

**Annual Investment Strategy  
2010/11**



## Annual Investment Strategy

1. Our Annual Investment Strategy details our approach to identifying counterparties deemed sufficiently secure to place our investments. In setting our Strategy the council has regard to the Government Guidance on Local Government Investments, issued in March 2004, any revisions to that guidance, the Audit Commission's report on Icelandic investments and the 2009 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes. This area has become significantly more important since the Icelandic banking crisis, and the impact of the credit crunch on domestic banks. This Authority did not have monies invested in Icelandic banks, and will only invest in institutions with the highest security and / or backing from the Government.
2. The monies the Authority has available for investing are primarily cash flow derived, and are only available temporarily pending expenditure. The council does not have funds available for long-term investments. Hence our investment priorities are:-
  - a) the security of capital and
  - b) the liquidity of our investments.
3. The council will aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. 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.

#### 4. Investment Instruments

Investment instruments identified are categorised as either 'Specified' or 'Non-Specified' Investments.

##### 4.1 Specified' Investments

Specified investments are identified by the Government Guidance as requiring "minimal procedural formalities", and all such investments will be sterling denominated, with maturities up to a maximum of one year, meeting the minimum 'high' rating criteria where applicable. These include deposits with the Government's Debt Management Office, deposits with local authorities and deposits with banks and building societies with 'high' credit ratings. Since the credit crunch there have been a number of developments which require separate consideration:-

##### **Fully nationalised banks in the UK**

Fully nationalised banks in the UK have credit ratings that do not conform to the credit criteria used to identify banks that are of high credit worthiness. In particular, as they are no longer separate institutions in their own right, it is impossible for the rating agencies to assign them an individual rating for their stand alone financial strength. Accordingly they have been assigned an F rating, which means that at a historical point of time, this bank has failed and is now owned by the Government. However, these institutions are now recipients of an F1+ short term rating as they effectively take on the creditworthiness of the Government. They also have a support rating of 1. So in other words, they have the highest ratings possible.

##### **Blanket guarantees on all deposits**

Some countries, such as Ireland, have supported their banking system by giving a blanket guarantee on ALL deposits. However, in determining lending policy the sovereign rating of the country needs to be considered as well as the individual credit

ratings for the banks covered by that guarantee. Investing only in countries with the highest sovereign ratings would have prevented authorities investing in Icelandic banks. This council will only invest in AAA rated countries. Ireland is only AA- rated so its guarantee will not be secure enough for us.

### **UK banking system support package**

The UK Government has NOT given a blanket guarantee on all deposits but has underlined its determination to ensure the security of the UK banking system by supporting eight named banks with a £500bn support package. They are Abbey (now Santander UK), Barclays, HBOS (now part of Lloyds Banking Group), Lloyds TSB, HSBC, Nationwide Building Society, RBS and Standard Chartered. This has resulted in RBS receiving substantial support (greater than 50% ownership) from the UK Government and being assigned an E (since upgraded to D/E) individual rating for their stand alone financial strength i.e. a bank which requires external support. The Lloyds Banking Group has also received significant support from the Government. Decisions as to whether to invest funds within these banks will also take into account their credit worthiness (as outlined in section 5).

### **Other categories of 'specified investments'**

These include Certificates of Deposit issued by banks and building societies either covered by UK Government guarantee or with 'high' credit ratings, Treasury Bills and AAA rated Money Market Funds.

#### **4.2 Non specified' investments**

Non specified' investments carry a higher risk than specified investments, but potentially have a higher yield. These include deposits with maturities in excess of one year. If funds were to be available, it is proposed that a maximum of £10m could be held in aggregate in 'non-specified' investments.

### **5. Creditworthiness policy**

#### **5.1 The council uses the creditworthiness service provided by Sector Treasury Services.**

This service has been progressively enhanced over the last year and now uses a sophisticated modelling approach with credit ratings from all three rating agencies - Fitch, Moodys, and Standard and Poors - forming the core element. By using a scoring system undue reliance is not given to any one agency's ratings. However, the service does not rely solely on the current credit ratings of counterparties but also uses the following as overlays:

- Credit watches and credit outlooks from credit rating agencies
- Credit default swap spreads to give early warning of likely changes in credit rating
- Sovereign ratings to select counterparties from only the most creditworthy countries.

