SOUTH LANARKSHIRE COUNCIL

Agenda Item

# Report

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| Report to: | **Finance and Information Technology Resources Committee (Special)** |
| Date of Meeting: | **9 February 2012** |
| Report by: | **Executive Director (Finance and Corporate Resources)** |

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| Subject: | **Annual Investment Strategy 2012/2013** |

## 1. Purpose of Report

1.1. The purpose of the report is to:-

- Inform Committee of the requirement to produce an Annual Investment Strategy
- Allow Committee to scrutinise the proposed Annual Investment Strategy for 2012/2013.

## 2. Recommendation(s)

2.1. The Committee is asked to approve the following recommendation(s):-

**(1)** that it endorses the 2012/2013 Annual Investment Strategy
**(2)** that the report be referred to the Executive Committee for approval prior to submission to Council for formal approval in line with investment regulations.

## 3. Background

3.1. Scottish Ministers issued The Local Government Investments (Scotland) Regulations 2010 on 1 April 2010 providing a formal investment framework through consent and Regulations.

3.2. The new regulatory framework introduced by regulations made by Scottish Ministers provides greater autonomy for local authorities in their investment activities. With this greater freedom comes greater responsibility and the onus is on local authorities to act prudently with regard to their investment and treasury management activities.

3.3. The Regulations introduced the ability in Scotland for Local Authorities to widen the instruments used to deposit and invest cash balances. The Council can now decide what investment tools it will class as permitted investments in the coming year. The Regulations require an Annual Investment Strategy detailing the permitted investments to be approved by the Council.

3.4. The two fundamental principles of the Investment Regulations are that:

- Councils are required to manage their investments and deposits in a way that minimises the risk to the capital sum and optimises the return on the funds consistent with those risks. Security should be considered first, then liquidity, and lastly the yield of the return.

- Councils are able to determine what investments they may make, including both the type and duration of the investment.

**4. Requirement for an Annual Investment Strategy**

4.1. The Annual Investment Strategy is considered to be central to the Regulation. The Council is required to prepare an Annual Investment Strategy prior to the start of the financial year.

4.2. The Regulations require the Council to consider its investment activity as a whole. This includes a range of investments, which covers the depositing of temporary surplus funds with banks and similar institutions, shareholdings in companies or joint ventures, loans to group undertakings and third parties. It also covers investment properties

4.3. The Council is required to set out a strategy for investments that explains investment objectives and policies including any special circumstances applying to them that have led to a particular approach.

4.4. The proposed Annual Investment Strategy for 2012/2013 has been included at Appendix 1 to allow scrutiny by Committee.

4.5. The attached strategy identifies the different types of treasury risk that investments are exposed to and the controls in place for limiting those risks. These include restrictions on who the Council will invest with and on the period of investment.

4.6. The Annual Investment Strategy will be referred to Executive Committee for approval before ratification by full Council. This is a requirement of the Regulation.

**5. Areas Covered by the Annual Investment Strategy**

5.1. The Council is required to set out in the strategy the types of investment that it will permit in the financial year. These will be known as “permitted investments”.

5.2. The strategy also limits the amounts that may be held in such investments at any time in the year.

5.3. Any loan issued to a third party should be included as an investment. Statutory powers exist for local authorities to provide this type of financial assistance, for example the Housing (Scotland) Act 1987, the Housing (Scotland) Act 2006 and the general power to advance well-being contained in the Local Government in Scotland Act 2003 at section 20.

5.4. After consideration of the Council’s requirements to manage funds and our approach to risk, no changes have been made to the permitted investments previously agreed for 2011/2012, however in taking a pragmatic view on placing deposits with banks and building societies, a minor adjustment has been made to the minimum credit rating threshold for such deposits.

5.5. During 2011/2012 the ratings agencies reviewed the credit ratings of most UK financial institutions. While the credit rating agencies believed that governments would continue to provide support to systemically important institutions the extent of this support would not be to the same extent as that provided in 2008, and as a result the long term ratings of many institutions were lowered slightly.

