HYMANS ROBERTSON

Surrey Pension Fund

Cashflow projections

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11 March 2025
For and on behalf of Hymans Robertson LLP

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Executive summary

This paper is addressed to Surrey County Council as the Administering Authority to the Surrey Pension Fund ("the Fund"). The paper considers different future projections of the Fund's cashflows under a range of different scenarios. The analysis and projections will help the Fund better understand its current and potential future cashflow position and is part of its management of risk in this area.

From the analysis and projections set out in this paper, the following conclusions can be drawn:

Excluding investment income, the Fund is expected to become cashflow negative by 2028 as a result of the recent high levels of inflation applied to LGPS benefits (10.1% in April 2023, 6.7% in April 2024). However, this is later than previously anticipated (2024 - as per the November 2023 analysis) due to the lower expected pension increase for April 2025 of 1.7%.

The cashflow position of the Fund is sensitive to future levels of inflation. The weak demand-driven inflation scenario represents a period of "low inflation" as the government embarks on fiscal consolidation through tax increases and spending cuts. Under this scenario, the Fund remains cashflow positive for a longer period of time highlighting the importance of reviewing the cashflow position on a regular basis in an uncertain inflationary environment.

In the longer-term, the most significant risk to the fund (in respect of its cashflow position) is a structurally higher inflation scenario, where inflation remains elevated for a longer period of time. Under this scenario, the Fund is also cashflow negative by 2028, with the gap increasing to a material level in the longer-term.

A reduction in contribution rates at the 2025 valuation will reduce the contribution income received by the Fund in the long-term. The impact on the cashflow position will depend on the level of reductions applied, however larger reductions in contributions will result in larger income requirements from the Fund's investments, potentially requiring an investment income yield of up to 0.9% pa.

Background and Inputs

What is cashflow negativity and does it matter?

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Every month, the Fund receives income via contributions and pays out benefits to members. Historically, the benefits have been paid out of the contribution income with any excess being invested. This is how the Fund's asset value has built up over time (along with investment returns).

Over time a pension fund will mature, and the level of benefit payments will start to exceed contribution income. At this point, a pension fund is considered "cashflow negative".

Being cashflow negative itself is not unexpected for a pension fund; the assets that have been accrued are for the purpose of paying benefits. However, if the transition to being cashflow negative is not monitored and managed effectively, it can pose a liquidity risk and the Fund may become a forced seller of assets.

Following recent high levels of inflation, the focus on cashflow is greater given the significant increases in benefit outgo (10.1% at April 2023, 6.7% at April 2024 and an expected 1.7% at April 2025).

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

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

This paper explores the Fund's cashflow position under a variety of different scenarios to inform the approach to cashflow management

Recent cashflow position

Using the annual report and accounts for years ending 2022, 2023 and 2024 (draft), we have analysed the recent cashflow position for the Fund.

The chart shows the absolute value of contribution income and benefit outgo (bars) and the net cashflow position (line and figures). During this period, the Fund was cashflow positive, i.e. contribution income exceeded benefit outgo.

Transfers in and out of the fund can significantly affect the cashflow position. In 2022/23, there were net transfers of c.£11m into the Fund which helped increase the net cashflow position. Transfers in 2023/24 had the opposite effect where c.£6m of transfers out of the Fund reduced the overall net positive cashflow position.

The effect of the April 2023 Pension Increase Order (of 10.1%) led to a significant reduction in net cashflow position in 2023/24.

NB, the average investment income yield (net of fees) is c.0.5% of assets pa.

The cashflow position has remained positive in recent years. Excluding the impact of transfers, the net cashflow position is around £12m (contributions exceeding benefits)

What are the cashflows of the Fund

In this paper we consider the main cashflows in and out of the Fund over the next 20 years.

The Fund's primary sources of income are:

- Contributions from employers in the Fund
- Contributions from employee members in the Fund
- Income streams generated from the Fund's investments

Contributions paid are estimated based on:

- The 2022 valuation payroll
- An allowance for an increase in payroll in 2023 and 2024 in line with national local government pay award information
- The 2024/25 and 2025/26 contribution rates (equivalent to an average of 21.8% and 21.7% of pay respectively). Thereafter the contribution rate has been assumed to remain at this level unless otherwise stated.

The Fund's outflows are the benefits payable to the members and their dependants. These include:

- Retirement lump sums paid to active and deferred members on retirement
- Retirement pensions paid to pensioners and their dependents
- Death in service benefits and ill health benefits.

Transfers in and out of the Fund by individual members are not usually a significant source of income or outflow and typically balance out over time.

The projected cashflows are sensitive to a number of assumptions. The most significant are:

- Level of future benefit increases (all LGPS benefits are index-linked and increase in line with Consumer Price Index (CPI) inflation)
- Level of current and future payroll (determines the amount of contributions received)

We have prepared future cashflow projections under a range of different inflation and contribution rate scenarios to inform decision making. This helps the fund understand the sensitivity of its cashflow position to these sources of uncertainty and make appropriate management plans.

Data, assumptions and methodology

Membership data

We have used the membership data provided for the 2022 valuation of the Fund.

Assumptions

The demographic and financial assumptions are in line with those adopted for the 2022 valuation of the Fund unless stated otherwise.

Further information on the membership data is detailed in the 2022 final valuation report dated March 2023.

Allowance for benefit outgo in respect of benefits yet to be accrued by current active members is included in the projection; however, given the relative short timeframe considered, no allowance has been made for benefit outgo in respect of accrual by members yet to join the scheme.

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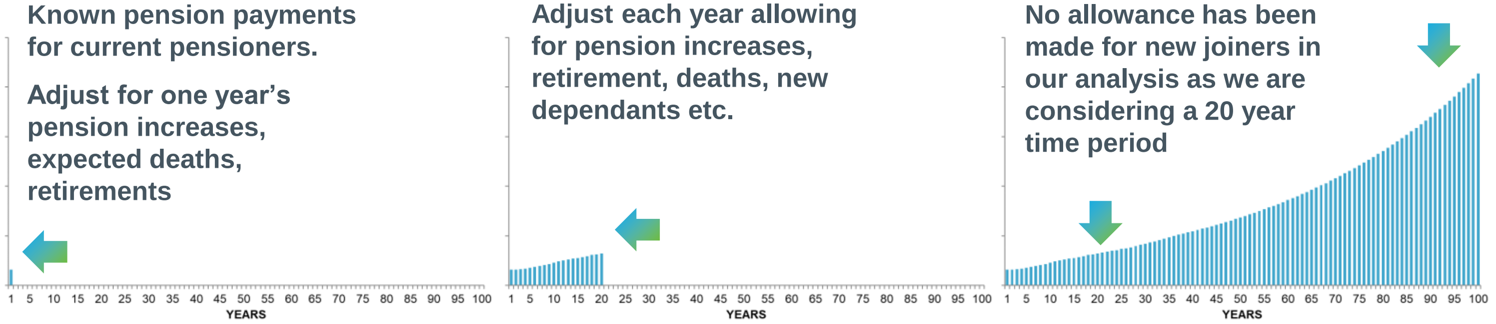
Methodology: how we project benefit payments



Methodology: projecting contribution income

- Payroll is assumed to stay constant in real terms, i.e. it increases in line with the valuation assumption of 3.7% pa.
- Employer contributions are assumed to be in line with the pattern as set out on page 7.
- Employee contributions are based on the weighted average for the Fund using the membership data provided for the 2022 valuation (6.6% of pay).

