Agenda Item

Report

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Report to:	**Finance and Information Technology Resources Committee**
Date of Meeting:	**13 September 2011**
Report by:	**Chief Executive**

Subject:	**Annual Investment Report 2010/2011**

1. Purpose of Report

1.1. The purpose of the report is to:-

- allow Committee to scrutinise the proposed Annual Investment Report for 2010/2011.

2. Recommendation(s)

2.1. The Committee is asked to approve the following recommendation(s):-

(1) that it endorses the 2010/11 Annual Investment Report

(2) that the report is referred to the Executive Committee prior to submission to the Council for formal approval in line with The Local Government Investments (Scotland) Regulations 2010.

3. Background

3.1. Scottish Ministers issued The Local Government Investments (Scotland) Regulations 2010 on 1 April 2010 providing a formal investment framework through consent and Regulations.

3.2. The Regulations require local authorities to prepare an Annual Investment Strategy before the start of the financial year and an Annual Investment Report after the financial year end. Both documents require to be approved by full Council.

3.3. The Annual Investment Strategy for 2010/2011 was presented to the Finance and Information Technology Resources Committee on 1 June 2010 and was approved by South Lanarkshire Council on 23 June 2010.

4. Annual Investment Strategy

4.1. The Annual Investment Strategy covered permitted investments, risk management and borrowing in advance. These sections from the strategy are summarised below.

4.2. Permitted Investments

4.2.1. The Annual Investment Strategy set out the types of investment that South Lanarkshire Council could use during 2010/11. These are known as "permitted investments". The permitted investments that South Lanarkshire Council approved for the financial year 2010/2011 are detailed in Appendix 1 to this report.

4.3. Risk Management

4.3.1. The strategy recognised that any investment activity carries an element of risk. It identified the associated risks and put controls and limits in place to mitigate these risks as required by the CIPFA Treasury Management Code of Practice.

4.3.2. The main consideration when investing surplus funds was to be the security of the transaction. Following this, the Council's liquidity requirement would be considered and, finally, the yield that would be gained from the investment considered.

4.3.3. In managing credit and counterparty risk the Council would:-

- Establish a sound diversification policy with high credit quality counterparties
- Set clear minimum credit limits for counterparties.
- Have regard to the credit ratings issued by all three rating agencies and make decisions based on the lowest rating
- Consider country, sector and group limits
- Regularly review credit ratings and act upon forward looking rating warnings

4.3.4. In order to manage liquidity risk, the Council would endeavour to maintain a minimum balance of £5m in bank accounts and money market funds with instant access. In addition, an overdraft facility of £5m, extendable on request to £18m, had been arranged with Royal Bank of Scotland.

4.3.5. Longer term investments would only be considered where the Council's liquidity requirements were ensured and an assessment of liquidity risk had been carried out. No more than £10m of investments would, at any one time, be for a period in excess of 364 days.

4.4. Borrowing in Advance

4.4.1 Borrowing in Advance would only be taken if considered appropriate. When considering borrowing in advance, the risks of holding increased levels of investments against the risk of adverse interest movements if borrowing was deferred would be considered.

5. Annual Investment Report

5.1. Permitted Investments

5.1.1. During 2010/2011 South Lanarkshire Council only used the following permitted investments

- Deposits with the Debt Management Account Deposit Facility
- Deposits with UK Local Authorities
- Deposits with Banks and Building Societies

5.1.2. Deposits made in the period 1 April 2010 to 31 March 2011 totalled £1,403.021m. This is broken down per sector and institution in the table below. 44.76% of these deposits were made in the UK Government through the Debt Management Office (DMO) deposit facility.

Counterparty	Deposit Totals (£m)	% of Total Deposits	Average Interest Rate
Deposits in UK Government	**628.059**	**44.76%**	**0.250%**
Deposits in UK Local Authorities	**445.980**	**31.79%**	**0.430%**
Deposits in UK Banks:			
Royal Bank of Scotland	99.272		
Bank of Scotland	177.460		
Barclays Bank	50.750		
Total Deposits in UK Banks	**167.482**	**11.94%**	**0.735%**
Deposits in UK Building Societies:			
Nationwide	47.400		
Total Deposits in UK Building Societies:	**47.400**	**3.38%**	**0.486%**
Deposits in UK Subsidiaries of Foreign Banks:			
Santander UK plc (Formerly Abbey)	24.100		
Clydesdale Bank	90.000		
Total Deposits in UK Subsidiaries of Foreign Banks	**114.100**	**8.13%**	**0.767%**
Total Deposits 01/04/10 to 31/03/2011	**1,403.021**	**100%**	

5.1.3. The average interest rates achieved from the deposits are shown in the table above. As the base interest rate has remained at 0.5% since March 2009, interest rates achievable from deposits are considerably lower than in previous years.

