Council	Agenda Item 94
6 April 2017	Brighton & Hove City Council

Subject:		**Annual Investment Strategy 2017/18**	
Date of Meeting:		**6 April 2017** 23 March 2017 – Policy, Resources & Growth Committee	
Report of:		**Executive Director, Finance & Resources**	
Contact Officer:	**Name:**	**James Hengeveld**	**Tel: 01273 29-1242**
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Ward(s) affected:		**All**	

FOR GENERAL RELEASE

1. PURPOSE OF REPORT AND POLICY CONTEXT

1.1 The Local Government Act 2003 introduced a prudential capital finance system whereby levels of borrowing and investments are decided locally.

1.2 Guidance issued under the Act requires a local authority to approve an annual investment strategy which prioritises security and liquidity and requires the council to set out its policies on:

- determining the credit-worthiness of its investment counterparties and the frequency at which such determinations are monitored;
- holding investment instruments other than deposits held in financial institutions or government bodies;
- determining the maximum periods for which funds may be invested;
- the minimum level of investments to be held at any one time.

2. RECOMMENDATIONS:

2.1 That Policy, Resources & Growth Committee recommend to full Council the approval of the Annual Investment Strategy 2017/18 as set out in Appendix 1 to this report.

3. CONTEXT/ BACKGROUND INFORMATION

3.1 The Annual Investment Strategy (AIS) for 2017/18 is set out in Appendix 1 to this report and covers investments made by the in-house treasury team and the council's external cash manager. The council currently uses a cash manager to take advantage of investment opportunities in specialist markets not covered by the in-house team, such as government stock. The AIS gives priority to security and liquidity.

3.2 Security is achieved by:

- selecting only those institutions that meet stringent credit rating criteria or, in the case of non-rated UK building societies, have a substantial asset base; and
- limiting the amount invested with any one institution.

3.3 The council uses independent credit rating agencies to assess the creditworthiness of investment counterparties. Aside from some specific exemptions (as set out in 1.3.3 of Appendix 1), the AIS 2017/18 continues with the policy of assessing creditworthiness by applying the lowest rating issued by the three main rating agencies – Fitch, Moody's and Standard & Poor's. In the majority of cases the ratings issued by these agencies are aligned but this is not always the case**.**

3.4 Rating criteria are only one factor taken into account in determining investment counterparties. There are other factors such as counterparty Credit Default Swap prices (traded financial derivatives that are essentially "insurance" against a counterparty's debt. The price trend of these instruments are able to provide some insight as to how the market views the risk of a particular counterparty), credit watches and outlooks published by the ratings agencies, and articles in the financial press will continue to be monitored. Action will be taken where it is felt the risk attached to a particular counterparty has or is likely to deteriorate. Action will include the temporary suspension of the counterparty if considered appropriate.

3.5 Liquidity is achieved by limiting the maximum period for investment and matching investment periods to cash flow requirements.

Review of externally managed investments - update

3.6 The return on the cash manager funds had been declining, which triggered a review and options appraisal by officers, supported by the council's treasury advisors. Officers reported findings and intentions, and the next steps of the review to the cross-party Budget Review Group in September 2016. The options appraisal concluded that a formal selection process should be undertaken to ensure that value for money and security are secured from the funds. Officers will be requesting the council's current treasury advisors, Capita Asset Services, to undertake a selection process for Corporate Bond Funds and Enhanced Cash Funds. The council is able to provide the investment parameters for the selection process, including an "ethical overlay" to ensure potential funds meet the council's ethical investment policy. The cost of this process will be approximately £2,500 which will be met by the Financing Costs budget, funded by improved investment income expected to arise from the review.

3.7 The review also concluded that direct investment into corporate bonds was an appropriate alternative to diversify the council's portfolio. The Annual Investment Strategy has not been amended at this stage to include corporate bonds as officers are confident that, subject to the amendments recommended in 3.17, the current investment strategy holds sufficient capacity to provide the council with a secure portfolio of investments for 2017/18. Future amendments to the AIS may be undertaken if diversification into corporate bonds is deemed appropriate.

3.8 Since the review was undertaken, the cash manager's return has improved significantly. Officers are closely monitoring the trend of the return of the fund to ascertain whether the improvement is temporary. The selection process will be triggered if officers assess that there is further decline in performance.

Upcoming and potential changes in regulations

Money Market Reforms

3.9 The EU is in the process of reforming Money Market Funds (MMFs). MMFs that the council currently invests in are Constant Net Asset Value funds (CNAV), which means the value of each "share" is maintained at a constant value so that no capital gain or loss is incurred. The proposals under EU reform would severely limit or change the market for CNAV funds which would effectively make them obsolete. MMFs are the council's main source of liquidity, so any amendments to the availability of CNAV funds will require a review and amendment to the council's Investment Strategy.

3.10 These changes are expected to be implemented within two years. Officers will ensure a timely review of the investment strategy is conducted and any amendments will be bought to Council at the earliest opportunity.

MiFID II consultation

3.11 The Markets in Financial Instruments Directive II (MiFID II) is a package of EU legislation, introduced in 2014, which regulates both retail and wholesale investment business in the UK. The aim of the MiFID legislation is to strengthen protection for investors. In this case, "investors" includes local authorities and local authority pension funds.

3.12 The Financial Conduct Authority (FCA) published consultation on how the directive will be implemented in the UK. Under current legislation, Local Authorities are "professional" investors. This classification enables local authorities to invest in a wide range of financial instruments, allowing diversification of investment portfolios. It also provides access to a large market of willing counterparties to transact with.