#### **5.2 This modelling approach combines credit ratings, credit watches, credit outlooks and credit default swap spreads in a weighted scoring system for which the end product is a series of bands that indicate the relative creditworthiness of counterparties. These bands are used by the council to determine the duration for 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 that the council would not be able to replicate using in house resources.**

#### **5.3 All credit ratings are monitored weekly. The council is alerted to changes to ratings of all three agencies through its use of the Sector creditworthiness service. If a downgrade**

- 5.4 In addition to the use of Credit Ratings the council is advised of information in movements in Credit Default Swaps 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.
- 5.5 Sole reliance is not placed on the use of this external service. The council also uses market data and market information, and information on government support for banks.
- 5.6 The council has determined that it will only use approved counterparties from the UK and from other countries with a sovereign credit rating of AAA from Fitch Ratings (or equivalent from other agencies if Fitch does not provide).

## **6. External Fund Managers**

- 6.1 The Authority's policy has generally been not to appoint external investment fund managers apart from for managing specific earmarked sums of money. The reason has been that the monies the Authority has for investing are primarily cash-flow derived, and are only available temporarily pending expenditure. However, the Director of Finance is authorised to review and appoint at the appropriate time external cash fund managers when of benefit to the Authority.

## **7. Investment Strategy**

- 7.1 Interest Rate Outlook: Bank Rate has stayed at 0.50% since March 2009. It is expected to stay at 0.50% until starting to rise gradually, with the first increase in mid to late 2010 and reaching 3.25% by the end of 2011. We will therefore avoid locking into longer term deals while investment rates are down at historically low levels.
- 7.2 The council's in-house managed funds are mainly cash flow derived. Investments will accordingly be made with reference to the cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).
- 7.3 Based on the above, the council will make deposits to banks and building societies based on the creditworthiness criteria set out above. As a minimum the following criteria will be applied:

Type	Minimum Rating	Definition
Short term	F1+, P-1, A-1	Highest credit quality. Indicates the strongest capability for timely payment of financial commitments.
Long term	A+	High credit quality. Low credit risk; capacity for payment of financial commitments is considered strong but may be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.
Individual	C	Adequate bank. Characteristics rated are profitability and balance sheet integrity, franchise, management, operating environment and prospects.
Support	2	High probability of external support.

These ratings are used in combination so that a bank with an individual rating of C would need a support rating of 1.

- 7.4 In addition the council will also make deposits to UK nationalised banks and banks receiving support from the UK Government, where the long term rating is lower than A and the individual rating is lower than C, but the support rating is 1. It will also make deposits to the Government's Debt Management Office, local authorities and AAA rated Money Market Funds.

## 8. Country Sovereign Ratings

It has been past policy to only lend to UK and Irish banks that meet the above criteria. However, the Republic of Ireland only has a Fitch sovereign rating of AA-, so Irish banks do not currently meet the criteria. The United Kingdom currently has a AAA sovereign rating but Standard & Poors have put the rating on negative outlook, which means that in the medium term they may need to downgrade the rating. Some countries have a AAA rating with a stable outlook and banks with stronger credit ratings than UK banks. Therefore to limit investments to UK banks is not consistent with a policy of lending to banks with the highest security. It is therefore recommended that selected foreign banks with high credit ratings be added to the council's Approved Lending List, where the home country is AAA rated.

## 9. Approved List of Counter-Parties at 2nd March 2010

- 9.1 The list of current approved counterparties is below, along with the list of foreign banks recommended to be added. The Director of Finance is delegated to monitor credit ratings and other market information and make additions, deletions and amendments to the Approved Lending List in the light of changing circumstances.
- 9.2 To minimise risk absolute limits are set for institutional categories.
- No limit is set for the Debt Management Office as this is backed by the UK Government.
  - Local authorities are underwritten by the local taxpayers hence their risk of default is negligible and hence a limit of £25m is set for each local authority.

- A limit of £15m per institution has been set for appropriately rated banks and money market funds.

9.3 The current lending list as at 2 March 2010 is

- a. No limit: - Debt Management Office
- b. £25m limit - All local authorities
- c. £15m limit
  - **Banks**
    - Santander UK/Alliance and Leicester
    - Royal Bank of Scotland
    - Barclays Bank
    - HSBC Bank
    - Lloyds TSB/Bank of Scotland
  - **Money Market Funds**
    - AIM STIC Global Sterling
    - Fidelity Institutional
    - HSBC Sterling Liquidity
    - Insight
    - Scottish Widows
    - IGNIS
    - Goldman Sachs
  - **Proposed Foreign Banks**
    - Canada: Royal Bank of Canada  
Toronto Dominion
    - France: BNP Paribas
    - Netherlands: Bank Nederlandse Gemeenten  
Cooperative Centrale Raiffeisen Boerenleenbank

9.4 The list is monitored by officers on a weekly basis. Daily emails are sent by Sector, enabling immediate action to be taken if a downgrading warning is issued. Changes to counterparty list and other relevant market activity will be included in the regular monitoring reports to Executive and the Audit Committee