POLICY AND RESOURCES SCRUTINY COMMITTEE – 4TH MARCH 2014

SUBJECT: TREASURY MANAGEMENT – POTENTIAL TO INCREASE INVESTMENT INCOME

REPORT BY: ACTING DIRECTOR OF CORPORATE SERVICES AND SECTION 151 OFFICER

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1. PURPOSE OF REPORT

1.1 To present Members with details of the potential additional investment income that could be generated by fine-tuning the Council's risk profile to enable lending to high credit quality counterparties in accordance with the Council's Treasury Management Strategy.

2. SUMMARY

2.1 Following the presentation of the 2014/215 Treasury Management Strategy to the Policy and Resources Scrutiny Committee on the 21st January 2014, Members requested a report on the additional income that could be generated on investment balances by lending to high credit quality institutions. The Council currently lends to the Debt Management Office (DMO) (part of HM Treasury) and local authorities. A copy of the findings is attached in Appendix 1. Appendix 2 details associated risks with identified counterparties.

3. LINKS TO STRATEGY

3.1 Treasury Management Strategy 2013/2014 as agreed by Council on 27th February 2013.

4. THE REPORT

4.1 <u>**Current Treasury Management Strategy (2013/14)**</u>

4.1.1 The Council currently lends surplus cash balances to the Debt Management Office (DMO) and other local authorities (including police and fire authorities) for periods up to three months. There is no restriction in terms of the value that can be placed with the DMO but only £5m can be deposited with a local authority. The rate on such investments is averaging at 0.26% for the first three quarters of 2013/14.

4.1.2 Investments placed with approved counterparties must be in accordance with statutory and regulatory frameworks as well as the objectives, and in order of priority, Security (how secure is the counterparty); Liquidity (subject to the Council's cashflow requirements); and Yield (the rate of return earned on the investment).

4.1.3 The current approved Strategy allows for the flexibility in the change of the Council's risk appetite to allow for surplus cash balances to be deposited with institutions other than those specified in 4.1.1 without resubmitting a revised Strategy to Full Council. However, any change in the Council's current risk profile will require Cabinet approval in the first instance.

4.1.4 In accordance with the current approved strategy, the minimum credit rating criteria that will apply if the Council was to lend to banks and money market funds is as follows: -

	Fitch (or equivalent)- Proposed 2013/14
Short-term	F1
Long-term	A-
Support	1
Viability / Individual	A
Non-UK Sovereign	AAA
Money Market Funds (MMFs)	AAA

4.1.5 The DMO and local authorities have the same credit rating as the UK Government. As at 31st January 2014 the UK Government had a long-term credit rating of AA+ from Fitch and Aa1 from Moody's credit rating agencies; and an AAA credit rating from S&P credit rating agency.

4.2 **Economic Outlook**

4.2.1 UK growth continues to gain momentum with strong data in the first three quarters of 2013 alongside the recovery in house prices propelled by government initiatives to boost mortgage lending. Whilst economic growth has been positive, it is still below the pre financial crisis level and some weakness remains in components of growth, most notably business investment (demand for credit from small business still remains flat). Consumer price inflation continues to fall from the high of 5.2% in September 2011 to 2.0% in December 2013. There was no change to UK monetary policy with official interest rates and asset purchases maintained at 0.50% and £375bn respectively. The current unemployment rate is 7.1% and has triggered a debate amongst economists whether the Bank Rate should start to rise. The Monetary Policy Committee (MPC) has repeatedly emphasised that the 7% unemployment threshold is not an automatic trigger for a rate rise.

4.2.2 In Europe, a fragile economic recovery, subdued inflation and depressed bank lending resulted in the European Central Bank cutting the repo rate from 0.50% to 0.25%. The future economic outlook will be driven by political uncertainty and a further tranche of cheap funding to European Banks to ease liquidity pressures.

4.2.3 In the US, economic recovery is also gaining momentum despite the partial government shut down in the awake of the political deadlock over the national debt, which will continue to create volatility in international financial markets, and will need resolving. The Fed will continue to slowly wind down its central bank funding programme.

4.2.4 The current forecasts for the UK Bank Rate suggest bank rate is likely to remain at 0.50% until 2016/17, though this could change if the economic outlook continues to stabilise and improve. The current Bank of England Quantitative Easing program and Funding-to-Lend scheme has enabled banks and investment funds to access funds at a very low rate. As a result this is reflected in the interest rate that is currently being offered by banks and money market funds as detailed in Appendix 1.

4.3 **Investment Income Proposal**

4.3.1 Appendix 1 details the income that could be generated by lending £10m to high credit quality banks and investment funds including AAA rated money market funds, UK Government backed banks (Lloyds TSB Group or RBS) or other high credit quality UK banks. A number of high credit quality International banks, which serve the local authority market, have also been included for comparison purposes. Interest rates will vary for different investment periods across all institutions as shown in Appendix 1. The current Treasury Management Strategy permits investment periods up to 3 months.

4.3.2 On a £10m investment with the DMO the Council currently earns an annual income of £25k. Using a AAA rated money market fund would enable the Council to double its income on the £10m investment, therefore a gain of £25k over the DMO income. Depositing £10m for 3 months with Lloyds Bank, which is part UK Government owned and pays the higher rate when compared to similar banks (with the added comfort of being Government owned), will generate annual income of £60k, therefore a gain of £35k over the DMO income. The gain with the Lloyds investment can be further enhanced to £45k and £70k if the investment period is changed to 6 months and 12 months respectively. Any changes to the investment duration will require an amendment to the current Strategy and will require full Council approval.

