

By: John Simmonds, Cabinet Member for Finance
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To: Cabinet - 12 October 2009

Subject: **TREASURY INVESTMENTS**

Summary: To seek agreement to recommending changes to the Council's treasury strategy

FOR DECISION

INTRODUCTION

1. This report focuses on the management of treasury investments as part of KCC's overall Treasury Strategy. It sets out proposals for asset allocation, selection of counterparties, counterparty limits and the duration of deposits.
2. This has been discussed and endorsed by the Treasury Advisory Group on 3 September 2009.

TREASURY STRATEGY

3. The Council's Treasury Strategy is agreed annually by County Council at its February budget meeting. The strategy previously permitted the following asset classes to be used:
 - Cash deposits
 - Callable deposits
 - Callable range accruals
 - Money Market Funds
 - Fixed Income and Corporate Bonds
 - Property
 - Absolute Return Funds

The Council has only ever used the first 3 categories.
4. The strategy also allowed for deposits to be made for up to 5 years.

5. Since October 2008 all new and maturing deposits have been placed with the Government Debt Management Office. This is seen as the most secure counterparty available to use as it would require the UK Government to default for the principal sum to be at risk. Interest rates are very low but that has been acceptable given the unprecedented turmoil in financial markets. All DMO deposits have to be for a fixed duration with a maximum period of 6 months.
6. This approach was implemented in consultation with the Economic Management Group. The advisory role to the Cabinet Member for Finance and the Director of Finance has now been taken over by the Treasury Advisory Group (TAG).
7. It was always envisaged that the policy on deposits would be reviewed as financial markets stabilized, the Council contracted with new treasury advisers to supplement Butlers and Corporate Finance strengthened its internal resource.
8. At a TAG meeting on 29 July Arlingclose gave a presentation on treasury investment issues and officers presented a discussion document. This report reflects the approach determined by Members at that meeting and the report was agreed by TAG at a meeting on 3 September.

DEPOSIT OPTIONS

9. **Risk and Return**

The rationale for moving away from sole use of the DMO is:

- (1) There are other UK institutions which effectively offer the same level of security. As set out below we would only place deposits with UK financial institutions which are of such significance that the UK Government could not allow them to fail. These are organisations named by UK authorities in October 2008 with automatic access to the Credit Guarantee Scheme (CGS) which are “systemically critical” to the UK’s financial system. These deposits are not guaranteed.
- (2) Institutions covered by the CGS may offer slightly better returns than the DMO. The motivation is not achieving higher returns per se – but if institutions have the same security as the DMO but offer better rates it is a waste of public resources not to use them.
- (3) As DMO deposits are all for fixed periods it is harder to effectively manage KCC’s daily cashflow. The use of overnight call accounts will ease this problem.

A move away from sole use of the DMO will be on a staged basis - a very limited range of counterparties could be introduced now and due diligence will be undertaken on other options.

10. **Asset Classes**

- (1) It is proposed that the following asset types should be used:
 - Cash deposits – call accounts and fixed deposits.
 - Debt Management Office
- (2) No other asset classes are recommended at this time. Consideration was given to lending to other local authorities but this is a very limited market and such lending could be perceived adversely by the public.
- (3) Members asked Officers to undertake more research on major overseas banks in major economies, Money Market Funds and the use of External Managers.

11. **Counterparties**

- (1) The previous counterparty policy was heavily reliant upon credit ratings information. The three credit ratings agencies, Standard & Poor's, Moodys and Fitch, will still be used but only as part of a wider information base. Other sources of information which will be used formally are Reuters and Bloomberg, supplemented by information from meetings with financial institutions and by information in the media.
- (2) The proposed criteria for the selection of a counterparty are:
 - Access to CGS
 - Credit rating / other information
 - Reputational issues – in the event of default how could their use be justified.
 - Exposure to other parts of the same banking group.
 - Country exposure.
- (3) The financial institutions with access to the CGS recommended by Arlingclose are:
 - Abbey National
 - HSBC
 - HBOS / Lloyds TSB
 - Clydesdale
 - Royal Bank of Scotland

