

HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Pension Fund Panel
Decision:	15 June 2012
Title:	Pension Fund cash – Annual Report 2011/12
Reference:	3866
Report From:	Director of Corporate Resources

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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. As reported to the Panel on 15 December 2010, the Government has required administrative authorities, such as the County Council, to maintain a separate bank account for the Pension Fund from 1 April 2011. This was set up well in advance of this statutory deadline, and has been fully operational since October 2010.
- 2.2. For transparency, the Pension Fund's cash balance has been separately invested from that of the County Council's own cash balance since that time.
- 2.3. 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.

- 2.4. 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.
- 2.5. 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 CBRE Global Investors purchases additional properties, to finance drawdowns by the indirect property and alternative investment funds, and the purchase of new and top-up hedge fund investments.
- 2.6. The Fund currently generates a surplus of income over expenditure as the income from contributions and investments exceeds the outgoings on pensions and benefits. The annual surplus is invested to reduce the Fund's projected long-term deficit and meet the Fund's future liabilities. However, the extent of this surplus might reduce in future as Local Government spending is cut and if changes are made to the Pension Scheme. This will be kept under review.
- 2.7. There are 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.
- 2.8. The next report to the Panel on cash management will be an updated version of the Annual Investment Strategy for 2013/14 in autumn 2012. The Strategy for 2012/13 is attached to this report as Appendix 1 as background information for the Panel.
- 2.9. 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 is managed on the basis that the need for borrowing for the Fund is avoided.
- 2.10. The County Council's treasury advisers, Arlingclose, provide support to the Director of Corporate Resources in undertaking treasury management activities.

3. Investment activity

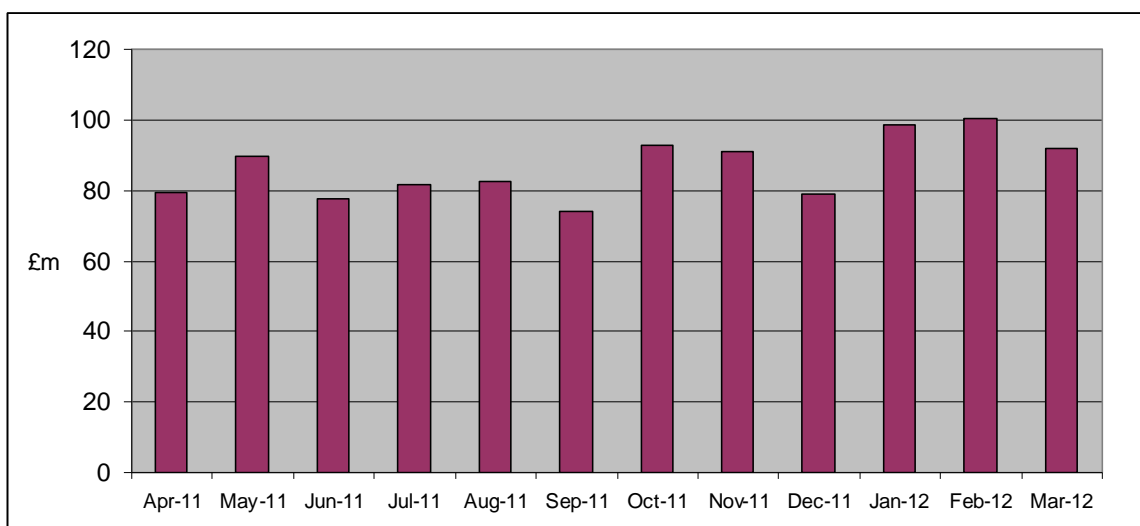
- 3.1. Security of capital remains the Fund's main investment objective for the management of the cash balance. This was maintained during 2011/12 by following the Fund's counterparty policy as set out in its Annual Investment Strategy. Investments during the year included :
 - Investments in AAA-rated Money Market Funds
 - Deposits with other UK local authorities
 - Call accounts and deposits with banks and building societies systemically important to the UK's banking system.

- 3.2. Counterparty credit quality was assessed and monitored with reference to:
 - credit ratings
 - credit default swaps
 - any potential support mechanisms
 - share prices.
- 3.3. The minimum long-term counterparty credit rating determined for the 2011/12 treasury strategy was A+/A1 across rating agencies Fitch, S&P and Moody's.
- 3.4. This particular criterion was amended with the agreement of the Panel on 16 December 2011 to A-/A3 in response to downgrades in credit ratings below A+ of many institutions considered to be systemically important to the financial system. The downgrades were driven principally by the agencies' view of the extent of future government support (flowing from the recommendations to the government from the Independent Commission on Banking) rather than a deterioration in the institutions' creditworthiness.
- 3.5. The Fund maintained a sufficient level of liquidity through the use of Money Market Funds and the use of call accounts.
- 3.6. The Fund sought to optimise returns commensurate with its objectives of security and liquidity. The UK base rate was maintained at 0.5% through the year.
- 3.7. The Director of Corporate Resources on behalf of the Pension Fund considered an appropriate risk management response to uncertain and deteriorating credit conditions in Europe was to shorten maturities for new investments. Short term money market rates remained at very low levels which had a significant impact on cash investment income – see Table 2 below.

