

Essex Pension Fund

Treasury Management Strategy for 2011/12

Pension Board 29 June 2011



Essex County Council

Introduction

The treasury management activities covered by this document are comprised of two separate areas:

Section A

- The day to day management of the Pension Fund's cash flows and associated short term cash investments known as ~~"County cash"~~ "In house cash". These activities are undertaken by Essex County Council on behalf of the Pension Fund under a service level agreement.

Section B

- The cash held and managed by the Global Custodian as part of the Fund's investment strategy

Longer term investments are administered separately by external fund managers and these activities are covered in the Pension Fund Statement of Investment Principles agreed by the Investment Steering Committee each year.

Section A – “County cash” “In House Cash” Treasury Management Arrangements

In undertaking the treasury management activities for the Essex Pension Fund, in the absence of any specific guidance on treasury management for Local Government Pension Scheme funds, Essex County Council will comply with the Treasury Management in the Public Services: Code of Practice and Cross-sectoral Guidance Notes (the Treasury Management Code) issued by the Chartered Institute of Public Finance and Accountancy (CIPFA).

A fundamental aim of treasury management is to effectively control the risks associated with treasury management activities and to pursue value for money, in so far as this is consistent with the effective management of risk.

The Treasury Management Code requires the following:

- A **Policy Statement** which states treasury management policies, objectives and approach to risk management.
- **Treasury Management Practices** (TMPs) which set out the manner in which the organisation will seek to achieve those policies and objectives, and prescribe how these activities will be managed and controlled.
- An annual **Treasury Management Strategy** that outlines the expected treasury activity. The strategy must define the organisation’s policies for managing its investments and for giving priority to the security and liquidity of those investments.

The Policy Statement and TMP's were updated and approved by the Board in March 2010. As no further changes or updates are considered necessary, neither have been reproduced in this report.

Treasury Management Strategy

The Treasury Management Strategy, which is set out in the subsequent paragraphs, includes:

- The expected movements in interest rates.
- Investment strategies.
- Treasury management performance indicators.
- Specific limits on treasury activities.

Interest Rates

An estimate of the movement in interest rates over the forthcoming three years is provided below :-

Expected movement in interest rates		2010-11 Actual	2011-12 Estimate	2012-13 Forecast	2013-14 Forecast
Bank Rate	%	0.5%	0.7%	1.6%	2.6%
Money rates					
3 month	%	0.6%	1.1%	2.1%	3.3%
1 year	%	1.4%	2.0%	3.1%	4.1%
Source:	Sector - June 2011				

~~Short term rates are expected to remain on hold for a considerable time. The recovery of the economy has commenced, but there is a danger that early reversal of monetary ease (rate cuts and Quantitative Easing (QE)) could trigger a dip back to negative growth.~~

Bank base rate is expected to remain on hold until the fourth quarter of 2011, although it could well slip back, unless there is some good news on the UK economic recovery before then. Inflation is running well above target, but it is expected to fall back to near target within a two to three year time horizon.

Sensitivity to Interest Rate Movements

Based on 2010/11, the estimated average balance for ~~“County cash”~~ “In house cash” is ~~£20.0m~~ £10.5m. A 1% movement in interest rates would affect the level of income earned from short term investments by ~~£200,000~~ £105,000.

Borrowing

The administering authority does not have the power to borrow on behalf of the Pension Fund, other than temporary borrowing for the following specific purposes detailed in section 5 of The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 :-

- paying benefits due under the Scheme, or
- to meet investment commitments arising from the implementation of a decision by the Fund to change the balance between different types of investment.

In the context of this Strategy, short term borrowing will only be undertaken in exceptional circumstance to manage unexpected cash flow fluctuations which will occur as a result of the above circumstances.

If short term borrowing is necessary, this will be secured via an overdraft facility with the Fund’s bankers or by borrowing from the money markets or other local authorities.

Short Term Cash Investment Strategy

▪ Key objectives

The primary objectives of investment activities are:

- Firstly, to **safeguard** the principal sums invested;
- Secondly, to ensure adequate **liquidity**; and
- Lastly, to consider investment returns or **yield**.

