Local Members Interest	
NIL	

PENSIONS PANEL – 6 MARCH 2018

Report of the Director of Finance and Resources

Annual Investment Strategy for Pension Fund Cash 2018/19

Recommendation of the Chairman

1. That the Pensions Panel approves the Staffordshire Pension Fund's ('the Pension Fund'), Annual Investment Strategy (AIS) for the investment of internally managed Pension Fund cash.

Reasons for Recommendations

2. In previous years, administering authorities were required to formulate a policy for the investment of Pension Fund cash by the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009; as a result the Pension Fund produced a separate AIS for its cash balances. The recently introduced 2016 regulations, infer policies for Pension Fund cash should form part of the Investment Strategy Statement (ISS). However, the Pension Fund considers it good practice to continue preparing a separate AIS for cash balances; making reference to it within the ISS.

3. The AIS for the Pension Fund is prepared on the same principles as the AIS for Staffordshire County Council, which follows the Chartered Institute of Public Finance & Accountancy (CIPFA) Treasury Management Code and the Department for Communities and Local Government - Guidance on Local Government Investments.

4. An updated CIPFA Treasury Management Code and Ministry of Housing, Communities and Local Government – Guidance on Local Government Investments, have recently been published. Changes within are attempting to bring a greater commercial focus to local authority investments but this will have no direct effect on the Pension Fund's AIS.

Background

5. The Pension Fund has a small strategic asset allocation to cash of 1%, recognising that cash balances are needed for the day to day management of the Pension Fund. This cash is managed by Officers in the County Council's Treasury and Pension Fund Team, to provide liquidity and pay bills as they arise. It is not invested solely to seek a return and is not usually considered a major asset allocation decision.

6. The cash does increase from time to time, pending investment in other major asset classes e.g. property and private debt. The proposed AIS will therefore need to allow for such situations occurring. The Pensions Panel will need to agree these temporary increases as part of its quarterly review of the strategic asset allocation benchmark, together with any associated ranges.

7. The AIS does not deal with the segregated, relatively small cash balances held by the custodian (Northern Trust) under the control of the investment managers or with cash arising from occasional transitional activity. Overnight, Northern Trust sweep funds into their "AAA" rated Money Market Funds (MMF's). Nor does the AIS deal with small working cash balances held by the Fund's property manager (Colliers), which are required for the efficient working of this part of the Fund's investment portfolio.

AIS for Pension Fund Cash 2018/19

Objectives of investment

8. The proposed main objectives for the AIS are to;
   - provide security of capital (i.e. ensure the return of the money and interest)
   - provide liquidity (i.e. pay the bills as they fall due and ensure funds are available for reinvestment when needed)
   - earn interest (i.e. obtain a reasonable return within the constraints outlined at a) and b)).

9. The 1% allocation to cash will by its nature need to be kept short-term. To accommodate balances exceeding this allocation, the investment limit for existing cash investment counterparties may need to be increased temporarily. If balances are higher longer-term, pending investment in other asset classes, investments may need to be considered that recognise their longer-term nature. It is anticipated that initially, any longer term requirements will be fulfilled through the use of 'cash plus or short bond funds' (see **paragraph 26**).

10. To allow for the practical management of the treasury transactions each day, it is proposed that the change in investment limits and the choice over the investments made is delegated to the Director of Finance and Resources Outside of this, the Pensions Panel will need to assess any specific requirements and consider any changes that may be required to the AIS.

11. Cash balances have been high throughout 2017/18 due to time lags between capital being committed and funds being drawn down e.g. to private debt funds. Also during 2017/18, tactical disinvestments from equities were made when valuations were high; the proceeds from these are still being held in cash pending reinvestment. As a result of these relatively high cash balances, the Director of Finance and Resources authorised the increase in the investment limits for individual MMF's (including cash plus funds) to £40m during the year and these increased limits are still in effect.

Credit Rating Criteria and the Approved Lending List (the List)

12. Current government regulations state that local authorities have to decide how they define a ‘high credit rated’ counterparty (i.e. a bank or a building society). In the past, the Fund has relied on advice and creditworthiness services from Treasury Management Advisors such as Arlingclose, who were originally appointed by the County Council in 2013.

