Agenda Item No. 7

Pensions Panel

2 February 2018

Treasury Management Report

Report by Director of Finance, Performance and Procurement

Executive Summary

The CIPFA "Treasury Management Code of Practice" requires the Pension Fund to determine a Treasury Management Strategy Statement (TMSS) on an annual basis. The 2017/18 TMSS was agreed in January 2017; no subsequent amendments have been made to the strategy as originally approved.

At 31 December 2017 the Pension Fund's internally managed cash, including balances held in EUR/USD bank accounts, amounted to £96.9m (£23.9m at 31 March 2017). During 2017/18 (to 31 December) the Pension Fund had an average internally managed investment balance, excluding foreign currency, of £49.2m (£34.1m for 2016/17; to 31 December 2016). Throughout the period GBP investments were held in a Lloyd's interest earning current account and a series of short-term (AAA credit rated) Money Market Funds.

The Pension Fund has received interest totalling £0.087m during the period 1 April 2017 to 31 December 2017 (£0.098m for 2016/17; to 31 December 2016), at a rate of return of 0.23% (0.38% during the same period in 2016/17) reflecting the low interest rates applicable on instant access investments.

In light of the current economic outlook the Director of Finance, Performance and Procurement recommends a continuation of the current treasury management strategy in 2018/19, with internally managed investments only being deposited into high creditworthy banks and building societies (up to a maximum duration of one week) and a series of high creditworthy short-term (instant access) Money Market Funds.

Recommendation(s)

1. The Panel approves the 2018/19 Treasury Management Strategy as set out in Appendix 1.

2. The Panel notes the treasury activity undertaken during 2017/18 (1 April to 31 December 2017).

1. Background

1.1 The CIPFA "Treasury Management Code of Practice" requires the West Sussex Pension Fund to determine a Treasury Management Strategy Statement (TMSS) on an annual basis. The TMSS includes the Annual Investment Strategy (AIS) that is a requirement of the Department for Communities and Local Government's (CLG) "Investment Guidance".

1.2 The CIPFA Code also requires regular reports detailing compliance and performance against approved treasury strategies to be reviewed by the Pension Panel.

1.3 With regard to internally managed cash, the purpose of this report is to:

- Approve the 2018/19 Treasury Management Strategy Statement.
- Review compliance against treasury strategies and performance of treasury activity undertaken during the period 1 April 2017 to 31 December 2017.

2. Economic Outlook

2.1 UK interest rate forecasts have been updated following the Bank of England's Monetary Policy Committee (MPC) meeting in November 2017. In line with market expectations the MPC increased the UK Bank Rate from 0.25% to 0.50% by a vote of 7-2 with no change to levels of Quantitative Easing (QE); removing the post Brexit referendum emergency monetary stimulus implemented in August 2016. In view of the robust rate of UK growth in the second half of 2016 which confounded the Bank's August 2016 forecasts for a sharp slowdown, many commentators subsequently held the view that the Bank's emergency action was unnecessary.

2.2 Given this was the first increase in Bank Rate for a decade, the MPC also gave forward guidance that they expected to increase Bank Rate only twice more in the next three years to reach 1.0% by 2020. This was therefore not quite the 'one and done' scenario but was nevertheless a very relaxed rate of increase prediction in Bank Rate in line with previous statements that Bank Rate would only go up very gradually and to a limited extent.

2.3 Following the meeting the MPC made some obvious comments around the fact that the UK is going through a period of heightened uncertainty due in particular to the unknowns around how the Brexit negotiations will proceed and the likely effect on households and companies. The MPC will adjust their responses according to how these turn out and in the light of how the economy progresses over the next two to three years; Brexit negotiations could put in doubt the expected two Bank Rate increases over the next three years, depending on their outcome. Furthermore, UK wage inflation remains a key issue over forecasting period; if it continues to remain very subdued this will act as a significant headwind to the MPC justifying further increases in Bank Rate even if other inflationary threats continue to escalate.

2.4 The Council's treasury management advisor's (Link Treasury Services Ltd-Link Asset Services) forecasts remain cautious and in line with a subdued path for increases in Bank Rate; with inflation not considered a significant threat over the next three years. Changes to the Bank Rate are forecast as an increase to 0.75% in November 2018, to 1.0% in November 2019 and to 1.25% in August 2020 (as shown below). The central assumption underpinning forecasts is that the UK will make progress with concluding a satisfactory outcome over the Brexit negotiations with the EU by March 2019, although the UK finance sector is likely to be an area of particular concern and potential difficulty.

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21
BANK RATE	0.50%	0.50%	0.50%	0.50%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.25%
3 month LIBID	0.40%	0.40%	0.40%	0.40%	0.60%	0.60%	0.60%	0.70%	0.90%	0.90%	1.20%
6 month LIBID	0.50%	0.50%	0.50%	0.60%	0.80%	0.80%	0.80%	0.90%	1.00%	1.00%	1.40%
12 month LIBID	0.70%	0.80%	0.80%	0.90%	1.00%	1.00%	1.10%	1.10%	1.30%	1.30%	1.60%

2.5 Interest rate forecasts (and future MPC decisions) will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next few years. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments.

