

## HAMPSHIRE COUNTY COUNCIL

### Decision Report

<b>Decision Maker:</b>	Hampshire Pension Fund Panel and Board
<b>Date:</b>	13 December 2019
<b>Title:</b>	Investments: Pension Fund cash monitoring report and Annual Cash Investment Strategy 2020/21
<b>Report From:</b>	Director of Corporate Resources

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#### **Purpose of this Report**

1. This report outlines the investment performance of the cash balances held by the Pension Fund in 2019/20 to 30 November 2019 and recommends the Annual Cash Investment Strategy for 2020/21.

#### **Recommendations**

2. That the Annual Cash Investment Strategy for 2020/21 be approved.
3. That, if the Annual Cash Investment Strategy referred to above is approved, that it be implemented from the date of this meeting for the remainder of 2019/20.
4. 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.

#### **Executive Summary**

5. This report provides an update on the management of the Pension Fund's cash balances and the Annual Cash Investment Strategy for those cash balances for 2020/21, which is outlined in paragraphs 28 to 40 for approval.
6. In accordance with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016, an investment policy must be formulated for the investment of the Fund's cash.

7. The production of an Annual Cash Investment Strategy is in line with the recommendations of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice 2017 Edition.

## **Background**

8. The Pension Fund's Cash Investment Strategy Statement 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.
9. Dividends from shares and interest receipts from bonds are held by the Pension Fund's custodian bank, JP Morgan, for segregated accounts and by the investment managers' custodian banks where the Pension Fund is investing in pooled funds. Cash in these accounts is 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.
10. 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, private debt and infrastructure funds, as well as covering day-to-day cashflow.

## **External Context**

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

### *Economic background*

12. The UK's progress negotiating its exit from the European Union (EU), together with its future trading arrangements, will continue to be a major influence on the Pension Fund's cash management strategy for 2020/21.
13. UK Consumer Price Inflation (CPIH) fell to 1.5% year on year in September 2019 from 1.7% in August, weaker than the consensus forecast of 1.6% and below the Bank of England's target.
14. Labour market data for the three months to September 2019 showed the unemployment rate edged down to 3.8% while the employment rate reduced slightly to 76.0%. Once adjusted for inflation, real wages were up 1.7% on an annual basis as wages continue to rise steadily and provide some upward pressure on general inflation.
15. There was an increase of 0.3% in quarterly GDP growth in the third calendar quarter of 2019 following the 0.2% contraction in Q2. Services and construction provided a positive contribution, while agriculture contributed negatively. Output in the production sector was flat for Q3 2019. Business investment was flat in Q3 which follows negative growth in Q2 2019 alongside four negative consecutive quarters in 2018.

16. The Bank of England maintained Bank Rate at 0.75% and while the potential for divergent paths for UK monetary policy remain in the event of the General Election result, the weaker external environment severely limits potential upside movement in Bank Rate, while the slowing UK economy will place pressure on the MPC to loosen monetary policy. Indeed, two MPC members voted for an immediate cut in November 2019.
17. Globally, the European Central Bank cut its deposit rate by 10 basis points in September 2019 alongside announcing another round of stimulus, which was closely followed by a 25 basis points cut by the US Federal Reserve.

#### *Credit outlook*

18. Credit Default Swap (CDS) spreads rose and then fell again during the second quarter of the financial year and have continued to fall since, remaining low in historical terms. After rising to almost 120bps in May, the spread on non-ringfenced bank NatWest Markets plc fell back to around 62bps by November, while for the ringfenced entity, National Westminster Bank plc, the spread was around 33bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 34 and 76bps at the end of September.
19. There were minimal credit rating changes during the period. Moody's upgraded The Co-operative Bank's long-term rating to B3 and Fitch upgraded Clydesdale Bank and Virgin Money to A-.

#### *Interest rate forecast*

20. Following the increase in Bank Rate to 0.75% in August 2018, the County Council's treasury management adviser, Arlingclose, is forecasting that rates stay at this level for the foreseeable future. The BoE's MPC predicts some modest tightening of policy, at a gradual pace and to a limited extent, may be needed to maintain inflation sustainably at the target. Arlingclose believes that MPC members consider both that ultra-low interest rates result in other economic problems, and that higher Bank Rate will be a more effective policy weapon should downside Brexit risks crystallise when rate cuts will be required.
21. The UK economic environment remains relatively soft, despite seemingly strong labour market data. Arlingclose's view is that the economy still faces a challenging outlook as it exits the EU and Eurozone growth softens. Whilst assumptions are that a Brexit deal is struck and some agreement reached on transition and future trading arrangements before the UK leaves the EU, the possibility of a "no deal" Brexit still hangs over economic activity. As such, the risks to the interest rate forecast are considered firmly to the downside.

#### *Negative interest rates*

22. If the UK enters into recession in 2020/21, there is a small chance that the BoE could cut 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.

