KENNET DISTRICT COUNCIL

Overview & Scrutiny Management Board
3rd April 2007

Report Number: C/09/07
Investment Review Scrutiny

Report by James Caldwell, Chairman of the scrutiny team

1.0 Purpose of the Report

1.1 To report back the findings of the review team.

2.0 Financial, Staffing, Legal & Risk Implications

2.1 There are no potential staffing, financial, risk or legal implications arising out of this report.

3.0 Background

3.1 The Overview & Scrutiny Management Board of the 5th December 2007 appointed a task group to review the council's investment policy and the resolved the terms of reference were as follows:-

3.1.1 An Investment Policy Review Task Group be set up consisting of five Councillors, Councillors Carter, Hoddinott, Parsons, Pearcy-Caldwell and Mrs. Winchcombe.
3.1.2 That the Task Group examine the Council's current investment policy, the investment policies of other Councils with a view to assessing high risk and risk averse approaches, seek to identify best practice and receive advice from independent investment brokers.
3.1.3 The task group should bring an interim report to the February 2007 meeting and should seek to present a final report to the April 2007 meeting.
3.1.4 The first meetings of the group to be held on 11th January and 22nd January, 2007.

4.0 Executive Summary

4.1 Kennet District Council is in a fortunate position. The council sold its housing stock in 1995 and as a consequence is now a debt free authority. The investment income we receive has helped pay for the services we provide. The capital sum has also enabled us to run a capital programme without the need to borrow.

4.2 Kennet had £46.2 million on 31/03/98 and £27.8 million on 31/03/06. We are expecting a further reduction of a £5 million in 2006/07. If we continue to spend on this basis it is likely that the capital fund will disappear within 10 years. There is currently no formal policy on the level of reserves we wish to maintain in the future.

4.3 The council's investments and management of its funds are governed by the Treasury Management Policy Statement and annual investment strategy, which are adopted by the Resources Executive Committee. These policies are in turn driven by the medium term financial and corporate strategy.

4.4 Officers are tasked with day to day management of the funds and monitoring of the investments, which are then reported back to Resources Executive Committee on an annual basis. This committee is also responsible for the appointment of external managers to look after our funds. These arrangements were last reviewed in 2004 by a sub-committee which led to the appointment of our current Cash and Fund Manager and the termination of the contract with a previous Fund Manager.

4.5 Comparisons with other local authorities and findings from the interviews with the financial services companies confirmed that Kennet has adopted a low risk strategy in accordance with statutory and other guidance. This is similar to many, if not most other authorities.

4.6 During the course of the task group a number of key issues emerged which can be summarised as follows:-

4.6.1 The need to review Kennet's policy on managing its capital, given the dependence of the current budget of the investment income generated. It is estimated that the council tax would have been over 38% higher in 2006/07 (£162.89 as opposed to £123.24 band D equivalent) if we had not had this investment income.
4.6.2 The need to review current targets, given the performance on the markets in recent years.
4.6.3 Further consideration of volatility versus risk of potential future investment types.
4.6.4 A review of the current investment strategy and whether any alterations would have any impact.

4.7 The Chairman of the task group declared a non-beneficial interest as a director of a financial services firm that deals with investment companies.

5.0 The review process

5.1 The task group met on a number of occasions to discuss the terms of reference and to identify the people and organisations they would wish to interview as well as other documentary evidence they would want to consider.

5.2 The following people and organisations were interviewed.

5.2.1 The Chairman of Resources Executive,
5.2.2 Officers in the council responsible for the day to day management,
5.2.3 The council's Fund Manager – Invesco,
5.2.4 The council's Cash Manager – Tradition,
5.2.5 Other financial companies (3rd parties) – Sector, Investment Perspectives & Morgan, Stanley Quilters.

5.3 The task group also considered a number of documents including:-

5.3.1 The council's Treasury Management Policy Statement for 2006/07.
5.3.2 A number of other councils Treasury Management Policy Statements for comparative purposes.
5.3.3 The council's corporate strategy & medium term financial strategy 2004 - 2008.
5.3.4 The agenda and minutes of the Appointment of Fund Managers Sub Committee 17th May 2004.
5.3.5 The Treasury management report to Resources Executive Committee 30th June 2006.
5.3.6 The annual audit & Inspection letter March 2006.
5.3.7 A report by the Chief Accountant & Auditor on Treasury Management Procedures at Kennet (attached as an appendix to this report).

