ITEM NO: 6.00

TITLE	**Update to the 2012/13 Treasury Management Strategy**
FOR CONSIDERATION BY	Audit Committee on 28 June 2012
WARD	None Specific
STRATEGIC DIRECTOR	Graham Ebers, Strategic Director Resources
LEAD MEMBER	Anthony Pollock, Executive Member for Finance

OUTCOME / BENEFITS TO THE COMMUNITY

Maximising our investment returns to fund Council services whilst protecting investment security and effectively managing our debt.

RECOMMENDATION

The Audit Committee is asked to approve and recommend to Executive and Council the following suggested amendments to the Treasury Strategy for 2012/13.

1) To include the use of corporate bond funds as counterparties (paragraph 34, Appendix A).
2) To revise the prudential indicator for the maturity structure of borrowing for 2012/13.This is due to the indicator requiring revision in the 12/13 strategy to take account of HRA Self financing. The revised indicator is shown in Appendix A paragraph 42.

SUMMARY OF REPORT

The treasury management strategy is reviewed annually and sets the criteria used to invest the Council's surplus cash balances with various investment counterparties. A change in legislation in April 2012 has meant the council now has the freedom to diversify its investment portfolio away from the volatile financial sector by granting the ability for local authorities to invest in Corporate Bonds. This would mean the council could invest across a variety of sectors, particularly as part of a managed portfolio within a corporate bond fund. With the current economic climate putting pressure on the availability of secure investments and the low interest rates received, it is recommended that the Council explore the use of corporate bonds as part of its Treasury Management activities. To enable this to happen a change in the treasury management strategy is required to provide the option to invest in corporate bonds. Any decision to invest in corporate bonds will then only be taken in full consultation between the Strategic Director of Resources and the Lead Executive Member for Finance.

An updated extract of the Investment Strategy contained within the 2012/13 Treasury Management Strategy approved by Council on the 22nd February 2012 is attached at Appendix A. This has been updated as follows :-

- To include the use of corporate bond funds as counterparties (Appendix A paragraph 34, further background surrounding this recommendation are given below).
- To revise the prudential indicator for the maturity structure of borrowing for 2012/13.This is due to the indicator requiring revision in the 12/13 strategy to take account of HRA Self financing. The revised indicator is shown in Appendix A paragraph 42.

Background

The Department for Communities and Local Government (CLG) has changed the capital finance regulations with effect from 1st April 2012. One of the changes allows Local Authorities to invest in loan capital without this being considered as capital expenditure. One major form of loan capital is Corporate Bonds.

Most central bank rates are at record lows and the credit quality of European financial institutions are still in question after central bank interventions. The Council's treasury advisor's latest forecast, predicts that the UK official interest rate will be at its current record low until the third quarter of 2013. In this economic climate the Corporate Finance Team is often struggling to find investment products that are most importantly, safe and credible, but also offer a reasonable investment return on the Council's investments. This is due to low interest rates and the Council's counterparty list being squeezed in terms of numbers of counterparty institutions, as a result of rating agencies having made many sovereign and bank credit rating downgrades. The economic factors suggest that consideration of alternative investments and assets return such as diversifying into the non-financial sector could be beneficial within the Council's statutory investment parameters. Corporate Bonds, Corporate Bond Funds and Property Funds offer such alternative investment vehicles within the Council's statutory parameters.

In essence, companies issue bonds in order to raise long-term capital or funding, rather than issuing equity. Investing in a corporate bond usually offers a fixed stream of income (except floating rate notes), known as a coupon, payable twice a year, for a fixed, predetermined period of time in exchange for an initial investment of capital. There are many types of corporate bonds including; zero-coupon bonds, debentures which are usually secured by a floating charge, mortgage bonds which have security of specific collateral and unsecured bonds which are based solely on the credit quality of the issuer. Corporate bonds are usually grouped by credit rating as the following;

- Investment-grade bonds - BBB or higher
- High yield/Speculative/Junk bonds - BB and below

The Corporate Finance team do not consider that it has the in house expertise to invest directly in corporate or property bonds. It also considers that Property Bonds will not offer the security that the Council seeks from its investments. However, the Council could invest in a Corporate Bond Fund and therefore use a fund manager (with the relevant expertise in the market) to invest on its behalf. This strategy would be in line with the use of Money Market Funds by the Corporate Finance Team as part of the in house managed investments and the use of our two external fund managers to manage the remainder of the council's funds.

The main benefits of using a corporate bond fund over investing in individual corporate bonds are:

- Investments via brokers and fund managers with professional expertise in the market
- Various structures of bond funds are available including OEIC's, Unit trusts, Closed end funds and MMF's, each of which would have varying risk profiles
- Investments would be redeemable at net asset value rather than at par or maturity date
- There would be a constant maturity date rather than a definite maturity date within an individual bond, this would allow the council to withdraw funds as required
- Interest rate risk would be constant across the portfolio (individual bond interest risk would be higher)
- Credit risk would be diversified compared to holding individual bonds

The main drawback of using a fund would be that fund managers would charge an annual management fee and commission.

