Local Members Interest	
NIL	

PENSIONS PANEL – 5 MARCH 2019

Joint report of the Director of Corporate Services and Chief Financial Officer (S151)

Annual Investment Strategy for Pension Fund Cash 2019/20

Recommendation of the Chairman

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

Reasons for recommendations

2. 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 Fund produced a separate AIS for its cash balances. The more recent 2016 regulations, infer policies for Pension Fund cash should form part of the Investment Strategy Statement (ISS). However, the Fund considers it good practice to continue preparing a separate AIS for cash balances, with reference made to it within the ISS.

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

Background

4. The 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 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. The management of this cash will continue to remain with the Fund and will not be transferred to LGPS Central under the LGPS pooling agenda.

5. 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 also need

to review the strategic asset allocation benchmark to cash on a quarterly basis, together with any associated ranges.

6. The AIS does not deal with the segregated, relatively small cash balances held by the Fund's custodian (Northern Trust) or with cash arising from occasional transition activity. Overnight, Northern Trust sweep funds into their "AAA" rated Money Market Funds (MMF's). Also, the AIS does not deal with the small working cash balances held by the Fund's property manager (Colliers), which are required for the efficient management of this part of the Fund's investment portfolio.

AIS for Pension Fund Cash 2019/20

Objectives

7. The Fund's AIS requires it to invest cash prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The objective when investing cash is to strike an appropriate balance between risk and return, thereby minimising the risk of incurring losses from defaults but also taking into account the risk of receiving unsuitably low investment income.

8. 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. For the past couple of years, longer-term cash requirements have been fulfilled by using 'cash-plus' MMF's (see **paragraph 33**).

9. 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 Chief Financial Officer (S151), who chairs the SCC Treasury Management Panel. Outside of this, the Pensions Panel will need to assess any specific requirements and consider any changes that may be required to the AIS.

Credit Outlook

10. Changes in legislation in recent years have made investing with banks and building societies riskier for local authorities and for the Fund which is classified as a local authority under regulations. Under the Bank Recovery and Resolution Directive (BRRD) introduced in 2015, a failing bank will need to be 'bailed-in' by current investors instead of a 'bail out' by government. 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.

11. Ring-fencing legislation adopted by UK financial regulators has also affected the creditworthiness of the larger UK banks, as it has forced them to separate their core retail banking activity from the rest of their business i.e. investment banking. The aim is to protect retail banking activity from unrelated risks elsewhere in the banking group, as occurred during the global financial crisis. The big four UK banking groups - Barclays, HSBC, Lloyds and Royal Bank of Scotland - have now divided their retail and investment banking divisions into separate legal entities. Credit rating agencies have adjusted the ratings of some of these banks with the ringfenced banks generally being better rated than their non-ringfenced counterparts.

12. Brexit in the form of a 'no-deal' scenario is also seen as a risk to the UK financial system. The uncertainty caused by the protracted negotiations between the UK and EU is weighing on the creditworthiness for UK and European banks with substantial operations in both jurisdictions. Recent Bank of England stress tests provide some re-assurance and indicate the strongest UK banks could withstand a no-deal Brexit scenario. In November 2018, the Bank of England released the results of its latest stress tests on seven of the UK's largest banks and building societies. The Bank of England believe that the tests showed that the UK banking system will be resilient to deep recessions that are more severe than the recent global financial crisis.

13. Under normal circumstances where the Fund is fully invested, there is forecast to be a lower level of cash and it is considered unlikely that the Pension Fund will need to invest directly in banks or building societies, thus reducing the risks outlined above.

<u>Guidance</u>

14. MHCLG Guidance on Local Government Investments specify the types of financial instruments that local authorities can invest in. The Fund's AIS has followed SCC's AIS in dividing investments between Standard and Non-Standard Investment categories.

<u>Standard Investments</u>

15. These are investments that are made with approved counterparties and do not require further approval from the Chief Financial Officer (S151) as Chair of the Treasury Management Panel or Pensions Panel Members. These investments tend to be for a period of less than a year and are the most frequently used. In the case of the Pension Fund, standard investments are;
   - the UK Government – central government or local authority, parish council or community council;
   - short-term money market funds (MMFs) as per the criteria set out below; and
   - the Fund's banking provider – (currently Lloyds Bank)

(i) The UK Government

16. The Fund can invest in the UK Government by purchasing Treasury Bills (T-Bills) or short dated Gilts (Up to 1-year maturity in the case of Standard Investments). These are relatively secure, tradeable investments issued by the UK government, however returns tend to be lower than those received elsewhere.

