ANNUAL INVESTMENT STRATEGY 2009/10 – RECOMMENDED FOR APPROVAL

BACKGROUND

The Local Government Investment Guidance issued in 2004 by the Secretary of State under section 15 of the Local Government Act 2003, requires local authorities to produce an Annual Investment Strategy each year. The Guidance promotes prudent management of cash with security and liquidity being priorities, while not ignoring yield.

Investments are grouped in two broad categories: specified and non-specified investments. Specified investments are in sterling, have high security and liquidity and not longer than 1 year. Non-specified investments are all other investments (excluding those forming part of a local authority pension fund) which the local authority decides, having considered their risks and benefits, are prudent, subject to exposure limits. There is no intention to discourage use of non-specified investments - they help diversify and improve returns, and in the case of government bonds are highly liquid and exposure to default risk is negligible.

The Annual Investment Strategy for 2009/10 drawing on that Guidance and requiring Council Assembly approval is set out below. Investment exposure has always been biased in favour of major banks, where the expectation of support, in the event it were needed, has always been high. This is underlined in the credit criteria, which has been expanded to include sovereign rating and support rating.

The Council has the benefit of external expertise in the form of fund managers to help manage its investments actively and ensure that capital preservation remains a high priority.

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1. INVESTMENT OBJECTIVES

1.1 The Council's investment objectives are to preserve principal, provide liquidity and secure a reasonable return. Cash investments may only be placed with specified and non-specified investments, which shall at all times be managed prudently.

1.2 Specified investments, as detailed below, are investments up to 1 year with high liquidity and credit qualities. Non-specified investments, as set out below, are investments that exceed 1 year and so potentially more responsive to liquidity, credit, and market factors. Prudent exposure to non-specified investments helps raise the level and sources of investment returns over the long term. Exposure to loan or share capital should be avoided as should investments not denominated in GBP Sterling.

1.3 The Finance Director is responsible for this strategy and its management. External specialists and fund managers shall assist in advising or executing elements of the strategy.

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2 CREDIT REQUIREMENTS

2.1 Credit risk is the risk that the institution with whom investments are held fails to meet its obligations to investors.

2.2 To contain exposure to this risk, these ratings shall be consulted:

a) Sovereign rating,
b) Support rating, and
c) Short and long term rating

The minimum ratings are set out in the tables below and rating definitions are attached at Annexe 1 to this strategy.

While these ratings are high and above the minimum regarded as investment grade by ratings agencies and indicate a low risk of default, it should be remembered that ratings may not always keep up with developments in turbulent markets (and do not in any case represent investment recommendations). Therefore, in managing exposure, close attention should be paid to developments in financial markets in general and credit markets in particular. Exposure to risks should always be managed prudently, with due care and attention.

i) Sovereign Rating

Sovereign Rating		
Rating Agency	**Minimum Long Term Sovereign**	**Minimum Short Term Sovereign**
Fitch Ratings	AA-	Issuer: F1+

ii) Support Rating

Support Rating	
Rating Agency	**Minimum Support Rating**
Fitch Ratings	2

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iii) Short and Long Term Rating
- in addition to Sovereign and Support Ratings

Issuer or Issue Rating Minimum from one of three Rating Agencies				
Rating Agency	**Minimum Short Term Rating**	**Minimum Long Term Rating**	**Maximum exposure up to 1 year £m**	**Maximum exposure 1 year to 3 years £m**
Fitch Ratings	F1+	AA-	40	20
Moody's Investor Services	P1	Aa3	40	20
Standard & Poor's	A-1+	AA-	40	20
Fitch Ratings	F1	A	40	0
Moody's Investor Services	P-1	A1	40	0
Standard & Poor's	A-1	A	40	0

iv) Money Market and Investment Grade Bond Fund Ratings

Money Market and Investment Grade Bond Fund Ratings			
Rating Agency	**Minimum Fund Credit Rating**	**Minimum Fund Value £m**	**Maximum exposure £m**
Fitch Ratings	AAA	1000	50
Moody's Investor Services	Aaa	1000	50
Standard & Poor's	AAA	1000	50
Fitch Ratings	A	200	Up to 5% of fund value max £5m
Moody's Investor Services	A1	200	Up to 5% of fund value max £5m
Standard & Poor's	A	200	Max of up to 5% of fund value max £5m

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2.3 Ratings shall be reviewed frequently and at least monthly. In the event of adverse rating changes, investments may be recalled prior to maturity where it would be prudent to do so.

2.4 Exposure to any one institution shall be diversified as is consistent with securing a reasonable return.

2.5 Credit requirements shall not apply to investments issued or guaranteed by UK Government entities, nationalised entities, Supranational entities or to local authorities where credit risk is very low. There shall be no upper limit on exposure to the UK Government for credit risk purposes and the upper limit on exposure to any one local authority or a Supranational body shall be £40m. The limit for any one nationalised entity shall be £40m, but may be increased where the entity is a major bank to protect the Council's interests.

