

Annual Investment Strategy 2018/19

1. Background

- 1.1 In 2010 the DCLG issued Investment Guidance with the key intention of the Guidance to maintain the current requirement for councils to invest prudently, and that priority is given to security and liquidity before yield. To facilitate these objectives 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 (the Code). This report fulfils the Authority's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the DCLG Guidance.
- 1.2 However, currently a consultation has been published by the DCLG considering changes to the 2010 Guidance which will impact the Prudential Code, the Treasury Management Code and the Minimum Revenue Provision (MRP) guidance. The key changes proposed are around ensuring that prudence and comprehensive due diligence forms part of any Council investment, including both treasury and property investments. The changes require greater transparency to ensure that Members understand and approve the overall investment strategy.
- 1.3 Although the exact requirements in the consultation are not known, this Council has a good track record of transparency of its treasury investments, and this report has been written to include all the proposed reporting requirements within the consultation. However, if additional reporting is required, then this will be included in the 2017/18 Treasury Management Annual Review report, due to be reported in June 2018.
- 1.4 Over the coming years the Council will significantly increase its investments in property as part of its Investments and Acquisition strategy. Financial risks, including the loss of capital, the loss of forecast income and the revenue effect of changing interest rates will be significant. The successful identification, monitoring and control of investment risk are therefore central to the Council's Treasury Management Strategy Statement (TMSS).
- 1.5 Borrowing risks also forms a key part of the TMSS, where a holistic approach to borrowing is outlined, taking into accounts opportunities from low interest rates, cash flow requirements and a significant range of borrowing options available to the Council. The strategy also outlines the need to avoid more complex forms, especially where derivatives are involved or where there is significant backloading of capital repayment
- 1.6 In accordance with the DCLG Guidance, the Council will be asked to approve a revised TMSS should the assumptions on which this report is based change significantly. Such circumstances would include, for example, a large unexpected change in interest rates or in the Council's capital programme.

2. Annual Investment Strategy (AIS)

2.1 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.

2.2 The Council's Annual Investment Strategy (AIS) continues to consider credit rating of financial institutions it invests with, but ratings are not the sole determinant of the quality of an institution. The strategy looks 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 takes 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".

2.3 Other information sources used will include the financial press, share price and other such information pertaining to the banking sector 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.

2.4 In addition to the Council's cash investments, which have historically been the main focus of the AIS, this year an additional section on property investments has been included. Although property investments will be agreed individually by Cabinet and the Investment Panel, the way these investments will be reported, how interest and profit will be recorded and how these investments will be held is outlined in section 3 of the AIS.

3. Creditworthiness policy

3.1 This Council uses an adapted version of the creditworthiness approach used by the Council's advisors, Link Asset Services (LAS). 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

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

3.3 Typically, the minimum credit ratings criteria the Council use will be a Short-Term rating (Fitch or equivalents) of **F1** 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.

3.4 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.

3.5 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.

3.6 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.

4. The Monitoring of Investment Counterparties

4.1 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 COO, and if required new counterparties which meet the criteria will be added to the list.

5. Use of External Cash Manager(s)

5.1 The Council no longer uses an external cash manager (ECM) within its investment portfolio, with all investments and borrowing managed in-house. Were the Council to use an ECM in the future there would be a requirement for the ECM to comply with

the AIS. Any agreement between the Council and the ECM will stipulate guidelines, durations and other limits to contain and control risk.

- 5.2 Prior to appointing an ECM, a full OJEU compliant tender process is required. An extensive background in cash management will be a prerequisite, alongside Financial Conduct Authority accreditation. The requirement to tender includes both for lending to a third party to invest and appointing an ECM to directly invest.

6. Use of additional information other than credit ratings

- 6.1 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.

7. Credit Quality Criteria and Allowable Financial Instruments

- 7.1 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.

- 7.2 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 minimal 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 Govt. (UK Treasury Bills, 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. (AAA Money Market Funds).
5. A body (i.e. bank of building society), of sufficiently high credit quality.

7.3 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.	Supranational Bonds (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.). (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.
b.	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.
c.	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.
d.	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).
e.	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.
f.	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.

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. These criteria is set out in section 11.3 in the body of the report. In respect of categories e and f, these will only be considered after obtaining external advice and subsequent Member approval.

7.4 Non-Treasury Investments

Although not classed as treasury management activities and therefore not covered by the CIPFA Code or the CLG Guidance, the Council may also purchase property for investment and regeneration purposes and may also make loans and investments for service purposes, for example loans to partner organisations or the Council subsidiaries.

Such loans and investments will be subject to the Council's normal approval processes for revenue and capital expenditure and need not comply with the TMSS. However, it is important to note that there are varying degrees of risks associated with such asset classes and this 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.

The Authority's existing non-treasury investments are listed in Appendix 1a.

