Agenda Item No. 13

SUSSEX POLICE AUTHORITY – 15 DECEMBER 2011

TREASURY MANAGEMENT MID-YEAR REPORT 2011-12

REPORT BY THE TREASURER

Purpose of the Report

1.1 The Police Authority is required by the Chartered Institute of Public Finance and Accountancy (CIPFA) to receive as a minimum each year:

- An annual strategy statement for the forthcoming year
- A mid-year review
- An annual report at year end

1.2 In addition effective governance is maintained through the submission of regular compliance reports to the Governance Committee.

1.3 In accordance with CIPFA's Treasury Management Code of Practice the Mid-Year Report (2011-12) reviewing treasury compliance and activity to the end of October is attached at Appendix 1.

Background

2.1 The Authority's treasury activities expose it to a variety of financial risks, the key risks are:

- **Credit Risk**: The possibility that other parties might fail to pay amounts due to the Authority;
- **Liquidity Risk**: The possibility that the Authority might not have funds available to meet its commitments to make payments;
- **Re-financing Risk**: The possibility that the Authority might be requiring to renew a financial instrument on maturity at disadvantageous interest rates or terms;
- **Market Risk**: The possibility that financial loss might arise for the Authority as a result of changes in such measures as interest rates movements.

2.2 The Authority's overall risk management procedures focus on the unpredictability of financial markets, and implementing restrictions to minimise these risks. The procedures for risk management are set out through a legal framework set out in the Local Government Act 2003 and the associated regulations (including CIPFA Codes of Practice).

2.3 The Authority has complied with all of the relevant statutory and regulatory requirements, which require the Authority to identify and where possible quantify the levels of risk associated with its treasury management activities.

2.4 Financial risks are minimised through the annual Treasury Management Strategy, which incorporates the Prudential Indicators, and was approved for 2011-12 by the Authority in February 2011.

2.5 Security of capital remains the Authority's main investment objective. This is maintained by following the Authority's counterparty policy as set out in its Treasury Management Strategy Statement for 2011-12 and subsequent amendments as approved by the Treasurer.

2.6 As reported to the Department for Communities and Local Government (CLG) on the 'Monthly Borrowing and Lending' return, at 30 September 2011 the Authority's Public Works Loans Board (PWLB) debt remained at £4.5m (£4.5m at 31 March 2011) and its investments totalled £79.3m (£67.4m).

Recommended - That the Treasury Management Mid-Year Report 2011-12, set out at the Appendix 1, be approved.

RICHARD HORNBY
Treasurer

Contact: John Eagles
Telephone: 01243 777292
E-mail: john.eagles@westsussex.gov.uk

Treasury Management Mid-Year Report (2011/12)

Introduction

1 Treasury management is defined as: "The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2 The Treasury Management Strategy for 2011/12 has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

3 The Code of Practice recommends that members be informed of Treasury Management activities at least twice a year. This mid-year report therefore ensures the Authority is embracing Best Practice in accordance with CIPFA's recommendations.

Compliance

4 The Authority has complied with all of the relevant statutory and regulatory requirements, which require the Authority to identify and where possible quantify the levels of risk associated with its treasury management activities.

5 The Authority also confirms that it has complied with its Prudential Indicators for 2011/12, which were set in February 2011 as part of the Authority's Treasury Management Strategy Statement. Details can be found in **Appendix 2**.

6 The Treasurer confirms that there were no breaches of the Authority's approved Treasury Management Strategy during the period 1 April to 30 September 2011.

7 Counterparty credit quality is assessed and monitored with reference to: Credit Ratings (the Authority's minimum long-term counterparty rating of A+ across rating agencies Fitch, S&P and Moody's); credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; sovereign support mechanisms; potential support from a well-resourced parent institution; share price.

8 Review of approved counterparties was facilitated by:

- The submission of regular statements of the disposition of deposits to the Chairman of the Police Authority and the Treasurer
- Weekly update meetings with the Treasurer and treasury management officers

Appendix 1

Economic Background

9 The Police Authority approved the 2011/12 Treasury Management Strategy Statement, including the Annual Investment Strategy, in February 2011. The assumption at this time that market indicators suggested a return to more normalised conditions underpinned the approved counterparties and maximum investment periods as set out within the strategy. However since April the Authority has considered it necessary to reassess its current policies in light of the threat of a new banking crisis and the escalating Eurozone crisis.

