Department of Infrastructure, Local Government and Planning

Investment Policy Guidelines for Local Governments

May 2015

Queensland Government

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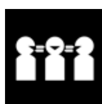

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1. Objective and scope

Background

Local governments derive particular financial powers from the *Statutory Bodies Financial Arrangements Act 1982* (SBFA Act). Part 6 of the SBFA Act deals with investments.

Section 47 of the SBFA Act requires local governments to invest in a prudent and appropriate manner. These Investment Policy Guidelines (the Guidelines) are designed to assist local governments in understanding their obligations under the SBFA Act, and to provide direction on some of the key considerations that should form the development of a prudent and appropriate investment framework. The Guidelines will also seek to assist local governments with the preparation of a formal investment policy, which should outline principles and practices for a local government to invest in the required manner, and be able to demonstrate it has done so.

The Guidelines incorporate a model investment policy that may be adapted according to each local government's specific requirements. The model investment policy is included at Appendix A to the Guidelines.

Application of the Investment Policy Guidelines

The Guidelines apply to all local governments and local government corporate entities.[1]

For the purposes of the Guidelines, 'investments' refers to investment arrangements authorised under sections 44, 45 and 46 of the SBFA Act.

Investment by local governments will generally be undertaken pursuant to the powers conferred under Part 6 of the SBFA Act. Accordingly, the Guidelines primarily deal with these powers. Investments outside the scope of these powers require the Treasurer's specific approval under Part 7A (type 2 financial arrangements) of the SBFA Act.

If a local government is uncertain of its obligations under the SBFA Act, it should seek clarification from the Department of Infrastructure, Local Government, and Planning (DILGP) in the first instance.

Objectives of the Investment Policy Guidelines

The key objectives of the Guidelines are to:

- assist local governments to invest in accordance with Part 6 of the SBFA Act;

[1] At time of publication, Wide Bay Water Corporation and Gladstone Airport Corporation.

- clearly articulate the expectations, priorities and risks associated with investments under Part 6 of the SBFA Act, without compromising the responsibility and accountability of local governments;
- assist local governments to develop clearly defined investment goals;
- outline necessary controls for compliance and reporting, and to ensure an adequate governance framework is applied to the investments of local governments;
- ensure a framework exists to manage a local government's investment risk in a prudent and appropriate manner; and
- provide confidence to all stakeholders that appropriate commercial disciplines are being applied to a local government's investment portfolio.

Scope of the Investment Policy Guidelines

The broad scope of the Guidelines is to:

- provide a summary of the impact of the SBFA Act on the investment operations of local governments;
- provide a framework to develop an investment policy in accordance with sound corporate governance principles for the cash, treasury and investment management functions of a local government;
- serve as a guide to establish and achieve the key objectives of investment management for local governments; and
- define policy, set benchmarks and assist staff and management of local governments in understanding their duties and responsibilities.

It is not the intention of the Guidelines to serve as a substitute for reading and understanding the SBFA Act as a whole.

Glossary

Chapter 8 contains a list of definitions to assist local governments with interpretation and understanding of the Guidelines.

General information warning

The information and model investment policy contained in the Guidelines have been prepared for general information purposes only. They do not take into account the specific circumstances and requirements of individual local governments.

Each local government should review, assess and utilise the Guidelines based upon its own particular circumstances. The Guidelines are not intended as a comprehensive statement of a local government's powers and obligations under the SBFA Act, and local governments are responsible for ensuring that they are aware of, and comply with, their powers and obligations under the SBFA Act.

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2. Overview of powers under the Act

Pursuant to section 101 of the *Local Government Act 2009*[2] (LG Act), local governments derive their investment powers from the SBFA Act and may enter into investment arrangements subject to Part 6 of the SBFA Act.

Part 6 of the SBFA Act allocates one of three categories of investment power to a local government, whereby the local government may undertake investments permitted under that category without further approval from the Treasurer.

Schedules 3, 4 and 5 of the *Statutory Bodies Financial Arrangements Regulation 2007* (SBFA Regulation) set out those local governments allocated Category 1, 2 or 3 investment powers respectively.

Category 1 investment power permits a local government to invest in a range of highly secure investments either:

- at call; or
- for a fixed time of not more than one year.

Category 2 investment power permits a local government to invest in a range of highly secure investments either:

- at call; or
- for a fixed time of not more than three years.

Category 3 investment power includes Category 2 investment powers and the power to undertake a range of other investments, regardless of the period of investment, including:

- the purchase of land in fee simple in any State;
- the purchase of leasehold land in the State held under a lease that is for a term of 40 years or more and that is unexpired at the time of the purchase,
- the purchase of a freeholding lease of land held from the State under the *Land Act 1994* and;
- debentures or other securities charged on the funds or property of a local government.

Further detail of the above investment categories, applicable ratings and investment products are contained in sections 44, 45 and 46 of the SBFA Act. These should be reviewed prior to making an investment decision to ensure compliance with the SBFA Act.

Section 43 of the SBFA Act limits the investment powers to investments in Australian money and undertaken in Australia.

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[2] Section 102 of the City of Brisbane Act 2010 (CoB Act)

Where investments are not permitted under Part 6 of the SBFA Act, a local government may seek approval from the Treasurer under Part 7A of the SBFA Act (for a type 2 financial arrangement). In this instance, a local government must provide DILGP with complete details of the proposal and a request that DILGP seeks the necessary approval on behalf of the local government.

3. Investment policy

What is an investment policy?

The importance having an explicit investment policy document cannot be understated. It should be an extension of a local government's business planning and form the primary building block of an intentional investment process within the requirements of the SBFA Act.

An investment policy provides guidance for those undertaking the investment process. Without an approved investment policy, the investment officers may make investment decisions that are not in accordance with the objectives, practices or risk appetite intended by the local government.

An investment policy is a governing document that communicates a local government's:

- investment philosophy and strategy;
- overall risk philosophy;
- investment objectives and expectations;
- identified roles for those involved in the investment process; and
- requirement for compliance with the policy's goals and procedures.

A checklist setting out some of the key matters that should be dealt with in a local government's investment policy document is included at Appendix B.

Objectives of an investment policy

In creating an investment portfolio, a local government's primary objective is to preserve capital and appropriate liquidity. The investment policy should set the framework to achieve this.

