	London Borough of Hammersmith & Fulham **AUDIT, PENSIONS AND STANDARDS COMMITTEE** **14 FEBRUARY 2013**
TREASURY MANAGEMENT STRATEGY	
Report of the Leader of the Council – Councillor Nicholas Botterill	
Open Report.	
Classification - For Information **Key Decision:** Yes	
Wards Affected:All	
Accountable Executive Director: Jane West, Executive Director of Finance and Corporate Governance	
Report Author: Vishal Sharma Westminster Treasury Manager	**Contact Details:** Tel. 0207 641 1067 E-mail: vsharma@weswtminster.gov.uk

1. EXECUTIVE SUMMARY

1.1 The report sets out the Council's Treasury Management Strategy for 2013/14. It seeks approval for borrowing limits and authorisation for the Executive Director of Finance and Corporate Governance to arrange the Council's cashflow, borrowing and investments in the year 2013/14.

2. RECOMMENDATIONS

2.1 That the report be noted.

2.2 That the Committee record any recommendation it wishes to make to Full Council prior to its consideration of the strategy at its meeting on 27 February 2013

3. BACKGROUND

3.1 Treasury Management is defined by the CIPFA Code of Practice as 'The management of the local authority'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.'

3.2 The Council is required to receive and approve, as a minimum, three main reports each year: a Treasury Strategy Report, Mid-year report and an Outturn report. These reports are required to be adequately scrutinised before being recommended to the Council by the Cabinet. This role is undertaken by the Audit, Pensions and Standards Committee and the Overview and Scrutiny Board.

3.3 The Treasury Management Strategy is set out in section 11 of this report, and the remainder of the report cover the following:

- Investment limits that will be applied that aim to limit the treasury risk and activities of the Council;
- prudential indicators
- the current treasury position;
- prospects for interest rates;
- the borrowing strategy;
- the investment strategy;
- approach to debt rescheduling;
- creditworthiness policy; and,
- policy on use of external service providers.

These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, the CIPFA Treasury Management Code and CLG Investment Guidance.

3.4 In summary, the investment approach for 2013/14 will include investment with the UK Government (via deposits with the Debt Management Office (DMO) or purchase of Gilts and T-Bills), lending to certain Local Authorities based on a policy agreed between Officers and the Leader, investments in certain Money Market Funds, deposits with certain banks and purchase of certain tradeable instruments by specific issuers. All these investment types are described further in this paper and set out in the proposed Treasury Management Strategy as set out in section 11 of this paper.

4. TREASURY MANAGEMENT APPROACH

4.1 The treasury management function ensures that the Council's cash is organised in accordance with the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cashflow and, where capital plans require, the organisation of appropriate borrowing facilities. The function covers the relevant treasury and prudential indicators, the current and projected debt positions and the annual investment strategy.

4.2 Under regulations set out by CLG in 2003, a Council's investment policy needs to cover so-called "specified investments" and "non-specified investments". A specified investment is defined as an investment which is denominated in sterling, is less than one year, is made with a body or scheme of high credit quality, UK Government or UK local authority and does not involve the acquisition of share capital or loan capital in any body corporate. Non-specified investments are those that do not meet these criteria.

4.3 Section 11 of this report sets out the investment approach, and takes account of the specified and non-specified approach. The Council is likely only to consider non-specified investments where an investment is made for longer than one year.

4.4 The CIPFA recommendations contained in the Code of Practice and Cross-Sectoral Guidance Notes issued as a revised version in 2009 for Treasury Management in the Public Services require that each Local Authority has a Treasury Management Policy Statement that is approved by the Full Council. This is set out in Appendix A to this paper.

5. CURRENT PORTFOLIO POSITION

5.1 The Council has for a number of years maintained a policy of debt reduction in order to deliver savings to the General Fund through reduced principal and interest payments. No new borrowing has been undertaken since November 2009 and where borrowings have fallen due for repayment, they have not been replaced. This policy is expected to continue for the foreseeable future.

5.2 The Council's treasury portfolio is summarised below. The table shows the total actual external borrowing (the treasury management operations), against the capital borrowing need (the Capital Financing Requirement – CFR), highlighting any over or under borrowing. The second table sets out the external borrowing and investments position for the HRA and General Fund separately.

