SURREY COUNTY COUNCIL

PENSION FUND COMMITTEE

DATE: **16 DECEMBER 2022**

LEAD OFFICER: **ANNA D'ALESSANDRO, DIRECTOR CORPORATE FINANCIAL & COMMERCIAL**

SUBJECT: **CASH FLOW REVIEW**

SUMMARY OF ISSUE:

Understanding the cash flow position of the Fund is vital regarding management and allocation of the assets such that pensions can be paid.

RECOMMENDATIONS:

It is recommended that:

1) The Committee note the Fund's current and projected cash flow position.

2) Approve an annual review of the cash flow position given heightened uncertainty related to inflation expectations.

3) Note the operational decision to utilise income from CBRE and initiate the income withdrawal plan for the Multi-Asset Credit (MAC) Fund to support the cash flow position.

4) The Local Pension Board (LPB) be tasked with reviewing the impact of inflation on cash flows and the entry within the Risk Register.

REASON FOR RECOMMENDATIONS:

Knowing when the Fund is likely to become cash flow negative is helpful as it can have implications for both the funding and investment strategy:

- Having adequate cash available to meet the Fund's primary objective of paying member benefits
- The ability to maintain stable contributions over time and withstand volatility from investment markets
- Understanding the level of cash balance that needs to be retained while avoiding a drag on investment returns
- Avoiding the risk of being a forced seller of assets at inopportune times
- Making the most efficient use of income generated by Fund assets
- Implementing optimum rebalancing and cash management policies

DETAILS:

Background

1. The Fund's cash flow position is reviewed periodically. The current review was instigated by officers due to the increased inflation within the UK

economy and the potential impact this could have on the amount paid out by the Fund in pension benefits.

2. At present, the Fund is cash flow positive, the amount paid out in pension benefits is less than the amount received in contributions.

3. Hymans Robertson have reviewed the cash flow projections of the Fund. Their report is in Annexe 1.

4. Using data as at 31 March 2022 with the exclusion of investment income, and also ignoring the effect of transfers, the baseline projection shows the Fund is likely to be cash flow negative by 2029. This allows for an expected pension increase of 10.1% in April 2023 and inflation thereafter in line with the median Hymans Robertson economic scenario service CPI assumption.

5. After consulting with officers, adjustments to the projections were requested from Hymans. These are shown on page 17 of Annexe 1 and include the calibration of benefit payments, current CPI expectations, and prepayment assumptions to reflect recent behaviours.

6. The combined effect of these adjustments suggests the Fund could be cashflow negative over the 2023 to 2026 period.

7. Mercer have reviewed the investment position given the information above. Their report is in Annexe 2. There is a healthy level of income potential from the assets, estimated at £180m p.a. in future. This will allow significant flexibility as to how the Fund invests over the long-term.

8. Given the inherent uncertainty in some of the assumptions, not least CPI, the Fund will start to take income from CBRE and the MAC Fund through the income withdrawal plan.

Commentary on the impact of inflation

9. LGPS benefits (including pensions in payment, deferred pensions and CARE benefits accrued by active members) are increased in April each year in line with the change in the Consumer Prices Inflation (CPI) Index over the 12 months to the previous September. Because of this, the CPI assumption used to value the liabilities is one of the key valuation assumptions.

   This assumption affects the projection of pension benefits into the future. As such, there is a simple relationship between the CPI assumption and the value of the liabilities – a higher CPI assumption leads to a higher value of the liabilities (and vice versa).

   LGPS benefits are expected to be increased by 10.1% in April 2023. This is a higher increase compared to recent years and is a key driver of the changing net cashflow position (ie leading to benefit outgo being greater than contribution income).

   For valuation purposes, the Actuary is required to set a single assumption for future CPI. The single assumption set at the 2022 valuation, of 2.7% pa, is based on an average of future CPI expectations over the next 20 years and, crucially, this recognises the expectation of very high CPI in the short term.

The CPI assumption is used to set the salary growth assumption at the 2022 valuation. Specifically, it is assumed the salaries grow at the rate of 3.7% pa, which is equal to the CPI assumption plus 1% pa. This is broadly in line with historic pay growth in the public sector.

For the purpose of the cash flow projections prepared by the Fund Actuary, the CPI assumption recognises the future shape of CPI expectations rather than adopt a single future CPI assumption of 2.7% (as is required for valuation purposes). The projections allow for higher CPI in the short term, in particular, the 10.1% increase expected to apply in April 2023 and lower CPI expectations in the long term. This leads to a much more realistic projection of short-term benefit outgo.

The inflation scenarios set out in pages 26-30 of Annexe 1 provide an indication of the impact of higher and lower long-term CPI (compared to the 'best estimate' baseline position). For example, higher CPI for a prolonged period of time (ie the stagflation scenario) would create a significant challenge for the Fund in meeting benefit outgo and this may necessitate a significant increase in the income generated from the Fund's assets.

CONSULTATION:

10. The Chair of the Pension Fund has been consulted on the report.

RISK MANAGEMENT AND IMPLICATIONS:

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11. Risk related issues are contained within the report.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

12. Financial and value for money implications are contained within the report.

DIRECTOR OF CORPORATE FINANCE & COMMERCIAL COMMENTARY

13. The Director of Corporate Finance & Commercial is satisfied that all material, financial and business issues and possibility of risks have been considered.

LEGAL IMPLICATIONS – MONITORING OFFICER

14. There are no legal implications or legislative requirements associated with this report.

EQUALITIES AND DIVERSITY

15. The review of the Fund's investment programme will not require an equality analysis, as the initiative is not a major policy, project or function being created or changed.

OTHER IMPLICATIONS

16. There are no potential implications for council priorities and policy areas.

WHAT HAPPENS NEXT

17. The following next steps are planned:

    a. Continued monitoring of cash flow position with a report to be brought to the committee on an annual basis

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Contact Officer:
Lloyd Whitworth, Head of Investment & Stewardship

Consulted:
Pension Fund Committee Chair

Annexes:

1. Cash Flow Analysis by Hymans Robertson – Annexe 1
2. Cash Flow Analysis by Mercer – Annexe 2

Sources/background papers:

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