

Treasury Management Mid-Year Report 2011/12

Background

- 1 The County Council is required by the Chartered Institute of Public Finance and Accountancy (CIPFA) to receive as a minimum each year:
 - An annual strategy statement for the forthcoming year
 - A mid-year review
 - An annual report at year end
- 2 In addition, effective governance is maintained through the submission of quarterly compliance reports to the Regulation, Audit and Accounts Committee and scrutiny reports as required to the Policy and Resources Select Committee.
- 3 In accordance with CIPFA's Treasury Management Code of Practice, the Mid-Year Report (2011/12) reviewing treasury compliance and activity to the end of October **is attached at the Appendix.**

Discussion

- 4 The County Council's treasury activities expose it to a variety of financial risks, the key risks are:
 - **Credit Risk:** The possibility that other parties might fail to pay amounts due to the County Council;
 - **Liquidity Risk:** The possibility that the County Council might not have funds available to meet its commitments to make payments;
 - **Re-financing Risk:** The possibility that the County Council might be requiring to renew a financial instrument on maturity at disadvantageous interest rates or terms; and
 - **Market Risk:** The possibility that financial loss might arise for the County Council as a result of changes in such measures as interest rates movements.
- 5 The County Council's overall risk management procedures focus on the unpredictability of financial markets, and implementing restrictions to minimise these risks. The procedures for risk management are set out through a legal framework set out in the Local Government Act 2003 and the associated regulations (including CIPFA Codes of Practice).
- 6 The County Council has complied with all of the relevant statutory and regulatory requirements which require the Council to identify and where possible quantify the levels of risk associated with its treasury management activities.
- 7 Financial risks are minimised through the annual Treasury Management Strategy, which incorporates the Prudential Indicators, and was approved for

2011/12 by County Council in February 2011 (available in full on the County Council's website).

- 8 Security of capital remains the County Council's main investment objective. This is maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2011/12 and subsequent amendments as approved by the Cabinet Member for Finance and Resources throughout the year.
- 9 As reported to the Department for Communities and Local Government on the 'Monthly Borrowing and Lending' return, at 30th September 2011 the County Council's Public Works Loan Board debt was £441.1m (£371.1m at 31st March 2011) and its investments totalled £264.3m (£157.8m).

Recommended

That the Treasury Management Mid-Year Report 2011/12, as set out at the Appendix, be approved.

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Background Papers

None

Treasury Management Mid-Year Report (2011/12)

Introduction

- 1 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.'
- 2 The Treasury Management Strategy for 2011/12 has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.
- 3 The Code of Practice recommends that members be informed of Treasury Management activities at least twice a year. This mid-year report therefore ensures the County Council is embracing Best Practice in accordance with CIPFA's recommendations.

Compliance

- 4 The County Council has complied with all of the relevant statutory and regulatory requirements, which require the Council to identify and where possible quantify the levels of risk associated with its treasury management activities.
- 5 The County Council also confirms that it has complied with its Prudential Indicators for 2011/12, which were set in February 2011 as part of the Council's Treasury Management Strategy Statement. Details can be found **in the attached Annex**.
- 6 The Cabinet Member for Finance and Resources confirms that there were no breaches of the County Council's approved Treasury Management Strategy during the period 1st April to 30th September 2011.
- 7 Counterparty credit quality is assessed and monitored with reference to: Credit Ratings (the County Council's minimum long-term counterparty rating of A+ across rating agencies Fitch, S&P and Moody's); credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; sovereign support mechanisms; potential support from a well-resourced parent institution; share price.
- 8 Review of approved counterparties was facilitated by:
 - The submission of regular statements of the disposition of deposits to the Cabinet Member, Executive Director Finance and Performance and the Treasury Management Panel
 - Weekly update meetings with the Executive Director Finance and Performance, Chief Accountant and the Treasury Management Officer.