6.0 Findings

6.1 Initial discussions took place with officers principally involved in the application of the investment policy on a day to day basis. These discussions focussed on the council's current Treasury Management Policy and legislation and guidance behind the arrangements.

6.2 Officers are responsible for developing the strategies and policies and the day to day management of the treasury management function. They must ensure that all investment is in line with the strategy and they have a monitoring role to ensure we are achieving our rate of return. Officers are further responsible for reporting any significant variance to members.

6.3 The same officers are responsible for developing the policy and monitoring it. However all the officers involved are explicitly named in the Treasury Management Policy.

6.4 It was noted that whilst officers of the council manage the Treasury Management function on a day to day basis, the council uses external Cash & Fund Managers to manage our investment portfolio. All officers involved in the treasury management function of the council are appropriately qualified. However it was felt that the specialist external advisors were better placed to take investment decisions for and on behalf of the council.

6.5 The approach Kennet District Council takes is very similar to other Local Authorities. This was confirmed by an examination of a number of other local authority Treasury Management Policies and also by the financial services representatives that were interviewed.

6.6 Members are responsible for approving the strategies and reviewing the performance. Whilst training is given to members on various aspects of finance, it was agreed that training on specific subjects such as this was useful. Decisions are endorsed through Resources Executive Committee.

6.7 Our Investment Fund manager (INVESCO) currently provides the credit ratings of allowable investments. Whilst Building Societies are not rated, it has been decided that if they have funds in excess of £1 billion, they can be considered. The council does not invest in Corporate and Preference Bonds.

6.8 Decisions are based on government guidance. While it is possible to invest in the stock market this would be treated as capital expenditure which may be disadvantageous to the council.

6.9 How target returns are set.

6.9.1 The targets set are based on the 7 day LIBID (London Interbank Bid Rate) cash rate. As this is what we could achieve as a minimum in house, Kennet has agreed this as a benchmark with Invesco, whilst the target for Invesco is based on this rate plus ½% over.

6.9.2 There are no targets set for the investment along the lines of inflation proofing, maintenance or variable target returns linked to requirements.

6.10 Corporate Protection.

6.10.1 Fixed term deposits with building societies offer 100% capital protection on the first £2000 and 90% of the next £33,000.

6.10.2 Gilt edge securities are safe if the investment is held until their maturity, unless the government is unable to meet its obligation.

6.10.3 Supranational bonds – no protection but low risk of default.

6.10.4 Highly rated sovereign bonds – none are protected, although Western Europe tends to perform satisfactorily. However some are issued by countries such as Russia and need to be treated with caution. These can offer the same risk as an AAA corporate bond.

6.10.5 In the event of a banking or specific building society failure, Kennet would lose all of the money invested up to our maximum counterparty risk (Currently £2,000,000 or about 9%).

6.10.6 If Kennet District Council's portfolio fell below £10 million, both the current Fund & Cash Managers would look into charging more as a percentage. However, the use of pooled funds would avoid this problem.

6.10.7 It may assist Kennet District Council to consider guaranteed returns through structured products. This is being considered by an increasing number of organisations.

6.11 Use of third parties.

6.11.1 It was not considered cost effective and/or efficient to undertake the investment function in house. Kennet could work with an independent 3rd party provider to agree an understanding of investment This could then lead to a suitable investment strategy being developed which the third party could monitor to ensure the fulfilment of objectives.

6.11.2 Third parties can assist in the development of strategy and they can monitor Kennet and the Investment Managers. They offer a model portfolio but are not fund managers and they can offer information on what investments are best suited to Kennet.

6.12 Other types of funds available that could be considered.

6.12.1 **Fixed Rate Funds.** These would not be classed as capital expenditure. There are some authorities in London that are looking in to this issue.

6.12.2 **Pooled Funds.** These include a wider range of asset classes. They diversify risk to reduce exposure and volatility. The pooled funds are not treated as capital expenditure. In the event that a pooled fund was introduced in Kennet, they would incur additional fees as they would probably use asset backed securities. Pooled funds will be increasingly common in the future.

6.12.3 **Real Estate Investment Trusts (Reits)** – Property funds available from April 2007, residential higher risk than commercial funds that are low risk.

6.12.4 **Structured (Guaranteed) returns** – Kennet District Council could consider broadening its structured returns as this would be of no greater risk.

