HERTFORDSHIRE COUNTY COUNCIL PENSIONS COMMITTEE TUESDAY, 7 MARCH 2017 AT 2:00PM	Agenda Item No: 6

TREASURY MANAGEMENT STRATEGY FOR PENSION FUND

Report of the Director of Resources

Author: Jolyon Adam, Finance Manager, Resources
(Telephone: 01992 555078)

1. Purpose of the Report

1.1 To propose the 2017/18 Treasury Management Strategy for the investment of Pension Fund cash held by the Administering Authority.

2. Summary

2.1 A treasury management strategy is prepared annually and approved by the Pensions Committee, to provide clarity about the management of these funds.

2.2 There is currently a cap of £35m for funds held by the Administering Authority for cashflow purposes. These funds are used to ensure that there is cash available for the payment of membership benefits and to fund cash drawdowns for the property and private equity Investment Managers. The Fund's benchmark allocation to cash is 1% of total pension fund assets.

2.3 This report sets out the proposed 2016/17 Treasury Management Strategy for the Pension Fund which would be effective from 1 April 2017. There are no changes in the proposed Strategy from the Strategy that was agreed by the Pensions Committee for 2016/17.

3. Recommendations

3.3 It is recommended that the Pensions Committee approves the proposed 2017/18 Treasury Management Strategy for lending Pension Fund cash which is set out in Appendix A.

4. Background

4.1 The updated LGPS (Management and Investment of Funds) Regulations 2016[1] still requires that Pension Fund cash managed by the Administering Authority be held in a separate bank account. A separate Pension Fund Treasury

[1] http://www.legislation.gov.uk/uksi/2016/946/contents/made

Management Strategy is prepared to provide clarity about the investment arrangements of Pension Fund cash managed by Officers of the Pension Fund.

4.2 The Pension Fund's treasury management strategy is based on the County Council's strategy which is revised and approved on an annual basis in accordance with CIPFA's Treasury Management in the Public Services: Code of Practice 2011 and CLG's guidance, "Guidance on Local Authority Investments". A more limited range of investment instruments are used by the Pension Fund to reflect that the funds are held to meet short term cash flow requirements only, such as the payment of pensions.

4.3 In accordance with the CLG Guidance, the Pensions Committee will be asked to approve a revised Treasury Management Strategy Statement, should the assumptions on which this report is based change significantly. Such circumstances would include, for example, a large unexpected change in interest rates.

4.4 As at January 2017 the Financial Conduct Authority is consulting on its third phase of implementing the Markets in Financial Instruments Directive (MiFID II). MiFID II is a package of EU legislation introduced in 2014 to regulate both retail and wholesale investment business. The draft proposals may significantly affect the ability for both Local Authorities and Pension Funds to carry out their Treasury Management Activities in their current form, and may require the Treasury Management Strategy to be revised.

5. Current Lending Position and Economic Context

5.1 Funds held by the Administering Authority are required for immediate cashflow requirements where the bulk of contribution income received each month funds pensions payroll. Therefore, funds are generally held in immediate access accounts, such as call accounts and Money Market Funds.

5.2 Table 1 provides an analysis of funds held by the Administering Authority at 31 December 2016.

Table 1 Funds held at 31 December 2016

Total Funds at 31 December 2016	Balance £000s	Interest Rate %
Analysed as:		
Barclays Bank Call Account	1,843	0.15%
Money Market Funds	14,141	0.24%

6. Proposed Treasury Management Strategy

6.1. The Fund's benchmark allocation to cash is 1% of the total Fund assets and it is suggested that the cap on cash held by the Administering Body be maintained in line with the 15/16 closing asset values. The Fund assets at the end of December 2016 were £4.1bn. Where there are surplus funds in excess of the £35m cap then it is proposed that these funds are distributed to Investment Managers in accordance with the Pension Fund's Investment Strategy. The Chief Financial Officer will authorise further distributions of funds to Investment Managers after taking advice from Mercer and following agreement by the Chair of the Pensions Committee. Any such distributions will be reported to the Pensions Committee at the next available meeting.

