Recommendations to the Council

12 December 2013

Revised Annual Investment Strategy 2013/14

1. Each year the County Council is required by Government regulations, to publish an Annual Investment Strategy (AIS) for its treasury operations in advance of the start of the financial year. There is also scope in the regulations to amend this at any time where this is necessary. The effect of this report, once approved by Council will be to replace the AIS agreed by Cabinet on 16 January 2013.

The full details of the revised AIS are shown at **Appendix 1**; a summary of the key changes are provided below.

Following the appointment of a new treasury advisor, Arlingclose, it is proposed to adopt their credit worthiness assessment; the output of this is a List of the banks and building societies which the Council will use to invest its cash balances. The precise mechanism differs from the Sector approach, involving a judgement by Arlingclose of a wide set of information:

- Credit Ratings;
- Statements of potential Government support;
- Credit Default Swaps (CDS) (i.e. the cost of insuring against counterparty default);
- Share prices;
- Gross Domestic Product (GDP) in the country of incorporation;
- Macro-economic factors;
- Information in the press;
- A subjective overlay, i.e. a judgement being made about whether the counterparty should be recommended or not.

The Co-operative Bank are the Council's bankers but they are not recommended by Arlingclose for investment purposes; in the past an exception was made to the Council's AIS to allow overnight deposits, but this is no longer proposed. Cash balances will be managed to as close to nil as possible each day, although the late receipt of funds may mean that overnight deposits are required on occasion.

It is proposed to adopt the Arlingclose system for diversification. This is set out in full in **Appendix 1**, paragraph 34, briefly this is to diversify by asset class and by individual investment using a system of percentage limits and caps. For practical reasons these will be reviewed monthly.

Arlingclose have presented new options for managing the Council's long-term loans position, these loans are very expensive to carry in the current interest rate environment. One of these options was to enter into long-term investments to match the cost of some of the loans as far as possible.

Under delegated powers, the Director of Finance and Resources, following consultation with the Cabinet Member for Finance, Resources and Transformation, made a decision to enter into long-term local authority investments with a maximum value of £45m. Following this

decision the AIS has been retrospectively modified to include the capacity for these investments and this is shown in full at **Appendix 1, 2 and 3**.

Also, under non-specified investments, the potential for investing in collective investment schemes has been added, subject to a decision by the Treasury Management Panel.

2. **Recommend** – That, in accordance with regulations, the revised Annual Investment Strategy (AIS) 2013/14, as shown in **Appendix 1, 2 and 3** to this report, be adopted.

Appendix 1

Revised Annual Investment Strategy (AIS) 2013/14

1. This Appendix sets out the details of a revised AIS for 2013/14 following the appointment of Arlingclose from the 1 April 2013 and a period of review with this new advisor.

2. During this review it was clear that the borrowing strategy, to use internal cash in lieu of borrowing should remain in force at this time. The half-year review earlier in the report provides an update but a new borrowing strategy has not been produced.

3. The Council manages a significant investment portfolio that can reach up to £200m in cash each year. Since the financial crisis in 2008, the Council has taken a low risk approach and the revised AIS continues in this vein.

Investment Options

4. The main characteristics which determine an investment strategy are related to:
   - the credit risk of the counterparties that you invest with;
   - the length of the investment; and
   - the type of financial instrument that is used.

5. These issues have to be considered in the light of the regulatory framework provided by the Government.

6. Key parts of this framework are the Government Guidance on Local Government Investments issued in March 2010 and the CIPFA Code of Practice for Treasury Management in the Public Services (the Code). These state that that the two prime risk issues are:
   - the security of capital; and
   - the liquidity of investments.

7. In addition, Government regulations specify the type of financial instruments you can invest in and they divide them into what they term 'specified' investments and 'non-specified' investments.

a) Specified Investments

8. Specified investments are investments made in sterling for a period of less than a year that are not counted as capital expenditure and are invested with:
   - the UK Government;
   - a local authority;
   - a parish or community council; or
   - a body, or in an investment instrument, **that has 'high credit quality'.**

9. The first three named investments will be used by the Council by virtue of their inclusion within the guidance (referred to as regulation investments subsequently in this report). The assessment of the fourth aspect is dealt with in the paragraphs that follow.

