

**Report to:** Cabinet  
Council

**Date of Meeting:** 10 November 2011  
24 November 2011

**Subject:** Treasury Management 2011/12 – Half year Update

**Report of:** Head of Corporate Finance & ICT

**Wards Affected:** All

**Is this a Key Decision?** No

**Is it included in the Forward Plan?** No. Report presented due to changes in the financial markets which may have a revenue impact.

**Exempt/Confidential** No

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### **Purpose/Summary**

To inform members of Treasury Management Activities undertaken in the first half of 2011/12, and of the recent activity of credit rating agencies. An amendment of the credit ratings as approved by Council on 3 March 2011 is also presented.

### **Recommendation(s)**

1. The Treasury Management update for the first half year of 2011/12 be noted;
2. Recommend to Council the following change to The Treasury Management Strategy Document approved by Council on 3 March 2011. The report stated that our credit criteria for investing with institutions would include those that had a “Fitch rating of F1+ AA-, with an individual rating of C, and support rating of minimum 2” (paragraph 2.8.9). This is to be amended to “Fitch rating F1 A-“.

### **How does the decision contribute to the Council’s Corporate Objectives?**

	<b><u>Corporate Objective</u></b>	<b><u>Positive Impact</u></b>	<b><u>Neutral Impact</u></b>	<b><u>Negative Impact</u></b>
1	Creating a Learning Community		√	
2	Jobs and Prosperity		√	
3	Environmental Sustainability		√	
4	Health and Well-Being		√	
5	Children and Young People		√	
6	Creating Safe Communities		√	
7	Creating Inclusive Communities		√	
8	Improving the Quality of Council Services and Strengthening Local Democracy		√	

**Reasons for the Recommendation:**

To ensure that Cabinet are fully appraised of treasury activity undertaken in the first quarter 2011/12, and approve the proposed actions in relation to the investment of temporarily available cash resources, following the recent credit rating agencies downgrading of a number of UK banks.

**What will it cost and how will it be financed?**

**(A) Revenue Costs**

The report recommendations seek to mitigate against a falling investment income.

**(B) Capital Costs**

None.

**Implications:**

The following implications of this proposal have been considered and where there are specific implications, these are set out below:

<b>Legal</b>	Statutory Duty
<b>Human Resources</b>	None
<b>Equality</b>	
1. No Equality Implication	<input checked="" type="checkbox"/>
2. Equality Implications identified and mitigated	<input type="checkbox"/>
3. Equality Implication identified and risk remains	<input type="checkbox"/>

**Impact on Service Delivery:**

None.

**What consultations have taken place on the proposals and when?**

The Head of Corporate Legal Services has been consulted on the content of this report. (LD 457/11)

**Are there any other options available for consideration?**

None.

**Implementation Date for the Decision**

Immediately following the Committee Meeting.

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**Background Papers:**

Treasury Management advisory reports.

# **TREASURY MANAGEMENT ACTIVITY HALF YEAR REPORT 2011/12**

## **1. BACKGROUND**

### **1.1 *Glossary of terms***

TMSS	Treasury Management Strategy Statement
CPI	Consumer Price Index
MPC	Monetary Policy Committee
ILO	International Labour Organisation
EFSF	European Financial Stability Facility
PWLB	Public Works Loan Board
CFR	Capital Financing requirement

1.2 The Treasury Management Policy and Strategy document for 2011/12 (approved by Council on 3 March 2011) included a requirement for a mid-year review of treasury management activities in 2011/12. The strategy document also requires a quarterly update on treasury management activity. The second quarter report will be included as part of this mid-year review and no separate quarterly report will be issued for the second quarter to September 2011.

1.3 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by this Council on 3 March 2011.

The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy for the year ahead, a Mid-year Review Report and an Annual Report covering activities during the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is Audit & Governance Committee.

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 2011/12

- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- A review of the Council's investment portfolio for 2011/12
- A review of interest earned
- A review of the Council's borrowing strategy for 2011/12
- A review of any debt rescheduling undertaken during 2011/12
- A review of compliance with Treasury and Prudential Limits for 2011/12

## 2 ECONOMIC UPDATE

2.1 **Growth:** Global growth prospects deteriorated considerably over the six months to September, moving from an expectation of modest expansion to the risk of a double-dip recession. Quarter 1 of 2011 Gross Domestic Product in the UK was 0.5% but was just 0.2% in Quarter 2. Economies such as Germany's, which were hitherto seemingly strong, have also now begun to see reductions, with growth registering 0.1% in Quarter 2.

**Inflation:** Inflation remained stubbornly high. Annual CPI for September was 5.2%; CPI had remained above MPC's 3% upper limit for 21 consecutive months and required the Bank of England's Governor to write a further open letter to the Chancellor. The Bank believed the elevated rate of inflation reflected the temporary impact of several factors: the increase in the VAT rate to 20%, past increases in global energy prices and import prices.

