

Subject: Treasury Management Policy Statement
(incorporating the Annual Investment Strategy)
2011/12 - End of year review

Date of Meeting: 12 July 2012

Report of: Director of Finance

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Key Decision: No

Wards Affected: All

FOR GENERAL RELEASE

1. SUMMARY AND POLICY CONTEXT:

- 1.1 The Treasury Management Policy Statement (TMPS) and the Treasury Management Practices (including the schedules) for the year 2011/12 were approved by Cabinet on 17 March 2011. The TMPS sets out the key role for treasury management, whilst the practices and schedules set out the annual targets for treasury management and the methods by which these targets shall be met.
- 1.2 The TMPS includes an annual investment strategy, which sets out the key investment parameters for council cash funds. Full Council approved the investment strategy on 24 March 2011.
- 1.3 The purpose of this report is to advise of the action taken during the second half of the financial year 2011/2012 on the TMPS, including the investment strategy.
- 1.4 In March 2012 full Council requested that officers look at investment alternatives for council funds. Section 4 of this report advises on the outcome of this review and recommends changes to the AIS.

2. RECOMMENDATIONS:

- 2.1 That Policy & Resources Committee endorses the action taken during the second half year to meet the treasury management policy statement and practices (including the annual investment strategy).
- 2.2 That Policy & Resources notes the maximum indicator for risk agreed at 0.05% has not been exceeded.
- 2.3 That Policy & Resources notes the authorised limit and operational boundary set by the Council have not been exceeded.

- 2.4 That Policy & Resources approve the change in the Annual Investment Strategy 2012-13 as set out in paragraph 4.11 of this report and the recommend the change to full Council on 19th July 2012

3. RELEVANT BACKGROUND INFORMATION/CHRONOLOGY OF KEY EVENTS:

Overview of markets

- 3.1 The second half-year has seen a continuation of the financial uncertainty within the Euro zone. The sovereign debt crisis affecting Greece now encapsulates a number of other Euro countries, most notable Portugal, Ireland and Spain. In the UK the bias of policy decisions by the Bank of England during the half-year continued towards stimulating the economy with official rates remaining at ½% and quantitative easing (QE) increasing by a further £75 billion to £325 billion. The financial difficulties being experienced in the Euro zone are predicted to adversely affect the recovery within the UK and a further round of QE has not yet been ruled out. Inflation, as measured by the consumer prices index has fallen during the half-year, mainly due to factors within the index falling out the 12-month calculation period.
- 3.2 A commentary on the markets is set out in Appendix 1 to this report.

Treasury Management Strategy

- 3.3 A summary of the action taken in the period October 2011 to March 2012 is provided in Appendix 2 to this report. The main points are:
- one flexible loan totalling £10m agreed in early 2011 became “live” with the cash being received in February 2012
 - new borrowing totalling £18.081m was raised to fund the settlement payment due under the HRA self financing regime
 - no long term loans were repaid during the period
 - the level of investments made by the in-house treasury team totalled £28.1m as at 31st March 2012, a decrease of £3.3m during the half-year
 - the return on investments has exceeded the benchmark rate for both in-house investments and those undertaken by the cash manager
 - the two borrowing limits approved by the Council – the authorised limit and operational boundary – have not been exceeded.
- 3.4 The council continues to promote its’ ethical investment statement with institutions within which it deposits money. Investment counterparties are advised of the following statement each and every time a deposit is placed with them:

“Brighton & Hove City Council, in making investments through its treasury management function, fully supports the ethos of socially responsible investments. We will actively seek to communicate this support to those institutions we invest in as well as those we are considering investing in by:

- *encouraging those institutions to adopt and publicise policies on socially responsible investments;*
- *requesting those institutions to apply council deposits in a socially responsible manner.”*

- 3.5 Treasury management activity in the half-year has continued to focus on a short-term horizon as summarised in the table below

| | Amount invested 1 Oct 11 to 31 Mar 12 | | | |
|--------------------------|---------------------------------------|--------------------|---------|------|
| | Fixed deposits | Money market funds | Total | |
| Up to 1 week | £138.9m | £106.4m | £245.3m | 77% |
| Between 1 week and 1 mth | £38.1m | - | £38.1m | 12% |
| Between 1 mth and 3 mths | £33.3m | - | £33.3m | 11% |
| | £210.3m | £106.4m | £316.7m | 100% |

Budget v Outturn 2011/12

- 3.6 The following table summarises the performance on investments compared with the budgeted position and benchmark.

