

Item 5.

Review of the Investment Policy and Strategy

File No: X020701

Summary

This report presents the revised Investment Policy and Investment Strategy for the Management of Council's Funds.

The Policy and Strategy are reviewed annually, as a minimum, to ensure they remain appropriate and respond to changes in economic, investment and legislative environments. The annual review of the Policy and Strategy, together with the proactive management of funds, has resulted in a secure investment portfolio that aims to continue to outperform the benchmark returns required by the policy.

The scope of the City's investments like the wider NSW local government sector is limited. It is mandated under the Local Government Act 1993, through a Ministerial Investment Order, that constrains council investments to deposits and / or bonds in Federal, State (including NSW TCorp) or Local Governments and in banks that are Approved Deposit Taking Institutions under the Banking Act. Councils are not permitted to invest in equities and therefore not permitted to invest directly in individual companies.

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 the City, 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 City first formally introduced social and responsible investment criteria into its investment policy and strategy in 2008, although environmental investments were already being actively incorporated into the portfolio as appropriate instruments came onto the market. Since that time, the City has progressively strengthened its position within its allowed investment framework.

In October 2016, Council endorsed a revised Investment Policy that further enhanced the social and responsible investment aspect of the City's investment policy. While the Policy already encouraged social and responsible investment, provided that products met the risk and return requirements of other investments, two amendments were adopted that:

- (a) strengthened Council's commitment to social and responsible investment (SRI) where returns and risk are equivalent to other available investments; and
- (b) expanded the definition of environmentally harmful activities to include specific reference to coal, gas and oil.

These two amendments continue to be included in the policy and the City now holds \$54.5M in explicitly SRI investments.

The City has developed good relationships with its financial institutions, partnered with them to help launch new products and continued to meet regularly with them to advocate for new investment vehicles and products that will achieve our desire to increase our commitments to social and responsible investment.

The legislative and regulatory environment for local government has remained static, and the existing Investment Policy continues to serve the City well.

In this annual update of the Investment Policy a number of minor amendments are proposed to streamline the administration of the portfolio. This includes updating the current credit rating structure to align to the formalised rating structures that are published by credit rating agencies, increasing the investment threshold for A+ and A rated institutions and clarifying maturity period assessment criteria. These changes are intended to make operation of the portfolio simpler, more efficient to administer and better aligned with industry standards.

The key objectives of the current Investment Strategy remain valid for the challenging economic and investment legislative requirements. The Strategy remains unchanged aside from some minor administrative adjustments as it presently meets liquidity requirements for Council's ongoing capital works program, the objectives for investment performance and continues to prudently manage credit risk.

The proposed Investment Policy and Strategy will continue to maintain an investment portfolio that is reasonably conservative; and comprise 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.

Recommendation

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

Attachments

- Attachment A.** Investment Policy 2023/24
- Attachment B.** Investment Strategy 2023/24
- Attachment C.** Credit Rating Structure Comparison

Background

1. The Local Government Act 1993 (the Act) was amended in 2016 to strengthen council's fiduciary duty. The changes are intended to guide councils to carry out their functions in a way that facilitates local communities that are strong, healthy and prosperous, and include an explicit reference to councils carrying out their functions in a way that provides the best possible value for residents and ratepayers.
2. The investment policy and strategy are a key part of ensuring that the City continues to manage its finances in an effective, efficient and prudent manner. The amendments to the Local Government Act 1993, as referred to above, reinforce the City's existing underlying financial principles.
3. The Act states that councils should have effective financial and asset management, including sound policies and processes, for the following:
 - (a) performance management and reporting;
 - (b) asset maintenance and enhancement;
 - (c) funding decisions; and
 - (d) risk management practices.
4. 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, Local Government (General) Regulation 2021 (NSW).
5. 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 may 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.
6. The purpose of the Policy and Strategy is to ensure the investments are secure, satisfy Council's risk / return criteria and are compliant with the Local Government Act 1993, as well as to optimise investment income from the short and long term investment of funds that are surplus to the City's present operational needs.
7. The City's investment portfolio remains conservative due to the robustness of the Australian domestic investment market under the supervision of the Australian Prudential Regulation Authority (APRA) which extends across the full range of financial institutions. The City has gradually diversified from its post 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 and A- rated bank investments together with a handful of investment-grade BBB rated investments.

