Meeting:	Cabinet
Date:	18 December 2008
Subject:	Half year 2008-09 Treasury Management Activity
Key Decision:	No
Responsible Officer:	Myfanwy Barrett: Corporate Director of Finance
Portfolio Holder:	David Ashton (Leader and Portfolio Holder for Strategy, Partnership and Finance**)**
Exempt:	No
Enclosures:	Nil

Section 1 – Summary and Recommendations

This report sets out
1. Proposed changes to the Treasury Management Strategy.
2. A half year summary of Treasury Management activities for 2008-09.

Recommendations
- a) Approve the changes to the criteria used to select the counterparties.
- b) Approve changes to the limits for Investments for periods longer than 364 days.
- c) Approve changes to the Long Term Borrowing profile.
- d) Note the half year treasury management activity for 2008-09.

Reason

To keep Cabinet Members informed of Treasury Management activities and performance.

Section 2 – Report

Introduction

1. The Council approved a Treasury Management Strategy for 2008-09 in February 2008, which complies with the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management and Prudential Code for Capital Finance.

2. The overall objective of Treasury Management is to manage the Council's cash flow, borrowing and investments, and to control the associated risks, so as to maintain liquidity, maximise the return on investments and to minimise charges on loan debt with minimal risk to the Council's assets.

3. This report is the half year summary of performance to 30 September 2008. It also includes a review and amendment of the Treasury Management policy in response to the financial market conditions and events experienced in this period. Because of extreme circumstances in financial markets some changes have been made on a temporary basis under the Section 151 officer's delegated responsibility for Treasury Management, approval is now sought to make these and other recommended changes permanent.

COUNTER PARTY LIST AND ALTERNATIVE INVESTMENTS

4. As a result of the collapse of the Icelandic banking system in October a large number of Local Authorities had substantial deposits frozen in the Icelandic banking system. The problems arose in spite of the banks concerned being credit rated within the parameters considered by Treasury Management Advisers as prudent for lending and therefore included on counterparty lending lists. Although this was also the case in Harrow no lending had taken place to Icelandic Banks.

5. This has called into question the robustness and reliability of the credit rating agencies. The banking collapse continued to spiral and the U.S, British and governments globally have stepped in to inject £billions of capital into the banks and stabilise the financial institutions. All of this turmoil, in addition to the Icelandic catastrophic position has caused uncertainty about how to safeguard investments. We have thoroughly reviewed our policy for lending to ensure all the necessary steps have been taken to help minimise risk. This includes reviewing our criteria for counterparties, lending limits and duration for lending.

6. Certain decisions were taken on a temporary basis by the Corporate Director of Finance as Section 151 officer under her delegated authority within the approved Treasury Management policy. The following amendments were made to the current lending list to address concerns in the current economic climate, maintain capacity for lending and minimise risk:

- Suspension of all new investments in Building Societies without credit ratings.
- Increase in the counter party limits for UK banks, credit rated UK building societies and Irish banks from £10m to £15m.

These changes are now proposed as permanent and included below for approval.

Review of Current Criteria

7. We use Fitch as our credit agency and there is no reason to suggest that we should change this – given that the problems experienced in reliability of credit ratings have occurred across all the major credit agencies. However, some added safeguards to the required criteria are proposed below.

8. The current lending list adheres to the minimum FITCH ratings as detailed below for both UK and Non UK banks:-

   a) **Long Term AA-** This denotes a very low expectation of credit risk, a very strong capacity for timely payment of financial commitments and is not significantly vulnerable to foreseeable events.
   b) **Short Term F1+** This indicates the strongest capacity for timely payment of financial commitments.
   c) **Support 2** This means that a bank for which there is a high probability of external support. The potential provider of support is highly rated in its own right and has a high propensity to provide support to the bank in question.
   d) **Individual B** This indicates that it is a strong bank, where there are no major concerns.

9. It should be noted that the credit agency Fitch downgraded the three biggest Icelandic Banks on 1 April 2008 and placed them on negative watch at risk, as a result of the fall in the krona and worldwide credit market problems. However, up until this period they fell within the parameters set out above which is reason why so many local authorities and public bodies had invested with them. At the same time the high returns offered by these banks with minimum capital backing means that despite running a highly risky business model which was recognised and shunned by some financial investors and institutions – this was not reflected in the credit rating. This clearly shows that it is not always possible to avoid risk by using the credit rating criteria. However, the main way to mitigate the risk is to ensure that investments are spread and not over invested even when rates appear high, where there is no absolute guarantee from the ruling government. There is a proposal below to restrict the lending limit for non UK banks within the lending criteria to mitigate over exposure.

