Committee: **Resources**

Date: **31 March 2005**

Agenda Item No: **7**

Title: **Treasury Management Strategy**

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Summary

1 Guidance issued by the Office of the Deputy Prime Minister (ODPM) under Section 15(1)(a) of the Local Government Act 2003 requires that local authorities prepare an Annual Investment Strategy. The guidance complements the existing requirements contained within in the *Treasury Management in the public Services : Code of Practice* and the *Prudential Code for Capital Finance in Local Authorities* both published by the Chartered Institute of Public Finance and Accountancy (CIPFA).

2 The Guidance requires the Strategy to be approved by Council and subject to any amendments proposed by this Committee the Strategy will be considered by the Council at its meeting on 26 April.

Background

3 LOCAL GOVERNMENT INVESTMENTS – GUIDANCE

The regulations governing what investments a local authority can undertake - the Approved Investment Regulations (1990) - were repealed on 1 April 2004 to be replaced by Part 1 of the Local Government Act 2003. With effect from this date investments are be dealt with by guidance, not legislation. The following is a summary of the guidance:

4 Annual Investment Strategy

As detailed in the introduction to this report there is also a requirement in the CIPFA Treasury Management Code for authorities to produce an annual investment strategy and an annual report on it. The guidance supplements this with the requirement to cover:

Specified Investments
Non - specified Investments
Liquidity of Investments

These terms are examined in further detail below:

Specified Investments

This identifies investments that offer high security and high liquidity. Authorities will be able to use these with minimal procedural formalities. These instruments must be sterling denominated and have a maturity of less than one year and if made with a body corporate this body must have been awarded a high credit rating by a credit rating agency. The Annual Investment Strategy must state how a high credit rating is to be defined, how frequently ratings are to be monitored and what action is to be taken when ratings change.

Non-Specified Investments

All other security types fall into this category, which appears to be a very wide definition and includes the use of derivative instruments. The Annual Investment Strategy must set out the procedures for determining which categories may prudently be used, which categories have been so identified and the maximum amounts that may be held in each category at any time during the financial year.

Liquidity of Investments

The Annual Investment Strategy must set out procedures for determining the maximum periods for which funds may prudently committed and the minimum amount which is to be held during the financial year in investments other than long-term investments.

5 UTTLESFORD DISTRICT COUNCIL'S ANNUAL INVESTMENT STRATEGY 2005-06

The Council has customarily considered an annual strategy statement but the adoption of the Treasury Management Code of Practice and the Government guidance outlined above place new requirements on the Council. Additionally the advent of the 2003 Prudential Code for Capital Finance in Local Authorities requires certain decisions to be made on treasury management matters. The suggested strategy for 2005-06 covers the following:

- Treasury Limits
- The current treasury position
- Prospects for interest rates
- Specified Investments.
- Non Specified Investments
- Liquidity of Investments

Treasury Limits

6. It is a statutory duty under Section 3 of the Local Government Act 2003 for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is the "Affordable Borrowing Limit". The Council must have regard to the Prudential Code when setting its limit for the next three years. In the report to the meeting of this Committee on 3 February 2005 it was resolved that since it was expected that the Council's debt free status would remain for 2005-06 to 2007-08, the related Prudential Indicators would be nil. It follows therefore that the "Affordable Borrowing Limit" should also be set at nil.

The Current Treasury Position

7 The Council currently (as at 22 March) has £10.30 million invested principally in UK Building Societies and UK registered banks together with £5m placed with the Fund Manger Standard Life Investments Ltd. All of these institutions meet the Council's lending criteria.

Prospects for Interest Rates

8 As part of its arrangement with the Council for treasury management advisory services Butlers provide regular commentaries on the future movements in interest rates. Their central forecast is that the Bank of England's Base Rate (currently 4.75%) has reached its peak and the Monetary Policy Committee (MPC) will start to reduce the rate during the December quarter. This is not necessarily a consensus view and the OECD has argued that rates will need to rise to 5.75% by the end of the year. Firstly, demand in the economy may continue to expand at a rate above trend and excess capacity in the economy is very low which means that inflationary pressures could increase. Secondly, buoyant consumer borrowing may continue to raise the level of consumer debt. Thirdly, the recent pace of consumer spending is not sustainable and will need to be rained in.

