HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Hampshire Pension Fund Panel and Board
Date:	4 December 2020
Title:	Investments: Pension Fund Cash Monitoring Report and Annual Cash Investment Strategy 2021/22
Report From:	Deputy Chief Executive and 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 2020/21 to 31 October 2020 and recommends the Annual Cash Investment Strategy for 2021/22.

Recommendations

2. That the Annual Cash Investment Strategy for 2021/22 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 2020/21.

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 2021/22, which is outlined in paragraphs 28 to 48 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, income from some of its investments as well as the potential inflows of cash from monthly rebalancing, all of which need to be managed.

9. Where the Pension Fund is invested 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, private debt 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 impact on the UK from the coronavirus pandemic, together with its exit from the European Union, will remain a major influence on the Pension Fund's cash investment strategy for 2021/22.

13. The Bank of England (BoE) maintained Bank Rate at 0.10% in November 2020 and also extended its Quantitative Easing programme by £150bn to £895bn. Within the latest forecasts, the BoE expects the UK economy to shrink -2% in Quarter 4 2020 before growing by 7.25% in 2021, lower than the previous forecast of 9%. The BoE also forecasts the economy will now take until Quarter 1 2022 to reach its pre-pandemic level rather than the end of 2021 as previously forecast.

14. UK Consumer Price Inflation (CPI) for September 2020 registered 0.5% year on year, up from 0.2% in the previous month, and core inflation rose to 1.3% from 0.9%. The most recent labour market data for the three months to August 2020 showed the unemployment rate rose to 4.5% while the employment rate fell to 75.6%. Both measures are expected to deteriorate further due to the ongoing impact of coronavirus on the jobs market, particularly when the various government job retention schemes start to be unwound in 2021, with the BoE forecasting unemployment will peak at 7.75% in Quarter 2 2021. In August 2020, the headline 3-month average annual growth rate for wages was 0.0% for total pay and 0.8% for regular pay. In real terms, after adjusting for inflation, total pay growth fell by -0.8% while regular pay was up 0.1%.

15. Gross Domestic Product (GDP) growth fell by -19.8% in the second quarter of 2020, a much sharper contraction from -2.0% in the previous three months,

with the annual rate falling -21.5% from -1.6%. Monthly GDP estimates have shown the economy is recovering but remains well below its pre-pandemic peak. Looking ahead, the BoE's November Monetary Policy Report forecasts economic growth will rise in 2021 with GDP reaching 11% in Quarter 4 2021.

Credit outlook

16. After spiking in late March as coronavirus became a global pandemic, credit default swap (CDS) prices for the larger UK banks have steadily fallen back to almost pre-pandemic levels. Although uncertainly around COVID-19 related loan defaults lead to banks provisioning billions for potential losses in the first half of 2020, drastically reducing profits, reported impairments for Quarter 3 were much reduced in some institutions. However, general bank profitability in 2020 is likely to be significantly lower than in previous years.

17. The credit ratings for many UK institutions were downgraded on the back of downgrades to the sovereign rating. However more generally credit conditions in banks and building societies have tended to be relatively benign, despite the impact of the pandemic.

18. Looking forward, the potential for bank losses is to be greater than expected when government and central bank support starts to be removed remains a risk, suggesting a cautious approach to bank deposits in 2021/22 remains advisable.

Interest rate forecast

19. The County Council's treasury management adviser Arlingclose is forecasting that BoE Bank Rate will remain at 0.1% until at least the end of 2023. The risks to this forecast are judged to be to the downside as the BoE and UK government continue to react to the coronavirus pandemic and the Brexit transition period ends. The BoE extended its asset purchase programme to £895 billion in November while keeping Bank Rate on hold. However, further interest rate cuts to zero, or possibly negative, cannot yet be ruled out but this is not part of the Arlingclose central forecast.

20. Gilt yields are expected to remain very low in the medium-term while short-term yields are likely remain below or at zero until such time as the BoE expressly rules out the chance of negative interest rates or growth and inflation prospects improve. The central case is for 10-year and 20-year to rise to around 0.5% and 0.75% respectively over the time horizon. The risks around the gilt yield forecasts are judged to be broadly balanced between upside and downside risks, but there will almost certainly be short-term volatility due to economic and political uncertainty and events.

Negative interest rates

21. The COVID-19 pandemic has increased the risk that the BoE will 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. Since investments cannot pay negative income, negative rates will be applied by reducing the value of

investments. 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

22. The Pension Fund’s cash investment holding was £179.9m as at 31 October 2020 which represents around 2% of the Pension Fund’s total value. The current cash balance is lower than last year’s cash balance as that included allocations held as cash ahead of re-investment, following the Panel and Board’s decision to reduce the Fund’s exposure to equities that were due to be invested in illiquid investments.

