PART A

Report to: Audit Committee

Date of meeting: 29 September 2011

Report of: Head of Strategic Finance

Title: Treasury Management Quarterly Report

1.0 SUMMARY

1.1 This report provides the second quarter's review of the Council's Treasury Management Strategy and investment performance.

2.0 RECOMMENDATIONS

2.1 That the Committee notes the report.

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3.0 Background

3.1 The UK and global economies have experienced a slowing of overall growth projections. Combined with that there has effectively been turmoil within ‘euroland’. Mixed messages from Continental politicians and a lack of firm action has increased speculation that their will be a sovereign default in Greece. Should this occur then the more pessimistic forecast is that this will create a domino affect in Portugal, Ireland, Belgium, Spain and Italy with each being picked off in turn.

3.2 French and German Banks have been drawn into this turmoil due to their large loan exposure initially to Greece, with French banks having the largest exposure (50billion euros). Consequently share values in French Banks have dropped significantly with the credit rating for Society Generale and Credit Agricole being downgraded and BNP Paribas put on ‘credit watch’.

3.3 The UK Bank scene has not been immune, and falls in the value of bank shares have also been experienced. Within the UK this has been exacerbated by the announcement of US Federal action against HSBC, RBS and Barclays for the mis-selling of sub prime mortgages. The impending report of the Independent Commission on Banking also ‘spooked’ the markets although its subsequent recommendation to allow a considerable implementation timescale has calmed initial concerns.

3.4 Within the United States fears of the implosion of euroland has resulted in no dollar lending to European financial institutions and which had the potential consequence of stopping all trade (as it is largely conducted in dollars). This forced (on 15th September) the Bank of England and its counterparts in America, Europe, Japan, and Switzerland to promise to lend ‘truckloads’ of money to any bank finding itself short of dollars. This promise will remain in place until December.

3.5 Meanwhile the Chinese Government has signalled a move away from purchasing sovereign treasury bonds and which is a particular blow to Italy where Chinese investment was seen to be a last hope. China’s sovereign wealth fund is now focussing on purchasing key industrial and strategic assets particularly in America and Italy and, in the case of the United States, will bring it into conflict with the President and Congress.

3.6 The consequence of this accumulation of ‘fear’ has resulted in a situation where lending between banks has virtually dried up, and the rest of the economy not really knowing where to place its surplus cash. Watford has not been immune from this dilemma and I have never experienced such uncertainty regarding where are the best safe havens whilst seeking to obtain some return on our investments.

3.7 The global slowdown in the economy has resulted in an increase in UK base rate being delayed until probably late 2012. This is additional bad news for the Council's investment portfolio as the base rate (currently 0.5%) determines the rates of interest that can be achieved on the money markets.

3.8 For Watford, the estimate of interest to be earned in 2011/2012 was geared to achieving an average rate of return of 1.3% for the year (for the first half year an average 1.25% has occurred). This has been achieved by the placing of a large part of the portfolio for between 6 to 12 months where the best rate of return could be obtained. The volatility in the financial markets referred to earlier has meant that this strategy has had to be reviewed and this is discussed within the next section of the report.

4.0 Revised Investment Strategy

4.1 The over-riding criteria for the Council's investments is governed by:

S ecurity of the investment (how safe is the counterparty)

L iquidity (how quickly can you move your investment somewhere else)

Y ield (what rate of interest can you achieve)

In that priority order.

4.2 Another tenet of investment strategy is to spread your investments (so any losses will not be disastrous—in this respect any loss would be a disaster from my perspective). The revised strategy in place at the present time therefore is to restrict all investments in banks to £3m or less per institution and to £2m for the top 5 building societies (previous limits were £5m and £3m respectively). Special Council approval has been obtained to the placing of overnight money with Nat West (maximum ceiling £10m) and the Co-op (maximum ceiling £5m).

4.3 Further, whilst current volatility in the markets prevails, the Watford portfolio is being managed with a shorter maturity profile than has been the case throughout 2010/2011 and the first quarter of 2011/2012. This will have an adverse affect upon the investment return. To some extent this is being ameliorated by placing investments with building societies with a six to twelve month profile. The logic for this being that the larger building societies have mainly cleaned up their loan portfolios and are not so reliant upon funding from the financial markets. With mortgage rates likely to remain low until there is a base rate increase, it is hoped that the largest building societies will prove less of a risk.

4.4 With regard to banking institutions, Watford's investments are being placed with a shorter profile. The current portfolio is attached at **Appendix 1** and indicates £20m of bank investments capable of maturity by 6th December. A further £3m will mature in February 2012, and a final £2m in May 2012. These two latter investments were placed before the current volatility struck the markets.