5.6. As a result of the reductions in the long term ratings, some well known high street UK banks no longer meet the Council's minimum lending criteria as approved in the 2011/2012 Annual Investment Strategy and are now suspended from the Council's lending list.

5.7. Advice received from the Council's Treasury Management advisers is that these banks are considered to be so important to the UK banking system that, while there is no explicit government guarantee, it is unlikely that they would be allowed to fail.

5.8. In order to best manage its funds, the Council should continue to consider banks as counterparties if we are comfortable in the security of these banks. This will also help in ensuring a diversification of investments.

5.9. The Council will always assess the risk of depositing funds in any bank. In addition to considering credit ratings, advice is also sought from our Treasury Management advisers and by analysing market data on counterparties.

5.10. Taking account of the adjustment in the way that rating agencies have altered their ratings of UK financial institutions and in order that the Council can continue to deposit funds in these banks, it is proposed that the minimum long term credit rating is reduced from A+ to A- (or equivalent). Fitch state that a credit rating of A denotes a low expectation of credit risk with the + and – being used to indicate relative status among organisations rated A.

5.9. The Executive Director (Finance and Corporate Resources) will ensure that the Strategy is adhered to at all times. The Council can only make an investment if that type of investment is detailed in this Strategy. The exception to this is where the Council has recognised as an investment a financial transaction that relies on separate legislative powers, for example loans to third parties.

## 6. Borrowing in Advance

6.1. Borrowing in advance of need increases the level of funds which require to be invested or deposited.

6.2. The CIPFA Prudential Code is clear that the Council must not borrow more than, or in advance of needs purely in order to profit from the investment of the extra sums borrowed.

6.3. The Council needs to be able to demonstrate that borrowing is for a legitimate purpose such as the exercise of day to day cash management or the management of borrowing for capital purposes.

6.4. The regulations do not prevent borrowing in advance of need but for it to be allowed the Council must detail its policy for borrowing in advance in the Strategy.

6.5. The Executive Director (Finance and Corporate Resources) will ensure that borrowing is taken at the most appropriate time to ensure best value and that the requirements of the Prudential Code are met.

## 7. Employee Implications

7.1. None

## 8. Financial Implications

8.1. The financial impact from treasury activity and borrowing for capital expenditure has been built into the long term revenue budget strategy.

## 9. Other Implications

9.1. South Lanarkshire Council recognises that any investment activity will carry an element of risk. It is important that risk is identified and controls put in place to limit those risks.

9.2. The CIPFA Treasury Management Code of Practice adopted by the Council, places Credit and Counterparty risk at the forefront of treasury risks.

9.3. Section 5 of the Annual Investment Strategy details how South Lanarkshire Council will manage these risks.

9.4 There are no implications for sustainability in terms of the information contained in this report.

## 10. Equality Impact Assessment and Consultation Arrangements

10.1. An Equality Impact Assessment on the Treasury Management Strategy was carried out in November 2008. This paper is an update to that strategy which relates to the Council's investment plans.

10.2. The conclusion of the initial equality impact assessment was that there was no adverse impact on any part of the community covered by equalities legislation, or on community relations.

10.3. There is no requirement to undertake any consultation in relation to the content of the report.

**Paul Manning**
**Executive Director (Finance and Corporate Resources)**

11 January 2012

**Link(s) to Council Values/Improvement Themes/Objectives**

- Value: Accountable, effective and efficient

**Previous References**

- None

**List of Background Papers**

- None

**Contact for Further Information**

If you would like to inspect the background papers or want further information, please contact:-

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**Appendix 1**

# Annual Investment Strategy 2012/2013

## 1. Background

1.1. Local authority investment activity is regulated by statute. In Scotland the legislation that local authorities rely on to make investments has consisted of the Trustee Investments Act 1961 and the Local Government (Scotland) Act 1973.

1.2. In response to representation from local authorities that the existing regulation was too prescriptive, provision was made in the Local Government in Scotland Act 2003 for Scottish Ministers to introduce a new regulatory framework.