Requirements of an investment policy

An investment policy should:

- define the risk profile of the local government;
- preserve the capital and liquidity of the investment portfolio;
- outline the return expectations for the investment portfolio;
- prohibit the purchase of derivative securities for non-hedging purposes, either directly or indirectly (refer Part 7 of the SBFA Act);
- prohibit the use of leveraging of an investment portfolio i.e. borrowing to invest in securities;
- prohibit the use of the investment portfolio for speculation;
- prohibit investment in securities that are complex in nature e.g. a securitised or structured product;
- prohibit investment in non-Australian dollar denominated securities;

- require investments to be regularly revalued to reflect prevailing market prices;
- require investment arrangements that are downgraded below a minimum rating acceptable under the SBFA Act to be liquidated, or the Treasurer's approval obtained within 28 days to continue with the investment arrangement (pursuant to section 52 of the SBFA Act);
- require the status and performance of a local government's investments to be reported regularly to Council; and
- where applicable, document the process to choose an external investment manager.

Approach of an investment policy

An investment policy should reflect the investment management approach adopted by Council.

The decision to employ a particular investment approach will depend on the specific circumstances of each local government. This would include an assessment of the scale of funds under management, level of risk aversion, confidence in management capability, systems capacity, and internal procedures to control financial and operational risks.

Local governments will generally adopt either a passive investment management approach or an active investment management approach.

Passive investment management

Passive investment management allows little discretion with regard to portfolio management. An example of passive investment management is to buy and hold investments to maturity, or replicate a specific index/benchmark of investments.

Passive investment management is generally the approach recommended to local governments, as investment management is not their core business. The objective is to ensure the return of capital, and at the same time, generate a return commensurate with the risk taken.

Active investment management

Active investment management allows a greater level of discretion and scope to change investments in expectation of future market developments. An example of active investment management is to identify and exploit short-term market anomalies in investments that may deliver a comparative advantage in light of longer-term economic developments.

A more rigorous risk management framework is required when a local government adopts an active investment management approach.

It is only appropriate for large, well-resourced local governments to consider adopting this approach.

4. Duties and responsibilities

This chapter seeks to outline best-practice principles for the approval and ongoing monitoring of investment policies and activities of local governments, as well as the responsibilities of officers involved with the investment activities of local governments.

Governance

Approval of the investment policy

Section 191 of the *Local Government Regulation 2012* (LG Regulation)[3] requires that a local government must prepare and adopt an investment policy.

Annual review of the investment policy

It is unlikely that the investment policy will change substantially from year to year. However, section 104(6) of the LG Act[4] requires that a local government regularly reviews and updates its investment policy as necessary.

The purpose of regularly reviewing an investment policy is to reassess the risk associated with changes in the market and within the local government (e.g. improved internal controls or change of management).

Approval of changes to the investment policy

Any changes to the investment policy should be reviewed and approved by Council. The purpose of this is to enhance the decision-making process and increase transparency and accountability of staff to Council.

Public access to the investment policy

Section 199 of the LG Regulation[5] requires that the public must be able to inspect the investment policy at the local government's public office and on the website, and to purchase copies of the investment policy from the local government.

Reporting to Council

Regular reporting to Council provides a complete picture of the financial health of the investment portfolio. In particular, it brings the performance and compliance of the portfolio to the attention of those responsible for oversight.

An investment policy should outline the minimum reporting requirements to Council, including:

- regular reporting of the portfolio value using market value methodology;

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[3] Section 183 of the City of Brisbane Regulation 2012 (CoB Regulation)

[4] There is no equivalent section in the CoB Act.

[5] Section 191 of the CoB Regulation

- reporting of investment category (e.g. cash, bonds) and issuer exposure by market value, par value and maturity dates;
- reporting of breaches of the investment policy; and
- comparing portfolio performance against benchmarks (if applicable).

The reporting frequency should reflect the assessed level of risk and/or overall importance of the investments to Council. Performance reporting for an investment portfolio should occur monthly, and a more detailed report provided on a quarterly basis.

Systems and internal controls

An investment policy should consider the capability of systems, staff, and Council to make various investment decisions in order to minimise the risk associated with the purchase of higher risk investments.

Responsibilities of local government officers

An investment policy should identify the fiduciary duties[6] and responsibilities of the investment officers of a local government. These are outlined in more detail below.

Fiduciary duties and the Prudent Person Standard

An investment policy should obligate the officers responsible for investing the local government funds to act with a duty of care, skill, prudence and diligence that a prudent person would exercise when investing and managing their own funds.

The purpose of the Prudent Person Standard is to protect beneficiaries (in this case, local governments) from mismanagement and misuse of funds.

Separation of duties

Separation of duties forms a critical component of an investment policy. A clearly defined investment policy will separate the functions of reporting, approval, and execution of transactions. The purpose of separation of duties is to reduce the risk of fraud and misuse of public monies.

Ethical standards and conflicts of interest

Conflicts of interests are to be appropriately recorded and disclosed to the Chief Executive Officer (CEO).

An investment policy should obligate the officers and management involved with the investment process to refrain from personal business activity that could interfere with the investment process or impair their ability to make impartial investment decisions.

[6] A fiduciary relationship is a relationship between a person in a position of special power and responsibility (the fiduciary) and the person or entity for whose benefit the fiduciary acts.

Compliance with legislation

Officers involved in a local government's investment activities should also be aware of the local government's duties under the SBFA Act, including:

- using its best endeavours to invest at the most advantageous rate available to it at the time for an investment of the proposed type (section 47(1)(a));
- maintaining records to verify that it has invested in an appropriate manner (section 47(2)); and
- where the rating of an investment arrangement is downgraded below the minimum rating prescribed under the SBFA Act, the local government must within 28 days either obtain the Treasurer's approval to continue with the arrangement, or liquidate the investment (section 52).

An investment policy should be amended to reflect any changes to the SBFA Act.

5. Investment portfolio composition, characteristics and limitations

An investment policy must include the investment expectations of the local government and should define how the investments will achieve these expectations by considering the issues outlined in this chapter.

Investable funds

An investment policy should include a list of all funds of the local government covered by the policy.

Rate of return expectations

A local government's rate of return expectation is a function of its risk appetite (including liquidity, market and default risks) and also its tolerance for volatility of returns.

An investment policy should provide guidance on return expectations and/or tolerable variations in performance of the local government's investment portfolio.

A local government that specifies an objective for out-performance relative to a benchmark should also clearly state its tolerance for underperformance or volatility of performance in the investment policy.

Approved investments

Acceptable counterparties

The purpose of including a list of acceptable counterparties in the investment policy is to provide clarity to the investment officers. The list should reflect the risk appetite of the local government and the SBFA Act.

An investment policy should outline approved categories of counterparty (for example, by rating), and delegate approval to the CEO or Chief Financial Officer (CFO) for individual credit counterparty limits or for specific instruments within the general category limits.