17. The other source of government investment for the Fund is via deposits with other local authorities. These can provide a higher return than T-Bills and Gilts depending on the liquidity in the local authority lending market. Like central government investments, local government investments are not subject to bail in risk, although they are not completely without risk. The financial risks of a few local authorities have been documented in the press recently which the County Council's Treasury Management Panel continue to monitor.

(ii) Money Market Funds (MMF's)

18 Money Market Funds have high credit quality and are pooled investment vehicles consisting of money market deposits and similar instruments. Short-term MMFs that offer same day liquidity can be used as an alternative to instant access bank accounts. MMFs have been used by the Fund for some time as they have tended to provide greater security and a higher yield than bank accounts.

19. MMFs will need to be compliant with new EU regulations by 29 March 2019. It is expected that most short-term (same day notice) MMFs will convert from a Constant Net Asset Value (CNAV) to a Low Volatility Net Asset Value (LVNAV) structure.

20. The assets of LVNAV MMFs are marked to market, meaning the dealing NAV (unit price) may fluctuate. However, the new regulations confirm they will be allowed to maintain a constant dealing NAV provided they meet strict new criteria and minimum liquidity requirements. Public debt CNAV MMFs will also be available where 99.5% of assets are invested in government debt instruments.

21. The Fund will continue to consider short-term MMFs for investment. MMFs that meet the criteria listed below will be considered to have sufficient high credit quality and be included on the Fund's Approved Lending List (see **Appendix 2**):
    - Diversified – MMFs invest across many different investments meaning they achieve more diversification than the Fund could achieve on its own account;
    - Short-term liquidity – cash can be accessed daily;
    - Ring-fenced assets – the investments are owned by investors and not the fund management company; and

- Custodian – the investments are managed by an independent bank known as a custodian, who operates at arms-length from the fund management company.

22. Like all treasury instruments, MMFs do carry an element of risk:
    - The failure of one or more of an MMFs investments could lead to a run on MMFs, especially during a financial crisis, although the new MMF regulations do limit this risk to some extent; and
    - If the UK enters a recession, there is a possibility that the Bank Rate could be set to near or below zero. This could mean interest earned from MMFs could become negative after the deduction of their fee. In this instance, the Fund could move monies to an alternative investment category.

23. The Fund currently has accounts open with 4 short-term MMF's. Additionally, the Fund invests in 2 'cash-plus' MMF's, which are detailed in the Non-Standard Investments section at **paragraph 33**.

(iii) The Fund's banking provider

24. The Fund's current banking provider is Lloyds Bank. Cash is invested with Lloyds Bank each night earning interest at a market rate; the maximum amount retained is detailed in the Approved Lending List (**Appendix 2**).

25. In respect of the bank ring-fencing legislation referred to in **paragraph 11**, Lloyds Bank has a relatively small investment banking operation meaning that 97% of the bank's assets remain within the 'retail' ring-fence. The Fund's business with Lloyds Bank will take place within the 'retail' ring-fence (Lloyds Bank Plc) and not form part of their investment banking operations (Lloyds Bank Corporate Markets).

Standard Investment diversification and duration

26. To ensure diversification, it is proposed that under normal circumstances, the maximum investment limit for each category of Standard Investment is as below (also see **Appendix 2**).
    - Short-term MMF's – these by default are already invested across a large number of counterparties. The limit set reflects this, at the lower of 50% of total cash or £30m per MMF.
    - UK Government – this is the lowest risk of all investment categories, so the investment limit is unlimited.
    - The Fund's banking provider – recognising operational cash is required to be invested overnight with Lloyds Bank, a limit of £5m has been set.

27. The Standard Investment arrangements set-out in this report are of short duration; investments in a short-term MMF or with the Fund's banking provider are liquid and available on same day notice. Other Standard Investments may be invested for up to 12 months but will typically be for periods of less than six months.

28. To allow for the practical management of treasury transactions each day, it is proposed that the choice over investments made is delegated to the Chief Financial Officer (S151) as Chair of the Treasury Management Panel and Treasury & Pension Fund Officers.

