

REPORT OF THE CHIEF FINANCIAL OFFICER

INVESTMENT STRATEGY 2012/13

1. Purpose of Report

To present to Members the 2012/13 Investment Strategy for consideration and recommendation to the Police Authority.

Recommendations

Members are asked to consider and recommend the approval of the Investment Strategy for 2012/13.

On advice of the Authority's Treasury Advisors, the Authority has included options to utilise non-UK banks, Gilts, Treasury Bills, bonds issued by Multilateral Development Banks, AAA rated Money Market Funds and Certificates of Deposit as investment instruments in 2012/13 should they be required to increase flexibility and management of credit and liquidity risk. These instruments are not being used at the time of writing this report and will only be used after express authorisation of the Chief Financial Officer.

Following the extreme tension and negative sentiment driving the markets recently, the Authority has taken a prudent response and has temporarily suspended new investments with UK Banks and Building Societies. At the time of writing this report, a cautious investment strategy has been adopted, with surplus funds only being invested with the Debt Management Office.

2. Background

In late November 2011, CIPFA issued '*Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes (the Code)*' which represents a revision of the 2009 Code. The Authority has incorporated the changes from the revised CIPFA Code of Practice into its treasury policies, procedures and practices.

One of the clauses adopted in the Code states that the Authority will receive reports on its treasury management policies, practices and activities, including as a minimum an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close, in the form prescribed in its Treasury Management Practices (TMPs).

CIPFA has defined Treasury Management as:

"the management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

No treasury management activity is without risk. The Authority regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of Treasury Management activities will focus on their risk implications for the Authority, and any financial instruments entered into to manage these risks.

Treasury management risks are identified in the Authority's approved Treasury Management Practices; the main risks to the Authority's treasury activities are:

- Credit and Counter-party Risk (Security of Investments)
- Liquidity Risk (Inadequate cash resources)
- Inflation Risk (Exposure to inflation)
- Market or Interest Rate Risk (Fluctuations in interest rate levels and thereby in the value of investments).
- Refinancing Risks (Impact of debt maturing in future years).
- Legal & Regulatory Risk (i.e. non-compliance with statutory and regulatory requirements, risk of fraud).

The Investment Strategy has been prepared with due regard to: -

- The Local Government Act 2003;
- Regulations made under the Local Government Act 2003;
- Guidance issued by the Welsh Assembly Government;
- CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes;
- Dyfed Powys Police's Treasury Management Policy.

3. Definitions

- A **credit rating agency** is an organisation that provides an opinion on the ability of an entity or of a securities issue to meet financial commitments such as interest, preferred dividends or repayment of principal, on a timely basis. They are used by investors as indications of the likelihood of getting their money back on the terms on which they were invested. The three main credit rating agencies are Standard and Poor's, Moody's Investors Service Limited and Fitch Ratings Limited.
- An **investment** is a transaction that relies upon the power in section 12 of the Local Government Act 2003 and is recorded in the balance sheet under the heading of investments within current assets or long-term investments.
- A **long-term investment** is any investment other than one that is contractually committed to be paid within twelve months of the date on which the investment was made.
- The **Official Bank Rate** is the base rate set by the Bank of England
- **Upside risk** is the risk that the official bank rate could be higher than expected (please refer to the table in Section 6).
- **Central case** is most likely outcome anticipated at a current point in time (please refer to the table in Section 6).

- **Downside risk** is the risk that the official bank rate could be lower than expected (please refer to the table in Section 6).
- **Triple A** Highest credit quality. 'AAA' ratings denote the lowest expectation of credit risk. They are assigned only in case of exceptionally strong capacity for timely payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.
- **Double A** Very high credit quality. 'AA' ratings denote expectations of a very low credit risk. They indicate very strong capacity for payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
- **Single A** High credit quality. 'A' ratings denote expectation of a 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.

Note: The above three rating definitions are for the Fitch Rating Agency.

4. Investment Policy and Strategy

This Authority delegates responsibility for the implementation and monitoring of its treasury management policies and practices to the Finance and General Purposes Committee, and for the execution and administration of treasury management decisions to the Chief Constable and Chief Financial Officer, who, being a CIPFA member, will act in accordance with the organisation's policy statement and TMPs and the *CIPFA: Standard of Professional Practice on Treasury Management*.

