SUBJECT:	**Investment Performance Quarter Ending 30th September 2011**
REPORT OF:	**Officer Management Team - Director of Resources** **Prepared by – Principal Accountant**

1. Purpose of Report

1.1 To inform Members of the investment returns for the quarter ending 30th September 2011.

2. Links to Council Policies & Plans

2.1 The Council's Treasury Management function is a key element to the Financial Strategy, which in turn feeds into the prudent use of Resources, one of the Council's Management Principles.

3. Background

3.1 The Council's Treasury Management Strategy 2011/12 details the following sources for generating investment income for the year:

(i) Set an estimated return on investment income for the year of £0.9 million.

(ii) Set the sources for generating income for the year as follows:

	£'000
Fixed & Callable Deposits	646
Short Term Cash Flow and Other Investments	179
Stoke Poges Memorial Gardens Fund	75
Total	900

3.2 In addition Sector Treasury Services Ltd is engaged by the Council as its Treasury Management consultants providing advice on investment, performance and regulations where necessary.

3.3 The Council has adopted the CIPFA code of practice on Treasury Management, which includes the creation of a Treasury Management Policy Statement setting out the policies and objectives of the Council's treasury management activities.

3.4 The code recommends that reports on investment performance are made on a quarterly basis including a Mid-year Review Report. This report represents the second of these reports for 2011/12 and incorporates the mid-year review.

4. Investment Performance – Quarter to 30 September 2011.

4.1 **In House Investments** – Officers invest cash flow surpluses with approved counter parties. Decisions on investing in callable and fixed deposits are taken by Officers in the light of advice from the Council's treasury consultants and brokers acting in the local authority money market, combined with general intelligence available from money market briefings made available to the authority. Members approved a new matrix for in house investments as part of the Treasury Management Strategy 2010/11 as follows.

	Fitch Credit Rating	Maximum Amount	Comment
UK Institutions	AAA	£10 million	The durations of the investment would be informed by the detailed credit rating information
	AA+ or AA-	£7 million*	
	A to A+	£1 million	
Non UK Institutions	AA or better	£2 million	As above but also sovereignty rating must be AAA
Corporate Bonds	AA or better	£2 million	Investment decision will be based on balancing yield against duration

* Members agreed that for RBS only this limit is increased to £10 million whist the bank substantially remained in state ownership.

** As part of the Council's Treasury Management Strategy 2011/12 Members agreed to add the Co-operative Bank (A-) with a limit of £1 million, on the basis of the competitive rates it currently offers.

4.2 A summary of the Council's holdings of fixed deposits at 30th September 2011 is shown below:

UK Institutions	Sept Credit Rating	Maximum Amount £7 Million* Principal £	Interest Rate	Invested	Matures	Notes
Royal Bank of Scotland	AA-					
Fixed Deposit		5,000,000	4.25%	08/02/11	08/02/16	(1)
Fixed Deposit		2,000,000	2.50%	02/06/11	02/06/14	(2)
Total RBS		7,000,000				
Cater Allen	AA-					
Fixed Deposit		1,000,000	2.25%	01/04/10	03/10/11	
Fixed Deposit		1,000,000	3.50%	21/07/10	21/07/13	
Fixed Deposit		2,000,000	3.20%	30/09/10	30/09/13	
Fixed Deposit		1,000,000	2.50%	02/11/10	02/11/11	
Fixed Deposit		2,000,000	2.50%	16/11/10	16/11/11	
Total CA		7,000,000				
Lloyds Bank	AA-					
Fixed Deposit		1,000,000	3 Month Libor, Floor 2.85%, Cap 5.85%	11/05/10	11/05/15	
Fixed Deposit		1,000,000	3 Month Libor, Floor 3.07%, Cap 5.00%	19/05/10	19/05/15	
Bank of Scotland	AA-					
Fixed Deposit		3,000,000	2.10%	15/07/11	16/07/12	
Fixed Deposit		1,000,000	1.90%	04/10/10	04/10/11	
Fixed Deposit		1,000,000	2.05%	14/02/11	14/02/12	
Total Lloyds Group		7,000,000				
Barclays	AA-					
Fixed Deposit		1,000,000	3 Month Libor, Floor 3.05%, Cap 5.00%	24/05/10	26/05/15	

UK Institutions	Sept Credit Rating	Maximum Amount £7 Million* Principal £	Interest Rate	Invested	Matures	Notes
Fixed Deposit		1,000,000	1.415%	15/04/11	15/02/12	
Total Barclays		2,000,000				
Clydesdale	A+					
Fixed Deposit		1,000,000	1.25%	19/04/11	19/01/12	
Total Clydesdale		1,000,000				
Co-operative Bank	A-					
Fixed Deposit		1,000,000	2.50%	14/02/11	14/02/12	
Total Co-op Bank		1,000,000				
Total Deposits		25,000,000				

* Members have agreed a £10 million limit for RBS whilst it substantially remains in state ownership.

