

**ITEM 3. REVIEW OF THE INVESTMENT POLICY AND STRATEGY FOR THE MANAGEMENT OF COUNCIL'S SURPLUS FUNDS**

**FILE NO: S108222**

**SUMMARY**

This report presents the revised Investment Policy and Investment Strategy for the Management of Council's Surplus Funds. Surplus funds are those funds that are not required to meet immediate cash needs and are invested until required for future operational and capital works delivery.

The Policy and Strategy are reviewed annually to ensure that they remain appropriate given changes to the economic, investment and legislative environments. The annual review of the Policy and Strategy, together with the proactive management of the portfolio, has resulted in a secure investment portfolio that consistently outperforms the benchmark returns required by the policy.

The Investment Policy sets out Council's investment objectives to safeguard the City's cash and investment portfolio, achieve appropriate rates of return and manage the portfolio to ensure sufficient liquidity to meet Council's business objectives. It includes investment criteria to frame investment decisions, risk management parameters, and investment governance standards to ensure transparency, internal controls and performance management.

The Investment Strategy outlines Council's investment intentions in light of the current economic, investment and legislative environments. The focus is on the investment opportunities available to Council, guiding investments to be maintained in the coming 12 months and the investment of new funds. The Strategy aims to accomplish a balanced and diversified portfolio in terms of investment products, credit ratings and term to maturity to ensure sufficient liquidity will be available as funds are required.

The legislative and regulatory environment for local government has remained static, and the existing Investment Policy continues to serve the City well. In line with the improving financial stability and increased regulation of investment markets, there are three minor amendments proposed to the Policy for 2016:

- removal of the two year term/maturity restriction on fixed rate term deposits;
- raising the minimum short-term cash holding from \$40M to \$50M to cater for inflation and higher capital expenditure;
- removal of all references to grandfathered structured investments since there are none of these investments held by the City.

There are also a range of further minor amendments to the policy which relate to the removal of inconsistencies and tidying up of definitions, which do not constitute policy changes.

The key objectives of the current Investment Strategy remain valid for the present economic, investment and legislative environments. The Strategy has been updated to reflect future liquidity requirements for Council's ongoing capital works program, as well as revised objectives for investment performance measurements.

The proposed Investment Policy and Strategy will continue to maintain an investment portfolio that is reasonably conservative; and comprises investments in institutions with high investment grade credit ratings that are all subject to APRA regulation, while at the same time allowing some flexibility for appropriate investment opportunities that enhance the City's financial returns.

Council's Investment Policy and Investment Strategy continue to permit and encourage environmental and socially responsible investment activity (SRI investments) subject to compliance with legislation and investment policy parameters. Council continues to pursue these objectives and meets regularly with representatives of the 'Big 4' banks and other financial institutions to explore opportunities. There have been no SRI opportunities that meet the restrictions on range on financial institutions and investment products in which NSW councils can invest.

### **RECOMMENDATION**

It is resolved that Council adopt the Investment Policy and the Investment Strategy, for the management and investment of Council's surplus funds, as shown at Attachments A and B respectively to the subject report.

### **ATTACHMENTS**

**Attachment A:** Investment Policy for the Management of Surplus Funds.

**Attachment B:** Investment Strategy for the Management of Surplus Funds.

## **BACKGROUND**

1. The Local Government Code of Accounting Practice and Financial Reporting (the Code) states that:

"Councils must maintain an investment policy that complies with the Act and ensures it or its representatives exercise care, diligence and prudence when investing council funds. Managers have a fiduciary obligation to ensure that the resources under their control are efficiently utilised and effectively protected.

In exercising its powers of investment council should be guided by the latest Ministerial Order and consider a range of factors. These include the purpose of the investment; the desirability of investment diversification; the nature and risks associated with those investments; the likely income return and timing of income return; the length of the proposed investment; the costs involved in making the investment and other matters as appropriate.

Councils should establish an investment strategy as part of its overall financial plan and have a process of performance review which should be undertaken regularly and in any case at least annually".

2. The purpose of the Policy and Strategy is to ensure the investments are secure, satisfy Council's risk/return criteria, are compliant with the Local Government Act 1993, and optimise investment income from the short and long term investment of funds that are surplus to Council's present operational needs.
3. The Investment Policy and Strategy are reviewed annually to ensure they remain relevant to prevailing market and legislative conditions. In situations where market volatility and uncertainty arise from changes in the economic, investment and legislative environments, the review will be brought forward for adoption by Council at an earlier date so that key changes can be made to the Policy and Strategy to deal with the respective market conditions.
4. Council's investment portfolio is efficiently utilised and effectively protected. The Australian domestic investment market remains under the supervision of the Australian Prudential Regulation Authority (APRA) which extends across the full range of financial institutions. Council has gradually diversified from its 2008 GFC-focused portfolio, which was highly conservative and significantly concentrated in the 'Big 4' AA-rated domestic banks. Its current portfolio remains conservative, but more diversified as it includes more APRA-regulated A-rated bank investments together with a handful of investment-grade BBB-rated investments.
5. The legislative and regulatory environment for local government has remained static, and the existing Investment Policy continues to serve the City well. In line with the improving financial stability and increased regulation of investment markets, there are three minor amendments proposed to the Policy for 2016:
  - (a) removal of the two year term/maturity restriction on fixed rate term deposits;
  - (b) raising the minimum short-term cash holding from \$40M to \$50M to cater for inflation and higher capital expenditure;
  - (c) removal of all references to grandfathered structured investments since there are none of these investments held by the City.

