

Appendix 1: Cash Flow Management Policy Cover Report – March 2023

Recommendations

The PAP is asked to:

- Note the need for a formalised cash flow management policy to be implemented for the London Borough of Southwark Pension Fund (LBSPF, 'the Fund').
- Agree the recommended approach to the Fund's cash flow management as set out below and in further detail in Appendix A.

Background

1. Due to the increasing maturity of its membership profile, the Fund is cash negative as monthly cash outgoings are no longer met by contributions and lump sum payments in.
2. This is expected to increase when pension benefit payments increase by 10.1% from April 2023 whilst contributions in are likely to remain fairly stable.
3. As the Fund moves further with its Net Zero carbon emission targets, there has been an increase in illiquid investment, which is expected to grow in the coming years. The Fund commits a given value of capital to each of these illiquid investments which are drawn down and paid as cash to fund managers over each investment's lifetime.
4. The current cash shortfall over the 2023-24 financial year is expected to be c. £34m, however additional capital drawdowns will exacerbate the cash negative status of the Fund beyond this.
5. As per LGPS regulations, the Fund holds operational cash balances in a bank account and additional cash is invested in a liquidity fund with an existing manager.
6. The current liquidity fund requires five clear working days to access cash, limiting the Fund's ability to be reactive to any unexpected large-scale payments.
7. A new cash flow management policy is required in order to allow officers to react more efficiently to capital drawdowns and minimise cash balances held in order to maximise potential investment returns and avoid the sale of other assets to fund illiquid asset needs.

Proposed Cash Flow Management Policy

8. The proposed cash flow management policy splits the Fund's assets into a five-tier structure, with the intention to reflect which assets should be used in order to meet obligations as they fall due.

9. Limits and thresholds on cash balances will be reviewed on a quarterly basis in the short-term to ensure they are suitable in practice.
10. Aon's Cash Flow Management report is set out for consideration in Appendix A.
11. Allocation of the Fund's assets as at 31 December 2022 into each of these tiers is included for reference in Appendix B.

Tier 1: Primary Cash Vehicle: Bank Account and Money Market Funds

12. A minimum of c. £7m to be held in this tier, split across the Fund bank account (£0.75m) and two money market funds (c. £6.25m) to be used to meet operational cash flows.
13. Assets at this level are highly liquid and should be accessible within at least one working days' notice whilst generating low returns through the money market funds.
14. If the balance on Tier 1 falls below an agreed lower limit, additional resource would be called down from Tier 2, or if it remains consistently above an agreed upper limit, additional resource would be invested into Tier 2.

Tier 2: Secondary Cash Vehicle: Liquidity Fund

15. The Fund is currently invested in the BlackRock Sterling Liquidity Fund but, on the agreement of this policy, the Fund will be divesting from this and investing the proceeds in the LGIM Sterling Liquidity Fund, selected due to shorter timeframes for accessing invested cash resources.
16. A minimum of c. £5m would be held at this tier to be accessed in order to meet larger expenses to the Fund or larger capital drawdowns.
17. These funds are less liquid than those in Tier 1 but will generate greater returns than money market funds to reward investors for lower liquidity.

Tier 3: Main Source of Liquidity to Fund New Investments

18. Assets at this level can be redeemed in order to meet substantial obligations that would exhaust balances at Tier 1 and 2, such as investments into new assets.
19. Historically, the Fund has relied on redeeming passive equity holdings to meet investments due to an ongoing overweight allocation to passive equities and low transaction costs incurred in redeeming passive assets. The Fund would continue to use passive equities to replenish low cash balances in Tier 2 assets.

20. The Investment Management Agreement between LBSPF and LGIM can be amended to trigger an automatic transfer of assets from the LGIM passive equity fund (a Tier 3 asset) to the LGIM Sterling Liquidity Fund (a Tier 2 asset) where balances on the liquidity fund reach a lower threshold.

21. The defensive allocation of the Fund is deemed as sitting within Tier 3:

- a. Blackrock DGF and ARB funds can be used to fund new investment once the upcoming allocation to multi-asset credit has been made
 - i. The incoming Multi-Asset Credit allocation would sit under Tier 4
- b. It is non-advisable to redeem index-linked gilts to meet new investment obligations due to the protection they offer to the Fund's value against rises in inflation.

Tier 4: Other Sources of Liquidity

22. Assets in this tier are those which have low liquidity characteristics but can be redeemed if assets at Tier 3 need to be replenished to maintain the Fund structure within the framework of the strategic asset allocation.

23. These assets are actively managed with the intention of applying fund manager expertise to deliver above-market returns and as such, redemption of these assets should be exercised with caution.

Tier 5: Illiquid Investments

24. These investments are often those which form the backbone for the Fund's progress to Net Zero and should not be considered where the Fund requires liquid resources to meet obligations.

25. Prior to investing in new illiquid assets, it is recommended that sustainability of the Fund's overall liquidity should be assessed to ascertain if the Fund can meet commitments whilst mitigating ongoing liquidity risk

Next Steps

26. Officers have begun the process to find suitable money market funds for Tier 1 as part of a wider project to improve the Fund's ability to respond efficiently to requests for large cash outflows.

27. Following agreement of this policy by the PAP, the following actions will be taken:

- a. The Fund's Investment Strategy Statement will be updated to reflect the new cash flow management policy
- b. Onboard the LGIM Sterling Liquidity Fund and divest from the current BlackRock Liquidity Fund
- c. Ongoing monitoring and assessment of the suitability of the cash flow policy to meet cash flow requirements, particularly around cash balance buffers

Community, Equalities (including socio-economic) and Health Impacts

28. Community Impact Statement

No immediate implications arising

29. Equalities (including socio-economic) Impact Statement

No immediate implications arising

30. Health Impact Statement

No immediate implications arising

31. Climate Change Implications

No immediate implications arising

32. Resource Implications

No immediate implications arising

33. Legal Implications

No immediate implications arising

34. Financial Implications

No immediate implications arising

35. Consultation

No immediate implications arising

APPENDICES

Name	Title
Appendix A	Aon Cashflow Management Framework Report
Appendix B	LBSPF Asset Structure: Tier Allocation

AUDIT TRAIL

Lead Officer	Duncan Whitfield, Strategic Director of Finance and Governance	
Report Author	Jack Emery – Divisional Accountant, Pensions and Investments	
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<i>Key Decision?</i>	N/A	
CONSULTATION WITH OTHER OFFICERS / DIRECTORATES / CABINET MEMBER		
Officer Title	Comments Sought	Comments Included
Director of Law and Democracy	N/A	N/A
Strategic Director of Finance and Governance	N/A	N/A
List other officers here		
Cabinet Member	N/A	N/A
Date final report sent to Constitutional Team		