**Employment / Consumer Confidence:** Weakness has persisted in the labour market. Job creation was unable to absorb the 90,000 quarterly growth in jobseekers, particularly those in the 16-20 age bracket. Unemployment on the International Labour Organisation (ILO) measure rose to 7.9%. Earnings growth is only 2.9%, with scarce availability of credit, stagnant house prices, all combined to lower disposable income, squeeze household spending power and leave consumer confidence fragile.

Central bankers' policies were driven by the low growth outlook rather than the upward trend in inflation. The Bank of England's Inflation Report downgraded the growth forecast, as it acknowledged CPI of 5% with an expectant reduction in inflation to 2% target over the medium-term. The UK's strategy of combining loose monetary policy (the Bank Rate had remained at 0.5% for 2½ years and Quantitative Easing at £200bn, although a further £75bn has recently been announced) with tight fiscal policy supported the rebalancing of the economy and also commanded support in the markets.

The impasse to resolve the US debt ceiling issue has identified a lack of both political governance and measures to address the high debt burden (put off until after the 2012 presidential election). This has ultimately led Standard & Poor's to downgrading the US Sovereign from AAA to AA+. The country's weak economic and fiscal situation and an unemployment rate of 9.1% left the Federal Reserve little option but to commit to exceptionally low interest rates until mid 2013.

The European sovereign debt crisis has deepened. The agreement in July to address Greece's fiscal problems and broaden the mandate for the European

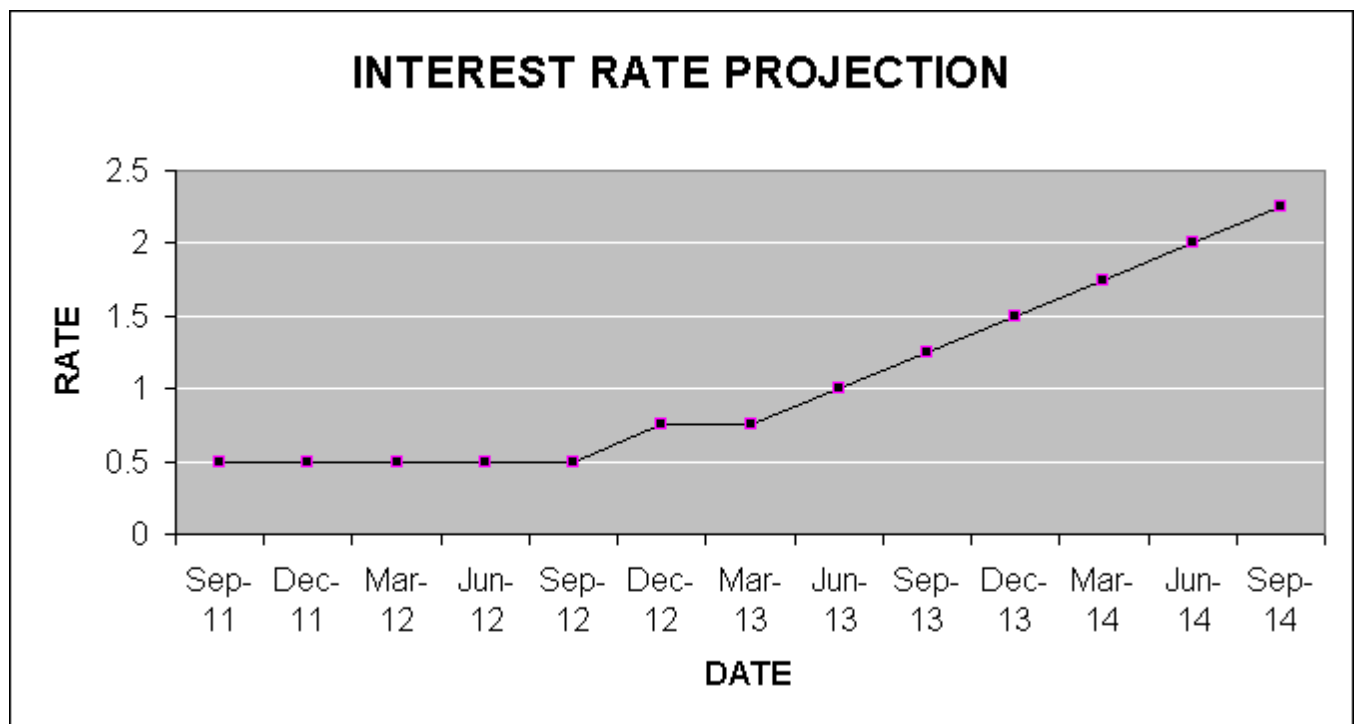
Financial Stability Facility (EFSF) only bought time for the Eurozone as market pressure increased on Italy and Spain, but did little to address the issue of overburdened sovereign balance sheets.

