

Annual Investment Strategy 2021-2022

1.0 Annual Investment Strategy

1.1 Investment policy

The Ministry of Housing, Communities and Local Government (MHCLG) and CIPFA have extended the meaning of 'investments' to include both financial and non-financial investments. This report deals solely with financial investments, as managed by the Treasury Management team. Non-financial investments, essentially the purchase of income yielding assets, are covered in the separate Capital Strategy report.

The Council's investment policy has regard to the following:

- MHCLG's Guidance on Local Government Investments ("the Guidance")
- the Audit Commission's report on Icelandic investments
- CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 ("the CIPFA TM Code")
- CIPFA Treasury Management Guidance Notes 2018.

The Council's investment priorities are:

- (a) firstly, the security of capital and
- (b) secondly, 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. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs. However, where appropriate (from an internal as well as external perspective), the Council will also consider the value available in periods up to 12 months with high credit rated financial institutions, as well as wider range fund options.

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

The above guidance place a high priority on the management of risk. The Council has adopted a prudent approach to managing risk and defines its risk appetite by the following means:

1. Minimum acceptable credit criteria are applied in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the Short Term and Long Term ratings.
2. However, ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To achieve this consideration the Council

will engage with its advisors to maintain a monitor on market pricing such as 'credit default swaps' and overlay that information on top of the credit ratings.

3. Other information sources used will include the financial press, share price and other such information pertaining to the financial sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.
4. Investment instruments identified for use in the financial year are listed under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the Council's Treasury Management Practices – Schedules.
 - Specified investments are those with a high level of credit quality and subject to a maturity limit of one year, or have less than a year left to run to maturity, if they were originally classified as being non-specified investments solely due to the maturity period exceeding one year.
 - Non-specified investments are those with less high credit quality, may be for periods in excess of one year, and/or are more complex instruments which require greater consideration by Councillors and officers before being authorised for use.
5. Non-specified investments limit: the Council has determined that it will limit the maximum total exposure to non-specified investments as being 50% of total investments with a cap of £35.0 million.
6. Lending limits, amounts and maturity, for each counterparty will be set through applying the methodology in the following section.
7. Transaction limits are set for each type of investment.
8. The Council will set a limit for the amount of its investments which are invested for longer than 365 days.
9. Investments will only be placed with counterparties from countries with a specified minimum sovereign rating.
10. The Council has engaged external consultants to provide expert advice on how to optimise an appropriate balance of security, liquidity and yield, given the risk appetite of this authority in the context of the expected level of cash balances and need for liquidity throughout the year.
11. All investments will be denominated in sterling.
12. As a result of the change in accounting standards for 2020-2021 under IFRS 9, the Council will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the General Revenue Account. In November 2018, MHCLG concluded a consultation for a temporary override to allow English local authorities time to adjust their portfolio of all pooled investments by announcing a statutory override to delay implementation of IFRS 9 for five years ending 31 March 2023.

However, the Council will also pursue value for money in treasury management and will monitor the yield from investment income against appropriate benchmarks for investment performance. Regular monitoring of investment performance will be carried out during the year.

Changes in risk management policy from last year

The above criteria are unchanged from last year.

1.2 Creditworthiness policy

This Council applies the creditworthiness service provided by Link Group. This service employs a sophisticated modelling approach using credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard and Poor's. The credit ratings of counterparties are supplemented with the following overlays:

- credit watches and credit outlooks from credit rating agencies;
- Credit Default Swap (CDS) spreads to give early warning of likely changes in credit ratings;
- sovereign ratings to select counterparties from only the most creditworthy countries.

This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments. The table below details Link's recommendations of bands and durations along with the more prudent parameters that the Council will apply:

	Link	Wolverhampton
Yellow (is for UK Government debt or equivalent, money market funds and collateralised deposits where the collateral is UK Government debt)	5 years	-
Dark Pink (for Ultra-Short Dated Bond Funds with a credit score of 1.25)	5 years	-
Light Pink (for Ultra-Short Dated Bond Funds with a credit score of 1.5)	5 years	-
Purple	2 years	1 year
Blue (only applies to nationalised or semi nationalised UK Banks)	1 year	3 months
Orange	1 year	6 months
Red	6 months	3 months
Green	100 days	50 days
No Colour	Not to be used	Not to be used

This list will be reviewed on any changes to the methodology used by Link and the Council may revert back to using Link's recommended durations if or when investment balances are at higher levels and longer deposits are possible without significantly increased risk to liquidity.

The Link creditworthiness service uses a wider array of information other than just primary ratings. Furthermore, by using a risk weighted scoring system, it does not give undue preponderance to just one agency's ratings.