Butlers believe however, that there are negative factors also to consider and they judge these to be more persuasive. Any rise would put unwelcome pressure on sterling, the outlook for inflation is less pessimistic and consumer borrowing will moderate in response to rises in interest rates that have already been made.

Specified Investments – Internally and Externally Managed Funds

9 As noted above the Strategy must state how a high credit rating is to be defined, how frequently ratings are to be monitored and what action is to be taken when ratings change. Currently the Council's approved lending criteria allow it to lend to banks that have been awarded ratings by Fitch, the credit rating agency as follows:

Short Term	F1+ or F1
Long Term	A+ or better
Individual Rating	B/C or better
Support Rating	3

An explanation of the concept of credit rating and the scales used by Fitch can be found in the appendix to this report.

To qualify as Specified the investment must be made with an institution having a “high” credit rating although “high” is not precisely defined in the guidance. Since the guidance also states that the Specified Investments must have a maturity of less than one year it makes sense that the Short Term Rating should form the mainstay of the criteria and it is proposed that in order to be described as a Specified an investment must be made with an institution carrying a Short Term Rating of F1 or F1+.

With regard to monitoring, as part of its service from Butlers, the Council is notified immediately by email of changes to the credit rating of individual banks. A regular summary report is also provided. It is proposed that the summary reports augmented by subsequent email alerts be consulted when a new investment is being considered.

If a rating is changed to less than F1 prior to a proposed investment being made, this may disqualify the bank from becoming a counterparty. If the rating changes during the duration of an investment to lower than F1, the Council’s Section 151 Officer will determine whether to request early repayment which will incur a cost or to let the investment run to maturity. In reaching this decision advice will be sought from Butlers and the Principal Accountant, the officer with day-to-day responsibility for treasury management.

<u>Non Specified Investments – Internally Managed Funds</u>

10 This is less straightforward as a number of different areas must be considered and is complicated further by the need to accommodate the funds under the management of Standard Life. Historically the Council has used the Fitch ratings agency but Standard Life use Moody’s. There is little difference in practical terms between these two agencies but they do use different scoring systems. The Moody’s criteria to be applied to the Fund managed by Standard Life are addressed later in this report.

Criteria for investments up to one year where the institutions have a credit rating are not required in the Non-Specified section of this report since such investments are deemed to be Specified and are dealt with in the preceding paragraphs.

Criteria where the institutions have no credit rating

11 Most banks and other institutions that the Council has invested in will have applied for and been awarded credit ratings by Fitch ore one of the other

ratings companies. Historically however, the Council has invested much of its portfolio with the major Building Societies ranked by asset size. The 2004-05 Strategy limited this list to nineteen being those societies having assets in excess of £1 billion. Since then one society has been removed from the list. Of these, ten have a Fitch rating of F1 or better. (The remainder have not applied to be rated but are nevertheless considered to be financially sound). It is proposed that the Council lends only to these 18 Building Societies with assets in excess of £1 billion. The ten Societies that have a rating of F1 or better will fall into the Specified category so long as an investment is made for a period of less than one year. The remaining eight must therefore fall into the Non-Specified category regardless of the investment duration.

The ranked Building Societies are as follows:

Nationwide
Britannia
Yorkshire
Portman
Coventry
Chelsea
Skipton
West Bromwich
Principality
Newcastle

The remaining eight without rankings are as follows:

Leeds and Holbeck
Cheshire
Derbyshire
Norwich and Peterborough
Stroud and Swindon
Nottingham
Dunfermline
Scarborough

Criteria for investments in excess of one year

12 The Council is advised that in the main the best rates for longer term investments will come from Building Societies, with only a few banks willing to quote for periods longer than one year. Therefore it is necessary to determine how rating criteria are used for long term investing. It is proposed that the following is adopted:

Societies with a ‘A-’ or better long-term rating – two year maximum duration. Currently these would be the ten societies identified in the paragraph above.