8. The Policy encourages investments in environmentally and socially responsible investments provided that they meet the risk and return requirements of other investments. Two amendments were adopted in October 2016 that:
 - (a) strengthened Council's commitment to social and responsible investment where returns and risk are equivalent to other available investments; and
 - (b) expanded the definition of environmentally harmful activities to include specific reference to coal, gas and oil.
9. The City of Sydney currently classifies each investment under an AAA, AA, A and BBB credit rating scale, set out in the existing Investment Policy, for the purpose of our approved threshold requirements. The credit risk investment parameters utilise credit rating bands that have been in place for over a decade that summarise the ratings published by the credit rating agencies. When considering an investment, typically in amounts of \$5M, institutional credit ratings, provided by rating agencies are aligned to the nearest appropriate rating within the City of Sydney's more summarised categorizations. For example, the Big 4 Banks (Westpac, NAB, ANZ and CBS) are currently rated as AA in the City's Investment rating framework. In the differentiated long-term rating structure used by Standard & Poor's (S&P) they are classified as AA-
10. It is proposed that the existing credit rating structure should be amended to align the City's credit rating structure to the formalised rating structures that are published by credit rating agencies S&P, Moody's and Fitch, in that order. This will continue to ensure a consistent, accurate and conservative credit rating approach is maintained but with the benefit of being simpler, more efficient to administer and aligned with industry standards.
11. A second amendment proposed is to place investments based on the long term credit rating of an institution only and not consider short term. Short-term ratings are generally assigned to those investments considered short-term in the relevant market, that is investments with an original maturity of no more than 365 days. Placing investments based on long term credit ratings only is a more conservative approach for the City and simpler to administer.
12. The third amendment is in relation to the maximum threshold exposure to a single institution for institution rated A+ to A. The current investment policy allows for up to \$75M to be placed with an A rated institution. The threshold for these institutions is recommended to be raised to \$100M per institution. The institutions in this category are mid-tier banks that also have substantial equity. Increasing the thresholds for these institutions will assist the City with diversification of portfolio as this amendment is proposed in accordance with the credit rating and equity of the institutions.
13. The fourth amendment proposed is to incorporate the maximum and minimum threshold by terms to maturity within a single table. Minimum thresholds are set to ensure adequate liquidity in earlier maturity bands before funds are committed to longer term investments. The minimum thresholds are obviously higher in the shorter term where liquidity is of greater priority. The cumulative nature of the minimum threshold limits inherently generates corresponding maximum thresholds; that is, maximum amounts that can be invested in each maturity band while remaining compliant with the minimum threshold limits. This provides better flexibility and simplification for monitoring and review purposes.

14. There are a number of other minor administrative changes including revising the language of the definitions and formatting updates that were also incorporated to the policy.
15. The amendments above do not change the overall intent of the Policy but clarifying the City's intent and simplify the administration of the policy.
16. Council's Investment Policy and Investment Strategy continue to permit and encourage environmental and socially responsible investment activity (SRI investments). The Ministerial Investment Order limits the range of financial institutions in which NSW councils can invest and prohibits many of the available socially responsible investment products.
17. The City has good relationships with its financial institutions, and regularly meets to advocate for new investment vehicles and products that will achieve our desire to increase our commitments to social and responsible investment. In a welcome development, in November 2018, Westpac informed the City that they had created a new sustainable investment product known as a Green Tailored Deposit, which has been independently certified to meet the Climate Bonds Standard while not compromising the credit risk of the product. These deposits are associated with a defined pool of eligible assets which meet the Climate Bond Standard criteria including renewable energy, low carbon transport, low carbon intensity emitting buildings, waste and water products and are independently certified annually. Currently, the City has invested \$45 million in this Westpac product.
18. The City currently holds \$5M in a sustainability bond/floating rate note (FRN) with Bank Australia due to mature on 24 November 2025 and an additional \$4.5M invested in February 2023 due to mature on 22 February 2027. This is based on an investment framework that is in line with the 2021 versions of the ICMA Green Bond Principles (GBP), Social Bond Principles (SBP) and Sustainability Bond Guidelines (SBG). This Socially Responsible investment opportunity meets both the credit risk and maturity profile requirement of the City.
19. The key objectives of the current Investment Strategy remain valid for the present economic, investment and legislative environments. The Strategy remains unchanged, aside from some minor administrative adjustments, as it presently meets liquidity requirements for Council's ongoing capital works program, objectives for investment performance and continues to prudently manage credit risk. Sections of the Investment Strategy that detail the current investment portfolio and its performance were amended to reflect the present results.
20. The proposed Investment Policy and Strategy continue to satisfy the compliance requirements of the Ministerial Investment Order.
21. It should be noted that the Investment Strategy is a 'guiding principles' document. 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.

Key Implications

22. 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 Financial Implications.

Financial Implications

23. It is worth noting Council's investment opportunities are constrained by a combination of legislation, regulation and any directions and guidelines issued by the Minister or the Office of Local Government. These guidelines were developed, in large part, as a response to the Global Financial Crisis and its impact on the local government sectors investments. They effectively limit the City's investment profile to something similar to a cash managed fund, which produces lower returns but provides a high level of security.
24. The annual inflation rate in Australia was 6.0 per cent as at June 2023, down from a high of 7.8 per cent as at December 2022. While global factors explain much of the increase in inflation, domestic factors also play a role. There are widespread continuing upward pressures on prices from strong demand, a tight labour market and capacity constraints in some sectors of the economy.
25. In response, the RBA has responded with 13 interest rate increases. The current official cash rate is now 4.10 per cent up from the record low 0.10 per cent level in May 2022. At the July and August RBA Board meetings official interest rates were held steady, however, further increases have been foreshadowed in an attempt to curb inflation.
26. The City's returns from the investment portfolio are in line with cash managed funds in the market. The recent increases to official cash rates have seen improvements in rates of return offered by the market, allowing maturing deposits to be re-invested at higher rates. This trend is anticipated to continue as investments placed during the period of suppressed interest rates reach maturity and are re-invested.
27. In 2022/23 the City earned \$23.5M on its financial investments. The annual budget was set at \$7.5M prior to the escalation in the rate of inflation and the resultant series of cash rate increases.

Relevant Legislation

28. Council is authorised to invest its surplus cash under Section 625 of the Local Government Act 1993.
29. The Local Government (General) Regulation 2021 (section 212) requires the City to provide a written monthly report of all monies invested, under Section 625 of the Act.
30. 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.

BOB WALLACE

Acting Chief Financial Officer