Scenarios explored (inflation)

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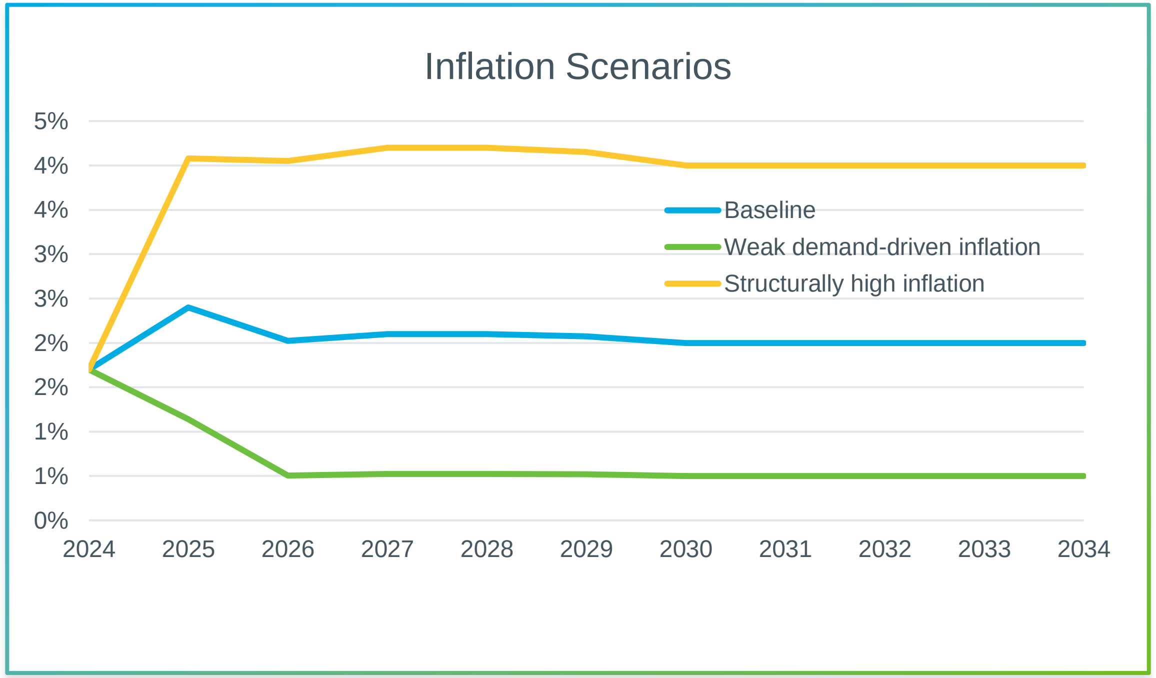
Future CPI inflation

Given the sensitivity of future benefit payments to inflation, we have considered three potential scenarios for future inflation. All scenarios recognise a 10.1% increase in benefits in April 2023, 6.7% increase in April 2024 and an expected 1.7% increase to benefits in April 2025:

- Scenario 1: this **baseline** scenario represents consensus forecasts for headline CPI inflation to trend towards, albeit slightly above, the Bank of England's target over the medium-term.
- Scenario 2: the **weak demand-driven inflation** scenario represents a "hard landing" from deficient demand as the government embarks on fiscal consolidation. This could be achieved through tax increases and spending cuts, leading to a period of weak growth and demand-driven inflation.
- Scenario 3: this represents a **structurally high inflation** scenario where persistent labour shortages and subsequent wage increases, alongside supply-side disruption owing to geopolitical and climate-induced disruptions lead to a period of structurally higher inflation.

In all scenarios we have kept the payroll assumption constant at 3.7% pa.



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Scenarios explored (contributions)

Impact of contribution rate reductions

Current market outlook has led to strong funding levels for the majority of employers participating in the Surrey Pension fund. We have therefore considered a number of scenarios where contribution rates are reduced at the 2025 valuation (i.e. from 1 April 2026). The scenarios considered are:

- **Scenario 1**: A phased 1% pa reduction in contribution rates for three years from 1 April 2026, then remaining at this reduced level for the remaining projection period.
- **Scenario 2**: A phased 2% pa reduction in contribution rates for three years from 1 April 2026, then remaining at this reduced level for the remaining projection period.
- **Scenario 3**: An immediate one-off 5% pa reduction in contribution rates, from 1 April 2026, then remaining at this reduced level for the remaining projection period.

The results of our analysis under all these scenarios are set out on the following pages.

Inflation scenarios

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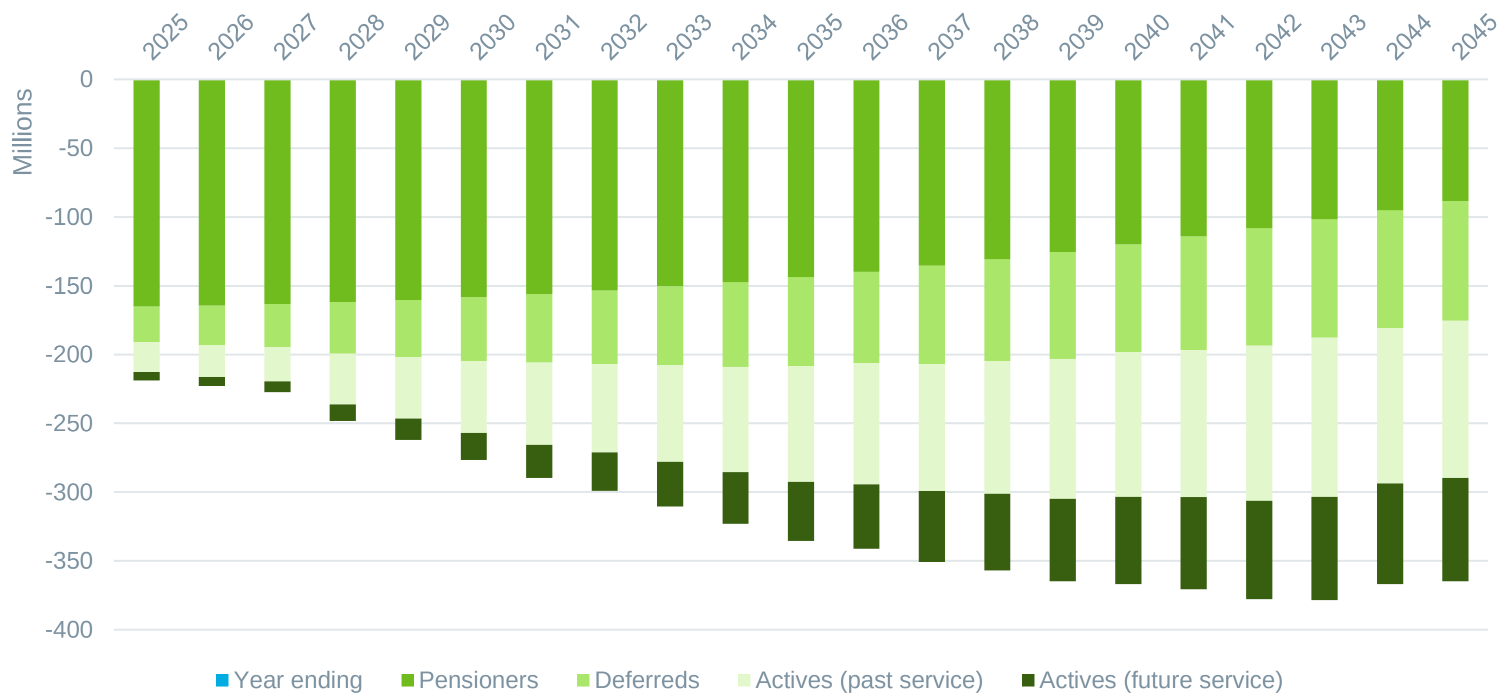
Projected benefit outflows (baseline scenario)



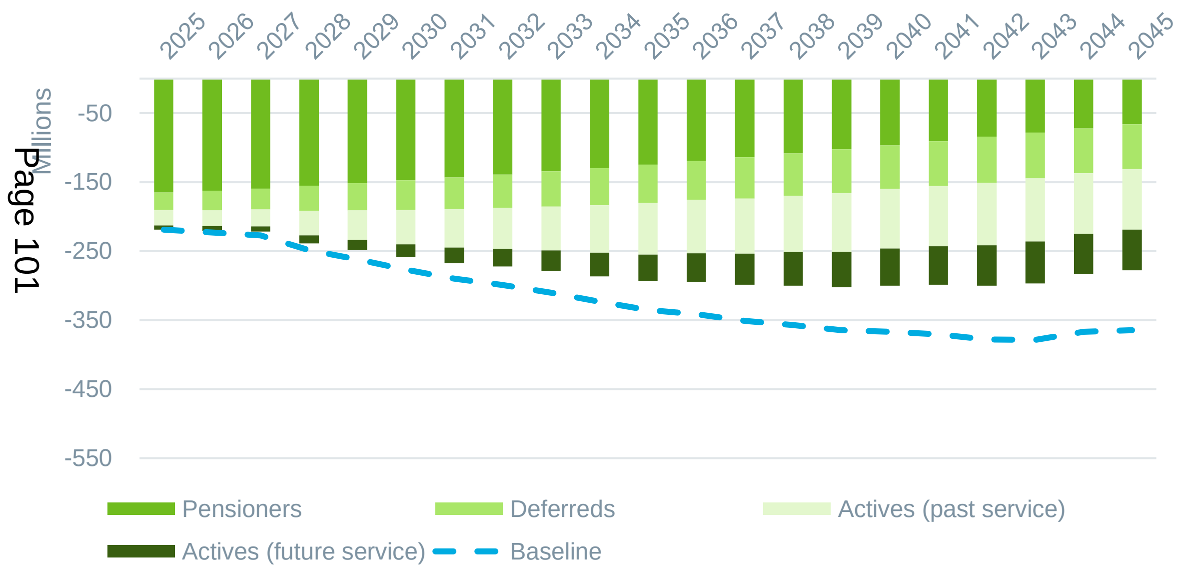
Notes

The years along the x-axis (horizontal) refer to the year-end i.e. 2025 means the 2024/25 financial year (from 1 April 2024 to 31 March 2025).

