SOUTHEND-ON-SEA BOROUGH COUNCIL

ANNUAL INVESTMENT STRATEGY 2012/13

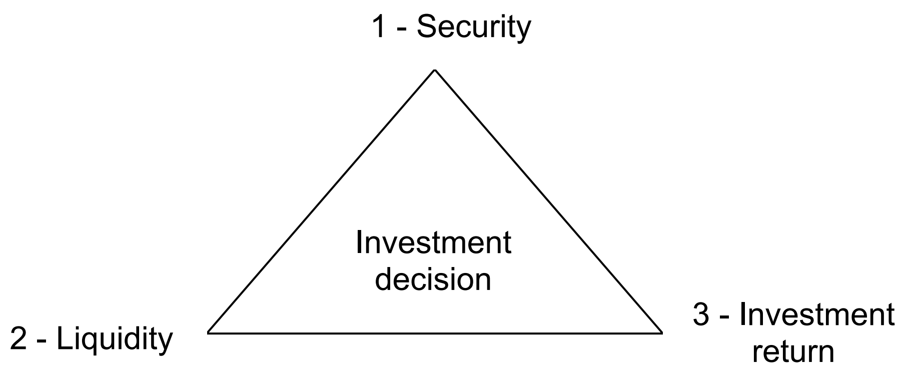
1 Investment Objectives

1.1 To secure the principal sums invested

1.2 To maintain liquidity (i.e. adequate cash resources)

1.3 To optimise the income generated by surplus cash in a way that is consistent with a prudent level of risk

1.4 Security and liquidity are placed ahead of the investment return. This is shown in the diagram below:



2 Policy on use of external fund managers

2.1 The Council currently uses one fund manager, Scottish Widows Investment Partnership Limited. The fund is estimated to have an average of £24m in 2012/13. This money is placed with the fund manager to invest on our behalf, to use their knowledge and experience with a balance of monies that is, under normal circumstances, not required for day to day cash flow purposes. Deposits and withdrawals may be made, as set out in the next paragraph.

2.2 During the first part of 2011/12 the Council continued to use two external fund managers to manage monies on our behalf. These were Aviva Fund Management and Scottish Widows Investment Partnership Limited. However, due to the performance of Aviva falling below expectation over a period of time with regard to their agreed performance targets, their Investment Management Agreement was terminated in July 2011. Aviva returned the funds as the investments matured to prevent loss of funds by early redemption, with the last of the fund being due to be repaid in November 2011.

2.3 Further withdrawals may be made during 2012/13 so that a proportion of the council's debt can be repaid or the monies invested as part of the in-house managed funds. Conversely, monies may be placed with a new fund manager during 2012/13 to take full advantage of the knowledge and experience of fund managers in making investment decisions. As to whether monies are deposited or withdrawn, the reason and timing of the decision will have regard to the council's cash flow, relevant interest rates and advice from our treasury management advisers.

2.4 It is anticipated that a new fund manager may be appointed during 2012/13. Any further appointments will need to be approved by Cabinet.

3 Policy on investment of in-house managed funds

3.1 The remaining funds will be managed in-house with the investment period and amounts being determined by the daily cash flow requirements of the Council. Cash flow forecasts will be produced in order to inform in-house investment decisions.

3.2 This authority has accepted the risk of placing funds with financial institutions, rather than solely with the UK government Debt Management Office. However, the risk is minimised by this Annual Investment Strategy, which restricts the types of investment, the counterparties used and the limits for these counterparties.

3.3 Guidance from the Communities and Local Government (CLG) department recommends that specified and non-specified investments are identified in the Investment Strategies of local authorities. Specified investments have relatively high security and liquidity, with high credit quality and a maturity of no more than a year. Non-specified investments are investments that do not fall into this category. The types of in-house investment and whether they are specified or non-specified are set out in Annex A.

3.4 During 2012/13 the Section 151 officer will, if appropriate, approve the placing of monies in deposit accounts, fixed term deposits or certificates of sterling cash deposits up to five years, subject to the proposed banks and building societies satisfying the investment criteria in a combined matrix of credit ratings, and having regard to other market information available at the time.

3.5 During 2012/13 the Section 151 officer will, if appropriate, approve the placing of monies in Money Market Funds, term repurchase arrangements, Treasury bills, with other Local Authorities or the Debt Management Office.