Societies with a ‘AA-’ or better long-term rating – four year maximum duration. Currently only one Building Society, the Nationwide has this ranking. It is not envisaged that the Council will be investing for a three to four year period during 2005-06.

Societies with a 'AAA' long-term rating – five year maximum duration
Currently no Building Societies have this ranking. It is not envisaged that the Council will be investing for a period above four years during 2005-06.

It is further proposed that as a further proviso building societies must have the following individual and support ratings:

For a two year investment limit:
    Individual Rating – C or better
    Support Rating – 3 or better
All ten Building Societies listed above have these ratings.

For a four year investment limit:
    Individual Rating – B or better
    Support Rating – 2 or better
Whilst all ten have an individual rating of B or better, only the Nationwide has a support rating of 2 or better. However, see comments above regarding likelihood of the Council investing for periods in excess of two years.

For a five year investment limit:
    Individual Rating – B or better
    Support Rating – 1
No Building Societies have a support rating of 1.

Although it is understood that many banks may be less willing than building societies to offer suitable rates for long term deals it is proposed that the same criteria be applied.

<u>Non – Specified Investments - Funds Managed by Standard Life</u>

13 As noted above Standard Life use Moody's rankings when considering an investment. These are broadly similar and comparable to the Fitch system. Moody's Aa and A Long Term ratings equate to the Fitch F1+ F1 ratings.

Standard Life are managing £5m of the Council's cash balances. In order to capitalise on their specialist expertise the following investment instruments have been agreed:

- UK Government Gilts and Treasury Bills. (Final Maturity must not be greater then five years.)
- Supranational Bonds. (Final Maturity must not be greater than five years.)
- Certificates of Deposit (For Aa rated institutions maximum security of five years, for A rated institutions maximum security of two years.)
- Cash Deposits. (Final maturity must not exceed two years.)

Criteria for what instruments the Council is willing to use

14 Currently the Council invests almost its entire portfolio in fixed rate, fixed duration investments, the exception being a £250,000 deposit with Abbey National. For the year ahead it is not proposed that the Council directly uses any other instruments. With regard to the fund manager, Standard Life, the terms of the appointment give Standard Life the scope to invest the Council's funds in UK Government securities (Gilts), Supranational bonds or Certificates of Deposit as well as cash deposits. It is therefore proposed that the use of these instruments by Standard Life be approved.

Monetary Limit

15 The Guidance states that the through the Annual Investment Strategy the Council must set a limit on the amount that may be held in Non Specified Investments at any time during the year. In order to bring an element of simplicity to the debate the limits applicable to the Council' internally managed funds and the funds under management by Standard Life are examined separately in the first instance.

Internally Managed Funds

16 As stated earlier in this report, most of the Council's cash balances are invested in Building Societies many of which have not applied for a credit rating. Therefore by definition investments with un-rated Building Societies must be classified as Non-Specified Investments even if the duration of the investment is less than one year. It is proposed that the maximum amount of Non-Specified investments be set at £12m for 2005-06.

Funds Managed by Standard Life

17 The weighted average of the fund will be two years or less. It is likely therefore, that on a duration basis alone the investments made by the fund will often be in excess of the twelve months that would be required for them to be qualify as Specified investments and it is therefore recommended that the maximum amount of Non-Specified investments made through the fund be set at £5m i.e. the whole value of the fund.

Liquidity of Investments

18 In determining the amount of funds that can be prudently committed for more than one year the Council must consider the relationship between overall funds and foreseeable spending needs, together with the need to make provision for contingencies and maintain adequate reserves. The Strategy must also state the minimum amount that is to be held in short term investments.