There are a large number of corporate bond funds currently issued in the market. It is recommended that the Council would use funds with a mixture of different fixed income securities that must be denominated in sterling. Furthermore, it should invest in funds that invest in bonds in a broad range of sectors, not just concentrated towards the volatile financial sector.

Members are requested to consider amending the 2012/13 treasury management strategy to include the use of AA rated corporate bond funds as an investment counterparty option for the Council's investments (see paragraph 34 of Appendix A)

FINANCIAL IMPLICATIONS OF THE RECOMMENDATION

	How much will it Cost/ (Save)	Is there sufficient funding – if not quantify the Shortfall	Revenue or Capital?
Current Financial Year (Year 1)	£0	Yes	Revenue and Capital
Next Financial Year (Year 2)	£0	Yes	Revenue and Capital
Following Financial Year (Year 3)	£0	Yes	Revenue and Capital

Other financial information relevant to the Recommendation/Decision
Investment in corporate bond funds should increase the investment income whilst maintaining security over investments.

Cross-Council Implications (how does this decision impact on other Council services and priorities?)

Reasons for considering the report in Part 2

List of Background Papers
The Treasury Annual report for 2011/12 – this will be presented to Executive at the *meeting on* 28th *July* 2012 **The Councils Counter party List at 31st March 2012 is shown in Appendix A.**

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Investment Strategy 2012/13 – 2014/15

26 **Key Objectives** - The Council's investment strategy primary objectives are safeguarding the re-payment of the principal and interest of its investments on time first and ensuring adequate liquidity second – the investment return being a third objective. Following the economic background above, the current investment climate has one over-riding risk consideration; that of counterparty security risk. As a result of these underlying concerns officers are implementing an operational investment strategy which tightens the controls already in place in the approved investment strategy.

27 **Risk Benchmarking** – A development in the revised Codes and the CLG consultation paper is the consideration and approval of security and liquidity benchmarks. Yield benchmarks are currently widely used to assess investment performance. Discrete security and liquidity benchmarks are new requirements to the Member reporting, although the application of these is more subjective in nature. Additional background in the approach taken is attached at Annex B2.

28 These benchmarks (see Annex B2) are targets (not limits) and so may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy depending on any changes. Any breach of the benchmarks will be reported, with supporting reasons in the Mid-Year or Annual Report.

Investment Counterparty Selection Criteria

29 The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. In addition, as a result of the current market volatility, liquidity is increasingly important as this will enable the Council to act quickly to changes in the market.

30 The Strategic Director of Resources will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. This criteria is separate to that which chooses Specified and Non-Specified investments as it provides an overall pool of counterparties considered high quality that the Council may use rather than defining what its investments are.

31 The rating criteria use the **lowest common denominator** (LCD) method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest

available rating for any institution. For instance if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria.

32 The lowest common denominator approach is to be used by the in house team only. The Fund Managers have their own approach to counterparty selection.

33 Credit rating information is supplied by our treasury consultants on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing. For instance a negative rating watch applying to a counterparty at the minimum Council criteria will be suspended from use, with all others being reviewed in light of market conditions.

34 The parameters for selecting high quality counterparties (both Specified and Non-specified investments) are:

- **Sovereign Rating for foreign countries – AAA.** This is the credit rating of a country and indicates the risk level of investment in that country. This is for the in-house team only as the fund managers have additional checks in place for selecting counterparties.
- **Banks 1 – Good Credit Quality** - the Council will only use banks which:
    i. Are UK banks; and/or
    ii. Are non-UK and domiciled in a country which has a minimum Sovereign long term rating of AAA (in-house team only)

and have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (LCD approach only for in-house team), where rated.

- **Short Term** – F1+ (highest rating)
- **Long Term** – AA- (AAA is highest rating)
- **Individual / Financial Strength** – B/C (Fitch / Moody's only)
- **Support** – 2 (Fitch only)

- **Banks 2 – Guaranteed Banks with suitable Sovereign Support** – In addition, the Council will use banks whose ratings fall below the criteria specified above if all of the following conditions are met:
    - (a) wholesale deposits in the bank are covered by a government guarantee;

- (b) the government providing the guarantee is rated "AAA" by all three major rating agencies (Fitch, Moody's and Standard & Poors); and
- (c) the Council's investments with the bank are limited to amounts and maturities within the terms of the stipulated guarantee.
- (d) that the UK will be excluded from any stipulated minimum sovereign rating requirement