The European Banking Authority released the results of the second of its stress tests in July. Eight banks (two Greek, one Austrian and five small domestic Spanish banks) out of ninety one banks failed the tests. All of the UK and non-UK banks tested by the EBA and which are on the Council's lending list met the 'stressed' Core Tier 1 Ratio of 5%, none were adjudged as 'near-failed' (i.e. having ratios between 5% and 6%).

**Gilt yields and money market rates:** The economic uncertainty resulted in analysts postponing the likelihood of an increase in the UK Bank Rate until mid 2012. Gilts were considered a safe haven and benefited from market turmoil. Gilt yields fell to their lowest levels in five years. Five year gilt yields fell to 1.25%, ten year yields to 2.2% and twenty year yields to 3.05%.

PWLB borrowing rates fell commensurately (the Board maintained the +0.90% margin above the equivalent gilt yield for new borrowing).

- 2.2 **AAA rating** – prior to the general election, credit rating agencies had been issuing repeated warnings that unless there was a major fiscal contraction, then the AAA sovereign rating was at significant risk of being downgraded. Sterling was also under major pressure during the first half of the year. However, after the Chancellor's budget on 22 June, Sterling has strengthened against the US dollar and confidence has returned that the UK will retain its AAA rating. In addition, international investors now view UK government gilts as being a safe haven from EU government debt. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and PWLB rates.
- 2.3 The Council's Treasury Management Consultants, Arlingclose, project bank base interest rates to be as follows:



### **3 TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY UPDATE**

The Treasury Management Strategy Statement (TMSS) for 2011/12 was approved by this Council on 3 March 2011. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as follows:

- Security of capital
- Liquidity

The Council will also aim to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term (maximum investment period of 3 or 6 months as advised by Arlingclose), and only invest with highly credit rated financial institutions, using Arlingclose's suggested creditworthiness approach, including sovereign credit rating and credit default swap (CDS) information. This is discussed further below.

A breakdown of the Council's investment portfolio is shown in Section 5 of this report.

Investments and borrowing during the first six months of the year have been in line with the strategy.

As outlined in Section 2 above, there is still uncertainty and volatility in the financial and banking market, both globally and in the UK. Against this background it is considered that the strategy approved on 3 March 2011 is still applicable in the current economic climate, subject to the issues raised in paragraph 10.

### **4 RISK APPETITE**

4.1 The Council's current policy is that investments will only be held in banking institutions that hold a minimum Fitch rating of F1+ AA-, or Aaa/Mr1+ for money market funds. The ratings applied to investment grade institutions and the much riskier speculative grade institutions, as defined by Fitch, has been placed into a risk matrix – see Appendix B. The matrix defines institutions in terms of their Fitch rating, and grades them as follows:

- Low risk – score of 1 – 4
- Low to medium risk - score of 5 – 9
- Medium risk – score of 10 – 20
- High risk – score of 21 - 36

4.2 The matrix shows how the Council has set its risk appetite by being risk averse and putting security and liquidity before yield, by ensuring that it invests with institutions where the probability of default, and consequence of any default, is kept to a minimum. This is done by keeping within the confines of institutions rated

with a risk profile of 1 - 4. The matrix also shows where the Council's deposits are held in terms of the matrix as at 30 September 2011.

- 4.3 Recent turmoil in the world markets has resulted in Ratings Agencies downgrading the credit ratings of a number of sovereign states. Whilst the U.K. has not been affected by this, (it has retained a AAA rating), there has been widespread reduction in the credit ratings of U.K. banking institutions during October (discussed further in paragraph 10). The Independent Commission on Banking issued a report, which said investment banks should be ring-fenced from retail banks so investment banks could be allowed to fail. The credit rating agencies have seen this as the Government signalling that it is now more likely to allow smaller institutions to fail if they get into financial difficulty. The expectation is that the Government is likely to continue to provide support to systemically important institutions. The banks which fall within this definition have not been made clear.

Downgrades do not represent deterioration in the financial strength of the UK government or the banking system. However, the implications of this for Sefton are potentially significant. However, a saving proposal to achieve an additional £100,000 of investment income in 2012/13, may be at risk as a result of the decision to downgrade the credit rating of UK banks.