10. Whilst it is difficult to define “high credit quality”, credit ratings are published by credit rating agencies (for example, Fitch, Standard and Poors, Moodys); this information is provided by Arlingclose to the Council where it is available.

Money Market Funds (MMF) – “AAA rated” (the highest credit rating)

11. When considering what is a high credit rating for our purposes it is perhaps sensible to start with “AAA” rated MMF’s; Arlingclose recommend the use of MMF’s by their local government clients, and indeed these have been used for some time by the Council.

12. MMF’s proposed for use all have the following characteristics:
    - “AAA” wrapper rating – this means that the MMF as a whole is rated as “AAA” by at least one of the rating agencies mentioned earlier;
    - Diversified – MMF’s are diversified across many different investments, far more than the Council could hope to achieve on its own account;
    - Same day liquidity – this means that funds can be accessed on a daily basis;
    - Stable fund value – the Council invests a pound and redeems a pound;
    - Ring-fenced assets – the investments are owned by the investors and not the fund management company;
    - Custodian – the investments are also managed by an independent bank known as a custodian, who operates at arms-length from the fund management company; and
    - Are recommended to clients by Arlingclose.

13. To be clear, MMF’s that meet these criteria are considered to have “high credit quality” and will be included on the List as a result.

14. All treasury activity carries an element of risk and MMF’s are no different. In the event of a further financial crisis, the failure of one or more of a MMF’s investments could lead to a run on the MMF as investors rush to redeem their investment. This could then spread to other MMF’s as investors took flight from this asset class.

15. The very low interest rate environment also threatens the ongoing continuity of MMF’s; each MMF charges a fee and this could mean that interest earned became negative after its deduction. If this problem arose then it would be a matter of moving funds to an alternative class of investment.

16. In conclusion, all of these issues point towards the need for diversification across investment categories and also within the category itself; this issue is dealt with later in this report (see investment diversification).

The Credit Management Strategy for 2013/14

17. Government guidance requires an explanation of how credit quality is monitored, what happens when it changes and what additional sources of information are used to assess credit quality.

18. The assessment of what is “high credit quality” for banks or building societies is set out in this section of the report.

19. Arlingclose were appointed as the Council's treasury advisor from the 1 April 2013. An important aspect of this service is credit advice. This is where the advisor provides information to the Council about suitable investments, in the context of the current economic risk environment and incorporates the views of credit rating agencies. What follows is an overview of how this operates, within this it is important to understand that the Council is responsible for the decisions it takes with its investments.

20. Credit ratings provided by the three main credit rating agencies form an important, but not the sole aspect of how creditworthiness is assessed by Arlingclose. For 2013/14 minimum credit-rating thresholds are set at a long-term rating of "A-" where available. Counterparties that are rated below this level are excluded.

21. In addition the following are also considered:
    - Statements of potential Government support;
    - Credit Default Swaps (CDS) (i.e. the cost of insuring against counterparty default);
    - Share prices;
    - Gross Domestic Product (GDP) in the country of incorporation;
    - Macro-economic factors;
    - Information in the press;
    - A subjective overlay, i.e. a judgement being made about whether the counterparty should be recommended or not.

22. In practical terms all of this information is considered by Arlingclose when they determine their recommendations and any change in these criteria can result in a counterparty being removed from the recommended List, not solely a change in credit rating.

23. In essence the Arlingclose system is not a mechanical or mathematical one where scores are attributed to different criteria leading to a recommendation. This is a system where a wide range of information is considered to form a judgement on what should be included on the List.

24. In the recent past, the economic environment has been very volatile, so the advice provided results in counterparties with high quality credit characteristics that are intended to insulate the Council against further volatility in adjusting its approach. Of course, the future cannot be foreseen and in some situations changes may need to be made quickly, but this is considered a cautious approach.

