PERFORMANCE AND GOVERNANCE COMMITTEE – 15 NOVEMBER 2011

INVESTMENT STRATEGY UPDATE

Report of the: Deputy Chief Executive & Director of Corporate Resources

Status: For consideration

Executive Summary: Members approved the Investment Strategy as part of the budget-setting process in December 2010. In considering that Strategy Members were advised that, given the current economic climate, the Strategy would need to be monitored and reviewed, where necessary, during the year.

This report gives details of recent developments in the financial markets and changes to credit ratings.

This report was considered by the Finance Advisory Group on 2nd November 2011 and their views will be fed back to this Committee.

This report supports the Key Aim of effective management of Council resources.

Portfolio Holder Cllr. B. Ramsay

Head of Service Head of Finance and Human Resources – Mrs. Tricia Marshall

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Recommendation: That the report and Members views be noted.

General Background

1 The Council aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The Council approved the current Investment Strategy for 2011/12 at the Council meeting on 16 December 2010.

2 Credit ratings form the basis of investment decisions and the matrix supplied by the Council's treasury advisers, Sector Treasury Services Ltd (Sector), encapsulates credit rating data to provide suggested counterparties and maturity limits.

Economic Background

<u>Global Economy</u>

3 Over the last few months the Euro zone sovereign debt crisis has continued with Spain, and particularly Italy, being the focus of renewed market concerns that they may soon join with Greece, Ireland and Portugal in needing assistance. This uncertainty and the lack of a co-ordinated or credible Euro zone response, left commentators concerned over the potential impact of sovereign default and resulting effect on the Euro zone banking sector. The approval by various countries of the €440bn bail out fund in September has

brought temporary relief to financial markets but this does not provide a credible remedy to the scale of the Greek debt problem or the sheer magnitude of the potential needs of other countries for support.

4 This, coupled with political difficulties in the US over their plans to address the budget deficit, the size and control over the US sovereign debt, and the subsequent loss of the AAA credit rating from Standard and Poor's, has led to a much more difficult and uncertain outlook for the world economy. Growth prospects in the US, UK and the Euro zone have been lower than expected, with future prospects similarly cut. Whilst not a central view, concerns of a double dip recession in some Western countries have increased. World stock markets fell in the second quarter of 2011/12 as a consequence.

UK Economy

5 Following zero growth in the final half of 2010/11 the UK economy grew by a weaker than expected 0.1% in the first quarter of 2011/12, providing a knock on effect to future growth prospects. Growth prospects will be governed by UK consumer sentiment, which is currently subdued due to falling disposable income. Higher VAT, overhanging debt, high inflation and concerns over employment are likely to weigh heavily on consumers into the future.

6 The announcement by the Bank of England's Monetary Policy Committee (MPC) on 6 October 2011 of a second round of quantitative easing (QE) of £75bn emphasised how seriously the MPC now views recession as being a much bigger concern than inflation. Although inflation remains stubbornly high, the MPC's expectation of future falls resulting in an undershoot of its 2% target opened the way for this new round of QE.

7 International investors continue to view UK government gilts as being a safe haven from the EU sovereign debt crisis. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and sent PWLB borrowing rates to low levels.

Outlook for the next six months of 2011/12

8 There remain huge uncertainties in economic forecasts due to the following major difficulties:

- the increase in risk that the UK, US and EU could fall into recession
- the likely political gridlock in the US preventing significant government fiscal action to boost growth ahead of the Presidential elections in November 2012
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economies
- the degree to which government austerity programmes will dampen economic growth;

- the potential for further QE, and the timing of this in both the UK and US
- the speed of recovery of banks' profitability and balance sheet imbalances and the risk of substantial losses being incurred on EU sovereign debt.

9 The overall balance of risks is weighted to the downside:

- The expectation is for low growth in the UK to continue, with a low Bank Rate to continue for at least 24 months, coupled with a possible further extension of QE. This will keep investment returns depressed.
- The expected longer run trend for PWLB borrowing rates is for them to rise, primarily due to the need for a high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. However the current safe haven status of the UK may continue for some time, postponing any increases until 2012.