6.13 Future policy on managing capital.

6.13.1 The council should consider a more dynamic approach, perhaps involving third parties in order to accrue benefits from investment monies that are sustainable in the longer term.

6.13.2 A more informed discussion on investment issues between officers and members would be helpful.

6.14 Targets.

6.14.1 It was considered important to have a consistent return on which Kennet could rely. A variable volatile return could cause problems in planning for each financial year. Analysis of achieved results in the last 10 years to 31/03/2006 shows the actual return has varied between 3.67% and 8.32%. On 6 occasions out of 11 there has been a return difference greater than 1% from year to year. It is accepted that year on year volatility may be greater than 1%.

6.14.2 It was noted that the targets had not been reached in seven of the past eleven years. The council's Fund Manager - Invesco had mostly achieved the 7 day London Interbank Bid Rate (LIBID) rate but not always the additional ½%.

6.14.3 LIBID+ 1/2 % target has only been achieved in 4 out of the last 10 years to 31/03/06. In one year the benchmark was not achieved. The results appeared to show a performance of less than 4.5% in 3 of the last 5 years and less than 3.6% in the other two. The table below highlights the interest that would have been received had the target been achieved.

INVESTMENT INTEREST HAD TARGET BEEN ACHIEVED.

INVESCO

Year	Opening Value/ Ave Value	Interest	Performance	Target*	Target Interest	Difference
2005/06	15,824,038	4.81%	761,445	4.95%	783,290	21,845
2004/05	14,623,638	4.70%	687,311	4.98%	728,257	40,946
2003/04	15,526,621	3.67%	569,827	4.02%		

					624,170	54,343
2002/03	19,129,271	4.53%	866,556	4.09%	782,387	- 84,169
2001/02	19,212,794	4.87%	935,663	4.83%	927,978	- 7,685
						25,280

* 7 Day rate plus 0.5%

TRADITION

Year	Opening Value/ Ave Value	Interest	Performance	Target*	Target Interest	Difference
2005/06	10,000,000	4.87%	487,406	4.90%	490,000	2,594
2004/05	10,000,000	4.91%	339,251	4.93%	340,372	1,121
						3,715

*7Day rate *1.1 (plus 10%)

Total "Lost" Interest	65,625
Amount per annum	13,125

6.14.4 The benchmark and the target yield specified were agreed in 1995 when the contract was agreed.

6.14.5 It was considered that the issue of target setting should be taken back to Resources Executive Committee.

6.15 Volatility and risk.

6.15.1 Fund managers rate risk on a comparison to the benchmark. The further away from that benchmark the higher the risk. Investments can be protected through either capital protection or inflation protection schemes. This depends on the clients needs. Capital protection is low risk and offers the maximum return with the minimum amount of risk. They tend to spread the risk by investing in a number of areas.

6.15.2 Investment term is used to measure the sensitivity of a portfolio to interest rate changes and sudden variations in interest rates are undesirable. The average investment term is currently running at about 7 Months. It was felt by third parties that because of this short term strategy Kennet missed out on the best returns from gilts. (If a fund has an average duration of 7 months investment managers would describe this as volatile, because short dated interest rates are more volatile).

6.15.3 The assessment and grading of risk is a methodical process that is undertaken to assess the volatility of the investment.

6.15.4 Inflation risks should be reviewed by officers and members.

6.15.5 Risk, as outlined in the Treasury Management Policy 4(TMP4) is not specific to the investment, but rather based on allowing for management risks. Due to the limited types of investment utilised, then there is little systemic or non-systemic risk protection.

6.16 Strategy for investment.

6.16.1 The Resources Executive Committee makes the decisions at Kennet as to whether the council should consider or allow new investment classes or types based on the recommendations from officers. Such recommendations arise from review meetings with the Cash & Fund Managers and/or statutory and other guidance.

6.16.2 The use of third parties might offer alternative investment options available to the council for consideration.

6.16.3 It was thought that it would be beneficial for members to be more involved in the development of the strategy and the monitoring of our performance outside the main committees.

7.0 Recommendations

7.1 The council should consider the retention of a core capital sum to sustain investment income.

7.2 The council should consider:

7.2.1 A guaranteed rate of return target to ensure strategic financial requirements are met.

7.2.2 An additional aggressive rate of return target to ensure regeneration of capital.

7.3 The council should consider the diversification of the types of investment to optimise return and to minimise risk.

7.4 The council should consider the use of third parties to provide independent guidance on investment opportunities and their associated risk.