- Barclays
 - Nationwide
- (4) Based on these criteria we propose to exclude Clydesdale (credit rating) and Nationwide (UK housing exposure). Standard Chartered are not on the Arlingclose list due to their credit rating. Use of Abbey National could only commence after 2 October when all the Cater Allen fixed deposits have expired – Cater Allen are part of the same banking group.
- (5) The recommended list of counterparties in-addition to the DMO are:
- Abbey National
 - HSBC
 - HBOS / Lloyds TSB (as one bank)
 - Royal Bank of Scotland
 - Barclays
- (6) The previous maximum counterparty limit with the strongest financial institutions or groups was £40m. It is recommended that this level is adopted. It needs to be recognised that these institutions will not always be seeking short term funds and that a large proportion of the total deposits will remain in the DMO.
- (7) The £40m limit would apply to call accounts and fixed deposits.
- (8) Officers will keep the major institutions under constant review. The Director of Finance in consultation with the Cabinet Member for Finance will suspend the use of any institution if they have concerns immediately. TAG members will be informed. If the Director of Finance and Cabinet Member for Finance wish to add any institution this will be subject to consultation with TAG, and agreement by Cabinet.

12. **Duration of Deposits**

- (1) It is recommended that at this time the duration of deposits is kept short with a maximum of 6 months. This reflects:
- That clearly there is some way to go before financial markets can be said to be operating in a 'normal' way. There are still huge amounts of toxic loans within the banking system.
 - Interest rates are likely to move upwards at some point and it would not be timely to lock into longer term deals.
 - Given the wide disparity between short term deposit rates and long term PWLB borrowing rates we are delaying long term borrowing. We need to keep funds on short term deposit to maximise our flexibility to do this.
- (2) Any change to this policy would be subject to a recommendation to Cabinet by the Director of Finance and Cabinet Member for Finance after consultation with TAG.

CONTROL ENVIRONMENT

13. Any return to a wider counterparty strategy has to be based on an updated control environment which makes improvements based upon PwC's specialist treasury review. TAG has received a detailed update on implementation.
14. The key issues to highlight are:
 - (1) Additional resource – the Head of Financial Services is no longer acting as the Council's senior procurement officer – freeing up time for treasury activity. A new senior level post of Treasury & Investments Manager has been created which will primarily focus on treasury issues.
 - (2) Separation of duties – the treasury dealer role has been separated from the treasury back-office activities.
 - (3) Revised Treasury Management Practices.
 - (4) Revised Treasury Operations Manual.
15. The area will be subject to an annual internal audit.

GOVERNANCE

16. Formal constitutional responsibility for Treasury Management is with the Director of Finance and the Cabinet Member for Finance. Given the need for senior management focus on operational issues the Director of Finance has formally delegated some responsibilities to the Head of Financial Services. These are documented in the Treasury Management Practices.
17. TAG has an advisory role to the Director of Finance and the Cabinet Member for Finance.
18. Major changes to the existing strategy will be taken to Cabinet for decision.
19. As well as the formal Annual Review taken to Governance & Audit Committee a short quarterly report will also be taken to Governance & Audit Committee.

TREASURY ADVISORS

20. An EU compliant procurement process has been commenced for treasury advisory services. The requirement places a heavy emphasis on investment advice not just the provision of information.
21. The appointment will be made by TAG.
22. Arlingclose are currently contracted until 30 September. Their appointment has been extended to see us through the tendering period.

RECOMMENDATIONS

23. Members are asked to:

- (1) Agree to the use of cash deposits, call accounts and fixed deposits, with selected financial institutions and the DMO.
- (2) Agree the criteria set out in paragraph 10(2).
- (3) Agree the use of Abbey National, HSBC, HBOS/ Lloyds TSB, Royal Bank of Scotland and Barclays.
- (4) The 5 institutions set out above should have a maximum limit of £40m.
- (5) Deposits should not be made for a period of longer than 6 months.
- (6) Note the new Control environment.
- (7) Note the new Governance arrangements.
- (8) Note the extension of the Arlingclose contract.

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