In accordance with Investment Guidance issued by the Welsh Government and best practice, the Authority's primary objective in relation to the investment of public funds remains the security of capital. The liquidity or accessibility of the Authority's investments followed by the yields earned on investments is important but are secondary considerations.

Credit markets remain in a state of distress as a result of the excessive and poor performing debt within the financial markets. In some instances, Greece and Italy being the most notable examples, the extent and implications of the debt it has built up have lead to a sovereign debt crisis and a banking crisis with the outcome still largely unknown. It is against this backdrop of uncertainty that the Authority's investment strategy is framed.

Investments are categorised as 'Specified' or 'Non Specified' within the investment guidance issued by the Welsh Government.

Specified investments are sterling denominated investments with a maximum maturity of one year. They also meet the 'high credit quality' as determined by the Authority and are not deemed capital expenditure investments under Statute. Non specified investments are, effectively, everything else.

The types of investments that are recommended for use by the Authority, and whether they are specified or non-specified are as follows:

| Investment | Specified | Non-Specified |
|--|-----------|---------------|
| Term deposits with banks and building societies | ✓ | x |
| Certificates of Deposit (CDs) with banks and building societies. | ✓ | x |
| Term deposits with other UK local authorities | ✓ | x |
| Gilts (bonds issued by the UK Government) | ✓ | ✓ |
| Treasury Bills (T-Bills) | ✓ | x |
| Bonds issued by Multilateral Development Banks | ✓ | ✓ |
| AAA rated Money Market Funds | ✓ | x |
| Debt Management Account Deposit Facility | ✓ | x |

A description of the various investment instruments, their benefits and associated risk are contained in [Appendix A](#).

A number of changes have been implemented to the Strategy for 2012/13 in response to evolving conditions in financial markets.

The Authority and its advisors, Arlingclose Ltd, select countries and financial institutions after analysis and on-going monitoring of:

- Published credit ratings of the financial institution (minimum long term rating of A- or equivalent for counterparties; AA+ or equivalent for non-UK sovereigns) – this is lower than the A+ minimum adopted in 2011/12 and is in response to downgrades in credit ratings below A+ of many institutions considered to be systemically important to the financial system;
- Credit default swaps (where quoted);
- Economic fundamentals, (such as a country's net debt as a percentage of it's GDP);
- Sovereign support mechanisms;
- Share prices (where available);
- Corporate developments, news, articles, markets sentiment and momentum;
- Subjective overlay – or, put more simply, common sense.

A list of the Authority's current counterparties which meets the Authority's criteria is maintained by the Authority within its Treasury Management Practices as a live, regularly updated, operational document. The counterparty names on the list are subject to regular review and therefore can change due to credit developments (for example if a counterparty is downgraded). All changes are approved by the Chief Financial Officer.

With short term interest rates low for even longer, an investment strategy will typically result in a lengthening of investment periods, where cash flow permits, in order to lock in higher rates of acceptable risk adjusted returns. The problem in the current environment is finding an investment counterparty providing acceptable levels of counterparty risk.

The Authority banks with Barclays Bank PLC. At the current time, it does meet the minimum credit criteria of A- (or equivalent) long term. Even if the credit rating falls below the Authority's minimum criteria, Barclays Bank PLC will continue to be used for short term liquidity requirements and business continuity arrangements.

Monies may only be borrowed in advance of need if it is line with the borrowing requirement set out within the 5 year capital financing strategy and if there is a clear financial case for so doing. If such borrowing is undertaken, the temporary investment of the monies will be in line with the Treasury Management Policy and measures in place to minimise risk of loss of the borrowed capital, and the risk associated with interest rate changes. The differential between medium and long-term borrowing rates on the one hand and current investment returns on the other remains acute and this is expected to remain a feature during 2012/13.

5. Upper Limit for total principal sums invested over 364 days

The risk inherent in the maturity structure of an authority's investment portfolio if it is forced to realise an investment before it reaches its final maturity, and thus at a time when its value may be dependent on market conditions that cannot be known in advance, is that it may lose some of its principal.

To address these risks, the Prudential Code requires local authorities to establish limits on long-term investments.