10. In addition to the banks, the current lending list also has the following counter parties:-

    a) Building Societies, individual limits were set for each building society dependent upon the asset size and investment with smaller societies had a maximum duration of 364 days.
    b) Local Authorities with a total limit of £5m.
    c) Money Market funds with long term AAA ratings

New Proposed Criteria

11. A meeting of the Treasury Management Committee and chaired by the Corporate Director for Finance met and agreed the following revisions.

a) Continue with the current criteria as listed in paragraph 1 above.

b) Introduce sovereign rating criteria of AAA for countries when inserting foreign banks on the counter party list. ‘AAA’ Sovereign rating is assigned to the “best” credit risk relative to all other issuers or issues in the same country and will normally be assigned to all financial commitments issued or guaranteed by the sovereign state.

c) Remove all the building societies from the list except for the ones which are credit rated and meet the minimum criteria.

12. The lending list under the new criteria will be more restrictive mainly due to the elimination of non credit rated building societies. Therefore, to create more flexibility it is recommended that the lending limits be amended as detailed below :-

    - Increase the individual limit of UK Banks, credit rated UK Building Societies and Irish Banks from £10m to £15m and increase the group limit from £15m to £25m.
    - Eliminate the total limit for Police and Local authorities and introduce an individual limit of £10m for Local and Police authorities.
    - Increase the limit from £10m to £15m for Non UK banks with sovereign rating AAA and where the Government have guaranteed deposits (Ireland and Singapore).
    - Reduce the limit from £10m to £5m for other Non UK banks.

Other controls operated

13. The lending list is updated as soon as the criteria of an institution is modified. Fitch provide a daily update.

14. The Treasury Management Group (S151 Officer, Deputy S151 Officer and the Treasury Manager) meet on a monthly basis to review the operation of the activity, lending list and performance and review the strategy against the latest available data for the coming month.

15. It is considered that the changes proposed will strengthen the robustness of the lending list and help to minimise risk by spreading investments – particularly in relation to reducing the limit for Non UK banks with a sovereign rating less than AAA.

Alternative Investments

16. The current economic climate, Bank of England base rate (now 2% and widely expected to be cut further in the next quarter) and more restricted counterparty list mean that the level of return on investments for the remainder of 2008/09, 2009 and probably into 2010 will be severely restricted. It is worth considering other investment instruments as detailed below:-

    - **Debt Management Office accounts** - This is most risk averse as the lending is to the UK Government. However, the returns are up to 2.5% below market rates.

    - **Treasury bills -** Short term government bonds.

    - **UK Government gilts -** No credit risk and a guaranteed rate of return for a specific period, if held to maturity.

    - **Multilateral Development Banks -** These are supranational financial institutions which aim to provide financial and technical assistance for projects of a social nature by raising fund on financial markets.

17. The last 3 investment instruments mentioned above are tradable instruments that require a certain amount of specialist knowledge. The intention is to explore further the potential for holding these instruments with our Treasury Management advisors Sector to see whether there are investment opportunities. At the present time, it is recommended to consider the Debt Management Office Account which is secure, but given that the rate of return is low, this will not be considered if other higher yielding investments within the approved parameters are available.

Investing for periods longer than 364 days

18. The latest base rate cut was agreed on 4 December 2008 taking the rate to 2%, a drop of 1%. A further cut is expected by major financial institutions in the next quarter. In order to reduce the Council's exposure to future decreases in interest rates it is proposed to secure fixed rates for longer periods, it is proposed that the above limits are revised as detailed below. This needs to be balanced against the risk and volatility in the market.

Current Limits

Period	£m	% of Portfolio
365 days to 1 year 364 days	£10m	10% (approx)
2 years to 2 years 364 days	£5m	5% (approx)
3 years to 3 years 364 days	£5m	5% (approx)

Proposed Limits

Period	£m	% of Portfolio
365 days to 1 year 364 days	£25m	25% (approx)
2 years to 2 years 364 days	£20m	20% (approx)
3 years to 3 years 364 days	£5m	5% (approx)

Maturity Structure of Long Term Borrowing

19. The debt restructuring and borrowing undertaken during 2007-08 has increased the average duration of the debt. The long term objective is to reduce the cost of borrowing from 5.35 to 4.50%. The current short term (1-5 years) and longer term (10 years+) PWLB borrowing rates are at rates low enough to support the overall long term objective of reducing the cost of borrowing. Therefore, it is proposed that the current limits are revised as detailed below

Current Limits

Prudential Code Limits	Upper Limit	Lower Limit
Under 12 Months	20%	0%
12 Months, and under 24 months	20%	0%
24 months, and within 5 years	30%	0%
5 years, and within 10 years	40%	10%
10 Years and above	85%	10%

Proposed Limits

Prudential Code Limits	Upper Limit	Lower Limit
Under 12 Months	20%	0%
12 Months, and under 24 months	20%	0%
24 months, and within 5 years	30%	0%
5 years, and within 10 years	40%	10%
10 Years and above	95%	10%

TREASURY MANAGEMENT ACTIVITY FOR THE PERIOD ENDING 30 SEPTEMBER 08

Temporary Investments

20. A total of £91.4m investments were placed via the London money market as at 30 September 2008. The average forecast return is expected to be approximately 4.5% compared to 5.94% in 2007-08 and less than the estimate of 4.75%. This is due to the base rate cuts since April. There have been four base rate cuts during the period April 08 to November 08 bringing the rate down from 5.25% to 2%, and a further cut is expected in the next quarter. The rate of return from UK banks is currently around 3% depending on period of lending.

