TREASURY MANAGEMENT UPDATE

Cabinet – 6 December 2012

Report of the:	Deputy Chief Executive and Director of Corporate Resources
Status:	For decision
Also considered by:	Performance and Governance Committee – 13 November 2012
Key Decision:	No

Executive Summary: Members approved the Investment Strategy as part of the budget-setting process in February 2012. 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, changes to credit ratings and fulfils the reporting requirements of the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice for Treasury Management.

An update on the Council's Icelandic bank investment is also provided.

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

Portfolio Holder	Cllr. Ramsay
Head of Service	Group Manager - Financial Services – Adrian Rowbotham

Recommendations: It be RESOLVED that

a) the report be noted;

b) the use of Money Market Funds as outlined in paragraphs 21 to 29 of the report be increased as described;

c) when setting the investment strategy for 2103/14, consideration be given to increasing the counterparty limits for Lloyds Bank Group and the Royal Bank of Scotland Group to £8m each; and

d) that the possibility of widening the list of counterparties to include building societies be investigated by the Finance Advisory Group.

Background

1 The Treasury Management Strategy for 2012/13, which includes the Annual Investment Strategy, was approved by the Council on 21 February 2012. It sets out the Council's investment priorities as being:

- Security of capital
- Liquidity
- Yield

2 The Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management suggests that, in addition to the Annual Strategy, regular reports should be submitted to Members in order for them to have an informed view of treasury management activity. This report constitutes the recommended mid-year review.

3 The Council aims to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity. In the current economic climate and the heightened credit concerns, it is considered appropriate to keep investments short term with a maximum duration of 3 months.

4 This limit applies to all institutions on the Counterparty List supplied by the Council's treasury management advisors, Sector Treasury Services Limited, with the following exceptions:

- UK Government and related entities such as Local Authorities. The suggested duration limit is 5 years
- UK semi-nationalised institutions (Lloyds/RBS). The current significant UK Government ownership of these entities is seen as providing comfort to investors.
- Money Market Funds

5 A full list of investments held at 30 September 2012 appears at Appendix A in both alphabetical and maturity date orders. Appendix B contains Sector's Investment Report for September 2012.

Investment Performance in 2012/13

6 As detailed above, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. The continuing Eurozone sovereign debt crisis, and its potential impact on banks, prompts a low risk and short term strategy. Given this risk averse environment, investment returns are likely to remain low.

7 There was one small breach of investment limits in the first six months of 2012/13. Over the weekend from 28 September to 1 October, the sum of £4.4m was held in the Business Premium Account with Barclays. Together with fixed deposits of £2m, the total held with Barclays was £6.4m, compared with the limit of £6m. This situation was corrected on 1 October.

8 The budgeted investment income for 2012/13 is £206k and performance for the year to date is £65k above budget. The forecast outturn is £317k.

9 The return on the investment portfolio stands at 1.1%, compared with the average 7 Day and 3 Month LIBID rates of 0.44% and 0.79% respectively.

Economic Update

10 An economic update and outlook for the remaining six months of the financial year appear at Appendix C.

Interest Rate Forecast

11 Sector have provided the following forecast:

	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%
5yr PWLB rate	1.50%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.30%
10yr PWLB rate	2.50%	2.50%	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.20%	3.30%
25yr PWLB rate	3.70%	3.70%	3.70%	3.80%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%
50yr PWLB rate	3.90%	3.90%	3.90%	4.00%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%

12 Sector undertook a review of its interest rate forecasts following the issue of the Bank of England Inflation Report for August 2012. Consequently, it pushed back the first rise in Bank Rate from Q1 2014 to Q4 2014, as well as lowering the pace of rises in gilt yields.

13 The Bank of England forecasts of the speed and strength of recovery and rate of reduction of CPI inflation over the last four years had been attracting increasing criticism for being consistently over optimistic. In this latest inflation report, the bank changed its position significantly, markedly downgrading its forecasts for the strength and speed of recovery in GDP growth. Whereas previously it had consistently been forecasting a strong recovery to over 3% p.a., it was now only forecasting growth to recover to around 2% during the period from early 2013 to the end of 2015.