10 UK growth prospects deteriorated considerably over the six months to September whilst inflation remained stubbornly high. Annual UK CPI for September was 5.2%, remaining above the Bank of England's 3% upper limit for 21 consecutive months. Weakness persisted in the UK labour and housing markets leaving consumer confidence fragile and decreasing the likelihood of a consumer driven recovery.

11 The disappointing growth outlook rather than the upward trend in inflation drove the Bank of England's central policies. The August Inflation Report downgraded the growth forecast whilst acknowledging energy price rises would push CPI to 5%, before falling back to the 2% target over the medium-term. The economic uncertainty resulted in analysts postponing the likelihood of an increase in the UK Bank Rate until late 2012 at the earliest.

	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14
Official Bank Rate													
Upside risk					0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.50	1.75
Central case	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk													

Counterparty Update

1 April to 30 September:

12 The European sovereign debt crisis deepened; the agreement in July to address Greece's fiscal problems and broaden the mandate for the European Financial Stability Facility (EFSF) only bought time for the Eurozone as market pressure increased on Italy and Spain, but did little to address the issue of overburdened sovereign balance sheets.

13 The lack of real progress in resolving the European sovereign debt crisis began to affect even the stronger Eurozone nations and their banking systems. Market volatility spiked sharply in August and banks' share prices fell sharply.

14 The Authority responded to the growing stress by scaling back maturities for new investments. Limits for UK banks, Nationwide BS and Australian, Canadian and US banks were temporarily reduced to 6 months (Santander UK plc restricted to overnight deposits only).

15 Formal limits, as set out in the treasury strategy, for European banks were temporarily reduced to 1 month (French banks suspended). In practice however no approval was given by the Treasurer to place deposits in non-UK institutions.

16 28 September: Clydesdale Bank was formally removed from the Authority's lending list following the bank's downgrade by Moody's, falling below the Authority's minimum criteria of A+ or equivalent as approved in the 2011/12 Treasury Strategy.

October 2011:

17 7 October: Moody's credit rating agency concluded its six month review of UK financial institutions, assessing the appropriate level of systemic support assigned in the credit ratings for the banks and building societies included within the review.

18 The review concluded with downgrades to the long-term credit ratings of twelve UK financial institutions, given the agency's assessment of a decrease in the probability that the UK Government would provide future support to these institutions. Moody's state that the downgrades do not represent deterioration in the systemic financial strength of the UK Government or the banking system, but means it is more likely that smaller institutions will be allowed to fail if they fall into financial difficulty.

19 13 October: Fitch credit rating agency followed the Moody's announcement by downgrading the long-term credit ratings for Lloyds and RBS banking groups, given the agency's view of a decrease in the likelihood of UK Government support.

20 The downgrades position UK financial institutions into three groups:

- Banks with a very high likelihood of government support (*Barclays, HSBC, Lloyds, and RBS*)
- Institutions with a moderate or high likelihood of support (*Clydesdale, Co-op, Nationwide and Santander UK plc*)
- Institutions with a low or no likelihood of support (*Other Building Societies*)

21 An internal review of credit indicators (including credit default swap prices), together with advice received from West Sussex County Council's advisors (Arlingclose), highlighted strong parallels between market indicators evident towards the end of September 2011 with those evident in 2008 in the build up to the first banking crisis.

22 Whilst there is no evidence to suggest that the UK Banks the Authority holds deposits with are likely to fail, or the risks of default are any higher following the rating downgrades, near term shocks in the overall banking sector can not be completely ruled out.

23 As a result of the rating downgrades and internal review Lloyds, Nationwide and Natwest (part of RBS Group) fall below the minimum rating criteria as approved in 2011/12 Treasury Strategy and are no longer considered suitable investment counterparties. Santander UK plc is rated equivalent to the approved minimum rating criteria and remains on negative rating watch, so requires explicit Treasurer Approval for all new deposits.

24 In accordance with the 2011/12 Treasury Strategy £10m held in a Natwest instant access call account was immediately recalled and repaid on Friday 7 October.

25 The large amounts withdrawn from Natwest nationally on this day raises questions over whether individual banks are in position to honour repayments at times of significant market stress, the very time at which a large withdrawal at short notice would be necessary. Under current market conditions the risks of placing money in bank call accounts are considered to outweigh the benefits.