Typically, the minimum credit ratings criteria the Council use will be a Short Term rating (Fitch or equivalents) of F1+ and a Long Term rating of AA-. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances, consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

All credit ratings will be monitored each time the Council is alerted to changes to ratings of all three agencies through its use of the Link creditworthiness service.

- 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. A severe downgrade may prompt the Director of Finance to instruct treasury management employees to take steps to withdraw any investment considered to be at risk. The potential penalties for such an action would need to be assessed.
- In addition to the use of Credit Ratings the Council will be advised of information in movements in Credit Default Swap spreads against the iTraxx European Financials benchmark and other market data on a daily basis. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

Sole reliance will not be placed on the use of this bought-in service. In addition, the Council will also use market data and market information, information on any external support for banks to help support its decision making process.

1.3 Creditworthiness

Although the credit rating agencies changed their outlook on many UK banks from Stable to Negative during the quarter ended 30 June 2020 due to upcoming risks to banks' earnings and asset quality during the economic downturn caused by the pandemic, the majority of ratings were affirmed due to the continuing strong credit profiles of major financial institutions, including UK banks. However, during quarter one and quarter two of 2020, banks made provisions for expected credit losses and the rating changes reflected these provisions. As we move into future quarters, more information will emerge on actual levels of credit losses (quarterly earnings reports are normally announced in the second half of the month following the end of the quarter). This has the potential to cause rating agencies to revisit their initial rating adjustments earlier in the current year. These adjustments could be negative or positive, although it should also be borne in mind that banks went into this pandemic with strong balance sheets. This is predominantly a result of regulatory changes imposed on banks following the

Great Financial Crisis. Indeed, the Financial Policy Committee (FPC) report on 6 August 2020 revised down their expected credit losses for the UK banking sector to “somewhat less than £80bn”. It stated that in its assessment, “banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the Monetary Policy Committee’s (MPC’s) central projection”. The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC’s projection, with unemployment rising to above 15%.

All three rating agencies have reviewed banks around the world with similar results in many countries of most banks being placed on Negative Outlook, but with a small number of actual downgrades.

1.4 **CDS prices**

Although bank CDS prices, (these are market indicators of credit risk), spiked upwards at the end of March / early April 2020 due to the heightened market uncertainty and ensuing liquidity crisis that affected financial markets, they have returned to more average levels since then. Nevertheless, prices are still elevated compared to end-February 2020. Pricing is likely to remain volatile as uncertainty continues. However, sentiment can easily shift, so it will remain important to undertake continual monitoring of all aspects of risk and return in the current circumstances. Link monitor CDS prices as part of their creditworthiness service to local authorities and the Council has access to this information.

1.5 **Country limits**

Due care will be taken to consider the exposure of the Council’s total investment portfolio to non-specified investments, countries, groups and sectors.

- **Non-specified investment limit.** The Council has determined that it will limit the maximum total exposure to non-specified investments as being 50% of the total investment portfolio with a cap of £35.0 million.
- **Country limit.** The Council has determined that it will only use approved counterparties from the UK and from countries with a minimum sovereign credit rating of AA from Fitch Ratings (or equivalent from other agencies if Fitch does not provide). The list of countries that qualify using this credit criteria as at the date of this report is shown below. This list will be amended by employees should ratings change in accordance with this policy.
- **Other limits.** In addition:
 - No more than 20% will be placed with any non-UK country at any time;
 - Limits in place above will apply to a group of companies;
 - Sector limits will be monitored regularly for appropriateness.

Approved countries for investments

AAA

- Australia
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland
- U.S.A.

AA+

- Canada
- Finland

AA

- Abu Dhabi (UAE)
- France

AA-

- Belgium
- Hong Kong
- Qatar
- U.K.

The above ratings are those used by Fitch. During 2020-2021 Fitch and Moody's both downgraded the UK's sovereign rating from AA to AA-, or equivalent, due to the unprecedented impact of Covid-19 pandemic on the economy. However, as Standard & Poors rating is still the equivalent of AA the Council has kept this as the sovereign limit. The Director of Finance has delegated authority to lower the minimum sovereign rating in the Annual Investment Strategy in the event that this position changes.

1.6 Specified investments

All such investments will be sterling denominated, with maturities up to a maximum of one year, meeting the minimum 'high' rating criteria where applicable.

Non-specified investments which would be specified investments apart from originally being for a period longer than 12 months, will be classified as being specified once the remaining period to maturity falls to under 12 months.

