Agenda item: 8

HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Hampshire Pension Fund Panel and Board
Date:	16 December 2016
Title:	Investments: Pension Fund cash monitoring report and Annual Investment Strategy 2017/18
Reference:	7947
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 2017/18, 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.

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 rental income from the Pension Fund's direct property portfolio, distributions from private equity investments, infrastructure 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 and infrastructure funds, as well as covering day-to-day cash flow.

3. External Context

3.1. The following paragraphs explain the economic and financial background against which the Annual Investment Strategy is being set.

Economic background

3.2. The major external influence on the Pension Fund's investment strategy for 2017/18 will be the UK's progress in negotiating a smooth exit from the European Union. Financial markets, wrong-footed by the referendum outcome, have since been weighed down by uncertainty over whether leaving the Union also means leaving the single market. Negotiations are expected to start once the UK formally triggers exit in early 2017 and last for at least two years. Uncertainty over future economic prospects will therefore remain throughout 2017/18.

3.3. The fall and continuing weakness in sterling and the near doubling in the price of oil in 2016 have combined to drive inflation expectations higher. The Bank of England is forecasting that Consumer Price Inflation will breach its target in 2017, the first time since late 2013, but the Bank is expected to look through inflation overshoots over the course of 2017 when setting interest rates so as to avoid derailing the economy.

Credit outlook

3.4. Markets have expressed concern over the financial viability of a number of European banks recently. Sluggish economies and continuing fines for pre-crisis behaviour have weighed on bank profits, and any future slowdown will exacerbate concerns in this regard.

Interest rate forecast

3.5. The County Council's treasury adviser Arlingclose's central case is for UK Bank Rate to remain at 0.25% during 2017/18. The Bank of England has, however, highlighted that excessive levels of inflation will not be tolerated for sustained periods. Given this view and the current inflation outlook, further falls in the Bank Rate look less likely.

3.6. Gilt yields have risen sharply, but remain at low levels. The Arlingclose central case is for yields to decline when the government triggers Article 50. Long-term economic fundamentals remain weak, and the quantitative easing (QE) stimulus provided by central banks globally has only delayed the fallout from the build-up of public and private sector debt. The Bank of England has defended QE as a monetary policy tool, and further QE in support of the UK economy in 2017/18 remains a distinct possibility, to keep long-term interest rates low.

4. Performance of cash investments

4.1. The Pension Fund’s cash investment holding was £109.7m as at 30 November 2016 which represents 1.8% of the Pension Fund’s total value. The current high cash balance has built up due to last year’s hiatus in alternatives investment due to the procurement of new alternatives managers. In addition, the slow nature of investment in property, private equity and infrastructure, where cash does not sit with the investment manager, and is instead called directly from the Fund’s cash balances, has added to the balance. However, the cash balance has been reduced significantly by the recent global equities transition, where the Fund took the opportunity to rebalance the global equities portfolios according to the strategic asset allocation.

4.2. The Pension Fund’s cash balances are expected to reduce further over the coming months. The Fund expects to have around 1% of the Fund in cash to ensure it has funds to pay benefits and fund immediate property, private equity and infrastructure investments. In addition, the Fund will aim to reduce the cash balances as opportunities become available as a result of the impending 2017 review of the strategic asset allocation.

4.3. 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 2016/17, which was approved by the Pension Fund Panel at its meeting in November 2015. A full breakdown of current investments is provided in the exempt appendix.

4.4. 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.

4.5. As at 30 November 2016 the weighted average return on the Pension Fund’s cash investments was 0.33%, which should be considered within the context of a recently lowered UK Base Rate of 0.25%, following a period of over 7 years of unchanged UK Base Rate at 0.50%, and very low short-term money market rates. This rate reflects interest rates available prior to the Base Rate cut, and is likely to fall in the coming months.

5. Annual Investment Strategy

5.1. In the past 12 months, the Pension Fund’s investment balance has ranged between £95.8 and £163.5 million. Levels are expected to reduce to around 1% of the Pension Fund’s total assets as explained in paragraph 4.2.

