**APPENDIX A**

# ANNUAL INVESTMENT MANAGEMENT STRATEGY 2013/14

## BACKGROUND

1. The guidance on local government investments produced by the Department of Communities and Local Government and updated in March 2010 requires local authorities to produce an annual investment strategy each year. The guidance promotes prudent management of cash with security and liquidity as priorities, while not ignoring yield.

2. Investments are grouped in two broad categories: specified and non-specified investments. Specified investments are in sterling, have high security and liquidity and are 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 UK government bonds are highly liquid and exposure to default risk is negligible.

3. The annual investment strategy for 2013/14 drawing on the 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, is high. This is underlined in the credit criteria, which is supplemented with sovereign rating and support rating.

4. The council employs fund managers to help actively manage its exposure to longer investments, with capital preservation and liquidity as high priorities.

5. The strategy is to be published on the council's website.

## ANNUAL INVESTMENT STRATEGY 2013/14

## INVESTMENT OBJECTIVES

6. The council's investment objectives are to preserve principal, provide liquidity and secure a reasonable return. Cash investments should be managed prudently and may only be placed with specified and non-specified investments.

7. Specified investments, as detailed below, are investments up to 1 year with high liquidity and credit quality. 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 share capital that is treated as capital expenditure should be avoided as should investments not denominated in GBP Sterling.

8. The strategic director of finance and corporate services is responsible for this strategy and its management. Fund managers shall assist in advising or executing elements of the strategy. As at February 2013 the council's fund managers are: AllianceBernstein Ltd and Aberdeen Asset Managers Ltd.

## CREDIT REQUIREMENTS

9. Credit risk is the risk that the institution with whom investments are held fails to meet its obligations to investors. To contain exposure to this risk, these ratings shall be consulted:
   a) Sovereign rating,
   b) Support rating, and
   c) Short and long term rating.

10. The minimum ratings required are set out in the tables below and rating definitions are given in paragraphs 27 to 36. While these ratings indicate a low risk of default and are well above the minimum regarded as investment grade, they may not always keep up with developments in turbulent markets (and do not in any case represent investment recommendations). Therefore, in managing exposure, attention should also be paid to capital strength and developments in the financial and credit markets. Exposure to risks should always be managed prudently and with due care and attention.

### i) Sovereign Rating

| **Minimum Long Term Sovereign Rating from one of the three rating agencies** | | |
|---|---|---|
| Fitch Ratings | Moody's Investor Services | Standard & Poor's |
| AA- | Aa3 | AA- |

Sovereign rating refers to the country the bank's principal parent or key regional subsidiary is operating within.

### ii) Support Rating

| **Support Rating for Individual Institution** | |
|---|---|
| **Rating Agency** | **Minimum Support Rating** |
| Fitch Ratings | 2 |

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

| **Issuer or Issue Rating, Minimum from one of the 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 | A2 | 40 | 0 |
| Standard & Poor's | A-1 | A | 40 | 0 |

### iv) Money Market Fund Rating

| **Money Market Fund Rating** | | | |
|---|---|---|---|
| **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 |

*The minimum size for funds holding only UK Government issued or guaranteed debt shall be £200m.

11. 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.

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

13. Credit requirements shall not apply to investments issued or guaranteed by the UK Government, nationalised entities, local authorities or the European Investment Bank (EIB) and the International Bank for Reconstruction and Development (IBRD, "the World Bank") where credit risk is very low.

14. 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 UK local authority shall be £40m. (Local authorities are not usually rated, but the Local Government Act 2003 provides sanctions in the event that an authority fails to meet its liabilities to lenders and exposure to local authorities helps diversify investments in a safe way when necessary). 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.

15. The limit for the European Investment Bank and the International Bank for Reconstruction and Development shall be £40m. The limit for the following supranational banks shall be £5m per issuer, with a maximum maturity of five years and subject to a rating of AAA/Aaa/AAA from at least one rating agency (Fitch, Moody's or S&P):
    - Asian Development Bank,
    - African Development Bank
    - Council for Europe Development Bank
    - Inter-American Development Bank, and
    - The Nordic Investment Bank.

16. The limit for GBP issues by foreign states shall be £5m per issuer, with a maximum maturity of five years and subject to a rating of AAA/Aaa/AAA from at least one rating agency (Fitch,Moody's or S&P):

17. The limit for RBS shall be £75m. The bank is critical to the day to day financial operations of the council. It is majority owned by the UK government and is of systemic importance to the global and UK financial system and in common with other major banks has access to central bank liquidity if needed. The limit will ensure the council can manage its day to day financial operations efficiently and effectively.

18. The limit for the Bank of New York Mellon (BNYM) shall also be £75m. BNYM provides custodial and settlement services to the fund managers, replacing HSBC who provided the service before. The limit will ensure that the council can continue using the managers. BNYM is one of the largest custodian banks in the world, globally significant, and likely to receive support if needed.

19. The strategic director of finance and corporate services shall have discretion to vary minimum rating and limits in response to market developments and operational requirements where prudent to protect the council's interests.

**OVERALL LIQUIDITY AND MATURITY CONSTRAINTS**

20. 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.

