

By: Cabinet Member – Finance & Business Support
Corporate Director of Finance & Procurement

To: Cabinet - 17 September 2012

Subject: **TREASURY STRATEGY UPDATE**

Classification: Unrestricted

Summary: To seek agreement to a number of changes to the Council's Treasury Strategy.

FOR DECISION

INTRODUCTION

1. The Council's Annual Treasury Strategy is agreed by Cabinet in January and Council in February. Any changes to the strategy during the year have to be agreed by Cabinet.

CURRENT POSITION

2. The Council's Treasury Strategy places the main emphasis on security of funds, liquidity is also an important consideration and then lastly yield. To achieve this the Council uses the Government Debt Management Account Deposit Facility and Treasury Bills and the following UK financial institutions all with a minimum long term credit rating of A- or equivalent:
 - Barclays
 - Lloyds TSB/HBOS
 - HSBC
 - Royal Bank of Scotland/NatWest
 - Nationwide
 - Standard Chartered
 - Santander UK
3. Each counterparty has a maximum allocation of £50m but Lloyds TSB/HBOS and Royal Bank of Scotland /NatWest have a £75m group limit. When all these counterparties are available to use, a counterparty can be put on hold at any time if there are concerns, we have a capacity of £400m without having to use the Debt Management Account Deposit Facility. Some counterparties will not take deposits at particular times, for example, Nationwide recently stopped taking deposits for a couple of months.

4. Rates of interest paid vary significantly and the following figures are indicative only:

- DMADF 0.25% (any deposit from overnight to 6 months)
- HSBC 0.35% (call account)
- Barclays 0.5% (call account)
- Lloyds TSB/HBOS 0.75% (call account)
- Santander UK 0.8% (call account)
- Standard Chartered 0.92% (for a 6 month Certificate of Deposit)
- RBS/Nat West 1.25%/1.15% (call account)
- Lloyds TSB 1.35% (3 month deposit)

5. Before the banking crisis started in 2008 the Council mainly used fixed term deposits for periods of up to 5 years. The market for deposits has changed radically since then, generally there is no significant interest gain for depositing for longer periods, there is no confidence to invest for longer and for security reasons we mainly use call accounts where funds are deposited overnight. Arlingclose, the Council's treasury advisers, originally expected financial institutions to reduce the availability of call accounts or for rates paid to reduce but for the moment this is not happening. There is also a significant possibility that the DMADF rate will be reduced at some point, Treasury Bills which we had been buying now pay less than the DMADF.

6. Within the Treasury Strategy the maximum duration for deposits is 12 months. The Council follows the maximum durations recommended by Arlingclose which changed at the end of July with durations being extended to:

- RBS/Nat West – from overnight to 35 days
- Santander UK – from overnight to 35 days
- Lloyds TSB/HBOS – from overnight to 100 days
- Barclays, Nationwide – remain at 100 days
- HSBC, Standard Chartered – from 6 months to 12 months.

The Arlingclose durations are higher than the Council will use for the moment but this is always under review. RBS/Nat West and Santander UK are only used overnight.

7. As spending cuts hit local authority budgets it was expected that cash flows would reduce and the Council would have substantially less money to place on deposit. This has not yet happened significantly for this Council or as far as we can establish for many other Councils either. Even after repaying a loan of £55m in August the latest balance was £300m and we forecast a minimum balance of £167m from now to the end of the financial year. And once again no new borrowing has been undertaken so capital expenditure due to be funded from borrowing is actually being met from internal resources. Given that borrowing costs are substantially higher than deposit rates this approach will be continued as the Council saves substantially by deferring the borrowing costs.

8. Whilst security and yield are the overriding criteria the state of public finances means that we do try to secure yield for the same level of risk. For example, Treasury Bills earning around 0.4% were bought at auction as an alternative to use of the DMADF and the Council bought Standard Chartered Certificates of Deposit when they would not take conventional deposits.