▪ Risk benchmarking

The current investment climate has one over-riding risk consideration – that of counterparty security risk. As a result of these underlying concerns, it is intended to apply risk benchmarking for the forthcoming period. This includes the benchmarking of security, liquidity and yield.

It is intended to benchmark **security** risk by assessing the historic level of default against the minimum criteria used in drawing up the Pension Fund's lending list. Based on the minimum long term rating of **A** embodied in the criteria for selecting cash investment counterparties, the maximum historic risk of default is ~~0.03%~~ **0.08%**. Where a counter party is not credit rated, a proxy rating will be applied for the purpose of monitoring security risk.

Liquidity is defined as having adequate, but not excessive cash resources, borrowing arrangements and overdraft or standby facilities to ensure that funds are available, at all times, for the achievement of the Pension Fund's objectives. In this respect, the Pension Fund will seek to maintain a contingency of **£1m** of cash available with a week's notice. This will be in excess of amounts available at short notice for managing expected cash flows.

Yield will be measured against the Local Authority Seven Day rate.

▪ Short and long term investments

Surplus cash balances will only be invested on a short term basis (up to a maximum period of 364 days) until the funds are next required. Longer term investments are outside the scope of this document.

▪ Investment counterparty selection criteria

Funds will be invested according to the Secretary of State's definition of specified investments, these being sterling deposits made for periods of less than one year, offering high security and high liquidity. Specified investments may include deposits with the UK Government, other local authorities, money market funds and bodies of high credit quality.

A lending list will be compiled to include counterparties satisfying the criteria set out within **Annex 1.1**. The lending limits that will be applied to counterparties satisfying these criteria are also set out within **Annex 1.1**.

Whilst the criteria set out within **Annex 1.1** rely on the application of credit ratings, additional operational market information will be applied before making any specific investment decision from the pool of counterparties. This additional market information (e.g. Credit Default Swaps, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.

The criteria for choosing counterparties set out within **Annex 1.1** provide a sound approach to investment in normal market circumstances. Under exceptional market circumstances, the Executive Director for Finance may temporarily limit investment activity to those counterparties considered of higher credit quality than the minimum criteria set out within **Annex 1.1**.

▪ **Interest rate exposure**

Given the short term nature of ~~“County cash”~~ **“In house cash”**, no limits are proposed on the maximum exposure to fixed or variable rates of interest.

Treasury Management Advisors

Essex County Council uses ~~Butlers Sector~~ as its treasury management advisor. ~~Butlers Sector~~ provides a range of services, including:

- Technical support on treasury matters;
- Economic and interest rate analysis;
- Generic investment advice on interest rates, timing and investment instruments;
- Credit ratings/market information comprising the three main credit rating agencies.

Whilst ~~Butlers Sector~~ provides support in these areas, the final decision on ~~all the Essex Pension Fund treasury management strategy matters~~ rests with the **Essex Pension Fund Board** and for day to day treasury management, with the Executive Director for Finance.

The services received from ~~Butlers Sector~~ are kept under regular review.

Section B – Custodian Cash Management Arrangements

- 1.1 One of the functions provided by the Fund’s custodian, BNY Mellon, is a banking service. A separate bank account is set up in each currency required by each mandate. As at ~~31 December 2009~~ **31 March 2011**, the Fund held ~~£83.5m~~ **£76.4m** in cash at the custodian. The details are set out in the table below.

Cash at Custodian	31-Mar-11	
	£m	%
Sterling	42.3	55.3%
US Dollar	5.7	7.5%
Euro	26.1	34.2%
Other	2.3	3.0%
	76.4	100.0%

