CABINET
4 NOVEMBER 2008

ITEM NO. ....7(d)..............

REVIEW OF THE TREASURY MANAGEMENT INVESTMENT STRATEGY

Responsible Cabinet Member – Councillor Stephen Harker, Resources Portfolio

Responsible Director – Paul Wildsmith, Director of Corporate Services

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SUMMARY REPORT

Purpose of the Report

1. To inform Members of the recent review of the Treasury Management Investment Strategy in light of the global economic situation aimed at reducing further risk to loss of investments in the current worldwide financial/banking crisis.

Summary

2. The Council has been well served by its current investment strategy, it has balanced risk and yield and delivers above average rates of return as regularly highlighted to Members in various reports. However, given the current financial climate it was felt appropriate to review existing practice and ensure Members are comfortable with the balance between risk and yield. Set out in the report are changes to practice that officers believe are appropriate given the current economic climate.

Recommendation

3. It is recommended that :-

   (a) Members note the steps already taken by Officers to reduce the risks to capital sums invested and safeguard the revenue budget.
   (b) Officers formalise the further procedures outlined in paragraph 19 by including these in the schedules to the Treasury Management Procedures.
   (c) Three money market funds be added to the counterparty list with an investment level of £5m.
   (d) The counterparty list for the debt management office be unlimited.
   (e) The Counterparty list be restricted to UK banks and building societies.
   (f) Nationalised Institutions such as Northern Rock be added to the counterparty list with a maximum limit for investments of 3 months and a maximum amount of £3m.

Reasons

4. The recommendations are supported by the following reasons :-

   (a) To reduce the risks to the Capital sums invested in Financial Institutions

   (b) To comply with the requirements of the Local Government Act 2003

Paul Wildsmith
Director of Corporate Services

Background Papers
Treasury Management Strategy

Elaine Hufford : Extension 2447

Glossary of Terms

Counterparty	Financial Institutions with which we make investments
Fixed Investment	Investments agreed to run a specified length of time
Call Investments	Investments that can be called back without a period of notice
Yield	Rate of interest returned with the investment
Financial Institutions	Banks or Building Societies

S17 Crime and Disorder	This report has no implications for S17 Crime and Disorder
Health and Well Being	This report has no implications for the Councils Health and Well Being agenda
Sustainability	This report has no implications for the Councils Sustainability agenda
Diversity	This report has no implications for the Councils Diversity agenda
Wards Affected	All wards
Groups Affected	All groups
Budget and Policy Framework	This report must be considered by Council
Key Decision	This is a key decision
Urgent Decision	For the purposes of call in this report is not an urgent decision
One Darlington: Perfectly Placed	This report has no particular implications for the Sustainable Community Strategy

MAIN REPORT

Information and Analysis
Background

5. In view of the current financial crisis within the worldwide banking system a review of how the Treasury Management function of Darlington Borough Council manages its counterparty (external lending) risk has been undertaken.

6. In the light of the collapse of the BCCI Bank in the early nineties when one local authority was hit when it had placed the majority of its investments with the bank, the government insisted that Local Authorities should manage its Treasury Management function in line with new guidelines and produce a Treasury Management Policy Statement and Strategy. By following these guidelines each local authority would put in place a number of Treasury Management Procedures that manage risk, including counterparty risk. One of the Prudential Indicators included in the Prudential Code is that Local Authorities have in place a Treasury Management Policy Statement, Darlington Borough Council consistently and continually complies with this indicator.

7. The main principle governing the Councils investment criteria is the security and liquidity of its investments before yield, although yield or return on the investment will be consideration subject to adequate security and liquidity.

Current Position

8. For a number of years Darlington Borough Council has engaged Butlers as its Treasury Management advisors. These consultants together with Sector (part of the Capita group) cover most of the UK Public Sector.

9. Butlers operates independently within the ICAP plc Group which is the world's leading financial brokering organisation. The Butlers team comprises fifteen members of staff, specialists in disciplines of particular relevance to local authorities and registered with the Financial Services Authority (FSA) to provide advice of a financial nature. Three team members have experience of local government finance at the highest level, having served as Chief Finance Officers at various authorities.

10. Butlers issue advice on how to create a counterparty list for Financial Institutions, the advice that we follow uses the major worldwide credit rating agencies Fitch, Moodys and Standard and Poors. Generally good banks will have ratings with all credit ratings agencies, whereas buildings societies, if rated, would generally only have ratings with Moodys.

11. At **Appendix 1** there is a table showing the minimum credit rating (or asset size, relating to Building Society's) required for inclusion on the Councils counterparty list. This is the standard advice from Butlers.

12. Appendix 1 means that only financial institutions with at least these ratings or Standard and Poors equivalent or in the case of UK Building Societies have an asset size of at least £1 billion and above can be included on our list.

13. Further to this a decision then has to be made as to what each counterparty’s monetary limit should be and the maximum length of time any investments should be for.

14. Prior to January 2008 the maximum amount invested in any one counterparty was £3m and this had been in force before the Council became a unitary authority when our total investments were around £12m.