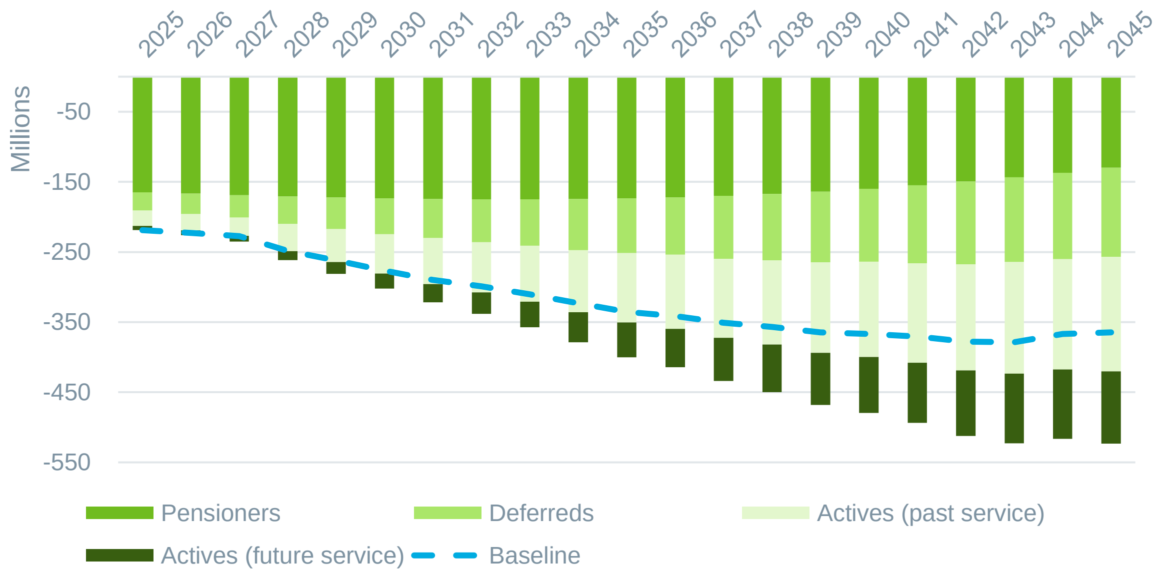
The Fund currently pays around £205m in benefit payments. This is expected to increase to over £375m by 2042.

Projected benefit outflows (alternative inflation scenarios)

Hard Landing



High Inflation



Scenario analysis helps understand the impact inflation may have on future benefit payments – difference of c£245m in annual benefit payment by 2045.

Projected contribution income (all inflation scenarios)

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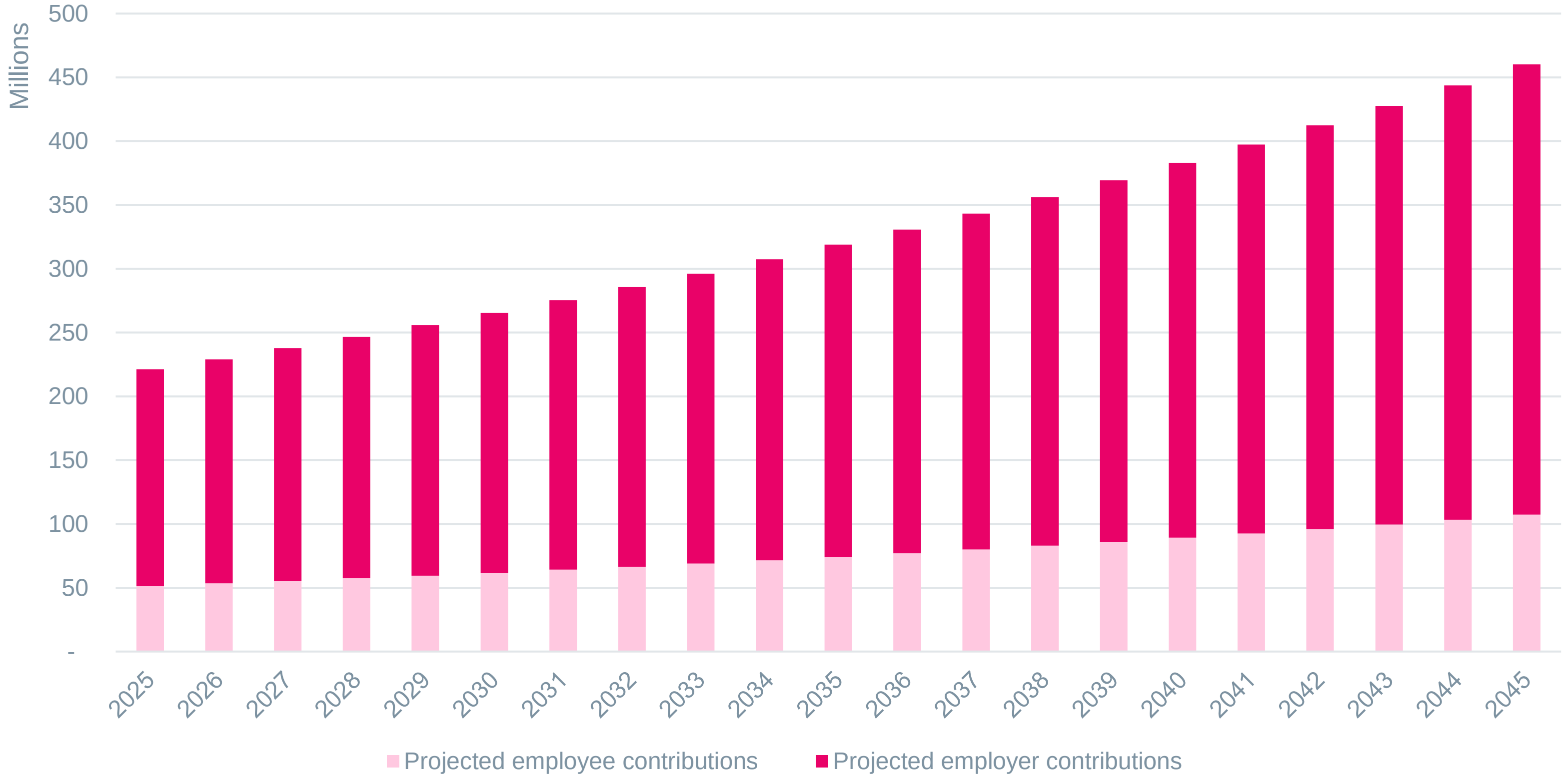


