St Edmundsbury
BOROUGH COUNCIL

E163

Treasury Management Sub-Committee 18 November 2013

Review of the Council's Treasury Management Strategy

1. Summary and Reasons for Recommendations

1.1 This report provides Members of the Sub-Committee with the findings of the review carried out by our appointed external consultants, PS Live, on the Council's current Treasury Management Investment Strategy at **Exempt Appendix 2**.

1.2 This report also provides Members with an outline to the external support available for treasury management activities and included at **Appendix 1**, a report from PS Live, summarising the external support presentations held at the Treasury Management Sub-Committee meeting on 23 September 2013.

1.3 The report seeks Members views as to the appropriate appointment to support the Council's Treasury Management Activities for the financial year 2014/2015.

2. Recommendations

2.1 The Sub-Committee is asked to:

(1) discuss and note the contents of the reports from PS Live contained in Appendix 1 and **Exempt Appendix 2** to Report E163; and

(2) consider the options included at Section 5 of Report E163 on the appropriate appointment to support the Council's Treasury Management Activities for the financial years 2014/2015 to 2017/2018.

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3. Corporate Priorities

3.1 The recommendations meet the following, as contained within the Corporate Plan:

(a) Working together for prosperous and environmentally-responsible communities; and

(c) Working together for an efficient Council.

4. Key Issues

4.1 Following consideration of paper E61 – 22 July 2013, PS Live – a specialist risk and treasury management consultancy company who currently works in partnership with the Chartered Institute of Public Finance and Accountancy (CIPFA) was appointed as an external advisor to provide an independent facilitation for the treasury management review.

Review of the Council's current Treasury Management Investment Strategy

4.2 A desktop review was undertaken by PS Live using data supplied by the Council and was analysed objectively using PS Live's proprietary analytic models based on historic and forward looking market data. Attached at **Exempt Appendix 2** are the findings of that review, which included:

(a) historic Analysis of each strategy in the context of credit exposure, duration and yield;

(b) projections of expected yield and risk around investment returns over medium term;

(c) comparison of portfolio positions to the 'Efficient Frontier'; and

(d) suggestions on framework for alternative strategy approach based on articulated credit appetite.

Treasury Management Support

4.3 Officers, in conjunction with the S151 Officer, have identified the following areas of external support that are required to assist the Council in ensuring that the Council has in place the necessary framework to ensure the effective management and control of treasury management activities:

(a) advice and guidance on preparation of treasury management annual investment strategy including advice on:

(i) the structure and timing of investment and borrowing decisions;

(ii) investment parameters / limits;

(iii) interest rate forecasts - Including short and medium term forecasts of Bank of England Base Rate, Public Works Loans Board (PWLB), London Inter-Bank Offer Rate (LIBOR), inflation and investment returns;

(b) economic analysis, including commentary on market movements, Monetary Policy Committee meetings and Bank of England inflation reports;

(c) advice on investment counter-party creditworthiness and regular alerts for changes in creditworthiness;

(d) appraisal of different investment products and debt instruments; and

(e) training for officers and Members.

Use of External Treasury Management Support providers

4.4 There are substantial numbers of service providers available to support the treasury management activities of public service organisations. These include Treasury Management Advisors (TMAs), brokers and external fund managers. Councils seek treasury management support from external providers for various reasons, a key reason being for their wealth of expertise in assessing the credit worthiness of investment counterparties, skills which are not usually available within a Council's officer structure due to their specialist nature.

4.5 Typically **treasury management advisers** will seek to help authorities to meet their obligations under the legislation and codes of practice, including; the production of an Annual Investment Strategy; keep the authorities up to date with changes to relevant public credit ratings (credit worthiness through up to date risk assessed counterparty lists); assist with the use of risk management techniques and assist with the training of officers and Members on the above.

4.6 It must be stressed that this support however only acts as a 'pass through' of information. TMAs state that they do not provide advice on counterparties or recommend investment decisions. The Council is required to review the information received and is then required to deal directly with counterparties in setting up all investments.

4.7 Additionally, while some local authorities will deal directly with counterparties in setting up investments, others employ **treasury management brokers** to carry out the transactions on their behalf. The Council would make the investment decision and the broker would have access to the market to make the transaction at the best value for money for the Council. Brokers cannot and do not offer treasury management or investment advice, but simply act as an intermediary.