23. During 2020/21 the Panel and Board agreed to tactically use its cash balance to ensure that the Protection element, made up of cash and index linked gilts, was at least 22% of the Pension Fund’s total value to protect the Fund from the increased risk of an over-exposure to equities. This entails rebalancing the Fund on a monthly basis by selling UK passive equities (which are no longer part of the Pension Fund’s strategic asset allocation) for cash to top up the Protection element to 22%.

24. This has resulted in one redemption of £99.3m of passive equities to cash, which at the time increased cash balances by 89%. In all other months there has not been a requirement to rebalance as the total of cash and gilts equalled at least 22% of the Pension Fund.

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 2020/21, which was approved by the Pension Fund Panel at its meeting in December 2019. 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 31 October 2020 the weighted average return on the Pension Fund’s cash investments was 0.06%, which should be considered within the context of a UK Base Rate of 0.10%.

Annual cash investment strategy

28. In the past 12 months, the Pension Fund’s cash investment balance has ranged between £95.3m and £379.8m.

29. Balances may increase for a short period at the beginning of April 2021 as prepayments of one year’s employer contributions will be received as cash and then invested by the investment managers. At this stage the total value of

prepayments has not been confirmed, however on 1 April 2020 the Fund received £347m of prepaid employers contributions, of which £40m were for one year's contributions, with the remainder 3 years worth of contributions paid in advance.

30. It is expected that during 2021/22 balances will generally vary in accordance with the normal cashflow expectations as a result of contributions from employers and payments of pension, and the investment and returns of the property and alternative portfolios. As previously reported to the Panel and Board as a result of the significant amount of contributions received in advance, the Pension Fund expected an average monthly deficit from dealing with members of nearly £12m, before funding additional property and alternative investments. In the 7 months to the end of October 2020, the Pension Fund's running cash deficit was £23m greater than forecast. As expected this shows the Pension Fund has made net additions to property and alternative investments, which is in line with the Fund's investment strategy to build up to the allocations to these asset classes.

31. Cash balances may also increase as a result of the decision by the Panel and Board to maintain the Protection element of the Investment Strategy at a minimum of 22%. It is unclear how economic markets will fair over 2021/22, and how gilts will perform in comparison to equities, and therefore there could potentially be very large redemptions from passive equities to cash to rebalance the Protection element of the Fund, but there may also be no requirement to rebalance.

32. The following Annual Cash Investment Strategy, for the period to 31 March 2022, has been prepared with the advice of the County Council's treasury management advisers, Arlingclose.

33. 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

34. 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.

35. 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

36. 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.

37. When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2020, 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

38. The limits below apply to the cash received into the Pension Fund's bank account that is managed internally by officers.

39. Cash limits have been increased in comparison to the 2020/21 cash investment strategy to allow for the suitable investment of increased cash balances as a result of maintaining the Protection element of the Investment Strategy at 22%. It will depend on the relative value of index-linked gilts if this policy would result in cash balances significantly rising, however if it does and total cash balances reach 5% of the total value of the Pension Fund, further advice will be taken on this strategy.

40. On 1 April 2021 it is expected that some employers will choose to prepay one year's employer contributions; currently it is not clear what the total impact of this income will be on the cash balances, and so the limits in this cash investment strategy will be reviewed once there is further information available. It may be required that a set of temporary increased cash limits be agreed for a few days to allow the appropriate management of the higher balances as a result of the prepayment of employer contributions.

41. The County Council's treasury adviser, Arlingclose, has recently amended their advice to remove the portfolio upper limit of 50% on all Money Market Fund (MMF) investments.

42. Arlingclose originally introduced a sector limit on MMFs recognising that they all make similar underlying investments and therefore moving from 50% to 100% in MMFs may not increase underlying diversification.

43. However, MMFs are a key tool to manage credit and liquidity risks and in the current economic climate diversification into other sectors may increase risk, and Arlingclose therefore no longer advises a 50% limit.

44. As a result the Cash Investment Strategy for 2021/22 excludes the upper limit on all Money Market Fund investments in line with Arlingclose's advice. Investment balances will continue to be invested with as much diversification as possible within appropriate sectors to ensure that risk to principal balances is not increased as a result of this change.

45. A group of entities 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	£40m each	2 years
UK Central Government	Unlimited	2 years
Any group of organisations under the same ownership	£40m per group	2 years
Any group of pooled funds under the same management	£40m per manager	2 years

Approved investment counterparties and limits

46. 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 largely 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

47. 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.

