Agenda Item No 4. (e)

DERBYSHIRE COUNTY COUNCIL

PENSIONS AND INVESTMENTS COMMITTEE

3 March 2021

Report of the Director of Finance & ICT

TREASURY MANAGEMENT STRATEGY

1 Purpose of the Report

To seek approval for Derbyshire Pension Fund's proposed Treasury Management Strategy for Derbyshire Pension Fund for 2021-22, attached as Appendix 1.

2 Information and Analysis

Derbyshire Pension Fund's (the Fund) Treasury Management Strategy has historically formed part of the County Council's Treasury Management Strategy. However, for 2021-22, the Fund has prepared a standalone Treasury Management Strategy to better reflect the characteristics and requirements of the Fund. In line with the County Council's Treasury Management Strategy, the Fund places security of capital and liquidity ahead of investment return.

The Fund's current benchmark allocation to cash is 2% (about £120m at current asset values). The Fund generally needs to retain a higher level of instant access funds than the County Council. A major buying opportunity in the market could require immediate access to significant sums of cash for investment. Equally, it may be desirable to hold a higher defensive cash allocation because market valuations have become stretched or cash is held in order to meet future commitment drawdowns. Furthermore, the Fund also occasionally receives employers' contributions in advance, which has the potential to substantially increase the Fund's cash balances, pending the identification, and drawdown, of suitable investment opportunities. The Fund's actual cash allocation at 31 January 2021 was 6.4%, equating to £359m. Future commitments at 31 January 2021 totalled around £330m.

The proposed Treasury Management Strategy for 2021-22 includes the following requirements and comments:

- The Fund's objective when investing money is to strike a balance between risk and return, minimizing the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income
- The Fund prioritises liquidity for cash investments over investment return
- The maximum amount and duration of cash investments by counterparty should be according to the limits set out in Table 1 on page 4 of the Treasury Management Strategy.
- Investments should be limited by type in accordance with Table 2 on page 6 of the Treasury Management Strategy.

Borrowings are permitted only in exceptional circumstances and in accordance with the LGPS (Management and Investment of Funds) Regulations 2016. Borrowings are limited to the maximum amount required to meet the Fund's obligations, and should not exceed 90 days in duration.

3 Other Considerations

In preparing this report the relevance of the following factors has been considered: financial, legal and human rights, human resources, equality and diversity, health, environmental, transport, property, prevention of crime and disorder considerations.

4 Officer's Recommendation

That Committee approve the Treasury Management Strategy for 2021-22 attached as Appendix 1.

PETER HANDFORD

Director of Finance & ICT

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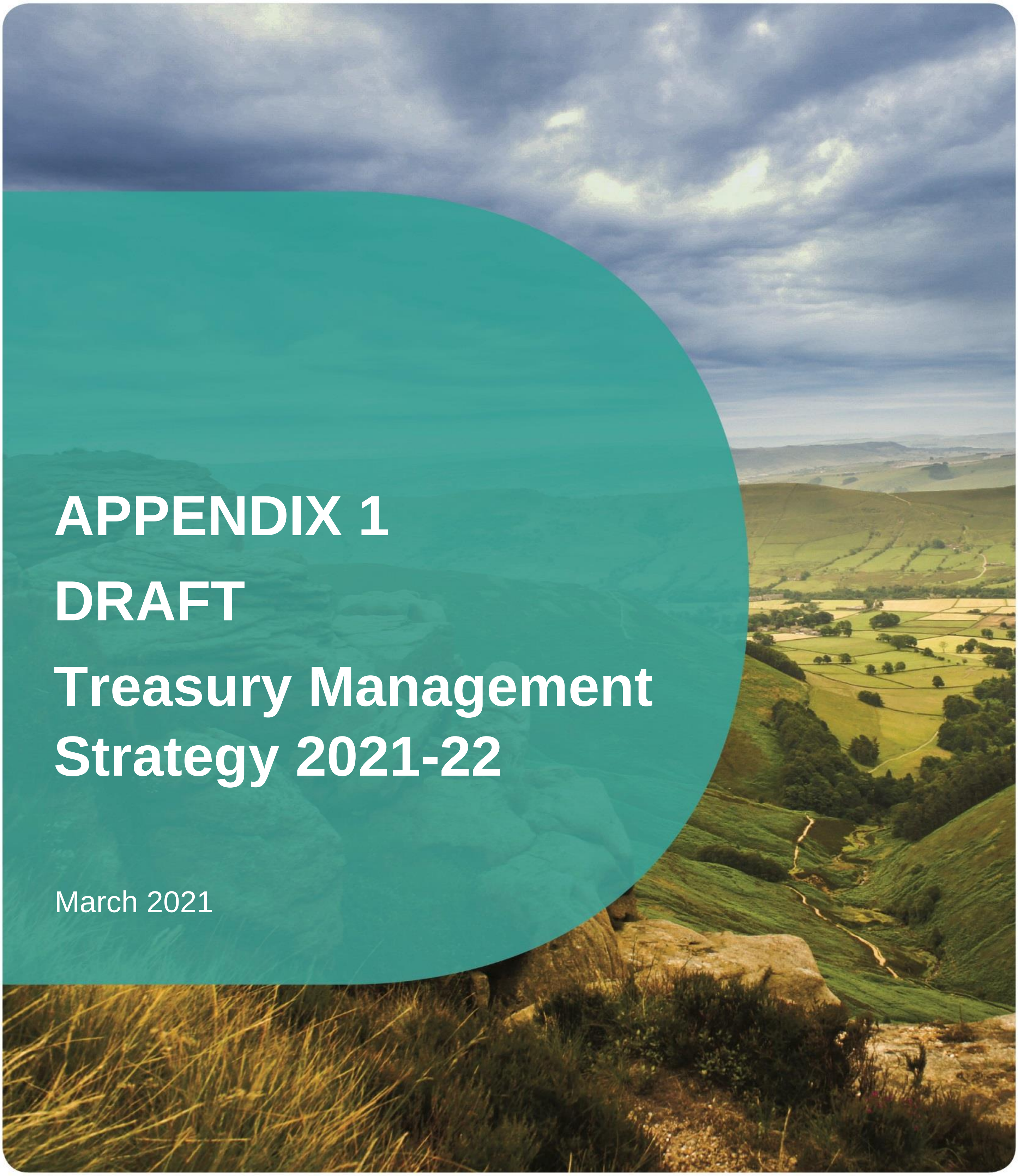