## 5 INVESTMENTS HELD

- 5.1 Investments held at the end of September 2011 comprise the following:

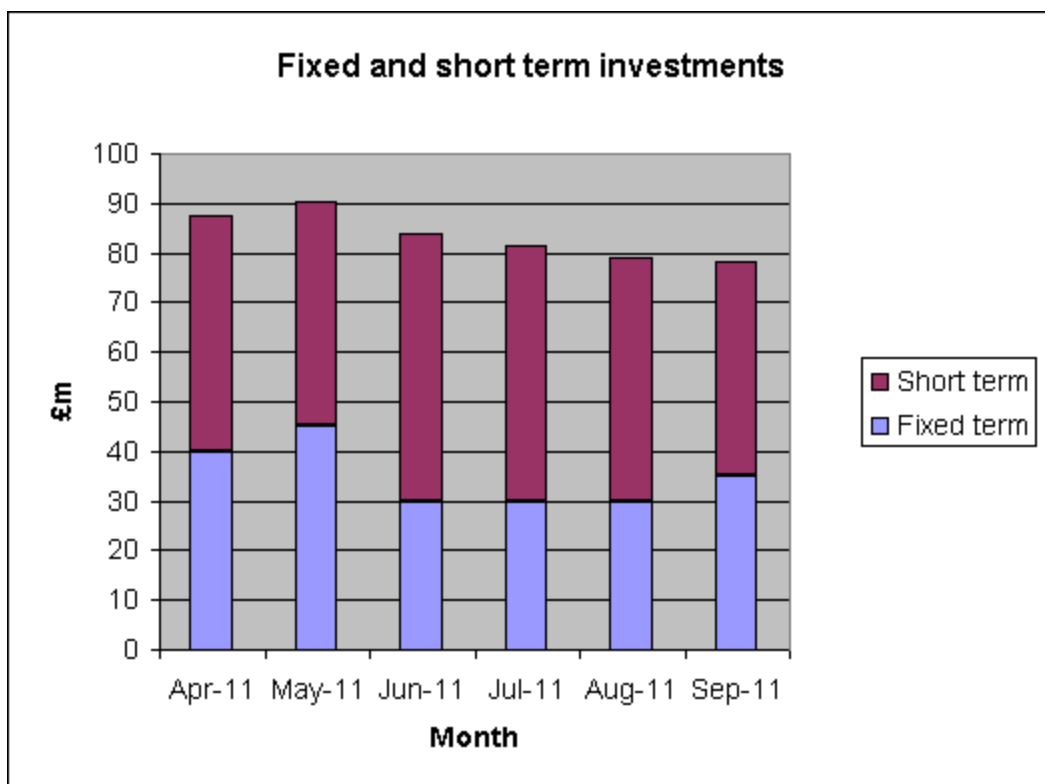
### Immediate access deposits

Institution	Deposit £m	Rate %	Maturity date	On current counterparty list?
Natwest	15.000	0.80	N/A	No
Blackrock MMF	9.060	0.58	N/A	Yes
Insight MMF	9.900	0.62	N/A	Yes
Goldman-Sachs MMF	9.070	0.6	N/A	Yes
<b>Total</b>	<u>43.030</u>			

### Fixed term deposits

Santander	10.000	1.32	14/10/2011	No
Santander	5.000	1.35	22/12/2011	No
Barclays	5.000	1.20	30/03/2012	Yes
Lloyds	10.000	1.14	23/03/2012	No
Lloyds	5.000	2.65	27/07/2012	No
<b>Total</b>	<u>35.000</u>			
<b>TOTAL</b>	<u><u>78.030</u></u>			

- 5.2 As can be seen, not all of the above organisations are on the **current** counterparty list as contained in Appendix A due to the recent reduction in credit ratings by Moody's and Fitch (see paragraph 10).
- 5.3 The maximum level of investment permitted in any one institution, or banking group, is currently £25m. Whilst the maximum should be retained, in case conditions change, a day to day operational maximum of £15m is currently being imposed. This will spread the risk of investments for the Council, but will have a small detrimental impact on the returns the Council will receive in the future.
- 5.3 The amount of cash held in fixed term deposits has recently increased in order to maximise investment income. In line with advice from Arlingclose, our overnight deposits with Money Market Funds (MMF's) are maintained at approximately equal levels between each institution.
- 5.4 The ratio of overnight deposits (i.e. short term) to fixed term investments is illustrated below:



The standard lending list is contained within appendix A

## 6 INTEREST EARNED

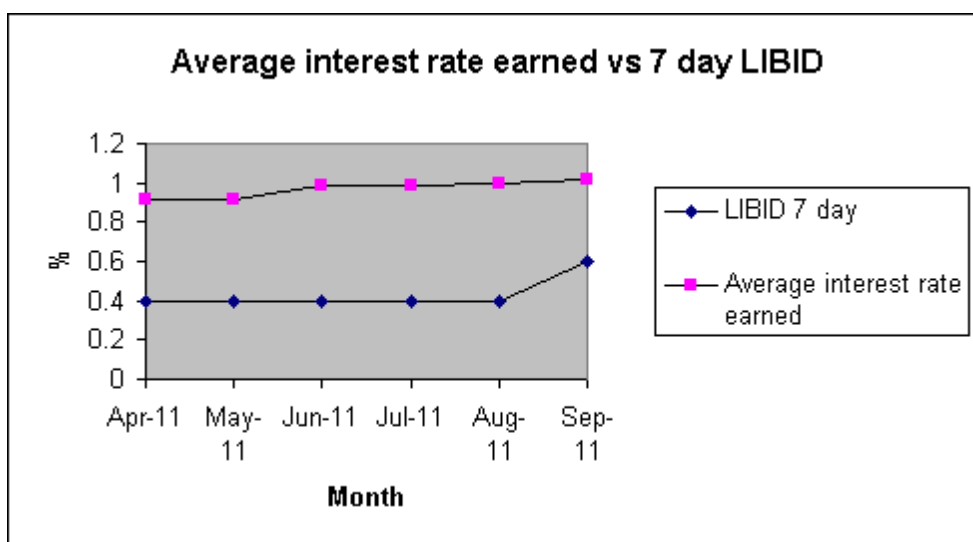
- 6.1 The actual performance of investments against the profiled budget for the period to 30 September is shown below:



	<b>Budget £'000s</b>	<b>Actual £'000s</b>	<b>Variance £'000s</b>
<b>To 30 September</b>	<b>354</b>	<b>397</b>	<b>43</b>

- 6.2 The original budget of investment income for 2011/12 was £0.856m (which equated to an average interest rate of 0.819%), was based on investments in place at 1st April 2010.
- 6.3 The investment income achieved during the first half year is £0.354m, which equates to an average interest rate of 0.97%.

We have outperformed the 7 day LIBID average (standard measure of performance for local authorities) as follows:



## 7 BORROWING

The Council's Capital Financing Requirement (CFR) for 2011/12 is £224m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive, the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Due to the high cost of borrowing as against the low level of interest rates earned on investments, the Council had taken the decision to internally borrow and not taken on any new external borrowings this financial year.

The Council's current level of PWLB borrowing at September 2011 is £131.24m, which in comparison with the CFR gives a borrowing capacity of £92.76m. It is not anticipated that any borrowing will be undertaken during the remainder of this financial year.

## 8 DEBT RESCHEDULING

Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. During the first six months of the year,

no debt rescheduling was undertaken. However, any future potential restructurings will be considered as they arise.

## **9 PRUDENTIAL INDICATOR MONITORING**

9.1 Prudential indicators are an integral component of measuring how prudently a Council is acting with regard to its finances. They were introduced into all local authorities (by CIPFA) following the Local Government Act 2003. A number of measures/limits/parameters including capital financing, external debt, impact on council tax, and treasury management are set prior to the start of the year and are monitored on a monthly basis.

9.2 It should be noted that the Interest Rate Exposure Indicator has been exceeded on a number of occasions in the recent months:

- The limits for fixed rate interest rate exposure expressed as a percentage of net outstanding debt were set to remain between 250% and 150%.
- The limits for variable rate interest rate exposure expressed as a percentage of net outstanding debt were set to remain between -50% and -150%.

9.4 The above indicators are there to prevent either too much investment in fixed or variable interest rate arrangements. This is to ensure a reasonable balance between fixed rate investments where cash is locked away, and variable rate investments that earn a lower rate of interest but give more immediate access to funds.

9.5 The variance in both of these indicators is due to the higher level of overnight deposits being held than originally envisaged earlier in the financial year. This is the same issue that arose in the last financial year. The Prudential Indicators were adjusted for 2011/12 in order to try and align the policy of retaining more temporarily available cash in short-term investments. However, the recent turmoil in the world / UK economic markets has meant that more short-term investments have been retained than anticipated. However, the breaching of these indicators is unlikely to continue over coming months, as the ratio of overnight to fixed term investments has reduced.

9.6 The breaching of these indicators has been caused by specific reasons identified which are not considered to be an indication of any inherent problems.

## **10 UK BANKS CREDIT RATINGS DOWNGRADE**

10.1 Due to the recent turmoil in the European financial sector, the spotlight has fallen on exposure that UK banks have to those Eurozone countries that are felt to be at risk (Spain, Portugal, Ireland, and Italy). This has caused Fitch and Moody's to downgrade a number of UK financial institutions.

10.2 The Council's Treasury Management Policy and Strategy, as agreed by Cabinet on 3 March 2011, allowed investments with institutions contained on our treasury management consultants approved counterparty list, but that had a minimum

credit rating with Fitch of F1+ (short term), AA- (long term) credit rating, and individual financial strength rating of the institution of C.