Table 1: Current Portfolio Position

£'000	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Borrowing at 1 April	475,520	262,166	262,066	250,510
Expected change in borrowing	(16,000)	(100)	(11,556)	(2,414)
HRA Settlement	(197,354)	0	0	0
Actual Borrowing at 31 March	**262,166**	**262,066**	**250,510**	**247,599**
Total investments at 31 March	(109,000)	(180,000)	(184,000)	(170,000)
Net borrowing	**153,166**	**82,066**	**66,510**	**77,599**
Other long-term liabilities at 31 March	13,078	13,000	12,000	11,000
CFR – the borrowing need	329,106	308,727	279,162	256,040

Table 2: Split between the HRA and General Fund

£'000	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
HRA borrowing at year end	217,427	217,299	207,717	205,303
General Fund borrowing at Year end	44,739	44,768	42,794	42,296
Total borrowing at year end	**262,166**	**262,067**	**250,511**	**247,599**

£'000	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
General Fund CFR	99,684	91,428	71,445	50,737
HRA CFR	217,381	217,299	207,717	205,303
TOTAL CFR	**317,065**	**308,727**	**279,162**	**256,040**

6. TREASURY INDICATORS – LIMITS TO BORROWING ACTIVITY

6.1 The Operational Boundary. This indicator is the focus of day to day treasury management activity within the authority. It is a means by which the Council manages its external debt to ensure that it remains within the self imposed Authorised Limit. Sustained breaches of the Operational Boundary would give an indication that the Authority may be in danger of stepping beyond the Prudential Indicators it set itself.

Table 3: Operational Boundary

£'000	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Borrowing	488,134	275,000	275,000	265,000
HRA Settlement	(197,354)			

Other long term liabilities	13,078	13,000	12,000	11,000
Total	**303,858**	**288,000**	**287,000**	**276,000**

6.2 The Authorised Limit for external borrowing. This is a control on the maximum level of borrowing and this limit needs to be set or revised by the full Council. It reflects the level of external borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. Breach of these levels by the Council is unlawful.

Table 4: Authorised Limit

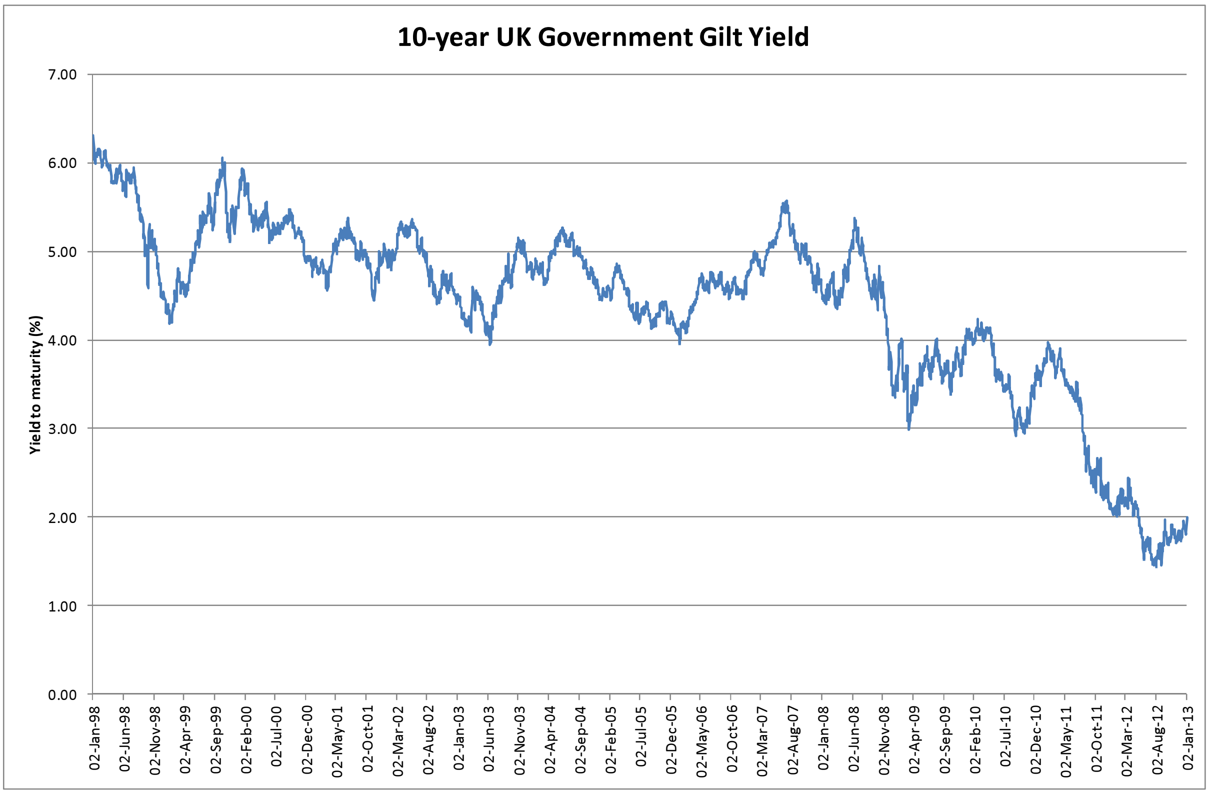
£'000	**2011/12 Actual**	**2012/13 Estimates**	**2013/14 Estimates**	**2014/15 Estimates**
Borrowing	548,909	325,000	325,000	315,000
Add HRA settlement	(197,354)			
Other long term liabilities	13,078	20,000	20,000	20,000
Total	**364,633**	**345,000**	**345,000**	**335,000**

6.3 Separately, the Council is also limited to a maximum HRA CFR through the HRA self-financing regime, as set by CLG. This is set out in the table above, and declines due to the repayment of the current borrowing as and when it falls due.

