WARDS AFFECTED: All **Item No**

AUDIT COMMITTEE
23 SEPTEMBER 2011

REPORT OF DEPUTY CHIEF EXECUTIVE & CORPORATE DIRECTOR OF RESOURCES

TREASURY MANAGEMENT STRATEGY 2011/12 – REVISED INVESTMENT STRATEGY

1. PURPOSE OF REPORT

1.1. The treasury management function is governed by provisions set out under Part 1 of the Local Government Act 2003, whereby the City Council must have regard to the CIPFA Prudential Code and the CIPFA Code of Practice (the Code).

1.2. The Code requires the submission to a full meeting of the City Council of three reports on treasury management each year; a policy and strategy statement for the ensuing financial year, a 6-monthly progress report and an outturn report. In addition, any proposed changes to the strategy must be approved by the same body. Prior to approval by the City Council, all reports are submitted to Audit Committee for scrutiny and to Executive Board for endorsement.

1.3. This report proposes changes to the Investment Strategy for 2011/12, which are submitted to Audit Committee for consideration.

2. RECOMMENDATIONS

2.1. Audit Committee are asked to consider and comment on the proposed revisions to the Investment Strategy detailed in this report.

3. REASONS FOR CONSIDERATION

3.1. The Code requires authorities to nominate a body within the organisation to be responsible for scrutiny of treasury management activity. It is considered that the City Council's Audit Committee is the most appropriate body for this function.

3.2. In undertaking this function, the Audit Committee holds the responsibility to provide effective scrutiny of treasury management policies and practices, and to deliver this in advance of the associated strategies being formally approved by Council in March. This provides an opportunity for detailed scrutiny and analysis of the Treasury Management and Investment Strategy by those charged with governance.

4. BACKGROUND

4.1. Treasury management is the management of an organisation's borrowings and investments, the effective management of the associated risks and the pursuit of optimum performance or return consistent with those risks.

4.2. The treasury management function is governed by provisions set out under Part 1 of the Local Government Act 2003, whereby the City Council must have regard to the CIPFA Prudential Code and the CIPFA Code of Practice.

5. INVESTMENT STRATEGY

5.1. The City Council's 2011/12 Investment Strategy was approved by the City Council on 7 March 2011, as part of the overall annual Treasury Management Strategy. **Appendix A** provides the relevant excerpt from that report, including the approved counterparties for investment, maximum sums and periods and other restrictions relating to country limits. Eligible counterparties for 2011/12 include UK banks and building societies, non-UK banks, Money Market Funds (pooled, short maturity, high quality investment vehicles offering instant access), supranational bonds (the debt of international organizations such as the World Bank, the Council of Europe and the European Investment Bank), UK local authorities and the Government's Debt Management Office (DMO).

5.2. The adopted strategy in 2011/12 to date has been to restrict investments to UK banks and building societies, other UK local authorities and AAA-rated Money Market Funds. This approach reflects an ongoing concern over the use of non-UK institutions and a desire to keep the maturity of investments relatively short, whilst financial markets remain volatile. At the beginning of August, City Council external investments totalled £140m, held with the following institutions:

- UK bank call accounts (instant notice) – £40m
- UK bank fixed-term deposits (average of 151 days to maturity) – £60m
- Money Market Funds (MMFs) – £40m

Interest earned on these investments ranged from 0.59% to 2.10%, with an average annual return of 1.12%.

5.3. During the year, ongoing monitoring of the financial position of all approved counterparties is carried out by both treasury management colleagues and by our retained treasury management advisors. This review considers individual credit ratings, credit default swap prices, share prices, changes in sovereign state credit ratings and more general developments in financial markets and the global economy. This then informs decisions to temporarily revise the Investment Strategy to ensure that the Council is well placed to manage any emerging and/or potential risks. As a result, there have been a number of occasions in 2011/12 when the existing investment criteria (counterparty, size and period) have been suspended or reduced:

- Clydesdale Bank (UK) – counterparty suspended, following downgrading of credit rating of parent bank, National Australia Banking Group (18 May).
- UK institutions – maximum period for all new investments reduced from 2 years to 1 year, following market concerns regarding the increased potential of a default by Greece in respect of its sovereign debt (3 August).
- Santander UK (UK) – maximum period for new investments with counterparty reduced to 3 months because of possible credit rating downgrade relating to problems with Spanish parent bank (11 August).
- Societé General (France) – counterparty suspended because of negative market sentiment (11 August).