Minimum 'High' Credit Criteria	
Debt Management Agency Deposit Facility	Government backed
Money Market Funds CNAV > LVNAV	AAAmf / Aaa-mf
Term deposits - UK Government	Government backed
Term deposits - Local Authorities	High Security
Term deposits - Banks & Building Societies	Short-term F1+, Long-term AA-

1.7 Non-specified investments

These are any investments which do not meet the specified investment criteria. A maximum of 50% of total investments with a cap of £35.0 million can be held in aggregate in non-specified investments.

	Minimum Credit Criteria	Max Limit	Max Maturity Period
Term deposits - UK Government (with maturities in excess of 1 year)	Government Backed	£10.0 million	5 years
Term deposits - Local Authorities (with maturities in excess of 1 year)	High Security	£10.0 million per LA	5 years
Term deposits - Banks & Building Societies (with maturities in excess of 1 year)	Short-term F1+ Long-term AA-	£10.0 million per Bank	5 years
Property funds	Internal and external due diligence	£20.0 million per single fund	5 years

Property funds – the use of these instruments can be deemed capital expenditure, and as such will be an application of capital resources. This Authority will seek guidance on the status of any fund it may consider using. Appropriate due diligence will also be undertaken before investment of this type is undertaken.

1.8 Accounting treatment of investments

The accounting treatment may differ from the underlying cash transactions arising from investment decisions made by the Council. To ensure that the Council is protected from any adverse revenue implications, which may arise from these differences, the

accounting implications of new transactions will be thoroughly reviewed before they are undertaken.

1.9 Investment strategy

In-house funds: All of the Council's funds are managed in-house. Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months). Greater returns are usually obtainable by investing for longer periods. Whilst most cash balances are required in order to manage the ups and downs of cash flow, where cash sums can be identified that could be invested for longer periods, the value to be obtained from longer term investments will be carefully assessed.

- If it is thought that the Bank Rate is likely to rise significantly within the time horizon being considered, then consideration will be given to keeping most investments as being short term or variable.
- Conversely, if it is thought that the Bank Rate is likely to fall within that time period, consideration will be given to locking in higher rates currently obtainable for longer periods.

Interest rate outlook: Bank Rate is forecast to unlikely rise from the current 0.10% for a considerable time.

The overall balance of risks to economic growth in the UK is probably now skewed to the upside, but is subject to major uncertainty due to Covid-19 and how quickly successful vaccines may become available and widely administered to the population. It may also be affected by the deal the UK agreed as part of Brexit.

There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, or a return of investor confidence in equities, could impact gilt yields, and so PWLB rates, in the UK.

The Council will avoid locking into longer term deals while investment rates are down at historically low levels unless exceptionally attractive rates are available which make longer term deals worthwhile, within the risk parameters set by this Council.

For 2021-2022 the Council will budget for an investment return of 0.05% on investments placed during the financial year. In addition, an upper limit for principal sums invested for longer than 365 days of £35.0 million is asked to be approved as can be seen in Appendix 3 Prudential and Treasury Indicators 2021-2022.

For its cash flow generated balances, the Council will seek to use its money market funds, business reserve accounts and short-dated deposits (overnight to 100 days) in order to benefit from the compounding of interest, whilst maintaining liquidity.

Negative investment rates: While the Bank of England said in August / September 2020 that it is unlikely to introduce a negative Bank Rate, at least in the next 6-12 months, and in November omitted any mention of negative rates in the minutes of the meeting of the Monetary Policy Committee, some deposit accounts are already offering negative rates for shorter periods. As part of the response to the pandemic and lockdown, the Bank and the Government have provided financial markets and businesses with plentiful access to credit, either directly or through commercial banks. In addition, the Government has provided grants to local authorities to help deal with the Covid-19 crisis; this has caused some local authorities to have sudden increases in cash balances searching for an investment home, some of which was only very short term until those sums were able to be passed on.

As for money market funds (MMFs), yields have continued to drift lower. Some managers have already resorted to trimming fee levels to ensure that net yields for investors remain in positive territory where possible and practical. Investor cash flow uncertainty, and the need to maintain liquidity in these unprecedented times, has meant there is a surplus of money around at the very short end of the market. This has seen a number of market operators, now including the DMADF, offer nil or negative rates for very short term maturities. This is not universal, and MMFs are still offering a marginally positive return, as are a number of financial institutions for investments at the very short end of the yield curve.

Inter-local authority lending and borrowing rates have also declined due to the surge in the levels of cash seeking a short-term home at a time when many local authorities are probably having difficulties over accurately forecasting when disbursements of funds received will occur or when further large receipts will be received from the Government.