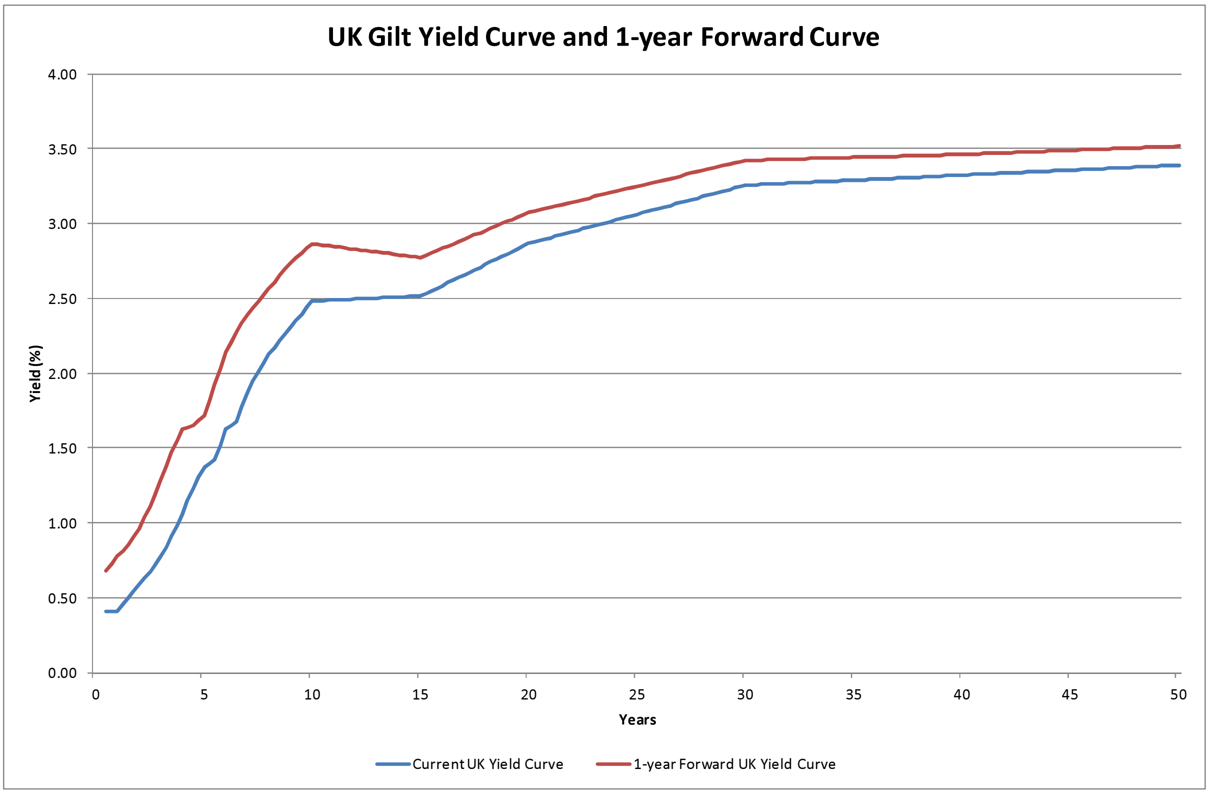
6.4 The Executive Director of Finance and Corporate Governance reports that the Council complied with the prudential indicators in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in the budget report.

7. PROSPECTS FOR INTEREST RATES

7.1 The levels of UK interest rates remain near all time lows, as shown on the graph below.



7.2 The graph below shows the current UK Gilt Yield Curve, and the one-year forward (i.e. what the market currently expects rates to be in one year's time).



7.3 The low interest rate has a disproportionate effect on the Council, as the Council has no expectation of borrowing in the near future (so cannot benefit from the low borrowing rates), but is impacted by the low investment returns. The challenging and uncertain economic outlook has a several key treasury management implications:

- The Eurozone sovereign debt difficulties, most evident in Greece, provide a clear indication of much higher counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods.
- Investment returns are likely to remain relatively low during 2013/14;
- Borrowing interest rates are currently attractive, but may remain low for some time. The timing of any borrowing will need to be monitored carefully;
- There will remain a cost of carry – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

8. BORROWING STRATEGY

8.1 Given its debt reduction strategy, the Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is high.

8.2 The tables below sets out these treasury indicators and limits. The Council is currently compliant with all these indicators:

Table 6 – Proposed interest Rate Exposure

£'000	**2013/14**	**2014/15**	**2015/16**
Upper Borrowing Limits on fixed interest rates	320,000	320,000	320,000
Upper Borrowing Limits on variable interest rates	64,000	64,000	64,000