Economic Background

- 9** The County Council approved the 2011/12 Treasury Management Strategy Statement, including the Annual Investment Strategy, in February 2011. The assumption at this time that market indicators suggested a return to more normalised conditions underpinned the approved counterparties and maximum investment periods as set out within the strategy. However, since April the County Council has considered it necessary to reassess its current policies in light of the threat of a new banking crisis and the escalating Eurozone crisis.
- 10** UK growth prospects deteriorated considerably over the six months to September whilst inflation remained stubbornly high. Annual UK CPI for September was 5.2%, remaining above the Bank of England's 3% upper limit for 21 consecutive months. Weakness persisted in the UK labour and housing markets leaving consumer confidence fragile and decreasing the likelihood of a consumer driven recovery.
- 11** The disappointing growth outlook rather than the upward trend in inflation drove the Bank of England's central policies. The August Inflation Report downgraded the growth forecast whilst acknowledging energy price rises would push CPI to 5%, before falling back to the 2% target over the medium-term. The economic uncertainty resulted in analysts postponing the likelihood of an increase in the UK Bank Rate until late 2012 at the earliest.

	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14
Official Bank Rate													
Upside risk					0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.50	1.75
Central case	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk													

Counterparty Update

1st April to 30th September:

- 12** The European sovereign debt crisis 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.
- 13** The lack of real progress in resolving the European sovereign debt crisis began to affect even the stronger Eurozone nations and their banking systems. Market volatility spiked sharply in August and banks' share prices fell sharply.
- 14** The County Council responded to the growing stress by scaling back maturities for new investments. Limits for UK banks, Nationwide BS and Australian, Canadian and US banks were temporarily reduced to six months (Santander UK plc restricted to overnight deposits only).

- 15 Formal limits, as set out in the treasury strategy, for European banks were temporarily reduced to one month (French banks suspended). In practice however no approval was given by the Cabinet Member to place deposits in non-UK institutions, the one exception being a £25m short-term fixed deposit with the European Bank for Reconstruction and Development.
- 16 28th September: Clydesdale Bank was formally removed from the County Council's lending list following the bank's downgrade by Moody's, falling below the Council's minimum criteria of A+ or equivalent as approved in the 2011/12 Treasury Strategy.

October 2011:

- 17 7th October: Moody's credit rating agency concluded its six month review of UK financial institutions, assessing the appropriate level of systemic support assigned in the credit ratings for the banks and building societies included within the review.
- 18 The review concluded with downgrades to the long-term credit ratings of 12 UK financial institutions, given the agency's assessment of a decrease in the probability that the UK Government would provide future support to these institutions. Moody's state that the downgrades do not represent deterioration in the systemic financial strength of the UK Government or the banking system, but means it is more likely that smaller institutions will be allowed to fail if they fall into financial difficulty.
- 19 13th October: Fitch credit rating agency followed the Moody's announcement by downgrading the long-term credit ratings for Lloyds and RBS banking groups, given the agency's view of a decrease in the likelihood of UK Government support.
- 20 The downgrades position UK financial institutions into three groups:
 - Banks with a very high likelihood of government support (Barclays, HSBC, Lloyds, and RBS)
 - Institutions with a moderate or high likelihood of support (Clydesdale, Co-op, Nationwide and Santander UK plc)
 - Institutions with a low or no likelihood of support (Other Building Societies)
- 21 An internal review of credit indicators (including credit default swap prices), together with advice received from Arlingclose, highlighted strong parallels between market indicators evident towards the end of September 2011 with those evident in 2008 in the build up to the first banking crisis.
- 22 Whilst there is no evidence to suggest that the UK Banks the County Council holds deposits with are likely to fail, or the risks of default are any higher following the rating downgrades, near term shocks in the overall banking sector can not be completely ruled out.

- 23** As a result of the rating downgrades and internal review Lloyds, Nationwide and Natwest (part of RBS Group) fall below the minimum rating criteria as approved in 2011/12 Treasury Strategy and are no longer considered suitable investment counterparties. Santander UK plc is rated equivalent to the approved minimum rating criteria and remains on negative rating watch, so requires explicit Cabinet Member approval for all new deposits.
- 24** In accordance with the 2011/12 Treasury Strategy £25m held in a Natwest instant access call account was immediately recalled. However, due to exceptionally high volumes of requests to withdraw funds held on call with Natwest following the Moody's announcement, the County Council did not receive repayment of the £25m on Friday, 7th October. The funds were repaid to the County Council on Monday, 10th October, leaving the main HSBC County Fund bank account £25m overdrawn over the weekend, incurring additional bank charges of £5,000.
- 25** The Treasury Management Officer has agreed compensation from Natwest over the additional bank charges resulting from non-payment. However this raises questions over whether individual banks are in position to honour repayments at times of significant market stress the very time at which a large withdrawal at short notice would be necessary. Under current market conditions, the risks of placing money in bank call accounts are considered to outweigh the benefits.