5.2. The following Annual Investment Strategy, for the period to 31 March 2018 has been prepared with the advice of the County Council’s treasury management advisers, Arlingclose.

5.3. 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.

Negative Interest Rates

5.4. If the UK enters into a recession in 2017/18, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

Risk Assessment and Credit Ratings

5.5. Credit ratings are obtained and monitored by the County Council's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made,
- any existing investments that can be recalled or sold at no cost will be, and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

5.6. Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

Other information on the Security of Investments

5.7. The Pension Fund understands that credit ratings are good but not perfect predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. No investments will be made with an organisation if there are substantial doubts about its credit quality, even though it may meet the credit rating criteria.

5.8. When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances the Pension Fund will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions.

Investment Limits

5.9. Given the impact of bail-in legislation, which has increased the credit risk that unsecured bank/building society investments could be subject to a loss and/or converted to equities, the following investment limits are proposed to mitigate the risk whilst allowing sufficient flexibility to manage the Pension Fund's investment balances.

5.10. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Maximum limits will also be placed on fund managers and industry sectors as below:

Table 1: Investment Limits

	Cash limit	**Maximum Term**
Any single organisation, except the UK Central Government	£20m each	2 years
UK Central Government	Unlimited	2 years
Any group of organisations under the same ownership	£20m per group	2 years
Any group of pooled funds under the same management	£15m per manager	2 years
Registered Providers	£15m in total	2 years
Money Market Funds	50% in total	Overnight

Approved Investment Counterparties and Limits

5.11. Appendix 1 shows a table of counterparty types which the Pension Fund may invest its cash in, subject to the cash limits (per counterparty) and the time limits shown. The Pension Fund will continue to largely invest overnight with banks and money market funds, given that cash is only held to meet immediate liabilities. Other more secure options that might mitigate the risk of bank bail-ins are available should the Pension Fund be required to hold larger amounts of cash for longer periods. The list of currently authorised counterparties is available in Appendix 2 for information. Therefore the Director of Corporate Resources and her staff will use the guidance of the Pension Fund's treasury management advisers, Arlingclose, in order to place cash on deposit, within the limits shown in Appendix 1.

Liquidity Management

5.12. The Pension Fund has due regard for its future cash flows when determining the maximum period for which funds may prudently be committed. Historic cash flows are analysed in addition to significant future cash movements.

6. Other items

Investment Training

6.1. The needs of the Pension Fund's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

6.2. Staff members regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, and other appropriate organisations.

6.3. The Pension Fund's training policy states that all Panel and Board members should receive appropriate training relevant to their needs and understand fully their roles and responsibilities, which includes treasury management responsibilities, and the scrutiny of the treasury management function. All Panel and Board members were invited to a workshop presented by Arlingclose on 29 November 2016, which gave an update on treasury matters. Another workshop is planned for November 2017.

Investment Advisers

6.4. The Pension Fund has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is controlled through quarterly review meetings with the Director of Corporate Resources and her staff and Arlingclose.

7. Recommendations

7.1. That the Annual Investment Strategy for 2017/18 be approved.

7.2. That, if the Annual Investment Strategy referred to in recommendation 7.1 is approved, that it be implemented from the date of this meeting for the remainder of 2016/17.

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.

Other Significant Links

Links to previous Member decisions:		
Title	Reference	Date
Direct links to specific legislation or Government Directives		
Title		Date

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.)

Document	Location
None	

IMPACT ASSESSMENTS:

1. Equality Duty

1.1. The County Council has a duty under Section 149 of the Equality Act 2010 ('the Act') to have due regard in the exercise of its functions to the need to:

- Eliminate discrimination, harassment and victimisation and any other conduct prohibited under the Act;
- Advance equality of opportunity between persons who share a relevant protected characteristic (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, gender and sexual orientation) and those who do not share it;
- Foster good relations between persons who share a relevant protected characteristic and persons who do not share it.