Table 7 – Proposed structure limits for debt maturity

Maturity structure of fixed rate borrowing during 2012/13	**Upper Limit**	**Lower Limit**
Under 12 months	15%	0%
12 months and within 24 months	15%	0%
24 months and within 5 years	60%	0%
5 years and within 10 years	75%	0%
10 years and above	100%	0%

8.3 There are three borrowing related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs/improve performance. The indicators are:

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments
- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
- Maturity structure of borrowing. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

9. POLICY ON BORROWING IN ADVANCE OF NEED

9.1 Under CIPFA's Prudential Code, Any decision to borrow in advance of need has to be within forward approved Capital Financing Requirement estimates, and would have to be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

9.2 The borrowing of monies purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity.

9.3 Given the Council's debt reduction strategy, it is unlikely that any new borrowing will be taken.

10. DEBT RESCHEDULING

10.1 As short term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term to short term debt. Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

10.2 However, these savings will need to be considered in the light of the current treasury position and premiums incurred in prematurely repaying debt. Given the current approach, Officers do not expect the premature repayment of borrowing to be likely in the next year.

10.3 The reasons for any rescheduling to take place will include:

- Generating cash savings.
- Enhancing the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

11. ANNUAL INVESTMENT STRATEGY

11.1 The Council must have regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2011 revised CIPFA's Treasury Management in Public Services of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code").

Allowable Investment Types

11.2 For 2013/14, it is proposed that the Council can invest in financial institutions (within certain credit rating limits, domiciles and amounts as set out above), external funds and certain capital market instruments as set out below. Those that are in bold would be new for 2013/14, and are described further below and will be subject to specific clearance with the Leader when any new investment is proposed for the first time. All investments would be in Sterling:

(i) Investment with the Debt Management Office with no financial limit (UK government guaranteed)

(ii) Investment in financial institutions of a minimum credit rating, with the parent company domiciled only in certain jurisdictions;

(iii) Lending to certain public authorities (Unitary Authorities, Local Authorities, Borough and District Councils, Met Police, Fire and Police Authorities)

(iv) Investment in AAA-rated Sterling Money Market Funds and longer term funds; and

(v) Investment in UK Treasury Bills (T-Bills) and Gilts;

(vi) Investments in UK Government repurchase agreements ("Repos" and "Reverse Repos");

(vii) Investment in close to maturity AAA-rated corporate bonds and commercial paper backed by UK Government guarantees;

(viii) Investment in supra-national AAA-rated issuer bonds and commercial paper;

(ix) Investment in commercial paper ("CP") of UK domiciled entities with minimum short term credit rating of A1/P-1/F-1.

11.3 **UK T-Bills**: UK Government Treasury Bills (T-Bills) are short term promissory notes issued by the UK Government at a discount to par, for tenors of up to one year. T-Bills provide a greater yield than cash deposits with the DMO and can be bought at the primary sale (by market makers), or in the secondary market.

11.4 **UK Gilts**: UK Government Gilts provide a greater yield than cash deposits with the DMO. At present, there are a limited number of gilts that will mature in the next two years, and as the shorter dated gilts were issued in a higher interest rate environment than at present, the coupons on these gilts are higher than current interest rates.

11.5 **UK Government repurchase agreements (Repos)**: UK Government repurchase agreements are the purchase of UK Government securities with an agreement to resell them back at a higher price at a specific future date. By their nature, repos are short term secured investments in UK Government bonds which provide a greater return than cash deposits with the DMO. Ownership of the UK Government bond is temporarily transferred to the Council, thereby providing security over the funds invested.

11.6 **Commercial Paper (CP)** is similar to a very short term bond issue (up to one year), issued to investors on a discounted basis, and with the interest rate based on prevailing rates at the time of pricing. The Council may invest in Commercial Paper issued by UK domiciled corporate subject to the minimum credit ratings for up to a maximum of six months with no more than £10 million per name, and £50 million in aggregate.

11.7 **Supra-national institutions** are those that sovereign backed or supported institutions that span more than one country, such as the European Investment Bank, the European Bank of Reconstruction and Development, the World Bank, etc.

11.8 **Money Market Funds**: At present, the Council invests in several AAA-rated Sterling money market funds ('MMFs') provided by Blackrock, Goldman Sachs, Insight and Prime Rate. It is proposed to widen this list to include the money market funds that comply with LBHF's required criteria, including the composition of the fund, credit rating of the fund, size of the fund and fund performance. In the past, the Council's approach to MMFs was discussed within the body of the Treasury Management Strategy. Given the proposal to widen the list of MMFs that the Council would use, Appendix B sets out this revised approach in more detail. It makes a specific recommendation that the MMFs specified in Table 1 of Appendix B are approved by Council for use in the Council's investment strategy.

Creditworthiness Criteria

11.9 The Council's investment priorities are the security of capital and the liquidity of its investments. The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of this Council is low in order to give priority to security of its investments.