2.6 Together with other large UK banks, the Royal Bank of Scotland, RBS, (of which National Westminster Bank is a subsidiary) and HSBC Bank are major banks of systemic importance to the UK financial system. RBS is now majority owned by the UK Government and in common with other major UK banks both RBS and HSBC have access to Government liquidity and loan guarantees. RBS is critical to the day to day financial operations of the Council and HSBC provides custodial services for investments managed by the Council's external fund managers. Against this support assurance and in the interest of effective management of financial operations of the scale that the Council has, a £75m limit for RBS and HSBC is prudent.

2.7 The Finance Director shall have discretion to vary minimum rating and limits in response to market developments and operational requirements where prudent to protect the Councils interests.

3 OVERALL LIQUIDITY AND MATURITY CONSTRAINTS

3.1 The first call on investments shall usually be cash flow requirements and normally not less than £60m of overall investments shall be held in maturities not exceeding 1 year.

3.2 Overall investments shall only have a low or low to moderately low sensitivity to market factors. As a guide, the average maturity of investments shall be below 3 years.

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4 SPECIFIED INVESTMENTS

4.1 Specified investments shall consist of the following categories of investments, subject to being denominated in sterling, meeting credit requirements set out above and not exceeding 1 year.

Specified Investments **- in Sterling, meeting credit requirements and not beyond 1 year**	
A	Bonds, bills, term deposits and accounts with the UK Government (or guaranteed by it) or UK local authorities.
B	Fixed term deposits, accounts, certificates of deposits, commercial paper and senior unsubordinated notes and bonds issued by banks and UK building societies
C	Money Market Funds AAA/Aaa rated with stable asset values

4.2 The specified investments have high capital preservation and liquidity characteristics, and as such there shall be no upper limit on sums held in them as a whole, though exposure to any one institution will be subject to credit limits set out in paragraph 2. It is further expected that overall exposure shall be biased towards major institutions, where the expectation of support, if it were needed, is high.

4.3 However market conditions may also justify prudent exposure to longer term investments or other non-specified investments.

5 NON-SPECIFIED INVESTMENTS

5.1 Non-specified investments shall consist of the following categories of investments, which shall be in sterling and meet applicable credit requirements.

Non-Specified Investments **- maturities beyond 1 year, in Sterling and meeting credit requirements**	
A	Bonds issued or guaranteed by the UK Government and bond issued by Supranational bodies
B	Fixed term deposits and certificates of deposits, senior unsubordinated bonds and notes issued by banks or UK building societies, with no interest or principal conditionality.
C	Bond funds - Investment Grade with strong protection against credit losses and weighted average maturity under 1 year

5.2 Details concerning the use, characteristics and limits applying to non-specified investments are set our below. The upper limit on exposure to non-specified investments as a whole shall be 50% of all investments. Overall liquidity, market and 3 year average constraints shall also be observed. In managing exposure to non-specified investments expertise and advice will be drawn on as necessary.

5.3 The non-specified investments are managed with help from external fund managers. Limits are placed to contain overall credit exposure. And any exposure to categories B to C in non-specified investments will in practice be subject to market and credit conditions and to being satisfied about the long run credit quality of the institution as well as the merits of the investment or fund. Capital preservation remains a priority.

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Non specified Investments- Usage, Characteristics and Limits	
A	**Bonds issued by or guaranteed by the UK Government and bonds issued by Supranational bodies** *i) Typical usage* - To capture additional yields that may be available from investing longer from time to time, or - To benefit from short and long run rate expectations. *ii) Characteristics* - These bonds are highly liquid and of high credit quality, however prices are sensitive to expectations about the future course of interest rates, inflation and financial conditions generally. As well as moving favourably, prices can move adversely, risking income – the longer the bond the more sensitive its price to these factors. But the principal is protected if held to maturity. Limits are placed to contain exposure to this risk. *iii) Limits* - No more than 50% of investments may be placed in this category and actively managed to contain market risks. - No one bond may have a maturity exceeding 10 years or the equivalent benchmark. No maturity limit applies to index linked or variable rate bonds. - Bank debt guaranteed by the UK Government shall fall within this category and exposure to such debt shall be limited to £40m per entity and a maximum term of 10 years.

APPENDIX A

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Non specified Investments- Usage, Characteristics and Limits	
B	**Fixed term deposits and certificates of deposits, senior unsubordinated bonds and notes issued by banks or UK building societies, with no interest or principal conditionality.** *i) Typical usage* - To capture additional yields over and above government issued debt that may be available from investing longer from time to time, - To benefit from short and long run rate expectations. *ii) Characteristics* - Investments in this category are issued by the high rated banks and building societies, but as credit certainty tends to be higher for longer periods, careful analysis is necessary to ensure no undue risks are taken. - Prices are sensitive to expectations about the future course of interest rates, inflation and financial conditions generally. As well as moving favourably, prices can move adversely, risking income – the longer the bond the more sensitive its price to these factors. - Investments in this category are negotiable, apart from fixed term deposits which are only repaid on maturity. *iii) Limits* - No more than 20% of investments shall be placed in this category and no one investment shall exceed 3 years in maturity. All investments should be actively managed. - Exposure will in practice be subject to market and credit conditions and being satisfied about the long run credit quality of the institution as well as the investment itself. Capital preservation would remain a priority. - Bank debt guaranteed by the UK Government shall fall within category A of non-specified investments.