1.3. Section 40 of the Local Government in Scotland Act 2003 provides local authorities with the power to invest money. This power may be exercised in accordance with regulations made by Scottish Ministers under this section.

1.4. Scottish Ministers have, through Consent and Regulations, provided a formal investment framework with effect from 1st April 2010. The Local Government Investments (Scotland) Regulations 2010 came into force on 1 April 2010.

1.5. The new regulatory framework introduced by regulations made by Scottish Ministers under Section 40, provides greater autonomy for local authorities in their investment activities. With this greater freedom comes greater responsibility and the onus is on local authorities to act prudently with regard to their investment and treasury management activities.

1.6. Local authorities are required to manage their investments in a way that minimises the risk to the capital sum and optimises the return on the funds consistent with those risks.

1.7. Local authorities are required to prepare an Annual Investment Strategy before the start of the financial year.

## 2. Investment Policy and Strategy

2.1. Scottish Ministers have identified two CIPFA Codes of Practice which local authorities must have regard to in managing their investments:

- Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes (Fully Revised Second Edition 2009)
- The Prudential Code for Capital Finance in Local Authorities (Fully Revised Second Edition 2009)

The first Code referenced covers the whole range of treasury management issues including the fundamental principles for making and managing investments.

The second Code deals with capital investment but also includes guidance on Treasury Management.

2.2. South Lanarkshire Council has adopted the CIPFA Treasury Management Code and the CIPFA Prudential Code updated in November 2011. There are no significant areas of change in the revised codes that would impact on our investment strategy.

2.3. This Council in its Treasury Management Policy Statement defines its Treasury Management Activities as:

*The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.*

2.4. The main objective when investing surplus funds will therefore be the security of the transaction. The Council must also meet its liquidity requirement and only invest for the period of time that is prudent. Finally, and only after consideration of security and liquidity, the yield that will be gained from the investment will be considered.

**3. Treasury Management Risks**

3.1. The CIPFA Treasury Management Code of Practice adopted by the Council includes a section on Managing Treasury Management Risks, placing Credit and Counterparty risk at the forefront of treasury risks.

3.2. South Lanarkshire Council recognises that any investment activity will carry an element of risk. It is important that risk is identified and controls put in place to limit those risks.

3.3. Risks when carrying out investment activities can broadly be categorised as follows:

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| Credit Risk: | failure to receive back the principal and interest on an investment in full and on the due date |
| Liquidity Risk: | the maturity or terms of the investment are such that insufficient cash is available in the short term |
| Market Risk: | the effect of market prices on the value of the investment |

**4. Permitted Investments**

4.1. Local authorities are required to list and document all types of investments that they will permit in the financial year. These will be described as the permitted investments for that local authority.

4.2. Local authorities are required to state the limits for the amounts which at any time during the year may be invested in each type of permitted investments, such limit being applied when the investment is made.

4.3. For each type of permitted investment the objectives of that investment are to be identified along with the associated treasury risks and the controls that will be put in place to limit those risks.

4.4. The permitted investments that South Lanarkshire Council have identified for the financial year 2012/13 are detailed in Appendix 2 to this strategy and listed below:

- Deposits with the Debt Management Account Deposit Facility
- Deposits with UK Local Authorities
- Deposits with Banks and Building Societies
- Certificates of Deposit with Banks and Building Societies
- UK Government Gilts and Treasury Bills
- AAA Rated Bonds Issued by Multilateral Development Banks
- AAA Rated Money Market Funds
- Loans to Third Parties

Inclusion as a permitted investment simply allows the Council to use that investment if considered to be appropriate. It is not necessarily the case that all permitted investments will be used.

