**COUNCIL – 16 DECEMBER 2010**

# INVESTMENT STRATEGY UPDATE

| | |
|---|---|
| Report of the: | Deputy Chief Executive & Director of Corporate Resources |
| Also considered by: | Finance Advisory Group – 21 July 2010<br>Performance and Governance Committee – 7 September 2010<br>Cabinet – 30 September 2010 |
| Status: | For decision |

**Executive Summary:** Members approved the Investment Strategy as part of the budget-setting process in February 2010. In considering that Strategy Members were advised that, given the current uncertainties in the financial sector, it may be necessary to review the Strategy during the year.

This report follows up on recent developments in the markets and changes to credit ratings. It also gives an update on treasury activity in the first quarter of the current financial year.

Members are asked to reaffirm, or otherwise, the current strategy in the light of issues raised in the report and consider possible alternative options for investment, where appropriate.

This report has been considered by the Finance Advisory Group (paragraphs 27 and 28) and they considered that, given the limited number of institutions to which the Council could lend, they were not adverse to increasing the lending limit for individual institutions to £5 million. Under this proposal the Group limit would also be £5 million.

This view was supported by the Performance and Governance Committee (paragraphs 29 to 33) with the suggestion that limits should also be applied to monies in call accounts.

**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

**Recommendations:** It be RESOLVED that

a) the update on treasury activity in the first quarter of 2010/11 be noted;

b) it be recommended to Council that the lending limit for individual institutions meeting the Council's lending criteria be increased to £6m with a limit of £6m across all institutions within a group of companies and that these limits should apply to call accounts as well as to fixed term investments;

c) the maximum length of an investment be confirmed at one year, where permitted by the Council's lending criteria; and

d) It be recommended to Council that the existing restriction of not lending more than 15% of the total fund to any one counterparty or counterparties within a group of companies be changed to 25% (at the time of placing the investment).

## 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 2010/11 at the Council meeting on 23 February 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.

3 Changes to the treasury management reporting regime brought about by the revised CIPFA Code of Practice on Treasury Management in the Public Services mean that regular reports should be presented to Members to enable them to have an informed view of the Council's treasury operation.

## Economic Background

4 The first quarter of 2010/11 saw:

- The new coalition government enact a fiscal squeeze set to be the most severe since the end of the 1930's, through its Emergency Budget on the 22 June;
- Activity indicators suggest that the recovery picked up a little pace in the first quarter;
- High street spending recovered after a weak start to the year;
- The labour market showed some tentative signs of improvement;
- The UK's trade position deteriorated, despite the weak pound;
- The broad measure of CPI inflation remained above target, however the measure of underlying inflation fell (when the volatile components of energy, food, alcohol and tobacco are excluded from the calculation);

- The Bank of England's Monetary Policy Committee (MPC) maintained Quantitative Easing (QE) and kept Bank Rate on hold at 0.5%;

- The equity rally went into reverse over concerns about the shape of the global recovery;

- The recovery in the US remains fairly strong, but remains weak in the euro-zone.

5 The key development of the first quarter was the Emergency Budget delivered on the 22 June which unveiled plans by the new Chancellor to severely tighten fiscal policy. According to the new (and independent) Office for Budget Responsibility, cyclically adjusted net borrowing – the portion of borrowing that will not disappear with economic growth – will now fall from 8.7% of GDP in the fiscal year just gone to 0.8% in 2014-15.

6 The Budget directed the bulk of the fiscal tightening at households and the public sector instead of private companies. Key measures within the Budget included a rise in the standard rate of VAT from 17.5% to 20%, to take effect in January 2011. Plans for social security payments were also scaled back. However, the burden on lower income households was partly offset by an increase in the income tax personal allowance by £1,000 to £7,475 from April 2011 from which high earners will not benefit.

7 Meanwhile, activity surveys suggested that the recovery gathered pace in the first quarter after the economy's 0.3% expansion. Encouragingly, the labour market has shown some tentative signs of improvement. The number of people claiming unemployment benefit fell by 32,000 in April and 31,000 in May, leaving the total at 1.48m. Employment also rose by 5,000 in the three months to April. However, the workforce increased at a faster rate, so that the total number of unemployed according to the wider International Labour Organisation (ILO) measure still rose by 23,000 in the three months to April.

