

**HAMPSHIRE COUNTY COUNCIL**

**Decision Report**

<b>Decision Maker:</b>	Pension Fund Panel
<b>Date of Decision:</b>	18 June 2010
<b>Decision Title:</b>	Pension Fund cash management
<b>Decision Reference:</b>	1732
<b>Report From:</b>	County Treasurer

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**1. Executive Summary**

- 1.1. This report provides an annual review of the policy for managing the Hampshire Pension Fund's cash balance.

**2. Background**

- 2.1. The Pension Fund's cash balance is held by the County Council and managed by the County Treasurer alongside the County Council's own cash balance.
- 2.2. The Pension Fund receives cash each month from contributions by employees and employers, and from investment income. Dividends from shares and interest receipts from bonds are retained by the external investment managers for reinvestment, but rent income from the Pension Fund's direct property portfolio is credited to the Fund's cash balance held by the County Council. Distributions from the Fund's alternative investments and indirect property funds are also paid to the Fund's balance.
- 2.3. The Pension Fund's investment managers aim to be fully invested in equities or bonds and do not plan to hold cash as a matter of investment policy. However, they will have some cash balances as a result of trading between stocks and from dividend and interest income pending investment. These relatively small cash balances are held by Northern Trust and are 'swept' on a daily basis into a Northern Trust money market fund in which they earn interest.
- 2.4. The Pension Fund requires a cash balance to be able to pay pensions and other benefits. Cash is also required if the UK property manager CB

Richard Ellis purchases additional properties and to finance drawdowns by the indirect property and alternative investment funds.

- 2.5. The Fund currently generates a surplus of income over expenditure of £65m to £70m per annum as the income from contributions and investments exceeds the outgoings on pensions and benefits. This surplus is expected to continue at this level, at least for the medium term, in line with the actuary's assessment of the need for contributions by employers to reduce the Fund's projected long-term deficit. The annual surplus is invested to meet the Fund's future liabilities.

### **3. Separate bank account**

- 3.1. As reported to the Panel on 30 April 2010, the Government has confirmed that administrative authorities, such as the County Council, will be required to maintain a separate bank account for the Pension Fund from 1 April 2011. Steps are in progress to meet this requirement by 1 October 2010 with the necessary changes to the County Council's computer and other administrative systems.
- 3.2. In addition, the Government has put in place regulations preventing administrative authorities from using Pension Fund cash from 1 April 2010. Subsequent guidance has clarified that it is acceptable for a Pension Fund to agree that its cash balance may be invested alongside those of the administrative authority, provided that the Pension Fund receives in full the interest earned on its balances.
- 3.3. The Pension Fund's cash balance can be placed with banks and other institutions in separately identified deposits, where interest rates and other considerations make this advantageous. The Pension Fund receives the interest earned on these specific deposits.
- 3.4. Where any residual balances are pooled with those of the County Council, the Pension Fund receives interest at the average interest rate earned on the pooled balances. As a result, the County Council and the Pension Fund share the risks of default by the counterparty. This approach has been applied during 2009/10 and replaces the previous policy of the County Council retaining liability for counterparty risks. A formal agreement with the County Council setting out the terms for 'co-mingling' cash balances was agreed by the Panel on 30 April 2010.
- 3.5. The County Council has rigorous procedures in place to ensure the security of all cash deposits, including criteria for the quality of counterparties and limits on the amount that can be placed with any one counterparty. An Annual Investment Strategy is approved by Cabinet and County Council in February each year (attached as Appendix 1).
- 3.6. The new regulations also provide an explicit power for pension funds to borrow, but only for cashflow purposes such as allowing scheme benefits to be paid and during a transition period when the investment of the fund's assets is being changed. Borrowing is limited to a maximum of 90 days. The Hampshire Pension Fund's cashflow will continue to be managed on the basis that the need for borrowing for the Fund is avoided.

#### 4. The Fund's cash balance

- 4.1. The report to the Panel on 21 July 2009 included a forecast that the Fund's cash balance at 31 March 2010 would be £121m. In the event, the actual cash balance was higher at £161m. The main reasons for this increase of £40m were the decisions by CB Richard Ellis to delay investment in the UK property portfolio (£24m) and lower than forecast drawdowns by private equity funds in the alternative investments portfolio (£12m).
- 4.2. The cash movements in 2009/10 are summarised below, together with a forecast of the cash balance for the next three years.

