TO: GOVERNANCE AND AUDIT COMMITTEE
29 JANUARY 2013

TREASURY MANAGEMENT REPORT
(Borough Treasurer)

1 PURPOSE OF DECISION

1.1 To review the Treasury Management Report.

2 RECOMMENDATIONS

2.1 That the Committee review the Treasury Management Report prior to its approval by Council.

3 REASONS FOR RECOMMENDATIONS

3.1 The reasons for the recommendations are set out in the report.

4 ALTERNATIVE OPTIONS CONSIDERED

4.1 The Code of Practice requires the Council's annual Treasury Strategy to be examined and reviewed by a responsible body. The Governance and Audit Committee has been nominated by Council to be that body.

5 SUPPORTING INFORMATION

5.1 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 Code of Practice on Treasury Management in the Public Sector, both issued by the Chartered Institute of Public Finance and Accountancy (CIPFA).

5.2 Under the requirements of the Prudential Code, the Council must set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable. The attached Treasury Management Report outlines the Council's Prudential Indicators for 2013/14 to 2015/16 and sets out the expected treasury operations for this period.

5.3 The Code of Practice recommends that a responsible body be nominated by the Council and having examined and assessed the effectiveness of the treasury management strategy and policies recommend them to Council. At its meeting on 2 March 2011 Council nominated the Governance and Audit Committee as the responsible body.

5.4 The attached Treasury Management Report (annex A) was approved by the Executive, as a part of the Council's overall budget proposals, on 11 December 2012. The Executive requested that the Governance and Audit Committee review each of the key elements. Following this review the Treasury Management Report and associated documents will be presented to Council for approval on 29 February 2013, as a part of the overall budget package and resolution on the Council Tax for 2013/14.

Counterparty Selection

5.5 The Committee reviewed the 2012/13 half-yearly report in November 2012 and included in that review was the recommendation that the Council should consider adopting an amended approach to selecting the Counterparties used for investments. The reasons behind this change were highlighted to the Committee and can be best summarised as follows

- 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 a result of the recent financial crisis and the sovereign creditworthiness difficulties, almost all financial institutions, and indeed countries, have experienced a substantial cut in their credit-ratings, almost to a level that would render most counterparty criteria unsuitable for practical purposes.
- It is 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.
- A widely-recognised additional indicator is the Credit Default Swap (CDS) which is a marketable instrument whereby the seller will compensate the buyer in the event of a loan default. 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.
- In light of the changing economic backdrop the Council's Treasury Management advisers (Sector) 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.

5.6 The Committee agreed, after discussing the attributes of the recommended Sector model, to support the amended approach to Counterparty selection and as such the 2013/14 Treasury Management Strategy, included within the 2013/14 Budget Proposals, recommended such an approach.

5.7 At the time of the November meeting there was still considerable uncertainty in global economic markets, with particular concern regarding the weaker Euro Zone countries (Greece and to a lesser extent Spain and Italy) and the impending American "Fiscal Cliff" which alluded to the difficult situation facing the United States administration in agreeing a fiscal budget by the end of December 2012. Given these continuing risks, the Sector Model maintained the approach adopted in September 2011 to limit for all but a few exceptions maximum durations of 3 months.

5.8 The Council's own Investment Criteria limits all investments to 364 days and £7m in any one institution, but operationally the majority of maturities are limited to 3 months, and as such was broadly in step with the Sector model.

5.9 However these temporary restrictions within in the Sector Model are to be lifted, and with the recommended full adoption of the Model in 2013/14 it is appropriate that the reasons behind this are explained to the Committee. It should be made clear that there will be no changes made to the underlying Treasury Management Strategy of the Council. Maturities will not extend beyond 364 days, however operationally, if cash flow permits it, investments can be extended beyond 3 months for financial institutions meeting the strict credit criteria adhered to by the Council.

5.10 Since the impositions to the temporary revisions Sector have maintained a constant oversight of market conditions and believe that given the underlying improvements in these as outlined below, the need for a more stringent limit on duration is no longer necessary. This does not mean that problems within financial markets are fully resolved; however it is a reflection that some of the excess fears surrounding the continued existence of the Eurozone have subsided and that liquidity in financial markets is now significantly improved.

5.11 There have been a number of clear reasons for the marked improvement in financial markets as follows:

- The decision by the European Central Bank to announce unlimited support for sovereigns subject to stringent requirements, via its Outright Monetary Transaction programme, who request external aid. Although no country has, as yet, sought help, just the offer of such backing has seen yields on peripheral government bonds fall back materially in the second half of 2012.
- There were two major UK funding announcements in 2012. The first was the Extended Collateral Term Repo facility which provided institutions, via regular auctions, access to 6 month funding at Bank Rate plus 0.25%. The second was the Funding for Lending scheme which also allowed financial institutions access to low cost funding for an extended period.
- The partial success in the US of averting the “fiscal cliff” via an agreement on tax changes in the opening moments of 2013.

5.12 However the outlook for 2013 remains mixed at best. The UK is expected to struggle to generate positive growth and this may lead one or more of the main rating agencies to cut our “AAA” sovereign rating. Although evidence from others who have been cut before from AAA would suggest that the impact may not be severe, it may add to market nervousness. In addition, the US fiscal situation is far from resolved and the final key element of market concern will remain the Eurozone. Fresh issues in Spain and Greece will always have the ability to raise concerns as well.

