

Annual Investment Strategy and Creditworthiness Policy 2017/18

1. Treasury Management Practice: Credit and Counterparty Risk Management

In 2010 the CLG issued Investment Guidance, which forms the structure of the Council's policy below (please note that these guidelines do not apply to trust funds or pension funds which operate under a different regulatory regime). The key intention of the Guidance is to maintain the current requirement for councils to invest prudently, and that priority is given to security and liquidity before yield.

To facilitate this objective the guidance requires this Council to have regard to the 2011 revised CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. In accordance with the Code, the Strategic Director -Finance & Investments (SDFI) has produced its treasury management practices (TMPs). This part, TMP 1(5), covering investment counterparty policy requires approval each year.

Continuing regulatory changes in the banking sector are designed to see greater stability, lower risk and the removal of expectations of Government financial support should an institution fail. The withdrawal of implied sovereign support is anticipated to have an effect on ratings applied to institutions.

This will result in the key ratings used to monitor counterparties being the Short and Long Term ratings only. Viability, financial strength and support ratings previously applied will effectively become redundant. This change does not reflect deterioration in the credit environment but rather a change of method in response to regulatory changes.

As with previous practice, ratings will not be the sole determinant of the quality of an institution and that it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate.

The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as "credit default swaps". Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

Investment instruments identified for use in the financial year are listed in this appendix under the 'specified' and 'non-specified' investments categories.

1.1 Annual Investment Strategy

The key requirements of the Code and investment guidance are to set an annual investment strategy covering the identification and approval of the following:

1. The strategy guidelines for choosing and placing investments, particularly non-specified investments.

2. The principles to be used to determine the maximum duration for investments.
3. Specified investments that the Council will use. These are high security and high liquidity investments in sterling and with a maturity of no more than a year.
4. Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.
5. An additional consideration is the variable cash position the Council will have because of Council's investment strategy. The investment strategy will mean that the Council will be making significant borrowing and investment decisions and these may result in period where the Council has a significant allocation to a counterparty.

1.2 Creditworthiness policy

This Council uses an adapted version of the creditworthiness approach used by CAS. This service employs a modelling approach utilising credit ratings from the three main credit rating agencies (Fitch, Moody's & Standard and Poor's). This approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. The Council uses the following colour codes to determine the suggested duration for investments:

- **Yellow** 5 years
- **Dark pink** 5 years - enhanced money market fund with a credit score of 1.25
- **Light pink** 5 years - enhanced money market fund with a credit score of 1.50
- **Purple** 2 years
- **Blue** 2 year (only applies to Royal Bank of Scotland)
- **Orange/Red** 1 year
- **Green** 100 days
- **No colour** not to be used

The Council uses a one year limit for red colour ratings, which differs from the model used by CAS, which sets a limit of 6 months. This difference reflects a different risk appetite to the standard limits recommended by CAS.

Typically the minimum credit ratings criteria the Council use will be a Short Term rating (Fitch or equivalents) of **F2** and a Long Term rating of **A-**. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

The Council is alerted to changes to ratings of all three agencies through its use of our creditworthiness service. If a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.

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

Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on sovereign support for banks and the credit ratings of that supporting government.

1.3 The Monitoring of Investment Counterparties

The credit rating of counterparties will be monitored regularly. The Council receives credit rating information from its advisor as and when ratings change, and counterparties are checked promptly. Any counterparty failing to meet the criteria will be removed from the list immediately by the SDFI, and if required new counterparties which meet the criteria will be added to the list.

1.4 Use of External Cash Manager(s)

The Council no longer uses an external cash manager within its investment portfolio. Were the Council to use an external cash manager in the future there would be a requirement for the Cash Manager to comply with the Annual Investment Strategy. Any agreement between the Council and the cash manager will stipulate guidelines, durations and other limits in order to contain and control risk. The investment restrictions for a cash manager have been included in the Credit Quality Criteria and Allowable Financial Instruments outlined below.

1.5 Use of additional information other than credit ratings

Additional requirements under the Code require the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties.

This additional market information (for example CDSs, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.