8 The UK's trade position continued to deteriorate, despite the support provided by the lower pound. The trade in goods and services deficit widened from £3.2bn to £3.3bn in April. Exported goods volumes fell again, this time by a monthly 0.5%. However, the export orders balances of the activity surveys continued to suggest that volumes would pick up soon.

9 Inflationary pressures have finally begun to ease. CPI inflation rose from 3.4% to a recent peak of 3.7% in April before falling back to 3.4% in May. Temporary factors, such as the rise in the rate of VAT to 17.5% in January and the rise in oil prices last year, continued to support above-target inflation.

10 The MPC continued to keep Bank Rate on hold at 0.5% and to maintain its stock of asset purchases. The Bank of England's quarterly Inflation Report in May also projected inflation to be below the 2% target at the two year horizon, suggesting that rates will remain on hold for a considerable period. Some MPC members expressed concern that the recent bout of high inflation could lead to a permanent shift in inflation expectations if it persisted much longer.

## Introduction

11 Part of the service offered by Sector is to produce a monthly analysis of the Council's investment portfolio together with the latest amendments to credit ratings. These are emailed to Members of the Finance Advisory Group each month and the one for June 2010 appears at Appendix A for information. A graphical representation of investment returns, which is used in the monthly financial results submitted to the Group appears at Appendix B.

12 Members will note that investment returns currently exceed target and that the benchmark percentage investment returns are also being exceeded.

13 This has been achieved against a background of a highly cautious investment policy which has been developed to address global concerns about the credit quality of financial institutions.

14 Over the last year, Officers expressed concern about the availability of suitable counterparties meeting the requirements of the strategy particularly as the lending criteria had been tightened in response to the credit crunch and worsening financial markets. The result of changes to the lending criteria is summarised in Appendix C along with the latest version of the lending list.

## Economic Forecast

15 The Council's Treasury Advisers, Sector, provided the following forecast in early July 2010:

| Sector's Interest Rate View | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | NOW | Sep-10 | Dec-10 | Mar-11 | Jun-11 | Sep-11 | Dec-11 | Mar-12 | Jun-12 | Sep-12 | Dec-12 | Mar-13 |
| Sector's Bank Rate View | **0.50%** | 0.50% | 0.50% | 0.75% | 1.00% | 1.50% | 1.75% | 2.25% | 2.50% | 3.00% | 3.50% | 3.75% |
| 5yr PWLB Rate | **2.48%** | 2.95% | 2.95% | 3.15% | 3.30% | 3.50% | 3.60% | 3.95% | 4.30% | 4.55% | 4.70% | 4.80% |
| 10yr PWLB View | **3.83%** | 4.30% | 4.40% | 4.45% | 4.55% | 4.60% | 4.65% | 4.70% | 4.75% | 4.90% | 4.95% | 5.10% |
| 25yr PWLB View | **4.46%** | 4.70% | 4.75% | 4.75% | 4.85% | 4.90% | 5.00% | 5.05% | 5.15% | 5.20% | 5.25% | 5.25% |
| 50yr PWLB Rate | **4.49%** | 4.70% | 4.75% | 4.80% | 4.90% | 4.95% | 5.05% | 5.05% | 5.20% | 5.25% | 5.25% | 5.25% |

- The forecast is based on moderate economic recovery and MPC inflation forecast being below target in two years' time

- The first Bank Rate increase is expected to be in 2011; and to reach 3.75% by March 2013

- Long term PWLB rates are expected to steadily increase to reach 5.25% by early 2013 due to huge gilt issuance, reversal of QE and investor concerns over inflation

- There is considerable uncertainty in all forecasts due to the difficulties of forecasting the timing and amounts of QE reversal, the tough cuts outlined in the Emergency Budget, speed of recovery of banks profitability and balance sheet position, changes in the consumer saving ratio, rebalancing of the UK economy in terms of export and import etc

- The balance of risks is weighted to the downside

- There is still some risk of a "double dip" recession.