4.8 **Fund managers** may also be used to manage local authorities' investments directly (placing the investment), by observing the limits set out in the Council's Annual Investment Strategy. There are well-established advantages in using external fund managers to manage a proportion of a Council's surplus funds, especially the access to a more diverse pool of highly credit rated banks and often hidden market deals. External fund managers typically would provide written reports providing the performance of the portfolio against benchmark, a track record and reasons for investments made and a forecast of interest rates and expected annual investment strategy.

External Treasury Management Support providers – presentations

4.9 At the Treasury Management Sub-Committee meeting on 23 September 2013 three presentations were delivered by external organisations, covering a range of external support that is available to the local authorities in support of its treasury management activities.

- Sector: The Council's current treasury management advisors
- Tradition: A quasi-external fund manager
- Payden and Rygel: An external fund management

4.10 PS Live provided support to Members and Officers during the meeting to assist in furthering the understanding of the different approaches, and the risk and reward characteristics of each. PS Live's analysis throughout the review is very much focused on the risk management implications of each approach. Attached at **Appendix 1** is the report from PS Live, summarising the findings and external support presentations held at the last Sub-Committee meeting.

5. Next Steps

5.1 Over the coming months the Council will be formulating thoughts on its 2014/2015 Treasury Management Strategy. With this in mind, it is requested from Members that a steer be given on the appointment of external support to assist with the formation of this strategy.

5.2 Officers consider the use of either a TMA and/or the use of an external fund manager as the options available to support the Council's treasury management activities. Brokers are unable to offer any form of treasury management advice to the Council, so have been excluded from the options below.

5.3 These options should be considered taking into account the PS Live reports provided at Appendix 1 and **<u>Exempt Appendix 2</u>** of this report.

<u>Option A – Treasury Management Advisors only.</u>

5.4 This option is about continuing with the existing external support through the use of a TMA. This option would assist the Council in addressing the support required in paragraph 4.3, plus extra support around governance and legislative obligations.

5.5 This option results in all investments being made by the Council directly with the institutions; this has a resource implication for the Council of approximately 2/3 hours per week on average. Resource implications may vary depending on information received from a TMA, suggested frequency of actions or investment amounts.

5.6 A risk to the Council of this option continues to be around the potential rate of return achieved as a result of the Council following a TMA's advice to the letter. The Council currently varies from the advice of its current TMA, Sector, as agreed in Report C294 – 22 January 2012.

5.7 It must be stressed that it is the Council who makes the investment decisions. It can take the information from TMA's into account and still deviate from that information when making a final decision on an individual or collective investment(s).

Option B – External Fund Managers only.

5.8 This option allows for the effective management of the Council's surplus funds by an external fund manager. The fund managers would access the credit worthiness of counterparties at the point of any direct investment. This option would in part assist the Council in addressing the support identified in paragraph 4.3, but only to the extent of the creditworthiness checks on those externally managed funds.

5.9 It is anticipated that this option would cost the Council around the same amount in external fund manager fees, potentially slightly less, than Option C below. In addition, there would be a saving in the TMA cost. This option however, would leave the Council making decisions relating to the internal funds without any expert advice, leaving Officers to use credit rating information and publications as their key criteria in assessing institutions' creditworthiness. In practice, this might mean an increased risk exposure in respect of the £5m of internally managed investments; it is, accordingly, not a recommended option.

Option C – Both A and B

5.10 This option would look to ensure that the Council receives the support outlined in paragraph 4.3 from both the information provided by TMA's and the expertise available through an external fund manager. The added benefit of this option is around the introduction of an external fund manager with the added remit of them investing the Council's surplus fund balances directly with the counterparties.

5.11 This option would cost the Council up to £15,000 in external fund manager fees (depending on current portfolio maturities and re-investment) per year. However it is envisaged that the Council's overall rate of return on investment balances would be slightly higher under this option, covering this cost along with the delivery a more balanced assessment of risk and return.

5.12 The Council is already in a contractual relationship with Sector which expires in March 2015.

6. Other Options Considered

6.1 Options for the management of Council investments have been considered as part of this review.

7. Community Impact

7.1 None

8. Consultation *(refer to the Consultation and Community Engagement Strategy)*

8.1 This Sub-Committee provides for the scrutiny of treasury management strategies and performance, with changes in strategies and policies subject to approval by Cabinet and full Council.