- 10.3 Fitch has recently downgraded number of institutions to F1 and A, and downgraded individual strength to C-, which is below the threshold contained in the Council's Treasury Management Policy and Strategy. The institutions downgraded are as follows:

RBS  
Natwest  
Lloyds  
HBOS

- 10.4 Moody's has downgraded RBS, Natwest, and Nationwide to a level comparable to the F1 and A rating used by Fitch. Lloyds, HBOS, and Santander have been downgraded to a level comparable to the F1 and A+ rating used by Fitch.

The advice from Arlingclose is that for those institutions downgraded:

- No new investments to be undertaken
- Fixed term investments should not be broken
- Funds in call accounts should be recalled.

A number of authorities have already withdrawn substantial resources from such banks. Recent discussions with Arlingclose have identified that they are completing work on a strategy for local authorities for the 2012/13 financial year. Consideration has been given by them to a range of options which could allow investment in the banks that have been downgraded. This however, puts their current advice to local authorities in a potentially conflicting situation. The potential impact of all authorities doing this could result in a de-stabilising impact on those banks with a wider impact on the economy.

- 10.5 The current advice from Arlingclose is to amend this year's strategy to reflect the advice which will be given for 2012/13, if required, which is to reduce our credit rating requirement to F1 A-. This will allow the Council to use the institutions noted above. Although a maximum duration of 6 months is suggested by Arlingclose for such institutions, it is advised by them that only call accounts are used. This revision has been reflected within appendix A pending Council's approval. These deposits would be classed as non-specified deposits as they are not of the highest credit rating.

- 10.6 The Council's current exposure, as at 25/10/2011, to such institutions is as follows:

Nationwide	£5m	Fixed term to 04/04/2012
Santander	£5m	Fixed term to 22/12/2011
Santander	£10m	Fixed term to 16/01/2012
Lloyds	£10m	Fixed term to 23/03/2012
Lloyds	£5m	Fixed term to 27/07/2012
Natwest	£15m	Call account

The deposit risk matrix has been updated in order to reflect the current situation (see appendix C).

- 10.7 It should be noted that Natwest is the Council's banker. Although it does not meet the minimum credit criteria of F1+ AA-, it will still be used for short term liquidity arrangements (overnight and weekend investments) and business continuity arrangements.
- 10.8 The level of systemic support given by the Government to these institutions has not been removed, and the main level of exposure of these banks is to Ireland, which is currently fairing best out of the troubled Eurozone economies. With regard to the Nationwide, Santander, and Lloyds investments, no action is proposed, as there is no immediate need to recall the monies in Arlingclose's advice. It is felt that our only exposure is to a Natwest overnight call account. Given that the NatWest are the Council's own bankers, as noted in 10.7, and more particularly, that the investment allows immediate access, the level of risk is considered to be low. Consequently, at this point in time, no action is being proposed to withdraw any monies from the "Call Account". Cabinet is asked to agree to this course of action.
- 10.9 The potential transfer of monies from the Call Account, poses the question as to where it can be invested. The Council's prudent approach means that there are limited investment opportunities in UK banks. One option is the investment in other Money Market Funds. Council Officers are currently looking at gaining access to new money market funds in order that the breadth of investment opportunities is as wide as possible, the 40% limit in non-specified investments is not breached, and that the £15m maximum investment in any one banking institution is maintained. This may result in a lowering of the level of investment income.

## APPENDIX A

### SEFTON COUNCIL STANDARD LENDING LIST POST CREDIT RATING REVISION

<u>UK and International Banks</u> <u>(including Nationwide</u> <u>Building Society</u>	RATING	Individual rating	Support rating
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#### ***United Kingdom AAA***

Santander UK <b>Requires Council approval</b>	F1 / A+	C-	1
Barclays	F1+ / AA-	B	1
Lloyds TSB/HBOS – nationalised <b>Requires Council approval</b>	F1 / A	C-	1
RBS Group – nationalised <b>Requires Council approval</b>	F1 / A	C-/D+	1
Nationwide <b>Requires Council approval</b>	F1 / A	C-	1
HSBC	F1+ / AA	B	1

#### ***Australia AAA***

Australia & New Zealand Banking Group	F1+ / AA-	B	1
Commonwealth Bank of Australia	F1+ / AA-	A/B	1
National Australia Bank	F1+ / AA-	B	1
Westpac Banking Group	F1+ / AA-	A/B	1

#### ***Canada AAA***

Bank of Montreal	F1+ / AA-	B	1
Bank of Nova Scotia	F1+ / AA-	B	1
Canadian Imperial Bank of Commerce	F1+ / AA-	B	1
Royal Bank of Canada	F1+ / AA	A/B	1
Toronto Dominion Bank	F1+ / AA-	B	1