The SBFA Act prescribes the acceptable categories of counterparty for a local government. For example, Category 1 investment power allows the following categories:

- financial institutions[7];
- the Commonwealth Government;

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[7] For a list of authorised deposit-taking institutions, refer to the website of the Australian Prudential Regulation Authority: http://www.apra.gov.au/adi/

- a State Government;
- investment arrangements managed or offered by Queensland Investment Corporation (QIC) or Queensland Treasury Corporation (QTC), as prescribed by regulation; and
- investment arrangements with a rating prescribed by regulation of:
  - F1+ or F1 by Fitch; or
  - Prime-1 (P-1) by Moody's; or
  - A-1+ or A-1 by Standard & Poor's; or
  - AAAm or AAm fund rating by Standard & Poor's.

It is important that counterparty definitions are clearly defined to avoid different interpretations relative to the original intention of the investment policy and the SBFA Act.

For example, simply stating "rated investment arrangements" is not a clearly defined category for inclusion in an investment policy. A more robust investment policy will provide further detail on different categories of rated counterparty. This will avoid investment in rated securities which may compromise a local government's liquidity or return objectives. For instance, corporate issuers, mortgage backed issuers and a first to default basket of securities may all be rated securities. However, the first to default basket of securities would compromise a local government's objective of preservation of capital in the event of default of a reference entity.

Acceptable security types

The purpose of an acceptable instrument (security type) list is to provide clarity to the investment officers. The list should reflect the risk appetite of the local government and the SBFA Act.

An investment policy should detail a list of acceptable securities for investment which will meet the unique requirements of each investment category provided under Part 6 of the SBFA Act. The list should include additional restrictions to reflect different risk tolerances for each security type.

For example, a list of acceptable securities for a local government with Category 1 investment power may include:

- cash;
- certificates of deposit;
- commercial paper;
- bills of exchange;
- bonds; and
- promissory notes.

Prohibited security types

The purpose of a prohibited instrument (security type) list is to provide further clarity to investment officers. The list should reflect the risk appetite of the local government and the SBFA Act.

An investment policy should detail the types of securities that have been assessed as being outside the parameters for acceptable investments and therefore expressly

prohibited. Inclusion of this list in the investment policy strengthens the framework within which investment officers make decisions about suitable investments.

For example, a list of prohibited security types for a local government with Category 1 investment power may include:

- derivative based instruments;
- principal only investments or securities that provide potentially nil or negative cash flow;
- stand-alone securities that have underlying futures, options, forward contracts and swaps of any kind;
- securities issued in non-Australian dollars;
- securitised debt instruments; and
- structured products.

An investment policy should also consider limiting or prohibiting securities exposed to certain geographies, such as emerging markets or peripheral Europe.

Minimum and maximum limits

The purpose of setting maximum and minimum limits is to assist the local government to manage its preservation of capital and tolerable volatility of return objectives.

An investment policy should establish minimum and/or maximum limits in relation to total amounts invested with various counterparties or categories. It may include the following:

- counterparty and security limits;
- market risk limits:
- credit quality limits;
- sector limits; and
- maximum volatility relative to selected benchmark limits.

General counterparty limits are not provided in the SBFA Act and should therefore reflect the individual risk appetite of the local government.

Care should be taken when expressing the counterparty limits in both dollar values and percentages of the portfolio, as this can lead to uncertainty as to which applies.

For further discussion on a ratings-based system for setting credit limits, as well as an outline of rating conventions and grading systems of the individual ratings agencies, refer to Appendix C and Appendix D respectively.

Maturity ranges

Maturity ranges defined by the SBFA Act

As discussed in Chapter 2, the SBFA Act provides investment maturity ranges for Category 1, 2 and 3 investment powers:

Category 1:	for a fixed time of not more than one year.
Category 2:	for a fixed time of not more than three years.
Category 3:	includes Category 2 investment power for a fixed time of not more than three years, but also allows a range of other investment options, regardless of the period of the investment.

Maturity ranges defined by an investment policy

The purpose of setting maturity ranges is to ensure that investments meet the cash flow requirements (or liquidity needs) of the local government. Cash flow forecasting is an important tool to help determine the appropriate maturity profile of each local government's investment portfolio.

Investment officers need to be aware that the longer the term to maturity, the greater the risk that the counterparty will default. Statistically, a highly rated counterparty (e.g. rated by Standard & Poor's as AA or better) is highly unlikely to default over a three year term, and will exhibit lower volatility of returns compared with lower rated counterparties.

An investment policy will ideally establish two points of maturity limitation:

- weighted average maturity of the portfolio; and
- length of maturity of any one security.

For an investment portfolio with a time horizon greater than one year, the use of only one of these limits may lead to a concentration of maturities. This may conflict with the cash flow needs of the local government.

The use of a one-year maturity limit is acceptable for a local government with Category 1 investment power as long as the investment policy requires the investment officers to consider the local government's cash flow needs.

Portfolio diversification

The purpose of counterparty diversification is to ensure that no single deteriorating counterparty undermines the capital preservation objective of the investment portfolio.

An investment policy should outline diversification requirements which avoid high concentrations of any one issue, issuer, industry, security type or geographic area.

The aim of diversification is to spread the investments by a number of different parameters to manage different risks within the investment portfolio. To achieve portfolio diversification, an investment policy should consider the following:

- issuer type;
- security type;
- maturity buckets (e.g. 0 to 1 year) which take into account cash flow requirements;

- industry standards;
- geographic consideration;
- quality of investment securities to be held;
- liquidity requirements;
- regulatory requirements;
- income levels or return expectations; and
- credit requirements.

Purpose of credit requirements

The primary objective of an investment portfolio is to preserve its capital. Therefore, a local government should have a strong preference for high credit quality investments, which are also generally more liquid (i.e. easier to sell). An investment policy should identify a minimum standard of credit quality in accordance with the SBFA Act.

The purpose of including credit requirements in an investment policy is to:

- reduce the risk of loss of capital;
- improve liquidity;
- maintain equity;
- maintain acceptable costs of capital; and
- maintain reputation.

Credit risk management

A local government can effectively manage credit risk by:

- clearly defining its key objectives (e.g. capital preservation);
- formulating and implementing a credit policy (e.g. counterparty limits by category, individual counterparty limits, and ratings category limits);
- establishing criteria for individual counterparties;
- monitoring counterparty limits, ratings, and any change in credit risk;
- identifying and reporting breaches, and taking corrective action where necessary; and
- assessing the ability of the local government to manage the risks and exposures involved with complex securities through credit and interest rate cycles.

