Pension Update

MC/23/18

Date of meeting	25-26 January 2023
Contact name and details	Matt Tattersall - Director of Finance and Resources tattersallm@methodistchurch.org.uk
Action required	To approve
Resolutions	18/1. The Council receives the report. 18/2. The Council delegates to the Director of Finance & Resources and Connexional Treasurer authority to undertake discussions with the Pension Trustees with the objective of securing a buy-in or buy-out of both pension schemes. 18/3. The Council recommends to the Conference that the increase in pension contribution rates from circuits in September 2023 is cancelled. 18/4. The Council recommends to the Conference that should circumstances allow, contributions from the property levy to the Pension Reserve Fund be suspended. 18/5. The Council recommends to the Conference that should circumstances allow over the coming years, the voluntary contributions to the Pension Reserve Fund be returned to the donors with interest paid at the CFB Deposit Rate. 18/6 The Council accepts the recommendation of the MMPS review task group to make no changes to the MMPS at the current time but to pass the review of MMPS to the Finance Sub-committee for ongoing consideration.

Summary of content

Subject of aims	To update the Council on pension issues including the estimated funding position and a report from the task group established by the Council to look at the future of t MMPS.
Main points	The risks concerning the pension schemes have materially shifted which requires some significant decisions to be taken.
Background context and relevant documents (with function)	Conference reports explain where we were: Conference 2022 Agenda Volume 2 (methodist.org.uk) Report 18 Conference 2021 Agenda Volume 2 (methodist.org.uk) Report 41 MC/22/13 sets out the terms of reference for the MMPS review task group
Consultations	A presentation by the Chair of the pension trustees was given at the November 2022 Finance Sub-Committee. Resolutions 1-3 in this paper are recommended to the Council for approval by the SRC. The MMPS task group have reviewed drafts of this paper.

Summary of impact

Standing Orders	The note to SO974 (1) will need amending to reflect the reduction in contributions to the Pension Reserve Fund to 0%.
Financial	Whilst decisions over the c£0.5bn pension funds are a matter for the pension trustees, the decision they take have a material impact of the finance across the connexion. The council is responsible for the c£50m in the pension reserve fund.
Wider connexional	The voluntary appeal for funds towards the pension reserve fund gained significant attention across the Connexion. The change in context and need for those funds is similarly a matter of wider connexional concern.
Risk	There is an opportunity materially to reduce the financial risk to the Church from the pension schemes.

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Glossary

Annuities: Annuities are financial products that pay a series of payments at regular intervals, like a pension.

DB scheme: A defined benefit pension scheme (such as MMPS and PASLEMC) where the benefits paid are based on length of service and salary.

DC scheme: A defined contribution pension scheme where the benefits paid are based on the contributions made in to the 'pension pot' and any investment returns on that pot.

Deficit payments Payments made by the employer to fund any deficit that has arisen in a pension scheme.

Framework Agreement: A legal document agreed in 2022 between the Council and the pension trustees. It sets out limits on the Pension Reserve Fund; agrees a long-term plan for reducing the investment risk in the schemes; a plan for making additional payments if the schemes varied away too much from the long-term plan, and provides property security to the trustees should the Council ever default on its pension debts.

Funding position: This is the level of deficit or surplus in the scheme

Future accrual: The pension that will be earned by active ministers in the future. The pension trustees are focussed on ensuring they can pay pensions that have accrued to date and it is this that generates a deficit or surplus. Future accrual needs to be funded from future contributions (and not rely on deficit payments).

Gilts: Gilts are bonds that are issued (sold) by the government in order to raise money to fund public expenditure. They repay a fixed sum on a specified date and are regarded as a very low risk investment as the government will always pay its debts.

Gilt yield: Gilts pay a regular coupon (like an interest payment). The yield is the coupon divided by the amount paid for the gilt. Yields increase when the price of gilts fall. Increases in yields are closely linked to expectations of increases in interest rates.

Hedging: Hedging is an investment strategy designed to protect oneself against a loss by making compensating transactions that are expected to mirror any movements between the two eg one investment increases at the same time another investment

decreases.