<b>Table 1 - Pension Fund cash balance</b>	<b>£m</b>
Actual balance at 31 March 2009	136.0
Surplus for 2009/10	+67.9
UK property purchases in 2009/10	-20.1
European property investment in 2009/10	-12.0
Drawdowns for alternative investments 2009/10	-14.8
Debtors and other adjustments	+3.5
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Forecast balance at 31 March 2010	160.5
Forecast surplus for 2010/11	+69.0
UK property purchases in 2010/11	-52.0
European property investment in 2010/11	-11.8
Drawdowns for alternative investments 2010/11, say	-40.1
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Forecast balance at 31 March 2011	125.6
Forecast surplus for 2011/12	+67.0
UK property purchases in 2011/12	-
European property investment in 2011/12	-2.1
Drawdowns for alternative investments 2011/12, say	-34.6
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Forecast balance at 31 March 2012	155.9
Forecast surplus for 2012/13	+65.0
Property purchases in 2012/13, say	-
Drawdowns for alternative investments 2012/13, say	-21.2
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Forecast balance at 31 March 2013	199.7

#### 5. Transferring part of the cash balance to the managers for investment

- 5.1. As Table 1 shows, part of the cash balance in 2010/11 is required to meet the existing commitments to invest in property and to fund drawdowns by

the private equity funds, as well as covering day-to-day cashflow. The cash balance will be kept under review during 2010/11.

- 5.2. The balance at the end of 2010/11 could be lower than the £126m shown in Table 1 if the Panel decides at its meeting on 11 June 2010 to increase the allocation to UK property by, say, £28m. Similarly, it could be reduced further if the Panel agrees to allocate a further £45m to Aberdeen for the alternative investments, as outlined in the report later on this Agenda. Both these options can be funded from the Pension Fund's cash balance in 2010/11, which would reduce from £126m to £53m at 31 March 2011 if both amounts were drawn down in full during 2010/11.
- 5.3. If the Panel decides not to proceed with further investment in UK property or alternative investments in 2010/11, consideration will need to be given to whether part of the cash balance of £126m is invested in equities or bonds. The interest available if the cash balance is kept on deposit during 2010/11 is unlikely to be very high. Currently, 0.7% per annum is available for deposits for three months, 1.0% for six months and 1.4% for twelve months. If equity or bond markets were to fall during the remainder of 2010/11, however, these returns could look much more attractive.
- 5.4. One option could be to share up to £75m with Schroders UK equities portfolio, Aberdeen's global equities portfolio, Western's global bonds portfolio or the UK index linked bonds portfolios managed by Legal & General and State Street.
- 5.5. In the future, as cash continues to flow into the Fund from the annual surplus of contributions over benefits, it will be necessary to consider further how these amounts should be invested. This can be done as part of the overall review of the Pension Fund's investment management arrangements following the actuarial valuation that is currently in progress.

## **6. Interest earned by the Pension Fund**

- 6.1. Interest on the cash balance is credited to the Pension Fund in two ways:
  - as the actual interest earned on specific external deposits of Pension Fund cash, and
  - at the average interest rate earned on cash invested alongside the County Council's cash balances.
- 6.2. During 2009/10, the Pension Fund earned an average of 1.3% on its specific external cash deposits which were for periods of between three and twelve months. The average amount on deposit was £85m.
- 6.3. The average interest rate paid to the Pension Fund in 2009/10 on cash invested alongside the County Council's cash balances was 0.7%. The interest earned on these balances was lower as the period of deposit was shorter than for the specific deposits. The average balance invested was £50m. Overall, the Pension Fund earned an average of 1.1% on its cash balances in 2009/10.

## **7. Policy for managing the Pension Fund's cash**

7.1. The following policy could be adopted for managing the Pension Fund's cash. It is based on the policy agreed by the Panel on 21 July 2009:

- a minimum cash balance of £20m will be held by the Pension Fund for cash flow purposes
- further consideration will be given to transferring part of the Pension Fund's cash balance to the equity and bond managers for longer-term investment if the Panel does not agree to increase the allocations for UK property and alternative investments
- the Pension Fund's remaining cash balance should be placed on deposit by the County Treasurer in accordance with the Annual Investment Strategy
- where part of the Pension Fund's cash balance is invested alongside the cash balance of the County Council, interest will be paid to the Pension Fund at the average interest rate earned by the combined amounts
- the risk of default on Pension Fund cash deposits that are invested alongside the County Council's cash deposits remains with the Pension Fund
- the County Treasurer will report to the Panel annually on the Pension Fund's cash balance.

## **8. Recommendation**

8.1. That the County Treasurer be authorised to manage the Fund's cash balance in accordance with the policy set out in this report.

**CORPORATE OR LEGAL INFORMATION:****Links to the Corporate Strategy**

<b>Hampshire safer and more secure for all:</b>	yes/no
Corporate Business plan link number (if appropriate):	
<b>Maximising well-being:</b>	yes/no
Corporate Business plan link number (if appropriate):	
<b>Enhancing our quality of place:</b>	yes/no
Corporate Business plan link number (if appropriate):	
<b>OR</b>	
<b>This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision because the management of the Pension Fund's cash balance needs to be decided.</b>	

**Other Significant Links**

<b>Links to previous Member decisions:</b>		
<u>Title</u>	<u>Reference</u>	<u>Date</u>
<b>Direct links to specific legislation or Government Directives</b>		
<u>Title</u>	<u>Date</u>	

**Section 100 D - Local Government Act 1972 - background documents**

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

<u>Document</u>	<u>Location</u>
None	

## **IMPACT ASSESSMENTS:**

### **1. Equalities Impact Assessment:**

- 1.1. Equality objectives are not considered to be adversely affected by the proposals in this report.

