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| Non-Executive Report of the: Pensions Committee 28 November 2019 |  |
| Report of: Neville Murton, Corporate Director, Resources | Classification: Unrestricted |
| Report on Fund Liquidity | |

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| Originating Officer(s) | Miriam Adams, Pensions & Investments Manager |
| Wards affected | All wards |

REASONS FOR URGENCY

The report was not published five clear days in advance of the meeting. This is due to the additional time required to review the report in order to provide the necessary clearances. Also as it is important that there should not be an extended period without member oversight of this matter this report cannot be deferred.

Summary

The London Borough of Tower Hamlets Pension Fund is open to new entrants however it is maturing fast. The prepayment of deficit contributions by the Council in 2016/17 and the use of the £25m internal cash to fund new investments in 2017/18 and 2018/19 has caused a major shift in the Fund's cash flow position to the extent that the Fund is expected to be cash flow by the end of December 2019. Estimated operational cash flow deficit at 31 March 2020 is £13m.

This is when the Fund pays out more in benefit and expenses that it takes in from contributions. This is significant in that a cash flow negative Fund needs a different funding strategy – preferably one that delays asset sell off as long as possible whilst still ensuring that the Fund meets its liabilities. A number of options to improve liquidity within the short term are available to the Fund

- Recall dividend and rental income from its property portfolio. Although a good bridging solution in the short term it does not provide the required cash
- Utilise part of the equity over weight from Equities Manager - Baillie Gifford

Recommendations

The Pensions Committee is recommended to:

- Note the estimated cash flow deficit of £13m from operational activities (Appendix A);
- Approve the recall of £2m dividend and rental from Schrodgers into the LBTH Pension Fund bank account to help meet the cost of in-year liabilities; and
- Approve the sale of Ballie Gifford equity investments £11m.

1. REASONS FOR THE DECISION

- 1.1 The London Borough of Tower Hamlets Pension Fund is part of the wider Local Government Pension Scheme (LGPS). The Scheme as with other LGPS schemes is funded and distinct from 'pay as you go' schemes which are unfunded.
- 1.2 The Fund receives contributions and investment income from current members, employers and fund assets which it uses to pay benefits as they fall due. Consequently, one of the main objectives of the Fund is to ensure that sufficient funds are available to meet all benefits as they fall due for payment. However, this objective may be jeopardised if the Fund does not maintain sufficient liquidity. The Pension Committee is charged with meeting the duties of the Council in respect of the Pension Fund. Therefore it is appropriate that the Committee formally approves any changes to the investment approach

2. ALTERNATIVE OPTION

- 2.1 The Fund is bound by legislation to ensure that members of the Fund receive benefits as they fall due under the Fund's terms. Although the Fund is free to determine how best to fund its liabilities as they fall due. It is expected to meet such obligations to its retired members.

3. DETAILS OF REPORT

- 3.1 In the past, the Fund has always been cash flow positive and therefore has always been able to meet all its liabilities without the need to sell any of its assets or recall dividends from its fund managers. However in August 2017 £15m cash was utilised to part fund investments in DGF and Absolute Return via the LCIV. In addition £10m was used to part fund the Multi-asset Credit LCIV fund in May 2018.
Appendix A to this report shows current and estimated future annual cash flow projections.
Although the Funding Strategy Statement has assumed that the Fund will mature at some point in the future, maturity has been reached a lot sooner than has been anticipated due to the cash outflow to fund £25m to part fund new investments purchased.
- 3.2 It is difficult to be exact about the day at which the Fund will become cash flow negative given the potential impact of transfers in/out and payment of lump sum amounts, both of which are very difficult to predict. Never the less based on actuals to date, it is expected that the Fund will be cash-flow negative by end of December.
- 3.3 A further contributor to the cash flow position has been the reduction in payroll numbers. This affects the Fund in two ways: firstly the Fund loses income that it could otherwise have received as contributions from employees and who are active members of the Fund and also employer contributions to the Fund by the Council in relation to active members; secondly, some staff will be made

redundant or retire both of which cases will mean immediate entitlements to cash lumps sums/retirement benefits, both of which will have the effect of impacting cash flow negatively.

