Security, Liquidity and Yield Benchmarking

Benchmarking and monitoring security, liquidity and yield in the investment portfolio

A proposed development for Member reporting is the consideration and approval of security and liquidity benchmarks. These benchmarks are targets and so may be breached from time to time. Any breach will be reported to Cabinet in either the mid year review of end of year review depending upon when the breach occurred.

Yield
These benchmarks are currently widely used to assess investment performance. Local measures of yield benchmarks are:

- Investments – Internal returns above the 7 day LIBID rate
- Investments – External fund managers - returns 115% above 7 day compounded LIBID.

Security & liquidity
Security and liquidity benchmarks are already intrinsic to the approved annual investment strategy through the counterparty selection criteria and a number of the prudential indicators approved as part of the Budget Strategy. However they have not previously been separately and explicitly set out for Member consideration.

Proposed benchmarks for the cash type investments are below and these will form the basis of future reporting in this area. In the other investment categories appropriate benchmarks will be used where available.

- *Liquidity* – This is defined as “having adequate, though not excessive cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives” (CIPFA Treasury Management Code of Practice). In respect of this area the Council seeks to maintain:
    - Bank overdraft - £1m
    - Liquid short term deposits and/ or short-term borrowing to fund the cash requirement on a weekly basis.

  The availability of liquidity and the term risk in the portfolio can be benchmarked by the monitoring of the Weighted Average Life (WAL) of the portfolio – shorter portfolios would generally embody less risk. In this respect the proposed benchmark is to be used:

    - WAL benchmark is expected to be no greater than 12 months.

- *Security* – In context of benchmarking, assessing security is a much more subjective area to assess. Security is currently evidenced by the application of minimum quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody’s and Standard and Poors).

  Whilst this approach embodies security considerations, benchmarking levels of risk is more difficult to determine. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the council’s investment strategy. The following table shows average defaults for differing periods of investment grade products for each Fitch long term rating category over the period 1990 to 2007.

Long term rating	1 year	2 years	3 years	4 years	5 years
AAA	0.00%	0.00%	0.00%	0.00%	0.00%
AA	0.00%	0.00%	0.00%	0.03%	0.06%
A	0.03%	0.15%	0.30%	0.44%	0.65%
BBB	0.24%	0.78%	1.48%	2.24%	3.11%

In other words no AAA rated institution defaulted on its loan obligations in the period covered by the table.

The Council's minimum long term rating criteria is currently "AA". In addition the annual investment strategy provides for investment in unrated building societies with an asset base in excess of £2bn, although only for a maximum of 6 months. The combined effect of the investment criteria in terms of default can therefore be considered at or around the 'A' rated long-term rating for 1 year – i.e. 0.03%. The average default factor for the portfolio during the half-year varied in the range 0.02% to 0.05%. The factor as at 30 September 2009 is 0.3%.

Based on the current criteria it is recommended that the default indicator is set at 0.05%.