1.6 Credit Quality Criteria and Allowable Financial Instruments

The table on the following page sets out the credit quality criteria for counterparties and allowable financial instruments for Council investments. These are split into Specified and Non-specified investments.

1.7 Specified Investments - Sterling investments of less than one year maturity, or those which could be for a longer period but where the Council has the right to be repaid within 12 months. These are considered low risk assets where the possibility of loss of principal or investment income is small.

These would include sterling investments which would not be defined as capital expenditure with:

1. The UK Government (such as the Debt Management Account Deposit Facility, UK Treasury Bills or Gilts with less than one year to maturity).
2. Supranational bonds of less than one year's duration.
3. A local authority, parish council or community council.
4. Pooled investment vehicles (PIV) with a high credit rating. This covers PIVs such as money market funds, rated AAA by the rating agencies.
5. A body (i.e. bank or building society), of sufficiently high credit quality.

1.8 Non-Specified Investments

Non-specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non specified investments would include any sterling investments with:

Non Specified Investment Category (maturity greater than one year)	
a.	<p>Supranational Bonds</p> <p>(a) Multilateral development bank bonds These are bonds defined as an international financial institution having as one of its objects economic development, either generally or in any region of the world (e.g. European Investment Bank etc.).</p> <p>(b) A financial institution that is guaranteed by the UK Government The security of interest and principal on maturity is on a par with the Government and so very secure. These bonds usually provide returns above equivalent gilt edged securities. However the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.</p>
b.	<p>Gilt edged securities. Government bonds which provide the highest security of interest and the repayment of principal on maturity. Similar to category (a) above, the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.</p>
c.	<p>The Council's own bank if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible. The Council's current bankers are Lloyds Banking Group which is currently supported by the UK government.</p>
d.	<p>Any bank or building society that has a minimum long term credit rating of A- or equivalent, for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).</p>
e.	<p>Share capital or loan capital in a body corporate – The use of these instruments will be deemed to be capital expenditure, and as such will be an application (spending) of capital resources. Revenue resources will not be invested in corporate bodies. There is a higher risk of loss with these types of instruments.</p>
f.	<p>Pooled property or bond funds – normally deemed to be capital expenditure, and as such will be an application (spending) of capital resources. Revenue resources will not be invested in corporate bodies.</p>

Within categories c and d, and in accordance with the Code, the Council has developed additional criteria to set the overall amount of monies which will be invested in these bodies. In respect of categories e and f, these will only be considered after obtaining external advice and subsequent Member approval.

1.9 Alternative investment instruments

Currently the Council invests its cash with financial institutions, other Local Authorities, with the UK Government or through loans to companies and schools where prior agreement has been made by Cabinet.

There are a range of alternative investments instruments that the Council could invest in and these are reviewed at least annually to see if they meet the Council's risk appetite. There are varying degrees of risks associated with such asset classes and these need comprehensive appreciation. It is not just credit risk that needs to be understood, but liquidity and interest rate / market risk as well, although these can often be intertwined. Any option in which an investor hopes to generate an elevated rate of return will almost always introduce a greater level of risk. By carefully considering and understanding the nature of these risks, an informed decision can be taken. These instruments are summarised below:

Property Funds

The Council's Pension Fund already invests in property funds and these have provided a good rate of return, especially over the past two years. The costs to invest in property and then to disinvest are around 8% but steady income streams and capital appreciation can provide a net return of 6% to 8% per annum.

Investing in property is not risk free and there is the potential to lose not just the investment return but some of the original amount invested and the investment period is generally long term (over 5 years). The use of these instruments can also be deemed capital expenditure, and as such will be an application (spending) of capital resources.

This type of investment is appropriate where a council has an amount of cash that it is unlikely to use over the long term. There is currently some significant uncertainty over the Council's medium term cash position, both positively as the Council uses its cash balances to invest in growth but also as a result of budget pressures reducing the Council's reserves. In addition the Council currently has a significant housing investment strategy which is likely to use a significant part of the Council's cash balances. As a result it is unlikely that the treasury section will seek to invest in a Property Fund.