25. As mentioned previously the Council remains responsible for its investment decisions; the Treasury Management Panel, chaired by the Director of Finance and Resources, meets monthly and at this meeting a review will take place of the List and any changes made by Arlingclose. However, in between meetings the treasury and pension fund team will implement the recommendations made by Arlingclose. On the rare occasion that Arlingclose do not make a firm recommendation then this will be referred to the Panel for their review.

26. Of course, under stressed market conditions additional panel meetings may take place at very short notice after which the panel may decide to adjust the Council's investment risk profile. The end result may involve moving investments to lower risk counterparties or instruments.

The Co-operative Bank

27. The Co-operative bank act as the Council's bankers; significant funds flow through these accounts over the course of a typical year. On rare occasions up to £50m can clear through these bank accounts on a single day.

28. Investments with the Co-operative bank are not recommended by Arlingclose; this is due to their low credit rating and other risk indicators. As a result, the intention is to manage the balances held with the Co-op Bank as close to nil as possible each day.

29. However, on a day to basis the Council cannot control when funds are credited to its accounts and late funds received cannot be processed to other counterparties on the List. This sometimes means that significant overnight funds are inevitably left with the Co-operative Bank. These instances will be reported to the Treasury Management Panel.

Overview

30. As required, an overview of the monitoring process is outlined below:
    - Rating changes and significant changes in risk indicators will be communicated to the treasury and pension fund team by Arlingclose together with any revisions to their recommendations.
    - Changes are sent by e-mail and in urgent situations followed up by a phone call as Arlingclose hold a record of the List of approved investment counterparties.

31. In summary, therefore, the proposed AIS would be based on the following definition of "high credit quality":
    - Regulation investments as set out;
    - diversified sterling Money Market Funds with a "AAA" rating by one of the three major credit rating organisations meeting the criteria set out; and
    - a bank or building society that is recommended by Arlingclose for inclusion on the List.

<u>Investment Duration for Specified Investments</u>

32. In considering the financial instruments that meet the definition of a specified investment, there is the scope to consider the length of the investment period.

33. One of the important lessons of the banking crisis has been to exercise caution in the duration of investments with banks and building societies, this recognises that the factors that led to the investment being considered sound can change adversely over time. As such it is judged reasonable to limit fixed term deposits with banks or building societies to a maximum duration of one year, regardless of the advice provided by Arlingclose.

<u>Investment Diversification</u>

34. Having determined the List of highly rated counterparties and the duration of investments the last piece of the process is to overlay the methodology for ensuring

diversification. This is achieved by setting a maximum amount to be invested with each counterparty to limit risk and spread investments.

35. Ensuring diversification has never been more important than now; it protects the security of the investments by limiting the Council's loss in the event of a counterparty default. However, diversification does not protect the Council from a systematic failure of the banking sector.

36. Investment balances rise and fall during the year, so diversification needs to take account of this. Arlingclose recommend limits based upon percentages and it is proposed to adopt these and that the treasury team review and reset the limits at least once a month. This action will then be ratified by the treasury panel at their next meeting. The interval between each review is very much a matter of balance between ensuring diversification and efficient processing; investment balances cannot practically be moved each day to accommodate shifting limits. It is judged that a monthly review strikes this balance.

37. Investment diversification is proposed at two levels; firstly at investment category level. The table below summarises:

Investment category	Maximum % of total investments
Regulation Investments *	100%
MMF	50%
Banks and Building Societies	50%

* *no limit is proposed, in certain circumstances these may be utilised for all of the Council's investments.*

38. Secondly, diversification will also take place at investment level. These limits are shown below for each category.

Banks and Building Societies Lower of:	
£m	Maximum investment as a proportion of the total
30	15%

MMF Lower of:	
Maximum investment as a proportion of total MMF size	Maximum investment as a proportion of the total
0.50%	10%

39. It is proposed that both the application and amendment of this policy are delegated to the Treasury Management Panel chaired by the Director of Finance and Resources with the results reported in the regular Treasury Management reports.

b) Non-specified investments

40. The Government regulations define non-specified investments as all other types of investment that do not meet the definition of specified investments. In contrast to specified investments, Government guidance indicates that the AIS should:
- set out procedures for determining which categories of non-specified investments should be prudently used;
- identify such investments;
- state an upper limit for each category of non specified investment; and
- state upper limits for the total amount to be held in such investments.