15. In the light of our investments nearing £50m we asked Butlers to review our limits as we sometimes had difficulty placing money as some of our higher rated counterparty’s had maximum amounts with them. It was agreed that rather than reduce the rating criteria it would be better to increase the lending monetary limits increasing the maximum from £3m to £5m. The following revised time/money limits were introduced after Council at the end of January 2008.

16. **Appendix 2** shows the time and financial limits placed on each organisation.

17. The credit rating of counterparties is monitored regularly. The council receives credit rating advice from Butlers, on a daily basis as and when ratings change, and counterparties are checked promptly and lists altered immediately. On occasions ratings may be downgraded when an investment has already been made depending on whether the investment was for a fixed period or on call the money may be returned at that point or may have to wait until its maturity date before it can be returned. Any counterparty failing to meet the criteria, will be removed from the list immediately by the Director of Corporate Services, and if required new counterparties which meet the criteria will be added to the list.

18. Above is the formal methodology for inclusion on the Council’s current counterparty list and this is agreed by Council annually.

19. There are further procedures operated by the Financial Services Manager as part of the Treasury Management function that tighten the counterparty list still further these are:-

    (a) Lowest common denominator approach to the counterparty list. Where institutions have ratings with more than one of the credit rating agencies then the lowest rating is used. If that doesn’t meet the criteria for inclusion on the list then it won’t be included even if the other ratings would permit the bank to be on the list.
    (b) Where banks do not have ratings from all three agencies then these too would not be included on the list.
    (c) Banks/ Building Societies that have been down graded are removed from the list immediately.
    (d) Banks/ Building Societies now meeting the criteria would only be added to the list when signed off by the Director of Corporate Services.
    (e) Where financial institutions have a negative watch placed on them by the credit rating agencies this would be noted on the list and no further investments would take place until that negative watch was removed.
    (f) Where institutions have merged investments would be made on the assumption that the merger had taken place. i.e. Nationwide’s takeover of Derbyshire and Cheshire Building Societies all three Societies will be counted as one.
    (g) Investments are also being conducted with a view to spreading risk where ever possible, not just looking at the return offered by the institution but also how much we already have invested with each.

(h) Keeping investments to a short time scale i.e. less than 1 month for institutions mentioned in the press in a negative way.
(i) Being aware that when investments are offered at a much higher rate of interest than other investments over the same period, the counterparty offering that rate may have a liquidity problem and therefore severe caution is exercised.

20. Combinations of these approaches have meant that we haven't been exposed to banks that have later had problems i.e. Northern Rock, Glitnir, Bradford and Bingley Landsbanki and Heritable Bank.

21. To formalise the above procedures it is proposed that they are included in the Schedules to the Treasury Management Procedures to ensure their continued application.

22. Attached at **Appendix 3** is the latest active counterparty list given the procedures outlined above together with the amounts deposited as at 14 October 2008.

Review of Investment Strategy

23. The Council has been well served by its current investment strategy, it has balanced risk and yield and delivers above average rates of return as regularly highlighted to Members in various reports. However, given the current financial climate it was felt appropriate to review existing practice and ensure Members are comfortable with the balance between risk and yield. Set out below are changes to practice that officers believe are appropriate given the current economic climate.

Money Market Funds

24. Butlers are advocating the use of Money Market funds for our short term/cashflow deposits. Our Investment Strategy allows the use of Money Market Funds. These funds have been used by organisations outside Local Authorities for a number of years, and since April 2004 have been approved for use by Local Authorities and are most useful in managing the day to day cashflow requirements of the authority and are used as a call account deposited one day and recalled without a period of notice as and when required. They represent vast pools of liquidity invested by a manager (such as Scottish Widows) in a very wide range of money market instruments, the type and maturity of these instruments is controlled and monitored by the official rating agencies and are a key criteria upon which these funds are assigned their ratings. Local Authorities are only allowed to use AAA rated funds that are denominated in sterling and are regulated by an officially recognised EU body such as the Financial Services Authority. The main considerations for using these funds are on the grounds of safety and can be summarised as follows:-

(a) Funds are invested in a wide range of top quality counterparties thereby minimising default risk.
(b) The manager limits its exposure to any one counterparty to a maximum of between 5% and 10% of the total of the fund.
(c) Limits are imposed upon the maximum average maturity of the fund, the decision resting with the rating agency.
(d) Fund is held by a custodian, ensuring there is no direct exposure to the underlying Investment. This means that the authority's funds are ring fenced from the manager who will be unable to use them to support its business in the event of difficulties.

25. With regard to yield the funds aim to provide returns at about the same rate as 1 month LIBOR after deduction of the managers fees, this in effect reduces the rate of return typically by 15 basis points i.e. from 5.65% to 5.5%. When interest rates are generally falling they offer better value than other investments but when interest rates are rising their returns are not as good as other investments, but they do provide more stability and less volatile returns.

26. Officers are currently evaluating Money Market funds with a view to opening three of these funds to be used for day to day cashflow management currently the Investment Strategy allows a maximum investment £5m per fund.

27. **Risk -** By using Money Market funds the risk of losing all of our capital sum with one fund is non existent, however the risk of losing part of the fund is greater than if the investment were with a single institution because within the fund risks are being spread.