13. Changes in legislation in recent years have made investing with banks and building societies more risky for local authorities, and for the Pension Fund which is classified as a local authority under regulations. In January 2015, the UK implemented the Bank Recovery and Resolution Directive (BRRD) which ensures EU Member States are consistent in how they deal with the failure of banks and investment firms; instead of a government “bail out” of a bank, a “bail in” of current investors will be forced upon the bank by regulators. The risk of loss for local authorities in a bail-in situation is much greater, as any unsecured fixed-term deposits would be ranked near the bottom of the capital structure and would be one of the first to suffer losses.

14. New Ring-fencing legislation is to be adopted by the UK’s largest banks before the end of 2018/19, with the effect on the creditworthiness of these banks as yet unclear. UK financial regulators require these banks to separate their core retail banking activity from the rest of their business i.e. investment banking. The aim of this legislation is to protect retail banking activity from unrelated risks elsewhere in the banking group, such as those that occurred during the global financial crisis.

15. Under normal circumstances where the Pension Fund is fully invested, there is forecast to be a low level of cash, and it is considered unlikely that the Pension Fund will need to enter into a large number of term deposits with banks or building societies, thus reducing the risk of “bail in”. This means a simplified AIS consisting of the three following elements, and acknowledging the ‘high credit rating’ concept, can still be implemented for 2018/19.

(i) Regulation Investments

16. Current government regulations specify the type of financial instruments that can be used and they divide them into ‘specified’ and ‘non-specified’ investments.

17. Specified investments are investments made in sterling for a period of less than a year that are invested with:

- the UK Government;
- a local authority;
- a parish or community council (unlikely to be used by the Pension Fund); or
- a body, or in an investment instrument, that has a ‘high credit rating’.

18. The first three named investments can be used by the Pension Fund by virtue of their inclusion within the guidance; these are referred to as Regulation Investments in the remainder of this report. It is important to note that these classes of investment are not subject to “bail-in” risk as mentioned earlier in this report (**see paragraph 13**).

(ii) Money Market Funds (MMF’s)

19. MMF’s are pooled investment vehicles consisting of money market deposits and similar instruments. MMF’s have been used for some time by the Pension Fund and by Northern Trust as stated earlier. They are also widely used by other public and private sector bodies.

20. MMF’s proposed for use by the Pension Fund would be ‘AAA’ rated, the highest possible credit rating and they would have the following attributes:

- Diversified – MMF’s are diversified across many different investments, far more than the Pension Fund could hope to achieve on its own account.
- Same day liquidity – this means that funds can be accessed on a daily basis.
- Ring-fenced assets – the investments are owned by the investors and not the fund management company.
- Custodian – the investments are also managed by an independent custodian, who operates at arms-length from the fund management company.

21. New EU regulations for MMF’s were approved and published in July 2017 and existing funds will need to be compliant by January 2019. It is expected that most short term MMF’s will convert from a Constant Net Asset Value (CNAV) to a Low Volatility Net Asset Value (LVNAV) structure.

22. The assets of LVNAV MMF’s are marked to market, meaning the dealing NAV (unit price) may fluctuate. However the new regulations allow for a constant dealing NAV to be maintained, provided the MMF meets strict new criteria and minimum liquidity requirements. Public debt CNAV MMF’s will still be available where 99.5% of assets are invested in government debt instruments.

23. All treasury activity carries an element of risk and MMF’s are no different. In the event of a further financial crisis, the failure of one or more of an MMF’s investments could lead to a run on the MMF as investors rush to redeem their investment. This could then spread to other MMF’s as investors take flight from this asset class.

24. The very low interest rate environment could threaten the ongoing continuity of MMFs. Each MMF charges a fee and this could mean that interest earned becomes negative after its deduction. If this problem arises then it would be a matter of moving funds to an alternative category of investment. This threat has receded to some degree with the rise in Bank Rate in November 2017.

25. MMF’s as described in these paragraphs are judged to meet the criteria of an instrument that meets the definition of a ‘high credit rating’. Providing daily liquidity, the Pension Fund currently has accounts open with 5 MMF’s.