3.13 Under MiFID II, it is proposed that all local authorities are automatically reclassified as "retail" investors. Authorities will then have the option to "opt-up" to professional investor status as long as specified criteria are satisfied, including a minimum investment portfolio of £15m. There is minimal impact expected for the council as it meets the criteria to "opt-up". However, many small councils will be unable to opt up, which would limit their ability to access appropriate investment opportunities. The council therefore responded to the consultation in support of smaller councils by suggesting the minimum investment portfolio size was unnecessary.

Changes to the Annual Investment Strategy 2017/18

3.14 In 2016/17, officers made a number of changes to the Investment Strategy including:

- an increase of all counterparty limits to provide additional capacity as a result of the investment portfolio increasing;
- introduction of the specific permitted use of new instruments to including Corporate Bonds, Corporate Bond Funds and Property Funds (see 3.6 for an update of use of these instruments);
- an increase in the investment limit for Lloyds Bank by £5.0m as our operational bank.

3.15 These increased limits have allowed the council to obtain best value within the investment portfolio over the last year and has facilitated a new £5 million investment with Lloyds which is invested directly into helping small local businesses.

3.16 Against the backdrop of increasing investment balances (as a result of taking on new borrowing which has not yet been spent) the average investment balances are higher than they have been in previous years. Subsequently, a large proportion of investments are held in Money Market Funds. Investment returns are declining as a result of the reduction in the official Bank Base Rate, and there are fewer opportunities to maximise yield on investments with high quality counterparties as capacity shrinks.

3.17 It would not be prudent to increase counterparty limits again, as there would be a risk that the concentration of the council's investment portfolio would narrow further. Instead officers recommend that an additional further UK counterparty (Sumitomo Mitsui Banking Corporation Europe Limited) is added to the council's list of authorised counterparties. This organisation meets the council's investment criteria and is on the treasury advisors recommended counterparty list. In addition, it is very active in the Local Authority investment market. Adding this name to the authorised counterparty list will allow the council further capacity in the investment portfolio which will result in reduction of risk through further diversification of investments as well as allowing reduction in liquidity, which will improve the average investment rate being achieved.

3.18 The Treasury Team continue to monitor the ongoing viability of all counterparties as described in paragraph 3.4.

4. ANALYSIS & CONSIDERATION OF ANY ALTERNATIVE OPTIONS

4.1 This report sets out the council's Annual Investment Strategy for the year commencing 1 April 2017. The AIS continues with the strong emphasis on risk management and liquidity, two cornerstones to the draft guidance issued by the Secretary of State, and the impact these have on investment performance.

5. COMMUNITY ENGAGEMENT & CONSULTATION

5.1 The council's external treasury advisors have been consulted in the drafting of this report.

6. CONCLUSION

6.1 The 2010 investment guidance requires that local authorities produce an investment strategy to be approved and amended by full Council. This report fulfils that requirement.

7. FINANCIAL & OTHER IMPLICATIONS:

Financial Implications:

7.1 The financial implications arising from the AIS have been included in the Financing Costs budget for 2017/18.

Finance Officer Consulted: James Hengeveld Date: 28/02/17

Legal Implications:

7.2 The legal framework for the council's Annual Investment Strategy is Part 1, chapter 1, of the Local Government Act 2003, and associated statutory guidance.

7.3 It is a legal requirement for the Annual Investment Strategy to be approved by full Council. It is the role of the Policy & Resources Committee to formulate the strategy prior to consideration by full Council.

Lawyer Consulted: Victoria Simpson Date: 28/02/17

Equalities Implications:

7.4 No equalities impacts have been identified in relation to this report.

Sustainability Implications:

7.5 The council's ethical investment statement requests that institutions apply council deposits in a socially responsible manner. Ethical options were considered in the report to 12 July 2012 Policy, Resources & Growth Committee

Any Other Significant Implications:

Risk & Opportunity Management Implications:

7.6 The investment guidance issued under the 2003 Act requires the council to assess credit worthiness by reference to an independent rating agency. The AIS 2017/18 will use the ratings assigned by Fitch, Moody's and Standard & Poor's.

7.7 The ratings provide an opinion on the relative ability of an institution to meet financial commitments, such as interest, preferred dividends, repayment of principal, insurance claims or counterparty obligations. The council uses credit ratings as an indication of the likelihood of receiving its money back in accordance with the terms of the investment. Other sources of information are also used to supplement that provided by the rating agencies.

7.8 The minimum ratings set out in the AIS have the following meaning:

	Generic criteria	Fitch	Moody's	Standard & Poor's
For investment up to 1 year				
Short-term	Good capacity for timely payment of financial commitments. Where the credit risk is particularly good, a "+" is added to the assigned rating by Fitch and S&P	F2	P-2	A-2
For investment in excess of 1 year				
Long-term	Strong capacity for payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.	BBB	Baa	BBB

7.9 Investment risk is managed by selecting only institutions that meet the council’s stringent credit rating criteria. Liquidity risk is managed by applying maximum investment periods to institutions.

SUPPORTING DOCUMENTATION

Appendices:

1. Annual Investment Strategy 2017/18 including the counterparty list in schedule 1.

Documents in Members' Rooms
None

Background Documents

1. Guidance issued by the secretary of State under Section 15(1)(a) of the Local Government Act 2003 effective from 1 April 2010

2. The Prudential Code for Capital Finance in Local Authorities published by CIPFA – fully revised third edition 2011