**5. Risk Management**

5.1. The CIPFA Treasury Management Code of Practice adopted by the Council includes a section on Managing Treasury Management Risks, placing Credit and Counterparty risk at the forefront of treasury risks. The Code states:

*Credit ratings should only be used as a starting point when considering credit risk. Organisations should make use of generally available market information, such as the quality financial press, market data, and information on government support for banks including the ability and willingness of the relevant government to provide adequate support.*

5.2. In managing credit and counterparty risk the Council will be required to:

- Establish a sound diversification policy with high credit quality counterparties
- Set clear minimum credit limits for counterparties.
- Have regard to the credit ratings issued by all three rating agencies and make decisions based on the lowest rating
- Consider country, sector and group limits
- Regularly review credit ratings and act upon forward looking rating warnings

**Deposits with the Debt Management Account Deposit Facility**

5.3. Deposits with the Debt Management Office Account Deposit facility provided by HM Treasury will be continued. This facility offers the highest security for investments and deposits will be subject to a maximum period of six months which is the maximum time allowed by the DMO and no maximum deposit size.

**Deposits with UK Local Authorities**

5.4. Deposits with UK local authorities, joint boards and passenger transport executives will be permitted subject to a maximum period of three years and a maximum deposit size of £15m for up to 364 days and £10m beyond this.

**Deposits and Certificates of Deposit with Banks and Building Societies**

5.5. The following minimum thresholds will be applied to all deposits with banks and building societies, including Certificate of Deposits.

| Rating Agency | Long Term Rating | Short Term Rating | Maximum Deposit |
|---|---|---|---|
| Fitch | A- | F1 | £10m |
| Moody's | A3 | P-1 | £10m |
| Standard and Poors | A- | A-1 | £10m |

5.6. In addition to the primary ratings detailed above, consideration will also be given to the secondary ratings provided by Fitch. Fitch is the only rating agency to provide two secondary ratings measuring a bank's individual and support ratings. As a minimum an organisation will require to have an individual rating of B (indicating that the bank is strong in its own right) or a support rating of 2 (indicating that there is a high probability of external support).

5.7. Prior to depositing funds with any bank or building society, additional indicators of creditworthiness (such as credit default swaps, GDP; net debt as a percentage of GDP, potential sovereign and parental support, share price) will also be considered.

5.8. Banks on negative rating watch will be heavily scrutinised before any deposit is made with that institution.

5.9. Currently all deposits are with UK institutions. Non UK banks would only be considered if they meet our strict criteria, and are recommended by our advisers. Any one foreign country would carry a limit of £10m deposits.

5.10. In the event that two or more organisations in the same group meet the criteria detailed in 5.5. then a group limit of £10m will be applied.

5.11. Deposits with banks or building societies will be restricted to 364 days.

5.12. The existing Counterparty policy sets out a sound approach to depositing cash in normal market circumstances. Whilst this policy still stands, under exceptional current market circumstances the Executive Director of Finance and Corporate Resources may consider temporarily restricting deposits to those counterparties considered of higher credit quality than the minimum criteria set out in the policy.

5.13. Examples of these restrictions would be greater use of higher rated institutions; increased use of the DMO account and restricting the term of deposits as appropriate.

**UK Government Gilts and Treasury Bills**

5.15. UK Government Gilts and Treasury Bills are bonds issued by HM Treasury. Purchasing these bonds is a means of investing in the UK Government. The UK Government has never failed to make interest or principal payments on these bonds.

5.16. Investments in Government Gilts and Treasury Bills carry very little risk as they are investments in the UK Government. There will be no maximum limit to the amount that will be invested in UK Gilts or Treasury Bills with a maximum period of five years. For Gilts in excess of one year a limit of £10m will be applied.

**AAA Rated Bonds Issued by Multilateral Development Banks**

5.17. These are bonds issued by supranational institutions such as the World Bank or the European Investment Bank.

5.18. Investments in AAA rated bonds issued by Multilateral Development Banks carry very little risk as they are backed by several Sovereign States. The maximum amount that will be invested in AAA rated bonds issued by Multilateral Development Banks is £10m with a maximum period of five years.

5.19. Any investments in these bonds would only be undertaken after careful consideration and with advice from our advisers to ensure security of our deposits.

