Annex 7

CIPFA The Chartered Institute of Public Finance & Accountancy

the national treasury management risk study

2012

PublicSectorLive LTD

Introduction

The National Treasury Management Risk Study is offered **free of charge** to all Councils in England and Wales, and represents the single largest exercise of its type, with a participating universe representing over £36bn of borrowing and over £13bn of cash investments. With the prime objective of the Treasury Management function being the management of risk, the Study is forward looking in nature and identifies participating Councils' treasury risks and how these risks are impacting on Councils' current strategies.

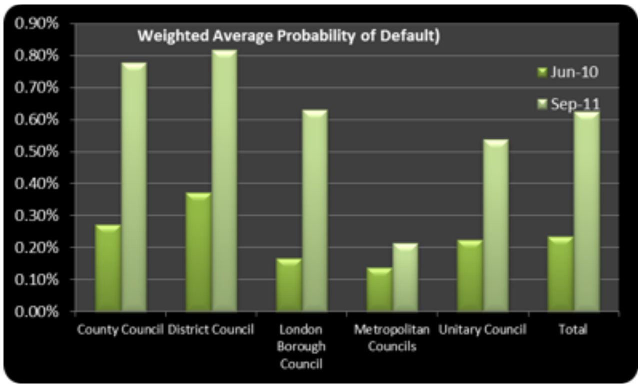
As Section 151 officer with responsibility for the management of the Treasury Function, CIPFA appreciate it is imperative that you remain informed of your Council's unique position in respect of these risks. It is hoped that your Treasury Officers have shared the results of the Study with you, and you have had the opportunity to familiarise yourself with the reports. In the event that you have not yet seen your authority's individual results, this report provides some of the key findings arising from the Study.

Presented immediately below are the headings and high level observations, taken from participating Councils. We believe the overall findings are significant and trust that you will be interested in seeing your Authority's own results.

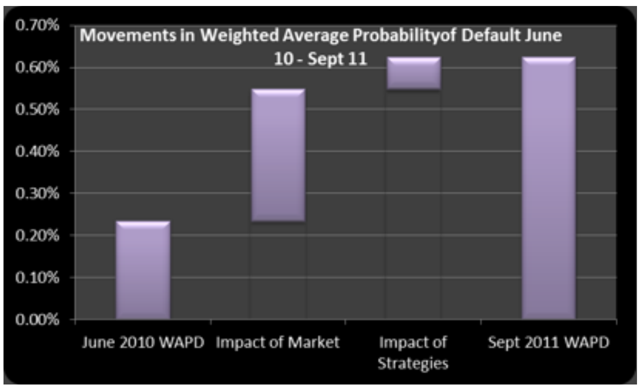
Investments

Security

In the aftermath of the Icelandic Banking crisis and continuing global uncertainties, the Study confirms a sustained move, on the part of Councils, to reduce their overall cash balances and invest in highly rated Financial Institutions and Money Market Funds. While this behaviour is observable at a macro level, the quantum of Credit Risk being taken by Local Authorities (presented within the report as the likelihood of a deposit-taking institution defaulting) has not fallen significantly. **In fact, despite anecdotal evidence suggesting a flight to quality has taken place, the Study confirms that the risk of default is now significantly greater than it was at the time of the 2010 Study.**



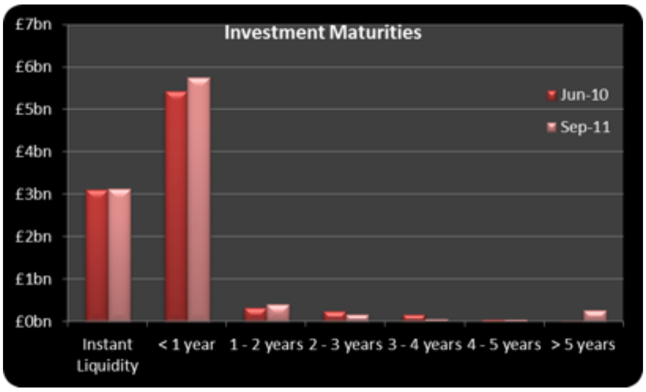
However, before jumping to the conclusion that strategies employed by authorities have become far less prudent, it is worth drilling a little deeper into the reasons for this overall rise in credit risk.



Since June 2010, global awareness of credit has continued to increase substantially, and it is this factor that has given rise to an overall increase in expected default risk. However, in addition, changes in portfolio composition by Authorities themselves, has also led to a further increase in credit risk. These macro and micro events reinforce the need for Authorities to be increasingly aware of how external market's perception of credit can impact their investments.

