

HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Pension Fund Panel
Date:	20 December 2013
Title:	Pension Fund cash monitoring report and Annual Investment Strategy 2014/15
Reference:	5482
Report From:	Director of Corporate Resources – Corporate Services

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1. Executive Summary

- 1.1. This report provides an update on the management of the Pension Fund's cash balances and the Annual Investment Strategy for those cash balances for 2014/15, which is outlined in Section 5, for approval.
- 1.2. In accordance with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009, an investment policy must be formulated for the investment of the Fund's cash.
- 1.3. The production of an Annual Investment Strategy is in line with the recommendations of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice for Treasury Management in the Public Services.

2. Background

- 2.1. The Pension Fund's Statement of Investment Principles does not include a strategic allocation in cash as an asset class. However, the Pension Fund receives cash each month from contributions by employees and employers, and income from some of its investments, which needs to be managed. In addition cash can be held as part of the Tactical Asset Allocation (TAA) portfolio on the advice of Aon Hewitt, the Pension Fund's advisers on the TAA portfolio, although there are no cash investments currently as part of the portfolio.
- 2.2. Dividends from shares and interest receipts from bonds are held by the Pension Fund's custodian bank, JP Morgan, and retained by the Fund's external investment managers for reinvestment, but rent income from the Pension Fund's direct property portfolio, distributions from alternative

investments and indirect property funds are credited to the Fund's cash balance.

- 2.3. The Pension Fund requires a cash balance to meet outgoings on pensions and benefits, existing commitments to invest in property and to fund drawdowns by the private equity funds and hedge funds, as well as covering day-to-day cash flow.

3. Economic Outlook

- 3.1. The flow of credit to households and businesses is slowly improving but is still below pre-crisis levels. The fall in consumer price inflation (CPI) from the high of 5.2% in September 2011 to 2.2% in October 2013 will allow real wage increases (i.e. after inflation) to slowly turn positive and aid consumer spending.
- 3.2. The Bank of England's Monetary Policy Committee (MPC) through its recent Forward Guidance is committed to keeping interest rates low for an extended period, using the Labour Force Survey unemployment rate of 7% as a threshold for when it would consider whether or not to raise interest rates, subject to certain conditions. Unemployment was 7.6% in November 2013.
- 3.3. Stronger growth data in 2013 (0.4% in Q1, 0.7% in Q2 and 0.8% in Q3) alongside a pick-up in property prices mainly stoked by Government initiatives to boost mortgage lending have led markets to price in an earlier rise in interest rates than warranted under Forward Guidance and the broader economic backdrop. However, with jobs growth picking up slowly, many employees working shorter hours than they would like and benefit cuts set to gather pace, growth is likely to be only gradual. The County Council's treasury management advisers, Arlingclose, forecast that unemployment will not fall below the 7% threshold until 2016, due to the UK's flexible workforce, and that the MPC will maintain its resolve to keep interest rates at their current level of 0.5% until the recovery is convincing and sustainable, which will be late 2016.
- 3.4. The credit risk of banking failures has diminished, but not dissipated altogether. Regulatory changes are afoot in the UK, US and Europe to move away from the bank bail-outs of previous years to bank resolution regimes in which shareholders, bond holders and unsecured creditors are 'bailed in' to participate in any recovery process. This is already manifest in relation to holders of subordinated debt issued by the Co-operative Bank which will likely suffer a haircut on its conversion bail-in to alternative securities and/or equity. As a result, to mitigate the greater risk to bank investments posed by the prospect of bail-ins, the Pension Fund will look to reduce the exposure of its cash investments to any individual counterparty, as well as continue to invest in only those institutions that are assessed as lower risk by meeting its credit criteria.