Considerations for Category 1 and Category 2 investment powers

Local governments should consider the following issues for the effective management of credit risk:

- Restrict the investment portfolio to investment grade BBB-[8] or above. Generally, it would be prudent to maintain investments with counterparties that have a rating of A- or better.
- Where the SBFA Act allows for unrated investments, these are to be limited to a percentage of the portfolio that is consistent with the overall investment philosophy and risk return profile of the local government. Local governments should not invest with unrated or sub-investment grade counterparties (i.e. below BBB-).
- Maintain, at a minimum, an average credit rating of AA- (Category 2) and A1+ (Category 1) for the investment portfolio.
- List all permissible securities in the investment policy. For example, list the type of security and investment amount by percentage relative to a benchmark or total assets (not both).
- List all prohibited securities in the investment policy.
- Individual security limits should reflect the loss appetite of the local government. To assist with this decision-making process, the default probability for each ratings category over a period can be obtained from the ratings agencies.
- Establish limits for credit risk (a single entity or group of associated entities) and market risk (interest rates and price) in the investment policy.
- Where there is a split rating for an individual security or counterparty, the lower rating should be adopted.
- Individual counterparty limits should expose a maximum of 10 per cent of the portfolio to an individual counterparty. A higher exposure would expose the local government to risk that could be diversified away with a broader portfolio. This counterparty limit should not preclude more significant investment levels in funds such as the QTC Capital Guaranteed Cash Fund and the QIC Cash Fund, where diversity of exposure is achieved through a portfolio of financial instruments from many counterparties (i.e. counterparty exposure is achieved by the investment manager).

  It would be appropriate to allow the percentage allocation for a counterparty to increase as its risk reduces. However, more sophisticated investment managers (i.e. investors with a high level of understanding of investment practices and theories) would achieve risk reduction that better recognises the risk of transition[9] and default.

For reference, further detail of credit ratings and the difference between long-term and short-term credit ratings is included at Appendix D.

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[8] To facilitate ease of reading, the ratings utilised in this section use the Standard & Poor's conventions.

[9] 'Transition' refers to the migration of a credit rating to a stronger or weaker rating.

Other risk considerations

When preparing an investment policy, consideration should be given to operational management expectations including administration, compliance, audit, technology, fraud control, broker counterparty limits, market risk and liquidity risk.

Market risk and liquidity risk should be further considered in an investment policy, and are discussed in more detail below.

Market risk

Market risk, or systematic risk, refers to the variability of returns or the likelihood that the value of an investment or investment portfolio will move with the overall market.

In particular, for fixed interest investments there is a risk that a change in interest rates will lower the value of an investment if it is sold before maturity. This risk arises because the market value (price) of a fixed interest instrument moves inversely to interest rates (yield).

For example, if a local government sells a fixed interest security which was bought with a five per cent yield (return) in a seven per cent yield environment; it will incur a loss of principal. The magnitude of the loss will depend on the remaining term to maturity of that security, all other things being equal.

Where a local government is required to sell a security before it matures, it will be selling the security into a commercial secondary market, and will receive a market rate of return. This may compromise its preservation of capital objective.

Liquidity risk

A further element of market risk is liquidity risk. This refers to the ability to sell securities in a timely manner without loss or penalty. The purpose of ensuring that a portfolio retains liquidity is to maintain the stability of cash flows and preserve the capital of the investment portfolio. Investments that are not publicly traded in sufficient volume to facilitate, under most market conditions, prompt sale without material adverse market price effect are regarded as illiquid.

An investment policy must provide a clear definition of illiquid investments and ensure that liquidity needs are clearly understood within the policy document.

Examples of illiquid investments include:

- securities with unique features or structured elements, or those issued by counterparties that are not well known or thinly traded;
- securities with an issuance volume of less than $150 million;
- sub-investment grade securities and potentially also securities with a BBB rating;
- private placements; and
- securities that are not priced, or priced by less than two brokers/dealers.

The level of liquid investments required largely depends on the cash flow needs of the local government; however it is recommended that investments held are highly liquid. Generally, an investment policy should articulate an illiquid securities limit of a maximum of 20 per cent for a conservative portfolio.

Criteria for the selection of broker/dealers and direct issuers

An investment policy should establish clear criteria for the appointment of brokers/dealers, or alternatively designate a list of acceptable securities dealers.

Council should also approve a process (which includes a requirement for obtaining references) to investigate and approve new brokers.

Selection criteria may include credit rating, market capitalisation, and capability to execute transactions. As a guide, a minimum credit rating of A+ should be expected of broker counterparties, along with the provision of annual audited financial statements and securities dealer certification. Brokers may be further required to certify that they have an understanding of the investment requirements of the SBFA Act.

Appointment of fund managers

The appointment of a fund manager by a local government requires specific approval from the Treasurer under Part 7, Division 2 of the SBFA Act.

Prior to seeking approval, Council should be satisfied that the person is suitable to manage the investment of its funds. Accordingly, the submission for approval should be based on a robust and defensible assessment process performed either by Council or an independent third party on Council’s behalf.

Bond Mutual (or Cash Plus) Funds

Bond mutual funds are structured investment unit trusts which act as an intermediary between investors and the capital market providers of cash and fixed interest securities. Bond mutual funds are often named ‘cash plus’ funds.

Local governments may not invest in bond mutual or cash plus funds using the investment powers conferred under Part 6 of the SBFA Act. The Treasurer’s specific approval to invest in such products is required under Part 7A (type 2 financial arrangements).

However on 1 September 2005, the Treasurer approved a framework for local governments to invest in Bond Mutual (or Cash Plus) Funds. The following terms and conditions apply to all investments in Bond Mutual Funds:

- The investment policy of a local government is to restrict the amount of funds invested in this category to a maximum of 50 per cent of total cash available for investment.
- The local government is to provide to DILGP a quarterly report showing the realised rate of return on investments in this category for the quarter and 12 months to date.
- The local government must provide to DILGP and to Queensland Treasury and Trade a quarterly report confirming that the investment funds used by the local government have complied with the following conditions:
  - the modified duration (average weighted days to maturity) of the fund has not exceeded three years;

- the fund must maintain a credit rating of AAf[10] or above, assigned to it by Standard & Poor's; and
- the local government and Queensland Treasury and Trade and must be notified in writing by the fund manager of any non-compliance.

In approving the framework, the Treasurer delegated the power to grant approvals to the Director-General of DILGP. However, the Treasurer retains the power to grant, amend or revoke approvals for investment by local governments in Bond Mutual Funds.

Please note that the above is an approved framework only. Local governments are still required to seek approval under the SBFA Act before entering into any investment in Bond Mutual funds.

[10] To differentiate bond mutual or cash plus fund ratings from conventional debt ratings and other types of fund ratings, Standard & Poor's adds an 'f' subscript. A bond mutual or cash plus fund's credit quality rating is based on an assessment of the protection its portfolio provides against default risk, which is derived from Standard & Poor's historical default and ratings transitions rates.

6. Valuation of investments for management reporting

The aim of this chapter is to provide guidance on the valuation of investments for management reporting purposes.