- All counterparties – maximum period for all new investments reduced to 6 months for UK, US Canadian and Australian banks, and 1 month for European banks, following further volatility in financial and equity markets (11 August).

5.4. Our advisors' view remains that there are no fundamental solvency issues with any of the existing counterparties, but it was considered prudent to make the above changes to the list of eligible institutions and to seek to reduce the average maturity profile of the investment portfolio. The financial position continues to be monitored, with further changes to be implemented if and when market conditions change. Such temporary changes are discussed with the Portfolio Holder as issues arise during the year.

5.5. As a consequence of the suspension of counterparties and the reduction in the maximum period of investments, significant levels of surplus cash have, on occasion, been placed overnight with the Council's own bank (the Co-Op), utilising their deposit account facility. Although such deposits are within the approved investment strategy, the interest rate earned is relatively low. Pressure therefore arose to consider alternative investment strategies. Consideration was given to number of options:

- Investing with other eligible UK counterparties – considered impractical currently given the large size of investment required and the poor returns available.
- Investing with non-UK institutions – considered imprudent in the face of ongoing financial problems in the European and US banking sectors.
- Using other investment products such as supranational bonds etc. – a more secure option, but offering a poor rate of return at present.
- Investing with other local authorities – impractical, with few authorities seeking to borrow monies at present.
- Investing with the DMO – the most secure option, but one offering the lowest rate of return.
- Increasing the limits for sums placed with existing counterparties – considered imprudent, as it would increase the proportion of the portfolio invested with a single counterparty.
- Increasing the maximum amount invested in MMFs – a more secure option, providing liquidity and diversity although attracting a limited rate of return.

5.6. The outcome of this was discussed at a meeting of the Treasury Management Panel (a group comprising the Chief Financial Officer, treasury management and other senior finance colleagues) on 8 August 2011, with an agreed proposal to increase the maximum sum to be invested in MMFs. This was endorsed by the Portfolio Holder. The strategic change was also referred to and endorsed by our external advisors. The perceived benefits of increasing the sums invested in MMFs are:

- **Security** – the additional MMFs would have a credit rating of AAA, which would increase the weighted average credit rating of the Council's investment portfolio.
- **Liquidity** – monies placed with MMFs can be recalled on a 'same day' notice basis, which would reduce the average 'days to maturity' rate of the portfolio.
- **Diversity** – MMFs 're-invest' pooled funds in a range of short-term debt instruments, many of which are not directly accessible by the Council.

This enables the Council to participate in a more diverse and high-quality portfolio than they could invest in directly.

- **Yield** – the rate of return offered by a number of eligible MMFs is greater than the rate paid in the Co-operative Bank's deposit account.

6. PROPOSALS

6.1. The proposal is to increase the maximum sum that can be invested in MMFs from £40m to £80m. The individual limit of £10m per Fund will be retained, with accounts with new Funds to be opened. The existing requirements for all Funds to have a AAA credit rating and a Constant Net Asset Value (preserving the principal value of the sum invested) will remain.

6.2. To improve the existing administration process, it is also proposed to trial the use of a portal for the management of monies invested in MMFs. This entails all future transactions being channelled through an appointed independent third party. The Council pays no charge for the service, and retains all existing controls in respect of investment decisions and money transfers. The benefits will be seen through a more streamlined process for investing and withdrawing monies in MMFs, easier creation of new MMF accounts and access to detailed reports on individual Funds, including a breakdown of the portfolio, analysis of the return earned etc

7. BACKGROUND PAPERS OTHER THAN PUBLISHED WORKS OR THOSE DISCLOSING EXEMPT OR CONFIDENTIAL INFORMATION

PWLB records, working papers

8. PUBLISHED DOCUMENTS REFERRED TO IN COMPILING THIS REPORT

Treasury Management in the Public Services, Code of Practice 2009 - CIPFA
The Prudential Code for Capital Finance in Local Authorities 2009 – CIPFA
Guidance on Local Government Investments 2009 – Communities & Local Government

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APPENDIX A

Excerpt from: 2011/12 Treasury Management Strategy
City Council, 7 March 2011

Investment Strategy 2011/12

Investment Policy
All external investments will be made in accordance with the City Council's adopted investment policy and prevailing legislation and regulation. In accordance with CLG guidance, the City Council's general policy objective is to invest its surplus funds prudently. The investment priorities are:

- Security of the invested capital
- Liquidity of the invested capital
- And, commensurate with security and liquidity, an optimum return on investments

During 2010/11, investments with UK banks and building societies were restricted to those institutions that had access to the Government's Credit Guarantee Scheme, set up to provide a platform to maintain the solvency of institutions critical to the UK's financial stability. In addition, a number of non-UK institutions were included on the list of approved counterparties, based on a range of criteria. A maximum period of 364 days was applied to all investments, with some counterparties being limited to shorter periods.