11.10 In accordance with the above, and in order to minimise the risk to investments, the Council has clearly stipulated below the minimum acceptable credit quality of counterparties for inclusion on the lending list.

11.11 The DCLG guidance requires authorities to specify their minimum acceptable credit rating. The minimum credit ratings required by the Council are:

	Long term	Short term
Fitch	A-	F2
Moodys	A3	P-2
S&P	A-	A-3

11.12 If a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately and any existing investment will be matured at the earliest possible convenience.

11.13 For the financial institution sector, the Council will invest in entities with a minimum credit rating of A-/A3/A- for a UK bank, and A/A2/A for a non – UK bank as suitable, as long as that entity has a short term rating of A-1/P-1/F-1 or better. Where a split rating applies the lowest rating will be used. This methodology excludes banks with UK Government ownership. Banks would need to be rated by at least two of the three main credit rating agencies and where there was a split rating the lower rating would be used.

11.14 The proposed bank investment limits are shown in the table below.

Table 8 – Bank Investment Limits

Institution Type	Minimum Credit Rating Required (S&P / Moodys / Fitch)	Maximum Individual Counterparty Investment limit (£m)	Maximum tenor of deposit / investment
UK Bank	With UK Government ownership of greater than 35%.	35	12 months
UK Bank	AA- / Aa3 / AA- and above subject to minimum ST ratings	25	12 months
UK Bank	A- / A3 / A- and above, subject to minimum ST ratings	25	Three months
Non-UK Bank	AA- / Aa2 / AA- and above, subject to minimum ST ratings	25	Six months
Non-UK Bank	A / A2 / A and above, subject to minimum ST ratings	10	Three months

11.15 The limits can change if there are rating changes, however the maximum limit would never be more than £25 million except for the part nationalised banks which have a £35 million limit.

11.16 In determining whether to place deposits with any institution or fund, the Tri–borough Director for Treasury and Pensions, after consultation with the Executive Director of Finance and Corporate Governance, will remain within the limits set out above, but take into account the following when deciding how much to invest within the limit set out above:

(i) the financial position and jurisdiction of the institution;

(ii) the market pricing of credit default swaps for the institution;

(iii) any implicit or explicit Government support for the institution;

(iv) Standard & Poor’s, Moody’s and Fitch’s short and long term credit ratings;

(v) Core Tier 1 capital ratios; and

(vi) other external views as necessary.

Country Limits

11.17 The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA+ / Aa1 / AA+ from S&P / Moodys / Fitch (respectively). The direct exposure limit to any one Country will be £25 million with the exception of the UK which will be unlimited.

Tenor of investments

11.18 Investments may be made for up to one year with any of the counterparties / investment types listed above. Investments more than one year may be placed with any of the following by Officers after seeking approval from the Leader:

(i) Deposits with those financial institutions allowed for as set out above

(ii) Term deposits with Local Authorities with maturities in excess of one year.

(iii) Tradeable instruments issued by the UK Government or Supra-national banks.

(iv) Tradeable instruments issued by any UK local authority or issuer guaranteed by the UK government.

Summary

11.19 In summary, the maximum amounts and tenor of investments that can be placed by Officers are as follows:

Institution Type	Minimum Credit Rating Required (S&P / Moodys / Fitch)	Maximum Individual Counterparty Investment limit (£m)	Maximum tenor of deposit / investment[1]
DMO Deposits	UK Government Rating	Unlimited	Six months
UK Government (Gilts / T-Bills / Repos)	UK Government Rating	Unlimited	Unlimited
Supra–national Banks	AA+ / Aa1 / AA+	10	12 months
European Agencies	AA+ / Aa1 / AA+	10	12 months
Network Rail	UK Government Rating	25	12 months
UK Local Authorities	NA	25	12 months
Commercial Paper issued by UK corporates	A-1 / P-1 / F-1	10	Six months
MMF	AAA / Aaa / AAA	10	One month
UK Bank	AA- / Aa3 / AA- and above (or UK Government ownership of greater than 35%), subject to minimum ST ratings	35	12 months
UK Bank	AA- / Aa3 / AA- and above, subject to minimum ST ratings	25	12 months
UK Bank	A- / A3 / A- and above, subject to minimum ST ratings	25	Three months
Non-UK Bank	AA- / Aa2 / AA- and above, subject to minimum ST ratings	25	Six months
Non-UK Bank	A / A2 / A and above, subject to minimum ST ratings	10	Three months

12. HRA

12.1 There are to be no changes to the current arrangements regarding debt and the HRA. The separate HRA and General Fund debt pool established from 1

[1] Investments of more than one year's tenor may be placed as agreed with the Leader.

April 2012 will continue to operate. The HRA shall continue to receive investment income on unapplied HRA receipts and other HRA cash balances calculated at the average rate of interest earned on temporary investments.