Liquidity

The Study highlights the significant sums that are currently being retained in very short dated investments. Of the investment universe, some 42% of all monies are held within one month facilities, with 32% being held on instant access accounts. It may be reasonable to surmise that such activity is the result of overriding credit concerns, however adopting such an approach has resulted in the large scale mismatching of budgeted and actual cashflows. Rather than investment balances reducing between June 2010 and September 2011 as was expected, in fact positive cashflows



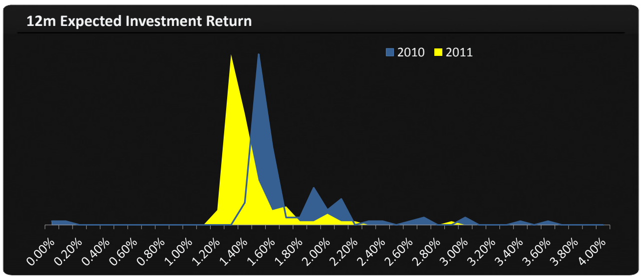
occurred during that period and balances increased. This therefore suggests that June 2010's total of 91% of deposits maturing within 12 months may have not been strictly necessary for liquidity requirements.

In total, weighted average duration has increased very slightly although, as the chart above demonstrates, the spread of maturities remains broadly consistent in the latest results.

Yield

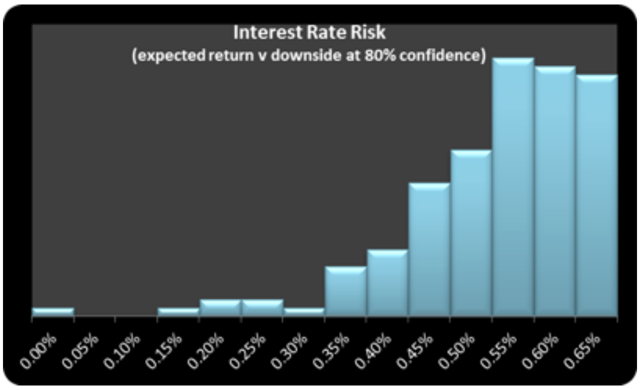
In part, owing to the approach taken to Liquidity, the Study highlights the degree of uncertainty that Council's face going forward, in respect of their investment income. Due to their short term investment strategies, Councils have far less certainty over their returns and are increasingly exposed to external market sentiment / events.

The following chart demonstrates that expectations for investment returns over a 12 month period have reduced significantly, and the upside potential of achieving higher rates has been scaled back.



A common misconception in terms of investment risk is that interest rate risk should be considered as a lower priority than credit and liquidity risk. However, whilst it is true that chasing returns at the expense of consideration of security and liquidity is definitely an inappropriate strategy, the management of interest rate risk within the investment portfolio alongside credit and liquidity risk should be undertaken.

The chart below illustrates that the strong bias of authorities towards low credit and low liquidity risk may well come at the expense of interest rate risk. The histogram below shows the extent of interest rate risk for the authorities in the 2011 Risk Study over the forthcoming 12 months. When considered in the context that returns are expected to be around 1.3% for many authorities, the fact that, under a number of plausible economic scenarios observed, returns could be as much as 50% lower than this (0.65%), may well give rise to unplanned pressure on already strained budgets.

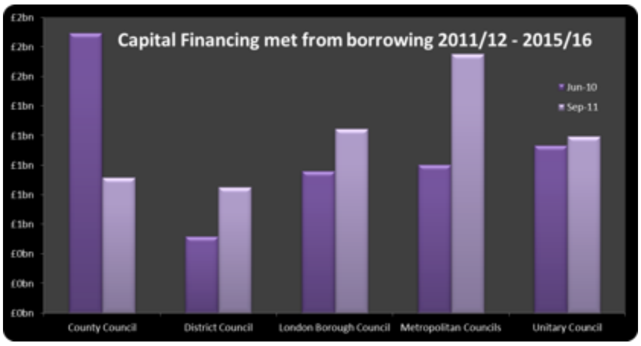


The possibility and scope for increasing duration in order to reduce interest rate risk could be given greater consideration by authorities not wishing to continue with this quantum of exposure, however, any proposed changes, would need to incorporate the resultant impact on the Authorities overall credit risk.

Funding

Capital Financing Requirements

Since the June 2010 Study, the announcement in October 2010's Comprehensive Spending Review to reduce the amount of revenue support for capital expenditure may have been expected to reduce the overall level of capital spend financed through borrowing. It may therefore come as somewhat of a surprise to see that the projections for the Capital Financing Requirement (the measure of the authority's underlying need to borrow for a capital purpose) are barely unchanged in the September 2011 projections.



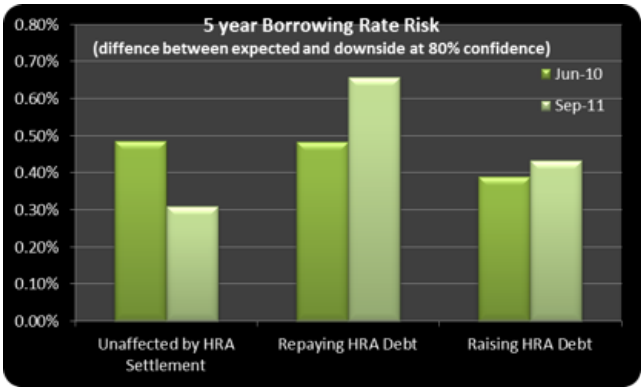
In fact, as the chart above shows, looking at the proposed capital financing for 2011/12 – 2015/16, it is only County Councils that have reduced their anticipated General Fund borrowing requirement over that period.

