TO: GOVERNANCE AND AUDIT COMMITTEE
6 NOVEMBER 2012

TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY – MID-YEAR REVIEW REPORT 2012/13
Borough Treasurer

1 PURPOSE OF REPORT

1.1 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensures this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering maximising investment return.

1.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the longer term cash flow planning needs to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses.

1.3 As a consequence treasury management is defined as:

"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks. "

1.4 The Local Government Act 2003 requires a local authority to "have regard to" guidance issued by, or specified by, the Secretary of State. As such, the Council is required to have regard to the Prudential Code and the Code of Practice on Treasury Management in the Public Sector, both issued by the Chartered Institute of Public Finance and Accountancy (CIPFA).

1.5 One of the primary requirements of the code is for the receipt by Full Council of a Mid-Year Review Report of the Treasury Management activities of the authority and for the review of the treasury management strategy by a delegated body.

2 RECOMMENDATIONS

2.1 That the Committee consider and review the Mid-Year Review Report and share the report with members of the Full Council.

2.2 That the Committee comment on the proposed approach to the future selection of investment counterparties.

3 REASONS FOR RECOMMENDATIONS

3.1 A primary requirement of the CIPFA Code of Practice on Treasury Management is to provide Full Council with a Mid-Year Review Report on its Treasury Management activities and for the delegation by the Council to a body for the review of the Treasury Management Strategy. This report, by being reviewed by the Governance and Audit Committee and shared with members of Full Council, fulfils this requirement.

4 ALTERNATIVE OPTIONS CONSIDERED

4.1 None.

5 SUPPORTING INFORMATION

5.1 This mid year report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- An economic update for the first six months of 2012/13
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- The Council's capital expenditure (prudential indicators)
- A review of the Council's investment portfolio for 2012/13;
- A review of compliance with Treasury and Prudential Limits for 2012/13

5.2 There have been no changes to the Council's Treasury Strategies during the year to date.

Economic Update

5.3 After a very uncertain and economically challenging start to the year, there are the initial signs that economic growth may have returned after three quarters of recession. However the normal economic indicators used to evaluate the financial health of the country have been impacted by a range of unique circumstances, including the Queen's Jubilee and associated additional bank holidays followed closely by the London 2012 Olympics, which combined with the climatic challenges faced by the country this summer have clouded many of the economic forecasts.

5.4 However as the third quarter begins, GDP growth looks set to be positive for the first quarter in a year, and both industrial production and the overall trade deficit have posted some encouraging numbers. This return to growth has also been supported by a continuing recovery in the jobs market whilst pay growth has remained modest.

5.5 Banks funding costs continued to ease over the year, reflecting the Bank of England's provision of low cost liquidity to banks and the start of the "Funding for Lending Scheme" initiative. Meanwhile the trend in public borrowing has continued to deteriorate, with forecasts suggesting borrowing of £145bn as a whole in 2012/13 coming in significantly above the Office for Budget Responsibility's forecast of £120bn.

5.6 Inflation has struggled to make further downward progress in the last quarter, and whilst inflation should continue to drop to around 2% in autumn, further falls over the remaining part of the year look unlikely.

5.7 As a result of the above, GDP posted a healthy quarterly rise of 1% in Quarter 3, however this is unlikely to contribute enough to generate positive growth for the year as whole and as such 2012 is likely to be seen as adding to the worst and slowest recovery from recession of any of the five recessions since 1930.

5.8 There remain huge uncertainties in economic forecasts due to the following major difficulties:

- the impact of the Euro-zone crisis on financial markets and the banking sector

- the impact of the UK Government's austerity plan on confidence and growth
- Monetary policy action failing to stimulate growth in western economies
- the potential for weak growth or recession in the UK's main trading partners – the EU and the US

5.9 The overall balance of risks remains weighted to the downside. Given the weak outlook for economic growth, the prospect for any interest rate changes before mid-2014 are very limited. The latest forecast on the Bank Rate, as provided by the Council's Treasury Management advisers, is shown below

	Now	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13	Mar 14
Bank Rate	0.5%	0.5%	0.5%	0.5%	0.5%	0.5%	0.5%

Treasury Management Strategy Statement Review

5.10 The Treasury Management Strategy Statement (TMSS) for 2012/13 was approved by the Council on 29th February 2012. There are no policy changes to the TMSS, the details in this report update the position in the light of the updated economic position.

