REPORT TO:	Executive Board Sub-Committee
DATE:	24th January 2008
REPORTING OFFICER:	Operational Director – Financial Services
SUBJECT:	Review of Treasury Management Policy Statement (Institutions Approved for Investment)
WARD(S):	Borough-wide

1.0 PURPOSE OF REPORT

1.1 The Authority operates a Treasury Management Policy in accordance with the recommendation of the Chartered Institute of Public Finance and Accountancy's Code of Practice.

1.2 One element of the policy deals with the Council's policy on lending.

1.3 This area was last subject to review in January 2006.

2.0 RECOMMENDED: That the list of institutions shown at Appendix C be accepted.

3.0 SUPPORTING INFORMATION

3.1 The Authority has always had a clear policy of lending at minimum risk to its capital, and as such has operated its lending function within a specific list of borrowers each with individual limits, which specify the maximum amount to be lent to each counterparty linked to the period of the investment. The current list is attached at Appendix A.

The list is reviewed every two years or so, to pick up changing circumstances such as the size of the council's investment portfolio, new financial instruments, changes in the financial climate, mergers and takeovers within the approved list etc.

3.2 Overview

At the time of the last review the council was investing a sum of around £30m. The current level is around £50m, but with a negative cash flow anticipated before the year-end, which will reduce this figure to an estimated level of around £35 to £40m for the financial year 2008/9.

The current counterparty lending limits are therefore set a little on the low side, resulting in deals being split into smaller sizes and with multiple counterparties so as to keep within the individual counterparty limits. Generally speaking there is nothing wrong with this as it means that the authority is spreading its risk. The downside however is it means that you cannot always secure the best rates available in the market. This is the price of achieving the extra level of security, and this should be borne in mind when looking at the comparative performance indicators at the year end.

The Council's requirements from the market, the counterparties that are interested in dealing with local authorities and the instruments that can be used are constantly changing. These are the main factors influencing this review of the counterparty lending list. The different types of organisations and the present economic climate are briefly discussed in the following paragraphs.

3.3 Flight to Quality

The last few months has seen a significant change in the relationship between counterparties who use the inter bank market. The collapse of the sub prime debt market in America has had knock on effects throughout the banking sector as each organisation has examined its own exposure to the debt and has been forced to make significant charges in their accounts.

This has led to banks being extra careful about who they are prepared to lend to in the short term and this flight to quality led to the situation which caught out Northern Rock. The mortgage bank, who although not directly involved in the sub prime problem suddenly found that it could not borrow from it's usual sources in the autumn, was forced to go to the Bank of England to refinance it's maturing loans. This situation was compounded by the withdrawal of deposits by investors who were unsure of the long term future of the bank and decided to move their cash elsewhere.

In mid November it looked as if the situation was beginning to sort itself out, and that the action taken by the Federal Bank of America and the European Central Bank in pumping extra cash into a tight market was working. However the 31st December is an important time of the year for a lot of banks and building societies as they present their annual financial statements, and with liquidity high on the agenda, cash has been in short supply again. This pushed short rates nearly 1% above the base rate; putting the market back to the situation it was in when the sub prime issues first broke.

The Monetary Policy Committee decision to cut rates by a quarter percent has had little effect so far, and the market remains nervous about further disclosures and credit quality issues. The stage managed intervention of the Federal Bank, the European Bank and the Bank of England in mid December to pump extra liquidity into the money market was initially welcomed but then questioned as to its motives and relatively small size. It does seem to have to have been successful in calming the market.

However many economists think that the worst of the situation may well be to come as more detail emerges about the scale of the exposure to the losses in the American mortgage market. Notable triple 'A' rated names such as UBS, Citibank & Morgan Stanley have needed to raise massive sums by way of extra equity from sovereign wealth funds. It is easy to see why interbank lending has dried up as the major banks do not feel comfortable with lending to each other.