March 2007

Appendix 1

INVESTMENT TASK GROUP

to be held on 26th February 2007

Report by Janet Ditte, Chief Accountant & Auditor

Treasury Management Procedures at Kennet

Purpose of Report

The purpose of this report is to provide Members of the Investment Task Group with an overview of the current Treasury Management arrangements in place at Kennet, within the context of the current regulatory environment for local authority investments.

Financial, Staffing and legal implications

There are no staffing, financial or legal implications arising from the report.

Risk Implications

The report is provided for information purposes and therefore there are no risk implications of this report.

Legislative and Regulatory Context

A Local Authority's powers to invest are set out within the Local Government Act 2003 and the Local Authority (Capital Finance and Accounting) (England) Regulations 2003, as amended.

Local Government Act 2003

Section 12 of the Local Government Act 2003 states that a Local Authority may invest:

(a) for any purpose relevant to its functions under any enactment, or
(b) for the purpose if the prudent financial management of its financial affairs.

The Local Government (Capital Finance and Accounting) (England) Regulations 2003 (The Regulations)

The Regulations (as amended) are made under the Local Government Act 2003. These regulations are important as they maintain the 1989 Act rule that the purchase of **share and loan capital** in a company is to be treated as capital expenditure. However, there is an exemption to this (regulation 25(3)), if shares or bonds are acquired through collective investment schemes, such as unit trusts (pooled investment schemes), they can be treated as investments.

The latest Regulations due to come into force on 1st April 2007, will extend regulation 25(3) to ensure that the purchase of shares in a Real Estate Investment Trust (REITS) will **not** count as capital expenditure.

The regulations do not mean that local authorities cannot purchase shares or loan capital, but if they do they must treat them as capital expenditure. This means that the local authority will have less resources to fund capital projects. It also means that whilst the dividend receipts can be used to fund revenue expenditure, the proceeds from the sale of the shares or loan capital have to be treated as capital receipts. For example, if the authority bought shares for £1,000 and then sold them for £2,000 (a profit of £1,000) this additional profit would be treated as a capital receipt. Capital receipts cannot be used to fund revenue services and therefore this "profit" on the shares and capital loans investments could not be used to support the revenue account. For example, the authority's investment proceeds could be £2m for a year, but if £1.5m of this was attributable to a profit on the sale of shares, only £0.5m could be used to support revenue.

The purchase of land and property for investment purposes would also be classed as capital expenditure. The income stream from the property would be a revenue receipt, but the initial purchase would be capital and would reduce the Council's available resources for other projects. In addition, the purchase of property could result in other liabilities, such as repair costs. In addition, with any capital item, there is a risk that the government will change the treatment of the capital receipt. The most recent example of this has been the requirement to "pool" housing capital receipts, requiring local authorities to pay a significant proportion of their housing capital receipts to the government
The Regulations also state that local authorities must have regard for CIPFA's **Treasury Management Code of Practice** and **Prudential Code for Capital Finance in Local Authorities.**

To summarise, a local authority has wide powers to invest their surplus funds. The only constraint to this is that The Regulations define as capital expenditure the acquisition of shares and corporate bonds in individual companies. However, where these shares or bonds are acquired through collective investment schemes, they can be treated as investments, not capital expenditure. In addition, the purchase of property assets for investment purposes would also be treated as capital expenditure.

<u>Guidance on Local Government Investments</u>

To coincide with the publication of The Regulations, the government issued the above guidance. Whilst this is guidance, this is issued under the Local Government Act 2003 and requires local authorities to have regard to it.

The guidance emphasises the government's wish that authorities invest prudently and highlights that the speculative procedure of borrowing to invest is unlawful. It also highlights that the definition of the acquisition of share and loan capital as capital expenditure, is to "*..discourage the use of speculative investments, such as equities".*

The guidance recommends that priority should be given to security and liquidity and that it is appropriate to seek the highest rate of return consistent with the proper levels of security and liquidity.

The guidance introduces the distinction between specified and non-specified investments, for local authorities. The idea of specified investments is to identify investments offering high security and high liquidity on which authorities will be free to rely on with minimal procedural formalities. All such investments should be in sterling and with a maturity of no more than 1 year. Such **short-term** investments with the government (i.e. Gilts) will automatically count as specified investments. In addition, short-term investments with bodies or investments schemes with "high credit ratings" will also count as specified investments. The Annual Investment Strategy should define what the authority will treat as a "high credit rating".