13. INVESTMENT CONSULTANTS AND INVESTMENT TRAINING

13.1 Sector Treasury Services were appointed as Treasury Management Consultants on 1 February 2011 for a three year period following a tendering exercise. Sector provide interest rate forecasts, economic updates, strategy reviews, accounting advice, training for treasury management staff and advice on the formulation of suitable borrowing and investment strategies and advice on investment counterparty creditworthiness.

13.2 The Council is a member of the CIPFA treasury management network which provides a forum for the exchange of views and training of treasury management staff independent of the treasury management consultants. It also provides a quality check on the services received from the consultants.

13.3 Officers attend the CIPFA network meetings and Sector seminars and training events on a regular basis throughout the year to ensure that they are up to date at all times on developments in treasury management and continue to develop their expertise in this area.

14. FINANCIAL AND RESOURCE IMPLICATIONS

14.1 The comments of the Executive Director of Finance and Corporate ` Governance are contained within this report.

15. LEGAL IMPLICATIONS

15.1 The statutory requirements are set out in the body of the report.

Provided by : Jonathan Hunt Tri-Borough Director of Treasury and Pensions is the relevant finance officer Tel: 020 7641 1804. I am not sure who dealt with it in Legal Dept.

16. COMMENTS OF THE AUDIT, PENSIONS AND STANDARDS COMMITTEE

16.1 Any comments from the Committee will be reported verbally at the meeting.

LOCAL GOVERNMENT ACT 2000
LIST OF BACKGROUND PAPERS USED IN PREPARING THIS REPORT

No.	Description of Background Papers	Name/Ext of holder of file/copy	Department/ Location
1.	Financial monitoring documents	Jade Cheung ext 3374	Finance Department, 2nd Floor, HTH Extension

APPENDIX A

THE TREASURY MANAGEMENT POLICY STATEMENT

The CIPFA recommendations contained in the Code of Practice and Cross-Sectoral Guidance Notes issued as a revised version in 2009 for Treasury Management in the Public Services require that each Local Authority has a Treasury Management Policy Statement that is approved by the Full Council.

CIPFA recommends that the Council's treasury management policy statement adopts the following form of words below to define the policies and objectives of its treasury management activities.

This Council defines its Treasury Management activities as:

- The management of the Council'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.

- This Council 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 organisation, and any financial instruments entered into to manage these risks.

- This Council acknowledges that effective Treasury Management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.

APPENDIX B

LBHF APPROACH TOWARDS MONEY MARKET FUNDS

Background

A Money Market Fund (MMF) is a pooled investment vehicle whose assets are comprised of various cash type instruments. Investors buy shares or units in the MMF with the aim of receiving regular dividends or an increase in the value of the units. These funds allow investors to participate in a more diverse and high quality portfolio than if they were to invest individually. Some of the investments at the MMF's disposal are not generic type of investments a Local Authority would usually enter into as they need to be managed in the market. By investing in a MMF, local authorities allow fund managers to manage asset portfolios under strict criteria to achieve the highest AAA credit rating.

Legislation Requirements for Local Authorities

Under the Local Authorities Regulations 2002[2] MMFs are classed as Approved Investments if they meet the following conditions:

- The funds must be dominated in GBP
- The funds must be rated AAA by Standard & Poor's, Moody's or Fitch in respect of creditworthiness.
- The fund must be approved under the Undertaking for Collective Investments in Transferable Securities (UCITS).
- The fund is either a unit trust scheme authorised under section 243 of the Financial Services Markets Act 2000 or a collective investment scheme recognized under section 264 of that Act.

Constant net asset value (CNAV) and variable net asset value (VNAV) funds

MMFs can be allowed to use two separate accounting techniques to value their assets The principal difference between CNAV and VNAV funds is likely to be the accounting technique used to value the assets:

- **Amortised cost accounting**, which values the asset at its purchase price, and then subtracts the premium / adds back the discount in a regular fashion (linearly) over the life of the asset. The asset will then be valued at par (100) at its maturity. This enables the funds to maintain a net asset value (NAV), or value of a share of the fund at £1. This is the approach adopted by CNAV funds.

- **Mark-to-market accounting** values the assets at market price. The NAV of a fund that uses this form of accounting will change due to the changing value of the assets or in the case of accumulating funds (where any interest is capitalised back into the fund instead of being paid out as an income) by the amount of interest earnt. This is usually the approach adopted by VNAV funds which have a constantly varying share price. In practice the fund manager will aim to

[2] Capital Finance & Approved Investments (Amendment) 2002 No.451

maintain the share price above £1 and ensure a smooth gradual increase in price on a daily basis.

Funds which use amortised cost accounting (CNAV) should compare the amortised cost price to the market price on a regular basis. If the variance is beyond a pre-set level (ie share price is higher or lower than £1 by a significant amount), the fund manager needs to implement procedures to narrow the gap. This can involve buying and selling different assets.

CNAV funds tend to pay out monthly dividends to investors whereas the VNAV funds tend to reinvest dividends back into the fund.

