PART A

Report to: Audit Committee

Date of meeting: 27th June 2012

Report of: Head of Strategic Finance

Title: Treasury Management Update Report

1.0 SUMMARY

1.1 This report provides the regular 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 In my last report to the Committee on 14th March the continuing problems in the Eurozone were highlighted and included:

''To some extent the announcement by the European Central Bank (ECB) in December 2011 that it would make an unlimited three year lending facility available to all eurozone banks @ 1% rates of interest has relieved a considerable amount of pressure from the financial system. To date, the ECB has loaned 1 trillion euros to European banks. The size of the funding already taken up reveals the extent of the problems within the euro zone where there is a strong suspicion that a lot of losses within the banks have yet to be reported / covered by alternative funding. The ECB bail out whilst apparently attractive (1% rate of interest for up to three years) does mean that the ECB becomes the 'preferred creditor' and all other depositors/ shareholders are effectively down graded to junior status.''

3.2 Further: ''Problems continue in Greece where social and political unrest are likely to reach breaking point in the near future. The latest 'bail out' package to Greece of circa 130 billion euros will only exacerbate the situation as the conditions for such a loan imposed principally by Germany/ Holland/ Finland/ and Austria will increase resentment. The Greek general election in April is likely to return a socialist government and a reversal of current austerity measures may well be the result. Private holders of Greek sovereign debt will probably be required to write off 70% of their holdings (and includes French and German banks; UK banks having very limited exposure)''. In fact the write down was in excess of 80%

3.3 And further: ''The probability of Greece being forced out of the eurozone remains high as the northern European countries now believe that any consequent 'contagion' can be contained.''

3.4 And again: ''As a consequence of all the activity over the past 3 months (and particularly the lending facility made available by the ECB) it is less likely that a wider banking crash will now occur and it is opportune for the Council to reconsider its current investment strategy for 2012/2013.''

3.5 And finally: ''It is probably the case that the situation has stabilised and a slightly longer maturity profile can be considered for 2012/2013. The portfolio will therefore be structured whereby circa 33% of funds will be invested up to 12 months duration; 33% of medium term duration—up to six months; and 33% will be kept with a maturity of less than two months. Counterparty limits may also revert to up to £5m with any one financial institution and £3m with any of the top 5 building societies. The use of Nat West and the Co-operative Bank for overnight facilities of £10m and £5m respectively will continue to be utilised.''

4.0 Current Situation in Spain

4.1 For a short period of time the markets remained relatively calm with the focus very much being on the political events in Greece and France. The ECB loan facility was heavily utilised by Spanish Banks who borrowed at 1% rates of interest and onloaned to the Spanish Government at circa 4% rates of interest (and thereby

believed they would make a 'turn' on the transaction). The problem however is that Spanish Sovereign debt can now only be raised at circa 6-7% rates of interest so that all those Spanish banks are now sitting on losses. This, of course, is in addition to the (in many cases) undeclared losses related to their property loan portfolios.

4.2 As a consequence Spanish Banks have had their credit ratings drastically down graded, there is a steady transfer of foreign capital out of Spain and available funding has virtually dried up. Over the weekend of 9/10th June it was announced that 'Spain' would have a 100 billion euro loan facility available at 3% rates of interest. There appears however to be a marked contrast in statements emanating from Madrid and Berlin with the Spanish Premier stating it is simply a line of credit with no strings attached. The German Finance Minister, Wolfgang Schaeuble, stating however that the loan would be subject to the same monitoring regime as Portugal, Ireland and Greece.

4.3 The larger issue however is whether the loan will be advanced from the European Financial Stability Facility (EFSF) or the European Stability Mechanism (ESM). The difference between the two being that the EFSF has identical creditor rights as all other loans; the ESM has preferential status and all other creditors would then be downgraded to junior status. If it is the latter case then it is likely that all remaining foreign capital in Spanish banks will be repatriated elsewhere (many creditors having already taken a 80% write down on their Greek Debt).

4.4 There is now a knock on situation that of the 100 billion euro loan,17.9% is being underwritten by Italy where difficulties in raising capital continues to be experienced. In effect Italy will have to borrow at 5.5% rates of interest in order to loan to Spain at 3% rates of interest. Is this reasonably sustainable ? Further, other countries such as Ireland & Portugal have received financial support from the ECB geared to 5-6% rates of interest and are starting to question why Spain should be given preferential treatment.