The table below sets out the position as at 30 September 2008.

	2007-08 Sept 2007		**2007-08 March 2008**		**2008-09 Sept 2008**	
	£m	**%**	**£m**	**%**	**£m**	**%**
Specified Investments						
Banks	0.0	0.0	3.0	3.5	9.7	10.6
Money Market Funds	2.0	2.3	3.4	4.0	7.8	8.5
Non –Specified Investments						
Building Societies	50.3	58.2	78.9	92.5	73.9	80.9
Sub Total	**52.3**		**85.3**		**91.4**	
External Manager	34.2	39.5	0.0	0.0	0.0	0.0
Total	**86.5**	**100.0**	**85.3**	**100.0**	**91.4**	**100.0**

Investing for periods longer than 364 days

21. During the year sums were invested for longer periods to take advantage of the higher rates on offer.

Length of investment	**Limit**		**Actual to Sept 2008**	
	£m	**% (approx)**	**£m**	**% of Portfolio**
365 days to 1 year 364 days	10	10	7.0	7.7
2 years to 2 years 364 days	5	5	5.0	5.5
3 years to 3 years 364 days	5	5	0.0	0.0

Prudential Code and Long Term Borrowing

Capital Expenditure

22. The original capital investment plan for 2008-09 reported to Cabinet in February 2008 was £83.5m. However, the revised plan as at quarter 2 is £106m, an increase of £22.5m. The main reasons for the changes are: capital projects of £49m brought forward from 2007-08; less £27m which is the net effect of deductions due to rephasing and additions of new schemes added during the first half of 2008-09. This leaves an overall additional £22m.

Long Term Borrowing

23. The Authorised Limit and Operational Boundary for External Debt are £271m and £236m respectively.

Capital Financing Requirement

24. The forecast position for 2008-09 for Non HRA has increased by £34m since the policy was approved in February 08. The main reasons for the significant movement are :-

- The capital programme brought forward from 2007-08 with a net funding requirement of £14m,
- The capital receipts anticipated in the capital programme approved in February 2008 have been adversely affected by the economy. This has resulted in an increase in the funding requirement of approximately £20m.

31 March	**2008**		**2009**	
	£000	**£000**	**£000**	**£000**
	Estimate	**Actual**	**Estimate**	**Forecast**
Non HRA	174,613	167,775	166,095	200,124
HRA	38,404	36,907	50,649	49,047

Ratio of financing Costs to Net Revenue Stream

25. The financing costs of the council include interest payable in respect of borrowing, premiums paid and the minimum revenue provision. Netted off against these expenses is interest earned on investments and discounts received on debt restructuring.

	2007-08		2008-09	
	Estimate	**Actual**	**Estimate**	**Forecast**
	%	**%**	**%**	**%**
Non HRA	8.54	7.30	8.15	8.01
HRA	31.80	28.69	32.66	30.08

Maturity Structure of Long Term Borrowing

26. Total long term debt of £202.31m at September 2008 is made up £81.8m Bank loans and £120.51m PWLB loans. The upper limit for borrowing over 10 years and above is breached due to the repayment of a £5m bank loan which matured in April 2008. This results since most of the borrowing is long term, so any reduction in the outstanding liabilities has a proportionately greater impact on the longer periods.

	Upper Limit	**Lower Limit**	**Actual 30 September 2008**	
	%	**%**	**£m**	**%**
Under 12 Months	20	0	0.01	0.01
12 Months and under 24 Months	20	0	0.02	0.01
24 Months and within 5 years	30	0	0.17	0.08
5 years and within 10 years	40	10	26.19	12.94
10 years and above	85	10	175.92	86.96
Total			202.31	100.00

Financial Implications

27. Financial matters are integral to the report.

Performance Issues

28. There are no direct implications for individual performance indicators.

Section 3 - Statutory Officer Clearance

Name: Myfanwy Barrett ☑ √ Chief Financial Officer

Date: 5 December 2008

Name: Hugh Peart | √ | Monitoring Officer

Date: 9 December 2008

Section 4 – Performance Officer Clearance

Name: Tom Whiting | √ | Performance Officer

Date: 5 December 2008

Section 5 - Contact Details and Background Papers

Contact: Jennifer Hydari (Divisional Director of Finance and Procurement)

Background Papers:
Report to February 2008 Cabinet : Approval of 2008-09 Treasury Management Strategy and Prudential Code.