4. Performance of cash investments

- 4.1. The Pension Fund's cash investment holding was £72.5m as at 10 December 2013 and the average balance since 1 April 2013 has been £72.9m, this represents 1.6% of the Pension Fund's total assets. The priority for cash investments is security and liquidity and the Pension Fund's aim is to achieve a yield commensurate with these principles. This has been maintained by following the Pension Fund's counterparty policy as set out in its Annual Investment Strategy for 2013/14, which was approved by the Panel at its meeting on 7 December 2012. A full breakdown of current investments is provided in the exempt appendix.
- 4.2. The Pension Fund's cash balances are expected to reduce over the coming months. The Pension Fund's property portfolio is fully committed so funds will not need to be made available for new purchases, but following the Panel's decision at its meeting on 27 September 2013 to increase the target for the alternative investment portfolio from £350m to £375m, further new purchases will need to be funded in the near future.
- 4.3. Whilst regulations provide an explicit power for pension funds to borrow for a period of up to 90 days for cash flow 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, the Pension Fund's cash flow will be managed on the basis that the need for borrowing for the Fund is avoided and therefore all of the Pension Fund's cash investments are either overnight or for a very short duration.
- 4.4. As at 10 December 2013 the weighted average return on the Pension Fund's cash investments was 0.53%, which should be considered within the context of an unchanged UK Base Rate of 0.5% since March 2009 and even lower short-term money market rates.

5. Annual Investment Strategy

- 5.1. The following Annual Investment Strategy, for the period to 31 March 2015, has been prepared with the advice of the County Council's treasury management advisers, Arlingclose.
- 5.2. The primary objective in relation to the investment of Pension Fund cash remains the security of capital. The liquidity or accessibility of the Fund's cash investments followed by the yields earned on these investments are important but secondary considerations.
- 5.3. There are three Government-recognised credit rating agencies, and their credit rating equivalents and definitions are provided in the following table. All the credit ratings listed are referred to as 'Investment Grade'.

Table 1 – Description of credit rating agencies' ratings

Long-term rating			
Fitch	S&P	Moody's	
AAA	AAA	Aaa	Highest credit quality. 'AAA' ratings denote the lowest expectation of credit risk.
AA+	AA+	Aa1	High credit quality. 'AA' ratings are subject to very low credit risk.
AA	AA	Aa2	
AA-	AA-	Aa3	
A+	A+	A1	'A' ratings are upper-medium investment grade and are subject to low credit risk.
A	A	A2	
A-	A-	A3	

- 5.4. The security risk of countries and the institutions within them is assessed using the following range of factors:
- Credit Ratings (minimum long-term A- or equivalent for counterparties)
 - Credit default swaps (the premium paid to a third party to insure against the risk that a country or institution will default on the repayment of a loan)
 - Economic fundamentals, such as a country's net debt as a percentage of its GDP
 - Sovereign support mechanisms
 - Share prices
 - Corporate developments, news, articles, market sentiment and trends.
- 5.5. In order to diversify the cash investment portfolio, new investments will be placed with a range of approved investment counterparties as shown in the table below. As outlined in Section 3 to reduce the exposure to any single counterparty the maximum deposit with UK counterparties has been reduced and a limit set equally between UK and foreign banks and money market funds. This will ensure that the Pension Fund has a greater level of diversification in its cash investments across a range of creditworthy counterparties, which is increasingly important to mitigate the risk of bank bail-ins as banking regulations change.

Table 2 – Investment strategy counterparty limits

Counterparty	Maximum term	Maximum deposit
Approved UK banks and building societies listed in Appendix 1	2 years	£15m per counterparty (previously £30m)
Approved foreign banks listed in Appendix 1	2 years	£15m per counterparty (previously £10m)
Money Market Funds	Overnight	£15m per fund (previously £10m) 50% of total cash balance
Treasury Bills	6 months	Unlimited
Local authorities	2 years	£10m (maximum per authority for the largest authorities, with reducing banding for smaller authorities)

- 5.6. The Investment Strategy provides flexibility to invest cash for periods of up to 2 years in order to access higher investment returns in the current low interest rate environment. Investment durations will be shortened in respect of those institutions with a higher perceived credit risk, based on the creditworthiness criteria outlined in paragraph 5.4. Given the Pension Fund's intention to maintain only a small cash balance the duration of investments will be limited to ensure that liquidity is maintained. The duration of any cash invested as part Tactical Asset Allocation portfolio will depend on the advice received from Aon Hewitt.
- 5.7. Local authorities are able to invest with the Government's Debt Management Office (DMO), which they may use during periods of significant stress in the markets given the low returns that are offered. This is considered as an acceptable trade-off for the guarantee that capital is secure, and there is no limit on the amount placed with the DMO. A separate account cannot be set up with the DMO specifically in the name of the Pension Fund as it is not a legally separate entity from the County Council as its administering authority. Therefore in order for the Pension Fund to access the DMO the funds would need to be placed via the County Council although the credit risk would remain with the Pension Fund.
- 5.8. The Director of Corporate Resources and Arlingclose will continue to analyse and monitor the indicators of credit risk and wider economic developments on a regular basis and respond as necessary to ensure security of the capital sums invested. Changes during the duration of this Annual Investment Strategy, to the lending list (in Appendix 1) and the limits on investments (in Table 2) will be subject to the approval of the

Director of Corporate Resources and any significant changes will be reported to the Pension Fund Panel at the first available opportunity.

