TONBRIDGE & MALLING BOROUGH COUNCIL

CABINET

7 February 2012

Report of the Director of Finance

Part 1- Public

Matters for Recommendation to Council

1 TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY FOR 2012/13

The report provides details of the current investment position and invites Members to consider using Sector's creditworthiness methodology to guide future updates to the Council's lending list. The report concludes with a review of and recommendation to full Council to adopt the Treasury Management Strategy Statement and Annual Investment Strategy for 2012/13.

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, therefore, 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.

1.1.3 The Strategies are set out in a single document at **[Annex 4]** to this report.

1.1.4 The portfolio of the Audit Committee includes the review of treasury management activities. Accordingly, that Committee was asked to review the matters covered by this report and **[ANNEX 4]** on 23 January 2012. Members recommended an alteration to the text included in the Economic Background (Appendix 5 of Annex 4) which has now been made. The recommendations as set out in the Audit Committee report and replicated at paragraph 1.8.1 to this report were approved.

1.1.5 The Strategy is a complex technical document and is a specialist area of work, I should be grateful if Members could **raise any queries with the author of this report (Michael Withey ext. 6103) in advance of the meeting as Michael will not be present on 7 February**.

1.2 2011/12 Investment Position

1.2.1 In accordance with the CIPFA Code, 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 the continuing Eurozone sovereign debt crisis prompts a low risk and short term strategy. Within this risk adverse 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 £21m 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 As at the beginning of January 2012 funds invested and interest earned is set out in the table below:

	Funds invested at 6 January 2012 £m	Average duration to maturity Days	Gross annualised return to 6 January 2012 %	7 day Libid benchmark %	Interest earned to 6 January 2012 £
In-house cash flow – excl Landsbanki	11.4	26.6	0.93	0.53	71,450
In-house core fund	0.0	0.00	6.25	0.53	23,950
Externally managed core funds	21.0	147.9	1.67	0.53	260,450
Total	32.4	105.0	1.50	0.53	355,850

1.2.4 The authority out-performed the benchmark by 97 basis points. Key contributions to that out-performance came from the internally managed core fund investment with the Nationwide Building Society which was acquired prior to the 'credit crunch' and from our external fund manager. In cash terms investment income is running some £89,000 above profile based on our original 2011/12 estimates.

In-house Managed Cash Flow and Core Fund 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:

£m	Bank / Building Society	Duration	Rate	Period
1.0	Bank of Scotland	9 Months	1.80%	24/05/11 – 24/02/12
1.0	Lloyds TSB	9 Months	1.80%	24/05/11 – 24/02/12
1.0	Barclays	6 Months	1.04%	24/05/11 – 24/11/11
0.5	Santander UK	3 Months	1.13%	09/06/11 – 09/09/11
1.5	National Westminster	3 Months	0.96%	30/11/11 – 29/02/12
2.0	Barclays	3 Months	0.94%	30/11/11 – 29/02/12

1.2.6 Our last remaining core fund investment matured on 27 May 2011 (Nationwide £2.5m at 6.25%, 28/05/08 - 27/05/11). In accordance with the 2011/12 Annual Investment Strategy those funds were passed to our external fund manager

Externally Managed Core Funds

1.2.7 Our external fund manager is currently performing above the level anticipated in our 2011/12 Annual Investment Strategy. Annualised gross return at the beginning of January was 1.67% vs an original estimate of 1.31%. This better than expected performance is primarily attributed to the opportunistic purchase and disposal of gilts during the summer months. The disposals took advantage of price increases when the UK was (and still is) seen as a safe haven given concerns over the Eurozone sovereign debt crisis.

Current Investments

1.2.8 A full list of investments held on 6 January 2012 is provided at **[Annex 1]** of this report. The yields on the total sum invested of £32.4m exclusive of Landsbanki is 1.11% comprising internally managed investments of £11.4m at 1.02% and externally managed investments of £21m at 1.16%.

1.2.9 Other than for the UK nationalised and semi-nationalised banks our 2011/12 Annual Investment Strategy stipulates a minimum credit criteria of Fitch long-term AA-, short-term F1+, Individual C and support 1. These minimum criteria must be observed at the time any new investment is placed. The risks arising from any subsequent downward revision of credit ratings are evaluated as they arise. Members will note from **[Annex 1]** that Barclays and Nationwide no longer meet our minimum Fitch requirement. The Treasury Management Team have reviewed the position and are content that whilst no new investments should be placed with these institutions the existing investments with both Barclays and Nationwide should be allowed to run to maturity.

1.2.10 As a consequence of heightened concerns in the week leading up to the November EU Leaders Summit meeting, the Treasury Management Team took the decision to transfer our money market fund investments to the UK Debt Management Office. The joint action taken by Central Banks at the end of November and the €489bn three year loans provided by the ECB to Eurozone banks in December have provided some respite to the growing liquidity problems facing European banks and as a consequence our use of money market funds was resumed in January. The Eurozone debt crisis is yet to be resolved to the satisfaction of the financial markets and officers remain vigilant to the risks this poses to European and global banking systems.

