

The Council's Annual Investment Strategy

Under the revised CIPFA's Treasury Management Code of Practice 2009, the Council is required to formulate a strategy each year regarding the investment of its revenue funds and capital receipts. From 2004-05 onwards the requirements of the Treasury Management Code have been supplemented by guidance from the Communities and Local Government (CLG) and any revisions to that guidance. Authorities are required to take the guidance into account under the terms of section 12 of the Local Government Act 2003. In addition, the Council has regard to the Audit Commission's report on Icelandic investments.

The income and expenditure flow of the Council is such that funds are temporarily available for investment. Under the Annual Investment Strategy the Council may use for the prudent management of its treasury balances any of the investments highlighted under the headings of **Specified Investments** and **Non-Specified Investments** as detailed on the attached table (Appendix 2A).

Creditworthiness Policy

The Council uses the creditworthiness service provided by its treasury advisor, Sector Treasury Services. Previously the Council set minimum long term, short term, individual and support credit ratings for its specified and non specified investments based on information supplied by Sector from two of the three credit rating agencies Fitch and Moody's. However, following the problems with Icelandic Banks and the issue of the revised CIPFA Code of Practice on Treasury Management the Council is now required to use ratings from all three credit rating agencies and must not solely rely on an institutions credit rating when considering placing an investment. In light of this, Sector has been progressively enhancing their service and now uses a sophisticated modelling approach with credit ratings from all three rating agencies Fitch, Moody's and Standard and Poor's. In addition, in line with the revised Treasury Management Code of Practice 2009, it does not rely solely on the current credit ratings of counterparties but also uses the following overlays:-

- Credit watches and credit outlooks from credit rating agencies.
- Credit Default Swap (CDS) spreads to give an early warning of likely changes in credit ratings.
- Sovereign ratings to select counterparties from only the most creditworthy countries.

This modelling approach combines credit ratings, credit watches, credit outlooks and CDS spreads in a weighted scoring system for which the end product is a series of colour code bands which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Council to determine the duration of investments and are therefore referred to as durational bands. The Council is satisfied that this service now gives a much improved level of security for its investments. It is also a service which the Council would not be able to replicate using in house resources.

The selection of counterparties with a high level of creditworthiness will be achieved by a selection of institutions down to a minimum durational band with Sector's weekly credit list of worldwide potential counterparties. The Council will therefore use counterparties within the following durational bands:-

- Yellow – 5yrs e.g. UK Gilts, Collateralised Deposits
- Purple - 2yrs (Council currently has maximum of 1 year)
- Blue - 1 year (only applies to nationalised or part nationalised UK Banks)
- Orange - 1 year
- Red - 6 months
- Green - 3 months
- No colour – not to be used

The Sector creditworthiness service uses ratings from all three agencies, but by using a scoring system, does not give undue over reliance to just one agency's ratings.

Monitoring of Credit Ratings

All credit ratings will continue to be monitored continuously and formally updated monthly. The Council is alerted to interim changes in ratings by Sector Treasury Services.

If a counterparty's or investment scheme's rating is downgraded with the result that it no longer meets the Council's minimum criteria, the further use of that counterparty will be withdrawn immediately. If a counterparty is upgraded so that it fulfils the Council's criteria, its inclusion will be considered for approval by the S151 Officer.

In addition to credit ratings the Council will be advised of information in movements in CDS against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in the downgrade of an institution or the removal from the Council's lending list.

Sole reliance will not be placed on the use of this external service. In addition, the Council will monitor the financial press and also use other market data and information e.g. information on government support for banks and the credit ratings of that government support.

Country Limits

It is recommended that the Council will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch Ratings (or equivalent from other agencies). However, following the problems with Icelandic Banks lending is currently restricted to the UK only which has the highest possible sovereign credit rating of AAA. The S151 Officer has delegated authority to revert back to placing investments in countries with a minimum sovereign credit rating of AA- in line with Sector's revised creditworthiness policy if required.

