TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

28 January 2013

Report of the Director of Finance

Part 1- Public

Matters for Recommendation to Cabinet - Council Decision

1 TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY FOR 2013/14

The report provides details of investments undertaken and returns achieved in the first nine months of the current financial year. Members are invited to consider amending the current non-UK AAA sovereign requirement and to confirm the current split of investment responsibilities for in-house and externally managed funds. The report concludes with a recommendation to adopt the Treasury Management Strategy Statement and Annual Investment Strategy for 2013/14.

1.1 Introduction

1.1.1 The Local Government Act 2003 requires the Council to 'have regard to the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

1.1.2 The Act also requires the Council to set out its Treasury Management Strategy Statement for borrowing and to prepare an Annual Investment Strategy; setting out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

1.2 Return on Investments

1.2.1 In accordance with the CIPFA Treasury Management Code of Practice, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. We find ourselves in a very difficult investment market. Yields are very low, in line with the 0.5% Bank Rate, and continuing Eurozone sovereign debt issues prompt a low risk and short term strategy. Within this risk averse environment, investment returns will remain low relative to pre 2008 'credit crunch' levels.

1.2.2 Cash flow funds are available on a temporary basis and their amount varies from month to month and during the course of each month dependent on the timing of receipts (council tax, business rates, grants and other sources of income) and payments (precepts, NNDR pool contributions, benefits, staff and suppliers). The authority holds £17.6m of core cash balances for investment purposes which are managed by our external fund manager. These funds which comprise our revenue and capital reserves are for the most part available to invest for more than one year.

1.2.3 At the end of December 2012 funds invested and interest earned is set out in the table below:

	Funds invested on 28 December 2012 £m	Average duration to maturity Days	Gross annualised return to 28 December 2012 %	7 day Libid benchmark (compounded) %	Interest earned to 28 December 2012 £
In-house cash flow – excluding Landsbanki	17.5	20.9	1.09	0.48	87,450
Externally managed core funds	17.6	386.0	1.30	0.48	179,650
Total	35.1	204.3	1.22	0.48	267,100

1.2.4 The authority out-performed the benchmark by 74 basis points. In cash terms investment income is running some £44,000 above profile based on our original 2012/13 estimates (£19,000 better than expected when measured against the revised 2012/13 draft estimates).

In-house managed cash flow investments

1.2.5 Our daily cash flow balances for the year ahead are modelled at the start of the financial year. That cash flow model is then updated daily and reviewed on a regular basis. The majority of our cash flow surpluses are invested overnight in bank deposit accounts and money market funds to ensure sufficient short term liquidity to meet payment obligations. However, when cash surpluses permit, fixed term investments are undertaken to take advantage of the higher yields available. Thus far in this financial year the following fixed term investments have been made including the acquisition of one certificate of deposit with the Nationwide Building Society:

£m	Bank / Building Society	Duration	Rate %	Period
1.0	Bank of Scotland	12 Months	3.00%	11/04/12 – 11/04/13
1.0	Lloyds TSB	12 Months	3.00%	11/04/12 – 11/04/13
0.5	Lloyds TSB	4 Months	1.20%	22/11/12 – 22/03/13
1.0	Nationwide (CD)	3 Months	0.44%	11/12/12 – 11/03/13

1.2.6 In addition to term deposits the opportunity is taken to generate additional yield by utilising notice accounts when cash flow surpluses are available for an extended period of time. £2m is currently placed in a National Westminster 95 day notice account at a rate of 1.20% pa and £2.0m in a 35 day notice account with Handelsbanken at 0.48% pa.

Externally managed core funds

1.2.7 Our external fund manager is currently performing above the level anticipated in our 2012/13 Annual Investment Strategy. Annualised gross return at the end of December was 1.30% vs an original estimate of 1.25%. This better than expected performance is primarily attributed to the opportunistic purchase and disposal of gilts. The disposals took advantage of price increases when the UK was (and still is) seen as a safe haven given Eurozone concerns and more recently “fiscal cliff” issues in the US.

Current investment position

1.2.8 A full list of investments held on 28 December 2012 is provided at **[Annex 1]** of this report and a copy of our internal lending list of the same date is provided at **[Annex 2]**. The yields on the total sum invested of £35.1m exclusive of Landsbanki is 0.83% comprising internally managed investments of £17.5m at 0.83% and externally managed investments of £17.6m at 0.83% (the identical yields for in-house and externally managed funds is a coincidence).

