Bath & North East Somerset Council		
MEETING: **AVON PENSION FUND COMMITTEE** MEETING DATE: **22 JUNE 2012**	**AGENDA ITEM NUMBER**	
TITLE: **CASH MANAGEMENT POLICY**		
WARD: **'ALL'**		
AN OPEN PUBLIC ITEM		
List of attachments to this report: **Appendix 1** Description of the Cash Flow Model and its current forecasts **Appendix 2** Graph illustrating the Fund's cash accumulation 2010 to 2012 **Appendix 3** Graph illustrating the Fund's forecast cash accumulation 2012 to 2018.		

THE ISSUE

1.1 At the March 2012 Committee it was reported that the Fund's rate of cash accumulation had fallen from c. £1m per month to close to zero and that it was expected to become negative within a few months. The Committee were told that further research would be undertaken with regard to the forecasting of future cash flows and that the results of that research together with proposals regarding the future management of the Fund's cash would be presented to the June Committee.

1.2 The purpose of this report is to:-

a) explain the background to the emerging gap in the monthly cash receipts and payments

b) describe the procedures that have been put in place to allow the management of the Fund's short term cash position.

c) propose a policy of utilising income and divestment that can be applied to meet the Fund's cash flow requirements over the longer term.

2. RECOMMENDATION

That the Committee:

2.1 notes the forecast change in the Fund's cash flow profile and the monitoring procedures including reporting activity to Committee (as set out in 6.3.)

2.2 approves the proposed policy for cash management as set out in Section 6.

2.3 delegates responsibility to the Head of Pensions to implement the policy in line with 6.2

3 FINANCIAL IMPLICATIONS

3.1 The Fund requires short term cash to meet its day to day operating requirements, predominantly the payment of pensions. In the event that cash received as contributions does not meet the cash required to pay pensions any shortfall must be met from an alternative source. The Fund requires a coherent policy to allow the structured sourcing of its cash requirements.

4 BACKGROUND

4.1 As a result of the Local Government pay freeze and reductions in Local Government and other public sector employee numbers, the level of contributions has started to decline. This trend is expected to continue. At the same time pension payments are expected to continue to rise. Pensions are linked to inflation and the total number of pensioners entitled to benefits increases each year due to improving longevity. In common with other Funds in the Local Government Pension Scheme these factors have over the last twelve months accelerated the maturity of the Fund. The graph at Appendix 2 shows the accumulation of cash since April 2010 illustrating the recent slow-down in the accumulation of cash. The periodic reduction in the accumulated balance is due to transfers to the Investment Managers as cash is accumulated. This accumulation can be seen to have flattened out in recent months.

4.2 In the normal life cycle of a Pension Fund a point is reached at which the amounts paid in pensions starts to exceed the contributions being paid in from active members. At this point the Fund becomes “mature”.

4.3 In the past the Fund has had positive monthly cash flow as contributions and other cash income (excluding investment income) have averaged £11.5m, exceeding the average payments of pensions and administration costs of £10.3m by c. £1.2m per month. The policy has been to transfer excess cash to Investment Managers in £5m tranches.

4.4 **Investment Income:** The Fund’s policy is for the Investment Managers to retain investment income for reinvestment within their portfolio. However, most of the investments are in pooled funds where the income is not distributed. Therefore within the current portfolio structure the Fund can only access income from the passively managed conventional and index linked gilt portfolios (income c. £6m p.a.), the actively managed UK equity portfolios (income c. £5m p.a.) and the UK property portfolio (income c. £2m p.a.). Given the nature of these mandates, the most convenient and predictable income to utilise for cash management is the passively managed conventional and index linked gilt income.

5 THE CASH FLOW MODEL

5.1 A model developed to forecast the Fund’s cash flows is described in detail in Appendix 1. This also sets out the current assumptions and resulting forecasts for best case, neutral and worst case scenarios. For operational reasons the Fund needs to maintain the average monthly cash balance above £12m.

5.2 The Neutral scenario currently forecasts that if gilt income is used to support the Fund’s cash flow, additional cash from divestments will be required to maintain the average balance above £12m from December 2014. However, divesting could be required as early as February 2014 in the worst case scenario or as late as December 2016 in the best case scenario. Assuming gilt income is used, in order to support the Fund’s cash position for twelve months from these dates divestments of

£9m, £12m or £15m would be required for best case, neutral or worst case scenarios respectively.

5.3 The table below summarises the model's forecast of annual cash flow, on the basis of the neutral assumptions up to March 2017. Please note that this is the forecast for each year and is not cumulative.

FORECAST PER YEAR (Neutral assumptions Not cumulative)	**2011/12 Actual £m**	**2012/13 £m**	**2013/14 £m**	**2014/15 £m**	**2015/16 £m**	**2016/17 £m**
Contributions	138	138	137	137	138	138
Benefits paid	-129	-137	-143	-149	-155	-161
Net transfers / Leavers etc.	1	1	1	1	1	1
Administration and Management Fees paid (i.e. excludes management charges deducted by managers)	-7	-5	-5	-5	-6	-6
Gilt Income	9	6	9	9	9	9
Net Total for year	12	3	-1	-7	-13	-19

6 PROPOSED CASH MANAGEMENT POLICY

6.1 To address the requirements of the Fund's cash flow position the following policy and procedures are proposed:-

i. The cash flow model will be updated with actual data each month to monitor the forecast cash flow against actual cash flow and consequently allow the review and possible adjustment of Best case, Neutral and Worst case assumptions.

ii. The cash position will be monitored on a monthly basis by the Investments Manager and the Finance and Systems Manager. The Head of Business Finance and Pensions will be informed of the Fund's cash position on a quarterly basis or more frequently if required.