Where a local authority invests, or plans to invest, for periods longer than 364 days, the local authority will set an upper limit for each forward financial year period for the maturing of such investments. These prudential indicators will be referred to as prudential limits for principal sums invested for periods longer than 364 days and the indicator for 2012/13 is as follows:

| | Average total principal invested for the year | Limit for total principal sums invested over 364 days |
|---------|--|--|
| 2012/13 | 24m | 10m |

6. Economic and Interest Rate Outlook

The interest rate forecast provided by the Authority's treasury Management advisor, Arlingclose, is as follows:

| Official Bank Rate | Mar-12 | Jun-12 | Sep-12 | Dec-12 | Mar-13 | Jun-13 | Sep-13 | Dec-13 | Mar-14 | Jun-14 | Sep-14 | Dec-14 | Mar-14 |
|--------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Upside risk | | | | | 0.25 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| Central case | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| Downside risk | | | | | | | | | | | | | |

The reduction in official interest rates to historically very low levels will continue to have direct and indirect consequences for the financial operations and budgets of this Authority.

The estimate for interest receipts in 2012/13 has been calculated based on a number of different scenarios, as follows:

| | Financial Institution | Overall period of investment with each Institution over the financial year. | Estimated Rate of Interest | Estimated Annual Interest |
|-------------------|-----------------------------|---|----------------------------|---------------------------|
| Scenario 1 | Debt Management Office | 12 months | 0.25% | £61,151 |
| Scenario 2 | Debt Management Office | 9 months | 0.25% | £76,438 |
| | Other approved Institutions | 3 months | 0.50% | |
| Scenario 3 | Debt Management Office | 6 months | 0.25% | £91,726 |
| | Other approved Institutions | 6 months | 0.50% | |
| Scenario 4 | Debt Management Office | 3 months | 0.25% | £107,014 |
| | Other approved Institutions | 9 months | 0.50% | |

The above scenarios assume that the 'other approved institutions' will only be utilised for investments with a maximum duration of one month at a time. This is a cautious strategy, reflecting the current uncertain and volatile global financial markets.

7. Prudential Indicator for Credit and counter-party risk management

The Authority considers security, liquidity and yield, in that order, when making investment decisions.

Credit ratings remain an important element of assessing credit risk, but they are not a sole feature in the Authority's assessment of counterparty credit risk.

The Authority also considers alternative assessments of credit strength, and information on corporate developments of counterparties and market sentiment towards counterparties. The following key tools are used to assess credit risk:

- Published credit ratings of the financial institution (minimum long term rating of A- or equivalent for UK counterparties; A+ or equivalent for non-UK counterparties, (AA+ or equivalent for non-UK sovereigns). The minimum long term ratings are lower than the minimums adopted in 2011/12 and this is in response to downgrades in credit ratings below A+

of many institutions considered to be systemically important to the financial system;

- Credit default swaps (where quoted);
- Economic fundamentals, (such as a country's net debt as a percentage of it's GDP);
- Sovereign support mechanisms;
- Share prices (where available);
- Corporate developments, news, articles, markets sentiment and momentum;
- Subjective overlay – or, put more simply, common sense.

The only indicators with prescriptive values are credit ratings. Other indicators of creditworthiness are considered in relative rather than absolute terms.

In order to diversify the counterparty list, Arlingclose consider the use of comparable non-UK Banks to be appropriate. The sovereign states whose banks may be included by the Authority are Australia, Canada, Finland, France, Germany, Netherlands, Sweden, Switzerland and the US.

Investments should be spread over a number of institutions on the Authority's lending list in order to minimise risk and to secure capital investment. The Authority anticipates the level of investment balances to average around £24m during 2012/13 and the following maximum investment levels have been set in order to spread the risk over the portfolio and safeguard investments:

| SPECIFIED INVESTMENTS | Maximum investment period | Counter-party investment limit for Specified Investments |
|---|----------------------------------|---|
| Debt Management Agency Deposit Facility (<i>the DMADF currently takes deposits for a maximum of 6 months</i>) | 6 months | No limit |
| Treasury Bills (T-Bills) (<i>T bills are currently issued for 1- 3- and 6-month maturities</i>) | 6 months | No limit |
| UK Government Gilts and AAA-rated Bonds issued by Multilateral Development Banks | 364 days | 100% of overall investments |
| AAA rated Money Market Funds with constant Net Asset Value (Constant NAV) | 364 days | £6m per Fund |
| Term deposits with other UK Local Authorities | 364 days | £6m |
| Term deposits/Certificates of Deposit and Call Accounts with UK Banks & Building Societies with minimum long term rating of A - or equivalent | 364 days | £6m |
| Term deposits/Certificates of Deposit and Call Accounts with Non UK Banks with minimum long term rating of A+ or equivalent | 364 days | £3m |
| NON-SPECIFIED INVESTMENTS The maximum amount invested in Non Specified Investments in aggregate will not exceed £10M at any time | Maximum investment period | Counter-party investment limit for Non-Specified Investments |
| UK Government Gilts and AAA-rated Bonds issued by Multilateral Development Banks | 10 years | Maximum £10m in aggregate between gilts and bonds |

As stated in Paragraph 4, a list of the Authority's current counterparties which meets the Authority's criteria is maintained by the Authority within its Treasury Management Practices as a live, regularly updated, operational document. The counterparty names on the list are subject to regular review and therefore, recommended investment periods and limits can change due to credit developments (for example if a counterparty is downgraded). All changes are approved by the Chief Financial Officer.

Currently, Local Authorities' legal power to use derivative instruments remains unclear. The General Power of Competence enshrined in the Localism Bill is not sufficiently explicit. Consequently, the Authority does not intend to use derivatives.

Should this position change, the Authority may seek to develop a detailed and robust risk management framework governing the use of derivatives, but this change in strategy will require full Authority approval.

8. Icelandic Bank Impairments

Early in October 2008, the Icelandic banks Landsbanki and Glitnir collapsed and the UK subsidiaries of the banks, Heritable and Kaupthing Singer and Friedlander (KSF) went into administration. The Authority had £2m deposited across two of these institutions in accordance with the Annual Investment Strategy, with varying maturity dates and interest rates as follows:

| Bank | Principal Invested £'000 | Date Invested | Maturity Date | Date of administration | Interest Rate % | Carrying £ at 31 st March 2009 | Impairment | Revised Impairment 2009/10 | Revised Impairment 2010/11 |
|--------------|--------------------------|-------------------------------|-------------------------------|------------------------------|-----------------|---|----------------|----------------------------|----------------------------|
| KSF | 1,000 | 3 rd April 2008 | 31 st October 2008 | 8 th October 2008 | 6.03 | 1,034,858 | 571,935 | 354,780 | 243,595 |
| Heritable | 1,000 | 4 th February 2008 | 4 th February 2009 | 7 th October 2008 | 5.43 | 1,054,449 | 306,908 | 244,070 | 244,807 |
| Total | 2,000 | | | | | 2,089,307 | 878,843 | 598,850 | 488,402 |

Kaupthing, Singer and Friedlander (KSF)

Dividend payments received to date are as follows:

| Declaration No | Payment Date | Pence in the £ | Dividend £ |
|----------------|--------------------------------|----------------|-------------------|
| 1 | 22nd July 2009 | 20.00 | 206,211.73 |
| 2 | 11 th December 2009 | 10.00 | 103,105.86 |
| 3 | 1 st April 2010 | 5.00 | 51,552.93 |
| 4 | 30 th July 2010 | 10.00 | 103,105.86 |
| 5 | 10 th December 2010 | 8.00 | 82,484.69 |
| 6 | 27 th May 2011 | 5.00 | 51,552.93 |
| 7 | 7 th October 2011 | 5.00 | 51,552.93 |
| Total | | 63.00 | 649,566.93 |

It is estimated that a total of £845k cash will be received against this investment resulting in an estimated cash loss of £155k.

