CT/20/99
Investment and Pension Fund Committee
27 November 2020

FUTURE CASHFLOW FORECAST

Report of the County Treasurer

Please note that the following recommendations are subject to consideration and determination by the Committee before taking effect.

Recommendation: that the Committee be asked to note the future cashflow forecast scenarios set out in the report.

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1. Introduction

1.1 A key priority for the Pension Fund is to ensure that it manages its cashflows to ensure it always has sufficient available funds to meet its obligation to pay pensions. Following each Triennial Actuarial Valuation it is, therefore, good practice to reassess forecasted future cashflows.

1.2 A pension fund where most of the liabilities are in relation to active members is said to be “immature” and will result in a positive cashflow as employee and employer contributions into the fund will exceed payments out. A fund where most of the liabilities are in relation to pensioners (current and deferred) is said to be “mature”, and will have a negative cashflow, where benefit payments exceed the level of contributions. There are two potential stages to maturity, firstly where investment income is used to supplement contributions to fund the payment of benefits, secondly where the Fund has to sell assets to meet benefit payments.

1.3 In 2008/09 the contributions into the Fund exceeded the benefits paid by £41 million. However, each year since 2014/15, with the exception of 2019/20, benefit payments have exceeded contributions. 2019/20 was an exception as Plymouth City Council paid £72 million into the Fund to pay off their deficit. Without that payment, benefit payments would have exceeded contributions.

1.4 The Fund Actuary has provided a model to enable the Fund to examine current cashflows and project ahead over the next 20 years. Three scenarios, based on the Actuary’s cashflow model, are outlined below.

2. Scenario 1 – Stable Active Membership

2.1 The first scenario assumes that the fund has a stable level of active membership going forward. The pensionable pay of the Fund’s employers would therefore remain stable, with a gradual rise each year resulting from
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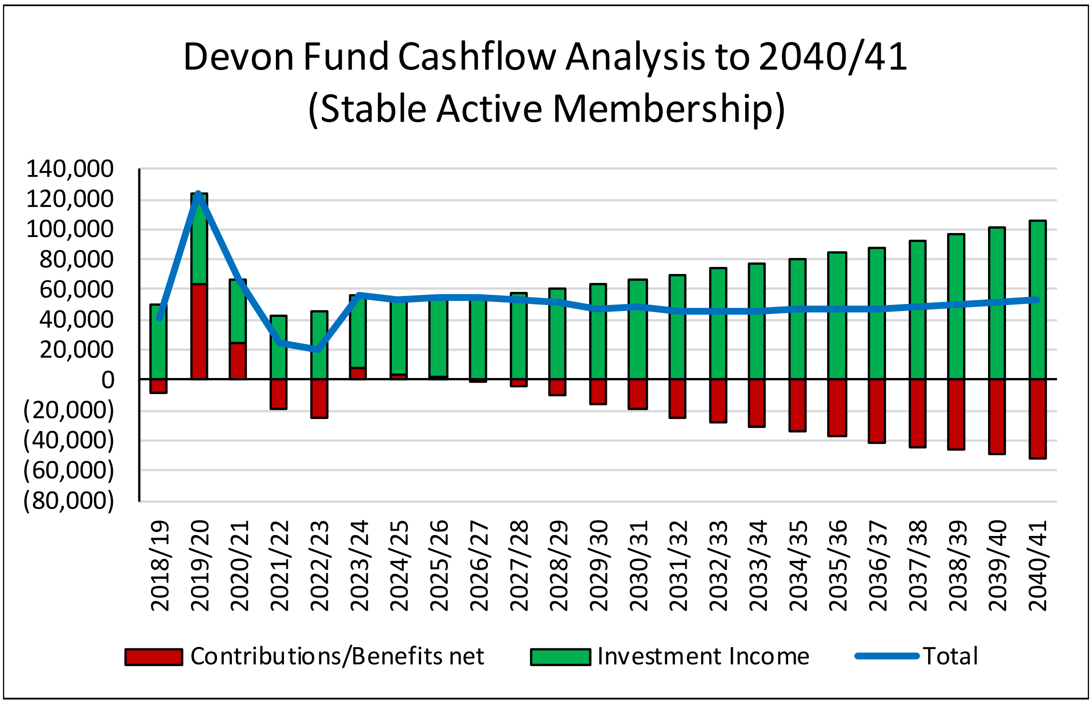
salary increases, assumed to be 3.6%. The percentage takes into account promotions as well as annual pay awards. This scenario is illustrated in the following graph.



2.2 The chart shows the positive net position between contributions and benefits in 2019/20 resulting from the Plymouth City Council deficit payment. The forecast cashflow for 2020/21 is also positive as a result of the advance payment of deficit contributions by a number of employers (please note this is different from the accounting position where the advance payments for 2021/22 and 2022/23 will be accrued to those years). The net position for 2021/22 and 2022/23 will then be negative, partly as a result of the advance deficit payments which will not therefore be paid in those years.

