

Report

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Report to:	Finance and Information Technology Resources Committee
Date of Meeting:	31 August 2010
Report by:	Executive Director (Finance and Information Technology Resources)

Subject:	Treasury Management Investment Activity - Quarterly Report
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1. Purpose of Report

1.1. The purpose of the report is to:-

- ◆ Provide a quarterly update of South Lanarkshire Council's investments, and information on how we manage our risk.
- ◆ Provide comments on how the market is performing.
- ◆ Provide details of projected cash flow and the investment framework that will be applied in the forthcoming quarter.

2. Recommendation(s)

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

- (1) that the content of the report regarding investments is noted
- (2) that the management of risk is noted
- (3) that the investment framework to be used in the next quarter is noted.

3. Background

3.1. In order to provide information on the Council's Treasury activities, a quarterly report to this committee will be provided. This report covers the period 1 April 2010 to 30 June 2010.

3.2. On a daily basis, the Treasury Management section within Finance and Information Technology (IT) Resources manages the Council's cash funds. These cash balances can result from day to day cash flow situations where income has been received before expenditure has taken place, and from the balances held in earmarked reserves for use at a later date. It is the responsibility of the section to manage these funds. The primary consideration when making deposits is the security of funds. Then consideration is given to ensuring we have access to funds when necessary, and that these funds are working as well as they can for the Council.

- 3.3. On 1 April 2010 Scottish Ministers introduced regulations on local authority investments. These regulations give South Lanarkshire Council greater freedom over its investments and subsequently an Annual Investment Strategy was presented to this Committee on 23 June 2010 which detailed permitted investment options for this Council.
- 3.4. The Council undertakes significant scrutiny of any counterparty that we place money with in partnership with our Treasury Advisers. This includes information on counterparty credit ratings, negative rating watch details and whether they are part of the UK Government Credit Guarantee Scheme. Additional market information on counterparties is also provided. This includes share prices, market research information and risk data in the form of Credit Default Swap prices which show how expensive it is to insure against a counterparty defaulting. The higher the price, the greater the perceived risk. Only when we are satisfied that there are no issues that raise any concerns about the security of the deposit would the deposit go ahead.

4. Investment Activity

- 4.1. Despite the greater freedom over what the Council can invest in following the approval of the Annual Investment Strategy on 23 June 2010, no new investment types have been used.
- 4.2. Deposits made in the period 1 April 2010 to 30 June 2010 totalled £227.476m. This is broken down per sector and institution in Table 1 below. 52.62% of these deposits were made in the UK Government through the Government's Debt Management Office (DMO) deposit facility. The DMO is the most secure counterparty, however rates of interest paid by the DMO are the lowest of all counterparties.

Table 1

Counterparty	Deposit Totals (£m)	Percentage of Total Deposits	Average Interest Rate
Deposits in UK Government	119.700	52.62%	0.250%
Deposits in UK Local Authorities	29.400	12.92%	0.294%
Deposits in UK Banks:			
Royal Bank of Scotland	46.816		
Bank of Scotland	17.460		
Total Deposits in UK Banks	64.276	28.26%	0.795%
Deposits in UK Subsidiaries of Foreign Banks:			
Santander UK plc (Formerly Abbey)	14.100		
Total Deposits in UK Subsidiaries of Foreign Banks	14.100	6.20%	0.800%
Total Deposits 01/04/10 to 30/06/2010	227.476	100%	

- 4.3. The average interest rates achieved from the deposits are shown in Table 1. 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. Management of Risk

- 5.1. An updated CIPFA Treasury Management Code of Practice has been issued and has been adopted by the Council. This updated Code introduced a new section on Managing Treasury Management Risks, placing Credit and Counterparty risk at the

forefront of treasury risks. The Council previously had met the requirement of the new code, and continues to do so.