Revised Treasury Management Strategy (October 2011)

26 With security of capital remaining the Authority's main investment objective, the Treasurer approved the following revision to the 2011/12 Treasury Strategy. All deposits held within traditional bank instant access accounts will be recalled and new investments will only be placed <u>overnight</u> with:

- AAA credit rated Stable Net Asset Value Sterling Money Market Funds
- UK Governments Debt Management Office (DMADF Account)

27 The Treasurer recommends the use of Sterling Liquidity Funds instead of individual bank call accounts, as such funds are set up to receive and repay large sums on any given day due to the diversified and liquid nature of the underlying fund assets, minimising the risk of money being recalled but not repaid.

28 The revised policy will be reviewed, in conjunction with advice received from Arlingclose, when formalising the 2012/13 Treasury Strategy.

Heritable Bank

29 The Authority had three deposits with Heritable Bank totalling £6.8m when Heritable was taken into administration in October 2008 following the failure of its Icelandic parent company, Landsbanki. An original claim of £6.844m was submitted to the administrators Ernst & Young in November 2008, which included interest accrued at the date of Heritable Bank entering administration (£43,828).

30 During July 2011 the administrator reported an increase in their estimated return to non-preferential unsecured creditors based upon the progress of the Administration to date and predicted future performance. Current projections now indicate a base rate of return to creditors of 86 to 90 pence in the pound (from 79 to 85 pence in the pound) and a stressed case return of 74 to 80 pence in the pound (from 63 to 73 pence in the pound).

31 Throughout the first half of 2011/12 the administrator declared two interim dividend payments totalling £0.7m to the Authority representing 10.31% of the total claim. The administrator declared a further dividend payment of £0.3m in October representing 4.18% of the claim.

32 At 31 October 2011 total repayments to the Authority amounted to £4.4m, representing 64.6% of the total claim. Payments received have been used to reduce the loan principal outstanding; interest adjustments if appropriate will be made when the final settlement total is known.

33 The administrator continues to report and declare quarterly dividend payments, the next payment due January 2012, the quantum remaining subject to the continual collection of funds through a run-off of Heritable's various loan books.

34 The position with regard to Heritable investments at 31 October 2011 is summarised below:

Heritable Bank	**£'000**
Original investment	6,800
Dividends (x3) received 2009/10 (34.98 pence in the £)	-2,394
Dividends (x3) received 2010/11 (15.13 pence in the £)	-1,035
7th dividend received 19 April 2011 (6.25 pence in the £)	-428
8th dividend received 15 July 2011 (4.06 pence in the £)	-278
9th dividend received 20 October 2011 (4.18 pence in the £)	-286
Balance to recover (excluding 2008/09 impairment)	**2,379**
20% loan impairment recognised in 2008/09 accounts	-1,360
Position at 31 October 2011	**1,019**

35 The Treasurer has been approached by a third party offering to buy out the outstanding Heritable debt at around 85 pence in the pound. This offer is below the administrator's estimated base return to creditors so the Treasurer does not recommend accepting the offer. Such third party interest however continues to show that the Authority should remain cautiously optimistic of achieving a final return in line with the administrator's forecasts.

Debt Management

36 In line with the Prudential Code the Authority continues to undertake long-term borrowing through the Public Works Loan Board (PWLB) to finance part of the capital programme. However no new loans have been arranged during 2011-12 as a consequence of slippage on the Authority's capital programme.

Appendix 1

37 The Authority's total long-term debt remains £4.5m at 30 September 2011. Interest payable to the Public Works Loan board amounts to £100,625 representing an average interest rate of 4.47%

38 None of the Authority's existing long-term debt has been repaid or rescheduled to date in 2011/12; this continues to be periodically reviewed in consultation with the Arlingclose Ltd.

39 No short-term borrowing was undertaken during the first half of 2011/12. All daily cash flow shortages were funded by withdrawals from the Authority's instant access Money Market Funds.