Due regard in this context involves having due regard in particular to:

a) The need to remove or minimise disadvantages suffered by persons sharing a relevant characteristic connected to that characteristic;

b) Take steps to meet the needs of persons sharing a relevant protected characteristic different from the needs of persons who do not share it;

c) Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity which participation by such persons is disproportionally low.

1.2. **Equalities Impact Assessment:**

1.3. 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.

Approved Investment Counterparties and Limits

Credit Rating	Banks Unsecured	Banks Secured	Government	Corporates
UK Govt	n/a	n/a	£ Unlimited 2 years	n/a
AAA	£15m 2 years	£20m 2 years	£20m 2 years	£15m 2 years
AA+	£15m 2 years	£20m 2 years	£20m 2 years	£15m 2 years
AA	£15m 2 years	£20m 2 years	£20m 2 years	£15m 2 years
AA-	£15m 2 years	£20m 2 years	£20m 2 years	£15m 2 years
A+	£15m 2 years	£20m 2 years	£15m 2 years	£15m 2 years
A	£15m 13 months	£20m 2 years	£15m 2 years	£15m 2 years
A-	£15m 6 months	£20m 13 months	£15m 2 years	£15m 13 months
BBB+	£10m 100 days	£15m 6 months	£10m 2 years	£10m 6 months
None	£1m 6 months	n/a	£15m 2 years	n/a
Pooled funds	£15m per fund			

The table must be read in conjunction with the notes below

Credit Rating

Investment limits are set by reference to the lowest published long-term credit rating from Fitch, Moody's or Standard & Poor's. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

Banks Unsecured

Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail.

Banks Secured

Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank/building society's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is not investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the highest of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

Government

Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is an insignificant risk of insolvency. Investments with the UK Central Government may be made in unlimited amounts for up to 2 years.

Corporates

Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made as part of a diversified pool in order to spread the risk widely.

Pooled Funds

Shares in diversified investment vehicles consisting of any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Money Market Funds that offer same-day liquidity and aim for a constant net asset value will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

List of UK and non-UK banks and building societies

Country / Domicile	Counterparty	Maximum investment	Maximum duration
UK	Barclays Bank	£15m	100 days
UK	Bank of Scotland	£15m	13 months
UK	Close Brothers	£15m	6 months
UK	Goldman Sachs	£15m	100 days
UK	HSBC Bank	£15m	13 months
UK	Leeds Building Society	£15m	100 days
UK	Lloyds Bank	£15m	13 months
UK	Nationwide Building Society	£15m	6 months
UK	NatWest	£10m	35 days
UK	Santander UK	£15m	6 months
Australia	Australia and NZ Banking Group	£15m	6 months
Australia	Commonwealth Bank of Australia	£15m	6 months
Australia	National Australia Bank	£15m	6 months
Australia	Westpac Banking Group	£15m	6 months
Canada	Bank of Montreal	£15m	13 months
Canada	Bank of Nova Scotia	£15m	13 months
Canada	Canadian Imperial Bank of Commerce	£15m	13 months
Canada	Royal Bank of Canada	£15m	13 months
Canada	Toronto-Dominion Bank	£15m	13 months
Denmark	Danske Bank	£15m	100 days
Finland	OP Corporate Bank	£15m	6 months
Germany	Landesbank Hessen-Thuringen (Helaba)	£15m	6 months
Netherlands	ING Bank	£15m	100 days
Netherlands	Rabobank	£15m	13 months
Singapore	DBS Bank Ltd	£15m	13 months
Singapore	Oversea-Chinese Banking Corporation	£15m	13 months
Singapore	United Overseas Bank	£15m	13 months
Sweden	Nordea Bank AB	£15m	13 months
Sweden	Svenska Handelsbanken	£15m	13 months
Switzerland	Credit Suisse	£15m	100 days
US	JP Morgan Chase Bank	£15m	13 months

* Please note that the counterparties listed above meet the Fund's minimum credit rating criteria as at 1 December 2016, 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.