions paid sooner rather than later will (all other things being equal) result in lower total required contributions over the longer term. This is because the (positive) investment returns received on contributions paid into the Fund, provide some of the required cash to pay benefits later. In particular, the earlier contributions are paid in, the higher the (positive) investment returns, which are therefore beneficial to the Council’s longer term pension obligations.

3 Such earlier contributions are not without cost, of course: whilst they provide gains within the Fund, they may also represent a lost opportunity outside the Fund. The Council’s request in effect seeks to identify the pension funding gain which can be measured against non-pension lost opportunity, to help the Council make its value judgement.

4 **We cannot advise the Council whether a given pre-payment proposal should be pursued or not**, as this ultimately involves the Council making its value judgement. However, we can calculate the impact of the proposal on its Fund contributions, all other things being equal, as given in the “Results” section.

Assumptions

We have been asked to illustrate the impact of pre-payment amounts relating to the secondary monetary contributions for the three years beginning 1 April 2020.

To determine the impact, we need to make two assumptions in particular:

a) Investment returns (for discounting purposes): based on the formal funding valuation assumption, i.e. 4.5% pa as at 31 March 2019, as per initial funding advice delivered to the Fund as part of the 2019 formal valuation.

This relates to the headline published funding level but does not relate to how contributions are actually determined for the Council.

In terms of contribution-setting for the Council at this valuation, we used an economic projection analysis (our "ComPASS" model) instead. Considering the three-year period covered by the contributions being pre-paid, this model uses a central expected return of a slightly different rate p.a. However, this is only a central assumption, and was not explicitly used by itself to determine the Council's contributions. Therefore, we propose to use the published discount rate above for this exercise.

In practice, the future investment returns achieved by the Fund will differ from our assumption and may be higher or lower (see "Risks" section below).

b) **Contribution rates applying until 31 March 2023:** these have been calculated as part of the formal actuarial valuation as at 31 March 2019 and are as set out in the "Background" section above.

The results tables show the secondary monetary contributions required for the Council for each of the next three years.

We have then calculated the present value of these contributions for the Council, discounted using the investment return assumption above: this is the required pre-payment lump sum, due in April 2020, as an alternative to the Council making those three years' contributions.

We have then shown the difference between the two sets of figures, being the cash saving due to pre-payment, as requested by the Fund. It must be stressed that this saving is strictly based on these assumptions, and the actual saving will prove to be lower or higher if investment returns are lower or higher than the investment return assumption above; there will be no saving (indeed, there will be a cost) if investment returns prove to be negative over the period.

Results

London Borough of Camden

Individual year	2020/21	2021/22	2022/23	**3 years total** 1 April 2020 to 31 March 2023
Secondary monetary contributions to be pre-paid (£000)	£19,675	£20,421	£21,166	**£61,262**
Secondary monetary contributions if pre-paid (£000)	£19,247	£19,116	£18.960	**£57,323**
Saving to the Council (£000)*	£428	£1,305	£2,206	**£3,939**

*Assuming a 4.5% p.a. investment return

Possible alternative treatment as an additional (not advance) payment

The results above assume that any lump sum is to be considered as an advance payment of part of future contributions. However, there is no requirement to do this, and it would be possible to treat this in an alternative way, i.e. make any lump sum payment in addition to the full calculated contributions as given earlier in order to improve the Council's funding position.

In these circumstances, the economic benefit would flow to the Council in the next actuarial valuation following the date of the payment. This alternative benefit would arise from an improved funding position at that time (due to the additional lump sum payment).

If the Council wishes to consider this alternative treatment of the payment, then it should advise the Fund accordingly.

Next steps

If the Council is considering paying this lump sum to offset future years' certified contributions then it would need to confirm the details with the following parties, in chronological order:

1. The Council's relevant decision-making group, to ensure compliance with its own governance processes in deciding to make such a large pre-payment, and to agree the timing and treatment of the payment;
2. The Council's auditor, to ensure they are satisfied with the proposed change in payments (we are aware that advance payment of future years' contributions is sometimes challenged by auditors, or at least requires careful recording and reporting).
3. The Fund officers, to ensure they are aware of the timing and treatment of the payment and amend their investment, accounting and reporting procedures accordingly;
4. Hymans Robertson LLP as Fund Actuary, to ensure that the payment is appropriately reflected in an updated Rates & Adjustments Certificate to be issued hereafter. See the "Professional notes" below for further information.

Risks

There are risks, as well as potential benefits, involved in paying a large lump sum to the Fund:

1. The economic advantages assume positive investment returns being obtained by the Fund. To the extent that returns are negative for a period, then this reduces the financial benefits of this arrangement. In the extreme case, if investment returns were negative over the whole period from 1 April 2020 - 31 March 2023, then it would prove to have been beneficial to leave contributions payable throughout the period as opposed to making a pre-payment;
2. The actual economic benefit will depend on the investment returns actually generated by the Fund. Our figures assume a 4.5% p.a. average return over the three years: a lower actual rate of return would deliver lower economic benefits, and higher actual returns would deliver higher benefits;
3. In general, the arrangement involves taking cash away from other potential uses by the Council. Such alternative uses may be considered by some to be more important or more valuable, and this will always be a value judgement for the Council to make and justify. As mentioned elsewhere in this paper, we have not advised on whether a large lump sum to the Fund would be in the Council's overall best interests, as we are only considering the pension funding aspects;
4. The Council's main contributions are paid at regular monthly intervals, and therefore "ride out" the ups and downs of the Fund's market returns. Regular contribution payments reduce the risk (and potential reward) of market losses (and gains) derived by investing at a high (or low) point in the market.

Conversely, paying a large lump sum contribution concentrates the risk on the market conditions applicable at that time: if this date proves to be at a market "high" (relatively speaking) then it will dilute the financial benefit to the Council; if instead it proves to be a relative market "low" then it will deliver a larger financial benefit.

We would recommend that the Council considers taking independent advice as to the nature and timing of a large lump sum contribution to the Fund.

Professional notes

This advice has been requested by, and is addressed to, the London Borough of Camden as the Administering Authority to the London Borough of Camden Pension Fund. The purpose of the advice is to advise on the actuarial and funding issues arising on the potential payment of a large lump sum employer contribution to the Fund, being the pre-payment of part of future years' Council contributions arising from the 2019 actuarial valuation.

The advice is not intended for any other party, nor for any other purpose, and Hymans Robertson does not accept any liability relating to any other party or purpose. This paper may be shared with the Council (as an employer in the Fund) and its auditors; however it should not be passed further or shared with other parties, without our consent. Where it is shared it must be in its entirety, in particular including these professional notes.

In particular, please note that:

- There is no conflict of interest in the contents of this paper, as this is purely factual information to assist the Council in its decision whether to pre-pay part of its future Pension Fund contributions, rather than advice one way or the other.
- This paper should not be considered advice to the Council regarding whether or not to make such a lump sum contribution.
- However, it is necessary for the Council to correspond with the Fund regarding any proposed pre-payment, as per "Next steps" above, so that appropriate arrangements can be made by the Fund.

This advice is covered by, and complies to a proportionate degree with, the following Technical Actuarial Standards applying to the professional aspects of actuarial advice:

- TAS 100 (Principles for Technical Actuarial Work); and
- TAS 300 (Pensions).

Barry Dodds FFA

For and on behalf of Hymans Robertson LLP

Fund Actuary to the London Borough of Camden Pension Fund

February 2020