PART A

Report to:	Audit Committee
Date of meeting:	26th June 2013
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 As this will be my last review of the global investment background, I should be expected, like Mervyn King (at the Bank of England) to give an up beat message. Regrettably, whilst all appears calm, very great turbulence probably lies ahead. So I will commence this review with a quick 'Whicker's' world tour (whilst the views are mine they are supported by a great many economic analysts).

Eurozone

3.2 Any starting point must be the euro zone which is mired in a recession and shrank for the sixth quarter in a row. France fell back with a 0.2% contraction of GDP and confirmed fears that the second biggest economy is in dangerous decline, whilst Germany only reported a 0.1% growth in GDP. In Italy the economy shrank for the seventh quarter in a row, with Spain showing another 0.5% contraction. Greece entered its sixth year of recession.

3.3 The ECB has eventually realised its tight money in the past has exacerbated the situation and has dropped its bank rate to 0.5% (the same as the US and UK) but this will be insufficient and the solution appears to be for the ECB to introduce its own quantitative easing to encourage growth (but that will be resisted by Germany).

3.4 Politicians within the euro zone, however, continue to believe the problem is an Anglo Saxon financial crisis rather than lack of competitiveness and trade imbalances. As a consequence 11 countries have agreed to introduce a 'Tobin' tax on financial transactions. This tax not just to apply to transactions within the euro zone but worldwide if denominated in euros (with a hoped for target of 35 bn of euros each year going into their coffers). The UK government has raised a legal challenge as it is a direct attack on the City of London and has been backed by the US. Interestingly, all central bankers within the euro zone (including the Bundesbank) are against the tax as it will push up government borrowing costs, will only deliver 3 bn of receipts and drive markets to the far east and New York.

3.5 There has been an unwritten convention within EC circles that the common agricultural policy was sacrosanct to France; the car industry to Germany; and financial services to the UK. This has now been torn up and is pushing the UK to the exit door. Latest intelligence suggests the wall of opposition will mean the Tobin tax so neutered as to be meaningless.

3.6 Meanwhile, gas prices in Europe are 4 times higher than the US and energy prices 3 times higher both of which seriously affects the European chemical, steel and glass industries. France has a moratorium on shale gas; Germany

is running down its nuclear reactors; and Italy won’t touch shale or nuclear. Europe is being left in a permanent slump and will probably lose its footing in the world.

United Kingdom

3.7 Household wealth is lower than it was a decade ago where British households had the fifth highest spending power in the World (behind USA, Luxembourg, Norway and Germany). By 2011 we had slumped to 12th wealthiest and helps to explain the lack of consumer demand. We continue to live above our means with a savings rate between 2005 and 2011 of minus 1.1% (compared to a positive11.8% savings rate in France; and 10.9% in Germany). British families are the most heavily indebted in the developed world at 98% of GDP and this had risen by a third between 1997 and 2009.

3.8 The housing market (and house prices) is improving spurred on by low mortgage rates and government initiatives. There is of course the danger that this will create a bubble further down the line.

3.9 There is however some clear, blue water emerging between the UK and our continental cousins. Euro zone unemployment averages 12.1% (the UK 7.9%); the UK growth performance (whilst pretty poor) is starting to pull away from the euro zone. This has considerable risk of reversal as the UK‘s main trading bloc is the EU. Even here there has been a rebalancing where 62% of exports in 2002 went to the EU whereas latest data shows £151bn to Europe and £149bn to the rest of the world.

3.10 Revisions to national statistics suggest the UK not only avoided a triple dip recession, but a double dip as well. Any growth will be extremely modest (circa 0.9% during 2013) but is a marked improvement on the position within the euro zone.

France

3.11 French labour costs are not competitive. The minimum wage is the highest in Europe combined with a 35 hour week. Pensions are high with entitlement at 62 (far lower for public sector employees). The French Socialist Party did not help matters by blaming the deep social and economic crisis on the ‘selfish intransigence of Mrs Merkel’. This provoked an instant response from the Free Democrat Party (in Mrs Merkel’s coalition) who responded by deriding France as a basket case with an economy in deep decline. It accused Paris of clinging to a coddled welfare model with a state sector near 56% of GDP.

Germany

3.12 Has fared reasonably well over the past 4 years due to its relatively low labour costs and the advantages of the euro being competitive (compared to what the deutschmark would have been). Recent data shows a slowdown

in growth and there has been a fall in new orders in the past quarter. The effective devaluation of the Japanese yen will affect its far eastern markets.

Italy

3.13 Italy's new premier, Enrico Letta is on a collision course with Germany after vowing to end austerity measures which were 'killing' his country. Silvio Berlusconi waded in calling for a showdown with northern powers before it loses its chemical, car and steel industries. It has now been recognised that it was a mistake to squeeze the budget by 3% of GDP last year. The consequence has been internal demand contracting 5.3% and increased Italian debt measured against a shrinking budget. It still remains the case that Italy would benefit most from euro exit. It has a primary trade surplus and fat gold reserves providing bond collateral that could raise 400 bn euros if necessary. Its only problem is that the euro is over valued by 20% compared to a return to the lira.