### **Performance of cash investments**

23. The Pension Fund's cash investment holding was £229.4m as at 30 November 2019 which represents around 3% of the Pension Fund's total value. The current cash balance is significantly higher than last year as, based on Pension Fund Panel and Board's approval of recommendations from Hymans Robertson to reduce the exposure to equities from funds that are intended to be invested in illiquid investments, amounts are currently being held as cash and asset-backed securities ahead of re-investment. To allow for this temporary increase of cash balances, higher cash limits were approved by the Pension Fund Panel and Board on 27 September 2019 along with the recommendation that £260m should be invested in cash on a one-off basis.
24. It is expected that during the next year the Pension Fund's cash balances will initially remain high, as it will take some time for the full re-allocation of cash to be invested. As agreed by the Panel and Board the Fund's cash holding will be reduced back down once this has been completed, but be higher than previous levels as cash will include the next 3 months of commitments for illiquid investments plus funds to cover operational requirements.
25. 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 Cash Investment Strategy for 2019/20, which was approved by the Pension Fund Panel at its meeting in December 2018. A full breakdown of current investments is provided in the exempt appendix.
26. 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.
27. As at 30 November 2019 the weighted average return on the Pension Fund's cash investments was 0.73%, which should be considered within the context of a UK Base Rate of 0.75%.

### **Annual Cash Investment Strategy**

28. In the past 12 months, the Pension Fund's cash investment balance has ranged between £27.7m and £258.1m.
29. The following Annual Cash Investment Strategy, for the period to 31 March 2021 has been prepared with the advice of the County Council's treasury management advisers, Arlingclose.

30. 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*

31. 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.
32. 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*

33. 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, reports in the quality financial press and analysis and advice from the County Council's treasury management adviser. No investments will be made with an organisation if there are substantial doubts about its credit quality, even though it may otherwise meet the credit rating criteria.
34. 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*

35. 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. As mentioned in paragraph 24, cash balances

are expected to remain high due to large Equity redemptions. As a result, changes have been made to the cash limits to allow this cash to be invested according to Arlingclose's advice. It is expected that lower cash limits will be reinstated in the Fund's annual cash investment strategy for 2021/22.

36. The limits below apply to the cash received into the Pension Fund's bank account that is managed internally by officers. Where cash is retained by the Fund's investment managers, a limit of 5% held in cash is specified in their investment management agreements to ensure they are fully invested in their particular investment class and to manage the risks from cash investment.
37. 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**

	<b>Cash limit</b>	<b>Maximum Term</b>
Any single organisation, except the UK Central Government	£30m each	2 years
UK Central Government	Unlimited	2 years
Any group of organisations under the same ownership	£30m per group	2 years
Any group of pooled funds under the same management	£25m per manager	2 years
Money Market Funds	50% in total	Overnight

38. From April 2020 employers have the option to pay their employers' pension contributions in advance for one or three years and a window will shortly be open for them to confirm whether they want to do this. The deadline when the Pension Fund will know the amounts to be received is 31 January 2019. Early estimates are that this could be up to £300m which could be held for a brief period before being invested in line with the Investment Strategy. In order to allow for this temporary increase in the Pension Fund cash balances, interim limits, as shown in Table 2, below will invoked. Pension Fund officers will confirm with the Director of Corporate Resources when these interim limits apply and when they return to the limits in Table 1 above:

**Table 2: Investment Limits (special circumstances)**

	<b>Cash limit</b>	<b>Maximum Term</b>
Any single organisation, except the UK	£100m each	2 years

Central Government		
UK Central Government	Unlimited	2 years
Any group of organisations under the same ownership	£100m per group	2 years
Any group of pooled funds under the same management	£80m per manager	2 years
Money Market Funds	50% in total	Overnight

#### *Approved Investment Counterparties and Limits*

39. 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 County Council's treasury management advisers, Arlingclose, in order to place cash on deposit, within the limits shown in Appendix 1.

#### *Liquidity Management*

40. 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.

#### **Other items**

##### *Investment Training*

41. 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.
42. 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.
43. 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 22 November 2019, which gave an update on treasury matters. Another workshop is planned for November 2020.

*Investment Advisers*

44. 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.

*Markets in Financial Instruments Directive*

45. The Pension Fund has opted up to professional client status with its providers of financial services, including advisers, brokers and fund managers allowing it access to a greater range of services, but without the greater regulatory protections afforded to individuals and small companies. As a Local Government Pension Scheme, this is the most appropriate status.