6.2. As with the County Council's treasury management strategy, the principal consideration when investing Pension Fund cash will be security and so the lending policy applied operationally by Officers may at times be more restrictive than the policy allows. The secondary consideration will be liquidity to ensure that there is always enough cash available to pay pension benefits and cash drawdowns for the property and private equity Investment Managers. Only once both of these factors are satisfied will yield be considered.

6.3. If the UK enters into a recession in 2017/19, there is a small change that the Bank of England could 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. 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 initially invested.

6.4. The Pensions Fund's treasury strategy sets lower limits and a narrower range of financial institutions and instruments than the County Council's treasury strategy to reflect the lower balances held by the Pension Fund as illustrated in Table 1, that these are held for the short term, and that they are held principally for liquidity to facilitate payment of benefits.

6.5. The proposed 2017/18 Treasury Management Strategy has considered a full range of risks and Officers will apply the Strategy to ensure that security of deposits is the prime consideration. However, in agreeing the proposed Strategy, Members should be aware that there is always a risk of default of counterparties other than the Debt Management Office which is guaranteed by the government.

6.6. Information on treasury management performance will continue to be provided on a quarterly basis to the Pensions Committee.

APPENDIX A: PROPOSED TREASURY MANAGEMENT LENDING POLICY 2017/18

1. Policy for determining which institutions should be on the lending list

1.1 The Pension Fund cash will be lent to the following types of institutions:

- Central Government
- Local Authorities
- UK Banks and Building Societies meeting the credit rating criteria set out in Table A
- Banks domiciled in other countries or their subsidiaries domiciled in the UK, providing the country has a sovereign rating of at least AA+ from each of the three credit rating agencies and the bank meets the credit rating criteria set out below. If the ratings of a parent bank fall below the minimum criteria, no lending will be undertaken with its subsidiaries even if their ratings continue to meet the minimum criteria (excepting Santander UK plc and Clydesdale Bank plc - see notes on overseas banks following Table A)
- Supranational banks (e.g. the European Investment Bank and the World Bank).
- Money Market Funds
- The Pension Fund's bank. If it does not meet the criteria for UK Banks then the Bank will be used for small balances up to £1m.

1.2 The Pension Fund will make investments using the following types of financial instruments. See sections 1.8 to 1.10 for further information on these investments.

- Call and notice accounts
- Fixed Term deposits
- Money Market Funds

1.3 The Pension Fund will apply the credit rating criteria set out in Table A for investments with UK Government, Local Authorities and unsecured investments with Banks and Building Societies and other institutions based on Fitch's long term credit rating criteria.

Table A Minimum credit rating criteria

Counterparty	Limits		
	Long term	Time	£
Sovereign (country) rating	AA+	N/A	N/A
UK Government	N/A	364 days	Unlimited
UK Local Authorities	N/A	364 days	£3.5m
Standalone Banks	A-	364 days	£3.5m
Rated Building Societies	A-	364 days	£3.5m
Supranational Banks	AA+	364 days	£3.5m
Money Market Funds	N/A	7 days notice	£7m
	Asset Value		
Unrated Building Societies	£1.0bn	6 months	£1.75m
	£0.5bn	3 months	£1.75m

1.4 Credit Ratings

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 issued, otherwise the counterparty credit rating is used. If an agency removes one of the set of ratings it issues for a bank or building society, the institution will be removed from the list. Table B provides a comparison of long term credit ratings for all agencies.

Table B Comparison of credit ratings for all agencies providing ratings

Fitch	Moody's	S&P	Definition
AAA	Aaa	AAA	Prime
AA+	Aa1	AA+	High Grade High Quality
AA	Aa2	AA	
AA-	Aa3	AA-	
A+	A1	A+	Upper Medium Grade
A	A2	A	
A-	A3	A-	
BBB+	Baa1	BBB+	Adequate Grade
BBB	Baa2	BBB	
BBB-	Baa3	BBB-	

1.5 The Pension Fund will continue to invest in UK institutions, e.g. banks, central government and MMF, even if the UK was not rated AA+.

1.6 Overseas subsidiaries of foreign banking groups will normally be assessed according to the country of domicile of the parent organisation. For the avoidance of doubt, Santander UK plc (a subsidiary of Spain's Banco Santander) will be classed as a UK bank due to their substantial UK franchises and the arms-length nature of the parent-subsidiary relationship.