- 1.2 If no other action were taken, these monies would remain on deposit with BNY Mellon earning interest at the Custodian’s rates.
- 1.3 However, in order to maximise the interest earned where possible, a “cash sweep” is in place for amounts held in sterling, US dollar and euro. This ensures that balances in these currencies across the Funds are swept each day into Global Liquidity Funds (GLFs) managed by either ~~Fortis Global Liquidity Fund PLC~~ **BNP Paribas Insticash** or ~~Universal Liquidity Funds PLC~~ **BNY Mellon Liquidity Funds PLC** where they earn a higher rate of interest. The three currencies subject to the sweep typically constitute in excess of 95% of all custodian cash balances. The GLF vehicles used have obtained, and seek to maintain an Aaa/MR1+ rating from Moody’s and an AAA rating from Standard & Poor’s. The GLFs operates a soft limit of 10% in any single security, although there are circumstances in which higher holding levels are permitted. A listing of the investment restrictions for both the ~~Universal~~ **BNY Mellon GLFs** and ~~Fortis~~ **BNP Paribas GLFs** are shown in Annex 2.1 and 2.2.
- 1.4 The GLFs are open-ended collective investment companies (OEIC). This means that in placing monies in the GLFs via the cash sweep, the Essex Pension Fund becomes a shareholder and has a share in the pool of investments. A GLF must appoint a board of directors, an investment manager, an administrator and custodian. Clients invest, not with the fund manager, but in the fund run by the fund manager. The manager manages the investments of the fund, an administrator runs the back office and the assets are kept in safe-keeping for the fund by the custodian. The GLFs’ overall ratings have two components: a credit risk rating (normally AAA) and a market risk rating. To achieve and maintain the rating, the funds must meet rigorous standards on investment quality, diversification and liquidity profile. Both internal management and the rating agencies ensure compliance with regulatory, prudential, investment and credit policy guidelines. The processes are monitored further by administrators, custodians and auditors.
- 1.5 In order to limit the exposure of the Fund to any single financial institution the maximum exposure to each of the ~~Universal~~ **BNY Mellon** and ~~Fortis~~ **BNP Paribas GLFs** has been set at £60m. The total cash holdings with the Custodian will be carefully monitored. If necessary we will negotiate with individual managers in order to arrange for them to make direct investments in other MMF/GLFs, so that the maximum limit of £120m is not breached.

Counterparty Criteria for Investments

Lending List

The Pension Fund will only invest its funds with UK banks and building societies, and non UK banks domiciled in a country with a minimum sovereign long term rating of **AA**, that have credit ratings equivalent to or better than the following:

Rating category	Credit rating agencies		
	Fitch	Standard and Poor	Moody's
Short term rating	F1	A-1	P-1
Long term rating	A	A	A2
Individual / financial strength rating	B	-	C
Support rating	3	-	-

The Pension Fund may also use eligible institutions for the HM Treasury Credit Guarantee Scheme initially announced on 13 October 2008, that satisfy the minimum short and long term ratings set out above.

In addition, the Pension Fund may invest its funds with:

- The UK Government.
- Other local authorities.
- Pooled investment vehicles (i.e. Money Market Funds) that have been awarded an **AAA** credit rating.
- Financial institutions nationalised by the UK Government whose credit ratings do not meet the above criteria.
- Bank subsidiaries and treasury operations where their parent bank has the necessary ratings outlined above. In addition, the subsidiary must itself have a short and long term rating meeting the above criteria or be guaranteed by the parent bank.

Finally, the Pension Fund may use banks and building societies whose ratings fall below the criteria specified above if all of the following conditions are satisfied:

- Wholesale deposits in the bank are covered by a government guarantee;
- The government providing the guarantee is rated **AAA** by Fitch, Standard and Poor and Moody's.
- The Pension Fund's investments with the bank are limited to amounts and maturities within the terms of the stipulated guarantee.

Notes:

- The criteria outlined above will ensure that funds are only invested with high quality counterparties.
- Not all ratings categories are assessed by each of the ratings agencies.