- 5.2. It is recognised that no Treasury Management activity is without risk, and practices are put in place in order to limit risk. In February 2010, the Treasury Management Strategy was approved which set minimum criteria for placing deposits with banks, building societies, local authorities and the Debt Management Office.
- 5.3. The Annual Investment Strategy approved in June 2010 included details on how risk would be managed for all permitted investments. This included criteria for placing deposits with the Debt Management Office, UK Local Authorities, Banks and Building Societies. Appendix 1 shows the agreed Criteria for permitted investments. All deposits placed have met the criteria agreed by this Committee.
- 5.4. Part of the criteria for counterparties is meeting minimum credit ratings with the three main rating agencies. The credit ratings of counterparties used from 1 April 2010 to 30 June 2010 are detailed below in Tables 2 to 4. A key to each of the ratings is attached at Appendix 2.

Table 2 – Fitch Ratings

Long Term Rating	Short Term Rating	Individual Rating	Support Rating	Deposits Totals	Percentage of Total Deposits
AAA				£149.100m	65.54%
AA-	F1+	B	1	£14.100m	6.20%
AA-	F1+	C	1	£17.460m	7.68%
AA-	F1+	D/E	1	£46.816m	20.58%
Total				£227.476m	100.00%

Table 3 – Moody's Ratings

Long Term Rating	Short Term Rating	Deposits Totals	Percentage of Total Deposits
AAA		£149.100m	65.54%
Aa3	P-1	£78.376m	34.46%
Total		£227.476m	100.00%

Table 4 – Standard and Poor's Ratings

Long Term Rating	Short Term Rating	Deposits Totals	Percentage of Total Deposits
AAA		£149.100m	65.54%
AA	A-1+	£14.100m	6.20%
A+	A-1	£64.276m	28.26%
Total		£227.476m	100.00%

- 5.5. The tables show that 65.54% of deposits were made with AAA rated counterparties (UK Government DMO account and other local authorities). All deposits were in line with approved lending limits and credit rating criteria.
- 5.6. The counterparty at the foot of Table 2 with Individual rating D/E is the Royal Bank of Scotland. The rating was upgraded on 18 December 2009 from E, reflecting the need at the time for UK Government assistance, to D/E. 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 again upgraded, moving to C/D from D/E.

- 5.7. The counterparty in Table 2 with the individual rating of B is Santander UK plc, a wholly owned subsidiary of the Spanish bank Banco Santander. On 1 June 2010 Fitch Ratings downgraded the sovereign rating of the Kingdom of Spain from AAA to AA+. Advice received at the time was that, although this did not raise concerns about the creditworthiness of Santander UK plc, it would be prudent to limit new deposits to no more than one month.
- 5.8. It was decided that, until the full impact of the downgrading of Spain's sovereign rating could be fully assessed, Santander UK plc would be temporarily suspended from the Council's counterparty list.
- 5.9. The graph at Appendix 3 shows the duration of deposits made from 1 April 2010 to 30 June 2010. The graph shows that, since 1 April 2010, all deposits have been made for 19 days or less. This is to ensure that liquidity requirements are met and that cash is available to fund expected payments.
- 5.10. Deposits with Royal Bank of Scotland and Bank of Scotland are in instant access call accounts, each with a limit of £10m. As both these accounts pay the highest interest rate available, we endeavour to ensure that the use of these accounts is maximised in the first instance, where possible.

6. Market Performance

- 6.1. The UK Base Rate remains at the historically low level of 0.5% and the Bank of England Asset Purchase Programme (commonly referred to as its policy of quantitative easing) remains at £200bn.
- 6.2. The Council's Treasury Management Advisers predict no change in the UK base rate until the final quarter of 2010.
- 6.3. Interest rates for the rest of 2010 are, therefore, expected to remain at a relatively low rate compared to previous years.

7. Projected Cash Flow

- 7.1. The Council's cash flow reflects the day to day cash position experienced. The daily cash position is dependent on income received and expenditure made on any given day.
- 7.2. Projected cash flow for the quarter 1 July 2010 to 30 September 2010 is detailed graphically in Appendix 4 to this report. The graph shows the daily cash position moving between positive and negative balances.
- 7.3. The cumulative cash flow line shows that a decrease of £52.974m in cash balances is expected over the three month period. This reflects the Council spending more money than we receive in income, however, it should be noted that the expenditure includes capital spend which requires to be funded through borrowing.

The cash flow projection does not include any funds that may be borrowed in the future.