Valuation of investments for a local government's general purpose financial statements must be conducted in accordance with the applicable Australian Accounting Standards.[11]

Reporting portfolio values

Reporting may be done at an aggregate or individual security level.

The purpose of reporting at an aggregate level is to retain the focus of the local government on total performance issues. For monthly reporting, it is acceptable to report at an aggregate portfolio market value level with individual security information available on request. This should be sufficient to satisfy the governance requirements of the local government.

By listing all securities held, a more complete picture of the financial health of a portfolio is provided and any adverse performance will be highlighted more quickly. However these benefits may be offset by increased micro-management of decisions by the investment officers.

Recording market value

An investment policy should prescribe independent third party valuation of investments on a regular basis. For local governments with significant investment portfolios, the most common approach is to request pricing information from its custodial service trustee.

Alternatively, the value of securities may be established by in-house analysis. This may include sources such as financial institution/dealer quotes, computer feeds, and publications that include price estimates. Although there may be a degree of inaccuracy, these sources offer a relatively inexpensive method to establish price estimates.

The best available source of pricing information should be obtained having regard to the local government's budget, systems, and resource requirements.

[11] Available on the Australian Accounting Standards Board website: http://www.aasb.gov.au/Pronouncements/Current-standards.aspx

Par value versus market value

Using par value or cost value should only be considered for highly rated, thinly traded securities within six months of maturity, and where reliable market estimates are not available.

7. Acceptable portfolio activities

Acceptable portfolio activities establish the conditions for a local government to buy and sell securities. As noted in the Section 'Passive investment management' of these Guidelines, it is recommended that local governments should buy with the aim of holding to maturity i.e. take a passive investment management approach.

Compliance with the SBFA Act and SBFA Regulation must always be considered.

Buying and selling securities

Buying and selling securities may apply to local governments with Category 2 or Category 3 investment powers.

An investment policy should outline the circumstances when a local government may buy or sell securities. This may be to improve returns, marketability and quality or to realign the portfolio's composition relative to an established benchmark.

Settlement

Settlement of securities is a core function of investment management. The purpose of a settlement process is to ensure that transactions are settled on the due date and the local government does not incur losses because a settlement is not made on time.

A local government must ensure that it has the necessary resources and systems, as well as an appropriate control framework and measures, to minimise the risk of losses (either monetary or reputation) occurring due to settlement failure.

Voting

Voting may apply to local governments with Category 2 or Category 3 investment powers.

Protocols regarding voting rights attached to investments may be considered in an investment policy. The premise for this is that any instance of poor governance may result in an erosion of capital value for particular investments. The following guiding principles may be applied:

- voting to be undertaken by the CFO;
- a vote either 'for' or 'against' can be made, except where there is a conflict of interest;
- the local government may recommend the standard of corporate governance to be applied to votes;
- voting activity should be carefully monitored and overridden by the CEO if necessary; and
- the local government retains the ultimate responsibility for voting decisions.

Investment records

Section 48 of the SBFA Act requires that a security, safe custody acknowledgement or other document evidencing the investment arrangement must be held by the local government. Where evidence of title is to be in another form, the Treasurer's approval is required.

An investment policy should detail how investment officers and management are to account for securities, and it should include a list of safekeeping locations. It is recommended that the number of acceptable record keeping institutions/safekeeping locations be limited so as to provide ready accessibility of documents.

Unacceptable portfolio activities

An investment policy should specifically exclude speculative activities or related party transactions that could compromise the integrity of the local government and/or the investment portfolio.

8. Glossary

At call	Refers to simple investments where the investment can be redeemed within 30 days without penalty. It does not contemplate the trade of investments such as floating rate notes and bonds in the secondary securities market. *Refer also to the definition of "at call" in the SBFA Act.*
Bank bill	A non-interest bearing security issued by a bank, whereby the bank takes on an obligation to pay the investor a fixed amount (face value) at a fixed future date. It is sold to an investor at a discount to the face value. Bank Bills are short-term money market investments with maturities usually between 30 days and 180 days.
Benchmark	A predetermined set of securities, based on published indices or customised for an investment strategy, used for performance comparisons.
Broker	The financial intermediary between a buyer and seller.
Conflicts of interest	Conflict between an investment officer's personal interest and the interest of the local government that might lead to a decision that is contrary to the local government interest, or where the investment officer's private interests may benefit from decisions or actions that they are entrusted to take on behalf of the local government.
Counterparty	The other individual or institution to an agreement or contract.
Credit quality/risk	The risk of loss due to the failure of the issuer or insurer of a security/investment to meet its financial obligations in a timely manner.
Dealer	An entity acting as a principal in a securities transaction that trades for its own account and risk.
Derivative	A derivative transaction is a financial contract that derives its value from an underlying asset, commodity, liability or index. Examples include forward agreements, futures, options, and swaps. *Refer also to the definition of "derivative transactions" in the SBFA Act.*
Direct issuer	A company that sells commercial paper or other debt directly to investors, rather than through brokers.
Financial institution	An authorised deposit-taking institution within the meaning of the *Banking Act 1959 (Commonwealth)*.

First to Default Note	A structured instrument that provides a return for taking risk on a set basket of reference credits/entities. If any credit in this basket experiences a credit event (e.g. failure to repay, restructure, bankruptcy), the notes are redeemed and the owner of the note is delivered with the defaulted entity's bonds. A credit event will result in a loss of capital for the note holders.
Investment arrangements	Defined by the SBFA Act as securities, investments and other similar arrangements including bills of exchange, bonds, certificates of deposits and promissory notes.
Investment portfolio	A collection of investments.
Market risk	The risk that the value of an investment will decrease due to movements in market factors such as interest rates, foreign exchange rates, equity prices and commodity prices.
Mortgage-backed security	A structured instrument where the cash flows are supported by the principal and interest repayments of mortgaged loans.
Par value	The maturity value or face value of a security that an issuer agrees to pay on maturity. Typically $100 per security.
Preservation of capital	An investment strategy with the primary goal of preventing losses in an investment's total value. In modern portfolio theory terms, it refers to a guaranteed investment of principal that would provide a return of at least inflation.
Private Placement	The sale of a debt investment to one buyer or a few buyers, as opposed to offering the security to the public through a group of dealers. This also refers to direct placement.
Prudent person standard	A legal standard restricting the investing and managing of a client's account to what a prudent person seeking reasonable income and preservation of capital might exercise for his or her own investment.
Secondary market	A market in which securities transactions are carried out between investors without involving the issuer.
Securitised product	A financial instrument referencing an underlying pool of financial assets. The pool of assets is tiered and the respective tiers are marketed to investors. For example, residential mortgage-backed securities are a securitised product that combines a pool of mortgages, which the issuer divides into smaller investment offerings for investors.
Structured product	A type of investment specifically designed to meet an investor's financial needs by customising the product mix to adhere to the investor's risk tolerance. Structured products are generally created by varying the amount of exposure to risky investments and often include the use of various derivatives.

