

## INVESTMENT STRATEGY UPDATE

### FINANCE ADVISORY GROUP – 25 JULY 2012

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

Status: For consideration

Also considered by: Performance and Governance Committee – 18 September 2012

Key Decision: No

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**Executive Summary:** Members approved the Investment Strategy in January/February 2012 as part of the budget setting process. In considering that strategy Members were advised that, given the prevailing economic climate, the strategy would need to be kept under review during the ensuing financial year and amended where necessary. It is also a requirement of the CIPFA Code of Practice on Treasury Management that regular updates are presented to Members to enable them to have an informed view of the treasury management function and its activities.

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 and the latest position with regard to the Council's investment with Landsbanki Islands hf.

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

Portfolio Holder Cllr. Ramsay

Head of Service Group Manager - Financial Services – Mr. Adrian Rowbotham

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#### Recommendations:

(a) That the update on treasury management activity in the first quarter of 2012/13 be noted; and

(b) that the upper investment limits for the Ignis and Insight Money Market Funds be increased to £3m each.

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#### General Background and Introduction

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 2012/13 at the Council meeting on 21 February 2012.

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.
4. The annual report of performance in the previous financial year will be presented to the meeting of the Performance and Governance Committee on 18 September 2012.

### Economic Background

5. Sector have produced a report on the recent economic background and it includes their summary outlook and forward view. This appears at Appendix A.

### Interest Rate Forecast

6. Sector have provided the following forecast:

	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
<b>Bank rate</b>	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.25%	1.50%
<b>5yr PWLB rate</b>	2.10%	2.20%	2.20%	2.30%	2.40%	2.50%	2.60%	2.80%	3.00%	3.20%	3.40%
<b>10yr PWLB rate</b>	3.00%	3.20%	3.30%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%
<b>25yr PWLB rate</b>	4.20%	4.30%	4.30%	4.40%	4.50%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%
<b>50yr PWLB rate</b>	4.30%	4.40%	4.40%	4.50%	4.60%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%

7. The Sector central forecast is for the first increase in Bank Rate to be in the first quarter of 2014 but there is downside risk to this projection. With growth predictions for the UK continuing to be reduced on an almost monthly basis by both the Office for Budget Responsibility and economic commentators generally, and financial markets unconvinced that politicians have resolved the Eurozone sovereign debt crisis in the medium-term, Sector's view is that we are likely to continue to experience high levels of volatility.

### Review of Annual Investment Strategy

#### Investment Performance

8. 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 Group each month and the one for June 2012 is reproduced at Appendix B for information. A graphical representation of investment returns, which is used in the monthly financial results submitted to Members of the Group appears at Appendix C.

9. Sector have also expanded their reporting service to include a Benchmarking Group of neighbouring authorities, for those wishing to participate. We are part of a group of five Kent authorities whose investment returns have been compared individually with the group as a whole, with 59 Non-Metropolitan Districts and with 157 authorities of all types. The results are presented quarterly and the March 2012 outcome appears at Appendix D. At the time of writing this report the June 2012 results were awaited. If available in time, they will be circulated at the meeting.
10. Members will note that investment returns currently exceed target and that the benchmark LIBID (London Interbank Bid Rate) comparisons are also being exceeded. This has been achieved against a background of a highly cautious investment policy which has been developed to address concerns about the credit quality of financial institutions.
11. It is interesting to note that when compared with the five Kent authorities as a whole, our rate of return for March was in line with the average. However, it appears that as a group we are far more risk averse than Non-Metropolitan authorities as a whole. This appears to be due to a greater appetite for structured products (such as range accruals), certificates of deposit and longer dated investments amongst the wider group.

#### Counterparty Issues

12. In a continuing theme, the availability of suitable counterparties has been a concern over recent months. Despite relaxing the minimum long term credit rating requirement from AA- to A in the current Investment Strategy, further worsening of conditions in the Eurozone and its consequent effect on UK institutions has resulted in more credit rating downgrades. At the time the strategy was agreed, institutions such as Santander and Clydesdale Bank met the criteria for lending but have since fallen below the lower limits. These two particular banks are active in the money markets and offer superior rates, but this opportunity has now been lost. The result has been to revert to options such as lending to other local authorities and to the UK Government's Debt Management Office at inferior rates.
13. More recently, the widely publicised issues surrounding the Council's own bankers, Barclays, has resulted in their financial strength rating being placed on negative outlook. If this were to turn into a rating downgrade, then this could have serious implications for our investment options both in terms of fixed deposits and as a home for cashflow surpluses.

