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<tr><td>COMMITTEE:
Pensions Committee</td><td>DATE:
21 February 2013</td><td>CLASSIFICATION:
Unrestricted</td><td>REPORT NO.</td><td>AGENDA NO.</td></tr>
<tr><td colspan="2">REPORT OF:
Interim Corporate Director of Resources

ORIGINATING OFFICER(S):
Alan Finch – Service Head Financial Service, risk and Accountability

Oladapo Shonola –
Chief Financial Strategy Officer</td><td colspan="3">TITLE:
Report on Fund Liquidity

Ward(s) affected:
N/A</td></tr>
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Lead Member	**Cllr Alibor Choudhury - Resources**
Community Plan Theme	**All**
Strategic Priority	**One Tower Hamlets**

1. SUMMARY

1.1 The London Borough of Tower Hamlets Pension Fund is maturing faster than previously anticipated. This has caused a major shift in the Fund's cash flow position to the extent that the Fund is expected to be cash flow negative (this is when the Fund pays out more in benefit and expenses that it takes in from contributions) within the next twelve to eighteen months.

1.2 This is significant in that a cash flow negative Fund needs a different funding strategy – preferably one that delays asset sell off for as long as possible whilst still ensuring that the Fund meets its liabilities.

1.3 Having reviewed the options available to the Fund, officers and Fund advisers are agreed that the best option to improve liquidity within the Fund in the short term and ensure liabilities are met is to recall dividend and rental income from two of its managers, GMO and Schroders. This is a good bridging solution in the short term pending the triennial actuarial valuation which should provide a timely opportunity to revise the Funding Strategy.

2. DECISIONS REQUIRED

2.1 The Committee is asked to approve the recall of dividend and rental income from two of the Fund's managers (GMO and Schroders) into the LBTH Pension Fund bank account to help meet the cost of in-year liabilities.

3. REASONS FOR DECISIONS

3.1 The London Borough of Tower Hamlets Pension Fund is part of the wider Local Government Pension Scheme (LGPS). The Scheme as with other LPGS schemes is funded and distinct from 'pay as you go' schemes which are unfunded.

3.2 The Fund receives contributions and investment income from current members 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.

3.3 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/funding strategy including taking decisions that will ensure that the Scheme is able to meets its liabilities as they fall due.

4. <u>ALTERNATIVE OPTIONS</u>

4.1 The London Borough of Tower Hamlets Pension Fund is bound by legislation to ensure that members of the Fund receive benefits as they fall due under the Fund's terms.

4.2 Other potential funding sources for the Fund that could be used to fulfil the Fund's obligations are as follows:

i. Use contributions into the Fund by active members and their employers to meet liabilities;
ii. Sell Fund assets and use the proceeds to meet Fund liabilities;
iii. Undertake temporary borrowing (this option is limited by legislation) to meet Fund liabilities.

4.3 Although, the Fund is free to determine how best to funds its liabilities as the fall due, it is expected to meet such obligations to its retired members.

5. <u>BACKGROUND</u>

5.1 In the past the London Borough of Tower Hamlets Pension Fund has always been cash flow positive and therefore has always been able to meet all its liabilities from contributions received without the need to sell off any of its assets, undertake temporary borrowing or recall income generated from invested assets.

5.2 The Fund was cash flow positive in 2011/12 taking in £3.7m more than it paid out in liabilities. Prior financial years also saw cash flow positive positions of £11.5m, £9.3m and £10.6m in 2008/09, 2009/10 and 2010/11 respectively. This shows that prior to austerity measures kicking in; the Fund was in a healthy cash flow position of taking in £10m more on average than it paid out annually. The transition from cash flow positivity to negativity is a natural part of the life cycle of a Fund. Although, the Funding Strategy has always assumed that the Fund will mature at some point in the future, maturity has been reached a lot sooner than had been anticipated.

5.3 It is difficult to be exact about the point at which the Scheme will become cash flow negative given the potential impact of transfers in/out and payment of lump sum amounts, both of which are extremely difficult to predict. Nevertheless, it is expected that the Fund will be cash flow negative at some point in the next 18 months. The biggest contributor to the jump toward a cash-flow negative Fund in the past two years is the pace of staff reductions by the Council, the main employer and contributor to the Fund. Reduction in payroll numbers by LBTH has a direct impact on scheme membership (i.e. reduces membership) and consequently cash inflow, and there is more to come.

5.4 The reduction in payroll affects the Fund in two ways: firstly, the Fund loses income that it would otherwise have received as contributions from employees who are active members of the Fund and also employer contributions to the Fund by the Council in relation to those active members; secondly, some staff will go straight into retirement which will mean immediate entitlement to cash lump sums /retirement benefits, both of which will have the effect of increasing cash outflow.

5.5 If the current trend is maintained, over the next two years, the Fund will need to find additional £10m cash inflow annually to fund in-year liabilities.

5.6 Officer and advisers have already taken actions to improve the Fund's cash flow position including negotiating and agreeing significant reduction in fund management fees paid to GMO and will continue to actively seek out opportunities to reduce cash outflow from the Fund.