Split rating	A difference in rating by two or more ratings agencies for the same security or counterparty.
Yield	The annual rate of return on an investment.

APPENDIX A: Model investment policy for category 1 investors

The following model investment policy is provided to assist local governments in preparing their own investment policy document.

It should be noted that the model investment policy has been drafted to incorporate specific investment products and parameters appropriate to local governments with Category 1 investment power under the SBFA Act.

This model investment policy is intended as a guide only, and should be amended to reflect the relevant category of investment power, as well as the expectations, objectives and risk appetite of the individual local government.

XYZ Local Government

Investment Policy

1. Overview

1.1 Preamble

[XYZ local government] (Council) has been granted authority to exercise Category 1 investment power under Part 6 of the *Statutory Bodies Financial Arrangement Act 1982* (SBFA Act).

The Treasurer may from time to time constrain the investing activities of local governments by limitation, caveat, restriction and/or other relevant regulation. Where this occurs, this Investment Policy (the Policy) will be reviewed and reissued to reflect such changes.

1.2 Intent

The intent of this document is to outline Council's investment policy and guidelines regarding the investment of surplus funds, with the objectives to maximise earnings within approved risk guidelines and to ensure the security of funds.

The activities of the investment officers or fund managers responsible for stewardship of Council's funds will be measured against the standards and objectives outlined in the Policy.

1.3 Scope

For the purpose of the Policy, investments are defined as arrangements that are undertaken or acquired with the expectation of achieving a financial return through interest, profit or capital growth.

The Policy applies to the investment of all surplus funds held by Council.

Amounts of less than $5 million are to be invested in a capital guaranteed cash fund or an approved cash management product. Category 1 investment power allows for investment at call or for a fixed term up to one year in the Queensland Treasury Corporation (QTC) Capital Guaranteed Cash Fund or the Queensland Investment Corporation (QIC) Cash Fund without further approval.

2. Policy Statement

2.1 Authority

All investments are to be made in accordance with:
Statutory Bodies Financial Arrangements Act 1982
Statutory Bodies Financial Arrangements Regulation 2007
Local Government Act 2009
Local Government Regulation 2012

2.2 Ethics and conflicts of interest

2.2.1 Prudent Person Standard

Prudence is to be used by investment officers when managing the investment portfolio. Investments will be managed with the care, diligence and skill that a prudent person would exercise in managing the affairs of other persons. This includes having in place appropriate reporting requirements that ensure the investments are reviewed regularly.

Investment officers are to manage the investment portfolio in accordance with the spirit of the Policy, and not for speculation. Investment officers are to avoid any transaction that might harm confidence in Council. They will consider the security of capital and income objectives when making an investment decision.

2.2.2 Ethics and conflicts of interest

Investment officers shall refrain from personal activities that conflict with the proper execution and management of Council's investment portfolio. This includes activities that impair the investment officer's ability to make impartial decisions.

The Policy requires that investment officers disclose to the Chief Executive Officer (CEO) any conflict of interest or any holding of investment positions that could be related to the investment portfolio.

2.2.3 Delegation of authority

Authority for the implementation of the Policy is delegated by Council to the CEO in accordance with section 257(1)(b) of the *Local Government Act 2009*.

Authority for the day-to-day management of Council's investment portfolio is delegated by the CEO to the Chief Financial Officer (CFO).

2.3 Investment objectives

Council's overall objective is to invest its surplus funds at the most advantageous rate of interest available at the time, and in a way that it considers most appropriate given the circumstances.

In order of priority, the objectives of undertaking investment activities shall be preservation of capital, maintenance of liquidity, and return on investments.

2.3.1 Preservation of capital

Preservation of capital shall be the principal objective of the investment portfolio, and investments are to be undertaken in a manner that seeks to ensure security of principal of the overall portfolio. This includes managing credit risk and interest rate risk within given risk management parameters and avoiding any transactions that would prejudice confidence in Council.

Credit risk

Council will evaluate and assess credit risk prior to undertaking an investment. Credit risk is the risk of loss due to the failure of an investment issuer or insurer. The investment officer will minimise credit risk by pre-qualifying all transactions and the brokers/securities dealers with whom they do business, diversifying the investment portfolio and limiting transactions to secure investments.

Interest rate risk

The investment officers shall seek to minimise the risk of a change in the market value of the investment portfolio due to a change in interest rates, by considering the cash flow requirements of Council and structuring the portfolio accordingly. This will avoid the need to sell securities prior to maturity in the open market. Interest rate risk can also be limited by investing in shorter term securities.

2.3.2 Maintenance of liquidity

Pursuant to section 31 of the SBFA Act, Council maintains a deposit and withdrawal account with XYZ Bank for its day-to-day operating transaction requirements.

In addition to the balances held in its bank account, the investment portfolio will maintain sufficient liquidity to meet all reasonably anticipated operating cash flow requirements of Council as and when they fall due, without incurring significant transaction costs due to any need to sell an investment.

Illiquid investments are defined as investments that are not publicly traded in sufficient volume to facilitate, under most market conditions, prompt sale without severe market price effect. Examples include:

- investment in private placements;
- a security that is not supported or priced by at least two approved brokers or securities dealers;
- sub investment grade securities i.e. a lower than rating BBB- (Standard & Poor’s) or equivalent; and
- unrated securities.

2.3.3 Return on investments

The investment portfolio is expected Return on investments to achieve a market average rate of return, taking into account Council’s risk tolerance, current interest rates, budget considerations, and the economic cycle. Any additional return target set by Council will also consider the risk limitations, prudent investment principles and cash flow characteristics identified within the Policy.

[Council should choose either A or B below]

A:
Council should ensure it achieves value for money or a competitive price after considering the costs of the investment.

B:
For performance purposes, the investment portfolio will be market valued and benchmarked against the UBS Australia Bank Bill Index[12] (UBS Index) over a rolling one-year period. The benchmark target is to be set equal to or above the UBS Index.

2.4 Portfolio implementation

2.4.1 Authorised personnel

The CFO is authorised to invest Council's surplus funds in investments that are consistent with the Policy and relevant legislation.

The CFO will report to Council's Finance Committee, which will provide the investment guidelines and approved lists for the purposes of the Policy.

2.4.2 Investment Oversight Committee

To ensure an appropriate separation of duties, the CEO will establish an Investment Oversight Committee, which will be responsible to the Finance Committee.

The Investment Oversight Committee will function as an advisory committee to Council, and its purpose is to:

- oversee the development of and updates to the Policy and recommend any such changes for approval to Council;
- monitor compliance with the Policy and the SBFA Act; and
- review the monthly and quarterly investment reports to Council.