### **2. Impact on Crime and Disorder:**

- 2.1. The proposals in this report are not considered to have any direct impact on the prevention of crime.

### **3. Climate Change:**

- a) How does what is being proposed impact on our carbon footprint / energy consumption?

No specific impact.

- b) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.

## County Council's Annual Investment Strategy 2010/11

The Annual Investment Strategy was agreed by the County Council in February 2010.

The 'lending list' section is under constant review by the County Treasurer and the version of the Strategy below reflects the current position.

1. This Annual Investment Strategy has been prepared in accordance with guidance issued under section 15(1)(a) of the Local Government Act 2003.
2. When investing its surplus funds, the Council's investment priority is to continue to maintain the security of capital and maintain policy flexibility through liquidity of its investments. The Council will aim to achieve the optimum return on its investments commensurate with the proper levels of security and liquidity.
3. Accordingly, only 'specified investments' will be used in 2010/11. Specified investments are defined in the Government's guidance as offering both high security and liquidity. All such investments should be in sterling and with a maturity of no more than a year. Such short-term investments made with the UK Government or a local authority will automatically count as specified investments. In addition, short-term sterling investments with banks and building societies with high credit ratings will count as specified investments.
4. Other, or 'non-specified', investments will not be used, given the greater potential risk.
5. The Council's surplus funds will either be invested in:
  - fixed-term deposits for periods of up to 364 days with local authorities, the Government's Debt Management Office, or banks and building societies rated at least A2 by Moody's (a Government-recognised credit rating agency) that are included on the Council's lending list;
  - call deposits with NatWest Bank (rated Aa3); and
  - call deposits with managed Aaa-rated money market funds included on the Council's lending list, which are currently listed as follows:
    - Standard Life Sterling Fund
    - RBS Global Treasury Sterling Fund
    - JP Morgan Sterling Liquidity Fund
    - Prime Rate Sterling Fund.
6. Such 'call deposits' may be recalled by the Council at any time. The Council's cash flow position will be monitored on a daily basis and adjustments made as necessary to the funds placed on call.
7. Lending is restricted to certain of the UK clearing banks and the larger UK

building societies, with the Council's current lending list given as follows:

Counterpart	Moody's long-term rating	Maximum lending term
Lloyds	Aa3	364 days
NatWest	Aa3	364 days
Barclays	Aa3	364 days
HSBC	Aa2	364 days
Nationwide Building Society	Aa3	364 days
Leeds Building Society	A2	3 months
Santander UK	Aa3	Overnight

Hierarchy of Moody's long-term ratings:

Aaa	Obligations rated Aaa are judged to be of the highest quality, with the "smallest degree of risk".
Aa1, Aa2, Aa3	Obligations rated Aa are judged to be of high quality and are subject to very low credit risk, but "their susceptibility to long-term risks appears somewhat greater".
A1, A2, A3	Obligations rated A are considered upper-medium grade and are subject to low credit risk, but that have elements "present that suggest a susceptibility to impairment over the long term".

8. The Council obtains credit rating information from Moody's, which is one of only three Government recognised credit rating agencies. Credit ratings are reviewed on at least a monthly basis to identify any changes.
9. The lending list is closely monitored and reviewed by the County Treasurer, taking into account each institution's credit ratings, asset base, market capitalisation, press reports, etc. Institutions will be removed immediately from the list if any doubt is cast on their credit worthiness. The credit rating agencies have been largely discredited by Iceland and their role in the credit crisis. Credit ratings are just one of the various tools used in making a considered assessment of credit risk.
10. Limits are placed on levels of total deposits made with individual institutions, based on their relative strength as a counterparty. Whilst the Treasury Management and Annual Investment Strategy sets a maximum lending term of 364 days, this will be shortened in respect of those institutions with a higher perceived credit risk.
11. The Council delegates responsibility of the execution and administration of treasury management investment decisions to the County Treasurer, who will act in accordance with this Treasury Management Strategy. .
12. Changes to the lending list and the limits on investment will be subject to the

approval of the County Treasurer and will be reported in the quarterly review of the financial health indicators.

13. The County Treasurer will continue to manage cash balances on a cautious basis with the emphasis on capital preservation at the expense, where necessary to avoid unjustifiable risks, of additional interest returns.
14. For information, the County Council has never placed deposits with Icelandic banks and has not used any overseas institutions in over two years.
15. County Treasurer's treasury management staff operate within detailed parameters set out in an internal code of practice, which takes account of CIPFA's Treasury Management in the Public Services: Code of Practice and other guidance issued by the Chartered Institute of Public Finance and Accountancy.
16. In-house expertise is considered sufficient not to warrant the use of external treasury management advisers.