Security of Capital

Following the market turmoil over the last few years and problems with Icelandic Banks, the Council's current policy is to not place investments with any Foreign banks or AAA rated Money Market Funds. Lending to Foreign banks which comply with Sectors creditworthiness policy or AAA rated Money Market Funds may be considered again but only with the express approval of the Head of Finance. In addition, in order not to solely rely on an institutions credit ratings there have also been a number of other developments which require separate consideration and approval for use:

Nationalised and Part Nationalised banks in the UK effectively take on the creditworthiness of the Government itself i.e. deposits made with them are effectively being made to the Government therefore they have been assigned an F1+ short term rating and a support rating of 1 both of which are the highest ratings possible. However, as they are no longer separate institutions in their own right the credit ratings agencies cannot assign them an individual rating for their stand alone financial strength. For this reason Lloyds TSB, Royal Bank of Scotland (RBS) and National Westminster Bank which are part of the RBS Group are included on the approved counterparty list.

A UK banking system support package (implicit guarantee) has been put in place to ensure the security of the UK banking system by supporting the following banks with a £500 billion support package:-

- Abbey (Now Santander UK)
- Barclays
- Halifax Bank of Scotland (HBOS)
- Lloyds TSB
- HSBC
- Nationwide Building Society
- Royal Bank of Scotland
- Standard Chartered Bank

Although the UK Government has not given a blanket guarantee on all deposits placed with these institutions this additional support provides extra security meaning that credit ratings alone are not relied upon. With the exception of Standard Chartered Bank and HBOS as they have now been taken over by the Lloyds Banking Group all of the institutions listed above meet the Council's creditworthiness policy so can therefore be included on the approved lending list.

Blanket (explicit) Guarantees on all deposits have been given by some countries in order to support their banking system e.g. Ireland and Singapore. Therefore, the country's sovereign rating may take precedence over the individual credit ratings for the banks covered by that guarantee. For this reason, in addition to credit ratings our treasury advisor now also include each country's sovereign ratings on their monthly credit rating lists. Other countries are also providing implicit guarantees for their banking systems. The US, countries within the EU and Switzerland are currently providing major support packages to their banking systems. Again due to this additional government support the authority may consider placing deposits with institutions covered by these guarantees following approval from the S151 Officer.

Local Authorities are not credit rated but where the investment is a straightforward cash loan, statute suggests that the credit risk attached to local authorities is an acceptable one (Local Government Act 2003 s13). Local Authorities are therefore included on the approved list.

The total permitted investment in any one organisation at any one time varies with the strength of the individual credit rating. For the highest rated and Part Nationalised Institutions the maximum amount is currently limited to £30m. Any changes to the maximum limit must be approved by the S151 Officer.

DCLG Investment Guidance

Guidance from the DCLG requires Councils to give priority to the security and liquidity of investments over yield whilst still aiming to provide good returns. This is in line with the Council's current practice and it is recommended that the policy should be reaffirmed.

The guidance also requires Councils to categorise their investments as either "specified" or "non-specified" investments.

(i) Specified Investments

Specified investments are deemed as "safer" investments and must meet certain conditions, ie they must :-

- be denominated in sterling
- have less than 12 months duration
- not constitute the acquisition of share or loan capital

- either: be invested in the UK government or a local authority
 or a body or investment scheme with a "high" credit quality.

The Council is required to specify its creditworthiness policy and how frequently credit ratings should be monitored. It must also specify the minimum level of such investments.

Of the investments currently authorised by the Council, deposits in the Debt Management Office Account and with other Local Authorities automatically qualify as specified investments as they are of less than 12 months duration and are denominated in sterling.

The classification of the other investments is dependent on the counterparty having high credit quality in line with Sector's creditworthiness policy. The Council is alerted to any changes in an institutions credit rating by Sector Treasury Services.

(ii) Non Specified Investments

The Council is required to look at non-specified investments in more detail. It must set out:

- procedures for determining which categories of non-specified investments should be used
- the categories deemed to be prudent
- the maximum amount to be held in each category

The Strategy must also set out procedures for determining the maximum period for committing funds.

It is recommended that the following procedure be adopted for determining which categories of non-specified investments should be used:

- the Cabinet/Council should approve categories on an annual basis
- advice should be provided by the S151 Officer
- priority should be given to security and liquidity ahead of yield

It is recommended that for specified investments the range of maximum limits is set between £10m and £30m for the internal treasury team. For non specified investments it is recommended that the limit for the internal treasury team should be restricted to £40m of the total investment portfolio. Any changes to the maximum limits must be approved by the S151 Officer.