6 OPTIONS TO IMPROVE FUND LIQUIDITY

6.1 Recent research by Hymans Robertson suggest that 50% of Funds expect to be cash flow negative once the impact of staffing reduction has fully fed through payroll, so this issue is not unique to LBTH Pension Fund. They also noted that a Fund going cash flow negative is not a cause for panic and that such funds will need to switch strategies from growth seeking to income generating.

6.2 As with all LGPS schemes, an objective of the LBTH scheme's funding policy is to ensure that sufficient funds are available to meet all benefits as they fall due for payment. The Fund receives contributions from employees and employers of fund members with a promise to pay benefits out at a later date, usually in retirement. However, given that the Fund is expected to be cash flow negative by the end of the next financial year, if not before that, 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.

6.3 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;
ii. Undertake temporary borrowing (this option is limited by legislation) to meet Fund liabilities; and
iii. Use income generated from invested assets to meet Fund liabilities.

6.4 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) and would need to start selling off assets to pay off benefits accrued by its members. The LBTH Pension Fund is some way off this point. Taking this approach could also lead to assets being sold off at a discount in unattractive market condition, and in so doing, crystallising temporary losses. Depending on the future trajectory of the Fund and the outcome of the next actuarial valuation this option could be part of the long term funding strategy for the Fund, but for now it is deemed unsuitable to the immediate needs of the Fund.

6.5 The second option is restricted by legislation and can only be adopted as a temporary measure. The LGPS (Administration) Regulation 2010 sets the conditions under which an LGPS can borrow money that is expected to be paid out of the pension fund. These are that the Fund:

- Uses the borrowed money to pay benefits due under the scheme; or
- Uses the borrowed money to meet investment commitments arising from a decision to rebalance the Fund's portfolio of investment; and
- Must reasonably believe that the sum borrowed and interest charged can be repaid out of the pension fund within 90 days of the date of the borrowing.

  This option also carries costs associated with the servicing of the debt.

6.6 There is no guarantee that the Fund will be able to meet these criteria in a cash flow negative situation. Further, this is not a sustainable solution if the Fund is projected to remain cash flow negative into the future.

6.7 The third option, which is the preferred option, ensures that the Fund asset base is maintained through volatile/unattractive periods of the market and therefore prevents crystallising temporary losses in asset value. It also avoids transaction cost that will arise from the selling of assets.

6.8 Whilst the option does mean asset base growth would be slightly stunted as income that would otherwise have been reinvested would instead be used to pay member benefits, it nevertheless prevents the greater risk that could materialise from asset sell off. Therefore this option is still regarded as the best bridging solution available pending a detailed review of the Funding Strategy that will follow the scheduled triennial actuarial valuation.

6.9 There are two fund mandates which currently provide a stream of investment income in a form that can readily be taken by the Fund; the GMO Global Equity mandate and the Schroders Property Fund. At present these managers are instructed to reinvest income into their portfolios, but by changing these instructions, the authority can boost income to the Fund without significantly changing the overall strategy at this stage.

6.10 In the longer run the growing maturity of the Fund will have an impact on strategy and officers will be reviewing the position with the Fund's advisers over the coming period with a view to making further recommendations to the Committee in due course.

7. COMMENTS OF THE CHIEF FINANCIAL OFFICER

7.1. The comments of the chief financial officer have been incorporated into the report.

8. CONCURRENT REPORT OF THE ASSISTANT CHIEF EXECUTIVE (LEGAL)

8.1 Under Regulation 11 of The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 the Council, as an administering authority, is required to invest fund money that is not needed immediately to make payments from the Pensions Fund.

8.2 This report details how those investments need to be rearranged in order to ensure adequate funds are available to make payments that will become due

9. ONE TOWER HAMLETS CONSIDERATIONS

9.1 The Pension Fund Accounts demonstrate the financial stewardship of the scheme members and employers assets. A financially viable and stable pension fund is a valuable recruitment and retention incentive.

10. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

10.1 There is no Sustainable Action for A Greener Environment implication arising from this report.

11. RISK MANAGEMENT IMPLICATIONS

11.1 The Fund will be at risk of not meet a key objective if it were not able to meets its obligations to scheme members as they fall due. This will be a major disincentive to current employees and would lead to the Fund being in breach of LGPS regulations.

12. CRIME AND DISORDER REDUCTION IMPLICATIONS

12.1 There are no Crime and Disorder Reduction implications arising from this report.

13. EFFICIENCY STATEMENT

13.1 The option proposed in this paper is regarded as the most efficient method for ensuring that the Fund is able to meet its obligations as it prevents forced sale of assets in unattractive markets and no transactional costs are incurred.

LOCAL GOVERNMENT ACT 1972 (AS AMENDED) SECTION 100D

LIST OF "BACKGROUND PAPERS" USED IN THE PREPARATION OF THIS REPORT

Brief description of "background papers"	Name and telephone number of holder And address where open to inspection