(1) RBS have the option to switch to 3 month LIBOR[1] plus 30 basis points in years 3,4 & 5.

(2) RBS have the option to switch to 3 month LIBOR 2 & 3.

4.2 In addition the Council held the following investments of short term cash at the end of the quarter:

	Amount £	Interest Rate	Notes
Nat West Bank	1,064,000	Base + 34 Basis Points	Instant Access
Nat West Bank	4,000,000	Base + 60 Basis Points	30 Day Notice Account
Bank of Scotland	500,000	1.35%	95 Day Notice Account
Total	5,564,000		

Since 30th September 2011 the following investment action has taken place:

Reinvestment of the £1 million 2.25% fixed deposit with Cater Allen that matured on 3rd October 2011 for a further year at a rate of 2.50%

Reinvestment of the £1 million 1.90% fixed deposit with the Bank of Scotland that matured on 4th October 2011 for a further year at a rate of 2.10%

Forward investment deals on the Cater Allen 2.50% fixed deposits listed below for a further year from their November maturity dates
£1 million at 2.50% matures on 2nd November 2011
£2 million at 2.50% on 16th November 2011

All of these investments have been renewed in order to maintain or improve their level of return against the forecast for interest rates detailed later in this report under 8.1

4.3 **Stoke Poges Memorial Gardens Fund:** The interest return from the fund is no longer credited directly to the Stoke Poges Memorial Gardens cost centre but has been incorporated with all of the Council's other investment returns.

4.4 The fund is managed on a passive basis by King & Shaxson .Due to the current cost of buying a new bond it is the current policy to reinvest any maturities within the Councils

[1] LIBOR – London Inter Bank Offered Rate

cash investment. There are no maturities from the Stoke Poges Memorial Gardens Fund due in 2011/12. The value of the fund at 30th September was £1,550,174.63

5. Treasury Management Strategy Update

5.1 The Treasury Management Strategy (TMSS) was approved by the Council on 22nd February 2011. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as

- Security of capital
- Liquidity

5.2 The Council also aim to achieve the optimum return on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered prudent to keep anything maturing short term for up to twelve months in order to take advantage of increases in interest rates during the second half of 2012/13 and to maintain a prudent minimum liquid reserve to maintain cash flow matters. This is reflected in the break down of the Council's investment portfolio detailed in 4.4 above.

5.3 Investments during the first six months of the year have been in line with the TMSS and there have been no deviations from the strategy which in the current uncertainty and volatility in the financial and banking markets is still considered fit for purpose.

5.4 On 13th October the rating agency Fitch revised downward to A the credit rating of most of the UK banks with the exception of Barclays, HSBC and Santander UK. The change reflects Fitch's view that support dynamics are changing in the UK. The banking system is not only large relative to the UK economy, but there is also more advanced political will to reduce the implicit support for the country's banks, building on The Banking Act 2009 and, more recently the various policy recommendations of the Independent Commission on Banking (ICB). Fitch believes that support for these banks is likely to remain high until elements of the UK banking sector complete their rehabilitation and some of the more practical aspects of bank resolution can be implemented. There is also the potential for the provision of extraordinary support for senior bank creditors to be relatively less certain than before. For Lloyds Banking Group (LBS) and Royal Bank of Scotland Group (RBSG) both of these banking groups have shown steady improvement in their risk profiles and prospects over the past two years and, assuming there is no major fallout from the euro zone crisis, for example, ought to be able to achieve higher ratings over the medium and long term.

5.5 This rating change would mean that as things stand the Council would have to significantly reduce its investments with most of the major UK as investments mature. It would also be faced with having a very limited range of counterparties to place funds of more than £1m with. The Council will not have to address this issue until 2012/13, as there is no suggestion that any of these banks are danger of default. A new Treasury Management Strategy for 2012/13 will be brought to this PAG at its meeting on 12th January 2012, and decisions on how to respond to the situation can be taken at that time.

5.6 In the current climate of low interest rates the review of the Treasury Management Strategy will also examine the situation around corporate bonds. This will identify what bonds of sufficient credit rating (see para 4.1) are available with yields above what the Council is likely to achieve on its cash investments. It will also establish what period the Council would have to hold these bonds for in order to avoid the risk of loss of capital, as it is not the intention to seek profits by trading bonds as that would require the use of external advisers.