28. It is recommended that three money market funds be added to the counterparty list with an investment level of £5m each.

Debt Management Office increase in Money Limit

29. Local Authorities have the opportunity of investing with the Government through the Debt Management Office, similar to the Public Works Loans Board. At present the Council has the same counterparty limit with this institution £5m as with others. However, it would be considered more prudent to increase this to unlimited so that more investments could be made. Currently the Council does not use this facility as rates of return are very low compared to other institutions. However the increase in limit will allow the Council to maximise its use of the facility should there be a significant risk with other institutions.

30. **Risk** Whilst the security of the deposits would be assured there would be a cost to the revenue budget. Typically the Debt Management Office pays between 0.5% and 1% less than other institutions depending on the length of time the investment is for, if all of our investments were placed with the government the cost to the revenue budget would be between £0.240m and £0.480m

31. It is recommended that the counterparty list for the debt management office be unlimited.

Limiting Future Exposure to UK and Building Societies only.

32. In view of the recent collapse of the Icelandic Banking System it may be prudent to restrict our future exposure to UK banks and building societies. In limiting our exposure to UK banks and building societies we may be able to avoid any future difficulties that arise in foreign banks . The recent action taken by the Government to support the UK banking system gives the UK system a more robust future.

33. **Risk** – No increased risk to capital sum or the revenue budget, however monetary counterparty limits may have to be revised in the future if investments are difficult to place within the current counterparty limits.

34. It is recommended that the Counterparty list be restricted to UK banks and building societies.

Nationalised Institutions

35. After the near collapse of Northern Rock late last year, the Government nationalised this institution. However, the credit rating agency Fitch has only given this bank an individual rating of F but a support rating (which measures the level of government support for an institution) of 1. This is outside our normal criteria for rated institutions but the Government have guaranteed their operation. This guarantee is in place going forward for up to 3 months.

36. **Risk –** These institutions effectively have the same guarantee as the Governments Debt Management Office and are assured. Interest rate levels are generally in line with money markets.

37. It is recommended that Nationalised Institutions such as Northern Rock be added to the counterparty list with a maximum limit for investments of 3 months and a maximum amount of £3m.

Other Local Authorities

38. As well as Financial Institutions our Investment Strategy also allows for investments in other Local Authorities. This is something that hasn't been pursued, mainly because there were always other well rated financial institutions offering good rates of return. Officers are now actively pursuing this line of investments as they offer the same amount of security as a AAA rated institutions. However, most Local Authorities are in a similar situation to ourselves in that they invest surplus cash and rarely need short term loans although there may be opportunities.

39. Risk – Little risk to capital sum as the likelihood of the Local Authority defaulting on the payment is negligible. Low risk to revenue budget as interest rates paid is consistent with money market rates.

Conclusion

40. By taking the above steps risks to the capital sum invested can be reduced still further however, there may be some reduction in the interest paid to the revenue budget. It is proposed that a mixture of these measures are taken to reduce the risk of loss of the capital sum invested and reduce the risk to income paid into the revenue budget.

41. The Annual Investment Strategy will be kept under constant review inline with the governments guidelines through the Prudential Code.

42. Clearly the local authority must keep investing as not to, will result in the council being over exposed with its current bankers risking its entire capital sum should the bank collapse. The most effective way to reduce risk without increasing the risk to the revenue budget is to spread investments as much as possible. Risk cannot be eliminated all together but can be managed down effectively.

43. The proposed actions to be taken detailed in this report have been reviewed by Audit Services and are considered to be both prudent and appropriate in the current financial climate.

Outcome of Consultation

44. The issues contained in this report do not require formal consultation

COUNTERPARTY LIST CREDIT RATING REQUIREMENTS

APPENDIX 1

	Fitch				**Moody's**			**Asset Size**
Type	**Short Term**	**Long Term**	**Ind**	**Support**	**Short Term**	**Long Term**	**Financial Strength**	
Bank	F1	A-	C	3				-
Money Market Funds	AAA				AAA			-
Debt Management Office (UK government)	-				-			-
Building Society (1)					P-1	A3	C	-
Building Society (2)	-	-	-	-	-	-	-	>£1bn

COUNTERPARTY LIST – INVESTMENT LIMITS

APPENDIX 2

	Fitch				**Moody's**			**Asset Size**		
Type	**Short Term**	**Long Term**	**Ind**	**Support**	**Short Term**	**Long Term**	**Financial Strength**		**Time Limit**	**Money limit**
Specified										
Bank / Building Society	F1	-	-	-	P-1				1 year	£5m
Building Society					P-2				9 months	£2m
Money Market Funds	AAA							-	1 year	£5m
Debt Management Office (UK government)	-				-			-	1 year	£5m
Non-Specified										
Un-rated BS	-	-	-	-	-	-	-	>£1bn	6 months	£2m
Long term Bank / BS	F1	A-	C	3	P-1	A3	C		2 years	£3m
	F1	AA-	B	2	P-1	Aa3	B		4 years	£5m
	F1	AAA	B	1	P-1	Aaa	B		5 years	£5m