Actual investments to date in 2010/11 have been limited to instant access call accounts and period deposits with UK banks and Money Market Funds. As a consequence of the base interest rate remaining at 0.50% throughout the period, the average return to 31 December 2010 was 1.01%, against an original budget estimate of 1.40%.

For 2011/12, the following changes are recommended:

- The extension of the maximum duration for UK deposits to 2 years
- The inclusion of Svenska Handelsbanken (Sweden) for non-UK bank term deposits
- The deletion of Spanish banks from the non-UK list for term deposits
- The addition of Supranational Bonds

Specific investment criteria
The selection of counterparties eligible for investment in 2011/12 has been based on advice received from our advisors and has taken into account all appropriate credit ratings of those institutions (using the lowest available rating from those supplied by the three main rating agencies). In addition, a range of other factors have been taken into account, including:

- The existence of Government support schemes or statements of potential government support
- Individual counterparty and Government credit ratings
- Credit default swap rates (where quoted)
- Share prices (where quoted)
- Press articles and reports
- Any other information pertinent to the security of the investment

All investments are required to be categorised as ‘Specified’ or Non-Specified’, based on criteria in the CLG guidance. To qualify as a Specified Investment, the investment is required to be:

- In sterling only
- For a maximum period of 364 days
- With a counterparty of a high credit quality, as determined by the City Council
- Not defined as capital expenditure under section 25(1)(d) in SI 2003 No 3146

Any investments not meeting the above requirements are deemed to be Non-Specified investments.

The categories of investment identified for use within the above criteria in 2011/12 are:

- Deposits with the Government’s Debt Management Account Deposit Facility
- Deposits with other UK local authorities
- Deposits with UK banks and building societies meeting the high credit quality, as determined by the City Council and included on the City Council’s approved counterparty list
- Deposits with non-UK banks on the City Council’s approved counterparty list
- Money Market Funds (pooled, short maturity, high quality investment vehicles offering instant access) with a AAA rating and a Constant Net Asset Value
- AAA-rated Supranational Bonds (the debt of international organizations such as the World Bank, the Council of Europe and the European Investment Bank)
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Approved investment counterparty list

The proposed counterparty list, shown in **Table 4**, has been drawn up after evaluating and applying the above criteria for available institutions. For all banks, a minimum long- and short-term credit rating from all three rating agencies (Fitch, S&P and Moodys) has been applied as follows:

- a short-term rating of F1 (Fitch), A-1 (S&P) or P-1 (Moodys)
- and a long-term rating of A+ (Fitch and S&P) or A1 (Moodys)

The interpretation of these various credit ratings is provided as a note to **Table 4.** Regular monitoring and evaluation of credit ratings and other criteria will be maintained, and counterparties will be removed from the approved list if this combined evaluation falls below the minimum level. This action will also be taken if other intelligence suggests that this would be prudent.

Limits on periods of investment and maximum sums to be deposited have been applied to individual institutions, based on the evaluation of the above criteria and strengthened through reference to the size of the investment portfolio, the remaining period of Government guarantees, banking group structures and country limits. The higher limits for UK institutions reflects their inclusion within the Government Credit Guarantee Scheme – an indication of their deemed systemic importance within the UK banking system.

The details of all limits applied are provided in **Table 4** and the associated notes - in particular:

- Co-Operative Bank – the City Council’s own bank, while not meeting the minimum criteria for investments, is included on the counterparty list for periods of up to 5 days, to accommodate necessary short-term cash management.

- Group limits – where more than one bank on the counterparty list is included within a banking group (e.g. Bank of Scotland and Lloyds TSB Bank), individual limits will also apply to the group as a whole.
- Country limits – other than for UK institutions, a total investment limit will apply to all counterparties in a particular country. No more than 10% of the total investment portfolio, at the time of the deposit, will be placed with any one country.
- Overall country limit – in addition, no more than 25% of the investment portfolio, at the time of the deposit, will be placed with non-UK banks in total.
- Supranational Bonds e.g. EIB/Council of Europe – maximum sum of £20m.
- Money Market Funds – as well as individual limits, a maximum sum of £40m will be held in MMFs in total, at any one time.