**AAA Rated Money Market Funds**

5.20. Investments in Money Market Funds will be limited to those funds rated as AAA by Fitch, Moody's or Standard and Poors. In the event that the Money Market Fund is rated by more than one credit rating agency, each rating must be AAA.

5.21. In addition to the credit rating, Money Market Funds will also be assessed for suitability on fund size, the strength of the custodian and the stability of invested capital.

5.22. Selection of suitable Money Market Funds will be undertaken in consultation with our advisers.

5.23. Investments in Money Market Funds will be restricted to 0.5% of the Money Market Fund size and to no more than £10m in any individual Money Market Fund.

**Loans to Third Parties**

5.24. Any new types of loans to third parties should be approved by Members through the appropriate Committee with full consideration of the service rationale behind the loan and the likelihood of partial or full default and the impact that this will have on service budgets.

**Liquidity Risk**

5.25. In order to manage liquidity risk, the Council will endeavour to maintain a minimum balance of £5m in bank accounts and money market funds with instant access (same day notice account). This is dependent on these facilities continuing to be provided by the banks and subject to our minimum lending criteria.

5.26. In addition to retaining a balance of deposits on instant access, South Lanarkshire Council will maintain an appropriate overdraft facility.

5.27. Longer term investments will only be considered where the Council's liquidity requirements are ensured and an assessment of liquidity risk has been carried out. No more than £10m of investments at any one time will be for a period in excess of 364 days.

## 6. Borrowing In Advance

6.1. Borrowing in advance may be taken if it is considered appropriate. Borrowing in advance of need would increase the level of deposits and investments. When considering borrowing in advance, the risks of holding increased level of investments against the risk of adverse interest rate movements if borrowing was deferred will be assessed.

6.2. The risks of holding increased levels of deposits and investments would be managed in accordance with section 5 above. The Council has unlimited access to using the DMO Deposit Facility where necessary. This facility offers the highest security for investments.

## 7. Investment Projection 2012/13 – 2013/14

7.1. It is expected that over the period 2011/12 – 2013/14 it is estimated that an average level of investments of approximately £87m will be required to be managed. It is recognised that this is only an estimate and that this figure will vary according to cash flow movements and the timing and size of any borrowing taken.

7.2. Regardless of the level of deposits, the main consideration when investing surplus funds will be the security of the transaction. The Council must also meet its liquidity requirement and only invest for the period of time that is prudent. Finally, and only after consideration of security and liquidity, the yield that will be gained from the investment will be considered.

## 8. Prudential Indicators

8.1 The consent requires that the Annual Investment Strategy contains details of the relevant prudential indicators for investments.

8.2 The Treasury Management Code requires local authorities to set an upper limit for each forward financial year period for investments longer than 364 days. The purpose is to contain the exposure to the possibility of loss that might arise as a result of having to seek early repayment of principal sums invested.

No more than £10m may be invested for periods in excess of 364 days and that the maximum period for any investment is 5 years.

## 9. Common Good Investments

9.1. The consent requires local authorities to identify separately the permitted investments relating to the Common Good.

9.2. All investments relating to the Common Good funds administered by South Lanarkshire Council are cash investments in South Lanarkshire Council. These investments are not considered to have any significant risk attached