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Non specified Investments- Usage, Characteristics and Limits	
C	**Bond funds - Investment Grade with strong protection against credit losses and weighted average maturity under 1 year** *i) Typical usage* - To access the wider range of investments and strategies that funds participate in, - To enhance returns over the longer term, or - To diversify investment and credit risk in overall investments. *ii) Characteristics* - Funds typically consist of investment grade corporate and financial institution debt and structured products. Exposure to any one counterparty is kept low and the wide range of credit rating and strategies available to funds helps raise returns over the longer term. - In addition to credit characteristics, funds may be distinguished according to volatility. The lower the average maturity of investment, the lower the volatility and the higher the short run capital preservation characteristics. However funds may require a longer time frame over which to enhance returns. Funds also have high liquidity. *iii) Limits* - No more than 10% of investments shall be placed in this category. - Funds should have a low or low to moderately low sensitivity to interest rate and market factors. - Exposure is in practice subject to market and credit conditions and being satisfied about the long run credit quality of the institution managing the fund and the assets underlying the funds. The objectives of the fund should be consistent with the capital preservation objectives of the Council.

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Annexe 1

Rating Definitions

Ratings are research based opinions of rating companies on the ability of an entity or a securities issue to meet financial commitments such as interest, preferred dividends, and repayment of principal, in accordance with their terms. Ratings do not constitute recommendations to buy, sell, or hold any security, nor do they comment on the adequacy of market price, the suitability of any security for a particular investor.

Fitch Long Term Rating (including Long Term Sovereign Rating)

AAA: Highest credit quality. 'AAA' ratings denote the lowest expectation of credit risk. They are assigned only in case of exceptionally strong capacity for payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.
AA: Very high credit quality. 'AA' ratings denote expectations of very low credit risk. They indicate very strong capacity for payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A: High credit quality. 'A' ratings denote expectations of low credit risk. The capacity for payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.

Fitch Short Term Rating (Including Short Term Sovereign Rating)

Short-term ratings place greater emphasis on the liquidity necessary to meet financial commitments in a timely manner.

F1: Highest credit quality. Indicates the strongest capacity for timely payment of financial commitments; may have an added "+" to denote any exceptionally strong credit feature.
F2: Good credit quality. A satisfactory capacity for timely payment of financial commitments, but the margin of safety is not as great as in the case of the higher ratings.

Note: *Fitch may append the modifiers "+" or "-" to a rating to denote relative status within major rating categories.*

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Annexe 1

FITCH SUPPORT RATINGS

The Support Ratings do not assess the quality of a bank. Rather they communicate Fitch Ratings' judgement on whether the bank would receive support should this become necessary. It is emphasised that these ratings are exclusively the expression of Fitch's opinion even though the principles underlying them may have been discussed with the relevant supervisory authorities and/or owners.

1: A bank for which there is an extremely high probability of external support. The potential provider of support is very highly rated in its own right and has a very high propensity to support the bank in question. This probability of support indicates a minimum Long-term rating floor of 'A-'.

2: A bank for which there is a high probability of external support. The potential provider of support is highly rated in its own right and has a high propensity to provide support to the bank in question. This probability of support indicates a minimum Long-term rating floor of 'BBB-'.

3: A bank for which there is a moderate probability of support because of uncertainties about the ability or propensity of the potential provider of support to do so. This probability of support indicates a minimum Long-term rating floor of 'BB-'.

Moody's Long Term Rating

Aaa: Obligations rated Aaa are judged to be of the highest quality, with minimal credit risk.

Aa: Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.

A: Obligations rated A are considered upper-medium grade and are subject to low credit risk.

Moody's appends numerical modifiers 1, 2 and 3 to each generic rating classification from Aa through Caa. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category.

Moody's Short Term Rating

Moody's short-term ratings are opinions of the ability of issuers to honour short-term financial obligations.

P-1: Issuers (or supporting institutions) rated Prime-1 have a superior ability to repay short-term debt obligations.

P-2: Issuers (or supporting institutions) rated Prime-2 have a strong ability to repay short-term debt obligations.

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Annexe 1

Standard and Poor’s (S&P) Long Term Rating

AAA: An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.
AA: An obligation rated 'AA' differs from the highest rated obligations only to a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.
A: An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.

The ratings from 'AA' to 'CCC' may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories.

Standard and Poor’s (S&P) Short Term Rating

A-1: A short-term obligation rated 'A-1' is rated in the highest category by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is strong. Within this category, certain obligations are designated with a plus sign (+). This indicates that the obligor's capacity to meet its financial commitment on these obligations is extremely strong.
A-2: A short-term obligation rated 'A-2' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher rating categories. However, the obligor's capacity to meet its financial commitment on the obligation is satisfactory.