Challenger Banks

At present Challenger Banks, which includes Metro Bank, Tesco Bank and Aldemore, do not have credit ratings and so fall outside of the Council's investment strategy criteria. It is likely that some of these banks will get a credit rating in coming years, and treasury will continue to monitor these banks as the UK banking environment would benefit from additional competition.

Specified Investments and Non-Specified Investments Limits and Criteria

Counterparty / Financial Instrument	Minimum Credit Rating Criteria / Colour Band	Specified Investments		Non-Specified Investments	
		Maximum Duration	Counterparty Limit £m	Maximum Duration	Counterparty Limit £m
Lloyds Banking Group SIBA (Call) Accounts Term Deposits, CDs, Structured Deposits, Corporate Bonds	A-	Up to 1 year	£80m	1 to 3 years	£80m
Government Supported UK Bank – Royal Bank of Scotland SIBA (Call) Accounts Term Deposits, CDs, Structured Deposits, Corporate Bonds	Blue	Up to 1 year	£80m	1 to 2 years	£80m
Other UK Banks & Building Societies SIBA (Call) Accounts Term Deposits, CDs, Structured Deposits, Corporate Bond	Yellow Purple Orange/Red Green No Colour	N/A N/A Up to 1 year Up to 3 mths Not for use	£30m per counterparty	1 to 5 years 1 to 2 years N/A N/A N/A	£30m per counterparty
Bond Funds - Corporate Bonds	Short-term F2, Long Term A-	Up to 1 year	£20m	1 to 2 years	£20m
Local Authorities: Term Deposits	Not credit rated	Up to 1 year	£40m per authority	1 to 3 year	£40m per authority
UK Government Treasury Bills Gilts DMADF	UK Sovereign Rating	Up to 1 year	£50m	1 to 5 years	£20m
Money Market Funds	AAA	T+1	£30m per Manager	N/A	N/A
Property Funds	N/A	N/A		N/A	£20m

1.10 Use of other Local Authorities

For cash loans the Local Government Act (LGA) 2003 s13 suggests the credit risk attached to English, Welsh and Scottish local authorities is an acceptable one.

1.11 Use of Multilateral Development Banks

S15 of the LGA Act 2003 SI 2004 no. 534 amended provides regulations to clarify that investments in multilateral development banks were not to be treated as being capital expenditure. Should the Council invest in such institutions then only such institutions with AA credit rating and government backing would be invested in consultation with the Council's treasury adviser and the S151 Officer.

1.12 Use of Brokers

The Council deals with most of its counterparties directly but from time to time the Council will use the services of brokers to act as agents between the Council and its counterparties when lending or borrowing. However no one broker will be favoured by the Council. The Council will ensure that sufficient quotes are obtained before investment or borrowing decisions are made via brokers.

1.13 Country limits and Use of Foreign Banks

The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- (excluding the United Kingdom) from Fitch. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy. This will ensure that the Council's investments are not concentrated in too few counterparties or countries.

Given the strength of some foreign banks the Council will invest in strong non UK foreign banks whose sovereign and individual ratings meet its AA minimum criteria.

Approved countries for investments (Credit Rating as at 31 December 2016)

The list below is based on those countries which have sovereign ratings of AA- or higher (below is the lowest rating from Fitch, Moody's and S&P) and also, (except - at the time of writing - for Hong Kong, Norway and Luxembourg), have banks operating in sterling markets which have credit ratings of green or above.

AAA	AAA	AA+	AA	AA-
Australia	Netherlands	Finland	Abu Dhabi (UAE)	Belgium
Canada	Norway	Hong Kong	France	
Denmark	Singapore	U.S.A.	Qatar	
Germany	Sweden		U.K.	
Luxembourg	Switzerland			

1.14 Provisions for Credit-related losses

If any of the Council's investments appeared at risk of loss due to default, (i.e. a credit-related loss and not one resulting from a fall in price due to movements in interest rates) the Council will make revenue provision of an appropriate amount.

Where there is a loss of the principal amount borrowed due to the collapse of the institution, the Council will seek legal and investment advice.

1.15 End of year investment report

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