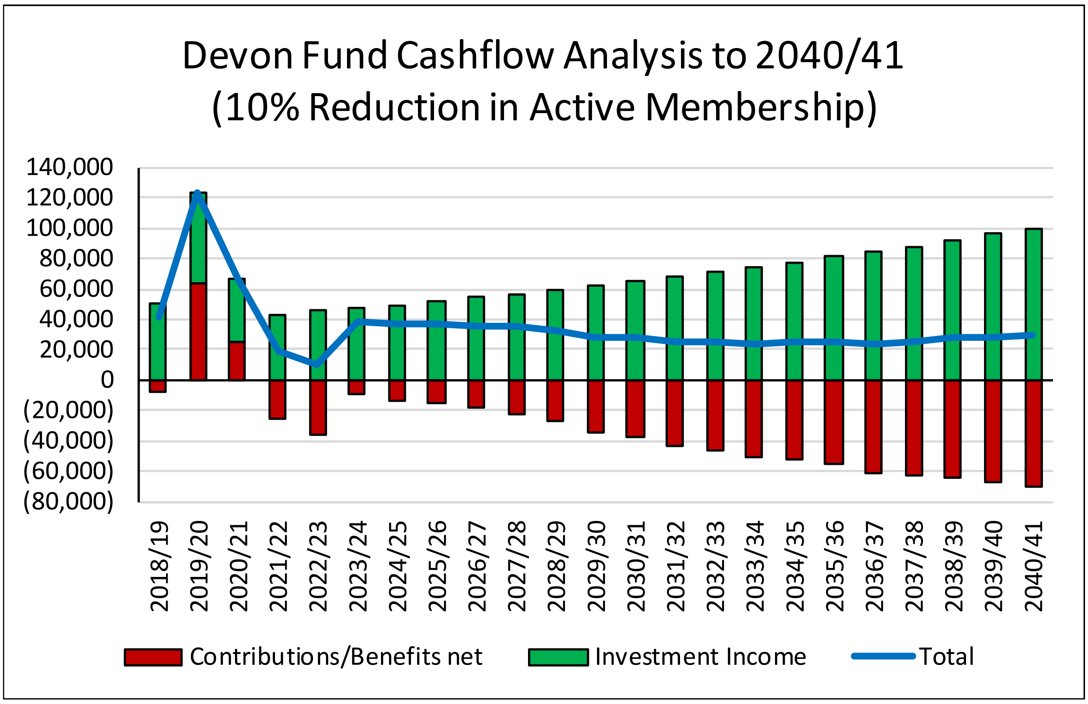
2.3 Contribution rates from 2023/24 onwards will be re-set by the next Triennial Valuation as at 31 March 2022. The model currently assumes that there will be an increase in contribution rates as a result of the poor investment return achieved in 2019/20 due to the pandemic, meaning that the Fund will not achieve the required 5.1% average return over the three year inter-valuation period. This produces a marginally positive position between contributions and benefit payments for the following three years, before the position turns negative again. The negative position then grows gradually each year as the Fund matures.

2.4 The green bars show the forecast investment income for each year. These are based on a prudent estimate, assuming a 4% yield on a quarter of the Fund’s assets. This comprises the income from the Fund’s private markets investments (property, infrastructure, private debt and private equity), on the basis that the Fund will receive the income back as distributions, whereas the income on the Fund’s equity and bond investments is automatically reinvested and not returned to the Fund. If there was a need for additional income, then it would be possible to access this additional income. As the value of the Fund’s assets grows, a consistent income yield will bring in higher investment income each year.

2.5 The result is the blue line, which shows the net cash position including contributions, benefit payments and investment income. It shows that over the next 20 years the Fund will benefit from positive cashflows, even as the contributions/benefit payments net position turns negative.