- **Banks 3 – Eligible Institutions** - the organisation is an Eligible Institution for the HM Treasury Credit Guarantee Scheme and meeting a minimum long term credit rating of A-. This was initially announced on 13 October 2008. These institutions have been subject to suitability checks before inclusion, and have access to HM Treasury liquidity if needed.
- **Banks 4 – The Council's own banker** (Nat West) for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.
- **Group Limits** – For each banking group the following limits will apply, dependent on the rating of the Parent Bank
    i. **AAA** : £7m with a maximum average duration of 1 year
    ii. **AA-** :£5m with a maximum average duration of 6 months
- **Building Societies** – the Council will only use Societies which are eligible to use the Bank of England's Credit Guarantee Scheme, subject to a minimum asset size of £5bn and meeting a minimum credit rating of A- (where rated).
- **Money Market Funds** – the Council and its Fund Managers will use AAA rated funds. The Strategic Director of Resources will keep under review the Money Market Funds used and will amend as necessary.
- **Corporate Bond Funds** - the Council and its Fund Managers will use AA rated funds denominated in Sterling and invests in bonds in a broad range of sectors, not just the volatile financial sector. The Strategic Director of Resources will keep under review the Corporate Bond Funds used and will amend as necessary.
- **UK Government** (including gilts and the DMO)
- **Local Authorities, Parish Councils**
- **Supranational institutions** – multilateral investment organisations such as the World Bank or European Investment Bank (sometimes used by the Fund Managers)
- ***In the event of an emergency, to allow an unlimited amount to be invested in the RBS Money Market Fund.*** This would be

done in the event of an extreme IT failure of the Council's computer systems. This fund is an AAA rated investment and would be a less risky option than leaving the funds in the NatWest accounts.

35 **Use of additional information other than credit ratings** – Additional requirements under the Code of Practice now require the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example, Credit Default Swaps, equity prices etc) will be applied to compare the relative security of differing investment counterparties.

36 **In House Investments only - the time and monetary limits** for institutions on the Council's Counterparty List are as follows (these will cover both Specified and Non-Specified Investments):
The DMADF account has a time limit of 3 months in reflection of the poor investment returns this account offers. This option would be used as a short term safe investment in times of extreme market volatility.

37 The proposed criteria for Specified and Non-Specified investments are shown in Annex B1 for approval.

38 In the normal course of the council's cash flow operations it is expected that both Specified and Non-Specified investments will be utilised for

	Fitch	Moody's	Standard & Poors	Money Limit	Time Limit
Upper Limit Category	**F1+/AAA**	**P-1/Aaa**	**A-1+/AAA**	**£5m**	**1 year**
Middle Limit Category	**F1+/AA-**	**P-1/Aa3**	**A-1+/AA-**	**£3m**	**1 year**
~~**Building Societies**~~	-	-	-	~~**£2m**~~	~~**6 months**~~
Debt Management Office DMADF Account (see below)	-	-	-	**£20m**	**3 months**
Guaranteed Organisations	-	-	-	**£2m**	**3 months**
Other Institution Limits (other local authorities, Money Market and Corporate Bond Funds, Gilts and Supranational investments)	-	-	-	**£5m**	**3 years**
Other named Banks (those subject to HM Treasury Credit Guarantee Scheme)	-	-	-	**£3m**	**6 months**

the control of liquidity as both categories allow for short term investments.

39 The use of longer term instruments (greater than one year from inception to repayment) will fall in the Non-Specified investment category. These instruments will only be used where the Council's liquidity requirements are safeguarded.

Economic Investment Considerations

40 Expectations on shorter-term interest rates, on which investment decisions are based, show the likelihood of the current 0.5% Bank Rate remaining flat till until Sept 2013. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisors own forecasts.

41 **The criteria for choosing counterparties set out above provides a sound approach to investment in "normal" market circumstances. Whilst Members are asked to approve this base criteria above, under the exceptional current market conditions the Strategic Director of Resources may temporarily restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria set out for approval. These restrictions will remain in place until the banking system returns to "normal" conditions. Similarly the time periods for investments will be restricted.**

Treasury Management Limits on Activity

42 There are four further treasury activity limits, which were previously prudential indicators. The purpose of these 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. However if these are set to be too restrictive they will impair the opportunities to reduce costs/improve performance. These are:

Interest Rate Exposures	2012/13 Upper £'000	2013/14 Upper £'000	2014/15 Upper £'000
Based on Debt only			
Limits on fixed interest rates	180,000	180,000	190,000
Limits on variable interest rates	40,000	40,000	40,000
Based on Investments only			
Limits on fixed interest rates	(80,000)	(80,000)	(80,000)
Limits on variable interest rates	(40,000)	(40,000)	(40,000)
Based on Debt Net of Investments			
Limits on fixed interest rates	100,000	100,000	125,000
Limits on variable interest rates	0	0	0

Maturity Structure of fixed term borrowing		
	Lower	Upper
Under 5 year	0%	5%
5 years to 10 years	0%	10%
10 years to 20 years	0%	40%
20 years to 30 years	0%	20%
30 years and above	0%	25%
Maximum principal sums invested over 364 days	£10m	