5.13 However the improvement in market metrics seen since the second half of 2012 and the more recent stability are enough for Sector to lift the temporary suggested investment cap put in place in September 2011 within its Model realising the potential for the Council to extend maturities over the coming months. However, this is a sign of markedly improved stability, not a signal that the ills of the financial crisis are gone. Conditions will likely remain volatile for some time, but within more reasoned levels than seen previously.

Understanding Credit Ratings

5.14 The Committee asked, at its meeting in November, for an explanation of the various Credit Ratings used by the Council in its Counterparty selection. The Sector Model uses a combination of all three of the main Credit Ratings Agencies who each use slightly different terminology. In order to examine and explain the ratings used by the Council, this summary focuses on those used by Fitch. A more comprehensive description of each category and its ratings is given in Annex B

- Sovereign Credit Rating
  Fitch assigns a long term credit rating to the country in which the financial institution being rated is domiciled. This credit rating assesses the economic health of the country including its ability to service its debt and also its capacity to support the banking system in that country should financial support be required. The assessment follows the normal long term rating scale, the highest rating being AAA with anything below BBB being non investment grade i.e. "junk bond status". The UK has a AAA rating and the Council's policy is to invest only in UK institutions.

- International Long - Term Credit Ratings
  Long - term credit ratings are an attempt to assess the ongoing stability of an institution's prospective financial condition given such factors as sensitivity to fluctuations in market conditions and the capacity for maintaining profitability or absorbing losses in a difficult operating environment. Traditionally they look beyond a 12 month horizon. Investment grade ratings range from AAA to BBB, the full range is given in Annex B

  The minimum rating that BFC will use is A- which is mid range in the ratings referred to above. **A** ratings denote a low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong.

- International Short - Term Credit Ratings
  A short - term rating has a timescale of less than 12 months for most obligations and thus places greater emphasis on the liquidity necessary to meet financial commitments in a timely manner. The minimum rating that BFC will use is F1. This indicates the strongest capacity for timely payment of financial commitments. The ratings range from F1 through to D.

- Viability Ratings
  Viability ratings are a relatively new introduction by Fitch and effectively replace the old Individual ratings. The viability rating represents the capacity of a bank to maintain ongoing operations and to avoid failure in the absence of external e.g. Governmental support , Thus, viability ratings permit an evaluation separate from any consideration of outside support. The Council's old minimum individual rating was B/C. The nearest equivalent Viability rating is BB+ which denotes moderate but acceptable prospects for ongoing viability. The bank's fundamentals are adequate such that there is a low risk that it would have to rely on extraordinary support to avoid default. However, adverse business or economic conditions are more likely to impair this capacity rather than say an A rating.

- Support Indicator
  This indicator gives an indication as to how much external support, predominately from the state, a bank could expect to receive if it were to run into difficulties. The range is from 1 to 5 with 1 being the highest degree of support and 5 the lowest. 1 is assigned only to banks for which there is an extremely high probability of external support e.g. Barclays Bank in the UK. The potential provider of support is very highly rated in its own right and has a very high propensity to support the bank in question e.g. the UK Government which is rated AAA. BFC will invest in institutions with a Support Indicator in the range of 1 to 3.

Level of Investments

5.15 Investments are governed by the level of cash available to the Council, those institutions that meet the Council's current investment criteria and the cash-flow requirements of the Council. The table below indicates the investments held on the 18th January 2013.

Investment	Maturity	Amount (£)	Average Rate (%)
Money Market Funds			
Prime Rate	1 Day	6,979,000	0.46
Ignis	1 Day	6,973,100	0.45
Golman Sachs	1 Day	6,981,000	0.38
RBS	1 Day	6,835,000	0.33
Black Rock	1 Day	1,075,000	0.31
		28,843,100	
Fixed Term Deposits			
RBS	31/01/2013	3,500,000	1.85
Lloyds	31/01/2013	3,500,000	2.50
Nationwide	07/02/2013	3,500,000	0.83
Nationwide	19/04/2013	3,500,000	0.45
RBS	17/05/2013	3,500,000	1.06
Lloyds	16/08/2013	3,500,000	2.85
		21,000,000	
Total Investments		**49,843,100**	

6 ADVICE RECEIVED FROM STATUTORY AND OTHER OFFICERS

Borough Solicitor

6.1 None.

Borough Treasurer

6.2 The financial implications are contained within the report.

Equalities Impact Assessment

6.3 None.

Strategic Risk Management Issues

6.4 The Treasury Management Report deals directly with the strategic management of risk associated with the Council's treasury management activities

7 CONSULTATION

Principal Groups Consulted

7.1 The Overview & Scrutiny Commission was consulted on the budget proposals, including the Treasury Management Strategy, in December. The timetable for the approval of the 2013/14 Budget is as follows

Executive agree proposals as basis for consultation	11 December 2012
Consultation period	12 December 2012 - 22 January 2013
Executive considers representations made and recommends budget.	13 February 2013
Council considers Executive budget proposals	27 February 2013

Background Papers

None

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