1.3 Treasury Management Strategy Statement and Annual Investment Strategy for 2013/14

1.3.1 Two years ago Members supported a rationalisation of our counterparty and non-UK sovereign exposure limits around a single figure of 25% and applied the result to both the in-house and externally managed portfolios. At that time Members also reviewed and made a modest amendment to the minimum credit criteria taking it to Fitch long term AA-, short term F1+, viability bbb-, **support 1**. A year ago, in response to an avalanche of downgrades to bank credit ratings, Members supported a lowering of our minimum counterparty credit criteria to Fitch A, F1, bbb-, 1 and provided some offset by reducing our counterparty and non-UK sovereign exposure limits to 20%. Audit Committee in October 2012 recommended that the exposure limits for investment in the UK nationalised / part nationalised banks revert back to a maximum of 25% per bank / group and also lowered our minimum AAA sovereign requirement for the UK to Fitch AA- or equivalent. At that meeting Members were advised that we would review the AAA sovereign requirement for non-UK investment when the strategy was redrafted for 2013/14. The credit rating agencies view of sovereigns rated AAA by at least one agency and an extract from the Fitch rating definitions is provided at **[Annex 3]**.

Sovereign requirement

1.3.2 We have always regarded the support rating of 1 to be an important and necessary component of our criteria. Fitch defines it as "A bank for which there is an extremely high probability of external support. The potential provider of that support is **very highly rated** in its own right and has a very high propensity to support the bank in question". To ensure that support would be available we required the sovereign responsible for regulating the institution to carry the highest rating i.e. AAA. A number of sovereigns currently have negative watches against their ratings which may result in a downgrade of their AAA status including the UK, USA, Germany, France and the Netherlands, The USA is already deemed AA+ by S&P (August 2011) and France AA+ by S&P (January 2012) and Moody's (November 2012). So under our current strategy (must be deemed AAA by at least two out of the three main rating agencies) investment in French banks is no longer permissible. Whilst non-UK sovereign downgrades are unlikely to have much if any impact on our internally managed investment opportunities it will impact on the opportunities available to our external fund manager. Amongst other benefits, Investec via the money markets are able to invest in a broad range of high quality counterparties. As at the end of December only 44% of Investec's investments were in UK institutions (Barclays, Standard Chartered and UK Government). To ensure a sufficient number of counterparties remain available to Investec in the future some reduction in our sovereign credit criteria is likely to be necessary.

1.3.3 The Fitch AAA rating signifies “the **lowest** expectation of default risk. They are assigned only in cases of **exceptionally strong** capacity for payment of financial commitments. This capacity is highly **unlikely** to be adversely affected by foreseeable events”. The AA category signifies “expectations of **low** default risk. The capacity for payment of financial commitments is **considered strong**. This capacity may, nevertheless, be **more vulnerable** to adverse business or economic conditions than is the case for higher ratings”. The AA category includes + and - modifiers to denote relative status within the category. These modifiers do not change the underlying definition. The short description of AAA is “highest credit quality” and AA is “very high credit quality”. Our external treasury advisors have confirmed that AA rated sovereigns meet Fitch's support 1 requirement. Whilst a requirement for sovereigns to be AAA rated is desirable it isn't strictly necessary, a minimum of the AA category would suffice.

1.3.4 Adopting AA- as our minimum sovereign requirement and applying that to both in-house and externally managed funds would enable our risk appetite to be expressed as simply as possible. However, it would not be unreasonable to select a higher non-UK sovereign requirement that still provides additional flexibility over the choice of counterparty i.e. AA or AA+. Treasury Management Team’s preference is simplicity (i.e. AA-) and allow our external fund manager to focus on the credit quality of the particular financial institution that they will be investing in on our behalf. A recommendation to that effect appears at paragraph 1.8.1(2).

1.3.5 The sovereign requirement under the current strategy must be recognised by at least two out of the three main rating agencies. In adopting a lower sovereign requirement the 2013/14 Strategy requires that the minimum or better is recognised by **all three agencies** (Fitch, Moody’s and Standard & Poor’s). A recommendation to that effect appears at paragraph 1.8.1(3).