3.4 The table below shows the membership over the last 3 years.

| Membership Type | 2016/17 | 2017/18 | 2018/19 |
|-----------------|---------|---------|---------|
| Actives | 7,256 | 6,809 | 6,740 |
| Deferred | 7,842 | 7,817 | 7,744 |
| Pensioners | 5,870 | 6,333 | 6,465 |

3.5 The general belief is that LGPS funds have lot of assets, but don't hold lots of cash. There are good reasons for this – funds generally invest for the longer term, and holding too much cash leads to lost opportunities on other assets that offer higher expected returns. Funds are therefore constantly trying to balance the need to hold enough cash to meet all benefit payments against the need to invest the need to invest in return seeking assets. LGPS funds also had very young age profile which meant income received from contributions far exceeded expenditure from benefit payments. Over the last decade LGPS funds are beginning to reach a mature age profile. Although 2018/19 figures released by the SAB showed that overall in England and Wales LGPS funds till remain cash flow positive.

3 OPTIONS TO IMPROVE FUND LIQUIDITY

3.3.1 As with all LGPS schemes, a key objective of the LBTH Pension Fund funding policy is to ensure that sufficient funds are available to meet all benefits as they fall due for payment. Given that the Fund is expected to be cash flow negative by the end of December, it is necessary to put in place measures to ensure liquidity is maintained within the Fund and that the Fund is able to meet its obligations to scheme members.

3.3.2 Being cash flow negative means that the Fund has less cash coming in than payments going out, therefore, less likely to be able to meet all of its liabilities in a given period. In this situation there are a number of options open to the Fund.

These are:

- i. Sell Fund assets and use the proceeds to meet Fund liabilities. The Fund's investment adviser advised using over weight Global Equities in the Baillie Gifford portfolio;
- ii. Undertake temporary borrowing (this option is limited by legislation) to meet Fund liabilities;
- iii. Avoid utilising internal cash to fund new investments without a proper cash flow review which shows the impact of such decisions;

- iv. Use income generated from invested assets to meet Fund liabilities; and
- v. In the long term invest in income generating assets which provide a steady stream of dividends which will be used to fund operational cash flow deficits.

3.3.3 The first option, although a viable option is more suited to Funds that have fully matured (i.e. retired members are more than active members in the long term) and would need to start selling off assets to pay off benefits accrued by its members. It is not anticipated that the LBTH Pension Fund can be categorised as such. Depending on the future trajectory of the Fund and the outcome of the 2019 valuation, this option could be part of the long term funding strategy of the Fund.

3.3.4 Option 2 above is restricted by legislation and can only be adopted as a temporary measure. The LGPS (Management and Investments of Fund) Regulation 2016 details the restrictions on borrowing. There is no guarantee that the Fund will be able to meet the conditions in a cash flow negative situation.

3.3.5 Option 3 is restricted by legislation and can only be adopted as a temporary measure. The LGPS (Management Investment of Funds) Regulations 2016 paragraph 4 – management of a pension fund requires an authority must credit to its pension fund in addition to any sum otherwise required to be credited by virtue of the 2013 Regulations or the Transitional Regulation the amounts payable by it or payable to it under regulations 15 (3)(b), 67 and 68 of the 2013 Regulations (employer's contributions and further payments); all amounts received under regulation 69(1)(a) of the 2013 Regulations (member contributions), all income arising from investment of the fund and all capital money deriving from such investment.

3.3.6 The fourth option, which is the preferred option, although it means that asset growth base would be slightly stunted as income would otherwise have been reinvested would instead be used to pay member benefits. This option is however the most preferred option.

4. INTERNAL CASH MANAGEMENT

4.1 The Pension Fund cash balance is invested in accordance with the Council's Treasury Management strategy agreed by Full Council in February 2018, which is delegated to the Corporate Director, Resources to manage on a day to day basis within the agreed parameters.

5. COMMENTS OF THE CHIEF FINANCE OFFICER

5.1 Finance comments are included in the report.

6. LEGAL COMMENTS

- 6.1 The Local Government Pension Scheme Management & Investment of Funds Regulations 2016 sets out the way in which administering authorities should manage their investments. Administering Authorities are under a fiduciary duty to manage their funds in an efficient and effective manner. The Authority must take steps to resolve the issue of the liquidity of the Fund and the proposals set out in this report are designed to achieve this. The Committee's consideration of the information in this report contributes towards the Administering Authority's performance of its statutory duties in respect of the proper management of the Fund.

7. ONE TOWER HAMLETS CONSIDERATIONS

- 7.1 The employer's contribution is a significant element of the Council's budget and consequently any improvement in investment performance will reduce the contribution and increase the funds available for other corporate priorities.