4.5 On 18th May, one of the three credit rating agencies, Moody's cut the credit rating of 16 Spanish banks (and included the two largest Spanish banks, Santander and Banco Bilbao Vizcava Argentaria (BBVA) who had their credit rating reduced to a single A rating). Most of the other banks were local regional banks, heavily influenced by the local authorities, and which were effectively downgraded to virtual junk status. Since that date another major Spanish bank, Bankia, has had to receive support from the Spanish Government to meet a 'black hole' in its accounts. Finally, on 12th June, another of the big three credit rating agencies, Fitch, downgraded Santander and BBVA from a single A credit rating to BBB+ status.

5.0 Current Situation In Europe

5.1 Greece has another general election on 17th June and, should the anti austerity parties be elected, then it could signal the final act in the demise of continued membership of the eurozone.

5.2 Portugal may need to apply for further funding in the near future and may well be joined by Cyprus (although Russian funding is a possibility). Ireland is experiencing a recession and increased unemployment. Belgium, whilst not on the radar at present, has serious funding problems. Italian and French banks have all been downgraded.

5.3 German and Austrian banking institutions have also had their credit ratings cut within the last month (including Commerzbank, the second largest bank in Germany; and also the three largest Austrian banks). It has been signalled that UK banking institutions are likely to suffer downgrades in the near future. Tensions also exist within the Dutch banking system.

5.4 Recent research indicates that the combined exposure of UK lenders to debt in Greece, Portugal, Spain, Italy and Ireland fell during 2011 by 13 per cent to £195billion (exposure of UK financial institutions to Ireland is the greatest risk). This level of indebtedness can be compared with £350 billion for Germany and £270billion for France.

5.5 In conclusion, my forecast at the Audit Committee's last meeting that …"it is less likely that a wider banking crash will now occur " (paragraph 3.4 earlier refers), suggests that I need a new crystal ball. In my defence, Chancellor Merkel is furious because she was assured that the 1 trillion euro bailout (referred to earlier at paragraph 3.1) would prevent a new banking crisis for 3 years.

6.0 The Council's Current Investment Portfolio

6.1 The Council's portfolio is attached at **Appendix 1**. It continues to focus upon the major UK Banks and the five largest Building Societies. The Portfolio's maturity has been lengthened (as indicated at the 14th March Audit Committee Meeting). Maximum exposure with any one financial institution has remained at £3m per bank and £2m with individual building societies. The exceptions to this being the overnight/ call accounts with Nat West and the Co-operative bank. The advantage in lengthening the maturity profile can be clearly appreciated by the rates of interest on offer –ranging from 1.5% to 3% (as compared to the average rate of interest accrued throughout 2011/2012 of 1.2%).

6.2 In the light of the uncertainties referred to at Sections 4 and 5 of this report, the Council's investment policy will be to keep its maturity profile of short duration (probably for the remainder of the year) and will affect rates of interest on offer. Those loans that effectively still have an over 6 month maturity profile will need to run their course. The maximum maturity is £2m with Lloyds which will mature in April 2013 (at a 3% rate of interest) and it is inconceivable that a bank 42% owned by the Government will be at risk.

6.3 A final comment about Santander UK Ltd which was downgraded by Moody's on 18th May as part of its cull of Spanish Banks. This was unfortunate and shows a degree of ignorance on the part of Moody's. Audit Committee has previously considered a detailed report at a previous meeting on the status of Santander UK Ltd which included:
* It is ring fenced from its parent and it would be illegal for Santander Spain to transfer funds from its UK entity.
* It is one of the best capitalised banks in the UK.
* It is regulated by the Financial Services Authority (and effectively the Bank of England).
Even after the Moody's downgrade it still meets the Council's credit criteria of F1/ P1/ A1 for short term investments up to 6 months. Nevertheless, when the loan matures on 7th September, the situation will be reviewed.

7.0 IMPLICATIONS

7.1 **Financial Issues**

The Head of Strategic Finance comments that the revenue estimates for 2012/ 2013 has assumed £325k of investment interest will be achieved (based upon a 1.3% rate of return). It is anticipated that this will be achieved due to an increased rate of return from the early part of the financial year (and is obviously predicated upon no financial institution defaulting).

7.2 **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.

7.3 **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.			

7.4 **Staffing**

None Directly

7.5 **Accommodation**

None Directly

Appendix 1 -