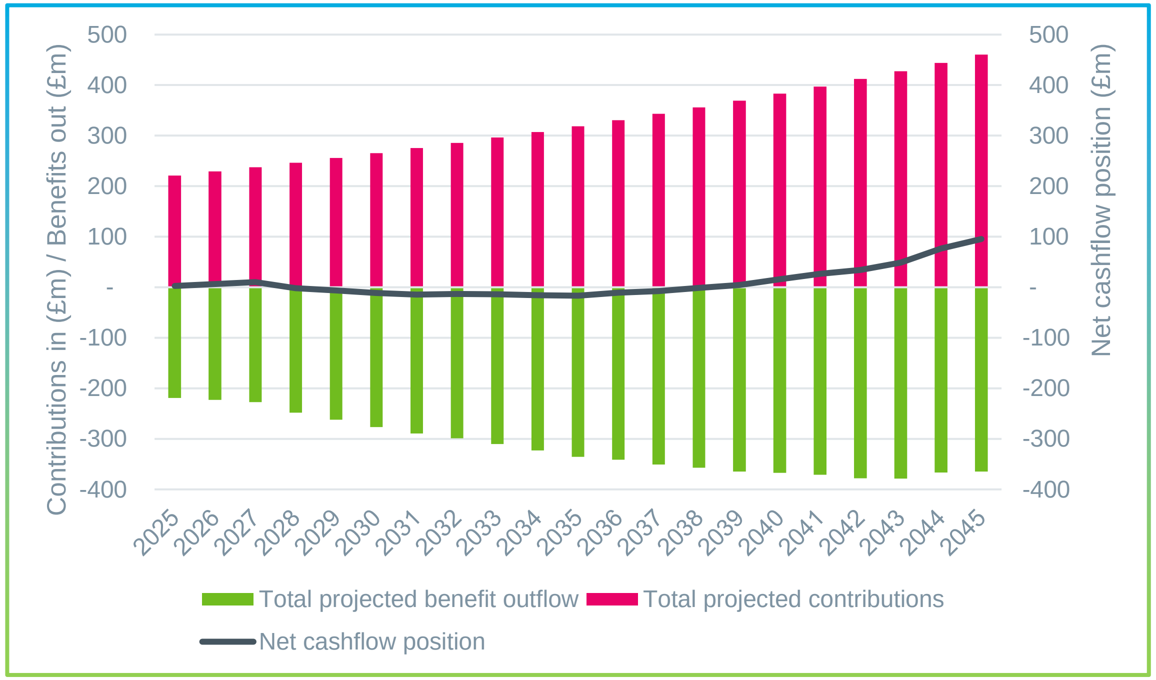
Notes

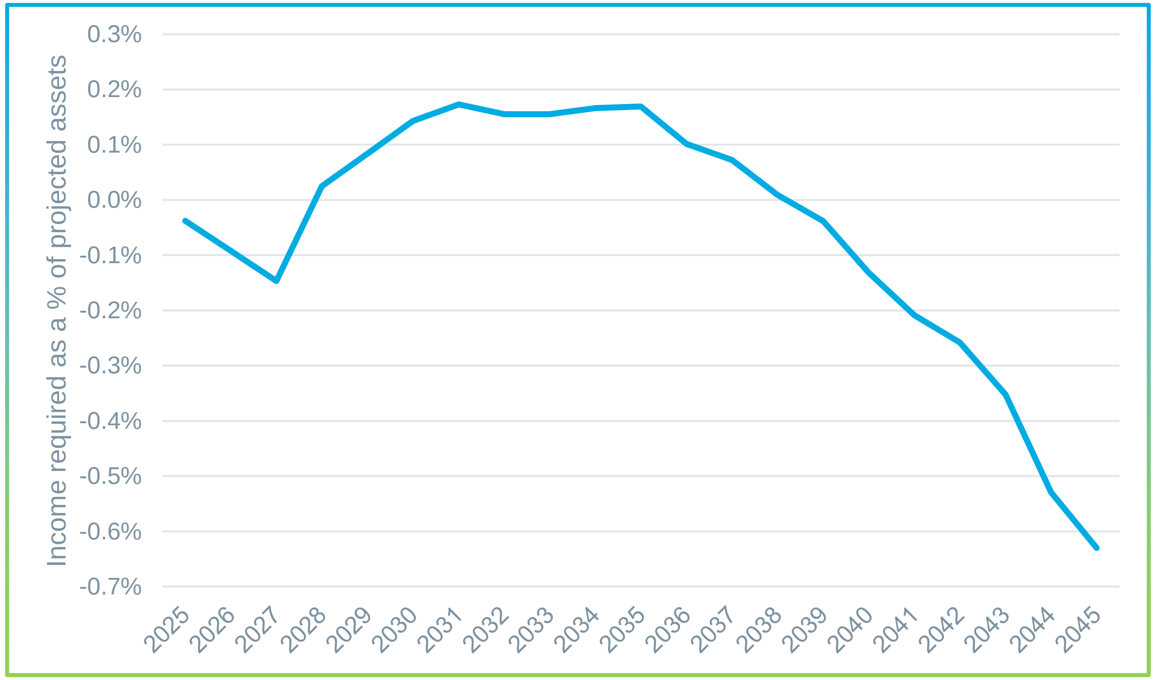
New entrants are implicitly allowed for in the income cashflow by assuming the payroll grows with inflation.

The years along the x-axis refer to the year-end i.e. 2025 means the 2024/25 financial year (from 1 April 2024 to 31 March 2025).

Payroll is assumed to increase at 3.7% pa (in line with the formal valuation)

Whole fund net cashflow (baseline scenario)





Contributions are not expected to be sufficient in meeting all benefit outgo over the period. Therefore, additional income will be required from assets to meet the shortfall, although this would not be at a significant level (less than 0.2% yield)

Assets are assumed to increase at 4.4% pa

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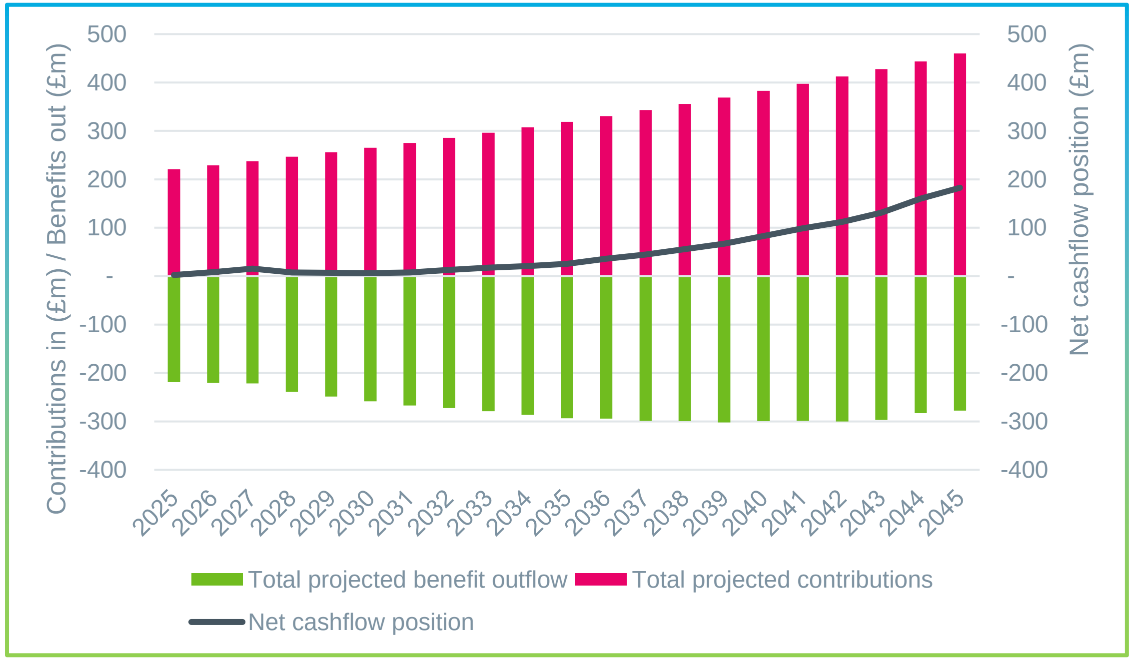
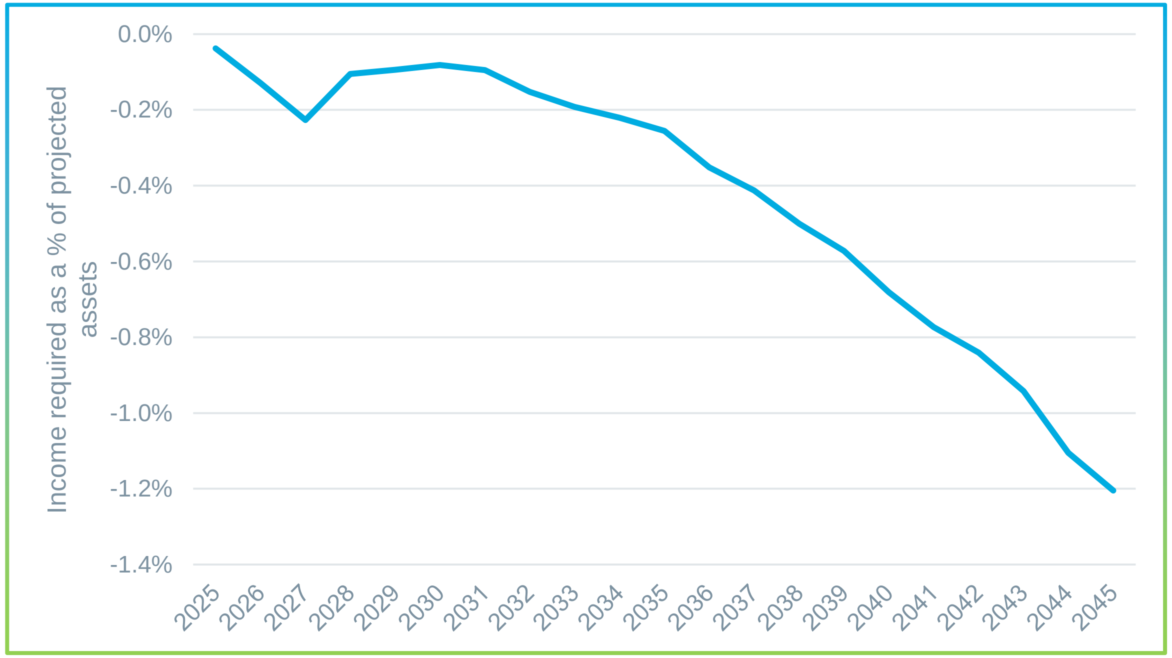
Whole fund net cashflow (hard landing scenario)





Relative to the baseline, a “hard landing” would improve the Fund’s cashflow position in the long term. The cashflow position would remain positive during the period and hence no additional income from assets would be required.