Non-specified investments are those that do not fall into the definition of specified investments. The guidance states that the local authority should have a policy on when other advice may be sought in relation to non-specified investments.

There is no notion of statutory or non-statutory investments or lists of investments. Prior to the 2003 Regulations there was a list of local authority approved investments. This is no longer the case.

Kennet's Investment Parameters

Having described the statutory and regulatory framework within which a local authority's investments operate, this section will outline how this is currently applied at Kennet.

The Council's treasury management arrangements are documented in the Treasury Management Policy Statement (TMPS), to which is appended the Annual Investment Strategy. The format and contents of the TMPS are set out in CIPFA's Treasury Management Code of Practice, which Local Authorities are required to have regard to. The Guidance on Local Authority Investments, issued by the ODPM, as was, sets out the requirements for an Annual Investment Strategy. These documents are reviewed and approved by the Resources Executive Committee in March each year. In June each year, the Resources Executive Committee receives a report comparing the performance of the treasury management function with the investment strategy, for the preceding financial year.

Treasury Management Practice (TMP) 4 within the Council's approved Treasury Management Policy Statement, sets out the Council's Approved Investments, Methods and Techniques. These have been split between the internally managed funds and the externally managed funds and between specified and non-specified investments for each.

Internally Managed Funds

The internally managed funds may currently be invested in the following instruments:

Specified Investments:

- Fixed Term Deposits
- On Call Deposits
- Money Market Funds

These investments may be made with the following organisations:

- Other Local Authorities
- Major clearing banks incorporated in the UK and their subsidiaries
- UK Building Societies with an F1/A Rating
- Foreign Banks with an F1+ Rating

With the exception of other Local Authorities, the Council may invest with these bodies to the extent that they have a “high” credit rating and up to 1 year. The following is a summary of the amounts of money that can be invested with any counter-party at any time, and the appropriate credit rating:

- F1+/AA- Highest quality financial institutions £5m
- Other Local Authorities £1m
- 100% owned subsidiaries of Clearing Banks £1m
- F1/AA Rated Building Societies £1m
- F1/A Rated Building Societies £0.5m
- F1/A Rated merchant or secondary banks £0.5m
- F2/A Rated merchant or secondary banks £0.25m

With regard to the highest quality institutions, this is used in conjunction with the lending list maintained by the fund manager and only institutions on that list will be lent to.

Non-specified Investments

As most building societies do not have a credit rating, they fall outside the definition of specified investments and are therefore non-specified investments. The Council is able to invest its internally managed funds in fixed term deposits with UK Building Societies with assets exceeding £1b, up to a maximum of £1m per counter-party.

Externally Managed Funds

The Council uses the services of two external managers to invest its surplus funds; Invesco Asset Management (Fund Manager) and Tradition UK (Cash Manager). They are permitted to invest in a broader range of investments, reflecting their considerable experience and expertise in this area.

Specified Investments

The following investments are permitted (for up to 1 year and with institutions with a "high" credit rating):

- Fixed Term Deposits with banks and building societies;
- Certificates of Deposit;
- Gilt Edged Securities (UK Government with maturity no more than 1 year);
- Highly Rated Supranational Bonds
- Highly Rated Ex UK Sovereign Issues
- AIM Money Market Fund (Invesco Asset Management Only)

Non-Specified Investments

- Fixed Term Deposits with UK Building Societies (with assets exceeding £1b);
- Gilt Edged Securities (UK Government with maturity greater than 1 year);
- Highly rated Supranational Bonds (with maturity greater than 1 year);
- Highly rated Ex UK sovereign issues (with maturity greater than 1 year)

Approved Organisations

The above investments can be made in the following organisations:

- Other Local Authorities
- Major clearing banks incorporated in the UK and their subsidiaries
- UK Building Societies
- Foreign Banks with F1+ Rating
- HM Government, Supranational Bonds and EX UK Sovereign Issues listed in London
- AIM Money Market Fund (Invesco only)

The Council has adopted the following minimum credit ratings to be used in conjunction with the above:

	Short-Term	Long-Term
British/International Banks	Min. F1+	Min. AA-
British Building Societies	Min F1	Min. A
British Building Societies	Assets must exceed £1billion	

