

HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Hampshire Pension Fund Panel and Board
Date:	6 November 2015
Title:	Pension Fund cash monitoring report and Annual Investment Strategy 2016/17
Reference:	7035
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 2016/17, 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 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. 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 economy has remained resilient over the last six months. GDP has now increased for ten consecutive quarters, breaking a pattern of slow and erratic growth from 2009. The annual rate for consumer price inflation (CPI) briefly turned negative in April, falling to -0.1%, before fluctuating between 0.0% and 0.1% over the next few months.
- 3.3. At its meeting ending on 8th October 2015, the Bank of England's Monetary Policy Committee (MPC) voted by a majority of 8-1 to maintain Bank Rate at 0.5%. For the third month in a row, Ian McCafferty voted for a 0.25% increase in Bank Rate. The Committee voted unanimously to maintain the stock of purchased assets financed by the issuance of central bank reserves at £375 billion. The minutes noted that near-term inflation appeared slightly weaker than at the time of the August Inflation Report; this was mainly due to the further decline in the oil price. They feel that inflation is likely to remain below 1% until spring 2016. The minutes stated that the outlook for inflation in the medium term was of more relevance to the setting of monetary policy.

Credit outlook

- 3.4. The continued global economic recovery has led to a general improvement in credit conditions. This is evidenced by a fall in the credit default swap spreads of banks and companies around the world. However, due to the Bank Recovery and Resolution Directive and the recast Deposit Guarantee Schemes Directive which formalise bail-in risk for certain types of investors, the credit risk associated with making unsecured bank deposits has increased relative to the risk of other investment options available to the Pension Fund.

Interest rate forecast

- 3.5. The Pension Fund's treasury management advisor Arlingclose forecasts the first rise in official interest rates in April 2016 and a gradual pace of increases thereafter. Arlingclose believes the normalised level of the Bank Rate post-crisis to range between 2.5% and 3.5%.

4. Performance of cash investments

- 4.1. The Pension Fund's cash investment holding was £95.1m as at 30 September 2015 and the average balance since 1 April 2015 has been £70.3m; this represents 1.4% of the Pension Fund's total assets.

- 4.2. The Pension Fund's cash balances are expected to reduce over the coming months. Going forward the Fund will aim to have around 1% of the Fund in cash to ensure it has funds to pay benefits and fund immediate property and alternative investment purchases, as both portfolios are due to increase (additions up to the target investment size of the alternative investments portfolio will now begin to be actioned now that the contracts have been awarded to the new investment managers).
- 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 2015/16, which was approved by the Pension Fund Panel at its meeting in March 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 September 2015 the weighted average return on the Pension Fund's cash investments was 0.51%, which is consistent 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. In the past 12 months, the Pension Fund's investment balance has ranged between £39.0 and £126.3 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 2017 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.

Risk Assessment and Credit Ratings

- 5.4. 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.
- 5.5. 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

- 5.6. 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.
- 5.7. 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

- 5.8. Given the impact of the Bank Recovery and Resolution Directive, and the recast Deposit Guarantee Schemes Directive, which has increased the credit risk that unsecured bank/building society investments could be ‘bailed-in’, the following investment limits are proposed to mitigate the risk whilst allowing sufficient flexibility to manage the Pension Fund’s investment balances.
- 5.9. 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

- 5.10. 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

- 5.11. 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, the Association of Corporate Treasurers 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 are invited to a workshop presented by Arlingclose on 23 November 2015, which will give an update on treasury matters.

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 2016/17 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 2015/16.
- 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:		
<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. 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 disproportionately 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
BBB or BBB-	£10m next day only	£15m 100 days	n/a	n/a
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 decisions are made 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.

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. Unsecured investments with banks rated BBB or BBB- are restricted to overnight deposits at the Pension Fund's current account at NatWest bank (which is currently rated at BBB+).

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

Long-term credit rating			Country / Domicile	Counterparty	Maximum investment	Maximum duration
FITCH	Moody's	S&P				
A	A2	A-	UK	Barclays Bank	£15m	100 days
A+	A1	A	UK	Bank of Scotland	£15m	13 months
A	Aa3	-	UK	Close Brothers	£15m	6 months
A	A1	A	UK	Goldman Sachs	£15m	100 days
AA-	Aa2	AA-	UK	HSBC Bank	£15m	13 months
A-	A2	-	UK	Leeds Building Society	£15m	100 days
A+	A1	A	UK	Lloyds Bank	£15m	13 months
A	A1	A	UK	Nationwide Building Society	£15m	6 months
BBB+	A3	BBB+	UK	NatWest	£10m	35 days
A	A1	A	UK	Santander UK	£15m	6 months
AA-	Aa2	A+	UK	Standard Chartered Bank	£15m	6 months
AA-	Aa2	AA-	Australia	Australia and NZ Banking Group	£15m	6 months
AA-	Aa2	AA-	Australia	Commonwealth Bank of Australia	£15m	6 months
AA-	Aa2	AA-	Australia	National Australia Bank	£15m	6 months
AA-	Aa2	AA-	Australia	Westpac Banking Group	£15m	6 months
AA-	Aa3	A+	Canada	Bank of Montreal	£15m	13 months
AA-	Aa2	A+	Canada	Bank of Nova Scotia	£15m	13 months
AA-	Aa3	A+	Canada	Canadian Imperial Bank of Commerce	£15m	13 months
AA	Aa3	AA-	Canada	Royal Bank of Canada	£15m	13 months
AA-	Aa1	AA-	Canada	Toronto-Dominion Bank	£15m	13 months
A	A2	A	Denmark	Danske Bank	£15m	100 days
A+	Aa3	AA-	Finland	Pohjola Bank	£15m	6 months
A	A3	BBB+	Germany	Deutsche Bank AG	£10m	35 days
A+	A1	A	Germany	Landesbank Hessen-Thuringen (Helaba)	£15m	6 months
AA+	Aaa	AA+	Netherlands	Bank Nederlandse Gemeenten	£15m	13 months
A	A1	A	Netherlands	ING Bank	£15m	100 days
AA-	Aa2	A+	Netherlands	Rabobank	£15m	13 months
AA-	Aa1	AA-	Singapore	DBS Bank Ltd	£15m	13 months
AA-	Aa1	AA-	Singapore	Oversea-Chinese Banking Corporation	£15m	13 months
AA-	Aa1	AA-	Singapore	United Overseas Bank	£15m	13 months
AA-	Aa3	AA-	Sweden	Nordea Bank AB	£15m	13 months
AA-	Aa2	AA-	Sweden	Svenska Handelsbanken	£15m	13 months
A	A1	A	Switzerland	Credit Suisse	£15m	100 days
AA-	Aa3	A+	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 20 October 2015, 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.