9. Resource implications *(including asset management implications)*

9.1 As outlined in the body of the report.

10.	**Risk/Opportunity Assessment** *(potential hazards or opportunities affecting corporate, service or project objectives)*
10.1	Non appointment of any external support on treasury management activities will result in a risk to the Council's framework to ensure the effective management and control of treasury management activities. As a worst case scenario this could result in putting the Councils maturing investment balances at risk.
10.2	Treasury Management, by its nature, brings risks associated with maximising performance and minimising exposure to capital loss. Positions at either extreme of this continuum are undesirable, and it is essential that the chosen solution balances these risks. There are issues in that TMA's often take a structured, process driven approach with low levels of underlying analysis, while External fund managers may bring an enhanced approach with 'on the ground' information from the market itself, but may have less tangible evidence to support this.
10.3	The responsibility for treasury management must always remain with the Council. It is essential that Members understand the treasury management services being offered to them and must not over-rely on these services. This is also stressed through the CIPFA Treasury Management Code which states the importance of ensuring that all staff involved in the treasury management function and those charged with governance are fully equipped to undertake the duties and responsibilities allocated to them. External support will look to include the provision of training support to assist the Council with training staff and Members
11.	**Legal or policy implications**
11.1	The Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators each year.
11.2	The Office of the Deputy Prime Minister's informal commentary on its formal statutory guidance under Section 15(1)(a) of the Local Government Act 2003 states that: the general policy objective is that local authorities should invest prudently the surplus funds held on behalf of their communities. The guidance recommends that priority should be given to security and liquidity. However, that does not mean that authorities should ignore yield. It will be appropriate to seek the highest rate of return consistent with the proper levels of security and liquidity.

Wards affected	All
Background Papers	Report C294 - Treasury Management Performance and Annual Treasury Management and Investment Strategy 2012/2013 – 23 January 2012 E61 - Annual Treasury Management Report 2012/2013 and Investment Activity 1 April to 30 June 2013 and Review of the Councils Treasury Management Strategy – 22 July 2013

PSLive

Report to the Treasury Management Sub-Committee, St Edmundsbury Borough Council

Introduction

Public Sector Live (PSL) have been mandated by St Edmundsbury Borough Council (SEBC) to provide a review of the current investment strategy of SEBC. This review was undertaken with reference to the alternative strategy being carried out by Forest Heath District Council (FHDC). A desktop review was undertaken using data supplied by officers of the Councils and analysed objectively using PSL's proprietary analytic models based on historic and forward looking market data.

The key deliverables from this mandate were:

- Attendance at a pre-meeting of SEBC Treasury Management Sub Committee on 23rd September 2013
- A presentation to members and officers including
  - Historic Analysis of each strategy in the context of credit exposure, duration and yield
  - Projections of expected and risk around investment returns over medium term
  - Comparison of portfolio positions to the "Efficient Frontier"
  - Suggestions on framework for alternative strategy approach based on articulated credit appetite

The SEBC Treasury Management Sub Committee meeting included presentations by three external organisations offering different approaches and levels of support to the Council's investment operations. PSL provided support to Members and Officers during the meeting to assist in furthering the understanding of the different approaches, and the risk and reward characteristics of each. PSL's analysis throughout the review is very much focused on the risk management implications of each approach.

Initial Review

The review focused on SEBC, whose portfolio is managed in house and receives support from Sector Treasury Services (STS), although reference was made to the FHDC portfolio which is managed on a quasi-external basis using the services of Tradition / City Deposit Cash Managers.

The report highlighted the following key considerations, which were explored further during the presentations in the formal meeting:

- Returns on SEBC portfolio had declined steadily over the period since April 2012, predominantly as a result of the short duration of the portfolio being exposed to reductions in interest rates. Duration had increased during 2012, which had reduced this interest rate risk to some extent, however it was not sufficient to prevent the return from falling.
- Although duration had increased over the period, credit risk (measured objectively as the likelihood of a default being experienced) had fallen by almost half over the period. This

reinforces the fact that there is not always a strong correlation between duration and credit risk.