In view of this information, the Authority has adopted the Local Authority Accounting Panel (LAAP) recommendation that the following repayment schedule is used to estimate the recoverable amount. The schedule is based on prudent expected total dividends of 72% of the claim, increased from 71% at the 31st March 2010.

| Date | Repayment Pence in the £ |
|--------------|--------------------------|
| May 2011 | 5.00 |
| January 2012 | 8.00 |
| July 2012 | 8.00 |
| January 2013 | 8.00 |

Heritable Bank

Dividend payments received to date are as follows:

| Declaration No | Payment Date | Pence in the £ | Dividend £ |
|----------------|-------------------------------|----------------|-------------------|
| 1 | 28th July 2009 | 16.13 | 167,162.15 |
| 2 | 6 th January 2010 | 12.66 | 131,277.24 |
| 3 | 30 th March 2010 | 6.19 | 64,197.20 |
| 4 | 16 th July 2010 | 6.27 | 65,040.36 |
| 5 | 18 th October 2010 | 4.14 | 42,888.07 |
| 6 | 14 th January 2011 | 4.71 | 48,896.01 |
| 7 | 15 th April 2011 | 6.25 | 64,803.08 |
| 8 | 13 th July 2011 | 4.06 | 42,059.53 |
| 9 | 20 th October 2011 | 4.18 | 43,344.19 |
| Total | | 64.59 | 669,667.83 |

On the 19th January 2012, the Authority was informed by Ernst and Young (Administrators) that a tenth dividend will shortly be paid of 3.32 pence in the pound, amounting to £34,457.15.

It is estimated that a total of £881k cash will be received against this investment resulting in an estimated cash loss of £119k.

In view of this information, the Authority has adopted the Local Authority Accounting Panel (LAAP) recommendation that the following repayment schedule is used to estimate the recoverable amount. The schedule is based on expected total dividends of 85% of the claim, increased slightly from 84.98% at the 31st March 2010.

| Date | Repayment Pence in the £ |
|--------------|--------------------------|
| April 2011 | 6.25 |
| July 2011 | 5.00 |
| October 2011 | 5.00 |
| January 2012 | 5.00 |
| April 2012 | 5.00 |
| July 2012 | 5.00 |
| October 2012 | 3.65 |

Following the latest guidance issued by CIPFA in September 2011 (LAAP Bulletin 82 Update 5), it is expected that for Heritable 86p-90p/£ will be recovered overall and for KSF it is now expected that 78p-86p/£ will be recovered overall.

9. Strategy Flexibility

The Chief Financial Officer, in consultation with the Chair of the Finance and General Purposes Committee, will agree, if necessary, any variation required from this Annual Investment Strategy and report to the next available Finance and General Purposes Committee.

10. Training

The Chief Financial Officer will ensure that Treasury Management Staff are trained in investment management and will maintain a record of all training as part of the Treasury Management Policy Appendix J.

11. Investment Consultants

The Authority has a contract for the provision of advice and assistance in relation to all aspects of treasury management detailed in the Treasury Management Policy Appendix K. The quality of advice will be monitored as part of ongoing investment processes.

12. Balanced Budget Requirement

The Authority complies with the provisions of S32 of the Local Government Finance Act 1992 to set a balanced budget.

13. Publication

This Investment Strategy, along with the Treasury Management Policy, Prudential Borrowing Limits Report and Capital Programme will be made available online via the Authority website.

14. Considerations

| Implication | Impact Considered (Yes/No) | Impact Identified (paragraph reference) |
|----------------------------------|----------------------------|---|
| Legal | Yes | Paragraph 15 |
| Financial | Yes | Paragraph 17 |
| Race and Equality | Yes | None |
| Human Rights | Yes | None |
| Environmental and Sustainability | Yes | None |
| Risk Analysis | Yes | Paragraph 16 |
| National Park Implications | Yes | None |

15. Legal Comment

The Authority fully complies with the CIPFA Code of Practice on Treasury Management in the Public Services and Cross Sectoral Guidance Notes.

16. Risk Analysis

Although economic and market risk are outside the control of the Authority, risk will be managed and mitigated in accordance with the policies set out in the Treasury Management Practices and Schedules.

17. Financial Implications

As included in the detailed section of this report.

The Authority funded the impairment in the 2008/09 Statement of Accounts from earmarked reserves and did not therefore need to utilise the available regulatory mitigation.

18. Appendices

Appendix A – Descriptions of Investment Instruments

19. Background papers

The Local Government Act 2003;

Regulations made under the Local Government Act 2003;

Guidance issued by the Welsh Assembly Government;

CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes;

Dyfed Powys Police's Treasury Management Policy.

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