3.4 The Role of the Rating Agencies

One traditional measure of organisations creditworthiness has been its credit rating. Independent organisations like Moody's and Fitch examine statements of account and issue credit ratings as appropriate. In theory this allows cross sector comparisons to be made without detailed knowledge of individual organisations. However, these ratings have been criticised of late as being too backward looking and slow to react to changing circumstances.

Our own selection of counterparties refers to credit ratings as and when they are available. However they should not be taken as an absolute guide to counterparty's current creditworthiness. An explanation of and guide to the Fitch credit ratings is attached at Appendix B.

3.3 Building Society Sector

There has been little change in the sector. Due to the continued high percentage increases in house prices the balance sheet size of the individual societies has increased across the board and this has resulted in several societies moving into higher brackets within our table, and one new society being added to the lowest tier. Those changing or coming in are marked with an asterisk.

Overall the sector continues to shrink as societies merge to form larger, more effective trading units. This does continue to have the effect of diluting the degree of mutuality previously held by this sector. Some societies are still not credit rated. However, with their strong asset base most people feel that they are a relatively safe investment.

The lending of smaller sums to the smaller societies seems an appropriate level of control for this sector. Consideration could be given to having the cut off set at say £2bn or £3bn to eliminate the very smallest societies but it is by no means certain that this would give significantly higher levels of security in this sector. The elimination of the smallest societies would also result in more cash being lent to the larger organisations and the risk which that entails.

3.4 Bank Sector

Banks operate in high-risk areas by lending money to organisations that can and do default; as such they are subject to capital losses, particularly in times of recession. Since the last review some banks have seen their credit ratings downgraded. The flight to quality issue mentioned above has hit this sector hard in the past few months.

'British Banks'

Although there is no such thing as a ' British owned' bank anymore, this group covers the traditional group of household names associated with the British banking sector, previously known as the clearing banks.

Some of these banks, despite being household names, do not have particularly good credit ratings. Since the last review the Bristol & West Plc has changed its trading name to that of its parent company the Bank of Ireland (reported to Exec Board sub meeting 19th July 2007) and they have been retained on the list.

A particular problem with this sector is their appetite for cash. Most of these banks transact at a much larger level (£10m to £50m) than is normal for a local authority, which by and large tends to deal in smaller sizes (£0.5m to £5.0m at Halton) and for shorter periods.

Halton's size and type of transaction does not interest them normally due to its high maintenance level (i.e. regular turnover) but of late with the short supply of cash in the market they are actively approaching authorities to see if deals can be done. This interest however is likely to be a short lived and the ability of this sector to provide full coverage for our money is doubtful. Although they will always give a quote for any money on offer, quite often the rate is poor and it is very much a take it or leave it situation.

With this in mind, the council's treasury advisor Sector has provided a list of banks, which can be considered for addition to our list. Their rating list is towards the top end of the market and as such make perfect sense to add to our list, however the downside is that they are the group of banks mentioned above, who do not transact in small denominations for short periods and as such would not help to provide a suitable counterparty as quite often they would not be interested in taking the council's money.

Several other banks have been looked at or have approached the council with a view to being placed on the counterparty list and they have been listed along with their current credit rating as potential new counterparties.

‘Foreign Banks’

The Authority has never included any foreign owned bank on its lending list. It is an area, which many other authorities have used and are comfortable with. Most of the banks from Sector’s additional list fall into this category and carry very good credit ratings. Following discussions with the money brokers who facilitate the market each day only two banks from the list deal on a regular basis with local authorities. They are marked as potential additions to the list.

Limits

Due to the risk associated within the banking sector the banks have been divided into two groups, with the total limit per bank for the higher credit rated banks being set at £10m whilst the total limit for the banks in the lower group has been set at £7.5m.

3.5 Local Authorities

No changes proposed. Leave as lend to any other Authority.