Other non-specified investments

41. In terms of ensuring future flexibility there are additional categories of investments that are also proposed for use within this AIS. None of the non-specified investments proposed below present additional security risk to those investments within specified investments. Each are explained in-turn below:
- Certificates of Deposit – identical to a fixed term deposit excepting the fact that they can be sold if needs be. This additional liquidity makes these investments more attractive to the Council;
- Government gilts / bonds – “AAA” rated and equivalent to the DMADF account and T-bills, simply a longer term investment with the UK Government that can also be sold;
- Multilateral development bank bonds – “AAA” rated, these are institutions created and backed by a group of countries which can be sold as needed.

42. Each of these investments is subject to market risk; this is the risk that the value of the investment can go down as well as up. In order to avoid this risk the inclusion of these investment instruments is proposed only on the basis that if purchased they would be held until maturity under normal circumstances. At maturity the investment and expected interest would be paid in full.

43. In the case of Certificates of Deposit then these would only be sold early on the basis that there were concerns over the borrower defaulting. This liquidity is one of the attractions of this type of investment.

44. The addition of these investments allows the Council to manage interest rate risk more effectively and in that sense reduces this risk. Investments that involve this judgement will only be taken by a decision of the Treasury Management Panel chaired by the Director of Finance and Resources.

45. In addition it is also possible to invest in collective investment schemes; there are many types of these with varying different risk and return profiles, but the category has been included here subject to a decision of the Treasury Management Panel.

46. It is proposed to cap the investment in these other categories of non-specified investments at £25m in total; when taken with the long-term local authority investment (£45m) the final total is £70m. This is reflected in the prudential indicators which have been amended to accommodate this revised AIS.

47. **Appendix 2** sets out the investment categories authorised for use in 2013/14 and **Appendix 3** list the actual counterparties recommended by Arlingclose at the time of writing this report.

Appendix 2

Investment categories authorised for use 2013/14

Investment	Specified	Non-Specified	Comments
UK Government - Debt Management Account Deposit Facility (DMADF) (regulation investment)	unlimited	n/a	6 months maximum available
UK Government - Treasury Bills (T-Bills) (regulation investment)	unlimited	n/a	6 months maximum available
UK local authorities term deposits (regulation investment)	unlimited	£45m	Up to 40 years in duration (non-specified)
AAA-Rated Money Market Funds *	✓	n/a	50% of total investments in this category Lower of 0.50% of MMF size or 10% of all investments per MMF
Term deposits with banks and building societies *	✓	×	50% of total investments in this category Lower of 15% of total investments or £30m per counterparty
Certificates of deposit with banks and building societies	✓	✓	Maximum £25m across all of these categories in total
UK Government - Gilts	✓	✓	
Bonds issued by Multilateral Development Banks	✓	✓	

Collective Investment Schemes	×	✓	

***** see **Appendix 3** for a list of investments

Appendix 3

Lending List (the List) - September 2013	
	Time Limit
Regulation Investments	
DMADF account	6 months
UK Government T-bills	6 months
UK Local Authority	12 months
Banks and Building Societies	
Barclays	12 months
Close Brothers Ltd	100 days
HSBC	12 months
Lloyds / Bank of Scotland	6 months
Nationwide	12 months
RBS / NatWest	overnight
Santander	100 days
Standard Chartered	12 months
MMF	
Black Rock	same day
Insight	same day
Federated Prime Rate	same day
Ignis	same day