#### ***Finland AAA***

**UK and International Banks  
(including Nationwide  
Building Society)**

**RATING      Individual  
rating      Support  
rating**

Nordea Bank      F1+ /  
AA-      B      1

***Germany AAA***

Deutsche Bank      F1+ /  
AA-      B/C      1

***Sweden AAA***

Svenska Handelsbanken      F1+ /  
AA-      A/B

***Switzerland AAA***

Credit Suisse      F1+ /  
AA-      B/C

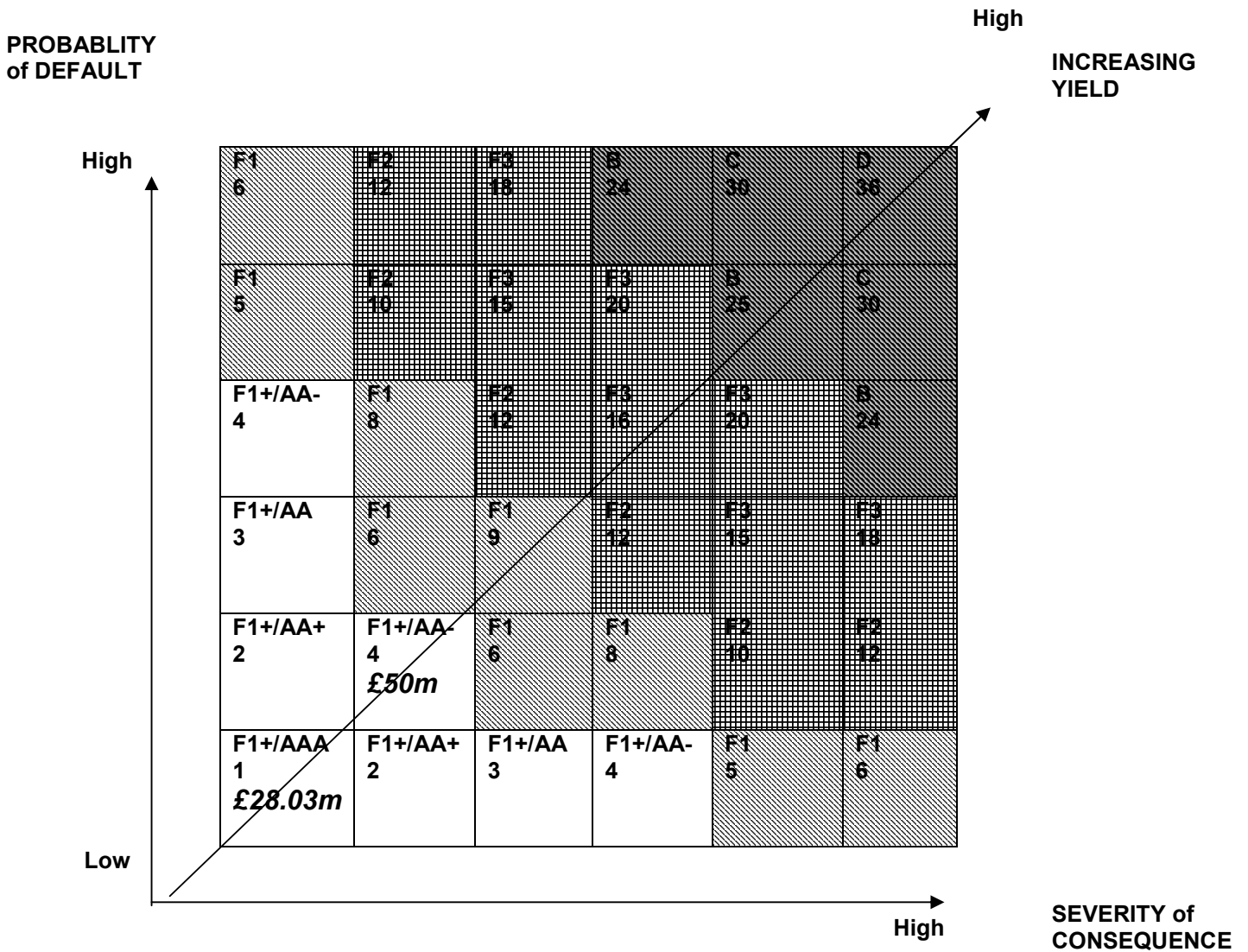
***USA AAA***

JP Morgan Chase Bank      F1+ /  
AA-      B

The recent economic situation has provided challenges for the Council with regard to its investment strategy. The report presented to Cabinet on 11 June 2009 explained the difficulties in identifying banking institutions to invest in (which provided reasonable investment returns), whilst remaining within the deposit limit of £15m. Consequently, Cabinet agreed to increase the deposit limit from £15m to £25m. As noted in 5.2 above, the Council has remained within an operational boundary of £15m. At present, it is not expected that the operational boundary will be increased to £25m.