5.1.4. Actual deposits as at 31 March 2011 totalled £114.407m.

5.2. Risk Management

5.2.1. The following minimum thresholds were set in the strategy for all deposits with banks and building societies, including Certificate of Deposits.

Rating Agency	Long Term Rating	Short Term Rating	Maximum Deposit
Fitch	A+	F1	£10m
Moody’s	A1	P-1	£10m
Standard and Poors	A+	A-1	£10m

5.2.3. In addition to the primary ratings detailed above, consideration was also given to the secondary ratings provided by Fitch. Fitch is the only rating agency to provide two secondary ratings measuring a bank’s individual and support ratings. As a minimum, an organisation was required to have an individual rating of B (indicating that the bank is strong in its own right) or a support rating of 2 (indicating that there is a high probability of external support).

5.2.4. The tables below show a breakdown of deposits with details of the credit ratings of banks and building societies used from 1 April 2010 to 31 March 2011. Deposits with the DMO are with the UK Government and so have a AAA rating. Deposits with local authorities are considered to be of very high credit quality despite most local authorities not having formal credit ratings.

Fitch Ratings

Long Term Rating	Short Term Rating	Individual Rating	Support Rating	Deposits Totals	Percentage of Total Deposits
Deposits in DMO (AAA)				**£628.059m**	**44.77%**
Deposits with Local Authorities				£445.980m	31.79%
AA-	F1+	B	1	£122.250m	8.71%
AA-	F1+	C	1	£107.460m	7.66%
AA-	F1+	C/D	1	£48.463m	3.45%
AA-	F1+	D/E	1	£50.809m	3.62%
Total				**£1,403.021m**	**100.00%**

Moody's Ratings

Long Term Rating	Short Term Rating	Deposits Totals	Percentage of Total Deposits
Deposits in DMO (AAA)		**£628.059m**	**44.77%**
Deposits with Local Authorities		£445.980m	31.79%
Aa3	P-1	£238.982m	17.03%
A1	P-1	£90.000m	6.41%
Total		**£1,403.021m**	**100.00%**

Standard and Poors Ratings

Long Term Rating	Short Term Rating	Deposits Totals	Percentage of Total Deposits
Deposits in DMO (AAA)		**£628.059m**	**44.77%**
Deposits with Local Authorities		£445.980m	31.79%
AA	A-1+	£34.100m	2.43%
AA-	A-1+	£40.750m	2.90%
A+	A-1	£254.132m	18.11%
Total		**£1,403.021m**	**100.00%**

5.2.5. The tables show that 76.56% of deposits were made with counterparties of very high credit quality (UK Government DMO account and other local authorities). All deposits were in line with approved lending limits and credit rating criteria.

5.2.6. The counterparty at the foot of the table Fitch Ratings with individual rating D/E is the Royal Bank of Scotland. The support rating of 1 shows the support the bank will continue to receive from the UK Government. It should be noted that on 15 July 2010, the individual rating for the Royal Bank of Scotland was upgraded, moving to C/D from D/E.

5.2.7. In order to manage liquidity risk, the Council held an average of £24.220m in bank accounts and money market funds with instant access. The amount held on instant access fell below £5m on a total of seven days, however, there was no material exposure to liquidity risk throughout the financial year.

5.2.8. No deposits were placed for periods in excess of 364 days.

5.3. Borrowing in Advance

5.3.1. Borrowing was taken during 2010/2011 in order to fund the capital programme and to replace maturing debt. No borrowing was taken in advance.

6. Employee Implications

6.1. None

7. Financial Implications

7.1. The financial impact from all treasury activity including investment activity has been built into the long term revenue budget strategy.

8. Other Implications

8.1. South Lanarkshire Council recognises that any investment activity will carry an element of risk. It is important that risk is identified and controls put in place to limit those risks.

8.2. The CIPFA Treasury Management Code of Practice, adopted by the Council, introduced a new section on Managing Treasury Management Risks, placing Credit and Counterparty risk at the forefront of treasury risks.

8.3. Section 5.details how South Lanarkshire Council has managed these risks.

9. Equality Impact Assessment and Consultation Arrangements

9.1. An Equality Impact Assessment on the Treasury Management Strategy was carried out in November 2008. This paper is an update to that strategy which relates to the investment of funds. The conclusion of the initial equality impact assessment was that there was no adverse impact on any part of the community covered by equalities legislation, or on community relations.

