

APPENDIX 2

ANNUAL INVESTMENT STRATEGY

Investment Policy

The Council will have regard to the CLG's Guidance on Local Authority Investments and CIPFA's Treasury Management in Public Services Code of Practice. Both the CIPFA Code and the CLG Guidance require the Council to invest its funds prudently, and to have regard to the **security** and **liquidity** of its investment before seeking the highest rate of return, or **yield**.

The borrowing of monies purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity.

Investment instruments identified for use in the financial year are listed below under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the Council's Treasury Management Practices – Schedules.

The strategy of this policy is to set outer limits for treasury management operations. In times of exceptional market uncertainty, Council Officers will operate in a more restrictive manner than the policy allows, as has been the case during the last three years.

Avon Pension Fund Investments

The Council's Treasury Management team also manage the Avon Pension Fund's internally held cash on behalf of the Fund. New regulations required that this cash is accounted for separately and needs to be invested separately from the Council's cash, and the split has been managed this way since 1 April 2010. The Fund's investment managers are responsible for the investment of cash held within their portfolios and this policy does not relate to their cash investments.

The cash balance held internally is a working balance to cover pension payments at any point in time and as a result the working balance will be c. £10 million. This working balance represents around 0.5% of the overall assets of the Fund. These investments will operate within the framework of this Annual Investment Strategy, but the maximum counterparty limit and investment term with any counterparty were set by the Avon Pension Fund Committee at its meeting on 18th December 2009. These limits are in addition to the Council's limits for counterparties as set out in Appendix 3.

Specified Investments

Specified investments are those expected to offer relatively high security and liquidity, and can be entered into with the minimum of formalities. The CLG Guidance defines specified investments as those:

- denominated in pounds sterling,
- due to be repaid within 12 months of arrangement,
- not defined as capital expenditure by legislation, and
- invested with one of:
 - the UK Government,
 - a UK local authority, parish council or community council, or
 - a body or investment scheme of “high credit quality”.

The Council defines the following as being of “high credit quality” for making specified investments, subject to the monetary and time limits shown.

	Maximum Monetary limit	Time limit (or notice)
Banks and building societies holding long-term credit ratings no lower than A or equivalent, short-term credit ratings no lower than F1 or equivalent and Support Ratings no lower than 3 or equivalent	£20m each (highest limit) ¹	12 months
UK building societies not meeting the above criteria that have a minimum asset size of £4bn and a long-term rating of BBB or above and short-term credit rating of F2 or above.	£2m each	3 months
Money market funds ² holding the highest possible credit ratings (AAA)	£5m each	1 week
UK Central Government (Including Debt Management Agency Deposit Facility)	no limit	12 months
UK Local Authorities ³	£5m each	12 months

¹ banks within the same group ownership are treated as one bank for limit purposes; Within this category and in accordance with the Code, The Council has set additional criteria to set the time limit and amount of monies which will be invested. The countries from which banks the Council can invest are detailed in the paragraph “Foreign Countries” below

² as defined in the Local Authorities (Capital Finance and Accounting) Regulations 2003

³ as defined in the Local Government Act 2003

The Council will continue its policy of using increased counterparty limits (£20m) in relation to investments with UK banks & Building Societies that have either already or are likely to receive support from the UK Government should they experience financial difficulties. These limits will only apply while the Fitch “Support” rating remains at the highest level (Level 1). This is restricted to the following banks and Building Societies:

Barclays Bank, HSBC Bank, Lloyds Banking Group (Lloyds TSB & Bank of Scotland), Royal Bank of Scotland Group (Nat West & Royal Bank of Scotland) and Nationwide Building Society.

Building Societies

UK building societies with lower credit ratings will be considered to be of “high credit quality”, but subject to a lower cash limit and shorter time limit than rated societies. The Council takes additional comfort from the building societies’ regulatory framework and insolvency regime where, in the unlikely event of a building society liquidation, the Council’s deposits would be paid out in preference to retail depositors. Investments in lower rated and unrated building societies will be reviewed if the insolvency regime is amended in future.

However, no investments will be made with building societies that hold a short-term credit rating lower than F2 or equivalent or a long-term credit rating of BBB or equivalent due to the increased likelihood of default implied by this rating.

Money market funds

Money market funds are pooled investment vehicles consisting of instruments similar to those used by the Council. They have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager. Fees of between 0.10% and 0.20% per annum are deducted from the interest paid to the Council.

The highest quality funds currently hold AAA credit ratings, although the rating scales applicable to money market funds are currently under review. Should the rating system change, funds holding ratings deemed to be equivalent to AAA will still be considered to be of “high credit quality”.

Non-Specified Investments

Any investment not meeting the definition of a specified investment is classed as non-specified. The Council does not intend to make any investments in foreign currencies, nor any with low credit quality bodies, nor any that are defined as capital expenditure by legislation (such as company shares or corporate bonds).

Non-specified investments will therefore be limited to long-term investments, i.e. those that are due to mature 12 months or longer from the date of arrangement. The maximum duration of the investment will depend upon its lowest published long-term credit rating and whether it is a UK counterparty:

Long-term credit rating	Time limit (UK)	Time limit (Foreign)
AAA	5 years	5 years
AA+	2 years	2 years
AA	2 years	N/A
AA-	2 years	N/A

The time limit for long-term investments in UK Local Authorities will be five years.

Long-term investments will be limited to 50% of a banks total counterparty limit where it meets the above credit rating criteria (except the UK Government). The combined value of short-term and long-term investments with any organisation will not exceed the limits for specified investments highlighted above.

The total limit on long-term investments, and the total limit on non-specified investments is 25% of total investments.

