

Local Members Interest	
NIL	

PENSIONS PANEL – 7 MARCH 2023

Report of the Director of Finance

ANNUAL INVESTMENT STRATEGY FOR PENSION FUND CASH 2023/24

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 of Practice and the Ministry of Housing, Communities and Local Government's (now referred to as Department for Levelling up, Communities and Local Government - DLUHC) Guidance on Local Government Investments.

Background

4. The Fund has a small strategic asset allocation to cash of 1.0%, 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 Limited, under the LGPS pooling agenda.
5. Cash does increase from time to time, pending investment in other major asset classes e.g. property, infrastructure and private debt. The proposed AIS will therefore need to allow for such situations occurring. The Pensions Panel

will also need to review the Fund's 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 2023/24

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 1.0% 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 few years, longer-term cash requirements have been fulfilled by using 'cash-plus' MMF's (see **paragraph 31**).
9. To allow for the practical management of the treasury transactions each day, it is proposed that the change in operational investment limits and the choice over the investments made is delegated to the Director of Finance 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 there being 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, which is what occurred during the global financial crisis. 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. The credit ratings for many UK institutions were downgraded on the back of downgrades to the UK sovereign rating post Brexit. Credit conditions more generally though in banks and building societies have tended to be relatively benign, despite the impact of global geo-political factors. Looking forward, the potential for bank losses to be greater than expected remains a risk; the UK is potentially entering a recession, global economic factors are cause for concern and the ongoing war in Ukraine all suggest a cautious approach to bank deposits in 2023/24 remains advisable.
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.

Guidance

14. DLHUC Guidance on Local Government Investments specifies 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.

Standard Investments

15. These are operational investments that are made with approved counterparties and do not require further approval from the Director of Finance, as Chair of the Treasury Management Panel, or this Pensions Panel. 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 made with;
 - 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 well documented in the press over the last few years, so a maximum lending limit of £10 million per individual local authority has been imposed. In addition, any single investment transaction with a Local Authority is limited to £5 million meaning that in practice the £10 million limit must be made up of at least two separate investments. The County Council's Treasury Management Panel will continue to monitor the situation with regards local authority lending, taking advice from the County Council's treasury adviser where appropriate.

(ii) Money Market Funds (MMFs)

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. The Fund will continue to consider short-term MMFs for investment. MMFs that meet the criteria listed below will be considered to have sufficiently 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.
20. 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 reduce 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.
21. The Fund currently has accounts open with 5 short-term MMFs. Additionally, the Fund invests in 2 'cash-plus' MMFs, which are detailed in the Non-Standard Investments section at **paragraph 31**.

(iii) The Fund's banking provider

22. 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**).
23. 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' bank ring-fence. The Fund's business with Lloyds Bank is within the 'retail' bank ring-fence (Lloyds Bank Plc) and does not form part of their investment banking operations (Lloyds Bank Corporate Markets).

Standard Investment diversification and duration

24. To ensure diversification, it is proposed that under normal circumstances, the maximum investment limit for each category of Standard Investment is as follows (see also **Appendix 2**).
- Short-term MMFs – by default, these are already invested across a large number of counterparties. The limit set reflects this and is set at 100% of total cash and £40 million per MMF.
 - UK Government – this is the lowest risk of all investment categories, so the investment limit is unlimited in totality, but a maximum lending limit of £10 million per individual local authority has been introduced due to the concerns expressed in **paragraph 17**.
 - The Fund's banking provider – recognising operational cash is required to be invested overnight with Lloyds Bank, a limit of £10 million has been set.
25. 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 up to six months.
26. To allow for the practical management of operational treasury transactions each day, it is proposed that the choice over investments made is delegated to the Director of Finance as Chair of the Treasury Management Panel and Treasury & Pension Fund Officers. This can include the use of additional approved counterparties or changes to investment levels and limits in categories where conditions demand such, and the amount of cash available to invest fluctuates.
27. The Fund's approved Lending List is shown at **Appendix 2**. The maximum recommended investment duration for 2023/24 sits within the definition of a Standard Investment which is to not invest for more than a year.

Non-Standard Investments

28. The Fund considers Non-Standard Investments as all other types of approved investment, 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.

29. The Non-Standard Investments proposed for use are listed below. Typically, these 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, which can be 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 (ETFs) which have different risk and return profiles to MMFs. Cash-plus MMFs are considered to be a collective investment scheme as they typically have a 3-5-day liquidity notice period.
30. 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

31. With the Fund experiencing higher cash balances in recent years, cash-plus MMFs have been invested in to enhance investment returns. Cash-plus MMFs are similar to short-term (same day) MMFs but typically have 3-5-day liquidity notice periods as they invest further along the yield curve. Cash-plus MMFs 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 two cash-plus MMFs in which the Fund invests currently are detailed in the Approved Lending List at **Appendix 2**, along with their investment limit.
32. Decisions about any further use of Non-Standard investments, as detailed in **paragraph 31**, are delegated to the Director of Finance, as Chair of the Treasury Management Panel.

Non-Standard Investment diversification

33. 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 MMFs and given an investment limit of £40 million each, as detailed in **Appendix 2**.
34. Changes to Non-Standard Investments limits will depend on the nature of the investment and the future forecast for Fund cash balances. These will be

judged on a case by case basis and approval delegated to the Director of Finance, as Chair of the Treasury Management Panel.

Risk

35. 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 forms a small part of the Strategic Asset Allocation.
36. 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 1.0% 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.
37. 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

38. 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; and
 - the regulatory environment.
39. 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 that the responsibility for assessing the circumstances above and taking urgent action, remains with the County Treasurer (S151), as Chair of the Treasury Management Panel.

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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

PENSIONS PANEL – 7 MARCH 2023

Staffordshire Pension Fund
Approved Lending List

Lending List – March 2023	
Standard Investments	Time limit
<i>UK Government (no maximum investment limit)</i>	
UK Government T-bills	6 months
UK Government Gilts	12 months
UK Local Authorities (£10m maximum investment limit per Local Authority)	12 months
<i>Banks</i>	
Lloyds Bank (£10m maximum investment limit)	call only
<i>Money Market Funds (MMFs) (maximum investment limit in each individual MMF is the lower of 50% of total cash or £40m)</i>	
Goldman Sachs	call only
Aviva	call only
Morgan Stanley	call only
HSBC	call only
Federated	call only
Non-Standard Investments	Time Limit
<i>Collective Investment Schemes (Cash-plus MMF's - maximum investment limit £30m)</i>	
Aberdeen Short Duration Fund	3 Days
Royal London Cash Plus Fund	3 Days