Assets are assumed to increase at 4.4% pa

Whole fund net cashflow (high inflation scenario)

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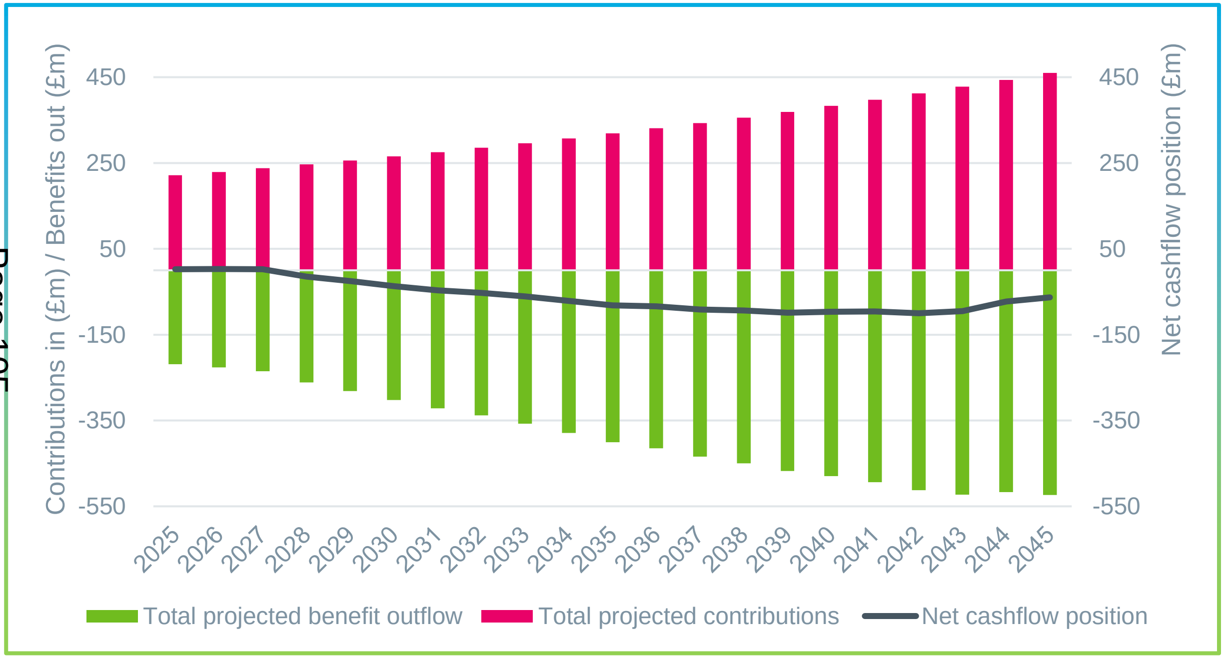

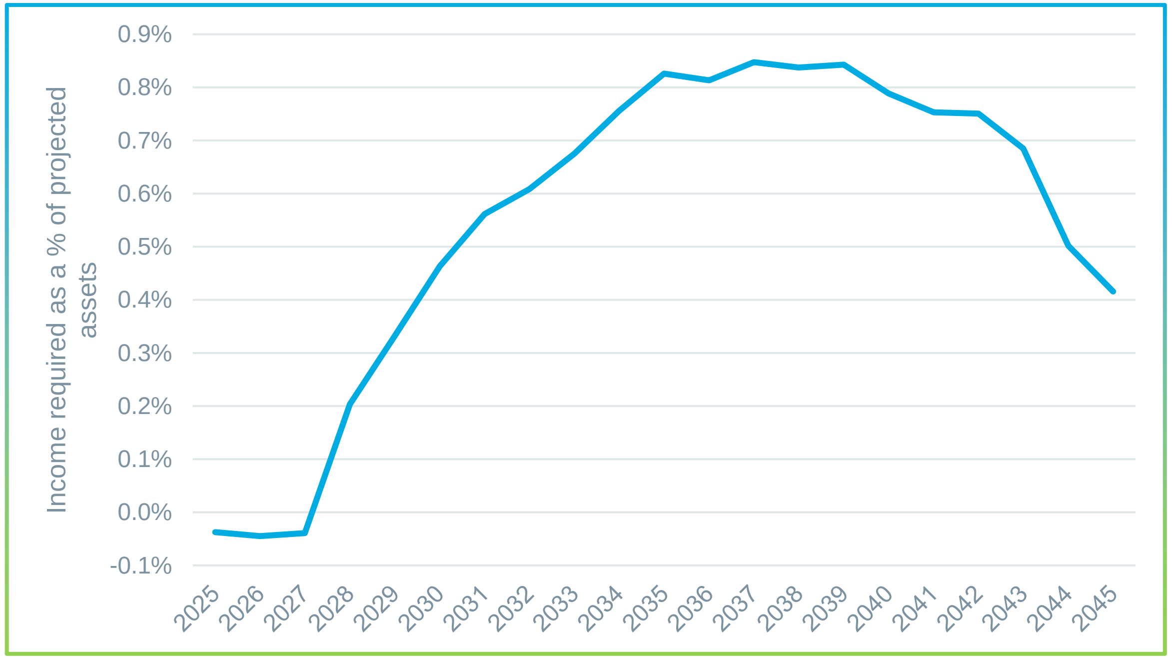

A high inflation scenario would worsen the Fund's cashflow position in future years, becoming cashflow negative by 2028 at much more significant levels than the baseline scenario. This would need to be managed by a higher level of income from the Fund's assets (around 0.9% yield).

Asset[redacted]ssumed to increase at 4.4% pa

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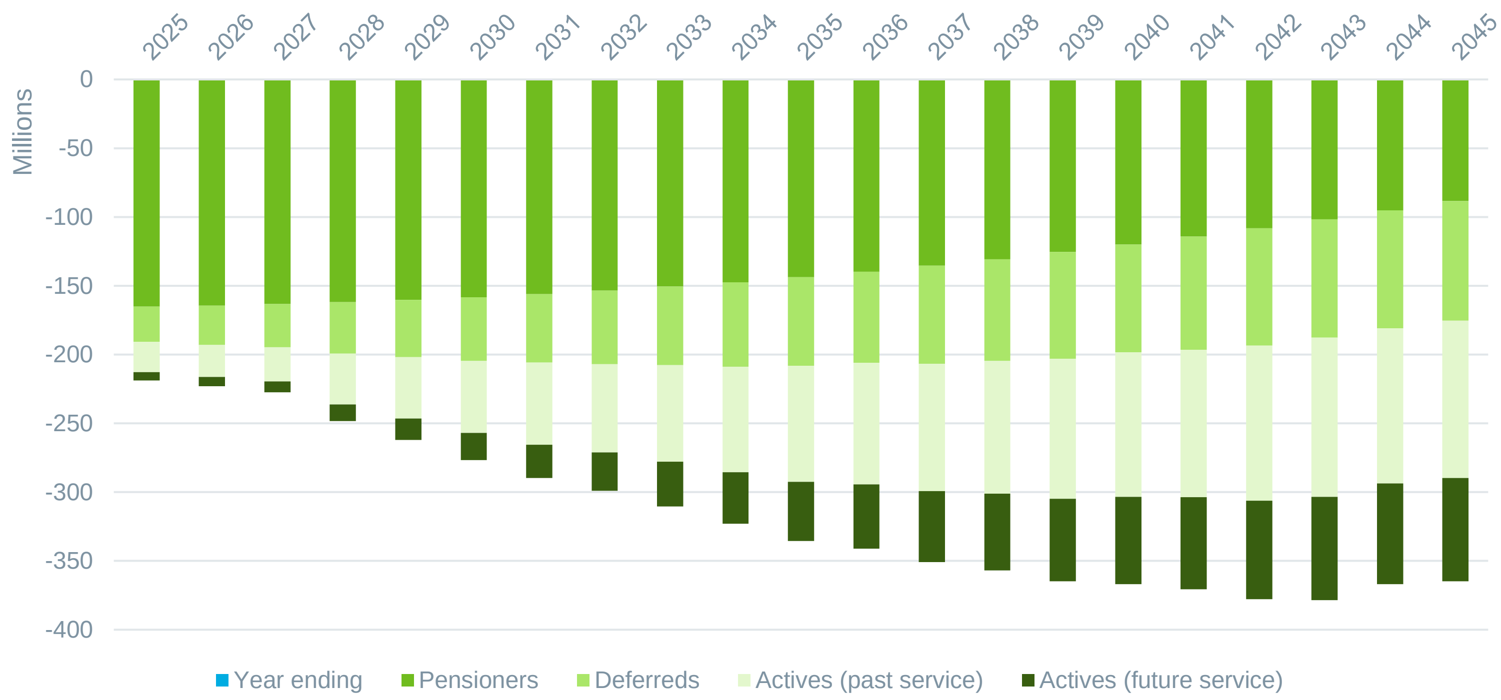
Contribution scenarios

Projected benefit outflows (baseline scenario)



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Notes

The years along the x-axis (horizontal) refer to the year-end i.e. 2025 means the 2024/25 financial year (from 1 April 2024 to 31 March 2025).