CNAV funds tend to be marketed as an instant access investment where funds can be invested and removed on a daily basis therefore forming part of a Council's operational cash pool.

VNAV funds tend to be marketed as a longer term investment that offers an enhanced return over the CNAV funds. Investments should therefore only be invested as part of a longer term investment plan as would happen for a 3 month bank deposit for example. Neither CNAV nor VNAV funds (or deposits for that matter) guarantee return of capital.

Investing in MMFs

It is important to stress that there are no principal guarantees with MMFs however as discussed CNAV funds have to manage funds to ensure a constant share price and VNAV funds aim to maintain a minimum of £1 per share if not higher.

For a credit rating agency to rate a fund AAA they must have an "extremely strong capacity to achieve MMF's investment objective of preserving principal and providing shareholder liquidity through limiting credit, market and liquidity risk"[3]

Over the last 40 years there have been three instances of a CNAV fund "breaking the buck". This occurs where a fund's NAV drops below £1 (or $1 for US MMFs)[4] per share and the investor loses money when they need to remove funds.

What can MMFs invest in?

The following assets are permitted investments for a MMF:

- Call Accounts – instant access accounts that are typically provided by retail banks.
- Term Deposits – a bank deposit where funds cannot be withdrawn for a fixed period of time.
- Certificate of Deposits (CDs) – a bank investment with a set maturity date and pre-determined, fixed interest rate. Investors receive an electronic certificate which can then be bought or sold in a secondary market.

[3] From Fitch Ratings
[4] First Multifund for Daily Income (1978), Community Bankers US Govt Fund (1994), Reserve Primary Fund (2008)

- Commercial Paper (CP) – a short term note issued by financial institutions and corporates, with a fixed maturity usually between 1 and 270 days. CP is tradable in a secondary market.
- Asset Backed Commercial Paper (ABCP) – as above but note is collateralised with assets or revenue streams.
- Bonds – a negotiable certificate whose ownership can be transferred in the secondary market. Issued by financial institutions and corporate often for longer maturities. This can have a fixed or floating rate.
- Government Securities – are financial instruments issued by government.
- REPO's – repurchase agreement allow a MMF's to invest cash on a secured basis.
- Asset Back securities – A financial security which is backed/collateralised by a specified pool of underlying assets such as mortgages. This security often has a long expected maturity date.

How MMFs achieve the AAA credit rating

MMFs have preservation of capital and liquidity as their primary objectives. Competitive money market returns is another key, but lesser, objective. Each credit rating agency will regularly identify, assess and weigh each fund in terms of its ability to deliver on these objectives. The ratings criteria comprises of three main areas of analysis:

- Credit Quality - Ratings criteria stipulate what the fund can buy (type of asset, maturity, credit quality of asset) and from whom (acceptable counterparty risk).
- Portfolio construction - Judging a MMF's ability to shield investors from adverse market swings by analysing a portfolio's sensitivity to changing market conditions.
- Fund Management - Level of fund manager's experience, investment objectives, management techniques, strategies, operating procedures and internal controls.

Benefits to Investors in MMFs

The key benefits to the investor are:
- Diversification of investments
- Intensive credit analysis on fund investments.
- Typically same day or very near liquidity with no redemption penalties.
- Managed by experienced fund managers who will implement strategies to mitigate credit, interest rate and liquidity risks.
- Funds have better investor power which enables them to obtain better yields.
- Competitive money market returns

MMFs ultimately offer a good balance between the LBHF's investment criteria of security, liquidity and yield and as such they form an integral part of treasury policy.

LBHF's approach to date

Existing treasury management policies regarding money market funds are restricted to analysis of credit ratings of the fund and limiting maximum fund exposures.

Traditionally, the Council has used funds selected by their advisors. In both instances the aim was for the policy to satisfy the aim of security, liquidity and yield. The proposals below aim to provide the Tri-borough Treasury team with a more detailed approach on how funds are selected, monitored and limits that should apply.

This approach builds on the current treasury management strategy and aims to provide an opportunity for each borough to formalise an operational framework. This should help the council to maximise their key objectives of security, liquidity and yield.

Approach to selecting MMFs

Set out below are the criteria Officers will use when considering recommending an investment in a MMF for approval by the Leader.

CNAV funds: CNAV funds make up the majority of the GBP market with around 20 different fund providers.