Insurance buy-in: The pension trustees sell their existing investments and use the proceeds to buy annuities from an insurer. These annuities match the expected pension payments to pensioners and the insurer is therefore taking the risk of life expectancy exceeding current estimates. The pension scheme remains responsible for paying the pensions.

Insurance buy-out: The pension trustees sell their existing investments and use the proceeds to buy annuities from an insurer. These annuities match the expected pension payments to pensioners and the insurer is therefore taking the risk of life expectancy exceeding current estimates. The pension scheme is wound up and the insurance company takes on responsibility for paying the pensions. The pensioner no long has a direct relationship with the Church for their pension; however, what they receive is unaffected.

Interim funding position: In between the triennial valuations, the actuaries will produce valuations at various times. This will not involve updating all the assumptions used in a triennial, so will include more estimates. Nevertheless, they give a more up to date indication of the position the schemes are at.

LDIs: Liability Driven Investments are hedging investments (see above) designed to reduce investment risk by responding to changes in interest rates and inflation. If the changes increase pension liabilities, the value of LDIs increase to offset the cost. Similarly, if liabilities fall, so does the value of the LDI. See [Managing Leverage (vimeo.com)] for an explanation of how LDIs work

Liquidity facility: An agreement that the Council provides cash support to the pension scheme(s) in the event that there is further unprecedented changes in the LDI market. This is not a formal loan, but an agreement about the timing of payments that are already due to the schemes.

Target funding level: A target is set for the level of risk in the investment portfolio. The “Gilts” rate is seen as a low level of risk, so any return above “Gilts” has an element of additional risk but also an expectation of additional return. The agreed target for both schemes is Gilts + 0.5%.

Triennial valuation: This is a valuation of the pension scheme undertaken by an actuary every three years as required by law. It has to be agreed between the Council and the pension trustee. If there is a deficit a recovery plan has to be agreed.

Introduction

1 This paper deals with pension issues that relate to the Methodist Council (the Council) as:

- an employer in the Pension and Assurance Scheme for Lay Employees of the Methodist Church (PASLEMC);
- the lead employer for other Methodist bodies in PASLEMC, and
- acting on behalf of Conference in relation to the Methodist Ministers’ Pension Scheme.

The Council has delegated to the Finance Sub-committee responsibility “to act as the employer in discussions with the Trustees of connexional pension funds.”

2 This paper provides an update on the estimated funding position of both schemes and recommends action to support both reductions in risk and cost that are being recommended by the Strategy and Resources Committee.

3 The paper also includes recommendations from the MMPS review task group that is looking at the future of the MMPS scheme (including any consequent impacts for PASLEMC).

4 Whilst the paper deals with issues that relate to the effective investment of Methodist monies, it should be noted that the Investment Strategy of the pension schemes is the responsibility of the respective Pension Trustee. The Council cannot direct their strategy but can offer comment.

2020 valuation update

5 As previously reported, the PASLEMC valuation was signed by the deadline of 30 November 2021. The 2020 MMPS valuation was signed by the revised deadline of 30 April 2022. The Framework Agreement that covers the long-term approach to funding both schemes was also signed on 30 April 2022. Part of the long-term agreement covered the de-risking of the schemes. This means investing in less risky investments (that reduce the likelihood of needing deficit recovery plans) but that deliver lower returns (so the overall cost of the scheme increases).

6 The increase in circuit contribution rates from 26.9% to 29.5% is currently being subsidised from the Pension Reserve Fund. Despite the Council narrowly agreeing a resolution to pass the increase to circuits from September 2022, the 2022 Conference decided to delay passing this increase on to circuits until September 2023.

Recent developments

7 Pension deficits (and surpluses) are the difference between the current value of the investments held by the pension schemes, and the estimated value of the liabilities (future pensions) that need to be paid. Stipend levels and life expectancy of pensioners are important determinants of these future liabilities. However, the discount rate is a major factor in calculating the current value of future pensions and is linked to interest rates. Given the low interest rate environment over many years, this factor has been relatively stable. The invasion of Ukraine and a global economy recovering from the impact of the pandemic changed this situation dramatically.