The Fund currently pays around £205m in benefit payments. This is expected to increase to over £375m by 2042.

Projected contribution income (phased contribution scenarios)

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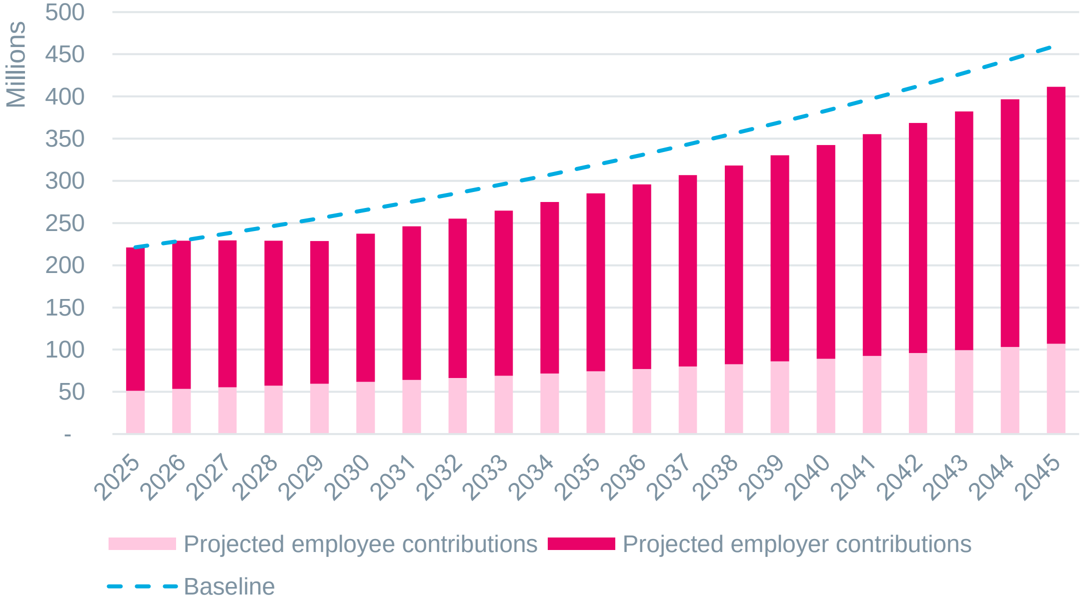
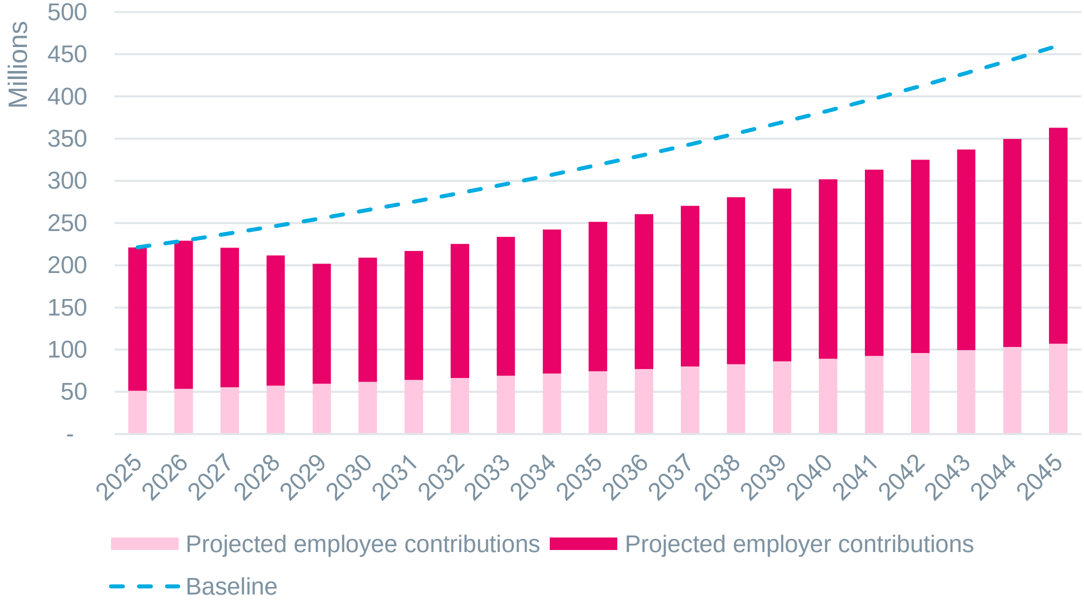
Scenario 1



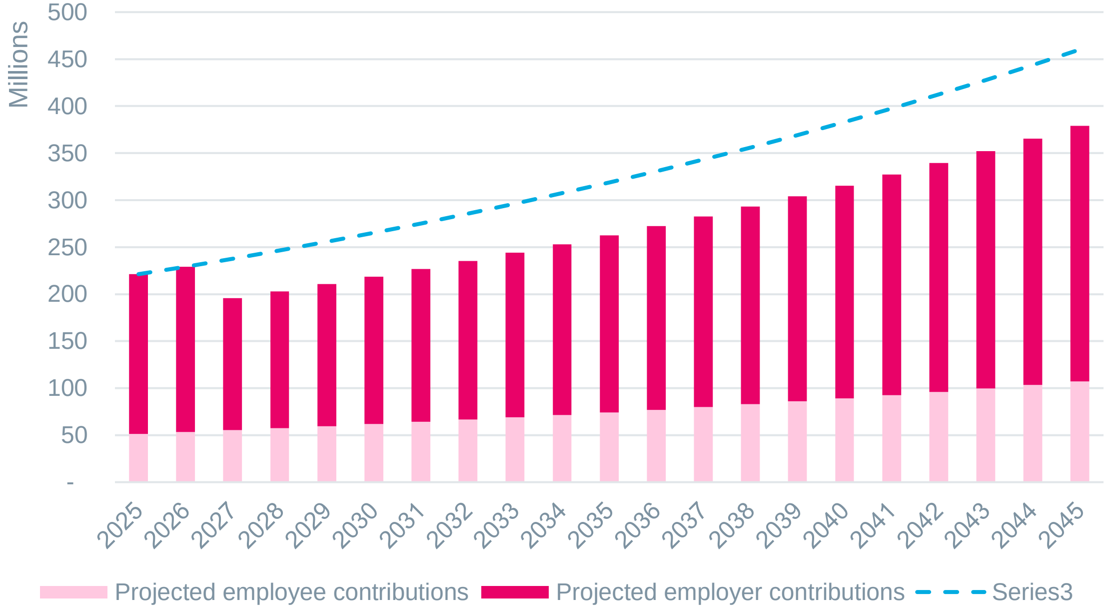
Scenario 2



Both scenarios demonstrate the effect of a reduction in contribution rates for 3 years from 2026; a 1% p.a. reduction and a 2% p.a. reduction respectively.

Projected contribution income (one-off contribution scenario)

Scenario 3



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Scenario 3 represents a one-off 5% p.a. reduction in contribution rates coming into effect from 1 April 2026.