Risk Guidelines for Invesco Asset Management

a. the funds can be invested in short-term fixed interest rate deposits and Certificates of deposit carrying rates of interest of up to one year or debt instruments guaranteed by the UK Government (Gilts) or supranational bonds and ex UK sovereign issues;

b. short-term cash deposits may be invested using the AIM Money Market Fund subject to a maximum investment of £5,000,000 at any one time;

c. at any given time, a maximum of 70% of the market value of the fund may be invested in debt instruments guaranteed by the UK Government;

d. at any given time, a maximum of 25% of the market value of the fund may be invested in a combination of supranational bonds and ex UK sovereign issues;

e. a maximum of 10% of the market value of the portfolio may be invested with any one counterparty (this does not apply to Gilts, Supranational Bonds or Ex UK Sovereign Issues);

f. the maximum period of maturity for any single investment in debt instruments guaranteed by the UK Government must not exceed 10 years;

g. the maximum average maturity of the portfolio will not exceed 3.5 years.

Risk Guidelines for Tradition UK

a. a maximum of £2million may be invested with any one counterparty.

b. funds may be invested in accordance with the duration limits outlined below,

Period of Investment	**Maximum Amount of Fund Invested**
Up to 364 days	£10 million (Total Fund)
From 365 days to 2 years	£2 million
Over 2 years	£2 million

It is important to note that these parameters represent the maximum permitted investments and the managers "manage" the funds within these parameters according to what they consider appropriate given prevailing market and economic conditions.

Other Investment Classes

As already noted, the investment in shares and loan capital is restricted for local authorities as it has to be classed as capital expenditure. For this reason, and those highlighted in Section 5 above, officers have not recommended the inclusion of this asset class in the Treasury Management Policy Statement.

However, investments in shares and capital as part of collective investment arrangements are excluded from the treatment as capital expenditure. However, before investing in such a pooled arrangement, the associated risks would have to be carefully assessed, along with any implications on the liquidity of the fund. It would be necessary to find a fund that had a risk profile that matched that of the Council. It would also be important to consider the impact of any possible early redemption penalties. Any fund selected would have to be appropriate to the low risk local authority market.

Performance Benchmarking

The benchmark that has been selected for both the external managers and the internal fund is the Local Authority 7 day rate. As the Council's funds are low risk cash funds, it is appropriate that the benchmark selected is a cash rate.

Current Investment Strategy

The Council's investment strategy and objectives are specified in the approved Treasury Management Policy Statement and Annual Investment Strategy.

When deciding the treasury management policies and strategies, the Council will give priority to the security and liquidity of the investments, rather than to the yield of the investments. The general policy objective is that the authority should prudently invest the temporarily surplus funds held on behalf of the community.

For the internally managed fund, the specific strategy is to invest surplus funds to achieve maximum liquidity and security and minimum risk and to achieve maximum returns whilst fulfilling short term cash flow requirements.

In terms of the externally managed funds, the specific strategy is to continue the low risk investment policy of maximising the rate of return whilst minimising capital risk, consistent with the requirement to secure the liquidity and security of the investments.

Decision Making and Delegations

The authority to make decisions is formally set out within the Treasury Management Policy Statement.

This Council has delegated responsibility for the implementation and monitoring of its treasury management policies and practices to the Resources Executive Committee, and for the execution and administration of treasury management decisions to the Financial Services Manager, who acts in accordance with the Council's policy statement and Treasury Management Practices and CIPFA's *Standard of Professional Practice on Treasury Management.*

In addition, the Director of Resources has the delegated authority to vary the list of approved organisations and limits as circumstances dictate, with such changes to be reported to the Resources Executive Committee at the earliest opportunity.

In managing and advising on the Council's Treasury Management arrangements, the officers of the Council have to have regard to the Council's investment strategy, set out in Section 7 above. In addition, they must also have regard of the reputational risk to the Council of the Treasury Management function.