48. The Pension Fund will spread its liquid cash over at least four providers (e.g. bank accounts and money market funds) to ensure that access to cash is maintained in the event of operational difficulties at any one provider.

Other items

Investment training

49. 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.

50. 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.

51. 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 8 December 2020, which will give an update on treasury matters. Another workshop is planned for November 2021.

Investment advisers

52. 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' staff and Arlingclose.

Markets in Financial Instruments Directive

53. 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

Hampshire maintains strong and sustainable economic growth and prosperity:	No
People in Hampshire live safe, healthy and independent lives:	No
People in Hampshire enjoy a rich and diverse environment:	No
People in Hampshire enjoy being part of strong, inclusive communities:	No
OR	
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.	

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	

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 disproportionally 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.

Treasury Investment Counterparties and Limits

Sector	Duration limit	Counterparty limit	Sector limit
The UK Government	2 years	Unlimited	N/A
Local authorities and other government entities	2 years	£40m	Unlimited
Secured investments*	2 years	£40m	Unlimited
Banks (unsecured)*	13 months	£25m	Unlimited
Building societies (unsecured)*	13 months	£25m	£40m
Registered providers (unsecured)*	2 years	£25m	£40m
Money market funds*	N/A	£40m	Unlimited
Strategic pooled funds	N/A	£40m	£100m
Real estate investment trusts	N/A	£40m	£40m
Other investments*	2 years	£25m	£40m

The table must be read in conjunction with the notes below

Minimum credit rating

Treasury investments in the sectors marked with an asterisk will only be made with entities whose lowest published long-term credit rating is no lower than A-. 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.

For entities without published credit ratings, investments may be made where external advice indicates the entity to be of similar credit quality.

Government

Loans to, and 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 Government are deemed to be zero credit risk due to its ability to create additional currency and therefore may be made in unlimited amounts for up to 2 years.

Secured investments

These investments are secured on the borrower's assets, which limits the potential losses in the event of insolvency. The amount and quality of the security will be a key factor in the investment decision. Covered bonds and reverse repurchase agreements with banks and building societies are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used. The combined secured and unsecured investments with any one counterparty will not exceed the cash limit for secured investments.

Banks and building societies (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

Registered providers (unsecured)

Loans to, and bonds issued or guaranteed by, registered providers of social housing or registered social landlords, formerly known as housing associations. These bodies are regulated by the Regulator of Social Housing (in England), the Scottish Housing Regulator, the Welsh Government and the Department for Communities (in Northern Ireland). As providers of public services, they retain the likelihood of receiving government support if needed.

Money market funds

Pooled funds that offer same-day or short notice liquidity and very low or no price volatility by investing in short-term money markets. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a small fee. Although no sector limit applies to money market funds, the Pension Fund will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.

Strategic pooled funds

Shares or units in diversified investment vehicles consisting of bond, equity and property investments. These funds offer enhanced returns over the longer term but are more volatile in the short term and allow the Pension Fund to diversify into asset classes other than cash without the need to own and manage the underlying investments. This sector also includes cash plus funds which are also a type of pooled fund, but are used for short-term funds, with a lower risk appetite. Because strategic pooled funds have no defined maturity date, but are available for withdrawal after a notice period; their performance and continued suitability in meeting the Pension Fund's investment objectives will be monitored regularly.

Real estate investment trusts (REITs)

Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties.

Other investments

This category covers treasury investments not listed above, for example unsecured corporate bonds and company loans. Non-bank companies cannot be bailed-in but can become insolvent placing the Pension Fund's investment at risk.

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

Country / Domicile	Counterparty	Maximum investment	Maximum duration
UK	Barclays Bank PLC / Barclays Bank UK PLC	£25m	35 days
UK	HSBC Bank PLC / HSBC UK Bank PLC	£25m	35 days
UK	Lloyds Bank PLC / Bank of Scotland PLC	£25m	35 days
UK	National Westminster Bank PLC / Royal Bank of Scotland PLC / Ulster Bank Limited	£25m	35 days
UK	Nationwide Building Society	£25m	35 days
UK	Santander UK PLC	£25m	35 days
UK	Standard Chartered Bank	£25m	35 days
Australia	Australia & New Zealand Banking Group	£25m	35 days
Australia	National Australia Bank	£25m	35 days
Finland	Nordea Bank	£25m	35 days
Germany	DZ Bank	£25m	35 days
Germany	Landesbank Baden-Wuerttemberg	£25m	35 days
Netherlands	Cooperative Rabobank	£25m	35 days
Singapore	DBS Bank Ltd	£25m	35 days

* Please note that the counterparties listed above meet the Fund's minimum credit rating criteria as at 23 November 2020, 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.