4.4 **Associated Risks**

4.4.1 Appendix 2 details the risks associated with each counterparty. Whilst all financial institutions are subject to the same operational risk stemming from events in the economy (e.g. economic bubbles), market risk, regulatory risk and ongoing operating losses, some counterparties are subject to specific risks such as UK Government owned banks (Lloyds {32%} and RBS {80%}) where the Government will seek to sell its shareholdings at some point in the future, and with respect to Lloyds Group this process has already started. Specific risks also include litigation risk arising from the mis-selling of financial products (PPI, interest rate swap loans, LIBOR scandal etc), which could potentially reduce the bank's profitability resulting in a possible rating downgrade and volatility in the CDS price.

4.4.2 With respect to regulatory risk, at national level the UK Government will soon be introducing new banking reforms that will result in the ending of government "bailed out" and instead impose "bailed in", the emphasis being unsecured creditors of the failed bank taking a loss rather than the tax payer. Local authorities would be classed as unsecured depositors with respect to wholesale investment deposits. At European level, the EU is looking to impose new legislation that will make it illegal for EU Sovereign states to bail out national banks.

4.4.3 Money market funds are also undergoing regulatory change that will affect the manner in which funds are valued. Currently funds are valued on a constant net asset valuation (CNAV) basis implying that all units within the fund are valued at £1 irrespective of actual market valuations. The new regulatory change will result in a move to a variable net asset valuation (VNAV) basis where all units in the fund will be marked to market resulting in potential capital gain or loss. The reason for such change is to prevent a run on the fund in the event of a liquidity crisis.

4.5 **Local Government Bond Agency Equity Investment**

4.5.1 The Local Government Association (LGA) is planning to create a AAA rated bond agency to provide Local Authorities with an alternative source of long-term borrowing and a viable rival to the Public Works Loan Board (PWLB). The Council will soon be presented with an opportunity to make an equity investment (terms unknown at present) to cover the set-up costs, and the LGA will be offering a rate of return of up to 9% per annum once the agency is profitable. The LGA is currently finalising its business plan and will be able to brief potential local authority investors by April 2014 with respect to the equity capital and business requirements. An equity investment will require a treasury management decision in accordance with the approved Treasury Management Strategy.

4.5.2 The benefit in putting an equity investment into the set-up of the agency will generate benefits in the form of, and in the long-term, cheaper borrowing costs for local authorities as well as flexibility to prematurely repay agency loans at "significantly improved premature redemption terms" compared to the PWLB.

4.5.3 The risks associated with the LGA bond agency proposal that will need to be considered if an equity stake is to be invested by the Council is as follows: -

1. The success of the agency and the rate of return on the equity capital are dependent on profitability and volume of business. The profit will be generated by applying a margin over the funding costs, which will in turn make up the loan rate.

2. The equity investment will be significantly at risk. If the agency was to default, the Council would lose all of its capital investment. Equity investors are ranked low down the list of creditors in the event of a recovery claim. To put the proposed 9% rate of return into perspective, a 10 year subordinated bond currently issued by the Co-Operative Bank, which is ranked B- ("Junk" status), is currently paying 7.5%. Therefore the LGA proposal is very risky.

3. It is possible that HM Treasury would see the LGA bond agency as a threat to its PWLB operation and could force through a restructure of the current PWLB rates resulting in reduced PWLB loan rates (which would in itself be a benefit to local authorities). This restructure would come at the expense of the LGA bond agency and to those investors with an equity stake, resulting in a loss of equity capital as the agency would no longer exist.

4. In the infancy stage of the agency, borrowers will have to accept long lead times for new loans (PWLB lead time is 3 days); inferior products; inflexible products; and unwanted interest rate exposure, resulting in a lack of enthusiasm for using the agency as a means to raise new debt.

5. The time it will take for the agency to become profitable and start paying a rate of return on the equity investment.

4.5.4 Members will be updated later in the year with regards to the development of the bond agency and the underlying terms of the equity capital investment.

5. EQUALITIES IMPLICATIONS

5.1 This report is for information purposes, so the Council's Equalities Impact Assessment (EqIA) process does not need to be applied.

6. FINANCIAL IMPLICATIONS

6.1 As detailed throughout the report.

7. PERSONNEL IMPLICATIONS

7.1 There are no direct personnel implications arising from this report.

8. CONSULTATIONS

8.1 There are no consultation responses that have not been reflected in this report.

9. RECOMMENDATIONS

9.1 Members are asked to note the contents of this report and consider whether or not it is in the best interest of the Council to lend to high credit quality counterparties to generate additional investment income.

10. REASONS FOR THE RECOMMENDATIONS

10.1 To engage with Members with regards to changing the Council's risk appetite in the context of treasury management investments.

11. STATUTORY POWER

11.1 Local Government Acts 1972 and 2003.

Author: N. Akhtar – Group Accountant (Financial Advice and Support)
E-mail: akhtan@caerphilly.gov.uk Tel: 01443 863313
Consultees: N. Scammell – Acting Director of Corporate Services and Section 151 Officer
S. Harris - Acting Head of Corporate Finance
A. Southcombe – Finance Manager, Corporate Services
Cllr K. Reynolds - Deputy Leader/Cabinet Member for Corporate Services

Background Papers:

Appendix 1 – Summary of Investment Income
Appendix 2 – Associated Risks