3. Treasury Management Strategy (2018/19)

3.1. The Director of Finance, Performance and Procurement recommends a continuation of the current treasury management strategy in 2018/19 *(as originally approved by the Pension Panel at their January 2017 meeting with no subsequent amendments)* with internally managed investments only being deposited into high creditworthy banks and building societies (up to a maximum duration of one week) and a series of high creditworthy short-term (instant access) Money Market Funds. Given the strategy of maintaining a highly liquid investment portfolio held exclusively in bank unsecured deposits, the Pension Fund's internally managed cash will remain subject to bail-in risks under EU banking directives.

3.2. Given the current level of internally managed cash balances, the Director of Finance, Performance and Procurement has and continues to give further consideration to passing surplus cash over to the Pension Fund's external fund managers (Baillie Gifford and UBS). Such approval will be made given the expected timing of payments out of the fund, including the purchase of any new investment properties as agreed by the Pension Fund's property managers (Aberdeen Asset Management). Given the significant cash holding of the Fund, disbursements will be made to Baillie Gifford and UBS in late January / early February, to the tune of £24m each.

3.3. The recommended 2018/19 Treasury Management Strategy is attached at Appendix 1.

4. Treasury Management Performance (2017/18)

4.1. Given the on-going period of low interest rates throughout 2017, the returns generated from investments made by West Sussex County Council as administrator of the West Sussex Pension Fund remain stubbornly low. The Director of Finance, Performance and Procurement confirms that there were no breaches of the approved Treasury Management Strategy during the period 1 April to 31 December 2017. The Director of Finance, Performance and Procurement further confirms that in addition to balances held for investment, foreign currency (EUR/USD) balances were held in attempting to achieve the most beneficial rates when exchanging back into Sterling.

4.2. Throughout the final quarter of 2017 the amount of internally managed cash increased pending the following expected payments out of the Pension Fund during the first quarter of 2018:

(a) Payments relating to the purchase of three investment properties as arranged by Aberdeen Asset Management (circa £30m); and
(b) The decision to transfer surplus cash balances to Baillie Gifford and UBS (£24m per Fund Manager) to enhance investment returns over those achievable on the Pension Fund's internally managed portfolio. Such opportunities will be kept under regular review for the year ahead.

4.3. As a consequence, at 31 December 2017 the Pension Fund's internally managed cash, including balances held in EUR/USD bank accounts, amounted to £96.9m (£23.9m at 31 March 2017). During 2017/18 (to 31 December) and <u>excluding</u> foreign currency the Pension Fund had an average internally managed GBP investment balance of £49.2m (£34.1m for 2016/17; to 31 December 2017). Throughout the period investments were held in a Lloyd's interest earning current account and a series of short-term (AAA credit rated) Money Market Funds.

4.4. In accordance with the investment strategy approved in January 2017 the Pension Fund received interest totalling £0.087m during the period 1 April 2017 to 31 December 2017 *(£0.098m for 2016/17; to 31 December 2016)* at a rate of return of 0.23% *(0.38% during the same period in 2015/16)* reflecting the low interest rates applicable on instant access investments.

	Average Balance £'m	**Interest Received £'m**	**Rate of Return %**
Lloyds-Current Account	10.7	0.025	0.31
Short-Term Money Market Funds	38.5	0.062	0.21
Total	**49.2**	**0.087**	**0.23**

4.5. During the same period West Sussex County Council achieved a rate of return of 0.66% on its invested cash balances. The higher yield reflects the Council's treasury management strategy of investing a proportion of its cash balances for periods up to 364 days and beyond (including a long-term investment in a Property Pooled Fund) at interest rates higher than those available on the instant access accounts used by the Pension Fund.

4.6. For additional information, the following amounts were held in foreign currency during the period 1 April to 31 December 2017 pending exchange back into Sterling ($40,491.24 interest received on USD balances held). At 31 December 2017 the total amount of foreign currency held was valued in GBP at £23.719m (based on 31 December exchange rates as provided by BNP Paribas):

	Balance at 31/12/17	**Average Balance**
Lloyds - Euro Account	€9.517m	€2.489m
Lloyds - US Dollar Account	$20.657m	$6.672m

5. Recommendation

5.1. The Panel approves the 2018/19 Treasury Management Strategy as set out in Appendix 1.

5.2. The Panel notes the treasury activity undertaken during 2017/18 (1 April to 31 December 2017).

Katharine Eberhart
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Appendices
Appendix 1 - Treasury Management Strategy

Background Papers
None

Treasury Management Strategy Statement (2018/19)

1. The Pension Fund holds cash as working balances. It operates a separate bank account, keeping its cash separate from the County Council in accordance with LGPS (Management and Investment of Funds) legislation, and consequently also has a separate treasury management policy to West Sussex County Council. Working balances comprise funds required to pay pensions, to fund private equity and property investments and to pay day-to-day expenses. Surplus balances will be sent to the external fund managers for investment in accordance with their approved strategies. A charge will be incurred by the fund for the treasury management service supplied by West Sussex County Council.