Table 2 – Base Rate, Money Market Rates

Date	Bank Rate	O/N LIBID	7-day LIBID	1-month LIBID	3-month LIBID	6-month LIBID	12-month LIBID	2-yr SWAP Bid	3-yr SWAP Bid	5-yr SWAP Bid
01/04/2011	0.50	0.40	0.54	0.54	0.69	1.12	1.59	1.89	2.36	3.00
30/04/2011	0.50	0.50	0.40	0.49	0.69	1.05	1.52	1.62	2.07	2.74
31/05/2011	0.50	0.40	0.40	0.52	0.69	1.08	1.56	1.53	1.89	2.54
30/06/2011	0.50	0.50	0.40	0.50	0.77	1.06	1.54	1.44	1.82	1.50
31/07/2011	0.50	0.40	0.40	0.50	0.78	1.07	1.55	1.29	1.53	2.09
31/08/2011	0.50	0.40	0.40	0.56	0.86	1.15	1.63	1.27	1.43	1.92
30/09/2011	0.50	0.60	0.60	0.54	0.92	1.21	1.69	1.25	1.38	1.75
31/10/2011	0.50	0.63	0.55	0.56	0.96	1.25	1.74	1.30	1.42	1.81
30/11/2011	0.50	0.65	0.58	0.64	1.01	1.31	1.80	1.41	1.49	1.76
31/12/2011	0.50	0.50	0.65	0.67	1.05	1.35	1.84	1.31	1.34	1.54
31/01/2012	0.50	0.50	0.70	0.68	1.06	1.38	1.87	1.20	1.23	1.46
29/02/2012	0.50	0.50	0.75	0.67	1.05	1.37	1.87	1.22	1.29	1.54
31/03/2012	0.50	0.55	0.55	0.61	1.00	1.33	1.84	1.22	1.30	1.59
Minimum	0.50	0.10	0.35	0.49	0.68	1.01	1.40	1.08	1.23	1.46
Average	0.50	0.47	0.52	0.58	0.89	1.21	1.69	1.36	1.55	1.98
Maximum	0.50	0.65	0.95	0.68	1.06	1.38	1.87	1.95	2.42	3.07
Spread	--	0.55	0.60	0.19	0.38	0.37	0.47	0.87	1.19	1.60

- 3.8. The Fund's average cash investment balance was £84.9m during 2011/12, and interest earned was £1.4m, leading to an average yield of 1.6%. Table 3 shows how the Pension Fund's cash balance at the end of each month has remained reasonably stable over the course of the year ranging between £74m and £100m.

Table 3 – Pension Fund cash balance during 2011/12

- 3.9. A small number of longer term cash investments for periods of up to two years were made in order to access higher investment returns in the current low interest rate environment. There are three deposits totalling £15m currently outstanding and due for repayment after July 2012 with Lloyds TSB and NatWest.
- 3.10. The Pension Fund's cash investment holding was £92.0m as at 31 March 2012, a breakdown of which is provided in the exempt report.

4. Borrowing

- 4.1. In accordance with the Pension Fund's Annual Investment Strategy for 2011/12, the cash flow was managed so as to avoid the need to borrow and as a consequence no borrowing was undertaken during 2011/12.

5. Recommendation

- 5.1. That the outturn report on the Pension Fund's cash management in 2011/12 be approved.

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

This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision by the Pension Fund Panel to approve the annual report on Pension Fund cash for 2011/12.
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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.

Annual Investment Strategy 2012/13

The following Annual Investment Strategy has been prepared with the advice of the County Council's treasury advisers, Arlingclose.

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.

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.

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.

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.

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.

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 3.2. For example, new investment deposits with banks and building societies are restricted to periods of up to 6 months at the present time.

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.

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	

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.

The Director of Corporate Resources 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.

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).

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.

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.

The Fund's surplus cash will either be invested in:-

- UK and non-UK banks and building societies 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;
 - Insight Sterling Liquidity Fund;
 - Ignis Sterling Liquidity Fund; and
 - Federated Prime Rate Sterling Liquidity 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.

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.

The Pension Fund Panel delegates responsibility for the execution and administration of treasury management investment decisions to the Director of Corporate Resources, who will act in accordance with this Annual Investment Strategy.

Changes to the lending list and the limits on investments will be subject to the approval of the Director of Corporate Resources and will be reported to the Pension Fund Panel at the first available opportunity.

The Director of Corporate Resources 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.

List of UK and non-UK banks and building societies

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	30
Aa2	AA	AA-	UK	HSBC	30
A2	A+	A+	UK	Nationwide Building Society	30
A2	A	A	UK	NatWest	30
A1	AA-	A+	UK	Standard Chartered	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.