- 5.9. The Director of Corporate Resources will continue to manage cash balances on a cautious basis with the emphasis on capital preservation at the expense of additional interest returns where necessary to avoid unjustifiable risks.

6. Pension Fund's banker

- 6.1. The Fund banks with NatWest. At the current time, it meets the minimum long-term credit rating criteria of A- (or equivalent). If its credit rating were to fall below the Pension Fund's minimum criteria the position would be reviewed and appropriate action taken to ensure the risk to investments was minimised but, as the Fund's banker, NatWest may continue to be used for short term liquidity requirements (overnight and weekend investments) and business continuity arrangements.

7. Recommendations

- 7.1. That the Annual Investment Strategy for 2014/15 be approved.
- 7.2. That, if approved, the Annual Investment Strategy referred to in recommendation 7.1 be implemented from the date of this meeting for the remainder of 2013/14.
- 7.3. That the Director of Corporate Resources 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**

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.
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Other Significant Links

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

DocumentLocation

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.

List of UK and non-UK banks and building societies

Moody's	Long-term credit rating		Country/ Domicile	Counterparty	Maximum Investment £m
	FITCH	S&P			
A2	A	A	UK	Barclays Bank	15
A3	A	-	UK	Close Brothers	15
Aa3	AA-	AA-	UK	Goldman Sachs International Bank	15
Aa3	AA-	AA-	UK	HSBC Bank	15
A3	A-	-	UK	Leeds Building Society	15
A2	A	A	UK	Lloyds TSB	15
A2	A	A	UK	Nationwide Building Society	15
A3	A	A-	UK	NatWest	15
A2	A	A	UK	Santander UK	15
A1	AA-	AA-	UK	Standard Chartered	15
Aa2	AA-	AA-	Australia	Australia and NZ Banking Group	15
Aa2	AA-	AA-	Australia	Commonwealth Bank of Australia	15
Aa2	AA-	AA-	Australia	National Australia Bank	15
Aa2	AA-	AA-	Australia	Westpac Banking Corp	15
Aa3	AA-	A+	Canada	Bank of Montreal	15
Aa2	AA-	A+	Canada	Bank of Nova Scotia	15
Aa3	AA-	A+	Canada	Canadian Imperial Bank of Commerce	15
Aa3	AA	AA-	Canada	Royal Bank of Canada	15
Aa1	AA-	AA-	Canada	Toronto-Dominion Bank	15
Aa3	AA-	AA-	Finland	Nordea Bank Finland	15
Aa3	A+	AA-	Finland	Pohjola Bank	15
A2	A+	A+	France	BNP Paribas	15
A2	A	A	France	Credit Agricole CIB	15
A2	A	A	France	Credit Agricole SA	15
A2	A	A	France	Societe Generale	15
A2	A+	A	Germany	Deutsche Bank AG	15
A2	A+	A	Germany	Landesbank Hessen-Thuringen Helaba	15
Aaa	AAA	AAA	Netherlands	Bank Nederlandse Gemeenten	15
A2	A+	A+	Netherlands	ING Bank	15
Aa2	AA-	AA-	Netherlands	Rabobank	15
Aa1	AA-	AA-	Singapore	DBS	15
Aa1	AA-	AA-	Singapore	Oversea Chinese Banking Corporation	15
Aa1	AA-	AA-	Singapore	United Overseas Bank	15
Aa3	AA-	AA-	Sweden	Svenska Handelsbanken	15
A1	A	A	Switzerland	Credit Suisse	15
Aa3	A+	A+	US	JP Morgan Chase Bank	15

* Please note that the counterparties listed above meet the Fund's minimum credit rating criteria as at 20 December 2013, additional counterparties could be added to this list if, for example, a counterparty/country is upgraded. Alternatively if a counterparty is downgraded, this list may be shortened.