Holland

3.14 Previous notions were that Germany, Holland, Finland and Austria were the hard liners calling for austerity. Recent comments (from the Bureau of Economic Policy Analysis) included 'the Dutch government's inability to acknowledge the damage done by austerity despite mounting evidence is a case of 'cognitive dissonance'. This evidence includes unemployment doubling over the past two years to 8.1%; the economy has been in recession since early 2011; a credit frenzy was allowed and household debt to disposable income in 2010 had risen to 266% . There has been an inevitable correction with house prices having fallen by 18%, leaving many households 'onder water'. Further falls are expected in 2013 and 2014. Consumer sentiment is not good. Dutch banks are heavily dependent upon capital markets as its loan to deposits ratio is 183% (compared to 120% in the UK). In February 2013, the Dutch Government was forced to nationalise the fourth largest bank after it was over exposed to commercial property debt.

Austerity Across Europe Continues

3.15 It is instructive to compare current targets for cutting public spending across Europe as the table below indicates:

	2013	2015
UK	6.8%	3% of GDP
France	3.9%	3%
Spain	6.5%	3%
Holland	3.6%	2.8%
Italy	3%	3%
Portugal	5.5%	2.5%

3.16 The effect of austerity does however increase the size of public debt (as it is related to a shrinking economy). So, for example public debt rose from 108% of GDP in Portugal to 124% last year; and 69% to 84% in Spain. The UK has experienced its public debt continuing to increase as it seeks to stabilise its finances.

The United States

3.17 The US has operated quantitative easing (like the UK) since the early stages of the financial crisis and has been printing 85 bn dollars of new money every month. This available credit has provided much needed world liquidity but the Swiss based Bank for International Settlements has observed that this emergency stimulus is becoming a dangerous addiction.

3.18 The Federal Reserve Board has a number of members who feel the tap should be turned off and this has caused panic in the wider world as it is toxic for anybody who relies on dollar funding and that particularly affects the emerging markets.

Emerging Markets/ BRICS (Brazil/ Russia/ India/ China/ South Africa)

3.19 Optimism that the world would be pulled out of recession by emerging markets/ BRICS has dissipated. Brazil has seen manufacturing output fall 2.8% since 2008 and its main exports, iron ore and agriculture have gone backwards. Russia is similarly heavily dependent upon oil and gas (whilst globally shale energy is on the increase). India still suffers power blackouts and a current account deficit of 6.7%. China has run out of steam where growth had largely been generated by increasing credit internally from 9 trillion dollars to 23 trillion in four years. Much of its municipalities/ industry are heavily in debt and has reached credit exhaustion which is now like pumping air into a leaking balloon. The danger for Europe is that much investment was shovelled into emerging markets-- 4.4 trillion dollars from the European bloc and any future shocks may well affect the repayment of this investment.

Japan

3.20 The new premier (Shinzo Abe) has attempted to lift Japan out of its deflationary 20 year ‘ice age’ by instructing the bank of Japan to start printing money (equivalent to 75bn dollars a month—nearly the same as the US but with an economy a third of the size). This had the effect of achieving an initial 3.5% growth rate and also devalued the yen by 30% which clearly has made it more competitive against the USA/ China/ South Korea/ and Europe. Germany in particular could find its far eastern markets drying up.

3.21 The Japanese stock market rose 70% since November 2012 with foreign hedge funds accounting for a third of all long positions. A correction was inevitable with the Tokyo Nikkei falling over 7% in one day. Investors are likely to be sitting on losses for quite a while.

Equity/ Stock Markets

3.22 Equity / stock markets across the world saw dramatic increases in their values in the early part of 2013 but was almost certainly not justified by fundamentals but rather because government bonds/ gilts continue to provide a negative return. A correction has subsequently occurred with the FTSE index reaching 6,875 before falling to a current level of 6,340. It is hoped that this level will be maintained as many pension funds in particular have suffered badly by the low level of investment returns from bonds.

Government Stock/ Gilts

3.23 Show a very poor return and this will continue until interest rates begin to rise. The UK continues to enjoy 'safe haven' status as the problems throughout the world start to emerge. It is anticipated that once a panic sets in most investors will turn to American treasury stock as the ultimate safe haven.

Conclusion

3.24 A rash of weak manufacturing data from America, Europe and Asia has cast serious doubts on the strength of the global economy and is in sharp contrast to the optimistically surging stock markets.
The levels of Government and Bank debt is far too high and has been heavily dependent upon printing presses being turned on. At some point this 'fix' will need to be addressed.
Personal debt is still high in the UK and this has resulted in a lack of demand for consumer goods and which has not helped the retail sector in particular.
If there is a glimmer of light it is that the UK economy has hopefully turned the corner but any growth will be extremely modest for the foreseeable future.