**CORPORATE OR LEGAL INFORMATION:****Links to the Strategic Plan**

<b>Hampshire maintains strong and sustainable economic growth and prosperity:</b>	No
<b>People in Hampshire live safe, healthy and independent lives:</b>	No
<b>People in Hampshire enjoy a rich and diverse environment:</b>	No
<b>People in Hampshire enjoy being part of strong, inclusive communities:</b>	No
<b>OR</b>	
<b>This proposal does not link to the Strategic Plan but, nevertheless, requires a decision because of the ongoing need to manage the Hampshire Pension Fund's cash.</b>	

**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

## **EQUALITIES IMPACT ASSESSMENTS:**

### **1. Equality Duty**

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 by or under the Act with regard to the protected characteristics as set out in section 4 of the Act (age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation);
- Advance equality of opportunity between persons who share a relevant protected characteristic within section 149(7) of the Act (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, sex and sexual orientation) and those who do not share it;
- Foster good relations between persons who share a relevant protected characteristic within section 149(7) of the Act (see above) and persons who do not share it.

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

- The need to remove or minimise disadvantages suffered by persons sharing a relevant protected characteristic that are connected to that characteristic;
- Take steps to meet the needs of persons sharing a relevant protected characteristic that are different from the needs of persons who do not share it;
- Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity in which participation by such persons is disproportionately low.

### **2. Equalities Impact Assessment:**

Equality objectives are not considered to be adversely affected by the proposals in this report as the proposals do not directly affect scheme members.

## 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	£25m 2 years	£30m 2 years	£30m 2 years	£25m 2 years
AA+	£25m 2 years	£30m 2 years	£30m 2 years	£25m 2 years
AA	£25m 2 years	£30m 2 years	£30m 2 years	£25m 2 years
AA-	£25m 2 years	£30m 2 years	£30m 2 years	£25m 2 years
A+	£25m 2 years	£30m 2 years	£25m 2 years	£25m 2 years
A	£25m 13 months	£30m 2 years	£25m 2 years	£25m 2 years
A-	£25m 6 months	£30m 13 months	£25m 2 years	£25m 13 months
None	£1m 6 months	n/a	£25m 2 years	n/a
Pooled funds	£25m 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 a selection of external rating agencies. 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. See below for arrangements relating to operational bank accounts

## **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 generally a lower risk of insolvency, although they are not zero risk. 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 or units 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. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility 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.

## **Operational bank accounts**

The Pension Fund may incur operational exposures, for example through current accounts, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments but are still subject to the risk of a bank bail-in and balances will therefore be kept low. The Pension Fund's operational bank account is with National Westminster and aims to keep the overnight balances held in current accounts as close as possible to £0. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Pension Fund maintaining operational continuity.

**List of UK and non-UK banks and building societies**

<b>Country / Domicile</b>	<b>Counterparty</b>	<b>Maximum investment</b>	<b>Maximum duration</b>
UK	Barclays Bank PLC / Barclays Bank UK PLC	£25m	100 days
UK	Close Brothers Limited	£25m	100 days
UK	Goldman Sachs International Bank	£25m	100 days
UK	HSBC Bank PLC / HSBC UK Bank PLC	£25m	6 months
UK	Leeds Building Society	£25m	100 days
UK	Lloyds Bank PLC / Bank of Scotland PLC	£25m	6 months
UK	National Westminster Bank PLC / Royal Bank of Scotland PLC / Ulster Bank Limited	£25m	100 days
UK	Nationwide Building Society	£25m	6 months
UK	Santander UK PLC	£25m	6 months
UK	Standard Chartered Bank	£25m	6 months
Australia	Australia & New Zealand Banking Group	£25m	6 months
Australia	Commonwealth Bank of Australia	£25m	6 months
Australia	National Australia Bank	£25m	100 days
Australia	Westpac Banking Group	£25m	6 months
Canada	Bank of Montreal	£25m	6 months
Canada	Bank of Nova Scotia	£25m	6 months
Canada	Canadian Imperial Bank of Commerce	£25m	6 months
Canada	Royal Bank of Canada	£25m	6 months
Canada	Toronto Dominion Bank	£25m	6 months
Denmark	Danske Bank	£25m	100 days
Finland	OP Corporate Bank	£25m	6 months
Germany	Bayerische Landesbank (BayernLB)	£25m	6 months
Germany	DZ Bank AG Deutsche Zentral	£25m	6 months
Germany	Landesbank Baden-Wuerttemberg (LBBW)	£25m	6 months
Germany	Landesbank Hessen-Thuringen (Helaba)	£25m	6 months
Netherlands	Cooperative Rabobank	£25m	6 months
Netherlands	ING Bank	£25m	100 days
Singapore	DBS Bank Ltd	£25m	6 months
Singapore	Oversea-Chinese Banking Corporation	£25m	6 months
Singapore	United Overseas Bank	£25m	6 months
Sweden	Nordea Bank ABP	£25m	6 months
Sweden	Svenska Handelsbanken	£25m	6 months
Switzerland	Credit Suisse	£25m	100 days

\* Please note that the counterparties listed above meet the Fund's minimum credit rating criteria as at 1 December 2019, 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.