Revised Treasury Management Strategy (October 2011)

- 26** With security of capital remaining the County Council's main investment objective, the Cabinet Member for Finance and Resources, supported by the Executive Director Finance and Performance and the Treasury Management Panel, approved the following revision to the 2011/12 Treasury Strategy. All deposits held within traditional bank instant access accounts will be recalled and new investments will only be placed **overnight** with:
- AAA credit rated Stable Net Asset Value Sterling Money Market Funds
 - UK Governments Debt Management Office (DMADF Account)
- 27** The Executive Director Finance and Performance recommends the use of Sterling Liquidity Funds instead of individual bank call accounts, as such funds are set up to receive and repay large sums on any given day due to the diversified and liquid nature of the underlying fund assets. This minimises the risk of money being recalled but not repaid as happened with Natwest.
- 28** The revised policy will be reviewed, in conjunction with advice received from Arlingclose, when formalising the 2012/13 Treasury Strategy.

Heritable Bank

- 29** The County Council had four deposits with Heritable Bank totalling £12.9m when Heritable was taken into administration in October 2008 following the failure of its Icelandic parent company, Landsbanki. An original claim of

£12.997m was submitted to the administrators Ernst & Young in November

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2008, which included interest accrued at date of Heritable entering administration (£97,137).

- 30 During July 2011 the administrator reported an increase in their estimated return to non-preferential unsecured creditors based upon the progress of the Administration to date and predicted future performance. Current projections now indicate a base rate of return to creditors of 86 to 90 pence in the pound (from 79 to 85 pence in the pound) and a stressed case return of 74 to 80 pence in the pound (from 63 to 73 pence in the pound).
- 31 Throughout the first half of 2011/12 the administrator declared two interim dividend payments totalling £1.4m to the County Council representing 10.31% of the total claim. The administrator declared a further dividend payment of £0.5m in October representing 4.18% of the claim.
- 32 At 31st October 2011 total repayments to the County Council amounted to £8.4m, representing 64.6% of the total claim. Payments received have been used to reduce the loan principal outstanding; interest adjustments if appropriate will be made when the final settlement total is known.
- 33 The administrator continues to report and declare quarterly dividend payments, the next payment due January 2012, the quantum remaining subject to the continual collection of funds through a run-off of Heritable's various loan books. The position with regard to Heritable investments at 31st October 2011 is summarised below:

Heritable Bank	£'000
Original investment	12,900
Dividends (x3) received 2009/10 (34.98 pence in the £)	-4,546
Dividends (x3) received 2010/11 (15.13 pence in the £)	-1,967
7th dividend received 19 April 2011 (6.25 pence in the £)	-813
8th dividend received 15 July 2011 (4.06 pence in the £)	-527
9th dividend received 20 October 2011 (4.18 pence in the £)	-543
Balance to recover (excluding 2008/09 impairment)	4,504
20% loan impairment recognised in 2008/09 accounts	-2,580
Position at 31st October 2011	1,924

- 34 The County Council has been approached by a third party offering to buy out the outstanding Heritable debt at around 85 pence in the pound. This offer is below the administrator's estimated base return to creditors so the Cabinet Member does not recommend accepting the offer. Such third party interest however continues to highlight that the County Council should remain cautiously optimistic of achieving a final return in line with the administrator's forecasts.

Debt Management

- 35 In line with the Prudential Code the County Council continues to undertake long-term borrowing to finance part of the capital programme. The County

Council's approved its 2011/12 budget and prudential indicators on 11th February 2011, including a medium-term financial plan and cashflow up

to 2013/14. This sets out the proposed capital programme for the period together with an approved level of borrowing (capital financing requirement).

- 36** The Public Works Loan Board (PWLB) remains the County Council's preferred source of borrowing given the transparency and control that its facilities continue to provide. Whilst there are increasing claims that competitive alternative sources of funding are readily available, the County Council continues to adopt a cautious and considered approach to funding from capital markets.
- 37** The financing requirements of the capital programme, particularly the MRM Contract, and the policy of reducing cash balances since late 2008 results in the County Council having a significant external borrowing requirement over the next three years.
- 38** UK Gilt prices, which are the main determinant for PWLB rates, are forecast to increase over the next three years. Therefore even with a 'cost of carry' of borrowing in advance of need, over the life of the loan it would be cheaper to lock into existing low PWLB rates whilst they remain available.
- 39** In consideration of advice received from Arlingclose, the Cabinet Member for Finance and Resources approved external borrowing totalling £70m for 2011/12. This was taken during April by way of a ten-year PWLB Equal Instalment of Principal (EIP) loan at a fixed interest rate of 3.77%, increasing the County Council's long-term borrowing to £441.1m
- 40** None of the County Council's existing long-term debt has been repaid or rescheduled to date in 2011/12; this continues to be periodically reviewed in consultation with the Council's treasury management advisers (Arlingclose Ltd). The County Council's long-term debt structure is shown below:

	Maximum Approved Limit	31.03.11 £'m	30.06.11 £'m	30.09.11 £'m
Less than 1 year	10%	0.0	0.0	0.0
Between 1 and 5 years	25%	0.0	0.0	0.0
Over 5 years to 10 years	50%	0.0	70.0	70.0
Over 10 years to 15 years	50%	34.0	34.0	34.0
Over 15 years to 20 years	75%	141.3	156.3	174.3
Over 20 years to 25 years	75%	155.8	140.8	122.8
Over 25 years to 30 years	50%	0.0	0.0	0.0
More than 30 years	15%	40.0	40.0	40.0
Total		371.1	441.1	441.1

- 41** Interest payable to the Public Works Loan Board in respect of the Council's long term borrowing amounted to £9.8m at 30 September, representing an average interest rate of 4.47%. The County Council forecasts that total

interest payable in 2011/12 will be £19.6m, in line with the capital financing budget as declared within the quarterly Total Performance Monitor.

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- 42 No short-term borrowing was undertaken during the first half of 2011/12. All daily cash flow shortages were funded by withdrawals from the County Council's instant access Money Market Funds.

Investment Activity

- 43 The Guidance on Local Government Investments in England gives priority to security and liquidity and the County Council's aim is to achieve a yield commensurate with these principles.
- 44 During the first half of 2011/12 the County Council (excluding Pension Fund cash deposits) had an average amount invested of £280.1m

	2010/11		2011/12 (to 30 Sep)	
	£'m	%	£'m	%
UK Banks-Fixed Deposits	47.9	23.7	62.8	22.4
Non UK Banks-Fixed Deposits	-	-	4.5	1.6
UK Banks-Call Accounts	89.3	44.2	40.0	14.3
UK Banks-Notice Accounts	9.6	4.8	-	-
UK Building Societies	19.0	9.4	25.0	8.9
Debt Management Office	4.7	2.3	0.2	0.1
Local Authority	20.0	9.9	35.9	12.8
Money Market Funds	4.0	2.0	106.3	38.0
Heritable Bank (i)	7.4	3.7	5.4	1.9
Total	201.9	100.0	280.1	100.0

- 45 The increase in the investment portfolio during 2011/12 is a consequence of the approval to borrow £70m from the Public Works Loan Board (PWLB) in April 2011 and the receipt of government grants and precepts from districts, in advance of 2011/12 capital and revenue expenditure.
- 46 The movement in the County Council's investment portfolio by the credit ratings of the financial institution is shown below:

Deposits with financial institutions	2010/11	2011/12			
	31.03.11 £'m	30-Jun £'m	30-Sep £'m	28-Oct £'m	31-Mar £'m
AAA rated counterparties (i)	1.4	120.9	71.3	121.5	
AA rated counterparties (ii)	60.0	100.0	113.0	83.0	
A+ rated counterparties	90.0	75.0	75.0	0.0	
A rated counterparties	0.0	0.0	0.0	45.0	
Un-rated Building Societies	0.0	0.0	0.0	0.0	
Heritable Bank	6.4	5.6	5.0	4.5	
Total	157.8	301.5	264.3	254.0	

(i) Includes UK Government-Debt Management Office and Money Market Funds

(ii) Includes Local Authorities, Police Authorities and Local Authority Pension Funds

- 47 The position at the end of October reflects treasury decisions made in light of the revised strategy implemented following the downgrades of UK banks and building societies.