16 In August, Sector undertook a review of their interest rate forecasts as follows:

- The main changes relate to a softening of their Bank Rate view over the next 3 years and a flattening of their PWLB forecasts over the next year before taking on a similar path to their previous forecast from Q1 2012 onwards.

- Bank Rate is expected to stay at 0.50% in Q1 2011, reach 1.25% in Q1 2012 and 3.00% in Q1 2013. Sector's PWLB forecasts are now expected to trend upwards from a lower starting point. This trajectory is consistent for 5, 10, 25 and 50 years.

17 The key factors behind this review are: -

- There are concerns that the acceleration of the elimination of the budget deficit will have a dampening effect on economic growth and will leave less room for the MPC to raise Bank Rate as fast and as far as previously expected.

- There are also considerable risks around a re-emergence of major sovereign debt concerns in the EU during 2010 which could increase the safe haven status of UK gilts and put further downward pressure on gilt yields during 2010/11.

- Other concerns such as the durability of the coalition government, acceptance of job cuts, pension cuts etc without stimulating strikes; the lack of growth in other countries undermining the potential for growth in UK exports and therefore, overall UK growth could also put downward pressure on yields.

- There have been major falls in bond yields. Bond markets and share markets are inextricably linked. Shares have gone downhill in recent weeks as the perception has taken hold that Western economies are now heading into weak economic recovery. This will have a negative impact on the likely level of corporate profits and so on share prices. This will underpin bond prices.

- Nevertheless, Sector still maintains that the general trend beyond 2010 of rising gilt yields is expected to remain unchanged as market fundamentals must eventually re-establish the current disconnect between the sheer volume of UK gilt issuance and the price of issue of new debt.

| Bank Rate | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | NOW | Sep-10 | Dec-10 | Mar-11 | Jun-11 | Sep-11 | Dec-11 | Mar-12 | Jun-12 | Sep-12 | Dec-12 | Mar-13 | Jun-13 | Sep-13 |
| Sector's View | **0.50%** | 0.50% | 0.50% | 0.50% | 0.50% | 0.75% | 1.00% | 1.25% | 1.50% | 2.00% | 2.50% | 3.00% | 3.25% | 3.25% |
| UBS | **0.50%** | 0.50% | 0.50% | 0.75% | 1.00% | 1.50% | 2.00% | - | - | - | - | - | - | - |
| Capital Economics | **0.50%** | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | - | - | - | - |
| 5yr PWLB Rate | | | | | | | | | | | | | | |
| | NOW | Sep-10 | Dec-10 | Mar-11 | Jun-11 | Sep-11 | Dec-11 | Mar-12 | Jun-12 | Sep-12 | Dec-12 | Mar-13 | Jun-13 | Sep-13 |
| Sector's View | **1.94%** | 2.20% | 2.20% | 2.20% | 2.40% | 2.60% | 2.80% | 3.00% | 3.30% | 3.60% | 3.80% | 4.10% | 4.40% | 4.40% |
| UBS | **1.94%** | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Capital Economics | **1.94%** | 1.85% | 1.65% | 1.65% | 1.65% | 1.65% | 1.65% | 1.65% | - | - | - | - | - | - |
| 10yr PWLB Rate | | | | | | | | | | | | | | |
| | NOW | Sep-10 | Dec-10 | Mar-11 | Jun-11 | Sep-11 | Dec-11 | Mar-12 | Jun-12 | Sep-12 | Dec-12 | Mar-13 | Jun-13 | Sep-13 |
| Sector's View | **3.20%** | 3.30% | 3.30% | 3.30% | 3.40% | 3.70% | 3.90% | 4.00% | 4.30% | 4.40% | 4.60% | 4.60% | 4.90% | 4.90% |
| UBS | **3.20%** | 3.55% | 3.70% | 3.85% | 4.00% | 4.25% | 4.35% | - | - | - | - | - | - | - |
| Capital Economics | **3.20%** | 3.15% | 2.90% | 2.90% | 2.90% | 2.90% | 2.90% | 2.90% | - | - | - | - | - | - |
| 25yr PWLB Rate | | | | | | | | | | | | | | |
| | NOW | Sep-10 | Dec-10 | Mar-11 | Jun-11 | Sep-11 | Dec-11 | Mar-12 | Jun-12 | Sep-12 | Dec-12 | Mar-13 | Jun-13 | Sep-13 |
| Sector's View | **4.14%** | 4.20% | 4.20% | 4.30% | 4.30% | 4.40% | 4.50% | 4.70% | 4.70% | 4.80% | 5.00% | 5.00% | 5.00% | 5.00% |
| UBS | **4.14%** | 4.37% | 4.45% | 4.60% | 4.70% | 4.80% | 4.95% | - | - | - | - | - | - | - |
| Capital Economics | **4.14%** | 4.05% | 3.90% | 3.85% | 3.85% | 3.85% | 3.85% | 3.85% | - | - | - | - | - | - |
| 50yr PWLB Rate | | | | | | | | | | | | | | |
| | NOW | Sep-10 | Dec-10 | Mar-11 | Jun-11 | Sep-11 | Dec-11 | Mar-12 | Jun-12 | Sep-12 | Dec-12 | Mar-13 | Jun-13 | Sep-13 |
| Sector's View | **4.17%** | 4.20% | 4.20% | 4.30% | 4.30% | 4.40% | 4.50% | 4.70% | 4.70% | 4.80% | 5.00% | 5.00% | 5.00% | 5.00% |
| UBS | **4.17%** | 4.44% | 4.55% | 4.70% | 4.80% | 4.90% | 5.05% | - | - | - | - | - | - | - |
| Capital Economics | **4.17%** | 4.25% | 4.25% | 4.25% | 4.25% | 4.25% | 4.25% | 4.25% | - | - | - | - | - | - |

