Sixty second summary

Managing net cashflow in the LGPS

LGPS funds face a number of challenges when it comes to managing their net cashflow position. With the added volatility that the COVID-19 outbreak brings, now more than ever, LGPS funds should be getting to grips with managing cashflow.

Current challenges

There are a number of current challenges faced by LGPS funds when it comes to managing their net cashflow position, namely:

- **Maturity** - The general ongoing levels of cash needed to administer funds has increased in recent years and is expected to continue to increase as funds mature.
- **Reduced deficit payment** – Due to improvements in funding level and reductions in deficit, the overall level of contributions being paid into funds, on average, has fallen.
- **Pre-payment of contributions** - Many employers within the LGPS have been exploring the opportunity of making contribution prepayments as lump sums in advance. This may result in a more uneven pattern of cashflows.
- **Private market commitments** – As funding positions have improved many funds have diversified their investment strategies with increased allocations to private markets. As a result, are managing more complex programmes of illiquid assets. Cash commitments to these markets will be drawn down in unknown lumps over the coming years as will any distributions of capital.
- **Exit credit regulations -** Under the Exit Credit regulations of May 2018 employers are now entitled to a refund of surplus, at the Fund's discretion, when they cease in the Fund. Some of these exit credits can be sizeable.
- **Market volatility** - The COVID-19 outbreak has introduced significant volatility and reduced liquidity in markets. As a result, there is more uncertainty over levels of income, employer contributions and benefit outgo within funds. With depressed asset values, choosing where to source cash and liquidity becomes a more complex question.
- **Higher death rates** – Sadly, COVID-19 has led to higher than expected claims for death benefits.

There is therefore an increased need for LGPS funds to understand and manage their cashflow requirements to ensure there is sufficient liquidity and readily available capital to meet the fund's ongoing cashflow requirements.

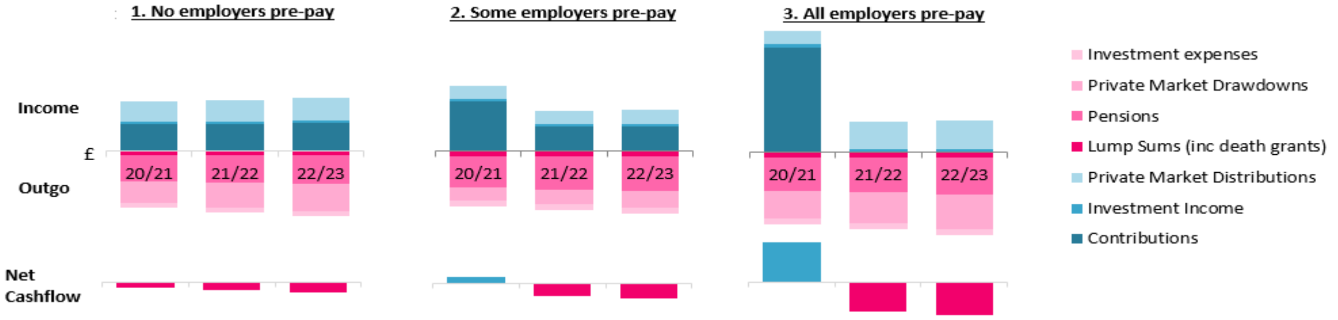
Understanding cashflow scenarios

One way of better understanding net cashflow requirements is to consider different scenarios that will impact both sources and timing of cash coming in and the cash going out. These could be scenarios such as:

- broader issues impacting the membership of the fund such as changes to the active membership profile which can have both an immediate and longer-term impact on cashflow requirements
  Variations in the pattern of contributions being received from employers
- Variations in investment income, highlighted by recent events and the impact this may have for both property rental income and equity dividend payments.

Impact of employer contribution pre-payments

The charts below illustrate how the short-term net cashflow position could change over the next 3 years for a typical fund under three different employer pre-payment scenarios.



Scenario 1 – If no employers elect to pre-pay contributions, then the fund is marginally cashflow negative over each of the next 3 years as fund outgo exceeds income. The cashflow negative position increases slowly as the fund matures.

Scenario 2 – If only some employers elect to pre-pay then the fund becomes cashflow positive in the first year and cashflow negative in the subsequent 2 years, reflecting the partial lump sum payment of contributions in advance.

Scenario 3 – If all employers elect to pre-pay pension contributions in advance, the fund becomes significantly cashflow positive in the first year, and significantly cashflow negative in years 2 and 3.

In all scenarios, the fund will need to consider where cash should be sourced from in the years where the net cashflow position is negative. In scenarios 2 and 3 further consideration will need to be given as to how much of the pre-payments are invested, and how these should be invested taking into account current asset values and the fund's overall investment strategy.

Actions to take

It is important to note that cashflow negativity in itself is not a 'bad' thing as long as it is appropriately managed. Ultimately a fund's assets are there to help pay member benefits and should be utilised accordingly. Understanding what impacts a fund's net cashflow position is critical in mitigating liquidity risk and to prevent a fund becoming a forced seller of assets.

We have identified a number of key actions that administering authorities can take to better understand and manage their net cashflow position in light of the challenges faced and the current market conditions:

- **Detailed cashflow analysis** – Funds can undertake detailed cashflow analysis aimed at projecting forward the likely short-term income and outgo for the fund under a variety of different conditions.

- **Re-balancing policy** - Having a robust and organised cashflow management and re-balancing policy in place will help mitigate liquidity risk under a wide range of future outcomes and keep the fund aligned with its strategy.

- **Hold a higher cash buffer –** Funds can consider maintaining a higher cash balance than they would normally hold to act as a buffer against more volatile fund outgo. This buffer can be used in the first instance to meet payments and then be routinely topped-up by redirecting investment income or disinvesting assets from the most appropriate place.

- **Understanding the disinvestment processes** – Officers should familiarise themselves with the process for making disinvestments (particularly if these have changed as a result of pooling) and timescales for liquidating assets.

- **Interim liquid assets solution** - Where funds do not wish to hold large proportions of assets in cash they can look to build an interim liquid assets solution whereby they can invest in very liquid 'cash-like' assets.

The 2019 valuations that have recently been signed off in England and Wales provide a rich source of data for predicting cash flows. If you wish to discuss any of the contents of this summary further, and how to make best use of your cash flow data, please contact your usual Hymans Robertson consultant.