9.2. There is no requirement to undertake any consultation in terms of the content of this report.

Archibald Strang
Chief Executive

11 August 2011

Link(s) to Council Values/Improvement Themes/Objectives

- Value: Accountable, effective and efficient

Previous References

- Report to Finance and IT Resources Committee 1 June 2010

List of Background Papers

None

Contact for Further Information

If you would like to inspect the background papers or want further information, please contact:-

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Permitted Investment	Treasury Risks	Mitigating Controls	Limits
Deposits with the Debt Management Account Deposit Facility	This is a deposit with the UK Government and so credit risk is very low. Liquidity risk has to be considered as deposits can only be broken with the agreement of the counterparty and penalties may apply. There is no market risk as the principal sum invested is not affected by market prices.	There are no mitigating controls required.	There is a maximum monetary limit of £80m. A maximum term of deposit of six months as set by the Debt Management Office.
Deposits with UK local authorities and other bodies defined as local authorities in the Local Government Scotland Act 2003 (And Equivalent English Act)	These are considered to be quasi UK Government investment and as such credit risk is very low. Liquidity risk has to be considered as deposits can only be broken with the agreement of the counterparty and penalties may apply. There is no market risk as the principal sum invested is not affected by market prices.	Very little mitigating controls are required for local authority deposits.	The maximum deposit with any local authority will be £15m. A maximum term of deposit of three years.
Deposits with Banks and Building Societies	These tend to be low risk but credit risk will be higher than deposits placed with the DMO or UK local authorities. Liquidity risk has to be considered as deposits can only be broken with the agreement of the counterparty and penalties may apply. There is no market risk as the principal sum invested is not affected by market prices.	The counterparty selection criteria restricts lending only to high quality counterparties, measured initially by credit ratings from Fitch, Moody's and Standard and Poors. Additional indicators of creditworthiness will also be considered prior to placing any deposits. Liquidity risk can be controlled by the use of instant access call accounts.	The maximum deposit with any bank or building society will be £10m. A maximum term of deposit of 364 days.

Certificates of Deposit with Banks and Building Societies	These are short to medium term dated marketable securities issued by financial institutions. These tend to be low risk investments but credit risk will be higher than deposits placed with the DMO or UK local authorities. Liquidity risk is lower than placing a deposit with a Bank or Building Society as these can be sold on the market. There is a risk of capital loss arising from selling ahead of maturity.	The counterparty selection criteria restricts lending only to high quality counterparties, measured initially by credit ratings from Fitch, Moody's and Standard and Poors. Additional indicators of creditworthiness will also be considered prior to using this type of instrument. Market risk would be mitigated by holding the instrument to maturity.	The maximum investment with any bank or building society will be £10m. A maximum period of investment of 364 days.
UK Government Gilts and Treasury Bills	These are marketable securities issued by the UK Government and as such credit risk is very low. Liquidity risk is very low as there is a huge market for Gilts and Treasury Bills There is a risk of capital loss arising from selling ahead of maturity.	There are no mitigating controls required for credit risk as the investment is with the UK Government. Market risk would be mitigated by holding the instrument to maturity.	The maximum amount that will be invested in UK Gilts or Treasury Bills is £80m for maturities less than one year of £10m for maturities greater than one year. The maximum period of investment will be five years.
AAA Rated Bonds Issued by Multilateral Development Banks	These are bonds issued by supranational bodies such as the European Investment Bank or World Bank and as a result are backed by several sovereign states and as such credit risk is very low. Liquidity risk is very low as there is a huge market for Supranational Bonds. There is a risk of capital loss arising from selling ahead of maturity.	There are no mitigating controls required for credit risk as the investment is effectively spread across a number of sovereign states. Market risk would be mitigated by holding the instrument to maturity.	The maximum amount that will be invested in AAA Rated Bonds issued by Multilateral Development Banks is £10m. The maximum period of investment will be five years.

AAA Rated Money Market Funds	Money market funds are mutual funds that invest in short-term money market instruments. Credit risk, liquidity risk and market risk are all very low.	Money Market Funds will only be used where they have obtained a AAA rating from the credit rating agencies. In addition to the credit rating, Money Market Funds will also be assessed for suitability on fund size, the strength of the custodian and the stability of invested capital.	Investments in Money Market Funds will be limited to 0.5% of the Money Market Fund Balance and to no more than £5m in any one Fund.
Loans to Third Parties	These are service investments which may exhibit credit risk and are likely to be highly illiquid.	Any new types of loans to third parties should be approved by Members through the appropriate Committee with full consideration of the service rationale behind the loan and the likelihood of partial or full default and the impact that this will have on service budgets.	