8 The 15 year real gilt yield (the yield on an index-linked gilt) increased by c1.7% per annum over the 6-month period from 28 February 2022 to 31 August 2022. There is no record of an increase this large over a 6-month period in data looking back as far as 1985 (ie, since records began, with the launch of the first index-linked gilts).

9 The increase in long term interest rates has been unprecedented and led to the trustees undertaking de-risking of their investment portfolios much sooner than anticipated.

10 Gilt yields increased further following the government's 'mini-budget' in September. Whilst there has been some reduction in yields since, it appears unlikely that long term interest rates are going to fall materially any time soon.

11 A further consequence of the 'mini-budget' was the near collapse of the Liability Driven Investment market that is heavily used by the defined benefit pension sector (including MMPS and PASLEMC) to achieve their lower risk investment strategies. Bank of England intervention was required to steady the market whilst pension schemes accessed additional liquidity to protect their liability hedging strategies. The deficit recovery payment payable from the PRF for PASLEMC due in August 2023 was paid early to support the scheme's liquidity, but despite the disruption, both MMPS and PASLEMC emerged with their desired level of hedging intact.

12 It should be noted that the Pension Trustees have indicated that the LDIs they used for investment were less heavily 'geared' than some of the larger pension funds in the market, and so were not as affected by the market turmoil as others.

13 As part of the pension discussions, it had been agreed that the schemes would de-risk gradually and achieve a target level of funding (by 2030 for PASLEMC and 2035 for MMPS). However, the unprecedented increase in the discount rate allowed a level of de-risking that means both schemes have already achieved their target funding level.

14 The interim funding positions as at 31 August 2022 were MMPS £48.0m surplus and PASLEMC £2.3m deficit. If the cost of future accrual in MMPS was recalculated using the current discount rates, it would drop from 39.8% to 28.1%. This is driven by increases in interest rates and the impact of the inflation cap on pension payments (2.5% on pensions earned after September 2006, and 5% for pensions earned before Sept 2006).

15 The improvement in the funding position of both schemes is so significant that the Trustees have

approached the Council to discuss the long-term future of the schemes and how insurance buy-ins or buy-outs are now realistically affordable options.

16 In summary:

- There has been an unprecedented and unforeseeable improvement in the valuation of the pension schemes.
- De-risking has achieved target funding positions 8 years (PASLEMC) and 13 years (MMPS) ahead of plan.
- Disinvestment from Central Finance Board funds has been at a pace that has left the CFB with a significant reduction in Assets Under Management and an unplanned budget deficit in 2022/23 and 2023/24.
- Having been de-risked, the schemes are less at risk from future changes in market conditions, ie the reduction in the deficit experienced in recent months would not be fully reversed even if interest rates returned to previous levels.
- There are further options (insurance buy-out/buy-in) that could remove the remaining current financial risk to the Church of the existing pension liabilities.
- This would leave c£40m of funds in the PRF surplus to requirement and potentially lead to calls for the return of the voluntary contributions back to the churches and circuits that gave to the appeal.
- It is possible that future capital levies will not be required to top up the PRF.
- If the future service rate were recalculated it would show a decrease, rather than the increase as reported to the Conference.
- The cap on inflation uplifts to pensions will be eroding the real terms value of the pensions paid.
- Economic turbulence has created cash flow challenges for the schemes in relation to the funding of their LDI positions. Without cash support from connexional funds there is a risk that gilts will be sold at the bottom of the market to reduce leverage, but then have to be bought back at a higher price later thus creating a real scheme deficit.

Investment strategy

17 The long-term funding target for both schemes is Gilts +0.5%, but the de-risking structure within the Framework Agreement extends to lower levels of risk. Whilst the investment strategy of the schemes remain entirely a matter for the pension trustees, the SRC has confirmed it is supportive of further de-risking and delegated detailed discussion to the Director of Finance & Resources and the Connexional Treasurer.

Insurance buy-out/buy-in

18 It had been an expected outcome for the PASLEMC Trustee that an insurance buy-out would be required at some point in the future. As the scheme is closed and the number of pensioners declines over the coming decades, it will not be viable to retain in-house management of the scheme in the long run.