Capital Expenditure

5.11 The table below shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget. The Council is on target to achieve the original forecast Capital Financing Requirement (£37m - reflecting the underlying need to borrow for a capital purpose) and no external borrowing is forecast for the year.

Department	Approved Budget 2012/13 £'000s	Cash Budget 2012/13 £'000s	Estimated Out-turn 2012/13 £'000s	Cash Budget 2013/14 £'000s	(Under) /Over Spend £'000s
Council Wide	9,292	4,383	4,383	4,908	0
Corporate Services	852	845	845	7	0
Children, Young People and Learning	21,672	12,581	12,581	9,090	0
Adult Social Care, Health and Housing	6,130	5,875	5,875	255	0
Environment, Culture & Communities	8,871	8,531	8,472	340	-59
TOTAL CAPITAL PROGRAMME	46,817	32,215	32,156	14,600	- 59

5.12 In accordance with the 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. As set out above, it is a very difficult investment market. Yields are very low, in line with the 0.5% Bank Rate, and the continuing Euro-zone sovereign debt crisis prompts a low risk strategy. Within this risk adverse environment investment returns are likely to remain low.

Review of Investment Portfolio 2012/13

5.13 The Council held £41.7m of investments as at 30 September 2012 (£35.2m at 31 March 2012) and the investment portfolio yield for the first six months of the year is 1.13% against a benchmark (Local Authority 7-Day Rate) of 0.43%.

5.14 The 2012/13 interest budget assumed that an average interest rate of 1.0% would be earned on the Council's investment portfolio. Taken together with the income generated by pre-funding the 2012/13 pension fund contribution the interest budget was estimated to be £469,000. The Bank Rate (set monthly by the Bank of England) has remained at an historical low of 0.5% and, given the current weaknesses in both the UK and the Global economy, is likely to remain at this level for some months to come.

5.15 However cash balances remain on the upside, creating additional opportunities to deposit surplus cash at longer fixed term maturities, rather than having to limit investments to overnight low-yielding money market funds. However the Council is limited by the number of counterparties available to it. Furthermore the continued global economic uncertainties pushed up yields on longer-dated maturities as banks faced liquidity challenges in the early part of this financial year. The Council continues to invest in only the most highly rated UK financial institutions, or those part-nationalised UK Banks. Notwithstanding this low-risk approach, given the opportunities presented by these longer-term maturities, the additional yield will contribute to the investment projections for 2012/13 and as such an additional £200,000 of investment income has been projected for the year.

Compliance with Treasury and Prudential Limits for 2012/13

5.16 The Borough Treasurer can confirm that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2012/13 and no changes to these limits are proposed in 2012/13.

Investment Counterparties

5.17 The authority employs a counterparty selection criteria approved annually by Council that sets out the financial institutions that the organisation can deposit funds with. The key criteria used are the credit ratings supplied by the three main credit rating agencies. The Council maintains a low risk approach to counterparty selection and there is no intention on diverging from this, however over recent years there has been a shift in the reliance placed purely in credit-ratings on counterparty selection. As such it is considered appropriate to review the current methodology with a view to moving to a more sophisticated model of counterparty selection.

5.18 The financial crisis following the Lehman's collapse and the recent sovereign credit-worthiness difficulties, almost all financial institutions, and indeed countries, have experienced a substantial cut in their credit-ratings, often to a level that would render most counterparty criteria unsuitable for practical purposes. The Council's current criteria limits investments in only two UK financial institutions willing to deal in the size of transactions available to the Council, namely HSBC and Nationwide. This list was supplemented last year with the inclusion of part-nationalised banks, which whilst not meeting the Council's strict credit-rating criteria are seen to offer low levels of risk given the support they are afforded through the UK Government. Whilst such a criteria mitigates a particular level of risk, it increases the risk associated with lack of diversification, resulting in a much higher weighting in low-yielding AAA rated overnight deposits.

5.19 In addition it has been widely acknowledged that credit-ratings on their own are not sufficient in capturing and evaluating the relative levels of risk attached to a counterparty. The CIPFA code recommends that Councils do not place sole reliance on credit-rating scores but use other techniques and financial analysis to evaluate credit-worthiness. There is a wide range of such information, much of which is provided by the Council's Treasury Management advisers.