The investment guidelines set by the Finance Committee may be more conservative than the Policy; however the guidelines cannot override the Policy.

An officer that does not have authority for the execution of investment transactions (e.g. the Financial Accountant) will provide compliance and investment analysis to the Investment Oversight Committee.

The Investment Oversight Committee is not permitted to direct daily investment decisions, select fund managers, or become involved in the daily operations of the investment portfolio. Its role is to review and refer investment decisions to Council if required.

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[12] The UBS Australia Bank Bill Index is constructed as a benchmark to represent the performance of a passively managed short-term money market portfolio. It comprises 13 Bank Bills of equal face value, each with a maturity seven days apart. The average term to maturity is approximately 45 days.

2.4.3 Internal controls

The CFO shall establish internal controls and processes that will ensure investment objectives are met, and that the investment portfolio is protected from loss, theft or misuse.

The internal controls will address the following:

- collusion;
- separation of transaction authority from accounting and record keeping;
- safekeeping of records;
- avoidance of physical delivery of securities;
- clear delegation of authority to investment officers;
- confirmation requirements for the settlement of securities;
- compliance and oversight of investment parameters; and
- reporting of breaches of the Policy.

The established processes will include monthly and quarterly reporting (including compliance reporting), as well as an annual review of the Policy.

The Investment Oversight Committee shall conduct an annual audit of the activities of the investment portfolio to verify compliance with the Policy and relevant legislation. A copy of the audit report is to be provided to Council, the CEO, and the Audit Committee.

2.5 Investment parameters

2.5.1 Investable funds

For the purposes of the Policy, investable funds are the surplus funds available for investment at any one time, including Council's bank account balance. However, the Policy does not apply to monies held on trust for third parties where those funds are subject to specific conditions.

The investable funds should match the cash flow needs of Council, as determined by the CFO after preparing Council's budget. In this regard, it is appropriate for the CFO to be conservative so that where possible, investments should not be broken to meet cash flow obligations.

It is the responsibility of the CFO to assess the cost of direct investment management by Council relative to the return generated. This should be compared with the cost of investing funds with a capital guaranteed cash fund, such as the QTC Capital Guaranteed Cash Fund.

2.5.2 Authorised investments

Investments are limited to those prescribed by Part 6 of the SBFA Act for local governments with Category 1 investment power, which include:

- interest bearing deposits;
- commercial paper;
- bank accepted/endorsed bank bills;

- bank negotiable certificates of deposit;
- short term bonds;
- floating rate notes;
- QIC Cash Fund; and
- QTC Capital Guaranteed Cash Fund, Debt Offset Facility, Fixed Rate Deposit and Working Capital Facility.

All investments will be either at call or for a fixed term of no more than one year.

2.5.3 Prohibited investments

The Policy prohibits any investment carried out for speculative purposes. The Finance Committee may include a prohibited investments list within the investment guidelines and approved lists (established pursuant to section 2.4.1 of the Policy).

The following investments are prohibited:

- derivative based instruments (excluding floating rate notes);
- securitised debt instruments;
- structured products;
- principal only investments or securities that provide potentially nil or negative cash flow;
- stand-alone securities that have underlying futures, options, forward contracts and swaps of any kind; and
- securities issued in non-Australian dollars.

2.5.4 Portfolio investment parameters and credit requirements

The following table shows the credit ratings and counterparty limits for Council, as a percentage of the market value of the investment portfolio:

Short Term Rating (S&P's)	***Individual Counterparty Limit***	***Total Limit***
A1+	30%	100%
A1	15%	50%
A2 (Financial Institutions only)	10%	30%
A3 (Financial Institutions only)	5%	10%
Unrated	Nil	Nil
QIC/QTC Cash Funds	100%	100%

A maximum of 20 per cent of the investment portfolio is to be invested in Floating Rate Notes.

2.5.5 Maturity

The maturity structure of the investment portfolio will reflect a maximum term to maturity of one year and include an interest rate reset of no longer than six months (185 days).

2.5.6 Liquidity requirement

Given the nature of the funds invested, a maximum of 20 per cent of the investment portfolio will be held in illiquid securities, and at least 10 per cent of the portfolio will be held in investments that can be called at no cost or that will mature within 7 days.

2.5.7 Approved lists

The Finance Committee shall prepare and maintain the following approved counterparty lists for the investment of surplus funds:

- banks;
- commercial paper and medium term note issuers;
- brokers/dealers and direct issuers for purchase or sale of security with a minimum Standard & Poor’s long-term credit rating of A+ (or equivalent), and
- credit unions.

2.5.8 New investment products

A new investment product requires a full risk assessment by the Finance Committee and approval by Council.

2.5.9 Breaches

Any breach of the Policy is to be reported to the CEO and CFO, and rectified within 24 hours of the breach occurring. The Investment Oversight Committee will report the breach to Council at the next meeting.

Where Council holds an investment arrangement that is downgraded below the minimum acceptable rating level as prescribed under regulation, Council shall within 28 days after the change becomes known, either obtain the Treasurer’s approval for continuing with the investment arrangement, or sell/redeem/withdraw the investment arrangement.

2.5.10 Safekeeping of records

Each transaction will require written confirmation by the broker/dealer/bank. Council will hold all security documents, or alternatively a third party custodian authorised by the CFO may hold security documents.

2.5.11 Authorised dealers and brokers

The Finance Committee will maintain a list of authorised financial institutions and securities brokers with whom the investment officers may deal with. These financial intermediaries must have a minimum long-term rating of at least either A+ (Standard & Poor’s), A1 (Moody’s), or A+ (Fitch).

All transactions undertaken on behalf of the investment portfolio will be executed either by Council directly, or through securities brokers registered as Australian Financial Service Licensees with an established sales presence in Australia, or issuers that directly issue their own securities which are on Council’s approved list of brokers/dealers and direct issuers.

2.6 Investment Guidelines

Pursuant to section 2.4.1 of the Policy, the Finance Committee may reduce the maturity limits as set out in the Policy or prescribe higher ratings through the investment guidelines and approved lists.

The Finance Committee may approve limits for unrated securities after being satisfied that adequate analysis has been performed to demonstrate above average credit quality.

The following table provides short-term rating equivalents:

Grade	***S&P***	***Moody's***	***Fitch***
Superior	A1+ A1	P-1	F1+ F1
Strong	A2	P-2	F2
Acceptable	A3	P-3	F3

The Treasurer's approval is required for long-term investments (i.e. with a maturity of greater than 12 months), as these investments fall outside Council's Category 1 investment power. Council's approval is required prior to any application being submitted to the Treasurer.