iii. With immediate effect gilt and index linked gilt income will no longer be automatically reinvested. Cash from gilt income will only be reinvested at the discretion of the Investment Manager taking account of the Fund's cash flow requirements.

iv. The Investments Manager will explore options for switching the passively managed pooled equity funds from accumulated units to distributing units. The estimated dividend income on the passively managed UK equity fund is c. £7m p.a.

v. As it becomes necessary as a result of the cumulative reduction in cash balances, divestments will be made from the Fund up to the forecast annual requirement of £15m. During any year, if the cashflow requirement exceeds this annual forecast, divestment will only occur following consultation with the Chair and Director of Resources.

vi. Any divestment will be implemented following these principles:

a. to bring asset allocation in line with the strategic policy, taking into account any tactical asset allocation

b. to divest from portfolios that exceed their strategic allocation, taking into account any tactical allocation

c. if no manager significantly exceeds their strategic allocation, to divest from the passive portfolio

d. if the Fund does not deviate from the strategic allocation to divest pro-rata between bonds and equities.

6.2 Implementation of the policy will be delegated to Officers.

6.3 The Committee will be informed of all divestments, and of any significant changes in the forecast of cash balances or the level of investment income, through the quarterly investment monitoring report.

7 EQUALITIES

7.1 An equalities impact assessment is not necessary.

8 CONSULTATION

8.1 None appropriate.

9 ISSUES TO CONSIDER IN REACHING THE DECISION

9.1 The issues are detailed in the report.

10 ADVICE SOUGHT

10.1 The Council's Monitoring Officer (Council Solicitor) and Section 151 Officer (Divisional Director - Finance) have had the opportunity to input to this report and have cleared it for publication.

Contact person	Martin Phillips Finance & Systems Manager (Pensions) Tel: 01225 395369.
Background papers	Various Accounting and Statistical Records

1 THE CASH FLOW MODEL

As the accumulated cash balance transitions to a negative trend there is a need to actively manage the Fund's cash position. A model has been developed to monitor the cash flows and allow forecasting of future cash flows based on stated assumptions. The model analyses the Fund's cash flow between:-

- Contributions
- Pensions paid
- Lump sums paid
- Transfers in
- Transfers out and leavers
- Administration costs

Each of these will be affected by such factors as inflation, public sector expenditure levels, pay settlements, changes in the LGPS scheme structure, and the decisions of individual members to join the fund, retire, take lump sums, transfer their accrued benefits etc.

It is recognised that with this number of factors and many different employers and employees determining those factors, the model represents the sum of a complex combination of decisions. In order to address this complexity without an inappropriate allocation of resources:-

- Within each of the categories the model permits assumptions to be made separately for each unitary authority and for the other employers as a whole.
- The model is designed to be updated with actual cash flow data each month allowing for an on-going comparison between the forecast and the actual cash flow. This will permit the adjustment of assumptions with the intention of continually improving the accuracy of the forecasts.
- The model can be run for different sets of assumptions. Modelling can then be done for a range of scenarios.

2 THE CURRENT CASH FLOW MODEL FORECASTS

The cash flow model has been run with three different sets of assumptions to provide “Best”, “Neutral”, and “Worst case” scenarios. In the resulting forecasts the cash balance consists of:

(i) the starting cash balance, plus

(ii) any excess of contributions over expenditure, plus

(iii) income from conventional and index linked gilts which is currently re-invested by the managers.

Note, the model assumes the gilt/corporate bond tactical switch will remain in place for 2012/13 financial year. As explained in paragraph 4.4, income from the gilt portfolios is the most conveniently available investment income to use to meet the Fund's cash flow requirements.

Appendix 2 shows the volatility of the cash balance on a daily basis. Appendix 3 illustrates the forecast **cumulative** cash balance from 2Q12 (calendar) to the 1Q18 for each of the three scenarios quarter by quarter. For operational reasons the Fund requires a minimum average monthly cash balance of £12m (to manage the intra-month volatility). The horizontal grid lines on Appendix 3 are set at £12m intervals to show this critical level more clearly.

The tables below show the assumptions made and resulting forecasts for the three scenarios. All scenarios are based on the Fund's current cash balance as the starting point and include the alternative assumptions that Gilt Income will be used to meet the Fund's cash flow requirements with effect from 1 April 2012 and that it will not be used.

The forecasts indicate the dates at which divestments will be required and amount of divestment required to support the Fund's cash flow for 12 months assuming gilt income is used.

Neutral Scenario

Assumptions	Year 1	Year 2	Year 3
% Change in Contributions received	-4%	-3%	-2%
% Change in Pensions and Lump sums paid	2%	2%	2%
Forecast			
Date of required cash transfer assuming no Gilt Income used	February 2013		
Date of required cash transfer assuming Gilt Income used.	December 2014		
Divestment required to fund for 12 months assuming Gilt income used	£12m		

Worst Case Scenario

Assumptions	Year 1	Year 2	Year 3
% Change in Contributions received	-5%	-4%	-3%
% Change in Pensions and Lump sums paid	3%	3%	3%
Forecast			
Date of required cash transfer assuming no Gilt Income used.	December 2012		
Date of required cash transfer assuming Gilt Income used.	February 2014		
Divestment required to fund for 12 months assuming Gilt income used	£15m		

Best Case Scenario

Assumptions	Year 1	Year 2	Year 3
% Change in Contributions received	-3%	-2%	-1%
% Change in Pensions and Lump sums paid	1%	1%	1%
Forecast			
Date of required cash transfer assuming no Gilt Income used	May 2013		
Date of required cash transfer assuming Gilt Income used.	December 2016		
Divestment required to fund for 12 months assuming Gilt income used	£9m		