**TONBRIDGE & MALLING BOROUGH COUNCIL**

**FINANCE and PROPERTY ADVISORY BOARD**

**30 September 2009**

**Report of the Director of Finance**

**Part 1- Public**

**Matters for Recommendation to Cabinet - Council Decision**

## 1 AMENDMENT TO THE TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY FOR 2009/10

**To seek Member approval of amendments to the Treasury Management Strategy Statement and Annual Investment Strategy for 2009/10 in response to changing market conditions.**

### 1.1 Introduction

1.1.1 The Treasury Management Strategy Statement (TMSS) for 2009/10 was approved by Council on 19 February 2009. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as follows:

- Security of Capital
- Liquidity

1.1.2 The Strategy also identified that the optimum return on investments should be achieved commensurate with the proper levels of security and liquidity. In the current economic climate it was considered appropriate to keep investments short term, and only invest with highly credit rated financial institutions using the Sector suggested creditworthiness matrices.

1.1.3 Whilst market conditions do not suggest that the Strategy needs to be amended in respect of duration, input from various bodies, including CIPFA and the Audit Commission, does suggest that changes to the Strategy might be appropriate in two key areas:

- Individual counter party, group and sovereign exposure limits; and

- The long term, support and individual rating limits applied to counter parties within the Specified and Non-specified Investment schedules that form an integral part of the annual strategy.

**1.2 Individual Counter Party, Group and Sovereign Exposure Limits**

1.2.1 Members will be aware from earlier reports that we have responded positively to the advice on treasury activities received post Iceland from the Audit Commission and CIPFA. The latest area to be reviewed in response to that advice is that of exposure limits to counter parties, groups and sovereign states. The current counter party and group limits are as follows:

- Internally managed funds £5m; and
- Externally managed funds £7m.

1.2.2 Since the issue of that advice we have been discussing with Sector and Investec how to redraw those limits such that they reflect the risk at each of the three levels. The consensus view was that the exposure limit of 10% mentioned by CIPFA and the Audit Commission was unsuited to smaller investors such as ourselves, may well prove unworkable in practice and might well fetter the ability of our fund manager to generate realistic returns.

1.2.3 It is suggested at **[Annex 1]** that differing limits be applied to core and cash flow investments. This is considered necessary in order to provide our fund manager with sufficient freedom to trade effectively within the investment parameters that we set and the constraints of their own lending list, a copy of which can be found at [Annex 4] of my Financial Planning and Control Report to this meeting. The separation also recognises the very real difficulties that are associated with disbursing large short term cash flow surpluses.

1.2.4 Sector and Investec were comfortable as a “rule of thumb” for us to apply an exposure limit of 25% with a single group. This limit has, therefore, been applied in the table of limits set out at **[Annex 1]** that members are now invited to consider.

1.2.5 Members may wonder if the large exposures (75% and 100%) to UK banks set out at **[Annex 1]** meet the test for diversity. It is suggested that at this time the level of support expected from HMG is such that those levels of exposure can be considered low risk and can be justified on practical grounds. It is also reassuring to know that this level of exposure was not considered to be untoward by either Sector or Investec.

**1.3 Credit rating limits**

1.3.1 In the aftermath of the banking crisis perhaps not unexpectedly, there have been a large number of credit downgrades. Credit rating agencies have since then appeared to be much more ready to down grade institutions and then to reverse that action in the short term. This volatility has meant that on a few occasions during the past few months the ratings for key UK banking institutions, such as

NatWest, RBS and Lloyds TSB, with whom we held investments fell below the minimum rating set out in the existing Strategy.

1.3.2 My purpose in drawing this to the attention of members is to seek retrospective approval for deciding not to recall those investments because the institutions retained the implicit support of HMG.

1.3.3 The minimum credit ratings now set out for consideration at **[Annex 1]** reflect the general fall in credit ratings, the continued volatility of those ratings and the level of support by HMG for UK banks. Whilst this might appear to generate additional risk, it is suggested that this is not so because those ratings will not be used in isolation and will specifically be subservient to the duration matrix provided on a weekly basis by Sector.

1.3.4 In respect of the matrix, it is worth recording that this was recently updated with a Credit Default Swap (CDS) overlay and is to be further enhanced within the next few weeks with an equity market overlay. In simple terms the credit rating is generally accepted as a backward looking indicator whilst the overlays look forward and take account of market perception of counter parties in real time.

1.3.5 Were members to approve the proposals for counter party, group and sovereign limits and also those in respect of credit ratings it will be necessary to amend the Investment Strategy for 2009/10, in particular the annexes specifying Specified and Non-specified Investments. Accordingly updated versions are appended to this report at **[Annexes 2 and 3]** for members to consider.

**1.4 Liquidity**

1.4.1 In updating the schedule of Non-specified investments the opportunity was taken to address concerns about the perceived increase in risk attached to illiquid fixed term deposits as a consequence of the banking crisis. It is suggested that these concerns be addressed by halving the maximum permitted proportion of fixed term deposits to 30% of core funds.

1.4.2 This change is supported by Sector and Investec who are both promoting the use of liquid assets such as certificates of deposit, gilts and supra-national bonds on the grounds that these can be liquated immediately counter party or sovereign concerns arise. Appropriate adjustments have been made to the Non-specified Investment Schedule at **[Annex 3]** for members to consider.

**1.5 Legal Implications**

1.5.1 This report fulfils the requirements placed on the Council through the adoption of the CIPFA Treasury Management Code in respect of the management and regulation of treasury activities.

**1.6 Financial and Value for Money Considerations**

1.6.1 The measures proposed are intended to maintain efficient and effective treasury arrangements such that investment returns are optimised.

**1.7 Risk Assessment**

1.7.1 The measures proposed are designed to reduce the risk of exposure to counter party failure without compromising investment returns un-necessarily.

**1.8 Recommendations**

1.8.1 Members are invited to recommend to Council that :

1) Retrospective approval be granted in respect of investments made with UK banks who retained the implicit support of HMG whilst their credit rating fell below the minimum stipulated in the Investment Strategy;

2) The counter party, group and sovereign ratings set out at **[Annex 1]** be adopted and incorporated in the Treasury Management and Investment Strategy for 2009/10; and

3) The amendments to the Specified and Non-specified Investment schedules to that Strategy set out at **[Annexes 2 and 3]** are adopted.

Background papers: contact: John Pickup

Nil

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