- The impact of this new Bank Rate forecast has meant that Sector's minimum investment levels have now been lowered and target levels for Fixed Term Deposits for 1 and 2 year investments are now : -

  1 year 0.75%      2 year 1.15%

**Future Investment Options**

18 For the sake of completeness, the UK banks and building societies currently meeting the investment criteria specified in Appendix C are as follows:-

- Bank of Scotland plc (part of the Lloyds group)
- Barclays Bank plc
- Cater Allen Ltd (part of the Santander group)
- Clydesdale Bank plc
- HSBC Bank plc
- Lloyds TSB Bank plc
- National Westminster Bank plc (part of the RBS group)
- Nationwide Building Society
- Royal Bank of Scotland plc
- Santander UK plc
- Ulster Bank Ltd (part of the RBS group)

19 As far as EU based institutions are concerned, whilst plenty meet our criteria, none are presently in the market to take our type of fixed deposit. Svenska Handelsbanken AB, a Swedish bank, does operate in the UK market and has an office in Tunbridge Wells. They were actively seeking local authority deposits last year, but at that time Members preferred UK banks/building societies as the first option.

20 At the end of April Spain's sovereign rating was downgraded from AAA to AA+ amid concerns about the country's deteriorating economic growth prospects, the challenges its government faces in achieving fiscal targets and concerns over the impact of rising funding costs in the medium term. This prompted many authorities to reconsider Santander as a counterparty and several removed it from lending lists. Sector issued a guidance note at the time and this appears at Appendix D. Members will note from Appendix A that we currently have £4m invested with Santander and its subsidiary Cater Allen plus £11.7m in an instant access account as at 30 June 2010. As at 23 August 2010, these figures were £4m and £9m respectively. Removing the Santander group of companies from our lending list would cause severe difficulties in finding suitable alternative counterparties.

21 If it was to be removed, there would be few options for surplus short-term cash flow funds other than lending to the Department for

Communities & Local Government special deposit account at very inferior rates (currently 0.25%) across all maturity periods. Alternatively, funds could be left in a deposit account that is linked to the Council's current account. This deposit account pays 0.05% interest on balances up to £1m or 0.15% on balances over £1m.

22 As far as the fixed term deposits with the Santander group are concerned, an alternative option would be to increase the limits for the UK banks and one building society that we currently lend to. In order to give enough investment opportunity, the limit (as detailed in paragraph 2a) of Appendix C) would need to be increased to £5m for each bank and the building society. An overall group limit of £5m would be required.