Investment of core funds

1.3.6 Our current strategy requires that all core funds (those funds that we will not need to spend during the course of a financial year) are managed by Investec. The strategy also requires that any cash flow surpluses that are available for a three month period or more are also passed to Investec unless Treasury Management Team believes the reward from placing investments in-house outweighs the risk. By default, the maximum duration of any internally managed investment will be twelve months (i.e. the financial year). The level of core funds is expected to be circa £15m at the end of this financial year and the annual draw circa £3m such that we can anticipate retaining the services of an external fund manager for at least the next two years. Market concerns arising from low growth (negative growth for some Western economies) yet persistent high levels of sovereign debt relative to GDP will remain for some time. As a consequence, Treasury Management Team believe the present split in investment responsibilities for core funds and cash flow funds should be retained and a recommendation to that effect appears at paragraphs 1.8.1(4).

External treasury advisors recommended duration

1.3.7 In August 2011 in response to increasing concerns relating to the Eurozone sovereign debt crisis our external treasury advisors recommended that investment in banks and financial institutions, other than the UK nationalised and part nationalised banks, be limited in duration to a maximum of three months. In early December 2011 the Bank of England Financial Policy Committee warned that banks should prepare to withstand an “extraordinarily serious and threatening” economic environment. The warning coincided with our decision to focus on security and transfer surplus funds to the UK Debt Management Office. Credit Defaults Swap (CDS) levels rose rapidly throughout the autumn of 2011 reaching a peak late December 2011. Since then the European Central Bank have introduced measures to ease bank liquidity and their Summer announcement to "do whatever it takes" followed by the detail of their bond purchasing scheme (Outright Money Transactions) has calmed markets. CDS levels have now fallen below those experienced in August 2011and in early January 2013 our external treasury advisors removed the three month duration cap. In common with the current Strategy, the 2013/14 Strategy requires that any investments placed in-house do not exceed our advisor’s recommended duration limit.

AAA rated bond / gilt / enhanced cash / government liquidity funds

1.3.8 These funds, like our money market funds (MMFs), are pooled investments i.e. our deposit is aggregated with other clients’ deposits to acquire assets with all deposit holders sharing the risks and rewards. Enhanced cash funds are being put forward by our external advisors as an alternative to more traditional fixed term investments of three or more months in duration.

1.3.9 Our strategy requires that any money market fund (**stable net asset value** fund) we use must carry the highest rating by at least one of the three main credit rating agencies. The Fitch rating of AAAmmf which most of our current MMFs have signifies a "strong capacity to achieve the money market fund's investment objective of preserving principal and providing shareholder liquidity through limiting credit, market, and liquidity risk". Enhanced cash and similar funds (**variable net asset value** funds) are designed to produce better returns than traditional MMFs. The fund manager will typically achieve this by taking more risk: credit, interest rate or liquidity. At present our strategy permits the use of enhanced cash and similar funds provided the fund is AAA rated and allows the same exposure to such funds as money market funds i.e. up to 20% of cash flow / core funds can be invested in any one fund with no limit on overall exposure to such funds. Whilst Treasury Management Team have yet to determine whether to take advantage of enhanced cash or similar funds we are minded to amend the strategy to recognise the greater risk associated with them and adopt a reduced exposure limit of 10% per fund and limit overall exposure to such funds to no more than 20% of cash flow and or core funds. A recommendation to adopt this approach appears at paragraph 1.8.1(5).

Updated strategies

1.3.10 The changes outlined in paragraphs 1.3.2 to 1.3.9 have been incorporated into the Treasury Management Strategy and Annual Investment Strategy for 2013/14. Both strategies are combined into a single document and are provided at **[Annex 4]**. Except where outlined above, no other changes to the Council's risk appetite have been incorporated into the new TMSS & AIS. A recommendation to adopt **[Annex 4]** appears at paragraph 1.8.1(6).

1.4 Legal Implications

1.4.1 These are set out above and at **[Annex 4]** to this report. In addition, Sector Treasury Services are employed to provide independent advice on legislative and professional changes that impact on the treasury management function.