As noted above when day-to-day cash flow considerations permit and when officers consider there is financial benefit to the Council, funds have been invested for periods greater than one year. Taking this and the needs of the fund manager into account it is considered that it would be prudent to maintain a minimum level of £8 million in short term investments.

It is RECOMMENDED that the Council be requested to approve at its meeting on 26 April

1. The Annual Investment Strategy 2005-06 including the criteria for determining suitable counterparties.

2. A maximum amount of £12 million for Non – Specified investments managed internally by the Council.

3. A maximum amount of £5m million for Non - Specified investments managed by Standard Life.

Background Papers: The Prudential Code for Capital Finance in Local Authorities (CIPFA)
Local Government Investments – Guidance (ODPM)

APPENDIX

Fitch Credit Ratings Defined

Credit ratings are an essential aid to Councils and other investors in considering suitable investment counterparties. They provide a guide as to the risks of the investment not being repaid. They are not it must be emphasised, a guarantee. Since it is not possible to eliminate all risks when undertaking investments, the Council must seek to strike a balance that sets the risks at an acceptable level whilst at the same time leaving scope to maximise investment returns. The use of credit ratings provided by a reputable agency is a rational approach to the risk/return dilemma.

Fitch is a widely used rating agency; it uses four criteria that can be used collectively as a guide to the overall financial standing of an institution or an individual basis for specific purposes. The following is a brief outline of how the ratings work.

Short Term

A Short Term rating has a time horizon of less than 12 months and is therefore the principal rating used for selecting counterparties for short-term investments. The scale is as follows:

<u>F1 – Highest Quality</u>
Indicates the strongest capacity for timely repayments of financial commitments and may have an added "+" to denote any exceptionally strong credit feature.

<u>F2, F3, B, C and D</u>
Indicate descending capacity for timely payment of financial commitments. F2 is defined as Good and D denotes actual or imminent payment default.

The Council will not invest in any institution rated below F1 other than Building Societies with assets over £1 billion that have not applied to be rated.

Long Term

The Long Term rating looks at a time frame in excess of 12 months and is the principal rating used when considering longer term investments. The scale is as follows:

<u>AAA – Highest Credit Quality</u>
Denotes the lowest expectation of credit risk and is assigned in cases of exceptionally strong capacity for timely payment of financial commitments. This capacity is unlikely to be adversely affected by foreseeable events.

<u>AA+, AA, AA-, A+</u>
Indicate a low expectation of credit risk but capacity for timely payment of financial commitments may be more vulnerable to foreseeable events. The Council will only invest in the longer term with a counterparty that has been awarded a rating of A+ or

better. The Council would not consider investing with counterparties rated B,C and D ratings due to the higher risk of credit risk developing over time.

Individual Ratings

Individual ratings attempt to assess how an institution would be viewed if it were entirely independent and could not rely on external support. These ratings are designed to assess an institution's exposure to, appetite for, and management of risk, and thus represents Fitch's view on the likelihood that it would run into significant difficulties such that it would require support. The scale is as follows:

A – A very strong institution. Characteristics may include outstanding profitability and balance sheet integrity.

B – A strong institution for which there are no major concerns. Characteristics may include strong profitability and balance sheet integrity.

C – An adequate institution that possesses one or more troublesome aspects. There may be some concerns regarding profitability and balance sheet integrity.

D and E indicate sufficient concerns for the Council not to consider investing in such counterparties.

Note: In addition, Fitch use gradations among these five ratings, i.e. A/B, B/C, C/D and D/E. For short term investments the Council will not use a counterparty with a rating below B/C.

Support Ratings

The Support Rating denotes the probability of external support either from a parent institution or national or regional government. The scale is as follows:

1 – Denotes an extremely high probability of support. The potential provider of support is very highly rated in its own right and has a very high propensity to provide support to the institution in question.

2, 3, 4 and 5 denote decreasing probability of support and/or the rating of the potential provider and/or the likelihood of the support being provided.