- 7.4. Between 1 April 2010 and 30 June 2010, the Council borrowed £42.000m from the Public Works Loans Board (PWLB) to fund capital expenditure. At 30 June 2010, the majority of the borrowing required for the Council's 2009/10 and 2010/11 capital programmes has still to be taken. The actual spend has been met from the Council's Loans Fund which has used the cash balances held from earmarked Reserves.
- 7.5. When considering the best time to borrow, the Council will continue to ensure that the borrowing rates we receive are attractive, whilst avoiding holding cash balances for an unnecessary period of time attracting poor interest returns. Any borrowing will affect the cash flow position and increase the level of deposits we have.

8. Next Quarter Investment plans

- 8.1. It is proposed that the current investment framework is continued in the next quarter. Deposits will continue to be placed with the institutions where their ratings are consistent with the Council's approved criteria and their access to the UK Government's Credit Guarantee Scheme is continued. Deposits will also continue to be placed with the DMO and UK local authorities.
- 8.2. Until the remaining borrowing requirement is taken, deposit levels will remain low.
- 8.3. We will continue to work with our Treasury Advisers, Arlingclose, to ensure we gain all information available on counterparties before any deposits are made.
- 8.4. As mentioned at 3.3. investment regulations now allow for a wider range of investments tools to be used. Over the next quarter, assessments of the suitability of new investment opportunities will be evaluated, however, given the low levels of cash held, it is unlikely that new investment types will be extensively used.

9. Employee Implications

- 9.1. There are no employee implications.

10. Financial Implications

- 10.1. The current rate of interest payable is very low in comparison to previous years. This is a direct result of the adherence of the Bank of England to a historically low base rate for the past four quarters.
- 10.2. Deposit interest received offsets Loan Charges made to the Council's Revenue budget. Currently, no account of deposit interest is factored into the Council's budget and therefore the low level of interest received will have no impact on existing budgets.

11. Other Implications

- 11.1. There are no other implications.

12. Risk Assessment

- 12.1. Section 5 of this report provides details of how investment risk is managed.

13. Equality Impact Assessment and Consultation Arrangements

- 13.1. This report does not introduce a new policy, function or strategy or recommend a change to an existing policy, function or strategy and, therefore, no impact assessment is required.

13.2. There is no requirement to undertake any consultation in terms of the information contained in this report.

Linda Hardie
Executive Director (Finance and Information Technology Resources)

4 August 2010

Link(s) to Council Values and Objectives

- ◆ Value: Accountable, Effective and Efficient

Previous References

- ◆ Finance and Information Technology 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 Criteria
(as agreed in the Annual Investment Strategy 2010/11)**

The permitted investments that South Lanarkshire Council have identified for the financial year 2010/11 are listed below:

- ◆ Deposits with the Debt Management Account Deposit Facility
- ◆ Deposits with UK Local Authorities
- ◆ Deposits with Banks and Building Societies
- ◆ Certificates of Deposit with Banks and Building Societies
- ◆ UK Government Gilts and Treasury Bills
- ◆ AAA Rated Bonds Issued by Multilateral Development Banks
- ◆ AAA Rated Money Market Funds
- ◆ Loans to Third Parties

Inclusion as a permitted investment simply allows the Council to use that investment if considered to be appropriate. It is not necessarily the case that all permitted investments will be used.

Criteria for Deposits with the Debt Management Account Deposit Facility

Deposits with the Debt Management Office Account Deposit facility provided by HM Treasury will be continued. This facility offers the highest security for investments and deposits will be subject to a maximum period of six months which is the maximum time allowed by the DMO and a maximum deposit size of £80m.

Criteria for Deposits with UK Local Authorities

Deposits with UK local authorities, joint boards and passenger transport executives will be permitted subject to a maximum period of three years and a maximum deposit size of £15m for up to 364 days and £10m beyond this.

Criteria for Deposits and Certificates of Deposit with Banks and Building Societies

The following minimum thresholds will be applied to 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

- In addition to the primary ratings detailed above, consideration will also be 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 will require 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).
- Prior to depositing funds with any bank or building society, additional indicators of creditworthiness (such as credit default swaps, GDP; net debt as a percentage of GDP, potential sovereign and parental support, share price) will also be considered.