Investment Activity

40 The Guidance on Local Government Investments in England gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles.

41 During the first half of 2011/12 the Authority had an average amount invested of £82.4m

	2010/11		2011/12 (to 30 Sep)	
	£'m	%	£'m	%
UK Banks-Fixed Deposits	19.4	25.3	26.0	31.6
UK Banks-Call Accounts	25.0	32.5	15.6	19.0
UK Building Societies	9.7	12.7	10.0	12.1
Debt Management Office	4.5	5.8	-	-
Local Authority	14.4	18.7	6.5	7.8
Money Market Funds	-	-	21.4	26.0
Heritable Bank *(i)*	3.9	5.0	2.9	3.5
TOTAL	**76.9**	**100.0**	**82.4**	**100.0**

42 The movement in the Authority's investment portfolio by the credit ratings of the financial institution is shown below:

Deposits with financial institutions	2010/11	2011/12			
	31.03.11 £'m	30-Jun £'m	30-Sep £'m	28-Oct £'m	31-Mar £'m
AAA rated counterparties *(i)*	0.0	14.9	6.6	28.6	
AA rated counterparties *(ii)*	38.5	20.0	40.0	30.0	
A+ rated counterparties	25.5	30.0	30.0	0.0	
A rated counterparties	0.0	0.0	0.0	20.0	
Un-rated Building Societies	0.0	0.0	0.0	0.0	
Heritable Bank	3.4	3.0	2.7	2.4	
TOTAL	**67.4**	**67.9**	**79.3**	**81.0**	

(i) Includes UK Government-Debt Management Office, Money Market Funds

(ii) Includes Local Authorities, Police Authorities and Local Authority Pension Funds

43 The increase in the investment portfolio during 2011/12 is a consequence of the receipt of government grants and precepts from districts, in advance of 2011/12 capital and revenue expenditure.

44 The position at the end of October reflects treasury decisions made in light of the revised strategy implemented following the downgrades of UK Banks and Building Societies.

45 £29m invested with AAA rated counterparties includes deposits made across four separate Money Market Funds. The amount invested in Money Market Funds at 30 September 2011 was £7m; the £22m increase results from the reinvestment of funds following the withdrawal of deposits held within Natwest and Santander UK call accounts.

46 £30m invested with AA rated institutions includes three fixed-term deposits arranged with Barclays (£10m), HSBC (£10m) and Lancashire County Council (£10m). The AA rating assignment for other local authorities follows the rating announcements for both Lancashire County Council and Birmingham City Council (both AA+). The reduction in the amount invested in AA rated institutions from 30 September follows the withdrawal of £10m from Santander UK.

47 £20m invested in A rated institutions (below the minimum rating criteria as set out in the Authority's investment strategy) includes three fixed-term deposits arranged with Nationwide (£10m) and Lloyds (£10m). In accordance with the revised strategy these deposits will run until maturity

48 The maturity profile of the Authority investments is shown below:

Deposits with financial institutions	2010/11	2011/12			
	31.03.11 £'m	30-Jun £'m	30-Sep £'m	28-Oct £'m	31-Mar £'m
Instant Access Accounts	15.5	24.9	26.6	28.6	
Up to one month	23.5	20.0	0.0	0.0	
One month to 3 months	5.0	10.0	10.0	10.0	
3 months to 6 months	20.0	0.0	20.0	25.0	
6 months to 1 year	0.0	5.0	20.0	15.0	
Greater than 1 year	0.0	5.0	0.0	0.0	
Heritable Bank (*i*)	3.4	3.0	2.7	2.4	
TOTAL	**67.4**	**67.9**	**79.3**	**81.0**	

(i) Heritable deposits not shown in specific time periods as final repayments dates unknown

Investment Performance

49 The original estimate of investment income for 2011/12 was £0.6m, based on the assumption that the Authority could achieve an average interest rate of 0.75% on an assumed investment portfolio of £75m.