| | In-house investments | | Cash manager investments (net of fees) | |
|---|----------------------|-----------|--|-----------|
| | Aver bal | Aver rate | Aver bal | Aver rate |
| Budget 2011/12 | £26.6m | 0.94% | £24.3m | 1.03% |
| Actual | £53.5m | 0.85% | £24.5m | 1.50% |
| Benchmark rate (i.e. average market rate) | - | 0.47% | - | 0.47% |

- 3.7 There was an overspend on the financing costs budget of circa £195k in 2011/12. The following table (before adjusting for principal repayments and interest on PFI projects) summarises the areas of variance.

| | | |
|--|----------|----------|
| Budget 2011/12 | | £10.427m |
| <u>Treasury management activity</u> | | |
| ○ Higher cost of borrowing | +£0.028m | |
| ○ Higher investment income | -£0.328m | -£0.300m |
| <u>Other changes not directed related to treasury management activity</u> (e.g. reduction in interest payable on interest reserves & provisions) | | +£0.495m |
| Actual 2011/12 | | £10.622m |

Summary of treasury activity October 2011 to March 2012

- 3.8 The table below summarises the treasury activity in the half-year to March 2012 with the corresponding period in the previous two years.

| | Oct 09 to Mar 10 | Oct 10 to Mar 11 | Oct 11 to Mar 12 |
|--|------------------|------------------|------------------|
| Long-term borrowing raised – capital financing requirement | £15.0m | £20.0m | £10.0m |
| Long-term borrowing raised – HRA self financing | - | - | £18.1m |

| | | | |
|-----------------------------|-----------|-----------|-----------|
| Long-term borrowing repaid | - | (£15.0m) | - |
| Short-term borrowing raised | £138.0m | - | - |
| Short-term borrowing repaid | (£119.4m) | - | - |
| Investments made | £230.0m | £340.4m | £316.7m |
| Investments maturing | (£228.0m) | (£347.3m) | (£320.0m) |

- 3.9 The following table summarises how the day-to-day cash flows in the second half-year have been funded compared to the same period in the previous two years.

| | Oct 09 to Mar 10 | Oct 10 to Mar 11 | Oct 11 to Mar 12 |
|---|---------------------|---------------------|---------------------|
| Cash flow shortage – general | (£31.6m) | (£11.9m) | (£13.0m) |
| HRA settlement payment | - | - | (£18.1m) |
| Net cash flow shortage | (£31.6m) | (£11.9m) | (£31.1m) |
| Increase in long-term borrowing | £15.0m | £5.0m | £28.1m |
| Increase in short-term borrowing | £18.6m | - | - |
| Decrease / (increase) in investments | (£2.0m) | £6.9m | £3.3m |
| Increase in bank balance | - | - | (£0.3m) |

Interest rate risk

- 3.10 Cabinet has previously been advised the policy of repaying debt (to reduce investment risk) left the council exposed to the risk of long-term interest rates rising. To protect against this risk three loans were entered into whereby the terms were agreed in advance of cash being received.
- 3.11 During the half-year the final loan of £10m were received. The average cost of these loans is 4.21% and the average period to maturity is 49 years. Details of the loans are set out in Appendix 2.

Security of investments

- 3.12 A summary of investments made by the in-house treasury team and outstanding as at 31 March 2012 is tabled below. The table shows that investments continue to be held in high quality, short-term instruments.

| | | |
|--|--------|------|
| 'A' rated institutions | £6.7m | 24% |
| Local authorities | £5.0m | 18% |
| 'AAA' rated money market funds | £16.4m | 58% |
| | £28.1m | 100% |
| Period – less than one week | £17.4m | 62% |
| Period – between one week and one month | £2.5m | 9% |
| Period – between one month and three months | £3.2m | 11% |
| Period – between three months and six months | £5.0m | 18% |
| | £28.1m | 100% |

Risk

- 3.13 As part of the investment strategy for 2011/12 the Council agreed a maximum risk indicator of 0.05%. The indicator is a simple target that measures the risk within the investment portfolio based on counterparty risk and length of investment. The indicator is consistent with the investment parameters set out in the investment strategy.
- 3.14 The following table summarises the indicator at the mid-point of each month in the half-year period and confirms investments have been made in high quality counterparties

| | Mid month | | | | | |
|------------------------|-----------|--------|--------|--------|--------|--------|
| | Oct 11 | Nov 11 | Dec 11 | Jan 12 | Feb 12 | Mar 12 |
| Maximum risk indicator | 0.050% | 0.050% | 0.050% | 0.050% | 0.050% | 0.050% |
| Risk indicator | 0.003% | 0.002% | 0.001% | 0.001% | 0.002% | 0.002% |