19 This approach would see annuities being purchased for PASLEMC scheme members to ensure their benefits are paid out in line with the scheme rules. The Council would need to agree to the winding up of the scheme and pensioners would then have a relationship with the provider of the annuity, not with the PASLEMC Trustees. However, there would be no actual change to the amount of pension they received, just to whom they received it from. The pension investments would sit with the annuity provider and would not be subject to the ethics of the Methodist Church, though in choosing a provider, ethical considerations would be factored into the selection process.

20 Previously, this approach was assumed to be prohibitively expensive. However, current estimates are that this would cost around £12m more than the current value of PASLEMC assets. This amount is equal to the deficit recovery plan that the Council has already agreed with the Trustees and is set aside in the PRF for this purpose. ie the approach has no additional cost to the Council.

21 Whilst MMPS remains open, a buy-out is not an option. However, the Trustee could purchase and hold annuities from an insurer to cover the current liabilities (called a buy-in). The Trustee would then use the cash flow from these annuities to pay out pensions due. How future accrual of pension

is handled would need to be explored, but most of the risk in the current scheme would have been dealt with. Again, the investments would be with an insurer and unlikely to follow the ethics of the Church. This approach does not require Council or Conference approval as the scheme is not being wound up; however, the Trustees are keen to understand if the Council is supportive of this approach.

22 Insurance buy-ins/outs take a long time to negotiate and implement (estimate of two years). It is proposed to delegate to the Connexional Treasurer and Director of Finance discussions with the pension trustees, with reporting back to each Finance Sub-committee meeting and escalation through the SRC to Council for a decision at the relevant time.

Liability Driven Investments

23 The Strategy and Resources Committee has agreed to a request from the Trustees for a 'liquidity facility', but one that would only be called on in extremis. The advantage to the Council is that by supporting the Trustees in this way allows the current level of hedging to be maintained and avoids an unnecessary deficit accruing through the forced sale of gilts in the event of a spike in gilt yields.

24 It is proposed the cash would be a prepayment against existing commitments, either future deficit payments (PASLEMC) or future pension contributions (MMPS). An alternative option would be to provide a loan, though this would likely be prohibitively complex and expensive and would need approval by the Council.

Pension Reserve Fund

25 When the Conference launched the appeal for additional voluntary contributions to the PRF it was on the basis that a well-funded PRF provided extra security to the pension trustees. In turn this supported the setting of a long-term target for each scheme and an agreed de-risking path to achieve that target. This helped prevent the setting of a more aggressive target, a spiralling of the pension deficit, and an unaffordable increase in the ongoing cost of the pension scheme. All this remains true.

26 It was implicit from the actuarial assumptions that the funds in the PRF would be required for most of the period up to the target dates of 2030 (PASLEMC) and 2035 (MMPS). The unprecedented economic events mean that the investments have been de-risked over the course of months, not years. In this context, it is much less likely that the voluntary contributions to the PRF will be required.

27 Whilst it may not be clear for the next 18-24 months that those funds are surplus to requirements, it is more likely than not. It is for the Conference to agree how any unspent funds are used, but given the circumstances, it is proposed that should the funds not be required that they are returned to the donor. As the funds have accrued interest whilst in the PRF it is appropriate this is also passed to the donors. It is proposed to pay interest at the CFB deposit fund rate.

28 By the end of August 2023 it is likely that the total funds in the PRF will exceed £50m. Allowing for the deficit payments to the PASLEMC (£12m) and the potential future return of the voluntary contributions with interest (c£7.5m), significant funds will still remain. Should the process towards insurance buy-in/out continue successfully it is possible there will be no ongoing requirement for a PRF. It is therefore proposed that subject to satisfactory negotiations with the pension trustees, contributions from the property levy to the PRF are suspended from September 2023.

MMPS review task group

29 The task group has been reviewing the future of the MMPS using four main parameters:

- the affordability of the scheme and the value for money provided;
- where risk over future costs and benefits should lie between circuits and ministers;
- the appropriateness of governance arrangements in the context of the Church, and
- the Covenant between the Church and those called to serve as ministers.