- Banks on negative rating watch will be heavily scrutinised before any deposit is made with that institution.
- Currently, in response to the banking crisis, all deposits are with UK institutions. Foreign banks would only be considered if they meet our strict criteria, and are recommended by our advisors. Any one foreign country would carry a limit of £10m deposits.
- In the event that two or more organisations in the same group meet the criteria detailed in 5.5. then a group limit of £10m will be applied.
- Deposits with banks or building societies will be restricted to 364 days.
- There is operational difficulty for managing deposits during the current period of uncertainty in the banking sector. Ideally, deposits would be placed for longer to secure better returns, however, uncertainty over counterparty creditworthiness suggests shorter dated deposits would provide better security. The Executive Director, Finance and IT Resources will restrict the term of deposits as appropriate.
- The Counterparty policy sets out a sound approach to depositing cash in normal market circumstances. Whilst this policy still stands, under exceptional current market circumstances the Executive Director, Finance and IT Resources will temporarily restrict deposits to those counterparties considered of higher credit quality than the minimum criteria set out in the policy.
- Examples of these restrictions would be greater use of strongly rated institutions offered support by the UK Government through the Credit Guarantee Scheme or increased use of the DMO account.

Fitch Credit Rating Definitions

Fitch provides a rating for four individual aspects of an organisation. Within each rating, different grades are applied to reflect the strength of the organisation.

- Short term rating – focuses on the liquidity to meet financial commitments (within a 12 month timetable)
- Long term rating – has a time horizon greater than 12 months and measures the capacity to meet financial commitments
- Individual rating – assess how a bank would be viewed if it were entirely independent and could not rely on external support
- Support rating – assess the likelihood of the bank receiving financial support in the event of difficulties.

Fitch Short Term Ratings

F1: Highest short-term credit quality.

Indicates the strongest intrinsic capacity for timely payment of financial commitments; may have an added “+” to denote any exceptionally strong credit feature.

F2: Good short-term credit quality.

Good intrinsic capacity for timely payment of financial commitments.

F3: Fair short-term credit quality.

The intrinsic capacity for timely payment of financial commitments is adequate.

Fitch Long Term Ratings

AAA: Highest credit quality.

‘AAA’ ratings denote the lowest expectation of default risk. They are assigned only in cases of exceptionally strong capacity for payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.

AA: Very high credit quality.

‘AA’ ratings denote expectations of very low default risk. They indicate very strong capacity for payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.

A: High credit quality.

‘A’ ratings denote expectations of low default risk. The capacity for payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to adverse business or economic conditions than is the case for higher ratings.

BBB: Good credit quality.

‘BBB’ ratings indicate that expectations of default risk are currently low. The capacity for payment of financial commitments is considered adequate but adverse business or economic conditions are more likely to impair this capacity.

Fitch Individual Ratings

A: A very strong bank. Characteristics may include outstanding profitability and balance sheet integrity, franchise, management, operating environment or prospects.

B: A strong bank. There are no major concerns regarding the bank. Characteristics may include strong profitability and balance sheet integrity, franchise, management, operating environment or prospects.

C: An adequate bank, which, however, possesses one or more troublesome aspects. There may be some concerns regarding its profitability and balance sheet integrity, franchise, management, operating environment or prospects.

D: A bank that has weaknesses of internal and/or external origin. There are concerns regarding its profitability and balance sheet integrity, franchise, management, operating environment or prospects. Banks in emerging markets are necessarily faced with a greater number of potential deficiencies of external origin.

E: A bank with very serious problems, which either requires or is likely to require external support.

F: A bank that has either defaulted or, in Fitch Ratings' opinion, would have defaulted if it had not received external support. Examples of such support include state or local government support, (deposit) insurance funds, acquisition by some other corporate entity or an injection of new funds from its shareholders or equivalent.

Fitch Support Ratings

1: A bank for which there is an extremely high probability of external support. The potential provider of support is very highly rated in its own right and has a very high propensity to support the bank in question.

