

**Annual Treasury Report 2008/09 and Updated Treasury Management Strategy for 2009/10**

**Report of:** Head of Financial Services

**Statutory Powers:** S.151 Local Government Act 1972

**Financial Implications:** Income from Treasury Management activities amounted to £1,299,000 in 2008/09.

**Purpose:** To inform the Executive of the results and performance of the Treasury Management activity undertaken in 2008/09 and to consider the Strategy for 2009/10. Consideration of this item relates to CP6 – “Improve core service performance in a cost effective way”.

**Recommendation:**

- 1. That the Executive notes the Treasury Management activity for 2008/09.**
- 2. That the updated Treasury Management Strategy for 2009/10 be approved.**

**1 Introduction and Background**

1.1 The Chartered Institute of Public Finance and Accountancy’s Code of Practice on Treasury Management 2001 was adopted by this Council on 2<sup>nd</sup> May 2002 and this Council fully complies with its requirements. The primary requirements of the Code are the: -

- 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 Executive of an annual strategy report for the year ahead and an annual review report of the previous year.

1.2 Treasury management in this context is defined as:

“The management of the local authority’s 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. ”

- 1.3 This annual treasury report covers:
- The Council's current treasury position;
  - assessment of 2009/09 performance;
  - compliance with treasury limits and Prudential Indicators;
  - Treasury Management Strategy 2009/10;

## 2 The Current Treasury Position

- 2.1 Our investment position at the beginning and the end of the year was as follows:

	As at 31/3/2009		As at 31/3/2008	
	Principal £	Interest %	Principal £	Interest %
Short Fixed	4,150,000	0.45	5,570,000	5.58
Long Fixed	15,000,000	6.16	15,000,000	4.69
Heritable Bank	1,250,000	0		
<b>Total</b>	<b>20,400,000</b>	<b>4.65</b>	<b>20,570,000</b>	<b>4.93</b>

The following is a list of our fixed investments at 31<sup>st</sup> March 2009:

	Fixed to	£	Interest rate
Nottingham BS	12.06.09	2,500,000	6.6%
Cheshire BS	01.09.09	2,500,000	6.09%
Chelsea BS	30.07.10	5,000,000	6.18%
Skipton BS	01.09.10	2,500,000	5.78%
Coventry BS	23.07.11	2,500,000	6.15%

- 2.2 We currently has a £1.25million deposit frozen in the Heritable Bank which is UK registered and regulated but a subsidiary of Landsbanki, one of the Icelandic Banks that have been affected by the world economic crisis. Banks in Iceland were taken over by the authorities when the country's financial system collapsed in October last year. Heritable Bank is registered in Scotland with a registered address in Edinburgh. Heritable Bank Plc. is authorised and regulated by the Financial Services Authority and is on the FSA Register. The bank's shares are owned by Icelandic bank Landsbanki.
- 2.3 We placed the deposit on 25th September 2008 At the time the deposit was placed the risk rating of Heritable was 'A' (long term deposits) and F1 (short term deposits) which are within the deposit policy approved by the Council. Both these ratings indicate low risk. The deposit was due back on 22 December and we have not yet been informed when the Administrators will be in a position to settle all creditors' claims. They have said that their initial investigations indicate that 70% to 80% liabilities will eventually be paid, with the first instalment of approximately £200,000 being paid in August 2009. The Administrators

have kept the bank trading and will slowly wind down the business over a period of years and have promised that further updates on the financial position will be made during 2009.

- 2.4 There is still a possibility that we will get all of our monies back because there are other legal avenues to be followed, namely; the forecast by the Administrators is based on a 'worse case scenario' so we may get more than the 70-80%; Heritable's parent bank, Landsbanki gave legal guarantees to honour all liabilities when it took over the Heritable; the Icelandic Government has stated its intention to honour all its commitments as a result of their banks being placed into receivership and the U.K. Government is working with the Icelandic Government to help bring this about.

### 3 Assessment of Performance

- 3.1 Investment interest of £1,299,000 was received during 2008/09 which amounts to £149,000 more than the budget of £1,150,000. This success has had a material impact in off-setting some of our budget issues that have arisen during the year.
- 3.2 Industry performance is judged and monitored by reference to a standard benchmark, this is the 7 day London Interbank Bid Rate (LIBID). The average weighted LIBID rate for 2008/09 was 5.58%, which is 0.58% higher than our weighted average return of 5.0%. However, our figure is influenced by the £1.25m frozen in the Heritable Bank and the ultra cautious investment strategy we have adopted since the banking crisis which started last October. The interest figure for 2008/09 does not include any interest owing to us from Heritable, although we are likely to eventually get back the majority of what we are owed.
- 3.3 Whilst the comparative return this year is lower, in prior years we have far exceeded the benchmark as illustrated in the following table. It is important that the investment strategy is measured over the longer term and it can be seen that our investment policy since 2001 has resulted in additional interest to the authority of £965,000.