| **Permitted Investment** | **Treasury Risks** | **Mitigating Controls** | **Limits** |
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| Deposits with the Debt Management Account Deposit Facility | This is a deposit with the UK Government and so credit risk is very low.<br><br>Liquidity risk has to be considered as deposits can only be broken with the agreement of the counterparty and penalties may apply.<br><br>There is no market risk as the principal sum invested is not affected by market prices. | There are no mitigating controls required. | There is no maximum monetary limit.<br><br>A maximum term of deposit of six months as set by the Debt Management Office. |
| Deposits with UK Local Authorities and other bodies defined as local authorities in the Local Government Scotland Act 2003 (And Equivalent English Act) | These are considered to be quasi UK Government investment and as such credit risk is very low.<br><br>Liquidity risk has to be considered as deposits can only be broken with the agreement of the counterparty and penalties may apply.<br><br>There is no market risk as the principal sum invested is not affected by market prices. | Very few mitigating controls are required for local authority deposits. | The maximum deposit with any local authority will be £15m for deposits less than one year.<br><br>Deposits in excess of one year will be subject to a maximum term of deposit of three years and be limited to £10m. |
| Deposits with Banks and Building Societies | These tend to be low risk but credit risk will be higher than deposits placed with the DMO or UK local authorities.<br><br>Liquidity risk has to be considered as deposits can only be broken with the agreement of the counterparty and penalties may apply.<br><br>There is no market risk as the principal sum invested is not affected by market prices. | The counterparty selection criteria restricts lending only to high quality counterparties, measured initially by credit ratings from Fitch, Moody's and Standard and Poors.<br><br>Additional indicators of creditworthiness will also be considered prior to placing any deposits.<br><br>Liquidity risk can be controlled by the use of instant access call accounts. | The maximum deposit with any bank or building society will be £10m.<br><br>A maximum term of deposit of 364 days. |

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| Certificates of Deposit with Banks and Building Societies | These are short to medium term dated marketable securities issued by financial institutions.<br><br>These tend to be low risk investments but credit risk will be higher than deposits placed with the DMO or UK local authorities.<br><br>Liquidity risk is lower than placing a deposit with a Bank or Building Society as these can be sold on the market.<br><br>There is a risk of capital loss arising from selling ahead of maturity. | The counterparty selection criteria restricts lending only to high quality counterparties, measured initially by credit ratings from Fitch, Moody's and Standard and Poors.<br><br>Additional indicators of creditworthiness will also be considered prior to using this type of instrument.<br><br>Market risk would be mitigated by holding the instrument to maturity. | The maximum investment with any bank or building society will be £10m.<br><br>A maximum period of investment of 364 days. |
| UK Government Gilts and Treasury Bills | These are marketable securities issued by the UK Government and as such credit risk is very low.<br><br>Liquidity risk is very low as there is a huge market for Gilts and Treasury Bills<br><br>There is a risk of capital loss arising from selling ahead of maturity. | There are no mitigating controls required for credit risk as the investment is with the UK Government.<br><br>Market risk would be mitigated by holding the instrument to maturity. | There is no maximum limit to investments in UK Gilts or Treasury Bills for maturities less than one year and a limit of £10m for maturities greater than one year.<br><br>The maximum period of investment will be five years. |
| AAA Rated Bonds Issued by Multilateral Development Banks | These are bonds issued by supranational bodies such as the European Investment Bank or World Bank and as a result are backed by several sovereign states and as such credit risk is very low.<br><br>Liquidity risk is very low as there is a huge market for Supranational Bonds.<br><br>There is a risk of capital loss arising from selling ahead of maturity. | As the investment is effectively spread across a number of sovereign states, the Council will mitigate the credit risk of holding such bonds by considering the sovereign rating of the underlying sovereign states and only holding bonds that have a AAA rating.<br><br>Market risk would be mitigated by holding the instrument to maturity. | The maximum amount that will be invested in AAA Rated Bonds issued by Multilateral Development Banks is £10m.<br><br>The maximum period of investment will be five years. |

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| AAA Rated Money Market Funds | Money market funds are mutual funds that invest in short-term money market instruments.<br><br>Credit risk, liquidity risk and market risk are all very low. | Money Market Funds will only be used where they have obtained a AAA rating from the credit rating agencies.<br><br>In addition to the credit rating, Money Market Funds will also be assessed for suitability on fund size, the strength of the custodian and the stability of invested capital. | Investments in Money Market Funds will be limited to 0.5% of the Money Market Fund Balance and to no more than £10m in any one Fund. |
| Loans to Third Parties | These are service investments which may exhibit credit risk and are likely to be highly illiquid. | Any new types of loans to third parties should be approved by Members through the appropriate Committee with full consideration of the service rationale behind the loan and the likelihood of partial or full default and the impact that this will have on service budgets. | |