

HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Pension Fund Panel
Date of Decision:	16 December 2011
Decision Title:	Pension Fund cash – Annual Investment Strategy 2012/13
Decision Reference:	3531
Report From:	County Treasurer

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1. Executive Summary

- 1.1. This report provides an Annual Investment Strategy for 2012/13 for approval, which is covered in Section 3.
- 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 its Fund's cash.
- 1.3. The policy has also been informed by the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice for Treasury Management in the Public Services, which recommends that an Annual Investment Strategy is produced.

2. Background

- 2.1. The Panel agreed the Annual Investment Strategy for 2011/12 on 15 December 2010. An outturn report on the Pension Fund's cash management in 2011/12 will be made to the Panel in June 2012.
- 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. Distributions from the Fund's alternative investments and indirect property funds are also paid to the Fund's balance.

- 2.3. The Pension Fund requires a cash balance to meet the outgoings on pensions and benefits, existing commitments to invest in property and to fund drawdowns by the private equity funds, as well as covering day-to-day cash flow.
- 2.4. 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.

3. Annual Investment Strategy

- 3.1. The following Annual Investment Strategy has been prepared with the advice of the County Council's treasury advisers, Arlingclose.
- 3.2. 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.
- 3.3. Credit markets remain in a state of uncertainty as a result of the excessive and poor performing debt within the financial markets. In some instances, Greece and Italy being the most notable examples, the extent and implications of the debt it has built up have led to a sovereign debt crisis and a banking crisis with the outcome still largely unknown. It is against this backdrop of uncertainty that the Fund's investment strategy is framed.
- 3.4. With short term interest rates expected to be maintained by the Bank of England at "low levels for even longer", an investment strategy will in normal circumstances result in a lengthening of investment periods, where cash flow permits, in order to lock into higher rates of returns. The problem in the current environment is finding an investment counterparty providing acceptable levels of counterparty risk.
- 3.5. In order to diversify the cash investment portfolio, investments will be placed with a range of approved investment counterparties, investment periods and rates of return. Maximum investment levels with each counterparty will be set to ensure prudent diversification is achieved.
- 3.6. Money market funds (MMFs) will be used, and the Fund will also seek to diversify any exposure by using more than one MMF where appropriate.
- 3.7. The Investment Strategy will provide flexibility to invest cash for periods of up to 364 days in order to access higher investment returns in the current low interest rate environment, although lending to UK local authorities can be for up to two years. This will be shortened in respect of those institutions with a higher perceived credit risk, based on the creditworthiness criteria outlined in paragraph 3.11. For example, new investment deposits with banks and building societies are restricted to periods of up to 3 months at the present time.

- 3.8. Cash investments with longer than 364 days to maturity will be restricted to a maximum of £20m, with a maximum investment being placed with one institution of £10m. Such limits are considered appropriate given that the Pension Fund's Statement of Investment Principles does not include a strategic allocation in cash as an asset class.
- 3.9. The Pension Fund's cash investments are made with reference to the outlook for the UK Official Bank Rate and money market rates. The UK Bank Rate has been maintained at 0.5% since March 2009, and is anticipated to remain unchanged throughout 2012/13. Short-term money market rates are likely to remain at low levels for an extended period.
- 3.10. There are three Government-recognised credit rating agencies, and their credit rating equivalents and definitions are provided in the following table. All of the credit ratings listed are referred to as 'Investment Grade'. Credit ratings of BB and lower are categorised as 'Speculative Grade'.

Fitch	S&P	Moody's	
Long-term	Long-term	Long-term	
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	
BBB+	BBB+	Baa1	'BBB' ratings indicate good credit quality. This is the lowest investment grade category.
BBB	BBB	Baa2	
BBB-	BBB-	Baa3	