Information on the security of investments

Full regard will be given to available information on the credit quality of banks and building societies, including credit default swap prices, financial statements and rating agency reports. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria set out above.

Use of Credit Ratings

The Council uses credit ratings from the three main rating agencies Fitch Ratings Ltd, Moody's Investors Service and Standard & Poor's to assess the risk of loss of investments. The lowest available credit rating will be used to determine credit quality.

In light of the experience of Government support to banks over the past year, and the likelihood this will continue, the Council will not be restricted on the "Individual" rating to assess counterparties, placing more reliance on the "Support" ratings to supplement long and short term ratings. Support Ratings are the Ratings Agencies assessment of a potential supporter's propensity to support a bank, and of its ability to support it. Support Ratings do not assess the intrinsic credit quality of a bank. Rather they communicate the agency's judgment on whether the bank would receive support should this become necessary. Although the Council will no longer be restricted by "Individual" ratings, they will still be considered as part of the overall investments decision making process. This move to no longer place such high reliance on "Individual" ratings has been suggested by our external adviser.

Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings on a daily basis as they occur, and the counterparty listing is updated immediately. Where an institution has its credit rating downgraded so that it fails to meet the above criteria then:

- no new investments will be made,
- any existing investments that can be recalled at no cost will be recalled, and
- full consideration will be given to the recall of any other existing investments

Where a credit rating agency announces that it is actively reviewing an organisation's credit ratings with a view to downgrading it so that it is likely to fall below the above criteria, no further investments will be made until the outcome of the review is announced.

If further counterparties are identified during the year that meet the minimum credit rating criteria and conform to the other criteria set out in the Treasury Management Practice Schedules, they can be added to the lending list following the agreement of the Section 151 Officer and the Cabinet Member for Resources.

Investment instruments

Investments may be made using any of the following instruments:

- interest paying bank accounts
- fixed term deposits
- call or notice deposits (where the Council can demand repayment)
- callable deposits (where the bank can make early repayment)
- certificates of deposit
- treasury bills and gilts issued by the UK Government
- bonds issued by multilateral development banks (*e.g. the EIB*)
- AAA money market funds

Investments may be made at either a fixed rate of interest, or at a variable rate linked to a market interest rate, such as LIBOR.

Foreign countries

Investments in foreign countries will be limited to those that hold a AAA or AA+ sovereign credit rating from all three major credit rating agencies, and to a maximum of £15 million per country. Banks that are domiciled in one country but are owned in another country will need to meet the rating criteria of and will count against the limit for both countries. There is no limit on investments in the UK.

Liquidity management

The Council regularly reviews and updates its cash flow forecasts to determine the maximum period for which funds may prudently be committed. Limits on long-term investments are set by reference to the Council's medium term financial plan, levels of reserves and cash flow forecast.

Planned investment strategy for 2011/12

Investments are made in three broad categories:

- Short-term – cash required to meet known cash outflows in the next month, plus a contingency to cover unexpected cash flows over the same period.

- Medium-term – cash required to manage the annual seasonal cash flow cycle, including amounts to cover forecast shortages, planned uses of reserves, and a longer-term contingency.
- Long-term – cash not required to meet cash flows, and used primarily to generate investment income.

Short-term funds are required to meet cash flows occurring in the next month or so, and the preservation of capital and liquidity is therefore of paramount importance. Generating investment returns is of limited concern here, although it should not be ignored. Bank deposit accounts will be the main methods used to manage short-term cash.

Medium-term funds which may be required in the next one to twelve months will be managed concentrating on security, with less importance attached to liquidity but a slightly higher emphasis on yield. The majority of investments in this period will be in the form of fixed term deposits with banks and building societies. Preference will continue to be given to investments with UK banks with high credit ratings, on the basis that they either had already or were likely to receive support from the UK Government should they experience financial difficulties. The higher counterparty limits assigned to these banks facilitates this approach.

Cash that is not required to meet any liquidity need can be invested for the longer term with a greater emphasis on achieving returns that will support spending on local authority services. Decisions on making longer term investments (i.e. over 1 year) will be considered during the year after taking account of the interest rate yield curve, levels of core cash and the amount of temporary internal borrowing related to funding of capital spend.

With short-term interest rates currently much lower than long-term rates, due consideration will also be given to using surplus funds to make early repayments of long-term borrowing. In addition to the savings on the interest rate differential, this strategy will also reduce the Council's exposure to credit risk and interest rate risk.

Review Reports

The revised CIPFA Code of Practice requires that both mid year and annual review reports on treasury activities are reported to Full Council.

Other Matters

The revised CLG Investment Guidance also requires the Council to note the following matters each year as part of the investment strategy:

Investment consultants

The Council contracts with Sterling Consultancy Services to provide advice and information relating to its investment and borrowing activities. However, responsibility for final decision making remains with the Council and its officers. The services received include:

- advice and guidance on relevant policies, strategies and reports,
- advice on investment decisions,
- notification of credit ratings and changes,
- other information on credit quality,
- advice on debt management decisions,
- accounting advice,
- reports on treasury performance,
- forecasts of interest rates, and
- training courses.

The quality of this service is monitored by officers on a regular basis, focusing on supply of relevant, accurate and timely information across the headings above.

Investment training

The needs of the Council's treasury management staff for training in investment management are assessed every year as part of the staff performance development review process, and additionally when the responsibilities of individual members of staff change. Staff regularly attend training courses, seminars and conferences provided by Sterling Consultancy Services and CIPFA.

Investment of money borrowed in advance of need

The Council may, from time to time, borrow in advance of spending need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks.

The total amount borrowed will not exceed the authorised borrowing limit of £204 million. The maximum periods between borrowing and expenditure is expected to be two years, although the Council does not link particular loans with particular items of expenditure.