Clearly Regulatory Risk is something almost impossible for authorities to protect themselves against, however, the potential for further changes to the capital financing regime, for macro-economic reasons or other, cannot be ruled out and may have a significant impact on the management of long term borrowing portfolios.

Housing Self-Financing

For Housing Authorities, the self-financing settlement has brought with it mixed blessings. For authorities having debt repaid, whilst the writing off of premiums (very significant in some cases) will be very welcomed in reducing the expected average rate of the residual portfolio, some will consequentially be left with a large proportion of LOBO (lenders option borrowers option) loans which increase the risk within the residual portfolios for both the General Fund and HRA. Furthermore, for those authorities taking on additional borrowings, risk has also increased.

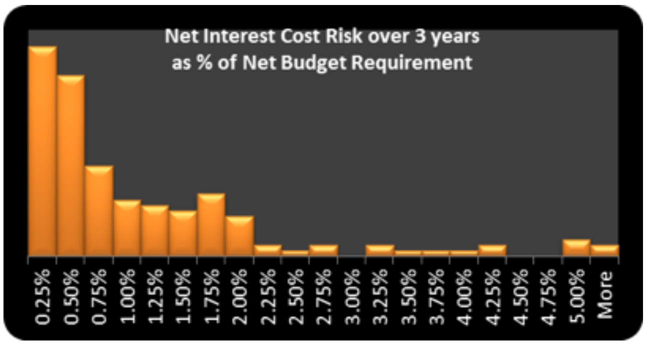
The chart below demonstrates that interest risk over a 5 year period (as measured by the difference between the expected and downside rate at 80% confidence) has increased for both authorities taking on new borrowing and those repaying it. It is only authorities unaffected by the settlement who see an overall reduction in interest rate risk since June 2010.



This increased interest rate risk reinforces the fact that the impact of self-financing is not purely about the build-up to the settlement date, but the on-going management of interest rate risk within the portfolios of both the General Fund and HRA.

Impact on Key Indicators

One of the primary drivers for undertaking the Study was to assist Local Authorities in quantifying the impact of their current treasury decisions on the delivery of Council front line services. Therefore, the Study identified the risk around General Fund Net Interest Costs and expressed this as a percentage of the Net Budget Requirement. The chart below expresses this risk (taken as the difference between expected and downside costs at 80% confidence over a 3 year period) as a percentage of the Net Budget Requirement. Whilst for most authorities the risk is less than 0.5% of the Net Budget Requirement, in many cases there is a significantly greater impact, and hence may point to a need for more proactive monitoring and management.



Conclusion

- **Despite anecdotal evidence suggesting a flight to quality has taken place, the Study confirms that the risk of default on Local Authority Investments is now significantly greater than it was at the time of the 2010 Study. However, this is mainly as a result of the markets perception of increased credit fears being reflected in the Credit Default Swap spreads, rather than authorities investment strategies shifting towards a greater appetite for credit risk.**
- **Rather than investment balances reducing between June 2010 and September 2011 as has been widely reported, cashflows have been positive during that period and overall balances have increased.**
- **In respect of Investment returns, whilst the observed expected outcome for 2012-13 is circa 1.3% for many authorities, a number of plausible economic scenarios observed, suggest that returns could be as much as 50% lower than this (at 0.65%), which could be expected to give rise to further unplanned pressure on already strained budgets.**
- **As a result of the imminent Housing Self-Financing changes, interest rate risk (as measured by the difference between the expected and downside rate at 80% confidence) has increased for both authorities taking on new borrowing and those repaying it. It is only authorities unaffected by the settlement who see an overall reduction in interest rate risk since June 2010.**
- **The Study quantified the risk around General Fund Net Interest Costs and expressed this as a percentage of the Net Budget Requirement. Whilst for most authorities the risk is less than 0.5% of the Net Budget Requirement, in many cases there is a significantly greater impact.**
- **One of the higher level observations to emerge from the Risk Study has been the shift by many Local Authorities to a more short term bias, in respect of their treasury dealings. While largely understandable (given external market conditions), any such short term focus, can reasonably be expected to give rise to a build-up of risk in the medium to longer term. This has specifically been captured in the degree of cashflow mismatching (between investments and borrowings) that can be seen in the 2011 results. This mismatch in turn gives rise to significant interest rate risk (via Investment and/or Refinancing); most likely to emerge in Medium Term Planning exercises.**

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With the competing internal backdrop of ongoing budgetary tightening and continued demands on Authorities to deliver front line services, the responsibility on S151 officers to have full visibility and understanding for their treasury risks has seldom seemed greater. CIPFA is therefore very keen to ensure that all S151 officers have direct access to the results of the National Treasury Management Risk Study. Alongside supporting and informing debate, we are requesting individual feedback from recipients, specifically in terms of how the Study might be developed to provide further practical support to you and your Council.

For questions relating to this study please contact:
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For more information on how CIPFA can help your organisation call our Business Development team:

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