30 The task group has received a verbal update on the steps being taken by the Church of England to develop a new type of pension scheme – a collective defined contribution scheme (CDC). Whilst it

shares some features of a DC scheme, a CDC scheme aims to achieve higher levels of investment return (and therefore higher pensions) by sharing the risk between member employees over time. The task group is to meet with CofE representatives in 2023 to further explore this option.

31 The task group commissioned work from a firm of pension specialists that addressed some key questions.

- Will future accrual costs increase as the schemes de-risk?

  They confirmed that based on the figures as at the time of the 2020 Valuation, the costs of the pension scheme would increase from the current 38.8% to c47.2%. However, given the massive increase in the discount rate, the de-risked level of contributions would now be more likely to be closer to 22.3%.

- Would a defined contribution pension scheme offer better benefits to members than the MMPS?

  For the current level of contributions MMPS provides a higher level of pension than an equivalent DC pension. However, a DC pension would offer more flexibility. If a minister wanted to forgo the provision of a 50% pension to a surviving dependant, they would be able to increase their own pension. Also, a DC scheme would offer more flexibility to draw down benefits sooner.

- Are the pension levels paid from MMPS reasonable?

  Research suggests that £20k represents a modest, but acceptable level of income in retirement. However, it would assume that housing costs are limited, whereas ministers may face above average housing costs. For a minister starting at age 35 with no other pension provision, and serving the Church until state pension age, their MMPS pension plus their state pension would total c£20k.

32 In the light of the very different circumstances now faced and the input from the pension specialists, the group has concluded as follows:

- For the level of benefits provided, the MMPS is not an expensive scheme. Reducing the cost of the scheme would reduce the benefits to members. As the benefits provided are not excessive and only provide for a modest level of income in retirement, reducing the pension further is not recommended.
- Based on the current position, it is likely that the cost of future accrual in the scheme will fall dramatically at the next valuation in September 2023. Whilst circumstances could change, particularly in the medium term, the immediate pressure from increasing costs has gone away.
- MMPS is less flexible than alternative pension arrangements but does provide a basic pension to all with the risk sitting with the Church. A DC scheme would offer more flexibility for ministers but would also increase the risk they carry. Whether the Church should offer more flexibility and allow ministers to take more decisions for themselves about their pensions, is a question about the relationship between Church and minister. The Secretary of the Conference will take this question forward.
- CDC may offer an interesting alternative pension arrangement, but it is some years away from being a viable replacement for MMPS.
- The task group will meet with the CofE to discuss CDC but then suggests: the group is stood down for the foreseeable future; no changes to MMPS are recommended, and conversations over the future of MMPS should continue at a slower pace, overseen for now by the Finance Sub-committee. This approach will allow the focus to be on developing the insurance buy-in/out options whilst not closing the door on new arrangements for MMPS.

Other issues

33 Further reflection should be undertaken by the Connexional Allowances Committee about the impact of inflation on pensions and pensioners. This will need to be discussed in the context of what is affordable and will therefore require input from FSC/SRC.

34 The interim valuation suggests that the future accrual rate for the MMPS has fallen significantly. It does not make sense to allow the circuit contribution rate to increase from September 2023, when it is likely it will reduce again once the 2023 Valuation is signed during 2023/24. Therefore, the increase to the circuit contribution rate should be cancelled and proposals for further changes (up or down) should await the outcome of the 2023 Valuation.

35 The impact on the CFB of pension disinvestment has been a rapid reduction in Assets Under Management and a consequent loss of revenue. The CFB has a strategy for addressing this deficit, however, it is noted that this includes increasing charges to the Church. Should other efforts to expand the business prove unsuccessful, these costs will increase further.

***RESOLUTIONS**

18/1. The Council receives the report.

18/2. The Council delegates to the Director of Finance & Resources and Connexional Treasurer authority to undertake discussions with the Pension Trustees with the objective of securing a buy-in or buy-out of both pension schemes.

18/3. The Council recommends to the Conference that the increase in pension contribution rates from circuits in September 2023 is cancelled.

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18/6 The Council accepts the recommendation of the MMPS review task group to make no changes to the MMPS at the current time but to pass the review of MMPS to the Finance Sub-committee for ongoing consideration.