- Principal exposures per counterparty is regularly monitored both internally and externally by STS. However, having a diversified range of counterparties does not always mean a diversification in risk. At the time that the analysis was undertaken, 44% of the principal exposure covered 94% of the credit risk over just 2 counterparties.
- Using the markets expectation of future interest rates, and sophisticated risk analysis, the expectation is that returns on the portfolio will fall further over the current financial year, and remain broadly flat throughout 2014/15 before beginning to rise. However, the markets expected path of rates is unlikely to be realised, and when alternative scenarios are considered, it is evident that there is significant downside risk to this. For example, the expected portfolio return in April 2014 is 0.71%, but it could be as low as 0.33%. Extending duration and locking into more certain rates over a longer period would reduce this uncertainty and risk. Interest rate risk is quantified as being the difference between the expected and the downside interest rate scenario.
- So whilst the portfolio is demonstrating a low exposure to credit risk, there is significant exposure to interest rate risk. Those two factors need to be considered holistically in order to determine an overall investment risk budget.
- FHDC demonstrates a very contrasting approach. Durations are made of a longer duration which reduce interest rate risk significantly, but take a much higher level of credit risk. Overall portfolio risk measured by PSL's proprietary framework demonstrates that whilst the returns that have been achieved and are expected to be achieved over the medium term are higher for FHDC using Tradition's quasi-externally managed service, there is a greater level of portfolio risk that has been taken in order to achieve this.

Background

There is no right or wrong approach to determining the level of risk to be taken. It is however essential that this risk appetite is determined internally by officers and members within the authority. Often risks may be conflicting, as minimal credit risk often comes at the expense of interest rate risk, but neither risk should be ignored when ascertaining the impact of the proposed strategy on the overall finances of the Council.

When professional expertise is used to support the investment function, the responsibility for determining the appropriate risk and reward trade-off is not discharged to this external organisation. This external organisation should be able to support the decisions / recommendations made to provide officers and members with the reassurances needed that the risks being taken are within reasonable parameters.

Since 2008 and the concerns regarding exposure to Icelandic banks by Local Authorities, there has been a consequential strategic approach to reduce the level of credit risk exposure. This reduced credit exposure has been managed in the main by keeping duration short. It does not however reflect that credit risk, measured by the likelihood of a default being experienced, is significantly impacted by the macroeconomic environment. Thus, even if duration remains consistently short, credit exposure may still remain volatile.

Furthermore, if investment balances are persistent, short duration creates uncertainty around re-investment rates, which presents risk to the authority as a result of the potential for the reinvestment to be lower.

It is likely that, as is the case with the vast majority of Local Authorities, liquidity is not a major risk to the Council and indeed, other than requiring a proportion of investments to remain available to meet the peaks and troughs of cashflow requirements in the near term, a proportion of the portfolio could be positioned in such a way as to reduce the interest rate risk within the portfolio by taking a longer duration, whilst still being mindful of the credit risk profile.

Approach

PSL considered the presentations from each of the three suppliers from the primary perspective of risk management. Each of the three suppliers provides a contrasting service model, and the primary focus for the treasury team should be to ensure complete transparency regarding what the supplier's risk management responsibilities are, and what therefore needs to be delivered from within the council. Any decision to proceed with one of these suppliers, or indeed any third party investment service, should be taken in conjunction with the council's in-house capacity and expertise. This report does not seek to review this element of the strategy.

1. Sector Treasury Services (STS)

General Comments

- STS state that the client articulates their own risk appetite, but they very much have a house view suitable investment counterparties and investment durations
- STS's benchmarking shows that St Eds have outperformed its peers, but this is clearly as a result of deviating away from their recommendations as previously agreed by the treasury sub-committee

Interest Rate Risk

- Interest rate risk does not feature in a significant way in their approach and their key focus is on credit risk mitigation
- The advice they provide on duration constraints results in a significant degree of interest rate risk, and has contributed to the falls in rates that have been seen.
- The longer duration deposits that the Council undertook which was not strictly in accordance with STS recommendations has reduced interest rate risk.

Credit Risk

- STS are arguably calling the market wrong in terms of the lower duration limit they assign to (for example) Barclays than to RBS – when credit risk is viewed through a market implied lens (PSL's preferred approach). In other words, whilst the market is expecting there to be a lower probability of Barclays defaulting on a deposit than RBS, STS do not believe the market is correct with this assumption and therefore advise that there is less credit risk to lend to RBS than to Barclays.