APPENDIX 1

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Treasury Management Strategy 2021-22

March 2021

County Hall, Matlock, Derbyshire, DE4 3AH
Administered by Derbyshire County Council

Introduction

Treasury Management is the management of Derbyshire Pension Fund's (the Fund) cash flows and associated risks. The Fund has invested substantial sums of money and is therefore exposed to financial risks, including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk is therefore central to the Fund's prudent financial management.

Treasury Risk Management at Derbyshire County Council (the County Council), as the administering authority of Derbyshire Pension Fund, is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's "*Treasury Management in the Public Services: Code of Practice 2017 Edition"* (the CIPFA Code).

This report fulfils the County Council's legal obligation, as the administering authority of Derbyshire Pension Fund, under the Local Government Act 2003 to have regard to the CIPFA Code.

The Fund's Pensions & Investments Committee is required to approve the Fund's Treasury Management Strategy before the start of each financial year.

1. External Context

Economic background: The impact on the UK of the Covid-19 pandemic and the UK's exit from the European Union (EU), together with its trading arrangements, will continue to be a major influence on the Fund's Treasury Management Strategy for 2021-22.

Credit outlook: The UK's credit rating was downgraded in late March 2020, as a result of the Covid-19 pandemic. This led to a downgrade of individual UK banking institutions.

Interest rate forecast: The Council's Treasury Management Adviser, Arlingclose, is forecasting that BoE Bank Rate will remain at 0.10% until at least the end of 2023. It is thought that this forecast could potentially prove to be higher than the actual (known as downside risk), as the BoE and UK Government continue to react to the Covid-19 pandemic and the Brexit transition period ends. The BoE extended its asset purchase programme to £895 billion in November, whilst not changing the Bank Rate. However, further interest rate cuts to zero, or possibly negative, cannot yet be ruled out. Gilt yields are expected to remain very low in the medium-term, whilst short-term yields are likely to remain below, or at zero, until such time as the BoE expressly rules out the chance of negative interest rates or growth and/or inflation prospects improve.

2. Local Context

On 31 January 2021, the Fund held £359m of cash. This is set out in further detail at Appendix A.

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3. Borrowing Strategy

Borrowings are permitted only in exceptional circumstances and in accordance with the LGPS (Management and Investment of Funds) Regulations 2016. Borrowings are limited to the maximum amount required to meet the Fund's obligations, and should not exceed 90 days in duration.

4. Sources of Borrowing

Any UK public sector body (except for Derbyshire County Council).

The Fund's main bank (currently Lloyds).

5. Treasury Investment Strategy

The Fund holds significant cash balances. In the past 12 months these balances have ranged from £254m to £359m and similar levels are expected to be maintained in the forthcoming year.

The CIPFA Code requires the Fund to invest its treasury funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Fund's primary strategy for cash is liquidity in order to take advantage of any market opportunities that may arise. The Fund's objective when investing money is to strike an appropriate balance between risk and return.

Negative interest rates: The Covid-19 pandemic has increased the risk that the Bank of England will set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. Since investments cannot pay negative income, negative rates would be applied by reducing the value of investments. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

Strategy: The majority of the Fund's surplus cash is currently invested in Local Authority loans for security and money market funds for liquidity.

Business models: Under the IFRS 9 standard, the accounting for certain investments depends on the Fund's 'business model' for managing them. The Fund aims to achieve value from its internally managed treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

Approved counterparties: The Fund may invest its surplus funds with any of the counterparty types in the table set out below, subject to the cash limits (per counterparty) and the time limits shown.