26. Additionally, the Pension Fund invests in 2 ‘cash plus’ MMF’s. ‘Cash plus and short bond’ funds provide a useful longer term option to investments in same day notice MMF’s. Whilst they are considered to be slightly higher risk and do not have daily liquidity, they can enhance investment returns and provide diversification away from very short term investments. An investment period of at least six months is generally recommended. It is proposed to delegate the decision on the further use of ‘cash plus and short bond’ funds to the Director of Finance and Resources, after taking appropriate advice.

(iii) The Pension Fund’s Banker

27. Relatively low levels of cash will be retained with Lloyds Bank each night earning interest at a market rate and in line with the current lending list (Appendix 2). It is important to note that funds are available daily and are not committed for any period of time.

Investment Diversification

28. In order to ensure diversification, it is proposed that under normal circumstances, the maximum investment limit for AAA rated diversified MMF’s which are, by default, already invested across a larger number of counterparties, is the lower of 50% of total cash or £30m, per MMF. Cash plus and short bond funds will also be subject to these limits. This approach is considered reasonable for the Pension Fund’s risk profile; taking into account that cash is only one asset class and the Pension Fund already has diversification across other asset classes. However, as stated in **paragraph 10**, temporary increases in cash balances currently dictate higher MMF limits.

29. To allow the practical management of the treasury transactions each day, it is proposed that the choice over the investments made is delegated to the Director of Finance and Resources.

Investment duration

30. The investment arrangements set-out in this report are of short duration; with the exception of cash plus or short bond funds (which require 3 days’ notice), investments in an MMF or with the Pension Fund’s banker are liquid and available at one days notice. Other regulation investments may be invested for up to 12 months but more typically will be for periods of less than six months.

31. The Pension Fund’s Approved Lending List is shown at **Appendix 2**. The maximum recommended investment duration for 2018/19 works within the definition of a specified investment which is to not invest for more than a year.

Risk

32. Cash is only a small part of the overall investments of the Pension Fund and the wider aspects of risk are taken into account in the ISS, where cash is shown to form a small part of the strategic asset allocation.

33. Looking at cash in isolation, treasury management usually recognises that the two prime risk areas are security and liquidity. It is considered that focussing primarily on these two risks is appropriate for the Pension Fund's relatively low 1% allocation to cash, for day to day cash management purposes; although the AIS has the flexibility to consider yield in the use of higher risk funds.

34. Should the Pensions Panel decide at some point in the future to make a higher strategic allocation to cash, where seeking a higher return would become more important, the balance of risk and reward would need to be revisited.

Review of Strategy

35. The main circumstances where a revised strategy would be prepared include a change in;

- the Fund's strategic asset allocation
- the economic environment
- the financial risk environment
- the regulatory environment.

36. Whilst the Pensions Panel will be responsible for approving any revised strategy, it may be necessary for action to be taken quickly. It is proposed, therefore, that the responsibility for assessing the circumstances above will rest with the Director of Finance and Resources.

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Appendix 1

Equalities implications: There are no equalities implications arising directly from this report.

Legal implications: There are no direct legal implications arising from this report.

Resource and Value for money implications: All resource and value for money implications are covered in the body of this report.

Risk implications: Risk is inherent in an AIS and is dealt with throughout the report.

Climate Change implications: There are no direct climate change implications arising from this report.

Health Impact Assessment Screening: There are no direct implications arising from this report

Appendix 2

PENSIONS PANEL – 6 MARCH 2018

Staffordshire Pension Fund
Approved Lending List

Lending List – March 2018	
	Time Limit
Regulation Investments ***(no maximum investment limit)***	
UK Government T-bills	6 months
UK Government Gilts	12 months
UK Local Authority	12 months
Banks	
Lloyds Bank (£5m maximum investment limit)	call only
Money Market Funds (MMFs) ***(maximum investment limit in each individual MMF is the lower of 50% of total cash or £30m)***	
Goldman Sachs	call only
J P Morgan	call only
Deutsche Bank	call only
Morgan Stanley	call only
Federated	call only
Standard Life Short Duration Cash Fund	3 days
Royal London Cash Plus Fund	3 days