6. The first amendment proposes to remove the two year maximum limit on fixed rate term deposits. Interest rate movements have changed over the past few years, with the result that locking in higher yields for longer periods in a declining interest rate market has become a safe practice. As a result, this limitation has become a restriction rather than a safeguard for portfolio management.
7. The second amendment deals with the minimum cash requirements within the 30 day maturity period that are presently set at the lesser of 10% of the total portfolio or \$40M. In line with the impact of inflation on operational expenditure and Council's increasing level of capital work activities, the amendment proposes a prudent increase of the minimum amount to \$50M.
8. The third amendment deals with inclusion of structured investments in the statutory account definition of the policy. In 2008, the Ministerial Investment Order placed grandfathering restrictions on any such investments held by Council. The City no longer holds any of these investments. It is no longer necessary for them to be included in the policy definition.
9. There are a number of minor amendments relating to policy inconsistencies and definitions that are of a 'housekeeping nature' and do not constitute fundamental change in policy. The main areas of change are definitions that have been clarified with respect to the distinction between cash and investments. A change in the name of a key benchmark rate has been updated in the policy and reference has been made to Council's delegations in the paragraph dealing with delegated authorities.
10. The key objectives of the current Investment Strategy remain valid for the present economic, investment and legislative environments. The Strategy has been updated to reflect future liquidity requirements for Council's ongoing capital works program, as well as revised objectives for investment performance measurements.
11. The revised Investment Strategy forecasts a decline in the rates of return delivered by the portfolio. In 2012, the City correctly forecast that interest rates would decline and, due to strong liquidity, was able invest in longer term maturities with fixed high yields. The last of these investments will mature in the forthcoming calendar year. As a result, the benefits of these investments will dissipate since the maturing funds can only be reinvested at the lower rates available in the current investment market.
12. The Strategy sets out the expected returns over the next 12 months. It forecasts an average return that is 110 basis points above the 30 day benchmark rate or an overall return of 3.2%, subject to no change in official interest rates.
13. The enhanced benchmark margin shows the *minimum* return expected on a portfolio operating under the parameters outlined in the Investment Policy if invested in 90 day maturities. It has been increased from 40 basis points to 45 basis points above the bank bill swap rate. The enhanced benchmark margin will remain sustainable only as long as the 30 – 90 day investment rates continue to remain available at their current spreads. While the City is able to invest in longer term maturities it is also required to ensure a portion of its portfolio is available to meet shorter term funding demands.
14. The proposed Investment Policy and Strategy continue to satisfy the compliance requirements of the Ministerial Investment Order.

15. It should be noted that the Investment Strategy is a 'guiding principles' document and that is deliberately more restrictive than the overall Investment Policy framework. As market conditions change significantly and very quickly, the Strategy may need to be amended from time to time, in which case Council would be advised through the monthly Investment Report.
16. Council's Investment Policy and Investment Strategy continue to permit and encourage environmental and socially responsible investment activity (SRI investments). While Council continues to pursue these objectives, the task has been made extremely difficult in recent times as the Ministerial Investment Order restricts the range of financial institutions in which NSW councils can invest, and prohibits many of the available SRI investment products.
17. In addition to these statutory restrictions, Council also imposes its own additional restrictions through its Investment Policy in order to further minimise and manage investment risk. The combined effect of these restrictions is that Council now operates in an investment market with very little opportunity for SRI investment. This conservative approach has, however, safeguarded Council's funds and maintained an investment portfolio that continues to exceed industry performance benchmarks.
18. Council's Investment Policy and Investment Strategy will also continue to support the objectives of the No Business in Abuse pledge, endorsed by the City of Sydney in late 2015, which clearly aligns to the existing SRI framework. Council staff will advocate with major financial institutions for the development of investment products that explicitly ensure the exclusion of socially harmful activity.
19. A Borrowing Policy is currently being drafted. While City's Long Term Financial Plan forecasts that there are sufficient funds available to deliver its extensive capital works program and operations, it is considered prudent to develop a borrowing policy that outlines the circumstances under which debt financing can occur if required for appropriate initiatives and projects.

### **KEY IMPLICATIONS**

20. Council's Investment Policy and Investment Strategy direct its investments to ensure compliance with the requirements of the Local Government Act 1993 and Minister's Investment Order within acceptable risk/return parameters.

### **FINANCIAL IMPLICATIONS**

21. Investment returns over the past five years have gradually reduced, reflecting lower interest rates and the more limited investment opportunities now available under the Ministerial Investment Order, Investment Policy and Investment Strategy. While the City continues to outperform its investment benchmarks, in part due to prudent investment in longer term maturities before the decline in cash rates.
22. Portfolio returns are expected to remain reasonably low for the next year with current interest rates at historic lows. The 2015/16 operating budget and draft 2016/17 budget in development both include investment revenues that are based on forecast investment returns and anticipated cash balances that are subject to achievement of the planned capital program.

**RELEVANT LEGISLATION**

23. Council is authorised to invest its surplus cash under Section 625 of the Local Government Act 1993.
24. The Local Government (General) Regulation 2005 (clause 212) requires Council to provide a written monthly report of all monies invested, under section 625 of the Act.
25. The Local Government Code of Accounting Practice and Financial Reporting (Legislative Requirements Update 10 at 11.3.5) states that Council must maintain an investment policy that complies with the Act and ensure it or its representatives exercise care, diligence and skill that a prudent person would exercise in investing council funds.

**BILL CARTER**

Chief Financial Officer