4.5 It must be emphasised that it is inconceivable that a financial meltdown would be allowed to occur but our investment strategy needs to try and anticipate any isolated problems before they materialise. Watford had registered with the Government Debt Management Office (DMO) in 2009 in case it needed to access the safest of havens. Investments have not been placed there to date (for the simple reason that the DMO pays a 0.25% rate of interest). Had we placed all our portfolio with the DMO for the past two years then a £750k loss of investment interest would have resulted). Use of the DMO is an available option in the worst scenario.

4.6 The Council pay an annual fee (£5k) to treasury management advisers, Sector Treasury Services, who also review the Council's performance. On 8th September 2011 Sector circulated a 'Credit Issues Newsflash' which included the following:

''We recommend all duration limits to banks be restricted to a maximum of three months. This limit would apply to all entities with the following exceptions:

- UK Govt and related entities such as Local Authorities.
- UK semi-nationalised institutions (Lloyds/ RBS) where we continue to view the current significant UK ownership of these entities as providing significant comfort to investors.
- Money Markey Funds

4.7 This advice supports the revised investment strategy currently in place. Sector does not provide advice regarding the building society market.

5.0 UK Financial Institutions

Watford's portfolio currently includes the following banks

- Clydesdale (parent bank, National Australia Bank). The £3m investment enjoys the protection of Clydesdale nationally, but is actually managed from the branch at Clarendon Road and provides supporting equity to enable the bank to lend to local businesses (no risk attaching to the Council's loan). The £3m is invested on a rolling 1 month notice period.
- Nat West (£8m) is a subsidiary of RBS and is covered by an implicit Government Guarantee (through its 93% ownership). This balance is effectively 'on call' and can be redeemed at one day's notice. It fluctuates daily and is dependent upon the Council's cash flows at any particular time.
- The Co-operative Bank (£3m) is the Council's banker and, like the

Nat West account, is an overnight facility and again will be subject to daily fluctuation. The Co-operative bank has traditionally been a conservative institution chiefly focussed upon its domestic market. It has had no exposure to reckless lending in the American market or those countries in Europe currently under threat.

- Barclays. The £3m investment has just over 4 months to run. It is likely the future use of Barclays will depend upon the changing financial scene.

- Nat West. This £2m investment was placed for 12 months in May 2011 at a rate of 1.51%. Nat West is deemed to be protected by the Government.

- Santander UK Ltd (£3m). Its parent bank is Santander Spain although it is ring fenced from the parent. Attached at **Appendix 2** is a summarised analysis which I requested from Sector Treasury Services and relating to Santander UK and its parent. It was produced on 8th August 2011.

- Lloyds. The Council initially had £5m with Lloyds for the period 5th September 2010 to 5th September 2011 and which earned a 2% rate of interest. The Council's most profitable recent investment. Due to market turmoil, this has now been reduced to £3m and for a three month period. It is over 40% owned by the Government and this has been deemed to provide a comfort factor.

6.0 Exposure to Sovereign Debt Default

6.1 The introduction to this report referred at paragraph 3.2 to the exposure of French and German banks to the risk of sovereign default in Greece. Detailed below are relevant figures for those institutions on the Council's portfolio and potentially affected by the immediate risk of sovereign default:

The figures have been provided by Sector and are quoted in Euro billions

	RBS	Lloyds	Barclays
Greece	1.160	0.773	0.093
Ireland	0.402	16.286	0.407
Portugal	0.208	0.156	1.170
Spain	0.379	3.731	5.496
Italy	4.650	0.172	2.920

6.2 As can be deduced from the figures, default in any one country would have differing effects upon these three high street banks.

7.0 Conclusion

7.1 The financial and sovereign debt markets are more volatile than at any time for potentially the past 80 years. The situation on the Continent of Europe is the main area of concern with the lack (and cost of funding) for Italy and Spain adding to the risk of sovereign default in Greece. Watford's investment portfolio has been structured to (hopefully) be able to respond to further developments.

7.2 This report was produced on 16th September and may well be out of date by the time of the Audit Committee.

8.0 IMPLICATIONS

8.1 **Financial Issues**

The Head of Strategic Finance comments that the revenue estimates for 2011/2012 has assumed £346k of investment interest will be achieved (based upon a 1.3% rate of return). The current rate of return is 1.25% so it is hoped that anticipated income will be achieved. This would of course be totally meaningless should any investment not be honoured by the counterparty.

8.2 **Legal Issues** (Monitoring Officer)

The Head of Legal and Property Services comments that there are statutory limitations governing cash fund investments and all proposals within this report ensure continued compliance.

8..3 **Potential Risks**

Potential Risk	**Likelihood**	**Impact**	**Overall score**
Investment with non approved body	1	3	3
Investment with an approved counterparty that subsequently defaults	1	4	4
Failure to achieve investment interest budget targets	2	2	4
Those risks scoring 9 or above are considered significant and will need specific attention in project management. They will also be added to the service's Risk Register.			

8.4 **Staffing**
None Directly

8.5 **Accommodation**
None Directly