1.5 Financial and Value for Money Considerations

1.5.1 The Bank Rate is expected to remain at a historical low (0.5%) throughout the 2013/14 financial year. Given the low interest rate environment and the continuing market uncertainty surrounding the Eurozone the Strategy is geared towards keeping investments short. The expected returns from cash flow and core investments for 2013/14 are 0.90% and 1.25% respectively. The "Funding for Lending" initiative introduced by the Bank of England together with similar initiatives abroad has had a significant downward impact on returns being offered by financial institutions in recent months. As a consequence the budgeted returns on both cash flow and core funds may prove difficult to achieve.

1.5.2 The performance of our fund manager is monitored against all of the players in the public sector cash management market place using data provided by Sector Treasury Services. In addition, the performances of both externally and internally managed investments are monitored against relevant benchmarks.

1.5.3 The Council invested £1m in a three month fixed term deposit with the Icelandic bank, Landsbanki. The bank went into administration a few days prior to the investments intended maturity in October 2008. The Council has participated in a joint action, co-ordinated by the Local Government Association, to recover the investment and associated interest. In April 2011 the Icelandic District Court ruled that such deposits have **priority status**. Following an appeal, this ruling was upheld by the Icelandic Supreme Court in September 2011. Agreement to the Council's settlement was approved by the Icelandic District court in May 2012 and payment of our first distribution of funds received in June 2012. A further distribution of funds was made in October 2012 bringing the total recovery to date to just under £491,000.

1.5.4 Subject to exchange rates, we anticipate that we will recover all of the £1m we had on deposit with Landsbanki together with the interest that was due had the deposit been repaid on time. In addition, this Council was one of a limited number of authorities who submitted a demand for repayment. The validity of our demand has been recognised by the award of additional interest (gap interest for the period October 2008 to April 2009). The way in which the LGA and our legal advisors have co-ordinated the legal action with other local authorities has minimised legal costs whilst enabling us to advance the strongest possible arguments to secure this excellent result. The cost of the litigation to date amounts to less than 1 per cent of the amount we expect to recover.

1.6 Risk Assessment

1.6.1 Sector Treasury Services are employed to advise on the content of the Treasury Management Strategy Statement and Annual Investment Strategy and this, coupled with a regular audit of treasury activities ensures that the requirements of the Strategy and the Treasury Policy Statement adopted by this Council are complied with.

1.6.2 Credit ratings remain a key tool in assessing risk. It is recognised that their use should be supplemented with sovereign ratings and market intelligence. Appropriate sovereign, group and counterparty limits need to be established to ensure an appropriate level of diversification.

1.6.3 In the light of these safeguards and stringent Treasury Management Procedures it is considered that any risks to the authority implicit in the 2013/14 Strategy have been minimised.

1.7 Equality Impact Assessment

1.7.1 See 'Screening for equality impacts' table at end of report.

1.8 Recommendations

1.8.1 Members are invited to **RECOMMEND** that Cabinet:

1) note the treasury management position as at 28 December 2012;

2) adopts a non-UK sovereign credit requirement of Fitch AA- or equivalent;

3) amends recognition of the minimum sovereign credit requirement to that expressed by all three credit rating agencies (Fitch, Moody's and Standard & Poor's);

4) maintains the current split of investment responsibilities requiring all core funds to be managed exclusively by the Council's external fund manager;

5) adopts a 10% exposure limit to each enhanced cash or similar AAA rated fund (no more than 20% exposure to such funds at any one time) and;

6) adopts the Treasury Management Strategy Statement and Annual Investment Strategy for 2013/14 set out at **[Annex 4]**.

Background papers: contact: Michael Withey

Templates and forecasts provided by Sector and Investec.
Fitch Rating Definitions.

Sharon Shelton
Director of Finance

Screening for equality impacts:		
Question	**Answer**	**Explanation of impacts**
a. Does the decision being made or recommended through this paper have potential to cause adverse impact or discriminate against different groups in the community?	No	N/A
b. Does the decision being made or recommended through this paper make a positive contribution to promoting equality?	No	N/A
c. What steps are you taking to mitigate, reduce, avoid or minimise the impacts identified above?		N/A

In submitting this report, the Chief Officer doing so is confirming that they have given due regard to the equality impacts of the decision being considered, as noted in the table above.