Internally Managed Funds

The investment parameters for the internal fund have been set to reflect the investment needs of the fund, and also the expertise of the internal staff. The internal fund is maintained for day-to-day cash flow purposes. As a result, the level of funds invested at any one time is considerably less than that of the external funds. Therefore, in deciding the parameters applicable to the internal fund, the following considerations were taken into account:

- the size of the fund and cash flow requirements dictate that the internal fund is generally invested in smaller "chunks", usually £250k to £1m, which often precludes the larger institutions who often have minimum requirements of £5m. Therefore, the policy permits the investment in smaller institutions;
- counter party limits reflect the nature of the organisations used and therefore smaller counter party limits have been set;
- the internal fund is limited to investments in term and call deposits either through the money markets or directly with the institution;
- the one exception to this is the use of the HSBC Money Market Fund, which allows surplus funds to be invested in a highly rated pooled vehicle. This is used because it provides flexibility and instant access (liquidity) to the Council's funds, combined with a higher credit rating than the smaller institutions that the Council would otherwise use. The HSBC fund is used, as being the Council's own bank's fund saves transaction costs.

On a day-to-day basis, investment decisions are based on the surplus funds available on the day and known cash flow requirements. In practice this means that surplus funds are invested to meet future cash flow requirements, for example precept and salary payments. The counter party used is dependent on existing investments and those organisations seeking money through the money markets. Counter party lists are maintained along with lists of existing investments. This ensures that Counter Party limits are not exceeded. All investments are authorised by either the Chief Accountant, Finance Services Manager or Director of Resources.

Because of the proportionally higher transaction costs for small investments, it has been decided that amounts less than £200k will not be invested through the money markets. These amounts will be invested in the Money Market Fund[1].

Externally Managed Funds

Again, the investment parameters of the externally managed funds have been developed to reflect the requirements of this part of the fund and also the expertise of the managers.
The cash managers (Tradition UK) specialise in fixed term deposits and as a result these are the only investments made by them. Building societies are key in this market, but are rarely credit rated. It is for this reason that the Council has permitted investment in building societies based on their assets.

The cash managers make the investment decision on their proportion of the externally managed fund (£10m), but the Council actions the decision (i.e. sends the money to the counter party). All interest receipts are paid direct to the Council and therefore the size of the fund managed by Tradition remains at £10m.

The fund managers (Invesco) have a broader range of investment classes, which reflects their expertise. The "added value" of fund managers come from their ability to trade investments to maximise their return, and for this reason they predominantly invest in tradable deposits such as certificates of deposit and gilts. The parameters have been set to maximise the level of flexibility permitted whilst managing the level of risk within the fund through the duration of the assets held.

Unlike the cash managers, the fund managers hold the money on behalf of the Council and make investment decisions on behalf of the Council and action these decisions. Investment/interest receipts are retained within the fund and re-invested until such a time that the Council recalls money from the fund.
The external managers are free to make the investment decisions that they feel are appropriate within the framework that has been set down within the Treasury Management Policy Statement and Annual Investment Strategy.

Changes to Investment Parameters

Changes to the investment parameters have to be approved by the Resources Executive Committee. These changes are based on

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[1] TMP 3 of Treasury Management Policy Statement

recommendations made by the officers. The officers may make recommendations on investment parameters for a number of reasons:

- changes in The Regulations, for example the change to the distinction between specified and non-specified investments for local authorities led to a consequential change to the Council's investment parameters;
- changes in The Regulations that lead to the consideration of additional investment classes, for example the 2007 Regulations extend the use of Real Estate Investment Trusts as investments. Officers would seek further advice from the fund managers before recommending this class of asset to Members;
- on the advice of the fund managers, the officers will consider the appropriateness of additional investment classes or amendments to the existing parameters, for example greater flexibility has been introduced through the inclusion of Supranational Bonds and Ex UK Sovereign Issues. These are all considered in the light of the broader investment strategy agreed by the Council.

Recommendations are made to Members of the Executive Committee either as part of the Annual Treasury Management Policy Report or as part of an interim report.

Summary

In summary, the Council has wide powers to invest its surplus funds. However, this is tempered by the requirement to have regard to the security and liquidity of the funds and the need to prudently manage any surplus funds. With this in mind, the Council has adopted a low risk strategy of maximising returns while having specific regard to the security and liquidity of those funds.

It is important to note that local authority investments are not only about return. Instead they are about balancing the requirements of security, prudence and liquidity with return.

<u>Background Papers:</u>

1. Kennet District Council Treasury Management Policy Statement
2. Kennet District Council Annual Investment Strategy
3. Local Government Act 2003
4. The Local Government (Capital Finance and Accounting) (England) Regulations 2003 (as amended)
5. ODPM Guidance on Local Government Investments
6. CIPFA's Treasury Management Code of Practice