#### Money Market Funds

14. At the meeting of the Group on 28 March 2012, it was agreed to commence investment in Money Market Funds (MMFs). The Investment Strategy already allowed for such investments up to a maximum of £5m per Fund. Consequently, two accounts were opened with £1m in each. The account opening procedure was relatively straightforward, although Members did have reservations about the domicile of the Funds being in Dublin. I hope that the email I sent shortly after the March meeting gave some reassurance on this point.

15. MMFs are liquid instruments meaning that redemptions (i.e. withdrawals) can be made up to early afternoon on the required day. As yet, our cashflow requirements have not necessitated any redemptions, so the balances remained at £1m each as at the end of June 2012. The return on the two funds after deduction of management fees were:-

	Ignis Liquidity Fund	Insight Liquidity Fund
May 2012 (Part)	0.75%	0.63%
June 2012	0.74%	0.63%

16. Members will note that we have several investments with other local authorities, none of which are approaching the MMF rates of return. In my opinion, a better option would be to increase deposits in the MMFs instead of reinvesting in the local authority market. Members views are sought on the suggestion that deposits are increased up to a maximum of £3m per MMF.
17. I have recently been approached by both HSBC and the CCLA Public Sector Deposit Fund with their MMF offerings. The HSBC MMF yielded 0.66% gross in May 2012, or 0.46% after management fees. The CCLA MMF has the advantage of being geared towards the public sector and comes with an endorsement from the Local Government Association and local authority leaders. However, it is a very small fund with just over £100m in assets and its gross yield in June 2012 was 0.75%, or 0.55% after management fees. I will keep these two options under review.

#### Icelandic Investment

18. A second distribution was received from the Winding Up Board of Landsbanki Islands hf on 29 May 2012. The first and second distributions together constitute approximately 40% of our claim.
19. At present, the Council expects to recover 100% of its deposit in Landsbanki but the precise amount will vary owing to foreign exchange fluctuations. The current repayment schedule is expected to extend until 2018 or 2019.
20. A small amount (approximately 2%) of the first distribution was made in Icelandic Krona (ISK). Under Icelandic currency controls, consent from the Icelandic Central Bank is required in order pay priority creditors the ISK element of the distribution. Accordingly, the entire ISK part of the distribution was paid into an escrow account denominated in ISK pending clearance from the Icelandic Central Bank. It is currently attracting interest at just over 3%.

## Key Implications

### Financial

21. The management of the Council's investment portfolio and cash-flow generated balances plays an important part in the financial planning of the authority. The security of its capital and liquidity of its investments is of paramount importance.
22. There are financial implications arising from the restriction of the Council's lending list following recent credit rating downgrades in that a large part of the portfolio has had to be placed with the Government or other local authorities at an inferior rate of interest.

### Community Impact and Outcomes

23. There are no community impacts arising from this report.

### Legal, Human Rights etc.

24. None.

## Conclusions

25. The overall return on the Council's investments continues to exceed budget, but this will be eroded if the current trend towards lending to other local authorities and to the Government continues. This could be addressed by increasing the amount deposited in Money Market Funds and Members' views on this option would be welcome.
26. The economic situation both globally and within the Eurozone in particular remains volatile with inevitable consequences for the UK economy. Further deterioration in the credit quality of banks and other financial institutions could have serious implications for the Council's investment decisions and this will be monitored closely over the coming months.
27. Recovery of the Icelandic deposit is ongoing and further updates will be provided as and when monies are received.

## Risk Assessment Statement

28. 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.
29. 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.

30. 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.

**Appendices:**

Appendix A – Economic background report from  
Sector Treasury Services Ltd

Appendix B – June 2012 investment report from  
Sector Treasury Services Ltd

Appendix C – Investment returns for 2012/13

Appendix D - March 2012 report from Sector  
Benchmarking Group

**Background Papers:**

Treasury Management Strategy for 2012/13 -  
Council 21 February 2012

Sector Treasury Services Ltd – economic updates,  
monthly investment reports, benchmarking reports  
and credit rating lists

**Contact Officer(s):**

Roy Parsons ext.7204

**Dr. Pav Ramewal**

**Deputy Chief Executive and Director of Corporate Resources**