29. The Fund's approved Lending List is shown at **Appendix 2**. The maximum recommended investment duration for 2019/20 works within the definition of a Standard Investment which is to not invest for more than a year.

Non-Standard Investments

30. The Fund considers Non-Standard Investments as all other types of approved investment counterparties that are not included as a Standard Investments i.e. those investments that are used less frequently for the Fund's cash allocation and require further approval.

31. The Non-Standard Investments proposed for use are listed below and do not present any additional security risk to the investments within the Standard Investments category:
    - Covered Bonds; issued by banks and building societies against mortgage assets and guaranteed by a separate group of companies. They are exempt from bail-in as their structure enables investors to have effective security over the mortgage assets, by being sold if needed.
    - Repos (Repurchase Agreements); comprise the purchase of securities with the agreement to sell them back at a higher price in the future. Investments are exchanged for assets such as government bonds, which can be sold in the case of a loss.
    - UK Government Gilts; as described in **Paragraph 16**, but with a maturity period of over 1 year.
    - Collective Investment Schemes; examples include property, equity and exchange traded funds (ETF's) which have different risk and return profiles to MMF's. Cash-plus MMF's are considered to be a collective investment scheme as they typically have a 3-5-day liquidity notice period.

32. Non-Standard Investments that are subject to market risk (this is the risk that the value of the investment can go down as well as up) would usually be held until maturity. At maturity the investment and accrued interest would be paid in full. However, some investments could be sold early if there were concerns over the borrower defaulting.

Current Non-Standard Investments

33. With the Fund having had higher cash balances in recent years, cash-plus MMF's have been invested in to enhance investment returns. Cash-plus MMF's are similar to short-term (same day) MMF's but typically have 3-5-day liquidity notice period, as they invest further along the yield curve. Cash-plus MMF's are usually structured as a variable net asset value (VNAV) MMF, where underlying assets are marked to market and the unit price fluctuates daily, hence a minimum 6-month investment period is recommended. The

current two cash-plus MMF’s invested in by the Fund are detailed in the Approved Lending List at **Appendix 2,** along with the investment limit.

34. The further use of Non-Standard investments, as detailed in **paragraph 31**, is proposed to be delegated to the Chief Financial Officer (S151), as Chair of the Treasury Management Panel.

Non-Standard Investment diversification

35. Diversification of Non-Standard Investments is equally important as it is with Standard Investments. The current Non-Standard cash-plus MMF investments have been treated comparably to short term MMF’s and given an investment limit of £30m each, as detailed in **Appendix 2**.

36. Any future Non-Standard Investments limits set will depend on the nature of the investment and the future forecast for Fund cash balances. Therefore, it is planned these would be judged on a case by case basis and delegated to the Chief Financial Officer (S151), as Chair of the Treasury Management Panel.

Risk

37. Cash is only a small component of the overall investments of the Fund and the wider aspects of risk are considered in the ISS, where cash is shown to form a small part of the Strategic Asset Allocation.

38. 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 Fund’s relatively low 1% allocation to cash, for day to day cash management purposes. However, the AIS does provide the flexibility to consider higher yields using Non-Standard Investments.

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

Review of Strategy

40. The main circumstances where a revised strategy would be prepared, include a significant change in;

- the Fund’s Strategic Asset Allocation
- the economic environment
- the financial risk environment
- the regulatory environment.

41. 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 Chief Financial Officer (S151), as chair of the Treasury Management Panel.

John Tradewell
Director of Corporate Services

Rob Salmon
Chief Financial Officer (S151)

Author's Name: Tim Byford
Senior Investment Accountant (Treasury and Pensions)

Telephone No. (01785) 278196

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 – 5 MARCH 2019

Staffordshire Pension Fund
Approved Lending List

Lending List – March 2019	
Standard Investments	**Time limit**
UK Government ***(no maximum investment limit)***	
UK Government T-bills	6 months
UK Government Gilts	12 months
UK Local Authorities	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
Morgan Stanley	call only
Federated	call only
Non-Standard Investments	**Time Limit**
Collective Investment Schemes ***(Cash-plus MMF's - maximum investment limit £30m)***	
Aberdeen Short Duration Fund	3 Days
Royal London Cash Plus Fund	3 Days