- 48** £121m invested with AAA rated counterparties includes deposits made across seven separate Money Market Funds. The amount invested in Money Market Funds at 30th September 2011 was £71m; the £50m increase results from the reinvestment of funds following the withdrawal of deposits held within Natwest and Santander UK call accounts.
- 49** £83m invested with AA rated institutions includes three fixed-term deposits arranged with Barclays (£25m) and HSBC (£15m) and investments with other local authorities (£43m). The AA rating assignment for other local authorities follows the rating announcements for both Lancashire County Council and Birmingham City Council (both AA+).
- 50** The reduction in the amount invested in AA rated institutions from 30th September follows the withdrawal of £25m from Santander UK and the decision for a £5m deposit with another local authority to be repaid to the County Council on loan maturity.
- 51** £45m invested in A rated institutions (below the minimum rating criteria as set out in the County Council's investment strategy) includes various fixed-term deposits arranged with Nationwide (£25m) and Lloyds (£20m). In accordance with the revised strategy these deposits will run until maturity.
- 52** The maturity profile of County Council investments is shown below:

Deposits with financial institutions	2010/11	2011/12			
	31.03.11 £'m	30-Jun £'m	30-Sep £'m	28-Oct £'m	31-Mar £'m
Instant Access Accounts	96.4	145.9	121.3	121.5	
Up to one month	0.0	35.0	15.0	0.0	
One month to 3 months	30.0	40.0	12.5	27.5	
3 months to 6 months	25.0	22.5	50.0	55.0	
6 months to 1 year	0.0	47.5	60.5	45.5	
Greater than 1 year	0.0	5.0	0.0	0.0	
Heritable Bank (i)	6.4	5.6	5.0	4.5	
Total	157.8	301.5	264.3	254.0	

(i) Heritable deposits not shown in specific time periods as final repayments dates unknown

Investment Performance

- 53** The original estimate of investment income for 2011/12 was £2.3m, based on the assumption that the County Council could achieve an average interest rate of 1.07% on an assumed investment portfolio of £220m.
- 54** The investment income budget as reported in the 2011/12 Budget Book (Appendix 1) includes an estimated £0.5m transfer to internal balances held

by the County Council (including school funds and PFI reserves) and balances held on behalf of the Chichester Harbour Conservancy.

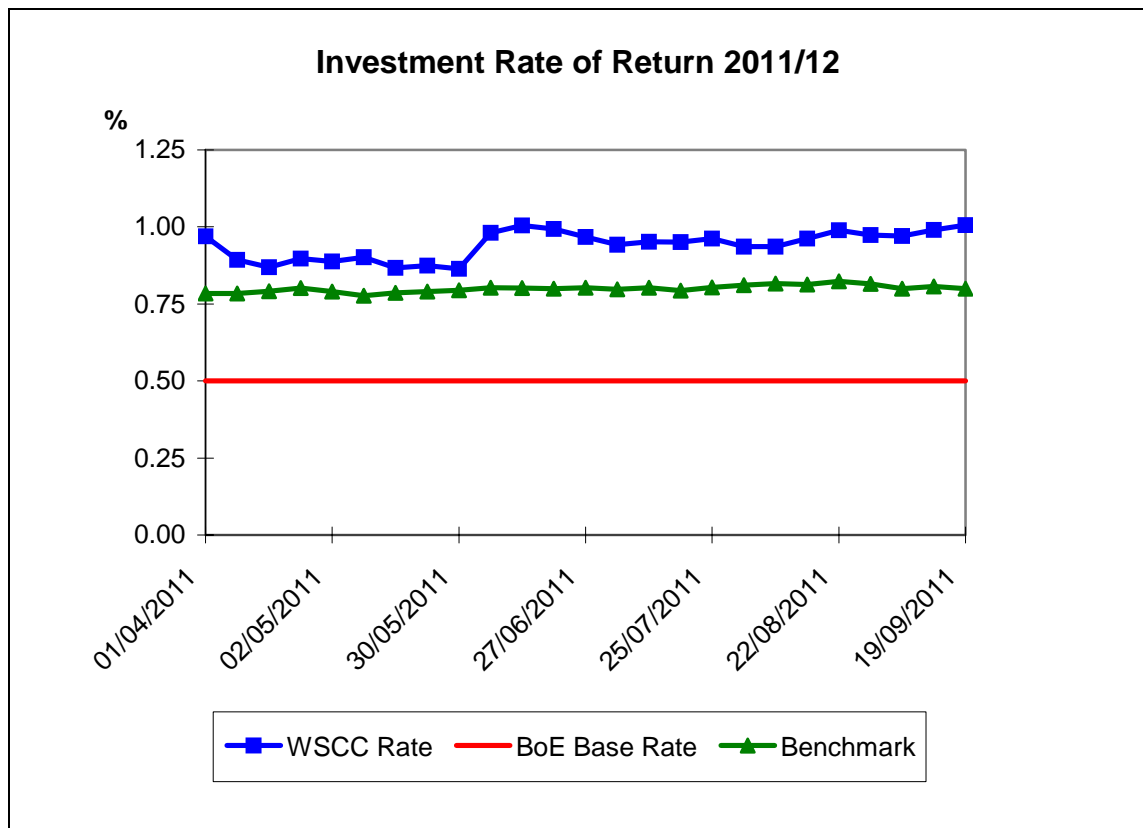
	£'000
Expected interest receipts on investment portfolio	2,344
Budgeted transfer to internal balances held	-480