Credit Rating Issues

10 As a result of the recent economic and financial market developments, our treasury management consultants, Sector Treasury Services, are stressing the importance of a cautionary investment stance. They have suggested that duration limits are temporarily restricted to a maximum of 3 months and this advice has been followed over the last few months.

11 This limit applies to all entities on the suggested Sector Credit Ratings List with the following exceptions:

a) UK Government and related entities such as Local Authorities. Their suggested duration limit will remain at 5yrs.

b) UK semi-nationalised institutions (Lloyds / RBS). The current significant UK government ownership of these entities is seen as providing significant comfort to investors.

c) Money Market Funds.

12 The above temporary changes are not a significant change of view, but aimed to stress the need for caution when making new investments. It is believed that current market uncertainty warrants this revision and it is hoped that if Euro zone governments formally agree to extend their support mechanisms then some of the excessive risk indicator movements that have been seen in recent weeks will be reversed. However, until market circumstances begin to stabilise then Sector believe that such a prudent investment approach should be taken.

13 However, Sector have stressed that they do not believe clients should be unduly worried about prior investment decisions, rather that by restricting new investments to the above limits client portfolios will be allowed to lower risk

naturally as investments mature. This should not require a change of the formal investment strategy, merely an operational restriction of that strategy.

14 More recently, a raft of downgradings have been announced by the Ratings Agencies both to sovereign and individual bank ratings. A number of UK institutions as well as Spanish and Italian ones have been affected.

Future Investment Options

15 Members will be aware that our list of potential counterparties has shrunk over the last few years, such that increases to individual lending limits were required in order to provide sufficient opportunity to place investments.

16 With the potential for removal of more institutions should global conditions worsen, an alternative approach may need to be considered. The questions that need to be addressed are:

a) Are we comfortable with the current counterparties on our lending list and the cash limits applying to them?

b) If not, or if conditions worsen, should a move to more secure investments such as lending to the Debt Management Office's Account Deposit Facility or opening of Money Market Funds be considered?

17 Members' views on these issues are sought. Details of the up to date investment portfolio and current lending list are attached at Appendix A and B.

Key Implications

Financial implications

18 The management of the Council's investment portfolio and cash-flow generated balances plays an important part in the financial planning of the authority with interest receipts in the order of £186k supporting the revenue budget for 2011/12. The security of its capital and liquidity of its investments is of paramount importance. Restricting the number of counterparties for deposits increases the risk of not achieving the interest receipts budget for 2011/12.

Legal, Human Rights etc.

19 None.

Impact on and Outcomes for the Community

20 Investment income is used to support the revenue budget, providing funding for Council services that would otherwise have to be met from higher fees and charges or by service reductions.

Risk Assessment Statement

21 Treasury management has two main risks:-

a) Fluctuations in interest rates can result in a reduction in income from investments; and

b) a counterparty to which the Council has lent money fails to repay the loan at the required time.

Consideration of risk is integral in the Council's approach to treasury management.

22 The movement towards having a restricted lending list of better quality institutions but higher individual limits with those institutions reduces the chances of a default. But if a default did occur, the potential loss would be greater. Previously, the preference was to have smaller investments with a greater range of institutions.

23 These risks are mitigated by the annual investment strategy which has been prepared on the basis of achieving the optimum return on investments commensurate with proper levels of security and liquidity. However, Members should recognise that in the current economic climate, these remain significant risks and that the strategy needs to be constantly monitored.

Sources of Information: Annual Investment Strategy report (Council 16 December 2010, Cabinet 13 December 2010, Performance and Governance Committee 16 November 2010)

CIPFA Code of Practice on Treasury Management in the Public Services (2009)

Sector Treasury Services Ltd. - economic updates, monthly investment reports and credit rating lists

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