5.20 One such technique is the use of a Credit Default Swap (CDS) which is a marketable instrument or agreement whereby the seller of the CDS will compensate the buyer in the event of a loan default. In simple terms the buyer of the CDS makes a payment to the seller and in exchange receives a payoff if the company defaults. However CDS are tradable and a huge market exists ($25tn) and they are actively used to monitor how the market views the credit risk of any entity for which a CDS is available. On their own, the risk reflected by the level of a CDS is complex to evaluate however they can be used in tracking their relative movement and more importantly their movement against an index of industry peers.

5.21 In light of the changing economic backdrop, the shift in the relative importance of credit-ratings and the sector's requirement for a more sophisticated approach to counterparty selection, the Council's Treasury Management advisers have developed a modelling approach utilising credit ratings from the three main credit rating agencies supplemented with overlays of credit watches and outlooks in a weighted scoring system which is then combined with CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. This service uses a wider array of information than just primary ratings and by using a risk weighted scoring system does not give undue preponderance to just one agency's ratings.

5.22 Typically the minimum credit rating that the Council will use will be a short term rating of F1 and a long term rating of A-, with Viability ratings of BB+ and a Support rating of 3. The existing criteria differs only in the Support Rating where the current limit is 2 and as such the recommended change in criteria represents a slight increase in risk.

5.23 The definition as provided by Fitch for a support level 2 compared to a support level 3 is documented below;

- Support Level 2: A bank for which there is a high probability of external support. The potential provider of support is highly rated in its own right and has a high propensity to provide support to the bank in question.

- Support Level 3: A bank for which there is a moderate probability of support because of uncertainties about the ability or propensity of the potential provider of support to do so.

5.24 The Support Rating is an assessment of a potential supporter's propensity to support a bank and of its ability to support it and as such does not assess the intrinsic credit quality of a bank, but rather communicates the agency's judgement on whether the bank would receive support should this become necessary. Support ratings have been significantly impacted by both the large number of sovereign rating cuts and the acceptance that sovereign nations will be unable to support all banks should the global economic conditions deteriorate substantially.

5.25 However this change in support level is offset to a large extent through the additional use of CDS spreads which adds an additional level of risk evaluation not currently used by the Council. All credit ratings will be monitored weekly and the Council will be alerted to changes in ratings through the use of its adviser's creditworthiness service. Furthermore sole reliance will not be placed on the use of this external service. In addition the Council will also use market data and information on government support for banks and the credit ratings of that government support.

5.26 The Council's investment criteria will continue to limit deposits in only UK banks, up to a limit of £7m, and whilst it will continue to limit investments to less than 1Year it will make use of the more sophisticated model provided by its advisers to limit individual institutions by duration.

5.27 Annex A contains the Council's existing Counterparty List and Annex B outlines how the list might look under the proposed changes. A number of new institutions have become available for consideration, before extending the CDS overlay. However once this additional rigour has been applied, only Barclays, Bank of New York Mellon (BNYM) and Credit Suisse International are added to the counterparty list. It is worth noting, that traditionally both BNYM and Credit Suisse do not deal with Local Authorities given the relatively small size of deposits involved. As such, in practical terms, the only additional name to the list would be Barclays.

5.28 The suggested adoption of this new model has many positive attributes; it broadly maintains the Council's risk exposure and explicitly identifies a clear list of approved counterparties. However a major benefit of this sophisticated model is that it provides a robust and methodical approach to the quantification of risk through both credit-ratings and market-generated risk assessment that can be clearly followed and communicated.

5.29 As such officers wish to take this early opportunity to examine such an approach alongside Members before recommending any possible change for 2013/14 in the Council's Treasury Management Strategy Statement which must be agreed in March 2013.

6 ADVICE RECEIVED FROM STATUTORY AND OTHER OFFICERS

<u>Borough Solicitor</u>

6.1 No further comments

<u>Borough Treasurer</u>

6.2 No further comments

<u>Equalities Impact Assessment</u>

6.3 None

<u>Strategic Risk Management Issues</u>

6.4 The income earned on investments contributes significantly to the Council's overall funding of services. This income will depend on the cash balances held by the Council and the interest rates earned by its deposits, both of which are linked directly to the Council's Treasury Management and Investment Strategy. This report sets out to update Members with the performance in the first half of the year; however the authority closely monitors investment performance on a monthly basis through its rigorous budget monitoring procedures.

Other Officers

6.5 None

7 CONSULTATION

Principal Groups Consulted

7.1 None

Method of Consultation

7.2 None

Representations Received

7.3 None

Background Papers

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