- Their significantly cautious approach to credit risk exposes the Council to interest rate risk; PSL did not see any evidence of this risk being quantified

Performance

- STS's benchmark reporting focuses on credit risk and return, and suggests performance is good, despite the low and falling returns that have been experienced and continue to be expected
- A performance benchmark should reflect the long term nature of your cash balances. The skew towards such a short term benchmark (3 month libor) does not reflect the nature of your balances and therefore may not be entirely suitable, and consequently highlight shortfalls in performance.

STS effectively provide an independent credit scoring framework, and target Local Authority investment portfolio. They do not consider either return or interest rate risk in this analysis. This approach should be used as an *input* into a completely in-house treasury investment framework. Interest rate risk quantification should be developed internally to ensure a complete picture is developed. STS are effectively an information provision service, and no external management or advice is involved. STS offer this service across a many Local Authorities, usually as part of a more formal advisory mandate.

2. Tradition / City Deposit Cash Managers (CDCM)

General Comments

- CDCM offer a *highly qualitative* investment management approach, based largely on their in-house views of the market
- CDCM place significant emphasis on experience and historic events, with reliance on a small number of known individuals
- In addition to the fee payable by the client for the cash management service, CDCM also receive brokerage from the counterparties with whom the deposits are made

Interest Rate Risk

- Decisions are made with regard to the shape of the yield curve on the basis of experience determining the appropriate duration of each deposit
- Although not explicitly a factor in determining the investment decisions, the longer durations that have been invested in offer protection against falling returns.

Credit Risk

- A loose counterparty criteria tends to be provided to enable longer duration, which enables them to "beat the market"
- Credit risk is not monitored routinely once the deposits have been placed

Performance

- CDCM suggest 3 month LIBID as a benchmark, although investments are rarely made for this duration
- Deposits favoured over bonds – although no coherent rationale was demonstrated for this strategy

CDCM offer a non-standard service (likely unique, at least from PSL's experience) with a limited number of public sector clients. They are able to make their own investment decisions based on a pre-agreed counterparty list. They do not provide robust risk measurement as part of their service. Their approach is highly qualitative. Utilising this model would necessitate developing in-house credit risk measurement tools and reporting framework.

Payden & Rygel (P&R)

General Comments

- P&R provide a traditional third party investment approach, operating on a discretionary management basis
- This involved paying the sums over to the manager who then, as part of the wider fund, makes investments on behalf of the investors
- Heavily regulation of the company ensures that governance and processes meet the highest regulatory standards

Interest Rate Risk

- As a result of the duration of the instruments and the volatility of their prices, the value of the fund, and consequently the investment, changes on a daily basis. Therefore, the overall return on the fund consists of interest received from the instruments, as well as a further gain or loss through changes in the capital value of the instrument
- The fund will be valued by the authority each year on 31st March, and this return for the year calculated and taken to revenue accordingly

Credit Risk

- The instruments used area combination of UK Government gilts, Commercial Paper, Certificates of Deposit, Covered Bonds, Bank Bonds and Supranational Bonds. These highly liquid tradable instruments allow the manager to generate value through active portfolio management
- Deep research capabilities and access to senior management of their counterparties ensure that the objectives of strong performance in a risk management framework are adhered to

Performance

- Investment decisions are made for the fund as whole, rather than purely for the Council, and therefore it is possible to look back at historical performance to gauge the returns that would have been achievable.
- Net of fees, the performance in 2012/13 was 2.09%

P&R offer a traditional investment management service within a heavily controlled regulatory environment with a clear and transparent mandate. Their regulatory environment ensures a significant focus on risk management, in particular through maintaining third party fund ratings. Whilst in-house decisions must be made to deploy funds with P&R, the day-to-day investment management has effectively being outsourced to a third party. This therefore ensures a reduced need for in-house expertise and resource.

Conclusions

The three service provides reviewed in this process could not be any more diverse. Each comes at a different explicit external cost, but also implicit through the varying need for developing in-house expertise and investment in risk management software. Costs should be considered on an 'all-in basis', reflecting the need to invest internally. PSL strongly suggest that members and officers need to be entirely comfortable with the extent of reliance that can be placed on each of the different types of service delivery model.

PSL do not provide any form of investment strategy or management advice.

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