8. BEST VALUE (BV) IMPLICATIONS

- 8.1 The Pension Fund accounts demonstrate the financial stewardship of the scheme members and employers assets.

9. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

- 9.1 There is no Sustainable Action for a Greener Environment implication arising from this report.

10. RISK MANAGEMENT IMPLICATIONS

- 10.1 Any form of investment inevitably involves a degree of risk.
- 10.2 To minimise risk, the Pensions Committee attempts to achieve a diversified portfolio. Diversification relates to asset classes and management styles.

11. CRIME AND DISORDER REDUCTION IMPLICATIONS

- 11.1 There are no crime and disorder reduction implications arising from this report.

Linked Reports, Appendices and Background Documents

Linked Report

- None

Appendices

Local Government Act, 1972 Section 100D (As amended)

List of "Background Papers" used in the preparation of this report

Officer contact details for documents:

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Appendix A

Pension Fund Cash Flow Forecast

| | | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 |
|--|---------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| | | Actual | Actual | Forecast | Forecast | Forecast |
| | | £,000 | £,000 | £,000 | £,000 | £,000 |
| Contributions | | | | | | |
| - from Employer | | 32,312 | 31,762 | 33,000 | 32,813 | 33,813 |
| - from Employees | | 13,396 | 11,945 | 12,000 | 13,500 | 14,000 |
| -Prepayment of Deficit Contributions | | 43,338 | 53 | 53 | 43,000 | 53 |
| Transfer Values In | | 6,093 | 6,156 | 8,466 | 6,500 | 7,000 |
| Other Income | | 2,626 | 1,816 | 1,900 | 1,900 | 2,100 |
| Other | | | 2,551 | 424 | 500 | 500 |
| Sub - Total Income | | 97,765 | 54,283 | 55,843 | 98,213 | 57,466 |
| Interest on internal cash | | 90 | 54 | | | |
| TOTAL INCOME | | 97,855 | 54,337 | 55,843 | 98,213 | 57,466 |
| EXPENDITURE | | | | | | |
| Benefits Payable | | (43,168) | (44,498) | (47,498) | (49,498) | (47,498) |
| - Lump Sums: Retirement Allowances | | (12,800) | (11,827) | (12,400) | (12,400) | (12,400) |
| - Lump Sums: Death Grants | | (2,256) | (1,681) | (2,001) | (2,800) | (2,800) |
| Payments to and on account of leavers | | | | | | |
| - Refunds of Contributions | | (356) | (223) | (1,500) | (300) | (300) |
| - Transfer Values Out | | (5,585) | (4,847) | (9,124) | (8,524) | (8,524) |
| Administrative and other expenses borne by the scheme | | | | | | |
| - Administration and processing | | (415) | (1,004) | (1,500) | (1,500) | (1,500) |
| - Administration - other | | | | | | |
| Sub - Total Expenses | | (64,580) | (64,080) | (74,023) | (75,022) | (73,022) |
| Investment management Expenses | | | | | | |
| -Fund Managers Fees | | (269) | (178) | (250) | (300) | (300) |
| -Shroders Property fund fees | | (269) | (178) | (250) | (300) | (300) |
| -GMO | | (149) | | | | |
| -Global Custodian Fees | | (15) | (51) | (75) | (75) | (75) |
| Internal Cash used to finance new investment purchase | | (15,000) | (10,000) | | | |
| Pensioners Payroll Tax 2016/17 Paid in 2017/18 | | (4,199) | | | | |
| Other expenditure | | (5,406) | | | | |
| TOTAL EXPENDITURE | | (89,887) | (74,487) | (74,598) | (75,697) | (73,697) |
| NET CASH INFLOW/OUTFLOW | | 7,968 | (20,150) | (18,755) | 22,516 | (16,231) |
| Closing bank balance | | 2,484 | 512 | 0 | | |
| Closing balance MMF | | 24,000 | 6,000 | 0 | | |
| FORECAST CLOSING CASH POSITION | | 26,484 | 6,512 | (12,243) | 22,516 | 6,285 |
| Actual Opening Bank Balance | 9,616 | 18,428 | 2,483 | | | |
| Total Income per bank | 94,557 | 235,728 | 141,555 | | | |
| Total Expenditure per bank | (85,745) | (251,673) | (143,526) | | | |
| Actual Closing Bank Balance | 18,428 | 2,483 | 512 | | | |
| MMF | 0 | 24,000 | 6,000 | | | |
| TOTAL CASH BALANCE | 18,428 | 26,483 | 6,512 | | | |