AUSTRALIAN AND CANADIAN BANKS

9. The financial institutions currently supported by Arlingclose for deposits are set out in the Appendix. Arlingclose have been very supportive of Australian and Canadian banks and they currently have a maximum duration recommended by Arlingclose of 12 months increased from 6 months. Arlingclose summarise the position as follows:
 - Australian banks have strong domestic franchise and good liquidity and capital positions. The banks benefit from a relatively stable economic environment and have weathered the credit crisis better than many of their international peers. Although Australian banks have a high reliance on wholesale funding, this funding is diversified by maturity, investor type and geography. The Australian banks remain among the higher rated global institutions, and their CDS levels are comparable to their peer group.
 - Canadian banks have exhibited consistent earnings performance (albeit with moderating earnings growth in common with their global peers), and benefit from favourable funding positions and sound liquidity and capitalisation levels as well as Canada's relatively favourable economic environment. There are no quoted CDS for Canadian banks; they however remain among the higher rated international banking institutions.

In late July Standard & Poor's revised the Outlook on 7 Canadian banks including 3 on Arlingclose's recommended list from Stable to Negative. The Outlook revision means they will review the long term credit ratings of the Canadian banks typically over a 6-24 month period. It is not the same as a Rating or Credit Watch announcement.

10. At the current time not all of the banks listed take deposits and rates are quite low. However, we need to have options in the event of further downgrades of UK financial institutions to avoid a situation where the Council has no option but to use the Debt Management Account Deposit Facility.
11. The proposal is that these banks would be added as counterparties but would not be used unless there was a significant deterioration in the position of UK financial institutions. A maximum limit with any one bank would be £25m and the maximum exposure to either country would be £50m.
12. The position of Australian and Canadian banks would continue to be closely monitored.

LOCAL AUTHORITY MORTGAGE SCHEME

13. The Council in April decided to participate in a national scheme run by Capita and in collaboration with Lloyds TSB to support first time buyers to buy their own house. This is seen as an innovative, practical and effective way of helping first time buyers to get onto the housing ladder. The basis principles of the Capita/Lloyds TSB scheme are:

- An individual borrower needs a 5% deposit, a further 20% portion is then guaranteed by the local authority and a mortgage is taken out by the borrower for the remaining 75%.
- The funds provided by the Council are placed in a 5 year deposit with Lloyds TSB at a rate of 4.25% (final rate to be confirmed).

KCC has offered to contribute up to £1m per District Council therefore giving a maximum liability of £12m. Responses from the District Councils are varied and to date only one has made a firm commitment although others are going through their own decision making processes.

14. The Council's Treasury Strategy needs to be amended to enable a 5 year deposit to be made with Lloyds TSB. This would be a one-off exception and other deposits for this period with Lloyds TSB could not be made. Members need to be aware in making such a long term commitment of the following:

- Lloyds TSB/HBOS is currently 40% owned by the UK Government. At some time it is expected that UK Government will sell its stake and the impact on Lloyds TSB/HBOS financial standing could be detrimental.
- Particularly through HBOS the group has a very large exposure to the UK property market which still potentially could expose it to further large losses.

But it should also be taken into account that Lloyds TSB/HBOS is one of the "systemically" important UK financial institutions and it would be expected, but not guaranteed, that the UK Government could not allow the bank to fail.

RECOMMENDATION

15. Members are asked to:

- (1) Agree to add Australian and Canadian banks (as specified in the Appendix) with a maximum limit of £25m on any one bank and a country limit of £50m.
- (2) To agree that a 5 year deposit can be made with Lloyds TSB of up to £12m in relation to the Local Authority Mortgage Scheme.

