EAST HERTS COUNCIL

CORPORATE BUSINESS SCRUTINY COMMITTEE
30 NOVEMBER 2010

EXECUTIVE 1 DECEMBER 2010

REPORT BY THE EXECUTIVE MEMBER FOR RESOURCES AND INTERNAL SUPPORT

AMENDMENT TO THE TREASURY MANAGEMENT STRATEGY

WARD(S) AFFECTED: ALL

Purpose/Summary of Report

To permit investments additional to those authorised by the current treasury management strategy to enable enhanced returns to be made.

RECOMMENDATION :	
	Council be asked to approve an amendment to the Treasury Management Strategy to permit in house investment in structured deposits as set out at paragraphs 2.4, 2.5 and 2.6 below.

1.0 Background

1.1. The Treasury Management Strategy was approved in February 2010 in the light of expectations that short term interest rates would start to rise in the third quarter of 2010. Latest forecast suggest rates will likely be held down for some time as the MPC gives support to economic recovery.

1.2. Investment income in 2010/11 is forecast to be some £850k below budget and this reduced return is reflected in the MTFP.

1.3. Discussions with the Council's treasury advisers on options to improve returns have identified the use of structured deposits as a means to achieve improved returns. The option requires the Council to reconsider the balance between risk and returns and this issue is set out in some detail in section 3 below

2.0 Report

2.1 The Council's fund managers have advised that their current mandates provide little scope for optimism that returns will improve in the near future.

2.2 Sectors view is that the MPC will leave rates unchanged until the last quarter of 2011 at the soonest with only modest increases over the subsequent two years. Officers and Sector have examined various options by which improved investment returns can be achieved in this continuing low interest rate environment.

2.3 There are products on the markets "absolute return funds" used by a small number of councils which use a wide mix of subsidiary investment vehicles (excluding direct equity investments). The lawfulness of these products has not been tested and returns can be expected to be volatile. The use of these products will continue to be monitored but it is not intended to use them immediately.

2.4 The preferred option is to use medium fixed term deposits with major UK banks. The features of these deposits are:

- a fixed period of investment of 4 or 5 years (the intention is to limit the period to 4 years)
- a variable rate of interest set at 3 months LIBOR
- the rate to be fixed within a band with a floor rate payable should 3 months LIBOR fall below this rate and a ceiling rate which caps the rate paid in the event LIBOR moves above this rate.
- The floor rate obtainable in the market on 4 year deposits is currently about 2.6% compared with fund managers' expectation of returns of up to 1%.

2.5 The added return is achieved by giving up liquidity – the money is locked away for 4 years – and by capping the return in the event that there might be an unexpected spike in interest rates.

2.6 If approved the following additional investment limits would apply

- A maximum total investment of £30m in these products
- No more than £10m with any single institution
- Staggered investment with tranches of no more than £10m invested at intervals not shorter than 3 calendar months.

2.7 In considering whether or not to approve the change to the strategy members must consider the risks involved and only approve the change if those risks are on balance acceptable. The Communities and Local Government Select Committee which looked into local authority investments following the collapse of Icelandic banks concluded that "the primary consideration of local authority investment…should remain security and liquidity; but yield should not be neglected."

3 Risks

3.1 The return on UK gilts is generally regarded as a risk free return by which to measure the risk premium of other investments. The higher the return on other investments the greater is the markets assessment of risk. If the Council wishes to achieve higher returns on its investments it must accept more risk.

3.2 It is for the Council to determine the level of risk it is comfortable with. While the advice of Sector the external advisers and of officers, and in this case the Council's S151 officer in particular, should be considered ultimately this is a decision for members.

3.3 The Council's treasury advisers recommend limits on duration of deposits of no more 12 months. The Director of Internal Services as S151 officer considers these limits to be prudent in the current environment but not ones that should be seen as an absolute barrier to longer term investment.

3.4 Shorter duration mitigates two risks. First, against an increase in interest rates (but not falls in interest rates) and second against counter party credit risk.

3.5 If the Council is to invest for periods of 4 years which is considerably longer than recommended it needs to carefully consider both of these risks. Whether any additional risk is worth accepting is a judgement which must also look at the benefits accruing from that extra return.

3.6 The figures used below are current market offerings and these may change.

Interest rate risk

3.7 In terms of interest rate movements the return on the proposed investments is linked to 3 months LIBOR which is a relatively short term rate. The “collar” structure provides a floor rate at 2.6% which is above the current LIBOR rate and a ceiling of 6.5%. The Council needs to consider the likelihood of interest rates increasing significantly such that the 6.5% ceiling limits the return. This consideration needs to look both at interest rates generally and whether the yield curve might steepen such that the opportunity to achieve a return better than 6.5% might arise on say 12 months money if not on the 3 month benchmark return.

3.8 There is no uniform view on future interest rates even within the MPC. At present rates are being kept down to stimulate economic growth notwithstanding that inflation as measured by CPI is above target. It is questionable as to how long this policy will persist if higher inflation expectations become embedded and become reflected in pay settlements. With public sector pay restraint and government spending cuts, both revenue and capital, together with some increases in taxation over the period of the CSR the risks of a rapid increase in interest rates over the next four years might be seen as modest if the risk of financial markets questioning the UK creditworthiness is discounted.