Credit rating issues

14 The first half of the financial year has seen some stabilisation in credit ratings. The number of downgrades has reduced compared with previous years, but there has been little sign of ratings improving.

15 At present, the Council's preference is for investment in UK based institutions only and so Sector's Counterparty List, mentioned above, has been severely curtailed.

16 Within Kent, there is little appetite for investment outside the UK, with only Svenska Handelsbanken (based in Sweden) being popular amongst other Kent districts. However, they have just given notice that the rate on their call account is to be halved to 0.40%

17 This appears to be the trend of late, with Santander reducing its call account rate from 0.80% to 0.50% and the semi-nationalised banks also cutting rates on their fixed deposit products. Members should note that we have not placed any deposits with Santander since late 2011 owing to concerns about the Spanish economy and, in fact, they do not currently meet Sector's minimum rating requirement.

18 Two Money Market Funds (MMFs) have been opened in the current financial year and they are operating well at the moment. We have set a maximum investment of £5m per MMF and, with the approval of the Finance Advisory Group, current balances in each stand at £3m. The yields for the month of September were 0.62% and 0.55%, but, again, these are on a decreasing trend.

19 The lack of availability of suitable counterparties has made investment decisions quite difficult within the present cash limits of £5m per counterparty (or £6m if a call account is included). This has resulted in a significant proportion of the portfolio having to be invested with the Government's Debt Management Office (DMO) at a standard rate of 0.25% for any period out to six months. Some success was achieved in placing money with other Local Authorities, but the rates were only marginally better than those offered by the DMO.

20 The result of this will be to reduce the yield on the portfolio for the financial year.

Future investment options

21 Discussions with other Local Authorities in Kent have revealed that most have, or intend to, increase the maximum amounts that they are prepared to lend to institutions on their counterparty lists. The aim is to maximise yield by concentrating more investment with the semi-nationalised banks (Lloyds TSB Bank Group and Royal Bank of Scotland Group). Despite the recent downward movement in rates, Lloyds, for example, still pays 2.25% on a one year fixed term deposit.

22 There also appears to be a greater use of MMFs within Kent. Some authorities have up to five open at any one time.

23 When considering next year's investment strategy (or indeed a revision to the current year's strategy), Members may wish to take these factors into account as a means of improving our yield, particularly if there are other budget pressures. It would also ease the problem of finding suitable counterparties mentioned in paragraph 19. In the short term, increasing the amount held in the existing MMFs up to the £5m limit, or opening new ones, would fall in line with the current investment strategy and would not require the approval of full Council. However, to increase the counterparty limits for fixed deposits and call accounts above the present £6m would require approval as the sums are specified within the strategy.

24 An option would be to increase the limit for fixed deposits and call accounts held with either Lloyds or RBS to £8m each, whilst keeping the other counterparty limits at £6m. An £8m holding in either of these Groups would represent about 40% of the portfolio as at year end and something like 25% during the year when cashflow balances are held. I am aware of at least one authority that is prepared

to hold in excess of 50% of its internally managed portfolio with either Lloyds or RBS.

25 A further option discussed at Performance and Governance Committee was the possibility of including building societies in the counterparty list. At present, only the Nationwide Building Society meets the Council's lending criteria. Research has shown that some other authorities lend to the top five (rated by asset size) building societies, namely:

- Nationwide Building Society (Group assets £196bn)
- Yorkshire Building Society (Group assets £33bn)
- Coventry Building Society (Group assets £24bn)
- Skipton Building Society (Group assets £14bn)
- Leeds Building Society (Group assets £10bn)

Conversely, some authorities do not lend to any building societies.

26 Prior to the credit crisis in 2008, the Council had the top 40 building societies on its counterparty list and regularly lent to most of them. More recently, the HM Treasury published a discussion paper on the future of building societies acknowledging that they have an important role to play in the financial services sector. If necessary, it says that the Government would consider reviewing existing legislative barriers (principally the Building Societies Act 1986) so that building societies can compete fairly in the financial services market.