4 REVISION TO ANNUAL INVESTMENT STRATEGY 2012/13

- 4.1 The Annual Investment Strategy 2012/13 (AIS) was presented to full Council on 22nd March 2012. Council resolved that the AIS be approved but added that *“Officers be requested to look at alternatives to financial investment in Barclays Bank, and to bring a report to a future meeting of the Policy & Resources Committee or other appropriate body of the council”*.
- 4.2 The current structure of the council’s balance sheet reflects the decision to repay debt early as part of the strategy to reduce counterparty risk in the investment portfolio following the collapse of Icelandic Banks and the funding crisis within the financial markets. Core reserves, which previously were available for investment longer than one year, are now being used to internally finance the council’s debt funding requirement.

Table: Amount internally financed as at 31st March 2012

| | |
|--|---------|
| Council’s funding requirement as at March 2012 | £297.0m |
| Total debt outstanding as at March 2012 | £207.8m |
| Internally financed | £89.2m |

- 4.3 With uncertainty in the financial markets continuing and the high number of downgrades of financial institutions World-wide it is not proposed to change this strategy at this stage. Subject to the recommended changes below investments will be made in selected UK based banks for periods up to one year only.
- 4.4 On 25th June officers and members met with Sector (the council’s external treasury advisors) to review the ethical investment options available for council investments and to consider changes to the counterparty list included in the AIS in light of the current conditions in the financial markets. The following paragraphs set out the outcome of the meeting.

Ethical investment options

- 4.5 Sector identified a number of ethical investment options (for example corporate ethical bonds) but in the main these require investors to deposit funds for periods between 2-5 years. The operation of these funds and the way in which the bonds

are valued mean that returns over the short-term can be extremely volatile, potentially resulting in loss of capital. The council's current investment strategy to invest only short-term effectively rules out these options at this time as the minimum period for investing in bonds is not consistent with this strategy.

- 4.6 Pension funds, such as the East Sussex LGPS, have a long-term investment objective. The longer-term investment opportunities offered by corporate ethical bonds are therefore more appropriate to this type of fund. Although not administered by this authority, Brighton & Hove does have representation on East Sussex LGPS investment panel. It is therefore possible to influence investments made by the LGPS if this Committee considers it a priority.
- 4.7 The council currently deposits funds with the Cooperative Bank. The Bank is currently categorised as good short-term credit quality and therefore falls below the current minimum criteria of highest credit quality set out in the AIS. The Bank is included only on the basis that they act as the council's bank for day-to-day operations. Investment in the Bank is limited to £10 million and one month duration to reflect the Bank's rating.
- 4.8 Additional banks with a strong ethical strategy have been considered such as Triodos Bank and the Ecology Building Society, but with each of these institutions it is difficult to assess their financial strength as there is no independent assessment (e.g. credit rating) or market involvement (e.g. equity prices) against which to compare with institutions of similar size. In respect of the Ecology BS the society is relatively small with an asset base at around £100 million. The majority of the Society's funding is raised through the retail sector (i.e. personal lenders) and any investment by the council would be considered material in size. Triodos Bank does offer investment opportunities but these require either direct investment in subsidiary companies (i.e. shares) which the council is prevented from doing or in funds such as those described in 4.5 above where investment is long-term.
- 4.9 Sector advise that the council is considered to be at the forefront of promoting an ethical investment statement for cash deposits and the statement is often passed by Sector to other local authorities seeking similar investment objectives. The council will continue to promote socially responsible investments through its statement. In addition the council will, where possible, seek the co-operation of fund managers to relay the council's commitment to socially responsible investment to the institutions in which their funds invest.

Changes to counterparty list

- 4.10 The recent and continuing down grade of financial institutions has meant the list of counterparties approved under the AIS has diminished, with limits on amounts and periods reduced and in some cases suspension from the list. This reduced list has meant that on two occasions in the first three months of the financial year the limits with existing counterparties have been breached for operational reasons. This was undertaken with the consent of the Director of Finance. The review of the AIS has identified a number of potential changes to the AIS that would help to negate the need to breach limits – namely increase the cash limit with existing counterparties or relax the minimum rating required in order that more counterparties may be added or a combination of the two.