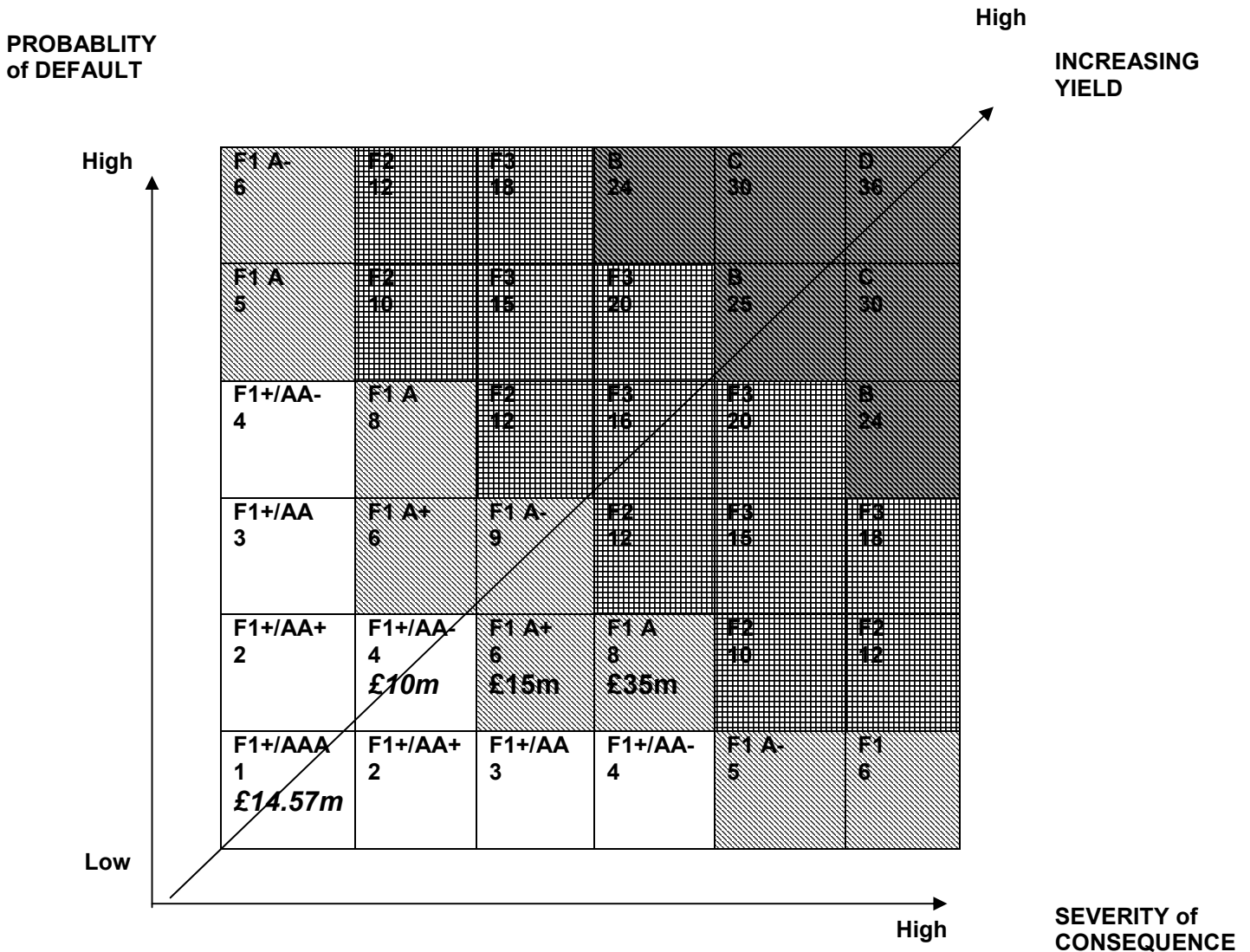
**Appendix B**

**RISK ASSESSMENT MATRIX - FITCH RATINGS @ 30/09/2011**



SEFTON RISK TOLERANCE	4		INVESTED
LOW RISK	1 - 4	Investment Grade	£78.030m
LOW - MEDIUM RISK	5 - 9	Investment Grade	Nil
MEDIUM RISK	10 - 20	Investment Grade	Nil
HIGH RISK	21 - 36	Speculative Grade	Nil

**RISK ASSESSMENT MATRIX - FITCH RATINGS POST REVISION @ 25/10/2011**



SEFTON RISK TOLERANCE	4		INVESTED
LOW RISK	1 - 4	Investment Grade	£24.57m
LOW - MEDIUM RISK	5 - 9	Investment Grade	£50m
MEDIUM RISK	10 - 20	Investment Grade	Nil
HIGH RISK	21 - 36	Speculative Grade	Nil