The following table provides long-term rating equivalents:

Grade	***S&P***	***Moody's***	***Fitch***
Highest Quality	AAA	Aaa	AAA
High Quality	AA+ AA AA-	Aa1 Aa2 Aa3	AA+ AA AA-
Above Average Quality	A+ A A-	A1 A2 A3	A+ A A-
Average Quality	BBB+ BBB BBB-	Baa1 Baa2 Baa3	BBB+ BBB BBB-
Speculative	BB+ BB BB-	B1 B2 B3	BB+ BB BB-
Poor	CCC+ CCC CCC- CC	Caa Ca C	CCC CC
Default	D		DDD DD D

3. Reporting

3.1 Reporting

The CFO will prepare a monthly evaluation and report of the transactions, concentrations, and performance of the investment portfolio. The report is to be provided to the Investment Oversight Committee within 10 days of the end of the reporting period, and will include:

- a list of securities held by maturity date/call date;
- the weighted average yield to maturity;
- percentage held by investment type; and
- the performance of the investment portfolio relative to the UBS Index benchmark.

On a quarterly basis, the CFO will provide to the Investment Oversight Committee and Council a detailed report on the investment portfolio, including a statement of compliance with the SBFA Act. The report is to list securities held by issue name, maturity date, par value, and dollar amount invested.

3.2 Performance measurement

The return for the investment portfolio shall be measured using the market value of the portfolio (which will include changes in the capital value of assets held, income from managed investment portfolio assets, proceeds of sales of assets sold, and cost of assets acquired), and the total performance of the portfolio compared to the UBS Index.

The market value of the portfolio is to be calculated at least monthly to coincide with monthly reporting. In defining market value, at least two pricing sources should be included in the valuation of the securities.

APPENDIX B: Investment policy checklist

The following check list sets out key items for consideration by local government officers who are responsible for preparing the investment policy document. This check list should be viewed as a guide to the structure of the policy, with additional subjects to be included as required.

1. Scope/Intent
2. Governing Authority
3. Standards of Care
4. Statement of Purpose
5. Investment Objectives
6. Roles and Responsibilities/Implementation
7. Investment Parameters
8. Reporting and Performance Monitoring
9. Record Keeping and Custody
10. Internal Controls

APPENDIX C: Ratings based approach to setting credit limits

A ratings based approach is used to increase the credit quality of counterparties. An investment policy may use the following key elements of this approach:

- utilising Standard & Poor's, Moody's, and Fitch as the primary sources of ratings information.
- setting the maximum or minimum level of exposure to be applied by ratings category, for example:

  A+ rated entities and lower, a maximum exposure limit

  AA rated entities and lower, a maximum exposure limit

  AAA rated entities and lower, a maximum exposure limit

  or

  A+ rated entities and higher, a minimum exposure limit or

  AA- rated entities and higher, a minimum exposure limit
- setting a maximum percentage limit and a maximum term limit for each counterparty. Approval must be obtained if an investment exceeds the maximum allowable limit or term for that rated counterparty.
- setting limits for country exposures in relation to managed funds.
- revising an exposure to conform with the investment policy parameters where a counterparty is placed on a negative ratings watch, or if there is a rating downgrade. A change in the outlook of a credit rating is a strong indicator that the underlying credit risks of the counterparty will change in the near term.

Typically, a conservative investor would hold at least 95 per cent of the market value of the investment portfolio in approved securities at all times. Cash positions for the remainder of the portfolio should be employed only for facilitating transactions from one active position to another.

APPENDIX D: Other considerations

Duration limits

An investment portfolio's exposure to interest rates is mostly as a result of its duration. Depending on the sophistication of the investor, a target duration may be either a constant (e.g. 3 years), or is equal to the duration of a benchmark chosen by Council.

Once the target duration is established, a range around the target duration is set and the portfolio's actual duration must be maintained within this range. Typically, the range around the target duration is between 0.5 and 1 year.

Sector and security quality

Maximum and minimum sector and security weightings are applied to ensure adequate diversification. Sector weightings are usually considered relative to a benchmark or consistent with the composition of the market. Issuer limits are set by considering the appetite of Council for maximum impact of a potential default in their funds.

Explanation of credit ratings

A credit rating is the current opinion of the credit worthiness of an individual counterparty generally expressed in terms of default risk. It is not a recommendation to buy or sell a security, and independent analysis should be undertaken with regard to the return or suitability for a local government's investment portfolio.

Long-term and short-term credit ratings

A credit rating can be either short-term or long-term. The difference between short and long-term depends on the relevant market. In Australia, a short-term rating is assigned to investments with an original maturity of no more than 365 days. Conversely, a long-term rating is greater than 365 days.

The table below details the three major ratings agencies' credit ratings for short and long-term investments. It includes a grade explanation for each credit rating.

SHORT TERM DEBT

Grade	Moody's	S&P	Fitch
Superior	P-1	A1+ A1	F1+ F1
Strong	P-2	A2	F2
Acceptable	P-3	A3	F3

LONG TERM DEBT

Grade	Moody's	S&P	Fitch
Highest Quality	Aaa	AAA	AAA
High Quality	Aa1 Aa2 Aa3	AA+ AA AA-	AA+ AA AA-
Above Average Quality	A1 A2 A3	A+ A A-	A+ A A-
Average Quality	Baa1 Baa2 Baa3	BBB+ BBB BBB-	BBB+ BBB BBB-
Speculative	B1 B2 B3	BB+ BB BB-	BB+ BB BB-
Poor	Caa Ca C	CCC+ CCC CCC- CC	CCC CC
Default	-	D	DDD DD D

Principal stability ratings

The prescribed ratings in section 8 of the SBFA Regulation include AAAm and AAm. These ratings refer to the principal stability of a fund, and are also known as a money market or cash fund rating. This is not a specific credit rating/default rating but rather an assessment by Standard & Poor's of the ability of a fund to maintain a stable principal or net asset value. It is a reflection of the creditworthiness of the investments held, liquidity, market price exposure, and management capability (including policies adopted by the manager).

Funds achieving the AAAm Principal Stability Fund Rating have to satisfy the following robust criteria:

- underlying investments must have the highest ratings from Standard & Poor's (minimum 50% short-term rating of A1+ and the remainder A1);
- the fund must have a very low sensitivity to interest rate risks with a weighted average maturity limited to a maximum of 60 days; and
- detailed information on the fund's holdings must be submitted every week to Standard & Poor's dedicated surveillance analysts.

Standard & Poor's defines the AAAm and AAm ratings as:

AAAm Fund: Provides extremely strong capacity to maintain principal stability and to limit exposure to principal losses due to credit, market, and/or liquidity risks.

AAm Fund: Provides very strong capacity to maintain principal value and to limit exposure to principal losses due to credit, market, and/or liquidity risks.

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