3.6 Where credit ratings are used to assess credit risk, they will be checked when an investment is taken out to ensure that investment satisfies the criteria in this Investment Strategy. Our treasury management advisers provide alerts when credit ratings are changed by the three main rating agencies. If the credit ratings of an institution or investment no longer satisfy the criteria the monies will be withdrawn as soon as possible. This would depend on the maturity date or notice period.

3.7 During 2012/13 the Section 151 officer will, if appropriate, approve the short term borrowing of monies from other Local Authorities in order to manage the cash flow and maintain liquidity.

3.8 Fixed term deposits may be made directly with the banks and building societies or through the use of a broker. Monies will be placed with other Local Authorities through the use of a broker. Investments in Certificates of Deposit and Treasury bills will be made through the use of a custodian account. The Council acknowledges that it retains responsibility for all investment decisions made whether they are made on its behalf or not.

3.9 When investing in-house managed funds, the following are considered; the type of investment, the individual counterparty, the amount that can be invested, the method of placement of monies. These are summarised in Annex A**.**

3.10 The services of our treasury management adviser, Sector, will be used throughout 2012/13 to provide advice as well as credit rating and other market information regarding counterparties and types of investment. However, the Council recognises that responsibility for investment decisions remains with the authority at all times.

4 Investment Criteria for Funds Managed In-house

4.1 All financial institutions considered for investment will be assessed for credit worthiness against a combined matrix of pre determined criteria using available credit ratings. Credit ratings are assessments by professional organisations of an entity’s ability to punctually service and repay debt obligations. Credit ratings are used by investors as indications of the likelihood of getting their money back in accordance with the terms on which they invested.

4.2 The credit rating components comprise:

- Short and long term ratings
- Viability/financial strength ratings
- Support ratings

Ratings provided by all three credit rating agencies will be consulted and the lowest rating will be taken.

4.3 The short term rating covers obligations which have an original maturity not exceeding one year. The short-term rating places greater emphasis on the liquidity necessary to meet financial commitments. All three credit rating agencies provide short term ratings. The ratings are expressed from F1+ (highest credit rating) through to D (highest default risk) for Fitch, from A-1+ (highest credit rating) through to D (highest default risk) for Standard and Poors, and from P-1 (highest credit rating) through to NP (highest default risk) for Moody’s.

4.4 The long term ratings generally cover periods in excess of one year. Due to the larger time horizon over which the rating is determined, the emphasis shifts to the assessment of the ongoing stability of the institution's prospective financial condition. All three credit rating agencies provide long term ratings. The ratings are expressed from AAA (highest credit rating) through to D (highest default risk) for Fitch and Standard and Poors and from AAA (highest credit rating) through to C (highest default risk) for Moody's.

4.5 The viability or financial strength rating is a measure of an institution's intrinsic safety and soundness on a stand alone basis and provides an assessment of the strength of the institution's financial structure, its performance and its risk profile. Fitch and Moody's provide viability or financial strength ratings. These ratings range from the strongest of A to the weakest of F.

4.6 At present, Fitch is the only agency which gives a support rating and explicitly states its view of the likely presence of a lender of last resort, either government or parent organisation with the willingness and the resources to aid a failing institution. These ratings range from the maximum support rating of 1 to the lowest of 5.

4.7 In order to balance the objective of securing the maximum level of return on investments with a prudent level of risk a matrix of criteria will be adopted as a starting point to determine the acceptability of a potential investment. All credit ratings will be considered for investments of less than one year and more than one year to assess the full credit worthiness of the lender.

4.8 These matrices are set out on the following pages:

For Lending of <u>up to one year</u> to Banks and Building societies:

If the short and long term ratings are at least:

	Fitch	S&P	Moodys
Short term rating minimum	F1+	A-1+	P-1
Long term rating minimum	AA+	AA+	Aa1

then the following table will be used:

Viability/financial strength		Support				
Fitch	Moodys	1	2	3	4	5
aa to aaa	A					
a to aa+	B+					
a- to aa-	B					
bbb to a	B-/C+					
bb+ to bbb+	C					
bb- to bbb-	C-/D+					
b- to bb	D					

up to one year investment
up to six month investment
up to three month investment

If the short and long term ratings are at least:

	Fitch	S&P	Moodys
Short term rating minimum	F1	A-1	P-1
Long term rating minimum	A	A	A2

but less than above, then the following table will be used:

Viability/financial strength		Support				
Fitch	Moodys	1	2	3	4	5
aa to aaa	A					
a to aa+	B+					
a- to aa-	B					
bbb to a	B-/C+					
bb+ to bbb+	C					
bb- to bbb-	C-/D+					
b- to bb	D					

up to one year investment
up to six month investment
up to three month investment

For Lending of <u>longer than one year</u> to Banks and Building societies:

If the short and long term ratings are at least:

	Fitch	S&P	Moodys
Short term rating minimum	F1+	A-1+	P-1
Long term rating minimum	AA+	AA+	Aa1

then the following table will be used:

Viability/financial strength		Support				
Fitch	Moodys	1	2	3	4	5
aa to aaa	A					
a to aa+	B+					
a- to aa-	B					
bbb to a	B-/C+					
bb+ to bbb+	C					
bb- to bbb-	C-/D+					
b- to bb	D					

Between 1 and 5 year investment
Between 1 and 3 year investment

If the short and long term ratings are at least:

	Fitch	S&P	Moodys
Short term rating minimum	F1+	A-1+	P-1
Long term rating minimum	AA-	AA-	Aa3

but less than above, then the following table will be used:

Viability/financial strength		Support				
Fitch	Moodys	1	2	3	4	5
aa to aaa	A					
a to aa+	B+					
a- to aa-	B					
bbb to a	B-/C+					
bb+ to bbb+	C					
bb- to bbb-	C-/D+					
b- to bb	D					

Between 1 and 2 year investment

4.9 An example of the use of this credit ratings matrix as at 19th December 2011 is shown below (the long and short term ratings are Fitch, then Standard and Poors, then Moodys) (the individual/financial strength ratings are Fitch then Moodys):

Financial Institution	Long Term Rating	Short Term Rating	Viability/ Financial Strength Rating	Support	Maximum length of investment
Royal Bank of Canada	AA AA- Aa1	F1+ A-1+ P-1	aa B	1	2 years
JP Morgan Chase Bank	AA- A+ Aa1	F1+ A-1 P-1	aa- B	1	6 months
Lloyds TSB Bank	A A A1	F1 A-1 P-1	bbb C-	1	Fails initial investment criteria

4.10 The individual ratings for many banks and building societies are low which means that they do not meet the criteria in our credit ratings matrix. This does not take into account the good support ratings of some of these banks and building societies, following the financial support schemes announced by Government. It is proposed that, following assessment against credit ratings, 7 of the 8 major UK banks and the largest building society that originally confirmed their participation in the UK Government-supported recapitalisation scheme will be added back to the counterparty list. (Standard Chartered are not active in the market.) These 7 institutions are:

- Santander UK plc (formally Abbey National plc)
- Barclays
- HBOS
- HSBC Bank plc
- Lloyds TSB
- Nationwide Building Society
- Royal Bank of Scotland

For example, Lloyds TSB fails the investment criteria of the credit ratings matrix but is one of the 7 institutions named above and would therefore be added back to the counterparty list.

These institutions have been added back to the counterparty list on the advice of our treasury management advisers and this approach is similar to that taken by many other local authorities.

4.11 The maximum length of investment for these 7 institutions will be determined by the Council’s Section 151 Officer at a level that is deemed appropriate given the prevailing financial market conditions and in consultation with our treasury management advisers.

4.12 Regard will be given to forward looking rating warnings (i.e. rating watches and outlooks) provided by our treasury management advisers.

4.13 The current advice from the Audit Commission is not to rely solely on the credit rating agencies, so regard will also be given to market information. Where available credit information, other than credit ratings has been used, this will be documented when the investment decision is made.

4.14 The achievement of an appropriate balance between short-term and longer-term deposits will be driven by the credit quality of counterparties, the council's cash flow requirements, and the need to achieve optimum performance from our investments consistent with effective management of risk.

5 Investment Limits for Funds Managed In-house

5.1 The ratings agencies produce a credit rating for each country, called a sovereign rating. The ratings are expressed from AAA (highest) to D (lowest). The following limits have been set for an investment with a bank or building society whose parent company is registered in a country with a sovereign rating from Fitch and S&P of AAA or AA+ or a sovereign rating from Moody's of AAA or Aa1. IDR sovereign ratings provided by all three credit rating agencies will be consulted and the lowest rating will be taken.

Country Sovereign Rating	Limit (£ million)
AAA	20
AA+/Aa1	5

5.2 £20 million is approximately 4% of the authority's estimated 2011/2012 gross revenue expenditure of £472m. £5m is slightly more than 1% of the estimated gross revenue expenditure.