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Table 1: Approved investment counterparties and limits

Sector	Time Limit	Counterparty Limit	Sector Limit
UK Government	Unlimited	Unlimited	Unlimited
Local Authorities & Other Government Bodies	13 months	£30m	Unlimited
Banks (unsecured) *	13 months	£30m	£100m
Building Societies (unsecured) *	13 months	£30m	£50m
Money Market Funds (MMF) *	n/a	£30m	Unlimited
Short Term Pooled Bond Funds	n/a	£50m	£100m

Pension Fund Main Operation Bank Account: It is requested that the additional overnight limit for the Fund's main operational bank account of £30m is maintained.

Pension Fund Currency Accounts US$/€: It is requested that additional limits of US$1,000,000 and €1,000,000 are maintained for lower value currency receipts.

Pension Fund Custodian Accounts:

A custotodian is a financial institution that holds a customer's securities (e.g. directly held shares) for safekeeping so as to minimise the risk of theft or loss. The Fund's current custodian is Northern Trust.

Northern Trust (In House Account): It is requested the existing limit of £30m is maintained.

Northern Trust (Wellington – US equities): It is requested the existing limit of 5% of assets under management (approximately £20m US$ equivalent) is maintained until such time as this account is wound-down in line with the approved Investment Strategy Statement.

BNP Paribas: It is requested a limit of £1m for the previous custodian is retained for receipt of outstanding tax claim rebates.

BNY Mellon: It is requested a limit of £1m for the former custodian is retained for the receipt of outstanding tax claim rebates.

Minimum Credit rating: Treasury investments in the sectors marked with an asterisk will only be made with entities whose lowest published long-term credit rating is no lower than

A-. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

Government: Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in (i.e. cancellation of debt owed to creditors in order to provide relief to the borrower) and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government are deemed to be zero credit risk due to its ability to create additional currency and therefore may be made in unlimited amounts for unlimited duration.

Banks and building societies (unsecured): Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. See below for arrangements relating to operational bank accounts.

Money market funds: Pooled funds that offer same-day or short notice liquidity and very low or no price volatility by investing in short-term money markets. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a small fee. Although no sector limit applies to money market funds, the Council will take care to diversify its liquid investments over a variety of providers to ensure access.

Short Dated Pooled Bond Funds: Pooled funds that offer same-day or short notice liquidity and comprise government or investment grade bonds with a short duration (typically less than five years). These bonds are typically held to maturity. These investments are subject to the risk of credit loss.

Operational bank accounts: These are not classed as investments, but are still subject to the risk of a bank bail-in. BoE has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

Risk assessment and credit ratings: Credit ratings are obtained and monitored by the County Council's Treasury Management Adviser, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the minimum approved investment criteria then:

- no new investments will be made;
- any existing investments that can be recalled or sold at no cost will be; and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

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Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "negative watch") so that it may fall below the minimum approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

Other information on the security of investments: The Fund understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support, reports in the quality financial press and analysis and advice from the Council's Treasury Management Adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria.

When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2020, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Fund will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Fund's cash balances, then the surplus will be deposited with the UK Government or with other Local Authorities. This will cause investment returns to fall but will protect the principal sum invested.

Investment limits: The Fund's cash balance is forecast to be around £350m, at 31 March 2021. In order to minimise risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government, Northern Trust (custodian), short dated Pooled Bond funds or Lloyds Bank operational bank accounts as previously detailed) will be £30m and capitalised interest. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on fund managers, investments in brokers' nominee accounts, foreign countries and industry sectors as below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries.

Table 2: Additional investment limits

	Cash limit
Negotiable instruments held in a broker's nominee account	£200m per broker
Foreign countries	£30m per country

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Liquidity management: The fund uses purpose-built cash flow forecasting software and Excel spreadsheets to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis.

6. Treasury Management Indicators

The Fund measures and manages its exposures to Treasury Management risks using the following indicators.

Security: The Fund has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. Unrated investments are assigned a score based on their perceived risk.

Credit risk indicator	Target
Portfolio average credit rating	A

Liquidity: – The Fund has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period.

Liquidity risk indicator	Target
Total cash available within 1 month	£100m

Related Matters

The CIPFA Code requires the Fund to include the following information in its Treasury Management Strategy.

Financial Derivatives: The Fund only uses financial derivatives for currency hedging of the Fund's Overseas Bond portfolio (US$ and €) etc.

Markets in Financial Instruments Directive: The Fund has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Fund's Treasury Management activities, the Director of Finance & ICT believes this to be the most appropriate status.

Other Options Considered

The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Director of Finance & ICT, having consulted the Cabinet Member for Council Services, believes that the above strategy represents an appropriate balance

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between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of a counterparty defaulting (i.e. because there are fewer counterparties) but any such losses are likely to be greater because there is less diversification
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller

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Appendix A – Existing Investment Position

	31/01/2021 Actual Portfolio £m	31/01/2021 Average Rate %
Treasury Investments:		
Local authorities	163	0.25
Funds Main Bank (unsecured)	35	0.00
Money market funds	90	0.01
Custodian	26	0.00
Wellington (custody)	3	-
Timing Differences	42	-
Total Treasury Investments	**359**	**0.15**

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