Annual Investment Strategy

2. Having due regard to the primacy of security of principal, and the short term nature of deposits, no financial institution will be eligible to receive deposits for longer than seven days without the explicit approval of the Director of Finance, Performance and Procurement in consultation with the Chairman of the Pensions Panel. The administering authority will therefore utilise investments that are designed to offer both high liquidity and high security, with the minimum of formalities. Such investments will be denominated in Sterling and may be deposited with the UK Government, a UK Local Authority (including local authority administered pension funds) or a financial institution with ‘high’ credit quality (including short-term Money Market Funds).

3. In assessing counterparty creditworthiness the administering authority will consider credit ratings as provided by Fitch, Moody’s and Standard and Poor’s. Additionally the administering authority will consider other indicators when assessing creditworthiness including, credit default swap (CDS) prices, share prices, media coverage and market sentiment. In assessing credit ratings the Director of Finance, Performance and Procurement uses the ‘Lowest Common Denominator (LCD)’ approach, meaning that it uses the lowest rating of those provided by Fitch, Moody’s and Standard & Poor’s. The minimum credit rating criteria will be:
   - Short-term minimum: F1(Fitch); P1(Moody’s); A1(S&P)
   - Long-term minimum: A-(Fitch); A3(Moody’s); A-(S&P)
   - Sovereign minimum (Non-UK): AA+(Fitch); Aa1(Moody’s); AA+(S&P)

Institution	**Minimum short-term credit rating**	**Minimum long-term credit rating**	**Monetary limit**
UK/Non-UK Banks	As Above	As Above	£5m per group
UK Building Societies	As Above	As Above	£5m per group
Money Market Funds *(i)*	-	AAA	£5m per fund *(ii)*
Local Authorities	-	-	£5m per Authority
UK Government	-	-	No limit

(i) Funds that operate either under a constant net asset valuation (CNAV) or under a Low Volatility Net Asset Valuation (LVNAV).
(ii) Exposure limit per fund set to £5m or 0.5% of the fund's net asset size, whichever is lowest.

4. The monetary limit per group will be subject to explicit approval by the Director of Finance, Performance and Procurement in consultation with the Chairman of the Pensions Panel and will be continually reviewed in-year. Such approval will relate to the institution rather than the particular investment and will remain in force until revoked. In particular, approval is given to hold cash deposits, including foreign currency (EUR/USD) held within separate bank accounts, in excess of the approved £5m monetary limit with the Pension Fund's main provider of banking services (currently Lloyds Bank).

5. As at **2 February 2018** institutions currently meeting these criteria and approved as acceptable investment counterparties are:

Institution	**Group**	**ST Credit Ratings**	**LT Credit Ratings**	**Maximum time limit**
Bank of Scotland plc	Lloyds	F1/P1/A1	A+/Aa3/A	7 days
Lloyds Bank plc	Lloyds	F1/P1/A1	A+/Aa3/A	7 days
Goldman Sachs Int. Bank		F1/P1/A1	A/A1/A+	7 days
HSBC Bank plc		F1+/P1/A1+	AA-/Aa3/AA-	7 days
Nationwide Building Society		F1/P1/A1	A+/Aa3/A	7 days
Santander UK plc		F1/P1/A1	A/Aa3/A	7 days
Svenska Handelsbanken		F1+/P1/A1+	AA/Aa2/AA-	7 days
Debt Management Office		-	AA	7 days
UK Local Authorities		-	AA-	7 days
Sterling Liquidity Money Market Funds				
Aberdeen Standard *(i)*		-	AAA	Overnight
Amundi		-	AAA	Overnight
BlackRock		-	AAA	Overnight
BNP Paribas		-	AAA	Overnight
Deutsche		-	AAA	Overnight
Federated Investors (UK)		-	AAA	Overnight
Goldman Sachs		-	AAA	Overnight
Insight		-	AAA	Overnight
JP Morgan		-	AAA	Overnight
Morgan Stanley		-	AAA	Overnight
State Street		-	AAA	Overnight

(i) Aberdeen Standard Investments following merger of Aberdeen Asset Management plc and Standard Life Investments in August 2017.

6. The administering authority will run a daily cash flow reconciliation of funds held by the Fund as working balances.

Borrowing Strategy

7. The LGPS (Management and Investment of Funds) Regulations 2016 give a fund's administering authority explicit power to borrow for up to 90 days for the purpose of its pension fund:

   - To pay benefits due under the scheme, or
   - To meet investment commitment arising from the implementation of a decision to change the balance between different types of investment

   provided that if, at the time of borrowing, the authority reasonably believes that the sum borrowed and interest charged in respect of such sum can be repaid out of its pension fund within 90 days of the date of the borrowing.

8. The West Sussex Pension Fund currently has sufficient cash flow and cash balances not to have to borrow to pay benefits due under the scheme.