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Revenue Budget 2011/12 (Investment Income)

1,864

- 55 The County Council forecasts a £0.2m interest receipt surplus, as declared in the quarterly Total Performance Monitor report, a consequence of a higher than budgeted investment portfolio size due to the timing of PWLB borrowing in advance of 2011/12 capital spend.
- 56 The County Council's gross investment return as compared with the benchmark rate (gross yield of the Blackrock Sterling Liquidity Fund) and the Bank of England base rate is shown graphically below:



West Sussex Pension Fund

- 57 In accordance with statutory requirements the investment of Pension Fund internally managed cash is governed by a separate treasury management strategy. At 30 September, Pension Fund internally managed cash amounted to £13m (£25.5m at 31st March 2011). The reduction in cash follows the decision to transfer £16m to external fund managers for investment purposes.
- 58 During the first half of 2011/12 the Pension Fund had an average internally managed cash balance of £20.1m. Cash was held in a NatWest instant access call account and a series of AAA credit rated Money Market Funds. The Pension Fund received interest of £78,300 relating to cash balances held, at a rate of return of 0.78%

- 59** As a result of Moody's rating downgrade to RBS and in accordance with the approved treasury strategy, £5m was withdrawn from the Natwest call account and reinvested into Money Market Funds held (7th October).

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(see paragraph 5, page 216)

Treasury Management Prudential Indicators

- 1 The CIPFA Code of Practice requires that compliance with treasury management prudential indicators be reported within regular treasury reports. The purpose of these indicators are to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates.
- 2 The County Council approved the prudential indicators for 2011/12 in February 2011, as part of the Budget Report and the Treasury Management Strategy Statement.
- 3 The Local Government Act 2003 requires the County Council to set an 'Authorised Borrowing Limit' irrespective of their indebted status. This is a statutory limit, which should not be breached.
- 4 The County Council's Authorised Borrowing Limit, which includes notional borrowing for PFI schemes, was set at £573.2m for 2011/12.
- 5 The 'Operational Borrowing Limit' is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst-case scenario without the additional headroom included within the Authorised Limit.
- 6 The Operational Borrowing Limit for 2011/12 was set at £533.2m.
- 7 The Cabinet Member for Finance and Resources confirms that there were no breaches to the Authorised and Operational Borrowing Limits during the period 1st April to 30th September 2011.
- 8 Compliance against other treasury management prudential indicators detailed below:

Treasury Management (a)	Actual 31.03.11	Estimate 2011/12	Actual 30.09.11	Estimate 2012/13	Estimate 2013/14
Compliance with Limits	Yes		Yes		
Debt Maturity:					
Over 30 Years	11%	15%	9%	15%	15%
Over 25 to 30 Years	0%	50%	0%	50%	50%
Over 20 to 25 Years	42%	75%	28%	75%	75%
Over 15 to 20 Years	38%	75%	39%	75%	75%
Over 10 to 15 Years	9%	50%	8%	50%	50%
Over 5 to 10 Years	0%	50%	16%	50%	50%
Over 1 to 5 Years	0%	25%	0%	25%	25%
Under 12 Months	0%	10%	0%	10%	10%

Treasury Management (b)	Actual 31.03.11	Estimate 2011/12	Actual 30.09.11	Estimate 2012/13	Estimate 2013/14
Compliance with Limits	Yes		Yes		
Maximum % borrowing at fixed rates	100%	100%	100%	100%	100%
Maximum % borrowing at variable rates	0%	25%	0%	25%	25%
Maximum % investments at fixed rates	39%	100%	54%	100%	100%
Maximum % investments at variable rates	61%	100%	46%	100%	100%
Maximum invested for a year or longer	0%	25%	0%	25%	25%