Counter party risk

3.9 Short duration mitigates against counter party risk by ensuring there is an ability to withdraw funds more quickly in the event of concerns about the solvency or liquidity of the counter party. The longer the duration the more chance there is that circumstances might change such that a counter party assessed as secure today becomes less so and liquidity or solvency becomes an issue.

3.10 The ceilings on duration recommended by Sector continue to reflect general uncertainties about financial markets after the crisis of 2008 and whether subsequent difficulties in a number of euro zone countries could trigger another round of unmanaged failures by major financial institutions causing systemic disruption to financial markets.

3.11 The counter parties to be used are UK banks, generally with

significant government shareholdings. They might be classed as being ones which are too big to be allowed to fail - the evidence for this being the government recapitalisation after 2008. However, that government support will be unwound at some point: and, although how to get there is not yet agreed, there is a general view of most regulators that restructuring needs to take place such that no bank is so big its failure would have a Lehman's effect on international financial markets. International concerns about the impact of a failure of any Irish banks begs the question of just how small a bank might need to be to avoid being too big to be allowed to fail.

3.12 Members should consider how likely it is that the UK government (and potentially the EU, IMF) would be unwilling or unable to support any of the UK's biggest banks to avoid its failure over the next four years notwithstanding the absence of any explicit guarantee (other than to small depositors). Similarly, is UK bank restructuring likely in the next four years such that UK government support can be withdrawn and a potential counter party become "losable" without systemic risk?

Impact assessment

3.13 In assessing risks the impact as well as the likelihood of events needs to be considered and how that impact can be mitigated. Impact in this case is an assessment of what the consequences might be if there was a loss of investment return and/or loss of capital.

3.14 The Council's MTFP has been revised to assume rates of return of 1.8% to 3.8% over the 4 years. Loss of return because of inability to benefit from returns in excess of 6.5% is not a material consideration taken in isolation. (Although what the implications for the MTFP would be of the factors giving rise to interest rates at 6.5% or above cannot be ignored).

3.15 A loss of capital accompanied by non payment of interest is the more significant issue. This would be mitigated by a ceiling on the total amount placed and diversification across a number of counter parties with no more than £10m with one bank.

3.16 Given the nature of the counterparties it is not unreasonable to question whether, if circumstances were such that there was a collective failure of all counterparties, any investments in financial instruments would be safe. However, a total loss of £30m would

clearly be catastrophic.

3.17 A more reasonable scenario to consider might be a single insolvency with both a delay in repayment of say up to two years and ultimate loss of up to 50% of the deposit. (These are simply illustrative examples to consider impact and there is no cap on potential loss.) Could the Council manage a loss on this scale?

3.18 A £6m loss would significantly deplete reserves. If reserves are retained at existing levels, a loss on this scale would not be immediately catastrophic in service delivery terms but would clearly substantially limit the Council's ability to respond to other adverse events and require time to build up reserves.

3.19 In considering impact reputational risks is another important factor. There is no doubt that the losses incurred by those councils which had invested in Icelandic banks created intense media interest and much criticism. There is much less comment, if any, on poor investment returns even if over time the impact might be similar to a capital loss.

Benefits accruing from the additional risk.

3.20 The Council would be able to plan on a given level of minimum return from part of its investments with an added degree of budget certainty. Should interest rates remain low an additional return will accrue for longer.

3.21 The following figures are based on current market offerings.

In the next year the added return is estimated at a minimum of

+ 1% on £10m for a full year
+ 1% on £10m for 9 months
+ 1% on £10m for 6 months

Some £225k in total and perhaps up to £450k if there is no movement in rates above current levels.

If /when 3 months LIBOR moves above 2.6% the benefit will reduce potentially to nil.

3.22 Members need to consider the marginal services this added income might fund in the light of the savings requirement currently

included in the MTFP. There will no doubt be differing views on the savings and this report does not attempt to link the added income to any particular service. However members should assess the degree to which the Council's financial position as set out in the MTFP creates an imperative to achieve a better return on its investments.

4.0 Implications/Consultations

4.1 Information on any corporate issues and consultation associated with this report can be found within Essential Reference Paper 'A'.

Background Papers

Report to the Executive
Treasury Management Strategy Statement 2010/11 and Minimum Revenue Provision Policy Statement.

Contact Member: Name – Michael Tindale Executive Member for Resources and Internal Support

Contact Officer: Alan Madin Director of Internal Services Ext 1406

Report Author: Alan Madin

Contribution to the Council’s Corporate Priorities/ Objectives	**Fit for purpose, services fit for you** *Deliver customer focused services by maintaining and developing a well managed and publicly accountable organisation.* Investment income is not hypothecated to any service or priority of the Council but allows all of these to be delivered with a lesser call on council tax.
Consultation:	None
Legal:	The Council must have regard to the CLG Guidance on Local Government Investments of March 2004.
Financial:	As set out in the report
Human Resource:	None
Risk Management:	As set out in the report