- Counterparties will only be considered for inclusion on the Pension Fund's lending list if they have all of the following credit ratings:
 - Short term rating.
 - Long term rating.
 - Individual / financial strength rating.
 - Support rating.
- Where a counterparty is rated by more than one credit rating agency, the lowest ratings will be used to determine whether or not it is included on the counterparty list.
- Credit ratings are continually monitored, and counterparties will be removed from the Pension Fund's lending list in the event that they receive a downgrading to their credit rating status below the minimum criteria outlined above. Counterparties will also be suspended from the lending list in the event that they are placed on 'negative ratings watch'. [The Executive Director for Finance, in consultation with the Chairman of the Pension Fund Board, \(or Deputy Chairman of the Pension Fund Board if the Chairman is unavailable\), will have discretion to reinstate counterparties which are on negative watch if circumstances make this desirable or necessary.](#)
- Money Market Funds (MMFs) are short term investment instruments; they are pooled investments that are placed, by a manager, in a wide range of money market instruments. The size of the investment pool of a MMF enables the manager to not only offer the flexibility of overnight and call money, but also the stability and returns of longer dated deposits. Strict rules and criteria are set down by the official rating agencies, covering the types of investment counterparties used, the maturity distribution of the funds and investment concentrations. The MMFs that the Pension Fund will use for this purpose will all be denominated in sterling and be regulated within the EU.
- In the event that the Pension Fund's own banker falls below the minimum credit rating criteria outlined above, the bank will be used for transactional purposes only, and not as an active outlet for investments.
- Organisations that are Eligible Institutions for the HM Treasury Credit Guarantee Scheme are authorised UK deposit-takers which have a substantial business in the UK or are UK building societies. The Government considers the role of institutions in the UK banking system, and to the overall economy, when considering applications to the Credit Guarantee Scheme. The Credit Guarantee Scheme provides Eligible Institutions with access to government help in raising capital and with the ability to issue securities with a government guarantee, thus enabling the organisations in question to meet their funding needs.

Lending Limits

For banks and building societies satisfying the ‘lending list’ criteria, lending limits will be determined with reference to the counterparties’ short and long term credit ratings, as follows:

- Investment limit of **£10m** for investments of up to **1** year:

Rating category	Credit rating agencies		
	Fitch	Standard and Poor	Moody's
Short term rating	F1+	A-1+	P-1
Long term rating	AA	AA	Aa2

- Investment limit of **£7.5m** for investments of up to **1** year:

Rating category	Credit rating agencies		
	Fitch	Standard and Poor	Moody's
Short term rating	F1+	A-1	P-1
Long term rating	AA-	AA-	Aa3

- Investment limit of **£5m** for investments of up to **1** year:

Rating category	Credit rating agencies		
	Fitch	Standard and Poor	Moody's
Short term rating	F1	A-1	P-1
Long term rating	A	A	A2

The lending limits for organisations that are Eligible Institutions for the HM Treasury Credit Guarantee Scheme will also be determined with reference to the counterparties’ short and long term credit ratings, as outlined above.

Lending limits for other counterparties will be as follows:

- No restrictions will be placed on the amounts that can be invested with the UK Government (i.e. Debt Management Office).
- An investment limit of **£10m** will be applied for investments of up to **one** year with individual Money Market Funds.
- An investment limit of **£7.5m** will be applied for investments of up to **one** year with individual top tier local authorities.
- An investment limit of **£5m** will be applied for investments of up to **one** year with individual lower tier local authorities.
- In addition to the limits outlined above, a further restriction will be applied in respect of investments with non UK financial institutions; that is, a country limit of **£5m** will be applied. Thus, the individual limits for non UK financial institutions will be the lower of the country limit or the limit that results from applying the credit rating criteria outlined above. In addition, the country limit will restrict the total amount that can be invested within any one country outside of the UK at any one time.

Notes:

- The above lending limits represent the maximum amounts that can be placed with counterparties; the ~~Chief Financial Officer~~ [Executive Director for Finance](#) may apply lower limits for management purposes, to ensure that funds are managed prudently according to prevailing circumstances.
- The short, long term, individual and support ratings will be used to determine the pool of counterparties with whom the Pension Fund can transact. The short and long term ratings will then be used further, to determine the maximum amount that can be invested with each of these counterparties, and for what period.
- Top tier local authorities will include county councils, unitary and metropolitan authorities and London boroughs.
- Lower tier local authorities will include district / borough councils, police and fire authorities, and passenger transport authorities.

Credit Ratings

Credit Ratings

There are three main agencies assigning credit ratings to financial institutions, namely Fitch, Standard and Poor and Moody's. When these agencies assign ratings, they take account of any country specific circumstances. Ratings are therefore applicable worldwide; hence the risk of investing with two different counterparties that have similar ratings is the same, irrespective of their country of origin.