Nick Vickers
Head of Financial Services

Arlingclose's Recommended Counterparty List

	Country	Fitch Long-Term Rating	Fitch Short-Term Rating	Moody's Long-term Rating	Moody's Short-Term Rating	S&P Long-Term Rating	S&P Short-Term Rating	Previous Duration Limit	Revised Duration Limit
UNITED KINGDOM	GB	AAA	F1+	Aaa		AAAu	A-1+u		
SANTANDER UK PLC	GB	A	F1	A2	*- P-1 *-	A	A-1	Overnight	35 days
NATIONAL WESTMINSTER BANK	GB	A	F1	A3	P-2	A	A-1	Overnight	35 days
ROYAL BANK OF SCOTLAND PLC	GB	A	F1	A3	P-2	A	A-1	Overnight	35 days
BANK OF SCOTLAND PLC	GB	A	F1	A2	P-1	A	A-1	Overnight	100 days
LLOYDS TSB BANK PLC	GB	A	F1	A2	P-1	A	A-1	Overnight	100 days
NATIONWIDE BUILDING SOCIETY	GB	A+	F1	A2	P-1	A+	A-1	100 days	100 days
BARCLAYS BK PLC-ADR C	GB	A	F1	A2	P-1	A+	A-1	100 days	100 days
HSBC BANK PLC	GB	AA	F1+	Aa3	P-1	AA-	A-1+	6 months	12 months
STANDARD CHARTERED BANK	GB	AA-	F1+	A1	P-1	AA-	A-1+	6 months	12 months
COMMONWEALTH OF AUSTRALIA	AU	AAA	F1+	Aaa		AAAu	A-1+u		
AUST AND NZ BANKING GROUP	AU	AA-	F1+	Aa2	P-1	AA-	A-1+	6 months	12 months
COMMONWEALTH BANK OF AUSTRAL	AU	AA-	F1+	Aa2	P-1	AA-	A-1+	6 months	12 months
NATIONAL AUSTRALIA BANK LTD	AU	AA-	F1+	Aa2	P-1	AA-	A-1+	6 months	12 months
WESTPAC BANKING CORP	AU	AA-	F1+	Aa2	P-1	AA-	A-1+	6 months	12 months
GOVERNMENT OF CANADA	CA	AAA		Aaa		AAA	A-1+		
BANK OF MONTREAL	CA	AA-	F1+	Aa2	P-1	A+	A-1	6 months	12 months
BANK OF NOVA SCOTIA	CA	AA-	F1+	Aa1	P-1	AA-	A-1+	6 months	12 months
CAN IMPERIAL BK OF COMMERCE	CA	AA-	F1+	Aa2	P-1	A+	A-1	6 months	12 months
ROYAL BANK OF CANADA	CA	AA	F1+	Aa3	P-1	AA-	A-1+	6 months	12 months
TORONTO-DOMINION BANK	CA	AA-	F1+	Aaa	P-1	AA-	A-1+	6 months	12 months
UNITED STATES (GOVT OF)	US	AAA	F1+	Aaa		AA+u	A-1+u		
JPMORGAN CHASE BANK NA	US	A+ *-	F1+	Aa3	P-1	A+	A-1	6 months	6 months
REPUBLIC OF FINLAND	FI	AAA		Aaa		AAA	A-1+		
NORDEA BANK FINLAND PLC	FI	AA-	F1+	Aa3	P-1	AA-	A-1+	Suspended	100 days
FEDERAL REPUBLIC OF GERMANY	GE	AAA	F1+	Aaa		AAAu	A-1+u		
DEUTSCHE BANK AG-REGISTERED	GE	A+	F1+	A2	P-1	A+	A-1	Suspended	100 days
KINGDOM OF THE NETHERLANDS	NE	AAA	F1+	Aaa		AAAu	A-1+u		
BANK NEDERLANDSE GEMEENTEN N.V.	NE	AAA	F1+	Aaa	P-1+	AAA	A-1+	Suspended	100 days
KINGDOM OF SWEDEN	SW	AAA	F1+	Aaa		AAA	A-1+		
SVENSKA HANDELSBANKEN-A SHS	SW	AA-	F1+	Aa3	P-1	AA-	A-1+	Suspended	100 days