Whole fund net cashflow (1% phased reduction in contribution rates)

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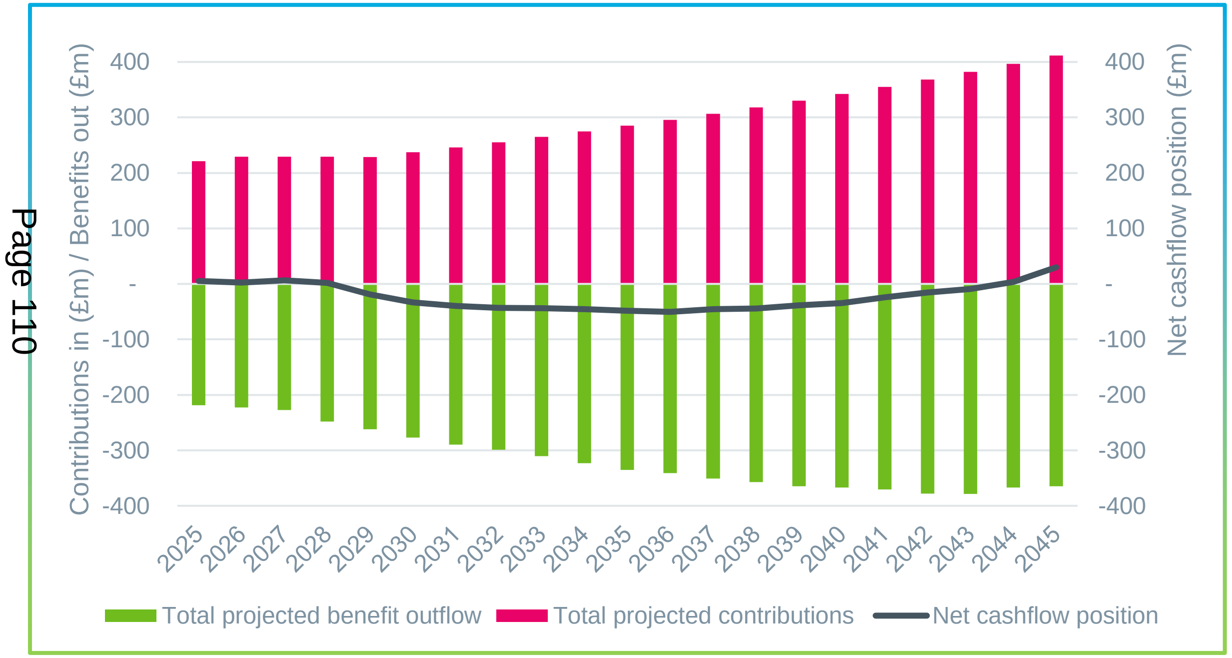

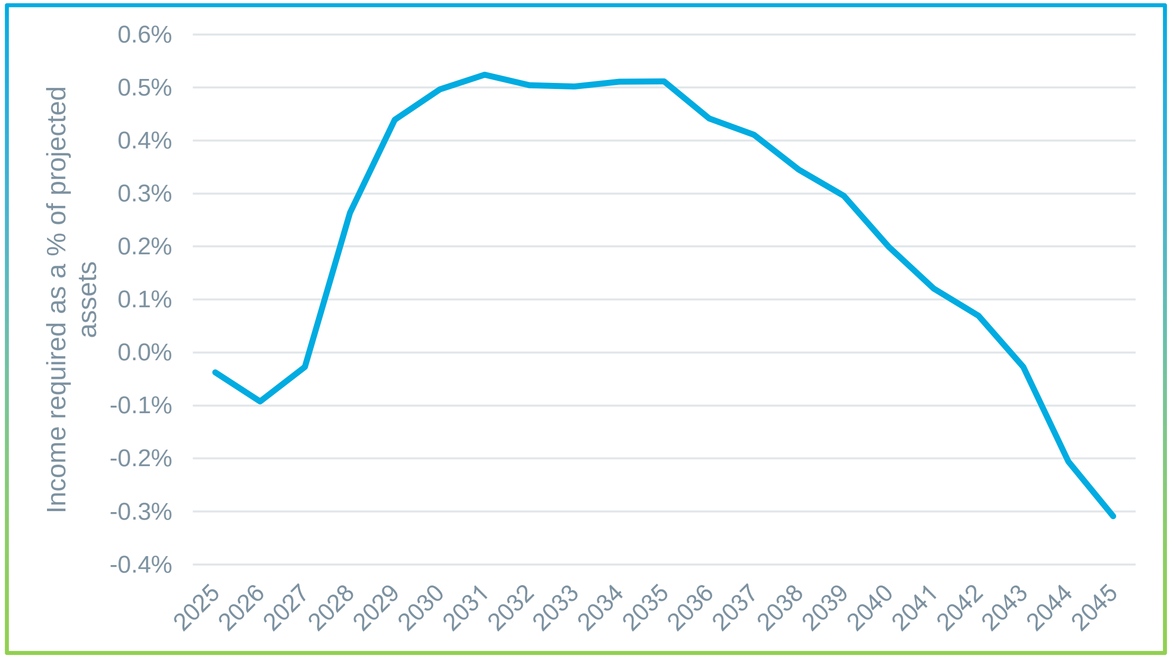

In comparison to the baseline, the impact on the cashflow position over the short-term is slightly accelerated. A higher level of income from assets would be required to meet benefit payments compared with the baseline scenario, however this would not be a significant amount (c. 0.5% pa yield).

Asset values are assumed to increase at 4.4% pa

Whole fund net cashflow (2% phased reduction in contribution rates)

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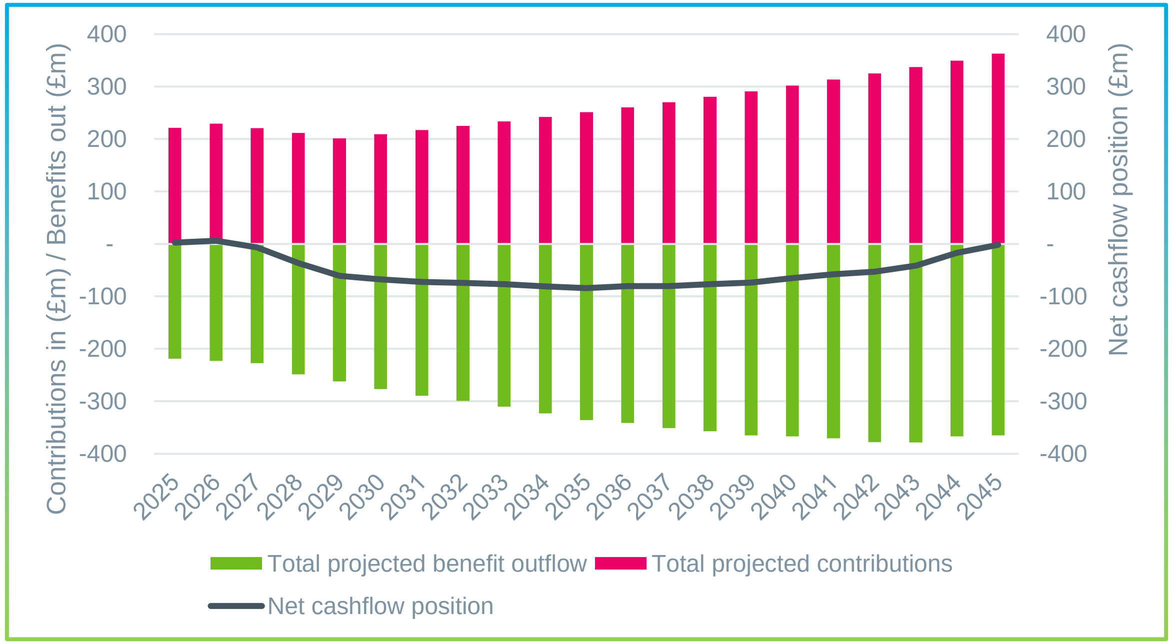

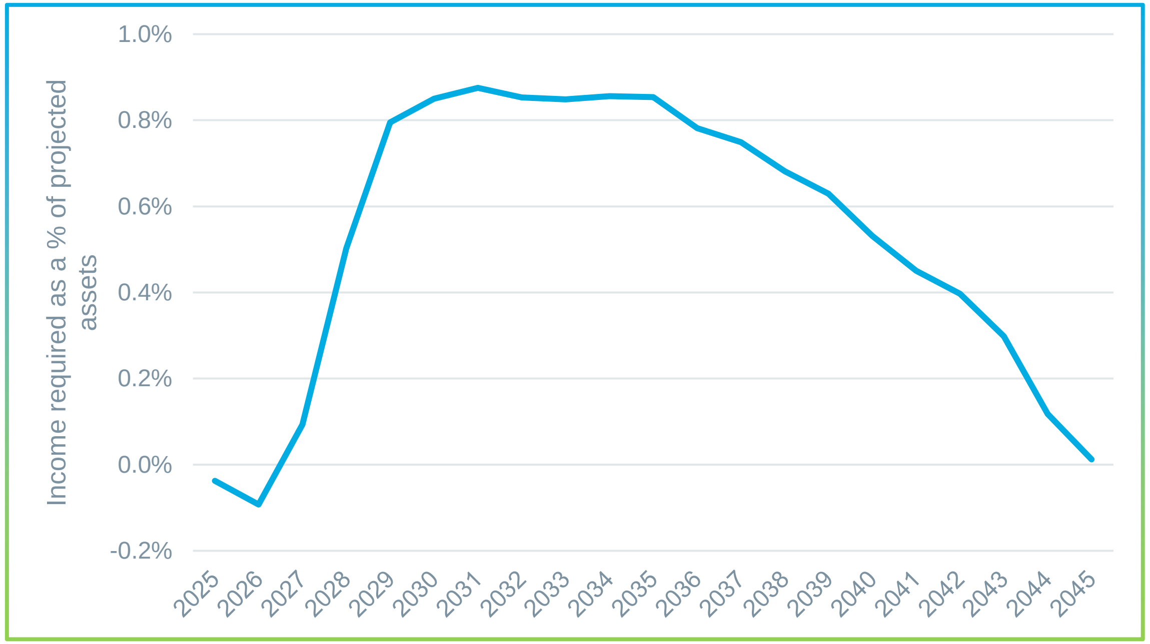

Larger contribution reductions for all employers would result in a larger shortfall between contribution income and benefit outgo. Under this scenario an estimated investment income yield of c. 1.0% would be required to meet benefit payments.