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
Council's Bank (currently Lloyds Baking Group)	A	T+1	£20m	N/A	N/A
Lloyds Banking Group SIBA (Call) Accounts Term Deposits, CDs, Structured Deposits, Corporate Bonds	A	Up to 1 year	£100m	1 to 3 years	£100m
Government Supported UK Bank – Royal Bank of Scotland SIBA (Call) Accounts Term Deposits, CDs, Structured Deposits, Corporate Bonds	Blue	Up to 1 year	£50m	1 to 2 years	£50m
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	£50m per counterparty	1 to 5 years 1 to 2 years 1 to 2 years N/A N/A	£50m per counterparty
Bond Funds - Corporate Bonds	Short-term F2, Long Term A	Up to 1 year	£20m	1 to 3 years	£20m
Local Authorities: Term Deposits	Not credit rated	Up to 1 year	£50m per authority	1 to 5 years	£50m per authority
UK Government - Treasury Bills, Gilts DMADF	UK Sovereign Rating	Up to 1 year	£50m	1 to 10 years	£20m
All types of Money Market Funds / Cash Plus	AAA	T+1	£30m per Manager	N/A	N/A
Property Funds	N/A	N/A		N/A	£40m

8. Use of other Local Authorities

8.1 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.

9. Use of Multilateral Development Banks

9.1 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.

10. Use of Brokers

10.1 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.

11. Country limits and Use of Foreign Banks

11.1 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.

11.2 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 2017)

11.3 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)	New Zealand
Canada	Norway	Hong Kong	France	South Korea
Denmark	Singapore	U.S.A.	Qatar	
Germany	Sweden	Austria	U.K.	
Luxembourg	Switzerland		Kuwait	

12. Third Party Loans

12.1 As part of the Council's Transformation Programme a number of loans have been made to third parties and wholly owned companies.

12.2 Each loan is closely monitored using the process outlined in section 13 below. The loan details, when it was agreed and the reason for each loan is outlined below.

i. Loan to Be First

At the November 2016 Cabinet, Members agreed to establish a new Council-owned company to manage the delivery of the borough's regeneration agenda, Be First, in line with Recommendation 8 of the report of the independent Growth Commission.

Be First is a 100% Council-owned company that is operationally independent of the Council, operating in the same way as a commercial organisation, and being accountable to members through a Shareholder Executive Board.

To support Be First cash flow requirements during the first few years of established, Members agreed a loan of up to £3.5m to Be First. The Loan details are:

Loan Amount: £3.5m
Start Date: 1 October 2017
Repayment Date 31 March 2021
Rate: 4.0%
Loan Guarantee: London Borough of Barking and Dagenham
Repayment: Equal Instalments. First payment 31 March 2020
Drawdown Period: 1 October 2017 to 30 September 2018

ii. Loan to Barking & Dagenham Trading Partnership

Following the production of a Business Plan, Members agreed a £595k loan for the initial set-up costs, including training, branding, marketing, communications, specialist resources required to set up the new company and initial governance costs such as payments to Directors.

Loan Amount: £595k
Start Date: 1 April 2018
Repayment Date 31 March 2021
Rate: 4.0%
Loan Guarantee: London Borough of Barking and Dagenham
Repayment: Equal Instalments. First payment 31 March 2019
Drawdown Period: 1 April 2018 to 30 September 2018

13. Provisions for Credit-related losses

13.1 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.

13.2 Where the Council holds a non-financial investment, such as property, it will have a physical asset that can be realised to recoup the capital invested. The Council will consider whether the asset retains sufficient value to provide security of investment

using the fair value model in International Accounting Standard 40: Investment Property. Where the fair value of non-financial investments is sufficient to provide security against loss, a fair value assessment will be made stating that a valuation has been made within the past twelve months, and that the underlying assets provide security for capital investment.

13.3 Where the fair value of non-financial investments is no longer sufficient to provide security against loss, the AIS will provide detail of the mitigating actions that the Council is taking or proposes to take to protect the capital invested.

13.4 Where the Council must impair a non-financial asset held for investment purposes as part of the year end accounts preparation and audit process, an updated AIS should be presented to full council detailing the impact of the impairment on the security of investments and any revenue consequences arising therefrom.

13.5 This above approach is reasonable and a prudent approach to investing should help to negate this impact. However, a significant market correction, more complicated investment structures (including investments via equity rather than debt) and a default on any of the Council's loans would leave the Council exposed to an impairment on assets. The impact of the impairment will have a greater impact as the council increases its investment portfolio and third-party loans.

14. End of year investment report

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

15. Policy on Use of Derivatives

15.1 Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

15.2 The Authority will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Authority is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

15.3 Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

16. Investment Training

- 16.1 The needs of the Authority's treasury management staff for training in investment management are assessed as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change. Staff regularly attend training courses, seminars and conferences provided by LAS and other relevant providers.

17. Investment of Money Borrowed in Advance of Need

- 17.1 The Council may, from time to time, borrow in advance of 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 Authority's overall management of its treasury risks.