	Benchmark	SHDC return	Additional interest received
2001/02	4.4%	5.0%	£285,000
2002/03	3.7%	4.7%	£359,000
2003/04	3.3%	4.7%	£420,000
2004/05	4.5%	4.7%	£63,000
2005/06	4.6%	4.7%	£27,000
2006/07	4.8%	4.8%	£0
2007/08	5.75%	5.05%	-£189,000
Total			<u>£965,000</u>

## **4 Compliance with Treasury Limits and Prudential Indicators**

- 4.1 During the financial year the Council operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Policy Statement and annual Treasury Strategy Statement. The outturn for the Prudential Indicators is shown in Appendix A which due to staff sickness will be sent out after the main Executive agenda.

## **5 Updated Treasury Management Strategy during 2009/2010**

- 5.1 The Executive approved the Treasury Management Strategy on 22<sup>nd</sup> January 2009 and also requested quarterly updates on our activities. This is the first such update.
- 5.2 Following the collapse of the Icelandic Banks, Local Authority treasury management has come under the spotlight. The Audit Commission has published its report "Risk and Return" on local authority treasury management and the Communities and Local Government Select Committee has carried out a review of local authority investments. CIPFA has issued a Treasury Management Bulletin providing some interim advice to local authorities on treasury management practices in the light of the Icelandic Banks collapse and the continuing 'credit crunch' and intends to revise both the Treasury Management Code and Guidance Notes in light of the lessons to be learnt.
- 5.3 Where possible the advice given by CIPFA and the Audit Commission has been followed and included within this report. However the Audit Commission included specific recommendations some of which will have to follow the CIPFA revised Code of Practice and Guidance notes. The full list of recommendations as they apply to local authorities is as follows:
- *Set the treasury management framework so that the organisation is explicit about the level of risk it accepts and the balance between security and liquidity and the yield to be achieved. At the highest level, the organisation should decide whether it has:*
    1. *appetite and capability to be able to manage risk by placing funds with financial institutions; or*
    2. *no appetite and/or insufficient capability to manage the risk of placing funds in the market, and should instead place funds with the UK government's Debt Management Office;*
  - *Ensure that treasury management policies:*
    - *follow the revised CIPFA code of practice;*

- *are scrutinised in detail by a specialist committee, before being accepted by the authority; and*
- *are monitored regularly;*
- *Ensure elected members receive regular updates on the full range of risks being run;*
- *Ensure that the treasury management function is appropriately resourced, commensurate with the risks involved. Staff should have the right skills and have access to information and external advice;*
- *Train those elected members of authorities who have accountability for the stewardship of public money so that they are able to scrutinise effectively and be accountable for the treasury management function;*
- *Ensure that the full range of options for managing funds is considered, and note that early repayment of loans, or not borrowing money ahead of need, may reduce risks;*
- *Use the fullest range of information before deciding where to deposit funds;*
- *Be clear about the role of external advisers, and recognise that local authorities remain accountable for decisions made; and*
- *Look for economies of scale by sharing resources between authorities or with pension funds, while maintaining separation of those funds.*

- 5.4 CIPFA intends to issue the new Code and Guidance notes in the summer 2009 after which we can revise our own policies and practices. It will then be opportune to provide training to the Scrutiny Committee so that they can take on the role suggested and consider these recommendations in detail.
- 5.5 Since January we have followed an ultra cautious investment policy only using the Governments' Debt Management Office and where possible other local authorities. This has had a severe impact on the level of interest received because due to their very low risk these accounts offer very low interest rates, between 0.3% and 0.4%. This compares to the market rate of approximately 1.5%.
- 5.6 To help local authorities improve their investment return Sector, our treasury advisors have changed and improved their investment advice to suit the current uncertain market. No combination of ratings can ever be viewed as 100% fail safe but one way to determine relative degrees of security is to use matrices based on credit ratings. Sector have introduced such a scheme and they provide a method to decide what levels of credit quality we might consider appropriate to

determine our policy on deposit taking institutions.