27 Assessing credit risk relating to building societies is difficult because few are rated by the ratings agencies and, the Nationwide apart, those that are assessed have poor ratings. The Nationwide has a long term rating of A+, the Yorkshire BBB+, the Coventry A, the Skipton BBB- and the Leeds A-. The most usual method of assessing suitability has been asset size. Investigation of the society's accounts would be a possibility, but data could be over a year out of date and not necessarily an indication of credit risk going forward.

28 As far as interest rates are concerned, levels on 16 November 2012 were:

- Nationwide: 3 months 0.44%, 1 year 0.81%
- Yorkshire (indicative only): 3 months 0.35%, 1 year 0.70%
- Coventry: 3 months 0.45%, 1 year 0.89%
- Skipton: 3 months 0.43%, 1 year 1.15%
- Leeds: 1 year 0.96%

29 If building societies are seen as a suitable lending option, then a £2m limit with each one for a maximum period of, say, three or four months would seem a sensible starting point.

Icelandic bank defaults

30 This authority currently has an investment of £1m frozen in Landsbanki Islands hf. The investment was placed on 25 June 2007 at 6.32%, to mature on 25 June 2009.

31 The Icelandic Government has stated its intention to honour all its commitments as a result of their banks being placed into receivership. The U.K. Government is working with the Icelandic Government to help bring this about. The Local Government Association is coordinating the efforts of all UK authorities with Icelandic investments.

32 At the current time, the process of recovering assets is still ongoing with the administrators. Investments outstanding with the two Iceland–domiciled banks (Glitnir Bank hf and Landsbanki Islands hf) have been subject to decisions of the Icelandic Courts. Following the successful outcome of legal test cases in the Icelandic Supreme Court in late 2011, the Administrators have now commenced the process of dividend payments in respect of both of these banks.

33 At the beginning of October 2012, a third distribution was made to priority creditors such as ourselves. Sums were received in Sterling, US Dollars and Euros. The foreign currency was converted to Sterling as soon as possible after it was received.

34 Our original claim in the insolvency was for £1m plus interest up to the official winding up date of 22 April 2009 amounting to just over £52k. To date, just over £495k has been received back. There is a very small sum, paid in Icelandic Krona, which remains in escrow in Iceland due to currency controls in operation there. The Sterling equivalent is in the region of £7k and it is earning interest at a rate in excess of 3%. The current indications are that 100% of the deposit plus interest up to April 2009 will be recovered over the period extending to 2018 or 2019.

35 Members will continue to be updated on the latest developments in these efforts.

Key Implications

<u>Financial</u>

36 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.

<u>Community Impact and Outcomes</u>

37 There are no community impacts arising from this report.

<u>Legal, Human Rights etc.</u>

38 Under Section 151 of the Local Government Act 1972, the Section 151 Officer has statutory duties in relation to the financial administration and stewardship of the authority, including securing effective arrangements for treasury management.

39 This half year review report fulfils the requirements of The Chartered Institute of Public Finance & Accountancy's Code of Practice on Treasury Management 2009.

Conclusions

40 The overall return on the Council's investments is exceeding budget in 2012/13 by approximately £65,000 as at the end of September 2012.

41 The economic situation both globally and within the Eurozone in particular remains volatile with inevitable consequences for the UK economy. Treasury management in the past six months has been conducted against this background and with a cautious investment approach.

42 Consideration should be given to increasing investment limits and adding counterparties to the lending list in order to maintain or increase yield and to offer an alternative to investment with the DMO or other local authorities.

43 Recovery of the Icelandic deposit is ongoing and further updates will be provided as and when monies are received.

Risk Assessment Statement

44 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.

Consideration of risk is integral in our approach to treasury management.

45 This report proposes new investment limits. The movement towards having a restricted lending list but higher individual limits with those institutions reduces the chance 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.

46 This 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 – Investment portfolio at 30 September 2012 in alphabetical and maturity date orders.

Appendix B – Monthly investment report for September 2012, produced by Sector Treasury Services Ltd.

Appendix C – Economic update and outlook for the

	coming six months, produced by Sector Treasury Services Ltd.
Background Papers:	Treasury Management Strategy for 2012/13 - Council 21 February 2012.
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