1.7 Sovereign credit rating criteria will not apply to investments in multilateral development banks (e.g. the European Investment Bank and the World Bank) or other supranational organisations.

1.8 Banks Unsecured

This relates to 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 investment with banks rated BBB or BBB- are restricted to overnight deposits at the Pension Fund's bank, Barclays Bank plc.

1.9 Government

Investments in this category are 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.

1.10 **Money Market Funds (Pooled Funds)**
These are shares in diversified investment vehicles consisting of any of the investment types above, plus equity shares and property. These funds provide wide investment risk diversification, 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.

2. Policy for determining limits for deposits

Table C and the following notes in this section set out the limits to be applied on investments in addition to the investment counterparty limits shown in Table A.

Table C: Limits on Investments

Type	Description	Limit
Cap	The maximum amount of cash to be held and invested by the Administering Authority	£35 m
Maximum Transaction Value	The maximum deposit size when placing funds for fixed terms in order to spread risk. The only exceptions to this are deposits with the DMADF and Money Market Funds.	£3.5 m
Fixed Term Deposits	The maximum amount as a single transaction when placing fixed term deposits. The only exceptions to this are deposits with the DMADF and movements in and out of call accounts and pooled funds.	£3.5 m per transaction
Banking Groups	A group limit will apply where a number of banks are owned by a single institution.	£7 m per Group
Money Market Funds	Total investment in any one Money Market Fund	£7m per Fund
Money Market Fund Groups	A group limit will apply where a number of Money Market Funds are owned by a single institution.	£7 m per Group
UK Country Limit	Maximum percentage of portfolio permitted to be in UK institutions	100% investment portfolio
Non-UK Country Limit	Maximum percentage of portfolio permitted to be in non-UK institutions (excluding Money Market Funds)	40% investment portfolio
Single Non-UK Country	Maximum percentage of portfolio permitted to be in any one country, other than UK	10% of investment portfolio
Sector	A sector limit applies to unsecured investments in Building Societies to limit exposure to a common risk factor – in this case the property market	40% investment portfolio

3 Policy to be followed when credit ratings change

3.1 Negative Watch
A status that credit rating agencies apply while they are deciding whether to lower that organisation's credit rating.

- If an institution is on negative rating watch the Council will treat it as one credit rating lower than it is currently rated.
- If an institution is at the bottom of the Council's credit rating criteria and is placed on negative watch, the Council will stop investing and attempt to call back any money which is currently invested, depending on the economic viability of withdrawing the investment.

This policy does not apply to a negative outlook on a credit rating. In the case of a negative outlook any investment decision will be considered in line with all other information available but will not prompt immediate action to review existing investments.

3.2 Downgrading

- If an institution is downgraded below the minimum credit rating criteria, then it will be removed from the list with immediate effect, along with any subsidiaries, and no new investments will be made.
- If funds are on call with an institution when a downgrade happens, they will be withdrawn or the balance reduced as appropriate, at the earliest possible opportunity, which may be the following working day.
- If there are outstanding fixed term deposits with an institution which has been removed from the list, terms for repayment will be sought and, if offered, fully considered and documented by Officers.
- Downgradings and the action taken will be reported in the weekly treasury management meetings and quarterly reports to members.

4 Other matters to be considered by Officers

4.1 In applying the policy set out above, Officers will refer to the following sources of market information on a regular basis:

- Credit Default Swap Rates
- Equity Prices
- Economic data
- Financial statements
- Outlook reports from credit agencies
- Financial Times and other news sources
- Professional journals and other publications

4.2 A regular briefing will be provided for all Officers involved in the dealing function, the Head of Specialist Accounting and/or the Assistant Director of Finance. This will provide all relevant information to enable decisions to be taken about treasury activity to ensure this remains within the policy. By its very nature the information will not be definitive and Officers will do all they can to react to these sources of information with the primary objective of security. The briefings will generally be delivered via weekly meetings. If for any reason, a meeting cannot be convened, then all relevant information will be circulated to Officers and the Assistant Director of Finance.

4.3 Officers maintain an overview of prevailing market rates in their regular contact with brokers. When considering fixed term deposits, Officers will consider quotes from brokers for a range of periods before making decisions.