- The asset classes contained within it are those instruments described above except Asset Backed Securities.
- The fund deals with counterparties of sufficient credit quality. Particular focus will be on the short term credit rating which will always need to remain above P-1 / A-1 / F-1 unless there is good reason and approval by the Tri-borough Director for Treasury and Pensions.
- In current financial climate Officers will not recommend any funds that are invested in peripheral European based banks.
- Santander UK is used by several funds who hold overnight call accounts. Officers are not concerned by this unless funds begin to invest in deposits that are greater than overnight duration. Santander UK is classified as a self financed UK based bank and although it has a Spanish parent it remains isolated from the troubles in the Spanish economy.
- RBS is currently rated P2 by Moody's but not all funds have removed them from their portfolios due to the level of state support offered to the bank. Also many of the funds use the other two ratings agencies to rate their portfolios where RBS still remain at the upper levels of the short term credit ratings. We believe that as long as funds are only invested on an overnight basis then funds can remain in the respective MMF.
- The fund's long term rating is rated AAA by at least two of the credit rating agencies.
- Funds are well established with a minimum fund size of £2bn to comfortably accommodate our investment limits.
- Counterparties will be reviewed when deciding on funds and then reviewed at least monthly. The asset classes contained within the MMFs will be reviewed when deciding on funds and then reviewed at least quarterly.
- After the above criteria have been met selection of funds can be based upon yield returns.

The table below sets out a list of CNAV funds (as of December 2012), which would automatically meet the criteria listed above. and are therefore proposed for approval as part of this report.

Table 1

Fund Name	Moodys	S&P	Fitch	Assets (£bn)	30 Day Simple Interest Yield (%)	WAM (days)[5]
Ignis Sterling Liquidity Class 2		AAA	AAA	14.7	0.70	54
Prime Rate Sterling Liquidity Fund Class 3		AAA	AAA	2.7	0.68	35
Insight Sterling Liquidity Fund Class 5	Aaa	AAA		15.1	0.59	35
LGIM Sterling Liquidity Fund Class 3		AAA	AAA	12.3	0.58	51
Goldman Sachs Sterling Reserves Fund	Aaa	AAA	AAA	5.7	0.53	51
SWIP Global GBP Liquidity Fund plc	Aaa	AAA	AAA	17.6	0.51	42
Deutsche Managed Sterling Fund - Advisory	Aaa	AAA		6.6	0.50	56
State Street Global Advisors Liquidity	Aaa	AAA		2.3	0.49	45
BlackRock ICS Sterling Fund Core Shares Dist.	Aaa	AAA		25.7	0.48	48
RBS GTF Sterling Fund Class 4	Aaa	AAA	AAA	5.9	0.46	42
HSBC Liquidity Fund	Aaa	AAA		5.4	0.45	27
JPMorgan Sterling Liquidity Fund Instit.	Aaa	AAA	AAA	10.1	0.45	41
BNY Mellon Sterling Liq Fund Advantage Shares	Aaa	AAA		2.7	0.38	25
Northern Trust Sterling Cash Fund Class F	Aaa	AAA		4.0	0.37	28

VNAV funds: These funds are provided by a handful of fund managers and are a relatively new product in the UK compared to the CNAV funds. As a consequence funds are much smaller than existing funds and the criteria needs to be adjusted accordingly. The same criteria will be applied as for CNAV funds except:

- Asset classes will be extended to include Asset Backed Securities which are deemed suitable given the long term nature of VNAV funds.
- Funds will be considered that are greater than £100m in size in order to accommodate our investment limits.
- Ensure fund is rated AAA by at least one of the credit rating agencies (VNAV funds tend to be rated by a single agency).

Formal procedure for selecting funds (both CNAV and VNAV): The treasury manager or officer will write a paper for approval by the Leader detailing the following:

- Which funds are requested to be added to the panel.
- Confirmation that the proposed funds adhere to the criteria detailed above.

Ongoing Monitoring

[5] WAM or weighted average maturity of the fund is the average number days to maturity calculated using the next coupon fixing date of floating rate instruments and final legal maturity date of all other instruments

Once funds have been selected ongoing monitoring is required. This will be carried out quarterly but at times of market stress and heightened credit concerns this may increase in frequency. Monitoring will take place in a formal regular meeting which should be organized as follows:

- Attended by Treasury staff who invest in MMFs
- Detailed holdings report for each fund should be provided for each meeting so investment classes/counterparties/ratings can be checked against criteria.
- Any issues or areas outside of policy need to be escalated to the Tri-borough Director for Treasury and Pensions.
- Meetings should be the around same time each quarter.

Investment Limits

Officers will work within certain investment limits for MMFs as set out below:

- Limit for total MMF exposures at any one time is £60m, Includes both CNAV and VNAV Funds
- Limit for individual fund manager at any one time is £10m.
- If a Fund manager provides both a CNAV and VNAV fund then these exposures should be added in this instance.
- Individual fund exposure of no more than 10% of fund assets under management.
- VNAV to CNAV fund ratio cannot be greater than 1:5.

Investments can be moved, within the allowed pool, from one fund to another (subject to the above limits). All funds with a nil balance will remain open and can be used if other funds make any changes that fall out of our policy criteria or if their returns become uncompetitive. It will not be necessary to close accounts with any existing providers.

New funds can be added to the panel as they come to market if they satisfy the criteria outlined within this paper. Officers will propose a new fund and this will have to be approved by the Leader.

Compliance with the proposed policies and limit recommendations will be the responsibility of Officers with oversight provided by the Tri-borough Director for Treasury and Pensions.