- 5.7 They now use a colour coded matrix for the duration of a deposit which is shown in Appendix B. The advice is still based on bank long and short term credit ratings (defined in Appendix C) but enhanced by a number of other criteria which are explained below:
- 5.8 **Support rating** – judgement of a potential supporter (either a sovereign state's or an institutional owner's) propensity to support a bank and of its ability to support it. Its ability to support is set by the potential supporter's own Fitch long term debt rating, both in foreign currency and, where appropriate, in local currency. Support ratings have a direct link to long term debt ratings, but they do not assess the intrinsic credit quality of a bank. Rather they communicate Fitch ratings, judgement on whether the bank would receive support should this become necessary. The support ratings range from 1 to 5 and are explained in Appendix C.
- 5.9 **Individual rating** – these ratings, which are internationally comparable, attempt to assess how a bank would be viewed if it were entirely independent and could not rely on external support. These ratings are designed to assess a banks' exposure to, appetite for, and management of risk, and thus represent the likelihood that it would run into significant difficulties such that it would require support. The individual ratings range from A to F and are explained in Appendix C.
- 5.10 **Credit Default Swap** – The above data is then overlaid with information from something known as the Credit Default Swap market. At its simplest a Credit Default Swap (CDS) is a cost of insuring debt against default. The more risky an institution is the higher the cost of insurance. There is a market for the CDSs and traders can profit from the changes in credit quality of institutions which is a useful way of predicting those banks which are under pressure. Interestingly the CDS market rated the HSBC bank higher than the British economy in March this year, this meant that there was more of a probability that the British Government would default on its debt than the HSBC bank.
- 5.11 Sector has set a range of parameters for benchmarking CDS data and assesses individual banks as; in range; monitoring; out of range. If a bank is 'in range' then the credit assessment colour remains unchanged; if the bank is 'being monitored' it means that the risk is higher and therefore the credit assessment is changed to a lower status; if the bank is 'out of range' the bank is deemed to be too risky to invest with. This is shown diagrammatically in Appendix B.
- 5.12 With regard to the overall policy to be followed until the next quarterly update to the executive it is considered appropriate that the maximum investment remain at £2.5 million per counterparty with the exception of the Government's DMO account which should remain unlimited. It is still considered prudent to only deal with GBR registered banks and not invest for more than one year.

- 5.13 We have made an assessment of the relative risks after taking advice from Sector and colleagues in other authorities and the suggested colour coded matrix is shown in Appendix D. It should be noted that our recommendation for dealing with counterparties with a credit rating of at least an AA- and an individual rating of at least a B is more cautious than the Sector standard advice which goes as low as an A for credit rating and a C for individual rating. This means that we will be accepting a lower risk for our investments but at the same time limits the number of counterparties that we can deal with.
- 5.14 The current recommended lending list is shown in Appendix E and consists of those institutions that meet the lending criteria shown in the various appendices.
- 5.15 In addition to the counterparty lending list shown in Appendix E should be added other types of investments as presented in the Treasury Management Strategy approved by the Executive in January 2009. It is prudent to assess the risk of using Money Market Funds. These types of fund are AAA rated and our financial advisor, Sector, is recommending risk averse authorities to consider them. The purpose behind these funds is to offer a secure, liquid investment that will offer a higher return than investments such as the Debt Management Office account but will still give high credit quality.
- 5.16 There are three underlying principles to these type of funds; Security, Liquidity and Yield. The Guidance issued by the Government under S19 of the Local Government Act 2003 recommends that priority be given to security and liquidity. Nevertheless, it will be appropriate to seek the highest rate of return consistent with proper levels of security and liquidity. The general objective is that the authorities should prudently invest the surplus. Money Market Funds address all three of these principles and meet the guidelines' objectives. They have high security - AAA and liquid – with daily access.
- 5.17 However, it must be noted that Money Market Funds' underlying assets e.g. Gilts, Certificates of Deposits and bonds are subject to capital fluctuations. The movements in capital are as a result of interest rate risk and credit risk. However, the structure of the fund minimises the movement of capital value due to the restrictions laid down by the credit rating agencies.
- 5.18 It is therefore recommended that Money Market Funds be added to our list of investment instruments and used because the level of risk is assessed as very low.

## 6 Risk Assessment

<b>Opportunities/Benefits</b>	
<p>Consideration of the Annual Treasury Report forms an essential component of the Council's systems for public accountability. It also provides a platform for future investment planning.</p>	
<b>Issues/Obstacles/Threats</b>	<b>Control measures / Mitigation</b>
<ul style="list-style-type: none"> <li>• risk of failure of counterparty</li> <li>• advancing monies to the wrong counterparty</li> <li>• failure to make advance when contracted to do so</li> <li>• liquidity constraints affecting interest rate performance</li> <li>• volatility of interest rates / inflation</li> <li>• day to day management fault resulting in overdrawn above agreed limits</li> </ul>	<p>The Council has adopted the CIPFA Code Of Practice for Treasury Management and produces an annual Treasury Management Strategy and Investment Strategy in accordance with ODPM guidelines. The Council employs a Treasury Management advisor and a prudent view is always taken regarding future interest rate movements. Investment interest income is reported monthly to SMT and quarterly to the Executive.</p>

## 7 Conclusion

- 7.1 The recommended investment strategy for 2009/10 will enable the Council to comply with the latest CIPFA objective for Treasury Management, namely '*It is important that treasury management policies adequately reflect risk and in particular security, liquidity and yield risk, in that order of importance. No treasury management transaction is without risk and management of risks is the key purpose of the treasury management strategy*'.

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Executive  
28 May 2009

Background papers: Treasury Management Strategy 2009/10