3.6 Central Government – Debt Management Account Deposit Facility (DMADF)

The Government, through the Bank of England, has always offered a short term lending service to the money market to help with liquidity. It now also offers a borrowing service. The service started in April 2002. Halton registered its interest and was accepted, and members agreed to the fund being added to its lending list. They provide on a daily basis indicative interest rates on which they are looking to borrow. Unfortunately the rates are not particularly attractive and we have never dealt with them. However they are retained on the list as a solid placing for funds in a falling market.

3.7 Private Sector – Money Market Funds (MMF)

At the last review MM funds were considered but members decided not to add them to our counterparty list. The ability to invest in these instruments followed a relaxation of the regulations controlling Local Authority investments. They are commercially run pooled investments.

It is a requirement that the fund is ‘AAA’ rated before an Authority can use it.

They have been in existence for around seven years and are quite diverse in their size and sector coverage. They operate by pooling cash and lending it to a range of companies who themselves are considered a good credit risk. Their structure is designed to minimise risk and the size of the pooled sums allows instant access to your cash without destabilising the fund. The security of size in the market place tends to smooth out variations (spikes) in interest rates as the cash can be placed in a variety of maturity dates. They are actively managed by money market professionals and usually offer good rates in falling market conditions.

The best funds are 'AAA' credit rated.

There was a steady flow of cash from local authorities into these funds over the years but still a fairly significant resistance to them despite fairly intense lobbying by the fund managers.

Halton has been approached by a variety of funds that were keen for the Council to invest its surplus funds on a temporary basis.

The main advantages offered by this type of fund are that of security by virtue of size and ease of access. Halton's cash would be added into the pool and an average rate of return is paid to all members on that day. The investment is not with the lead name (fund manager), but with a whole range of other organisations using a variety of financial instruments.

The Authority has monitored with the aid of Sector (our Treasury Management Advisors) a selection of these funds over the past two years. A list of the funds, which have approached the Council, is shown below (they are all 'AAA' rated);

ABN AMRO Global Liquidity Funds Plc-Sterling Fund
BGI Sterling Liquidity First Fund
HSBC Global Liquid Funds Plc-Sterling Liquidity Fund
JP Morgan Fleming Liquidity Funds-Sterling Liquidity Fund
Royal Bank of Scotland International Money Market Funds Limited-Sterling Class Fund
Standard Life Investments (Global Liquidity Fund) Plc-Sterling Sub Fund
Scottish Widows Investment Partnership- Global Liquidity Fund

There are a significant number of other funds in the market place.

The return offered by this type of fund can be very competitive especially in a falling market. However the Council itself has a good track record of returning a higher than average yield on it's investments and bearing in mind all the funds concerned charge management fees it is felt that it is unlikely that the funds would offer added value.

3.8 The proposed new lendlist for approval is attached as Appendix C

4.0 POLICY IMPLICATIONS

4.1 None.

5.0 OTHER IMPLICATIONS

5.1 None.

6.0 IMPLICATIONS FOR THE COUNCIL'S PRIORITIES

6.1 Children and Young People in Halton

There are no direct implications on the Council's priorities. However, the treasury management function ensures that cash is available to fund all the Council's activities.

6.2 Employment, Learning and Skills in Halton

There are no direct implications on the Council's priorities. However, the treasury management function ensures that cash is available to fund all the Council's activities.

6.3 A Healthy Halton

There are no direct implications on the Council's priorities. However, the treasury management function ensures that cash is available to fund all the Council's activities.

6.4 A Safer Halton

There are no direct implications on the Council's priorities. However, the treasury management function ensures that cash is available to fund all the Council's activities.

6.5 Halton's Urban Renewal

There are no direct implications on the Council's priorities. However, the treasury management function ensures that cash is available to fund all the Council's activities.

7.0 RISK ANALYSIS

7.1 None.

8.0 LIST OF BACKGROUND PAPERS UNDER SECTION 100D OF THE LOCAL GOVERNMENT ACT 1972

Document	Place of Inspection	Contact Officer
Sector's advice	1st Floor, Municipal Building	J. Viggers