23 Should it be decided to increase the limits, then consideration would also need to be given to increasing the percentage institution and group limits (as detailed in paragraph 2b) of Appendix C). It is suggested that 20% would be an appropriate limit.

24 The funds that we hold in Santander's instant access account can be withdrawn without notice. Should there be any further deterioration in Spain's sovereign rating or the bank's credit rating, an immediate decision can be made to remove the funds. However, there still remains a risk that should a problem with the bank arise overnight or over a weekend, then funds could not be withdrawn until the next working day.

25 Money Market Funds could be a useful alternative investment method and are currently included as an option within the Investment Strategy. They typically invest in a suite of money market investments across a range of asset classes, counterparties and maturities. They are designed to spread risk for the investor (funds are AAA rated) whilst giving the benefits of same day liquidity and relatively attractive yields. They complement bank deposits and other short term money market investments and act as a safe, liquid home for short term cash. At the current time yields do not approach that of Santander's instant access account.

26 Research would need to be carried out to find the most suitable fund as this will be dependent on the lending constraints applied to the fund and the success of the fund manager.

**Consideration by Finance Advisory Group on 21 July 2010**

27 At its meeting on 21 July the Finance Advisory considered this report and examined the issues around the Council's lending list and financial limits. They considered the issues surrounding the use of the Council's call (instant access) account and reviewed the effectiveness of the current Investment Strategy.

28 The Group were concerned that high balances were being held in the call account due to the limited number of institutions remaining on the lending list. They considered that, in order to provide sufficient opportunity to invest the Council's funds with low risk institutions, and thus prevent high balances being held in the call account, they would not be adverse to an increase in the limit on amounts held with individual institutions from £3 million to £5 million, with the limit for any group of institutions also being £5 million.

**Consideration by Performance and Governance Committee on 7 September 2010**

29 At its meeting on 7 September the Performance and Governance Committee agreed with the Finance Advisory Group's view that the two limits should be increased to £5m and were equally concerned about the large balances building up by default in the Santander call account resulting from the restricted lending list.

30 Officers have investigated the possibility of using call accounts and short-notice accounts with other institutions and two of these are now operational. In view of this, it would be prudent to include these types of account within the individual and group limits for institutions.

31 However, in order to provide enough flexibility, limits which are to include call accounts probably need to be higher than £5m and so it is recommended that these be set at £6m.

32 Over the last year or so, investments have been restricted to a maximum duration of six months. It is now proposed to revert to the one year limit stated in the current strategy. The duration of any particular investment is dependent on the institution's creditworthiness assessment.

33 The current strategy also places a limit on the maximum percentage of the total fund that may be placed with a counterparty or counterparties within a group of companies. At present, this is set at 15%. By amending the cash limits as suggested, this percentage limit may well be breached regularly. The total value of the fund varies between £20m and £30m during the financial year depending on the various cash inflows and outflows resulting from council tax receipts and precept payments. It is, therefore, recommended that the percentage limit be increased to 25% (at the time of placing the investment) rather than the 20% mentioned earlier in this report.

**Key Implications**

Financial implications

34 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 £250,000 supporting

the revenue budget for 2010/11. 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 2010/11.

Legal, Human Rights etc.

35 None.

Impact on and Outcomes for the Community

36 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.

**Conclusions**

37 The effect of the proposals set out in this report is to allow the Council to effectively and efficiently manage cash balances.

38 In line with the revised CIPFA Code of Practice on Treasury Management in the Public Services, the annual treasury strategy was considered by Council at its meeting on 23 February 2010. Given the current uncertainties in the financial markets and the banking sector, the Council recognises the need to reconsider its strategy during the year.

**Risk Assessment Statement**

39 Treasury management has two main risks:-

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

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

40 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.

41 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 23 February 2010, Cabinet 18 February 2010, Performance and Governance Committee 16 February 2010)<br><br>CIPFA Code of Practice on Treasury Management in the Public Services (2009)<br><br>Sector Treasury Services Ltd. - economic updates and credit rating changes |
| **Contact Officer(s):** | Adrian Rowbotham – ext. 7153<br>Roy Parsons - ext. 7204 |

**Dr. Pav Ramewal**
**Deputy Chief Executive & Director of Corporate Resources**