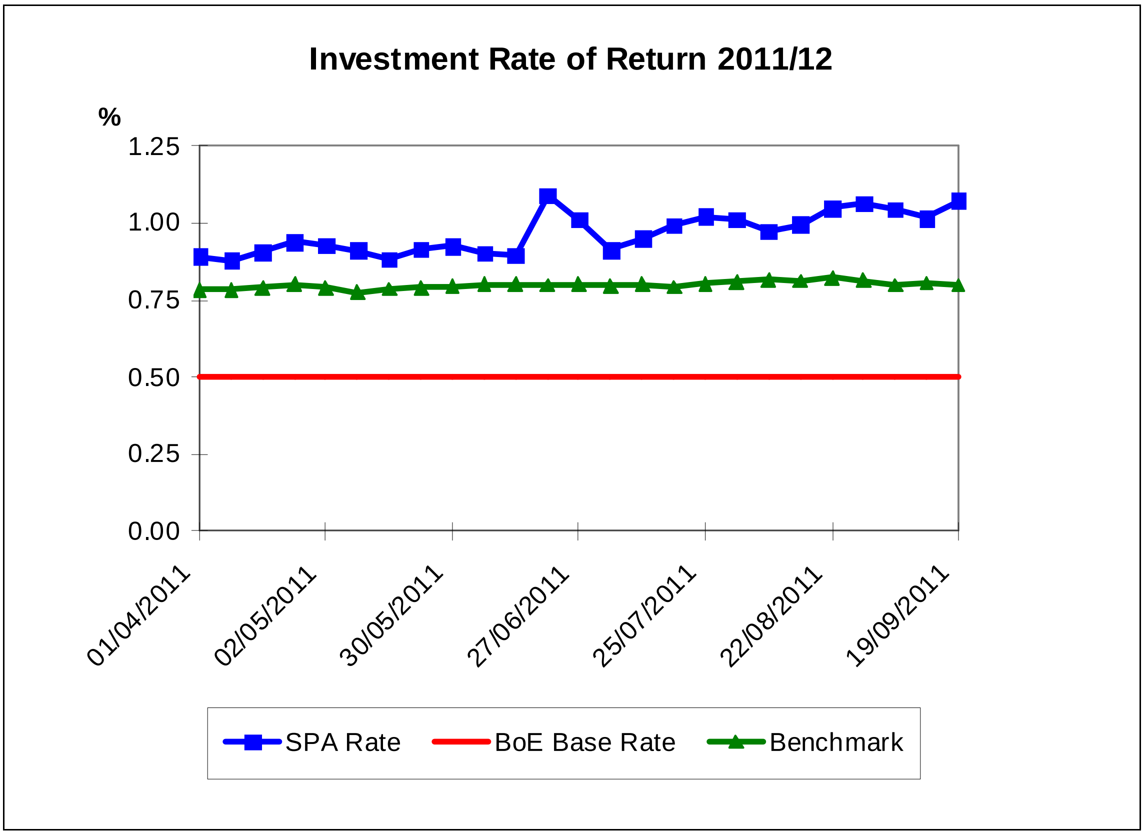
Appendix 1

50 The investment income budget as reported in the 2011/12 budget includes an estimated £0.1m transfer to the PFI reserve.

	£'000
Expected interest receipts on investment portfolio	562
Budgeted transfer to internal balances held	-94
Revenue Budget 2011/12 (Investment Income)	**468**

51 The Authority forecasts a £0.2m interest receipt surplus, a consequence of a higher actual rate of return and higher average investment portfolio size than assumed in the original budget.

52 The Authority's gross investment return as compared with the benchmark rate (gross yield of the Blackrock Sterling Liquidity Fund) and the Bank of England base rate is shown graphically below:



Treasury Management Prudential Indicators

1 The CIPFA Code of Practice requires that compliance with treasury management prudential indicators be reported within regular treasury reports. The purpose of these indicators are to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates.

2 The Authority approved the prudential indicators for 2011/12 in February 2011, as part of the Budget Report and the Treasury Management Strategy Statement

3 The Local Government Act 2003 requires the Authority to set an "Authorised Borrowing Limit" irrespective of their indebted status. This is a statutory limit, which should not be breached.

4 The Authority's Authorised Borrowing Limit, which includes notional borrowing for PFI schemes, was set at £41.8m for 2011/12.

5 The "Operational Borrowing Limit" is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst-case scenario without the additional headroom included within the Authorised Limit.

6 The Operational Borrowing Limit for 2011/12 was set at £26.8m

7 The Treasurer confirms that there were no breaches to the Authorised and Operational Borrowing Limits during the period 1 April to 30 September 2011.

8 Compliance against other treasury management prudential indicators detailed below:

Treasury Management	**Actual 31.03.11**	**Estimate 2011/12**	**Actual 30.09.11**	**Estimate 2012/13**	**Estimate 2013/14**
Compliance with Limits	YES		**YES**		
Maximum % borrowing at fixed rates	100%	100%	100%	100%	100%
Maximum % borrowing at variable rates	0%	25%	0%	25%	25%
Maximum % investments at fixed rates	77%	100%	66%	100%	100%
Maximum % investments at variable rates	23%	75%	34%	75%	75%
Maximum invested for a year or longer	0%	25%	0%	25%	25%