5.3 To minimise counterparty risk, the limit on any investment with a bank or building society (with the exception of the Council's bank which is currently Barclays Bank) will be determined in the following way:

- consider the country in which the parent company of the bank or building society is registered
- use the sovereign rating of that country to apply the limits above
- consider the cumulative balance of funds already held in various investment products with that bank or building society
- consider the cumulative balance of funds already held in various investment products for any related group of financial institutions
- determine the remaining amount that can be placed with that bank or building society

For example, the limit on an investment with Lloyds TSB Bank would be determined in the following way:

Steps to determine limit:	**Remaining limit available at each stage:**
Lloyds TSB Bank is part of the Lloyds Banking Group which is registered in the UK, the UK has a sovereign rating of AAA	£20 million
£4 million already placed in an instant access account with Lloyds TSB Bank	£16 million
£5 million already placed in a fixed term deposit with Lloyds TSB Bank	£11 million
Therefore the maximum investment would be £11 million	

The Council's bank is the exception to these investment limits however, and under normal circumstances our intention would be to comply with a counterparty limit of £30 million, to enable the efficient and effective management of the Council's cashflow.

5.4 The limit on deposits in Money Market Funds will be £20 million with any one AAAm rated liquidity fund. These work in the same way as a deposit account but the money in the overall fund is invested in a number of counterparties, therefore spreading the counterparty risk.

5.5 There are products being developed that are similar to, but not the same as Money Market Funds, such as 'term repurchase arrangements'. The risk associated with these funds is somewhere between a fixed term deposit and a Money Market Fund. The Section 151 officer will approve the placing of monies in these types of fund up to a maximum of £20 million per fund, if deemed appropriate and in consultation with our treasury management advisers.

5.6 Given the prevailing financial market conditions, financial institutions will inevitably devise various investment products to offer enhanced returns. The Council's Section 151 Officer will consider these in consultation with our treasury management advisers and will approve the placing of monies in such investment products with appropriate limits, only after the options and their associated risks have been fully analysed by the treasury management team and our treasury management advisers.

5.7 To maximise flexibility, there is no limit on deposits with the UK Government (e.g. Debt Management Office, HM Treasury bills).

5.8 The limit on deposits with other Local Authorities will be £40 million which is approximately 8.5% of the authority's estimated 2011/2012 gross revenue expenditure of £472m.

6 Fund Managers investment criteria

6.1 Investments undertaken by external fund managers on behalf of the Council can only be placed in certain types of investment as permitted under the Local Government Act. The types of investment, counterparties and limits used by each fund manager are set out in their Investment Management Agreement.

6.2 The Council's Section 151 Officer is authorised to amend these Investment Management Agreements as appropriate to reflect the needs of the Council, after fully considering the options and their associated risk and in consultation with the Council's treasury management advisers.

Annex A

Type of Investment	Individual Counterparty	Limit	Method of placement	Specified/non-specified
Deposit accounts	Bank or building society that meets the criteria of our combined matrix of credit ratings, or one of the 7 major banks and largest building society	Per bank or building society, based on country sovereign rating	Directly or through a broker	Specified (if 1 year or less), Non-specified (if more than 1 year)
Fixed term deposits			Directly or through a broker	
Certificates of sterling cash deposits			Custodian account	
Money Market Funds	AAAm rated* liquidity fund	Per fund	Directly or via an on-line site for managing money market funds	Specified
Term repurchase arrangements	AAAf/S1 rated#	Per fund	Directly	Specified (if 1 year or less), Non-specified (if more than 1 year)
Other Local Authorities	Depends on which Local Authorities want to borrow money at that time	For total invested with other Local Authorities	Through a broker	Specified (if 1 year or less), Non-specified (if more than 1 year)
Debt Management Office	UK Government	For total invested with UK Government	Directly	Specified
Treasury Bills			Custodian account	

* A fund with a principal stability rating of 'AAAm' has an extremely strong capacity to maintain stability and to limit exposure to losses of the principal sums invested due to credit, market and/or liquidity risks.

A fund with a credit quality rating of ‘AAAf’ has a portfolio holding that provides extremely strong protection against losses from credit defaults. A fund with a volatility rating of S1 possesses low sensitivity to changing market conditions.

This table is subject to change as new products are added as deemed appropriate – see paragraph 5.6.