4.0 The Co-operative Bank

4.1 The Co-op was formally seen as an old fashioned, safe and secure mutual institution. Its Chief Executive was keen to transform it to become a leading player both in the retail (supermarket) sector and in the banking industry. As a consequence the Co-op swallowed up Somerfield supermarkets and also bought out the Brittania Building Society. As a final act, the CEO also engineered the Co-op to be preferred bidder for 632 branches of the TSB brand within the Lloyd's/ HBOS bank umbrella.

4.2 This last act proved his, and the Co-ops undoing, because the Financial Services Authority, in carrying out due diligence concluded that a sizeable black hole existed in the Co-op Bank's balance sheet. Recent losses have had to be declared as a consequence of a new finance package (to

integrate the Co-op and Brittania financial systems). This has now been scrapped at an abortive cost of £250m.
In addition, prior to the take over of Brittania, due diligence was less than thorough and a sizeable tranche of commercial bad debts have had to be written down.

4.3 The exact size of the black hole has yet to be declared but is in the range £1bn to £1.8bn. The Co-op Bank has a capital 'adequacy' of 1% whereas 7% is where it should be. Its parent, the wider Co-operative Group (which includes retail and funeral operations) has signally failed to state it will bridge any capital shortfall.

4.4 In the short term the Co-op Bank is seeking to sell its insurance business but at a knockdown price of circa £220m and is seeking to identify further disposal opportunities. It is also seeking to make its £1.3bn of subordinated bond and preference shareholders take a hit.

4.5 The Co-op has over 6.5m customers and as at the present date there has been no run on the bank (savers would expect to have the first £85k of any deposits covered by the government compensation scheme). The Co-op is also the council's banker (and indeed is banker to a number of local authorities, as well as the Labour Party nationally). The current contract for Watford expires in April 2014 and a procurement process has commenced.

4.6 It is not feasible to bring this date forward as any change of banker requires proper planning with changes to cheque stationery, standing orders, direct debit mandates etc. The main problem for the council is that it has tended to leave a chunk of money 'overnight' in the Co-op to meet cash flow requirements (the Treasury Policy Statement limits this to £5m maximum at any one time). As an example of the fluctuations in the council's cash flows, on 15th May there was £45m in our portfolio which has now fallen to circa £39m and is due to the timing of payments into the council's bank accounts and payments out to HCC/HPA preceptors and business rates to the government.

4.7 The council has received assurances from the Co-op that any money in its current account is not classified as either subordinated bonds or preference shares. Nevertheless we are leaving as little as possible in the Co-op at the end of each day and has resulted in using the government's Debt Management Office as the depository for overnight facilities. This is inconvenient and has caused the council's investment officers to spend more time on the cash management process. It is however necessary until a strategy to meet the Co-op's black hole has been announced (hopefully within the next two weeks).

5.0 Council's Current Investment Strategy

5.1 The Council's strategy gives priority to the security of its assets before seeking a high interest rate return and can be summarised as follows:

- **S**ecurity (counterparty reliability)r
- **L**iquidity (timescale for return of investment)
- **Y**ield (rate of interest)

5.2 The previous sections of this report have indicated that I believe we have a 'calm before the storm' and that, as a consequence, the maturity of the portfolio will be kept relatively short. The problem in generating a reasonable return from the portfolio is the fact that commercial banks/ building societies are able to borrow from the markets and are not interested in small deposits from local authorities.

5.3 This can be demonstrated by the latest rates on offer (as at 31st May 2013) as the information below indicates:

	1month %	2 months %	3 months %
Barclays	0.30	0.30	0.35
Nationwide	0.38	0.40	0.44

5.4 The Audit Committee may recall that I have previously reported that the council would not use the government guaranteed Debt Management Office because its rates of interest were far too low. Interestingly the DMO rates have remained constant (0.25%) whilst commercial operations have been significantly lowering their rates (see above Barclay's at 0.30%). In these circumstances the greater security offered by the DMO far outweighs a very small increase in the rate of interest on offer.

5.5 The Council's current investment portfolio is attached at **Appendix 1** and indicates £8.8m with Nat West (as it is 83% government owned) and £5m with Lloyds (again the government has a major interest). This will need to be monitored as the intention of the Treasury is to reduce government ownership within the next two years. It should be noted that the overnight balance with the Co-op is £60k; and a sizeable part of the portfolio (£10m) is with the Debt Management Office with very short maturity periods as it is now being used for immediate cash flow variances.

5.6 The next report to the Audit Committee will be under the aegis of the Shared Services Director of Finance who may take a different view of events. At least I have left a reasonably secure set of counterparties with a short maturity profile so there will be plenty of opportunity to make changes.

6.0 IMPLICATIONS

6.1 Financial Issues

The Head of Strategic Finance comments that the revenue estimates for 2013/ 2014 has assumed £270k of investment interest will be achieved (based upon a 1.0% rate of return). The rate of return may be difficult to achieve in the current climate but the cash return is possible as it will be

dependent upon the drawdown of council finances to meet funding of the capital programme.

6.2 **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.

6.3 **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	3	2	6
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.			

6.4 **Staffing & Equalities**

None Directly

6.5 **Accommodation**

None Directly