6. Investment Policy and Procedures

6.1 As detailed in 3.3 above the Council has adopted the CIPFA Code of Practice on Treasury Management.

6.2 The Code recommends the creation & maintenance of Treasury Management Policy & Procedures.

6.3 It is not normally expected that the procedures will need to be revised very often and any changes have therefore been delegated down to me as Chief Finance Officer. A copy of the document is brought to Members attention on an annual basis and a copy has therefore been attached at Appendix A for Members information.

7. Economic Background

7.1 The second calendar quarter of the year saw:

- Indicators suggesting that the economy has at best stagnated
- Conditions on the high street have deteriorated further
- Employment has fallen again
- The public finances are expected to miss this years fiscal forecasts
- CPI inflation rising, heading for a peak of around 5% in Q4
- The Monetary Policy Committee signalling a move to increasing Quantitative Easing
- Equities prices plummet and gilt yields fall to historic lows
- The economic recoveries falter in the US and Europe

7.2 **Global Economy**

The Euro zone sovereign debt crisis continued with Spain, and particularly Italy, being the focus of renewed market concerns that they may soon joining with Greece, Ireland and Portugal in needing assistance. This uncertainty and the lack of a co-ordinated or credible Euro zone response, left commentators concerned over the potential impact of sovereign default and resulting effect on the Euro zone banking sector. The approval by various countries of the 440bn euro bail out fund in September has brought temporary relief to financial markets but this does not provide a credible remedy to the scale of the Greek debt problem or the sheer magnitude of the potential needs of other countries for support.

7.3 This, coupled with political difficulties in the US over their plans to address the budget deficit, the size and control over the US sovereign debt, and the subsequent loss of the AAA credit rating from Standard and Poor's, has led to a much more difficult and uncertain outlook for the world economy. Growth prospects in the US, UK and the euro zone have been lower than expected, with future prospects similarly cut. Whilst not a central view, concerns of a double dip recession in some Western countries have increased. World stock markets fell in the second quarter of 2011/12 as a consequence.

7.4 **UK Economy**

Following zero growth in the final half of 2010/11 the UK economy grew by a weaker than expected 0.01% in the first quarter of 2011/12, providing a knock on effect to future growth prospects. Growth prospects will be governed by UK consumer sentiment, which is currently subdued due to falling disposable income. Higher VAT, overhanging debt, high inflation and concerns over employment are likely to weigh heavily on consumers into the future.

7.5 The announcement by the MPC on 6th October of a second round of quantitative easing (QE) of £75bn emphasised how seriously the MPC now views recession as being a much bigger concern than inflation. Although inflation remains stubbornly high, the MPC's expectation of future falls resulting in an undershoot of its 2% target opened the way for this new round of QE.

7.6 International investors continue to view UK government gilts as being a safe haven from the EU sovereign debt crisis. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and sent PWLB borrowing rates to low levels.

7.7 **<u>Outlook for the next six months of 2011/12</u>**
There remain huge uncertainties in economic forecasts due to the following major difficulties:

- The increase in risk that the UK,US and EU could fall into recession
- The likely political gridlock in the US preventing significant government fiscal action to boost growth ahead of the Presidential elections in November 2012
- The potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economies
- The degree to which government austerity programmes will dampen economic growth
- The potential for further quantitative easing, and the timing of this in both the UK and US
- The speed of recovery of banks' profitability and balance sheet imbalances and the risk of substantial losses being incurred on EU sovereign debt

The overall balance of risks is weighted to the downside:

- Sector expects low growth in the UK to continue, with a low Bank Rate to continue for at least 24 months, coupled with a possible further extension of quantitative easing. This will keep investment returns depressed.

- The expected longer trend for PWLB borrowing rates is for them to rise, primarily due to the need for a high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. However the current safe haven status of the UK may continue for some time, postponing any increase until 2012.

A more detailed economic assessment at September 2011 is shown at appendix B

8. Interest Rate Forecasts

8.1 The latest forecast for interest rates provided by Sector is shown below:

	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13	Jun 13	Sep 12	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14	Mar 15
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%

The Sector central forecast is for the first increase in bank rate to be in September 2013 previous forecasts had shown a prediction of the first increase to be in June 2012. Sector have made comment of just how unpredictable PWLB rates and bond yields are as we are experiencing exceptional levels of volatility which are highly correlated to political developments (or lack of them) in the sovereign debt crisis.

A more detailed summary outlook on the prospects for interest rates is shown at appendix C

9. Resources, Risk & Other Implications

9.1 The investment budget set for the year is £900,000.The Council is currently on target to meet the investment budget for the year however the budget for 2011/12 had an assumption built in that interest rates would rise in the last quarter of the year which is no longer forecast to happen and there maybe a small underachievement in matching the target which will become more apparent as the year progresses.

10. Summary

10.1 The PAG is requested to:

1. Note the investment performance for the quarter to 30th September 2011.

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Background Papers:	**None**