TABLE 4: ELIGIBLE COUNTERPARTIES FOR INVESTMENT 2011/12

INSTRUMENT	COUNTRY	COUNTERPARTY	MAX. SUM	MAX. PERIOD
Term deposit / Call account	U.K.	Debt Management Office	No limit	No limit
		UK local authorities	No limit	2 years
		Bank of Scotland / Lloyds TSB Bank	£20m	2 years
		Barclays Bank	£20m	2 years
		Co-Operative Bank	No limit	5 days
		Clydesdale Bank	£20m	2 years
		HSBC Bank	£20m	2 years
		Nationwide Building Society	£20m	2 years
		Royal Bank of Scotland / Nat West Bank / Standard Chartered	£20m	2 years
		Santander UK (Abbey National)	£20m	2 years
	Australia	Australia & NZ Banking Group	£5m	364 days
		Commonwealth Bank of Australia	£5m	364 days
		National Australia Bank Ltd	£5m	364 days
		Westpac Banking Corporation	£5m	364 days
	Canada	Bank of Montreal	£5m	364 days
		Bank of Nova Scotia	£5m	364 days
		Canadian Imp. Bank of Commerce	£5m	364 days
		Royal Bank of Canada	£5m	364 days
		Toronto-Dominion Bank	£5m	364 days
	Finland	Nordea Bank Finland	£5m	364 days
	France	BNP Paribas	£5m	364 days
		Calyon	£5m	364 days
		Credit Agricole SA	£5m	364 days
		Soc Gen	£5m	364 days
	Germany	Deutsche Bank AG	£5m	364 days
	Netherlands	Rabobank	£5m	364 days
		ING Bank	£5m	364 days
	Sweden	Svenska Handelsbanken	£5m	364 days
	Switzerland	Credit Suisse	£5m	364 days
	USA	JP Morgan	£5m	364 days
Supranational Bonds	World-wide	E.g. European Investment Bank/Council of Europe/World Bank	£20m	2 years
Money Market Funds	World-wide	AAA-rated funds (Constant Net Asset Value)	£10m / fund	N/A

Credit Rating Definitions

Short Term Ratings

Fitch F1
Highest credit quality, indicating the strongest capacity or timely payment of commitments.

Standard & Poor's A-1
Strong capacity to meet its financial commitments.

Moody's P-1
Offers superior credit quality and a very strong capacity for timely payment of short-term deposit obligations.

Long Term Ratings

Fitch A+
High credit quality. 'A' ratings denote expectations of low credit risk. They indicate strong capacity for payment of financial commitments. The '+' denotes the relative status within the category.

Standard & Poor's A+
An obligor rated 'A' has strong capacity to meet its financial commitments. The '+' denotes the relative status within the category.

Moody's A1
Banks rated A are considered upper-medium grade and are subject to low credit risk. The modifier 1 indicates that the rating is in the higher end of its generic rating category.

<u>Limiting Factors</u>

Co-operative Bank – *the City Council's own bank does not meet the City Council's applied criteria. They are included on the counterparty list, with a maximum period of investment of 5 days, for cash flow purposes.*

Groups *- where more than one institution is included within a banking group, the individual limit will apply to the total investment in that group*

Countries *- a maximum of 10% of the investment portfolio to be invested in any one country (excluding the UK) at the time of investment, with a maximum of 25% of the portfolio, at the time of investment, in non-UK banks in total.*

Supranational Bonds *– a maximum sum of £20m*

Money Market Funds *– a limit of £40m in all MMFs is to be applied at all times.*

<u>Investment management</u>

Counterparties – all investments will be limited to institutions based on the adopted criteria. A schedule of eligible counterparties will be maintained. Their credit ratings and other relevant information will be analysed and monitored on a regular basis by the City Council and its advisors, to ensure the security of monies invested.

Maximum sums - total investments with individual counterparties, groups, non-UK institutions and Money Market Funds, as detailed in **Table** 4, will apply at all times.

Liquidity - the maximum period for any deposit will be 2 years. For investments with non-UK institutions, a maximum period of 364 days will apply. In order to maintain liquidity and reduce the associated risk, the average period for investments will be monitor