2: A bank for which there is a high probability of external support. The potential provider of support is highly rated in its own right and has a high propensity to provide support to the bank in question.

3: A bank for which there is a moderate probability of support because of uncertainties about the ability or propensity of the potential provider of support to do so.

4: A bank for which there is a limited probability of support because of significant uncertainties about the ability or propensity of any possible provider of support to do so.

5: A bank for which external support, although possible, cannot be relied upon. This may be due to a lack of propensity to provide support or to very weak financial ability to do so.

Moody's Credit Rating Definitions

Moody's provide a rating for two aspects of an organisation. Within each rating, different grades are applied to reflect the strength of the organisation.

- Moody's long-term ratings are opinions of the relative credit risk of financial obligations with an original maturity of one year or more. They address the possibility that a financial obligation will not be honoured as promised.
- Moody's short-term ratings are opinions of the ability of issuers to honour short-term financial obligations not exceeding thirteen months, unless explicitly noted.

Moody's Long Term Ratings

- Aaa Obligations rated Aaa are judged to be of the highest quality, with minimal credit risk.
- Aa Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.
- A Obligations rated A are considered upper-medium grade and are subject to low credit risk.
- Baa Obligations rated Baa are subject to moderate credit risk. They are considered medium grade and as such may possess certain speculative characteristics.
- Ba Obligations rated Ba are judged to have speculative elements and are subject to substantial credit risk.
- B Obligations rated B are considered speculative and are subject to high credit risk.
- Caa Obligations rated Caa are judged to be of poor standing and are subject to very high credit risk.
- Ca Obligations rated Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest.
- C Obligations rated C are the lowest rated class and are typically in default, with little prospect for recovery of principal or interest.

Moody's Short Term Ratings

- P-1 Issuers rated Prime-1 have a superior ability to repay short-term debt obligations.
- P-2 Issuers rated Prime-2 have a strong ability to repay short-term debt obligations.
- P-3 Issuers rated Prime-3 have an acceptable ability to repay short-term obligations.

Standard & Poor's Credit Rating Definitions

Standard and Poor's Credit Ratings reflect their view of the obligor's capacity and willingness to meet its financial commitments as they come due, whether this be in the long term or short term