- 4.11 The Director of Finance recommends that the AIS be revised so that:
- investment is made in selected financial institutions incorporated within the UK and regulated by the Financial Services Authority (this is a change from the current restriction of UK only institutions),
 - financial institutions that have received Government support (i.e. part nationalised banks) are deemed to have the highest rating irrespective of the actual rating assigned to them. This is due to the inherent guarantee that Government support affords them. The limits on the amount advanced and length of investment would be £10 million and 12 months respectively.
 - a combination of:
 - relaxation in the minimum short-term rating from highest short-term credit quality (F1, P-1, A-1) to good short-term credit quality (F2, P-2, A-2), and
 - relaxation in the minimum long-term rating from high credit quality (A, A2, A) to good credit quality (BBB, Baa, BBB).
- This will enable a number of financial institutions previously on the council's list to be used. The limits on the amount advanced and length of investment would be £5 million and 6 months respectively.

A revised list of counterparties is attached at Appendix 5 to this report.

- 4.12 The above changes continue with the underlying principle of security of investment but offer a wider range of investment opportunities. As and when the financial markets return to a more stable footing the above changes will be reviewed to ensure risk within the investment portfolio is not compromised.

5 CONSULTATION

- 5.1 The council's external treasury advisor has contributed to this report.

6 FINANCIAL & OTHER IMPLICATIONS

Financial Implications:

- 6.1 The financial implications arising from the action taken under the TMPS are included in Financing Costs. Details of the 2011/12 outturn for financing costs are included under Section 3.7 above.
- 6.2 The changes proposed to the AIS will increase the number of institutions in which the council may invest thereby negating the need to breach investment limits with institutions for operational purposes.

Finance Officer consulted: Peter Sargent

Date: 12 June 2012

Legal Implications:

- 6.3 The TMPS and action under it must be in accordance with Part I of the Local Government Act 2003 and regulations issued thereunder. Relevant guidance also needs to be taken into account.
- 6.4 This report is for information purposes only and as such it is not considered that anyone's rights under the Human Rights Act will be adversely affected by it.

Lawyer consulted: Abraham Ghebre-Ghiorghis Date: 12 June 2012

Equalities Implications:

- 6.5 No equalities impact assessment is required for this report.

Sustainability Implications:

- 6.6 None arising from this report.

Crime & Disorder Implications:

- 6.7 None arising from this report.

Risk and Opportunity Management Implications:

- 6.8 Action taken in the six months to March 2012 is consistent with the risks identified within the TMPS and associated schedules.
- 6.9 In February 2012 the council's Head of Internal Audit & Business Risk undertook an audit of the treasury management function. The audit concluded that "substantial assurance" is provided on the effectiveness of the control framework operating and mitigation of risks for treasury management meaning that effective controls are in place to manage the key risks to the system/service.
- 6.10 The change in the short-term and long-term minimum ratings in selecting investment counterparties as set out in paragraph 4.11 above will only marginally increase the risk on the investment portfolio and will still be within the maximum risk indicator of 0.05% approved within the AIS.

Corporate / Citywide Implications:

- 6.11 None arising from this report.

7. EVALUATION OF ANY ALTERNATIVE OPTION(S):

- 7.1 This report sets out action taken in the six months to March 2012. No alternative options are therefore considered necessary.

8. REASONS FOR REPORT RECOMMENDATIONS

- 8.1 Treasury management is governed by a code that is recognised as 'best and proper practice' under the Local Government Act 2003. The Code requires a minimum of two reports per year, one of which is a report looking back at the closing year. This report fulfils this requirement.

SUPPORTING DOCUMENTATION

Appendices:

1. Appendix 1 – Economic background
2. Appendix 2 – A summary of the action taken in the period October 2011 to March 2012
3. Appendix 3 – Performance and balances
4. Appendix 4 – Prudential indicators 2011/12 Actual
5. Appendix 5 – Revised schedule of investment counterparties

Documents In Members' Rooms

None

Background Documents

1. Part I of the Local Government Act 2003 and associated regulations
2. "The Treasury Management Policy Statement and associated schedules 2011/12" approved by Cabinet on 17 March 2011
3. The "Annual Investment Strategy 2011/12" approved by full Council on 24 March 2011
4. Papers held within Strategic Finance, Finance & Resources
5. "The Prudential Code for Capital Finance in Local Authorities" published by CIPFA 2003 and revised in 2009