DF/23/109
Investment and Pension Fund Committee
24 November 2023

FUTURE CASHFLOW FORECAST

Report of the Director of Finance and Public Value

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

1) Recommendation

That the Committee be asked to note the future cashflow forecast scenarios set out in the report.

2) Introduction

2.1 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 forecast future cashflows.

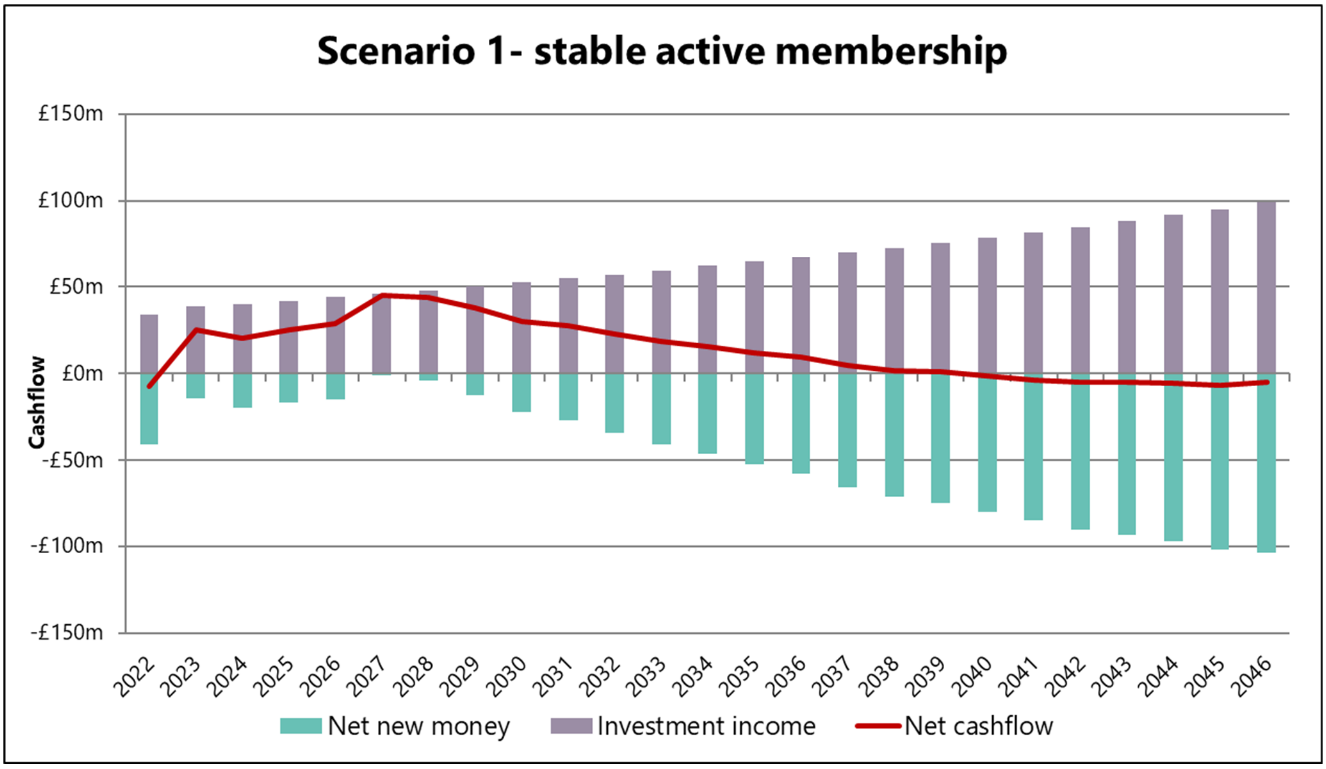
2.2 A pension fund where most of the liabilities are in relation to active members is said to be "immature" and will result in a positive cashflow as employee and employer contributions into the fund will exceed payments out. A fund where most of the liabilities are in relation to pensioners (current 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.

2.3 Going back 15 years, 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.

2.4 The Fund Actuary has provided a model to enable the Fund to examine current cashflows and project ahead over a 25 year period. Three scenarios, based on the Actuary's cashflow model, are outlined below.

3) Scenario 1 – Stable Active Membership

3.1 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 salary increases, assumed to be 3.9%. This percentage takes into account promotions as well as annual pay awards. This scenario is illustrated in the following graph.



3.2 The green bars on the chart show the forecast balance between contributions and benefits, which is negative across the period shown. In 2021/22 there was a negative balance of around £40 million. A significant factor in this was a £16 million transfer payment to the Dorset Pension Fund due to the transfer of a significant number of support staff from Devon and Cornwall Police to Dorset Police as part of a strategic partnership between the two forces. The negative position reduced to around £14 million in 2022/23. The forecast position then remains at around the same level over the next three years.