21. 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 and actual exposure will depend on interest rate expectations and credit quality.

**SPECIFIED INVESTMENTS**

22. 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**<br>**- in Sterling, meeting credit requirements and not beyond 1 year** | |
|---|---|
| A | Term deposits, accounts, bills or bonds issued or guaranteed by the UK government or UK local authorities, and<br>bonds issued or guaranteed by supranational bodies or<br>foreign governments. |
| B | Term deposits, accounts, certificates of deposits, commercial paper, senior unsubordinated notes, bonds issued by banks or UK building societies with no interest or principal conditionality. |
| C | Money Market Funds AAA/Aaa/AAA (Fitch/Moody's/S&P) rated with stable or variable net asset values |

23. 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.

**NON-SPECIFIED INVESTMENTS**

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

| **Non-specified Investments**<br>**- maturities beyond 1 year, in Sterling and meeting credit requirements** | |
|---|---|
| A | Bonds issued or guaranteed by the UK Government, supranational bodies or foreign governments |
| B | Term deposits, certificates of deposits, senior unsubordinated notes, bonds issued by banks or UK building societies, with no interest or principal conditionality. |

25. Details concerning the use, characteristics and limits applying to non-specified investments are set out below. The upper limit on exposure to non-specified investments as a whole shall be 50% of all investments. In managing exposure to non-specified investments expertise and advice shall be drawn on as necessary.

| **Non-specified Investments- Usage, Characteristics and Limits** |
|---|

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|---|---|
| A | **Bonds issued by or guaranteed by the UK Government, supranational bodies, or foreign governments**<br>*i) Typical usage*<br>• To capture additional yields that may be available from investing longer from time to time,<br>• To benefit from short and long run rate expectations.<br><br>*ii) Characteristics*<br>• 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.<br><br>*iii) Limits*<br>• No more than 50% of investments may be placed in this category, and exposure shall be actively managed to contain market risks.<br>• No one bond may have a maturity exceeding 10 years or the equivalent benchmark.<br>• 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. |

| **Non-specified Investments- Usage, Characteristics and Limits** | |
|---|---|
| B | **Fixed term deposits, certificates of deposits, senior unsubordinated notes, bonds issued by banks or UK building societies, with no interest or principal conditionality.**<br>*i) Typical usage*<br>• To capture additional yields over and above government issued debt that may be available from investing longer from time to time,<br>• To benefit from short and long run rate expectations.<br><br>*ii) Characteristics*<br>• Investments in this category are issued by the high rated banks and building societies, but as credit certainty tends to be lower for longer periods, careful analysis is necessary to ensure no undue risks are taken.<br>• 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.<br>• Investments in this category are negotiable, apart from fixed term deposits which are only repaid on maturity.<br><br>*iii) Limits*<br>• 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.<br>• Exposure shall in practice be subject to market and credit conditions and the long run credit quality of the institution as well as the merits of the investment itself. Capital preservation shall remain a priority. |

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| | • Bank debt guaranteed by the UK Government shall fall within category A of non-specified investments. |

26. The non-specified investments are managed with help from external fund managers and limits are placed to contain overall credit exposure. Any actual exposure shall be subject to the merits of the investment and market conditions.

**RATING DEFINITIONS**

27. Ratings are research based opinions of rating companies (Fitch Ratings, Moody's and Standard & Poor's) on the ability of an entity or security 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, or the suitability of any security for a particular investor.

28. Fitch Long Term Rating:

| | |
|---|---|
| **AAA** | Highest credit quality. AAA ratings denote the lowest expectation of default risk. They are assigned only in cases 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 default 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 default risk. The capacity for payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to adverse business or economic conditions than is the case for higher ratings. |

29. The Fitch Short Term Rating is a short-term issuer or obligation rating is based in all cases on the short-term vulnerability to default of the rated entity or security stream, and relates to the capacity to meet financial obligations in accordance with the documentation governing the relevant obligation. The modifiers "+" or "-" may be appended to a rating to denote relative status within major rating categories. Such suffixes are not added to the 'AAA' obligation rating category.

| | |
|---|---|
| **F1** | Highest short-term credit quality. Indicates the strongest intrinsic capacity for timely payment of financial commitments; may have an added "+" to denote any exceptionally strong credit feature. |
| **F2** | Good short-term credit quality. Good intrinsic capacity for timely payment of financial commitments |
| **F3** | Fair short-term credit quality. |

30. Fitch Support Ratings do not assess the intrinsic credit quality of a bank. Rather they communicate the agency's judgment on whether the bank would receive support should this become necessary. These ratings are exclusively the expression of Fitch Ratings' 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. |
| **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. |
| **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. |

31. Moody's Long Term Rating:

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|---|---|
| **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. |

32. Moody's appends numerical modifiers 1, 2, and 3 to each generic rating classification from Aa through Caa.

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

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|---|---|
| **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. |

34. Standard and Poor's (S&P) Long Term Rating:

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|---|---|
| **AAA** | An obligation rated AAA has the highest rating assigned by S&P. 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. |

35. 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.

36. Standard and Poor's (S&P) Short Term Rating:

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| **A-1** | A short-term obligation rated A-1 is rated in the highest category by S&P. 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. |