1.3 Treasury Management Strategy Statement and Annual Investment Strategy for 2012/13

1.3.1 A copy of our internal lending list as of 9 January 2012 is provided at **[Annex2]**. Members may recall earlier versions which have been submitted to previous meetings of the Audit Committee. The current list is notable for its lack of UK financial institutions. Several 'High Street' names which have been utilised during the financial year to provide fixed term investment opportunities, no longer meet our minimum Fitch requirement (AA-, F1+, C, 1). Moody's undertook a review of UK financial institutions in October following the publication of the Independent Commission on Banking's report (often referred to as the Vickers report) in September. The report made a number of recommendations one of which is to separate retail and investment banking. Whilst the recommendations contained in the report are supported by the Government, legislation is not imminent and separation unlikely for a number of years. Nevertheless, Moody's reacted to the change in "political will" to support UK banks and reflected this in their credit analysis in early October. Within a week Fitch had followed suit. There have been subsequent downgrades by all three rating agencies reflecting the weaker growth forecasts for the UK and other European economies.

1.3.2 The same minimum credit requirement is applied by our external fund manager when undertaking investments on the Council's behalf. Via the money markets the fund manager has access to non-UK financial institutions. However, the general decline in prospects for economic growth throughout western economies together with concerns relating to the Eurozone sovereign debt has led to a spate of downgrades by the credit rating agencies. Going forward, the fund manager's access to non-UK financial institutions is becoming increasingly limited and his access to UK banks and building societies on a par with our own. Diversification of investment across a variety of counterparties is an essential element in the control of risk.

1.3.3 With assistance from our external fund manager and Sector our treasury advisors, the Treasury Management Team have concluded that a new approach to the assessment of credit risk is called for. In response to perceived weaknesses of rating agencies credit risk assessments, Sector introduced a credit worthiness methodology. The methodology uses a sophisticated modelling approach utlilising the credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard and Poor's. The credit ratings of counterparties are then supplemented with overlays to reflect:

- the credit watches and credit outlooks from credit rating agencies and;
- the credit default data (CDS spreads) to give early warning of likely changes in credit ratings.

1.3.4 This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads. The end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties (green - 3 month duration, red - 6 month duration etc). In the absence of any negative adjustment for credit watches, outlooks or CDS spreads, a financial institution with a Fitch rating of (A, F1, C (bbb-) and 1) would be attributed a 3 month durational band. An illustration of the approach and its resultant impact on our lending list by adopting counterparties with a minimum duration band of three months (green) is provided at **[Annex 3]**. The annex also includes a high level interpretation of the Fitch rating scale.

1.3.5 The methodology was devised following the 2008 'credit crunch' which saw a number of financial institutions fail. Using the approach would enable UK institutions including Barclays, Santander UK and Nationwide to be reinstated onto the Council's lending list. The methodology has been adopted by a number of Kent authorities including Gravesham, Medway and Sevenoaks.

1.3.6 The Sector credit list is updated in full on a weekly basis. Sector also circulate changes in credit rating agency assessments as they are issued which ensures the credit list reflects the latest position. Our external fund manager applies a similar approach to the Sector methodology when assessing counterparty credit and duration risk. To enable them to operate effectively they require clarity over the Council's minimum counterparty credit rating. The 2012/13 Annual Investment Strategy adopts a minimum requirement of Fitch (A, F1, C(bbb-),1).

1.3.7 As a counterbalance to the lower initial credit quality requirement the Treasury Management Team have reviewed our counterparty exposure limits. In the Annual Investment Strategy 2012/13 exposure to non-UK sovereigns, counterparties and groups of related counterparty is being reduced from the current 25% to 20%. In cash terms this is likely to equate to a limit of circa £4m for externally managed investments and £2m for internally managed investments.

1.3.8 The changes outlined in paragraphs 1.3.3 to 1.3.7 have been incorporated into the Treasury Management Strategy and Annual Investment Strategy 2012/13. Both strategies are combined into a single document and provided at **[Annex 4]**.

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 2012/13 financial year. Given the low interest rate environment the Strategy is geared towards keeping investments short in order to benefit from the compounding of interest. The expected returns from cash flow and core investments are 0.90% and 1.25% respectively.

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 In respect of our “defaulted” £1m investment with Landsbanki, the Landsbanki test case appeal hearings took place in the Supreme Court of Iceland on 14 and 15 September 2011. We are delighted the Icelandic Supreme Court has found in favour of UK local authorities and other UK wholesale depositors. This judgement means that UK local authorities’ claims have been recognised as deposits with priority status over other creditors' claims. We expect the winding up board of Landsbanki to apply the Supreme Court decision to the non-test cases, of which this Council is one. This should mean that we will be paid first when it comes to getting our money back and will recover almost all (98%) of the £1m we had on deposit with the failed Icelandic bank Landsbanki.

1.5.4 This decision which comes more than 3 years after the bank failed is a huge victory. 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.

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 2012/13 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 Cabinet are invited to consider and **RECOMMEND** that full Council:

1) notes the treasury management position as at 6 January 2012;

2) endorses Officers decision not to call for the premature repayment of investments held with Barclays and the Nationwide;

3) adopts Sector's creditworthiness methodology for use in the selection and deselection of counterparties to be included on or removed from the Council's internal lending list;

4) adopts the minimum credit criteria of Fitch long-term A, short-term F1, individual (viability) C (bbb-) and support 1 for use by the Council's external fund manager;

5) adopts a 20% exposure limit to counterparties, groups of related counterparty and non-UK sovereigns and;

6) adopts the Treasury Management Strategy Statement and Annual Investment Strategy for 2012/13 set out at **[Annex4]**.

Background papers: contact: Michael Withey

Templates and forecasts provided by Sector and Investec.
Fitch Rating Definitions September 2011.

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

Screening for equality impacts:		
Question	**Answer**	**Explanation of impacts**
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.