- 3.11. Countries and the institutions within them are selected for the counterparty list after analysis and careful monitoring of:
- Credit Ratings (minimum long-term A- or equivalent for counterparties) – this is lower than the A+ minimum adopted in 2011/12 and is in response to downgrades in credit ratings below A+ of many institutions considered to be systemically important to the financial system
 - Credit default swaps
 - 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.
- 3.12. The County Treasurer and Arlingclose will continue to analyse and monitor these indicators and credit developments on a regular basis and respond as necessary to ensure security of the capital sums invested.
- 3.13. Pension Fund's banker – The Fund banks with NatWest. At the current time, it meets the minimum credit rating criteria of A- (or equivalent) long term. Even if the credit rating falls below the Fund's minimum criteria NatWest will continue to be used for short term liquidity requirements (overnight and weekend investments).
- 3.14. This policy change has been prompted by the downgrading of the long-term ratings of UK banks and building societies in October 2011, which was based on a reassessment of the support environment in the UK. The rating agencies have emphasised that the downgrades do not reflect a deterioration in the financial strength of the banking system.
- 3.15. The minimum credit rating criteria of A+ in respect of the minimum adopted for 2011/12 meant that monies have been temporarily withdrawn from the Fund's own banker, NatWest, as well as Lloyds TSB and Nationwide, until such time as a new investment strategy could be presented to this Panel for discussion and approval.
- 3.16. The Fund's surplus cash will either be invested in:-
- UK and non-UK banks and building societies listed in Appendix 1 for periods of up to an outer limit of 364 days (although this may be shortened at any point during the year as is currently the case), which are rated at least A- which denotes a high credit quality and expectations of low default risk and a strong capacity to meet its financial commitments;
 - fixed-term deposits with the Government's Debt Management Office (DMO) will only be used as a default position during a period of significant stress in the markets given the low returns. This would be considered as an acceptable trade-off for the guarantee that the Pension Fund's capital is secure, and there would be no limit on the amount placed with the DMO. Given that a separate account cannot be set up with the DMO specifically in the name of the Pension Fund given that it is not a legally separate entity from its administering authority, the funds would need to be placed with the DMO via the County Council although the credit risk would remain with the Pension Fund;
 - fixed-term deposits with other local authorities for periods of up to two years; and

- same-day liquidity deposits with managed AAA rated money market funds, which are currently listed as follows (although other AAA rated money market funds may also be used if deemed necessary):
 - RBS Global Treasury Sterling Liquidity Fund;
 - Deutsche Sterling Liquidity Fund;
 - Ignis Sterling Liquidity Fund; and
 - Prime Rate Liquidity Sterling Fund.

No more than £10m will be placed with any one money market fund, and the overall exposure to money market funds will not exceed £50m.

- 3.17. Same-day liquidity deposits may be recalled at any time. The Pension Fund's cash flow position will be monitored on a daily basis and adjustments made as necessary to the funds placed on instant access.
- 3.18. The Pension Fund Panel delegates responsibility for the execution and administration of treasury management investment decisions to the County Treasurer, who will act in accordance with this Annual Investment Strategy.
- 3.19. Changes to the lending list and the limits on investments will be subject to the approval of the County Treasurer and will be reported to the Pension Fund Panel at the first available opportunity.
- 3.20. 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.
- 3.21. The Pension Fund's cash investment holding was £91m as at 30 November 2011, a breakdown of which is provided in the exempt report.

4. Recommendations

- 4.1. That the Annual Investment Strategy for 2012/13 be approved.
- 4.2. That, if approved, the Annual Investment Strategy referred to in recommendation 4.1 be implemented from the date of this meeting for the remainder of 2011/12.

[Carolyn – please note that this would mean that for an albeit temporary period of around 8 weeks, the cash investment strategy for the Pension Fund would be different to the ones for HCC, HPA, and HFRA, although these are all separate entities in their own right.]

- 4.3. 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

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:

<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.)

<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.

List of UK and non-UK banks and building societies

(which meet the Fund's minimum credit rating criteria as at 30 November 2011)

Moody's long-term credit rating	FITCH long-term credit rating	S&P long-term credit rating	Country/ Domicile	Counterparty	Maximum Counterparty Limit £m
A1	A+	AA-	UK	Santander UK	30
A1	A	A	UK	Lloyds TSB	30
Aa3	AA-	A+	UK	Barclays Bank	30
Aa2	AA	AA-	UK	HSBC Bank	30
A2	A+	A+	UK	Nationwide Building Society	30
A2	A	A	UK	NatWest	30
Aa2	AA-	AA	Australia	Australia and NZ Banking Group	10
Aa2	AA	AA	Australia	Commonwealth Bank of Australia	10
Aa2	AA	AA	Australia	National Australia Bank	10
Aa2	AA	AA	Australia	Westpac Banking Corp	10
Aa2	AA-	A+	Canada	Bank of Montreal	10
Aa1	AA-	AA-	Canada	Bank of Nova Scotia	10
Aa2	AA-	A+	Canada	Canadian Imperial Bank of Commerce	10
Aa1	AA	AA-	Canada	Royal Bank of Canada	10
Aaa	AA-	AA-	Canada	Toronto-Dominion Bank	10
Aa2	AA-	AA-	Finland	Nordea Bank Finland	10
Aa3	AA-	A+	Germany	Deutsche Bank AG	10
Aa3	A+	A+	Netherlands	ING Bank	10
Aaa	AA+	AA	Netherlands	Rabobank	10
Aa2	AA-	AA-	Sweden	Svenska Handelsbanken	10
Aa1	AA-	A+	Switzerland	Credit Suisse	10
Aa1	AA-	A+	US	JP Morgan	10

* Please note that 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.