Fitch Credit Ratings

Description	Rating	Definition
Short term rating	F1	Indicates the strongest capacity for timely repayment of financial commitments. The addition of + denotes any exceptionally strong credit feature.
Long term ratings	AAA	Indicates lowest expectation of credit risk. This rating is assigned only in the case of exceptionally strong capacity for timely repayment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.
	AA	Indicates a very low expectation of credit risk, with a very strong capacity for timely repayment of financial commitments. This capacity is not significantly vulnerable to foreseeable events. The addition of + or - indicate the bank's position within the category. i.e. the order of ranking is AA +, AA, AA -.
	A	Indicates a low expectation of credit risk, with a strong capacity for timely repayment of financial commitments. This capacity may be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings. The addition of + or - indicate the bank's position within the category.
Individual ratings	A	A very strong bank. Characteristics may include outstanding profitability and balance sheet integrity, franchise management, operating environment or prospects.
	B	A strong bank. There are no major concerns regarding the bank. Characteristics may include strong profitability and balance sheet integrity, franchise management, operating environment or prospects.

Description	Rating	Definition
Support ratings	1	Denotes a bank for which there is extremely high probability of external support. The potential provider of support is very highly rated in its own right and has a very high propensity to support the bank in question.
	2	Denotes a bank for which there is a high probability of external support. The potential provider of support is highly rated in its own right and has a high propensity to support the bank in question.
	3	Denotes a bank for which there is a moderate probability of external support because of uncertainties about the ability or propensity of the potential provider of support to do so.
Money Market Funds rating	AAA	Indicates lowest expectation of credit risk. This rating is assigned only in the case of exceptionally strong capacity for timely repayment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.

Standard and Poor's

Description	Rating	Definition
Short term rating	A-1	Indicates a strong capacity to meet its financial commitments. It is rated in the highest category by Standard and Poor's. The addition of + denotes an extremely strong capacity to meet its financial commitments.
Long term ratings	AAA	Indicates an extremely strong capacity to meet its financial commitments.
	AA	Indicates a very strong capacity to meet its financial commitments. The addition of + or - indicate the bank's position within the category. i.e. the order of ranking is AA+, AA, AA-.
	A	Indicates a strong capacity to meet its financial commitments, but is susceptible to the adverse effects of changes in circumstances and economic conditions. The addition of + or - indicates the bank's position within the category.
Money Market Funds rating	AAA	The fund's portfolio holdings provide extremely strong protection against losses from credit defaults.

Moody's

Description	Rating	Definition
Short term rating	P-1	Banks rated P-1 for deposits offer superior credit quality and a very strong capacity for timely payment of short term deposits.
Long term ratings	Aaa	Indicates exceptional credit quality and have the smallest degree of risk. Whilst credit qualities may change, such changes as can be visualised are most unlikely to materially impair the bank's strong position.
	Aa	Indicates excellent credit quality, but a greater susceptibility to long term risks than those banks rated Aaa. The addition of numerical modifiers 1, 2 or 3 indicates the bank's position within the category. (i.e.. the addition of 1 indicates the bank is in the highest end of its letter rating category, 2 indicates a mid range ranking and 3 indicates the bank is in the lower end of the ranking).
	A	Indicates good credit quality. However elements may be present that suggest a susceptibility to impairment over the long term. The addition of numerical modifiers 1, 2 or 3 indicates the bank's position within the category.
Financial strength ratings	A	Possesses superior intrinsic financial strength. Typically, they will be institutions with highly valuable and defensible business franchises, strong financial fundamentals and a very predictable and stable operating environment.
	B	Possesses strong intrinsic financial strength. Typically, they will be institutions with valuable and defensible business franchises, good financial fundamentals and a predictable and stable operating environment.
	C	Possesses adequate intrinsic financial strength. Typically, they will be institutions with more limited but still valuable business franchises. These banks will display either acceptable financial fundamentals within a predictable and stable operating environment or good financial fundamentals within a less predictable and stable operating environment.
Money Market Funds rating	Aaa	Money Market Funds and Bond Funds rated Aaa are judged to be of an investment quality similar to Aaa-rated fixed income obligations – that is, they are judged to be of the best quality.