3. Scenario 2 – 10% Reduction in Active Membership

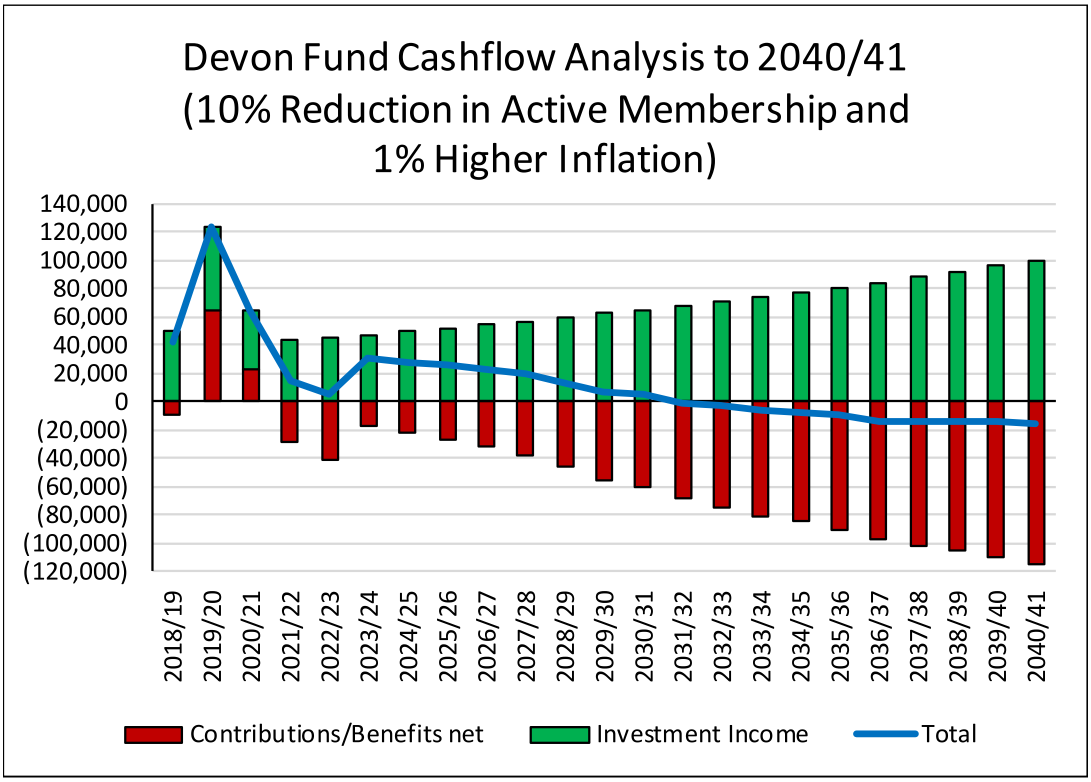
3.1 Scenario 2 is based on a 10% reduction in total pensionable pay of the active membership over the next three years. This scenario envisages a decline resulting from continuing reductions in the size of the public sector as a result of funding cuts and the outsourcing of services where new employees are not permitted access to the LGPS. Scenario 2 is illustrated in the following chart.



3.2 In this scenario, the net position on contributions / benefit payments is negative each year from 2021/22 onwards. The negative position also grows more quickly as a result of the reduction in active members. This will also have a small impact on the investment income forecast, as the Fund will grow more slowly as a result of the growing negative position between contributions and benefit payments. However, the blue line demonstrates that there is still a positive cashflow across the whole of the 20 year period when the investment income is taken into account.

4. Scenario 3 – Higher than anticipated inflation

4.1 One of the key risks to the Pension Fund is inflation. Pensions are uprated in April each year by the value of the Consumer Prices Index (CPI) at the preceding September. Therefore, if inflation is higher then the cost of pensions in payment will be higher. The following graph illustrates the impact on benefit payments if CPI is 1% per year higher, but on the assumption that salary increases and contribution rates remain unaffected.



4.2 In this scenario, the gap between contributions and benefit payments grows at a faster rate. From 2031/32 onwards, the assumed investment income is not sufficient to meet the gap.

4.3 However, this is unlikely to materialise in the way set out. In practice equity prices are likely to increase at a higher rate in the scenario of higher inflation. Private markets income is also likely to increase as rental increases on commercial property and income streams from many infrastructure assets will be inflation linked. Therefore, investment income is likely to increase by more than is shown.

4.4 In addition, an increase in the inflation assumption by the Actuary at future Triennial Valuations will increase the estimated deficit and so increase the deficit contributions required. While this will be bad news for employers, as it will increase their contribution rates, it will provide the cashflow required by the Fund to meet pension payments.

5. Conclusion

5.1 The scenarios shown demonstrate that with the use of investment income from its private markets allocation, the Fund should have sufficient cashflow to meet its pension payment liabilities over the next 20 year period.

5.2 There is, therefore, no requirement to review the current investment strategy in order to deliver the required cashflows. However, it will be important that the Fund continues to build up its private market investments to the 26% medium term target set out in the Investment Strategy Statement, in order to deliver the income yield assumed in the cashflow forecasting model. The current allocation stands at around 15%, although significant additional commitments have been made which are yet to be drawn down.

5.3 The private markets allocation will make a contribution both to delivering the income yield required and to growing the Fund’s assets. The remainder of the investment strategy should therefore continue to focus on growing the assets and managing risk, to meet the Actuary’s return expectations and build the Fund up to a 100% funding position over the medium term at an acceptable cost to fund members, employers and ultimately tax payers.

Mary Davis
County Treasurer

Electoral Divisions: All

Local Government Act 1972:
List of Background Papers: Nil

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