Asset re assumed to increase at 4.4% pa

Whole fund net cashflow (5% one-off reduction of contribution rates)

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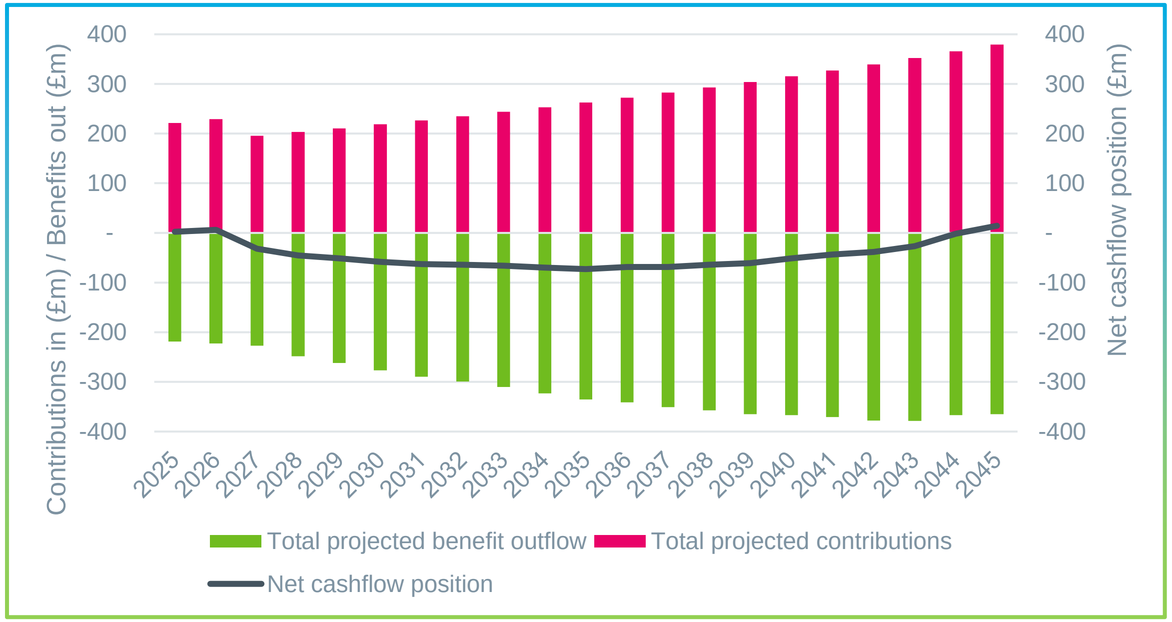

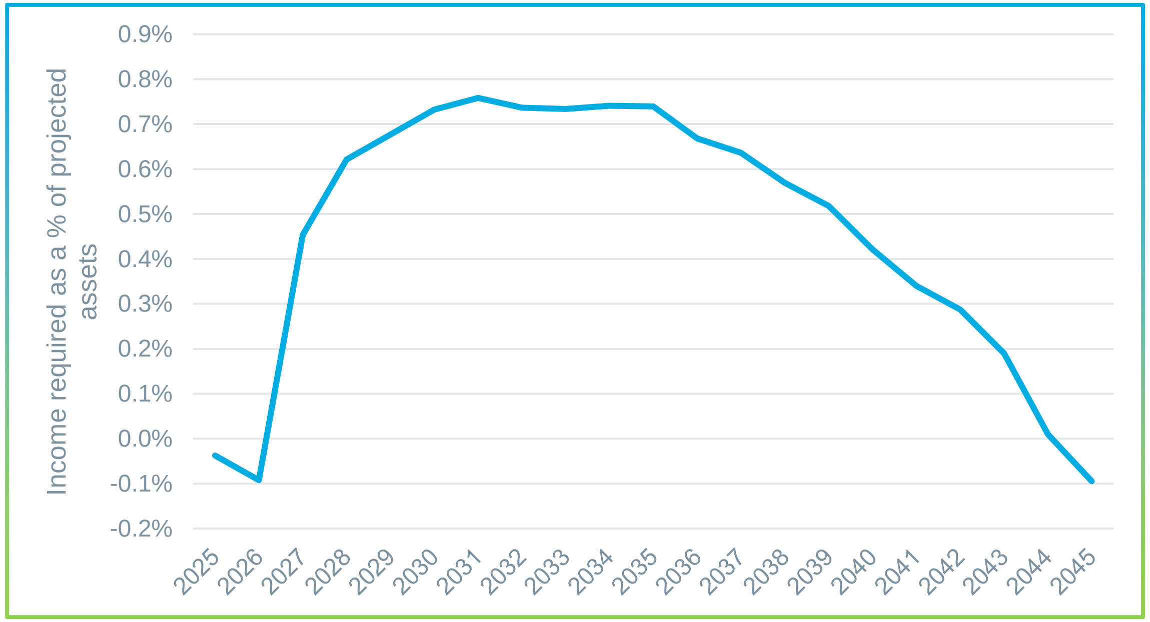

A one-off reduction of 5% p.a. from 2026 will result in a significant reduction contribution income in 2026/27 and would require an immediate increase in investment income to at c.0.5% pa yield. The level of investment income needed to meet benefit payments over the longer-term would reduce to c. 0.8% pa (when compared with scenario 2) due to the higher contribution rates being paid over the long term.

Asset values are assumed to increase at 4.4% pa

Next steps

Next steps

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1. Monitor membership changes and their impact on the cashflow position
2. Consider any factors (e.g. inflation) that may affect the cashflow position
3. Consider the investment strategy in light of any future possible negative cashflow position
4. Consider evolving or developing new cashflow management and/or rebalancing policies with your investment advisor

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Reliances and limitations

APPENDIX 1

Reliances and limitations

This paper is addressed to Surrey County Council as Administering Authority to the Surrey Pension Fund. It has been prepared in our capacity as actuaries to the Fund and is solely for the purpose of projecting the expected cashflows of the Fund over a 20-year time horizon. It has not been prepared for any other purpose and should not be used for any other purpose.

The cashflow projections are based on a specific set of deterministic assumptions, which are highly unlikely to be borne out exactly. We therefore do not claim that the future will exactly match the figures in this paper. The results should be used to give an indicative idea of the Fund's medium term cashflow requirements only.

Any party must accept full responsibility for establishing that the cashflows are appropriate for the purpose to which they want to put them and any decisions that are taken based on their analysis. We cannot be held responsible for any losses sustained as a result of third parties relying on the cashflows provided, or if the cashflows are used for any inappropriate purpose

The extent of the deviations from the assumptions underpinning the cashflow projections depends on uncertain economic events as well as other factors that are not known in advance such as members' decisions, variations in mortality rates, retirement rates and withdrawal rates, fluctuations and rates of salary increase, and the numbers and ages of future new entrants which cannot be accurately predicted. In addition, there could be changes in the regulatory environment and possible changes in retirement benefits. These other uncertainties are often not related to any particular investment and economic eventualities.

Three of the important uncertainties are the:
(a) Rate of pension increases, the vast majority of which increase at the annual increase in CPI inflation
(b) Extent to which members elect to exchange pension for cash at retirement
(c) Level of future payroll and contribution rates which will determine the amount of contributions paid into the Fund

The Administering Authority is the only user of this advice. Neither we nor Hymans Robertson LLP accept any liability to any party other than the Administering Authority unless we have expressly accepted such liability in writing.

This report may be shared with the Fund's independent investment advisor for information purposes only but may not be passed onto any other third party (such as including in the public part of the Pension Committee & Board's meeting papers or the Fund's investment consultant) except as required by law or regulatory obligation, without prior written consent of Hymans Robertson LLP.

In circumstances where disclosure is permitted, the advice may only be released or otherwise disclosed in its entirety fully disclosing the basis upon which it has been produced (including any and all limitations, caveats or qualifications).

The following Technical Actuarial Standards are applicable in relation to this advice, and have been complied with where material and to a proportionate degree:
- TAS100
- TAS300.

Thank you

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