1.10 End of year investment report

At the end of the financial year, a report will be submitted to the Cabinet and full Council on the Council's investment activity as part of its Annual Treasury Report.

1.11 Combined Authority

The Council will be prepared to lend to the Combined Authority. Such lending may be as part of arrangements agreed with the Combined Authority and other constituent authorities.

1.12 Council Owned Companies

The Council will be prepared to lend or invest in companies which are wholly or partly owned by the Council. In doing this, consideration will be given to the benefits and risks to the Council.

2.0 Interest rate forecasts

- 2.1 The table below has been provided by Link Asset Services and shows a more detailed interest rate view along with the view of Capital Economics (an independent forecasting consultancy). PWLB rates and forecast shown below have taken into account the 20 basis point certainty rate reduction effective as of 1 November 2012.

Link Group Interest Rate View		9.11.20				(The Capital Economics forecasts were done 11.11.20)								
These Link forecasts have been amended for the reduction in PWLB margins by 1.0% from 26.11.20														
	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	
BANK RATE	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	
12 month ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	
5 yr PWLB	0.80	0.80	0.80	0.80	0.90	0.90	0.90	0.90	0.90	1.00	1.00	1.00	1.00	
10 yr PWLB	1.10	1.10	1.10	1.10	1.20	1.20	1.20	1.20	1.20	1.30	1.30	1.30	1.30	
25 yr PWLB	1.50	1.60	1.60	1.60	1.60	1.70	1.70	1.70	1.70	1.80	1.80	1.80	1.80	
50 yr PWLB	1.30	1.40	1.40	1.40	1.40	1.50	1.50	1.50	1.50	1.60	1.60	1.60	1.60	
Bank Rate														
Link	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	
Capital Economics	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	-	-	-	-	-	
5yr PWLB Rate														
Link	0.80	0.80	0.80	0.80	0.90	0.90	0.90	0.90	0.90	1.00	1.00	1.00	1.00	
Capital Economics	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	-	-	-	-	-	
10yr PWLB Rate														
Link	1.10	1.10	1.10	1.10	1.20	1.20	1.20	1.20	1.20	1.30	1.30	1.30	1.30	
Capital Economics	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	-	-	-	-	-	
25yr PWLB Rate														
Link	1.50	1.60	1.60	1.60	1.60	1.70	1.70	1.70	1.70	1.80	1.80	1.80	1.80	
Capital Economics	1.80	1.80	1.80	1.80	1.80	1.80	1.80	1.80	-	-	-	-	-	
50yr PWLB Rate														
Link	1.30	1.40	1.40	1.40	1.40	1.50	1.50	1.50	1.50	1.60	1.60	1.60	1.60	
Capital Economics	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	-	-	-	-	-	

City of Wolverhampton Council
Specified Investments Lending List

Institution	Country (Sovereign Rating)	Limit £000	Term Limit
Bank Nederlandse Gemeenten	Netherlands (AAA)	20,000	12 mths
DBS Bank Ltd	Singapore (AAA)	10,000	6 mths
HSBC Bank plc	UK (AA-)	5,000	3 mths
Landwirtschaftliche Rentenbank	Germany (AAA)	20,000	12 mths
National Bank of Abu Dhabi	Abu Dhabi (U.A.E) (AA)	5,000	3 mths
NRW.BANK	Germany (AAA)	20,000	12 mths
Oversea Chinese Banking Corporation Ltd	Singapore (AAA)	10,000	6 mths
United Overseas Bank Ltd	Singapore (AAA)	10,000	6 mths
Nationalised Banks			
Royal Bank of Scotland Group plc			
National Westminster Bank plc	UK (AA-)	10,000	3 mths
The Royal Bank of Scotland plc	UK (AA-)	10,000	3 mths
AAA Rated and Government Backed Securities			
Debt Management Office	UK (AA-)	20,000	30 mths
Money Market Funds		Fund Rating	
Invesco STIC Account	Fitch AAmmf	20,000	Instant Access
Aberdeen Liquidity Fund (LUX) Class 2	Fitch AAmmf	20,000	Instant Access
Federated Short-Term Sterling Prime Fund	Fitch AAmmf	20,000	Instant Access
Black Rock Sterling Liquidity Fund	Moody's Aaa-mf	20,000	Instant Access
Scottish Widows Sterling Liquidity Fund	Moody's Aaa-mf	20,000	Instant Access

Non-rated Institutions

County Councils, London Boroughs, Metropolitan Districts and Unitary Authorities - limits £6m and 12 months.
Shire District Councils, Fire and Civil Defence Authorities, Passenger Transport Authorities and Police
Authorities - limits £3m and 12 months.