Standard & Poor's Long Term Ratings

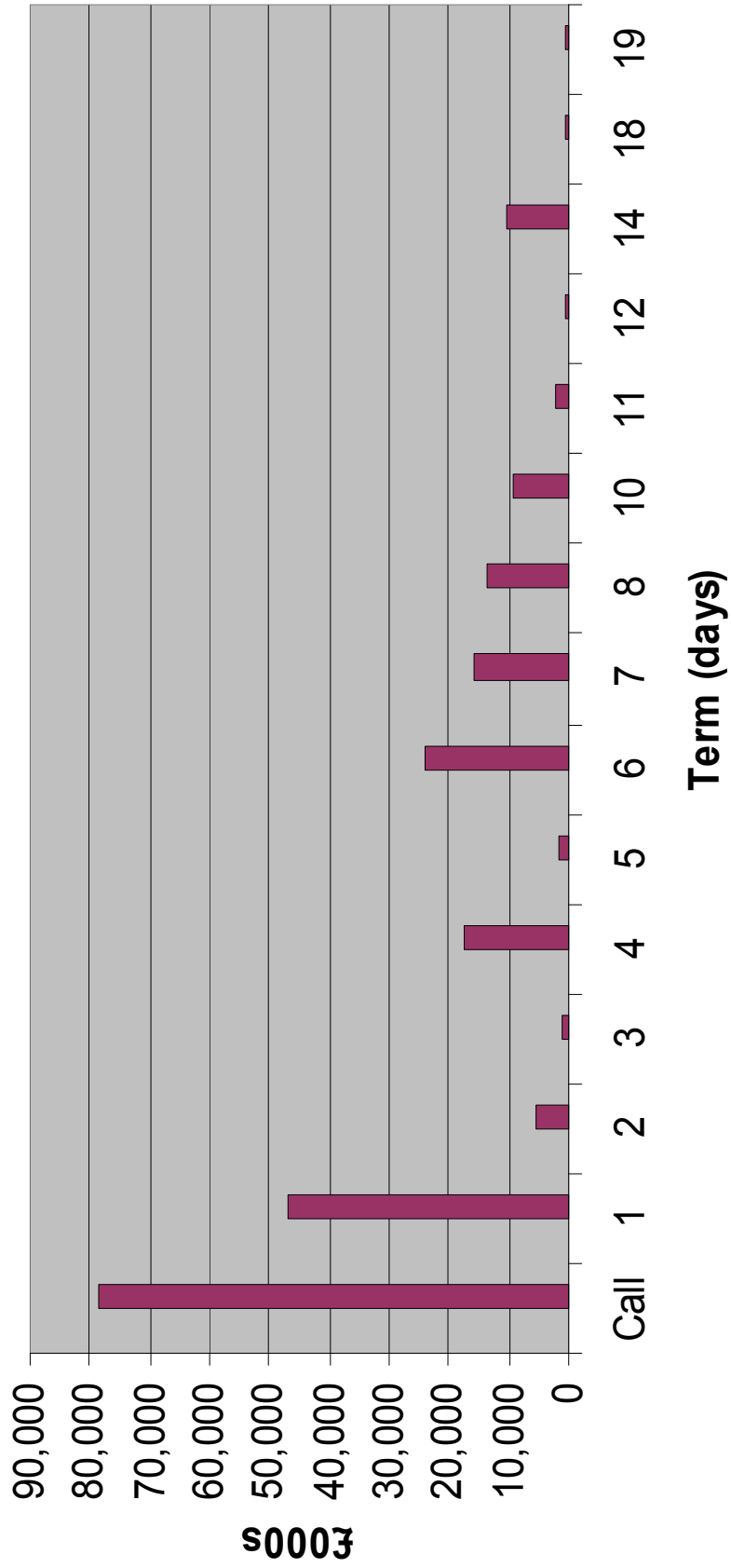
- AAA Extremely strong capacity to meet financial commitments.
 - AA Very strong capacity to meet financial commitments.
 - A Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances.
 - BBB Adequate capacity to meet financial commitments, but more subject to adverse economic conditions.
 - BB Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions.
 - B More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments.
 - CCC Currently vulnerable and dependent on favourable business, financial and economic conditions to meet financial commitments.
 - CC Currently highly vulnerable.
 - C Currently highly vulnerable obligations and other defined circumstances.
 - D Payment default on financial commitments.
- Note Ratings from 'AA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

Standard & Poor's Short Term Ratings

- A-1 A short-term obligation rated 'A-1' is rated in the highest category by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is strong. Within this category, certain obligations are designated with a plus sign (+). This indicates that the obligor's capacity to meet its financial commitment on these obligations is extremely strong.
- A-2 A short-term obligation rated 'A-2' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher rating categories. However, the obligor's capacity to meet its financial commitment on the obligation is satisfactory.
- A-3 A short-term obligation rated 'A-3' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.

- B A short-term obligation rated 'B' is regarded as having significant speculative characteristics. The obligor currently has the capacity to meet its financial commitment on the obligation; however, it faces major ongoing uncertainties which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.
- B-1 A short-term obligation rated 'B-1' is regarded as having significant speculative characteristics, but the obligor has a relatively stronger capacity to meet its financial commitments over the short-term compared to other speculative-grade obligors.
- B-2 A short-term obligation rated 'B-2' is regarded as having significant speculative characteristics, and the obligor has an average speculative-grade capacity to meet its financial commitments over the short-term compared to other speculative-grade obligors.
- B-3 A short-term obligation rated 'B-3' is regarded as having significant speculative characteristics, and the obligor has a relatively weaker capacity to meet its financial commitments over the short-term compared to other speculative-grade obligors.
- C A short-term obligation rated 'C' is currently vulnerable to nonpayment and is dependent upon favourable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation.
- D A short-term obligation rated 'D' is in payment default.

South Lanarkshire Council - Maturity of Deposits Placed 1/04/2010 to 30/06/2010



South Lanarkshire Council Projected Cash Flow 01/07/10 - 30-09/10