Temporary Investment Strategy

The next financial year is expected to see investment rates continue to be at historically low levels. The Bank Rate has remained at 0.50% since March 2009. It is not expected to rise to 0.75% until December 2011. It is expected to end the financial year at 1.00% following a further 0.25% rise in March 2012. There is a downside risk to these forecasts if recovery from recession proves to be weaker and slower than currently expected. This view is based on the latest forecasts obtained by the Authority's treasury advisor, Sector Treasury Services.

If an external fund manager is appointed in 2011/2012 they would also have to adhere to the authorised specified and non-specified investments on the attached table. They would also have to comply with the Council's Annual Investment Strategy and their agreement must stipulate guidelines and other limits in order to contain and control risk.

Short term cash flow requirements limit the scope for longer term investments for the in-house treasury team, but the market is continually monitored for opportunities to lock in to higher, longer term rates in order to bring some stability to the returns going forward and add value. However, based on the interest rate assumptions outlined above, we do not expect to lock into longer term deals while investment rates are down at historically low levels unless exceptionally attractive rates are available which make longer term deals worthwhile.

For the cash flow generated balances, we will seek to utilise instant access accounts and short dated deposits (1-3 months) in order to benefit from the compounding of interest.

The present strategy is to diversify investments so as to spread risk over a range of investment types and periods and provide the opportunity to enhance returns. Due to the current lending restrictions in place diversification has been somewhat reduced due to the reduction in the number of institutions which we can lend to however, by taking this course of action the credit risk has been reduced. The current portfolio is set out in paragraph 29 of the Treasury Strategy 2011/12 report. Performance of the in-house operation will continue to be monitored on a quarterly basis by your officers in conjunction with the treasury advisor.

In December 2007, Council approved that dollar denominated deposits could be held, on behalf of West Mercia Supplies (WMS) only. This was so the cost of ordering goods from overseas could be minimised. The schedule of specified/non specified investments allows WMS funds only to be placed in US dollars. No Council funds are permitted to be placed in US dollars.

All investments will continue to be made in accordance with the Local Government Act 2003, and with those institutions on the authorised lending list. The credit status of institutions on the approved list is monitored continuously.

At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

Policy on the use of external service providers

The Council currently uses Sector Treasury Services as its external treasury management advisers. The Council recognises that the responsibility for treasury management decisions remains with the Council at all times and will ensure the undue reliance is not placed upon our external service providers. The Council also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented and subjected to review.

Scheme of Delegation

Full Council

- Approval of Treasury Strategy.
- Receiving and reviewing reports on treasury management policies, practices and activities including the Annual Treasury Report and Mid Year Report.
- Budget consideration and approval

Cabinet

- Receiving & reviewing Treasury Strategy, Mid Year Report, Annual Treasury Report and Quarterly Treasury Management Update Reports

Audit Committee

- Reviewing the treasury management policy and procedures and making recommendations to the responsible body.
- Receiving & reviewing Treasury Strategy, Mid Year Report, Annual Treasury Report.

Role of the Section 151 Officer

The role of the S151 Officer in relation to treasury management is as follows:-

- Recommending clauses, treasury management policy/practices for approval, reviewing the same regularly and monitoring compliance.
- Approval of segregation of responsibilities.
- Approval of the Treasury Policy Statement and Treasury Management Practices.
- Submitting regular treasury management policy reports.
- Submitting budgets and budget variations.
- Receiving and reviewing management information reports.
- Reviewing the performance of the treasury management function.
- Ensuring the adequacy of treasury management resources and skills and the effective division of responsibilities within the treasury management function.
- Ensuring the adequacy of internal audit and liaising with external audit.
- Recommending the appointment of external service providers.

Pension Fund Cash

This Council will comply with the requirements of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009, which were implemented on 1st January 2010, and from 1st April 2010 will not pool pension fund cash with its own balances for investment purposes. Any investments made by the Pension Fund directly with the Council after 1st April 2010 will comply with the requirements of SI 2009 No 393.