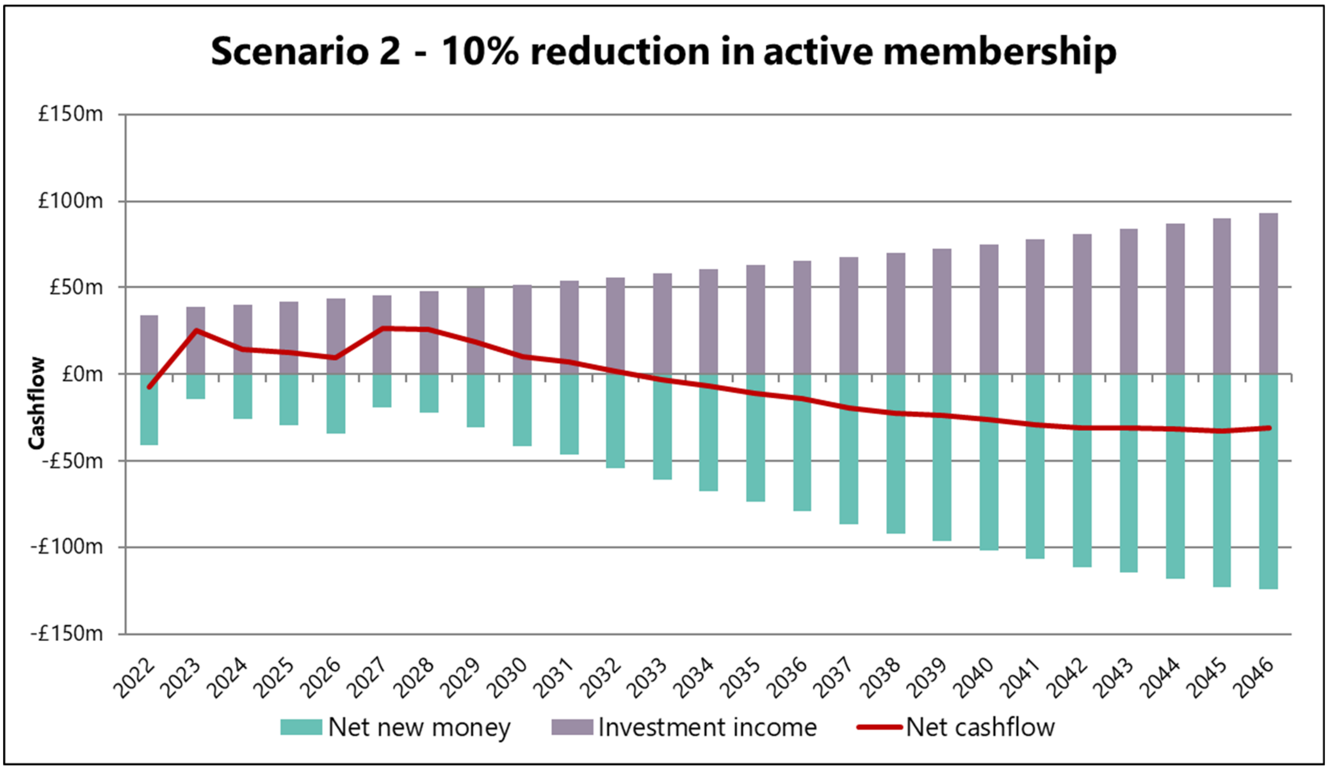
3.3 Contribution rates from 2026/27 onwards will be re-set by the next triennial valuation as at 31 March 2025. The model currently assumes that there will be an increase in contribution rates from April 2026. This assumes that the funding level will have fallen due to the negative investment return achieved in 2022/23, meaning that the Fund will not have achieved the 4.7% return assumed at the 2022 Valuation. This produces a balanced position between contributions and benefit payments for 2026/27, before the position turns negative again. The negative position then grows gradually each year as the Fund matures.

3.4 The grey bars show the forecast investment income for each year. These are based on a prudent estimate, assuming a 2.5% 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 back the income from those assets as distributions. 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.

3.5 The investment income received can be used to fund the shortfall position between contributions income and pension benefits payments. The result is the red line, which shows the net cash position including contributions, benefit payments and investment income. It shows that until around 2039 the Fund will benefit from positive cashflows, even as the contributions/benefit payments net position remains negative.

4) Scenario 2 – 10% Reduction in Active Membership

4.1 Scenario 2 is based on a 10% reduction in total pensionable pay of the active membership over the next three years. With the current significant budget challenges facing local authorities, there is likely to be pressure to reduce staffing budgets, which will reduce contributions income to the Pension Fund. This scenario is illustrated in the following chart.

