Essex Pension Fund

Treasury Management Strategy for 2012/13

ABX

Pension Board 7 March 2012

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 "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 – "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 is set out in the subsequent paragraphs.

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**.

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**. The lending limits that will be applied to counterparties satisfying these criteria are also set out within **Annex 1**. Additional operational market information (e.g. Credit Default Swaps, negative rating watches/outlooks) will also be considered before making any specific investment decisions.

  The criteria for choosing counterparties provide a sound approach to investment in normal market circumstances. However, the Executive Director for Finance will determine the extent to which the criteria set out within **Annex 1** will be applied in practice (i.e. according to prevailing market circumstances).

- **Liquidity**

  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 at least **£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.

- **Performance**

  Investment performance will be measured against the Local Authority Seven Day rate; the aim being to achieve investment returns that are equivalent to, or greater than, the average LA7DR for the year (i.e. subject to security and liquidity considerations being fully satisfied).

Interest Rates

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

Expected movement in interest rates	2011-12 Latest estimate	2012-13 Estimate	2013-14 Estimate	2014-15 Estimate

Bank rate	0.5%	0.5%	0.9%	2.1%
Money rates				
3 month	0.7%	0.7%	1.1%	2.2%
1 year	1.5%	1.6%	2.1%	3.1%
Source : Sector (December 2011)				

The economic outlook for the forthcoming few years is likely to remain both challenging and uncertain. Bank base rate is currently expected to remain on hold until the third quarter of 2013.

The estimated average balance for "In house cash" is around **£10m**. A **1%** movement in interest rates would affect the level of income earned from short term investments by **£100,000**.

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

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 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.

Treasury Management Advisors

Essex County Council uses Sector as its treasury management advisor. Sector provides a range of services, including technical advice on treasury matters, economic and interest rate analysis and credit worthiness information. The services received from Sector are kept under regular review.

Whilst Sector provides treasury management advice to the Council, the final decision on treasury matters remains vested with the Essex Pension Fund Board, and for day to day treasury management, with the Executive Director for Finance.

Section B – Custodian Cash Management Arrangements

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. At 31 December 2011, the Fund held £63.2m in cash at the custodian. The details are set out in the table below.

Cash at Custodian	31/12/2011	
	£m	%
Sterling	39.7	62.8%
US Dollar	6.3	10.0%
Euro	13.7	21.7%
Other	3.5	5.5%
	63.2	**100.0%**

If no other action were taken, these monies would remain on deposit with BNY Mellon earning interest at the Custodian's rates.

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 BNP Paribas Insticash or 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 BNY Mellon GLFs and BNP Paribas GLFs are shown are shown in Annex 2.1 and 2.2.

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.

In order to limit the exposure of the Fund to any single financial institution the maximum exposure to each of the BNY Mellon and 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 – In House Cash Annex 1

Lending List

The Pension Fund will only invest its short term 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**
Viability / financial strength rating	**a**	**-**	**C**
Support rating	**3**	**-**	**-**

The above ratings will be used to determine the pool of counterparties with whom the Council 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 – see lending limits section.

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 fully or part nationalised by the UK Government whose credit ratings do not meet the above criteria.
- Bank subsidiaries and treasury operations which do not have a full set of credit ratings can be included on the list provided the 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 have an unconditional guarantee from 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:

- There are three main credit rating agencies that assign 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.
- Definitions of the credit ratings of the three main credit rating agencies were included last year and are not reproduced within this report, but are available upon request.
- 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 <u>all</u> of the following credit ratings:
    - Short term rating.
    - Long term rating.
    - Viability / financial strength rating.
    - Support rating.
- For group organisations, the viability rating of the group will be used if an individual entity does not have a viability rating.
- A minimum viability rating of a+ will apply to non UK financial institutions.
- 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, with changes in credit ratings being notified by the Council's treasury management advisors. 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 that are placed on 'negative ratings watch' will remain on the Pension Fund's lending list at the discretion of 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)
- 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.

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 **£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**

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). It is not possible to set up a separate Pension Fund account with the DMO so funds would be placed via the County Council, although the credit risk would remain with the Pension Fund.
- 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. Top tier local authorities will include county councils, unitary and metropolitan authorities and London boroughs.
- An investment limit of **£5m** will be applied for investments of up to **one** year with individual lower tier local authorities. Lower tier local authorities will include district / borough councils, and police and fire 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. The country limit will restrict the total amount that can be invested within any one country outside of the UK at any one time.