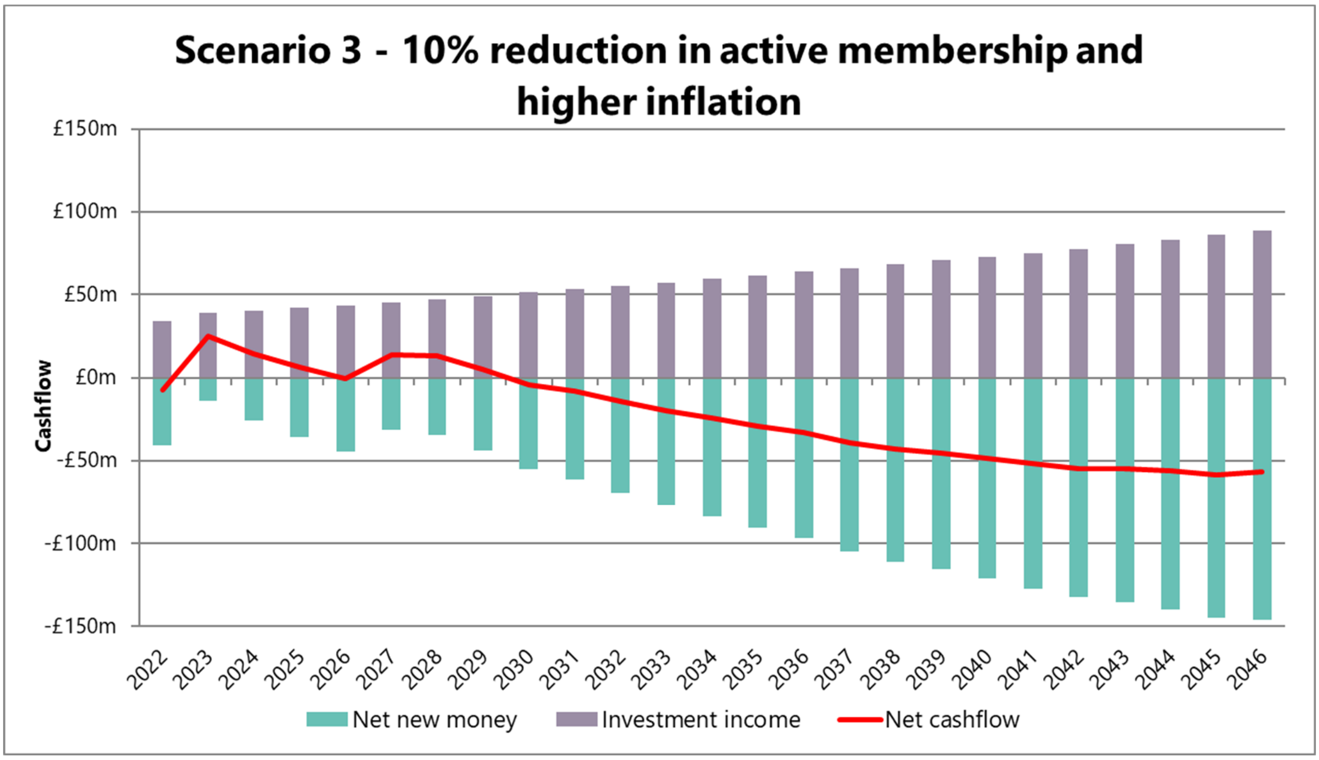


4.2 In this scenario, the net position on contributions / benefit payments is more negative each year going forwards. As with scenario 1, the position improves in 2026/27 following the 2025 triennial valuation, but in this case there will still be a negative balance in that year. The negative position 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.

4.3 The red line demonstrates that taking the investment income into account there is still a positive cashflow until around 2032, but from that date onwards the investment income will not be sufficient to fund the negative balance between contributions and benefit payments.

5) Scenario 3 – 10% Reduction in active membership and higher inflation

5.1 Scenario 3 is based on inflation being 0.3% per annum higher than the current actuarial assumption in addition to a 10% reduction the active membership over the next three years. While the current level of inflation is likely to fall, there is a risk it remains higher for longer. This scenario is illustrated in the following chart.



5.2 In this scenario, the gap between benefit payments and contributions grows more quickly. 2025/26 could see a position where investment income is only just sufficient to meet the deficit position, before the position is reset by the 2025 triennial valuation. The cashflow position then turns negative in 2029/30. The position would be a particular concern if pay increases are below inflation, as pensions would rise more quickly than increases in contributions income.

6) Conclusion

6.1 Under scenario 1, 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 15 years. However, there is a level of sensitivity around the core assumptions and if we see falling active membership and higher inflation, then the cashflow situation could deteriorate more quickly.

6.2 Under those circumstances the Fund would need to start to sell assets to meet pension payments or change its investment strategy to one that generated higher levels of investment income, rather than focusing on capital growth.

6.3 This is not an urgent issue, given that under all scenarios cashflow, including investment income, remains positive for the next 5 years. However, this is an issue that should be considered when the Fund next commissions an external review of its investment strategy, which is due in early 2025 in the lead up to the next triennial valuation.

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Electoral Divisions: All

Local Government Act 1972: List of background papers

Nil

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