Report for information

Report to	Executive 30 September 2009	8
Report of	Head of Finance	
Subject	Treasury Management – Investment Performance 2008/09	

Purpose

To advise members of the Council's Treasury Management Investment Performance for 2008/09.

Recommendations

Report is for information

Financial Consequences

Investment interest earned by the council for 2008/09 was £2.230m and this assisted in supporting the Councils ongoing business.

Risk Assessment

Investments are governed by the limits and ratings framework set within the Treasury Management Strategy for the Council.

Strategic Priority and Outcome/Service Priorities

The report highlights the contribution the Council's Treasury Management Team makes both to the Council's resources and stewardship.

Executive Member: Councillor Waters - Corporate Resources and Governance

Ward: All wards

Contact Officers

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Background Documents

N/A

Report

Background

1. The Council's Treasury Management Strategy requires that a report is taken to members before the 30 September on the councils Treasury Management performance. At 31 March 2009 the Council had an investment portfolio of £28.364m and earned £2.230m in investment interest during the year.

Detail

2. The Council's investment performance is monitored by our appointed external investment advisors Butlers. A review of the Council's performance is attached in Annex A to this report

   The key messages to note are;

   - The Council rate of return on investments was 4.204% compared with 5.934% for 2007/08 and the 2008/09 benchmark of 3.56% (7day rate).
   - The Council achieved £2.230m investment income in 2008/09, which compares £2.959m for 2007/08.
   - The Council's investment performance should continue to exceed the benchmark during 2009/10.
   - The investment portfolio at the end of the financial year 2008/09 was split between long term investments of £4m and short term investments of £16.5m. Compared to £7m long term investments and £28m short term investments in 2007/08.

Financial Commentary

3. The reduction in interest income between the financial years 2007/08 and 2008/09 that had been previously forecast within the Council's budget monitoring programme arose primarily due to the fall in interest rates between October 2008 and March 2009. A further impact on the level of investment was the timing of the payment of housing benefit subsidy. This position is now rectified and the Councils present investment portfolio is £42m. The impact of the fall in interest rates has already been fully taken into account in the councils Medium Term Financial Strategy.

Risk & Strategy

4. The treasury function continues to adhere closely to the limits and ratings framework set within the Council's treasury management strategy. The financial crisis and general recession requires this adherence along lines of risk aversion to safeguard the current portfolio of investment assets whilst seeking to invest the funds wisely to achieve return above the benchmark rates within the strategy. Decisions on investment short or long term under kept under constant review to ensure the best returns subject to limits and ratings is obtained.

Annex A

Norwich City Council Investment Review 2008-09

Introduction

This report looks at the internal investment performance of the Council during financial year 2008-09. As in previous reports, investment details have been provided by Council officers where possible and the comparisons of performance will be made against various money market rates.

Under more "normal" market circumstances one of the great difficulties of analysing and assessing Council investment performance is that local circumstances will play a fundamental part in deciding which investments are made. The main driver behind investment decisions will be the nature of the funds, ie are they cash flow or cash fund money. Cash flow money will likely provide little scope for active investment of funds and as such a performance significantly ahead of particular benchmarks will be difficult to achieve. However, if the Council has identified that a proportion of their outstanding investments has a longer outlook then this will help the Council to outperform short term cash benchmarks.

However, in the financial year just passed the added significant issue of investor counterparty fear has added an extra dimension to analysis. This fear factor was one of the main drivers behind investment decisions in the second half of 2008-09 whether it transpired as significant shortening of investments, tighter range of counterparties used or both.

Economic Background

The past financial year has seen the world's financial markets stagger from one crisis to another. Without doubt, it has been the most traumatic period since the 1930s and by the end, the edifice of Capitalism that seemed near impregnable just a few years ago was as close as it has ever been to crumbling.

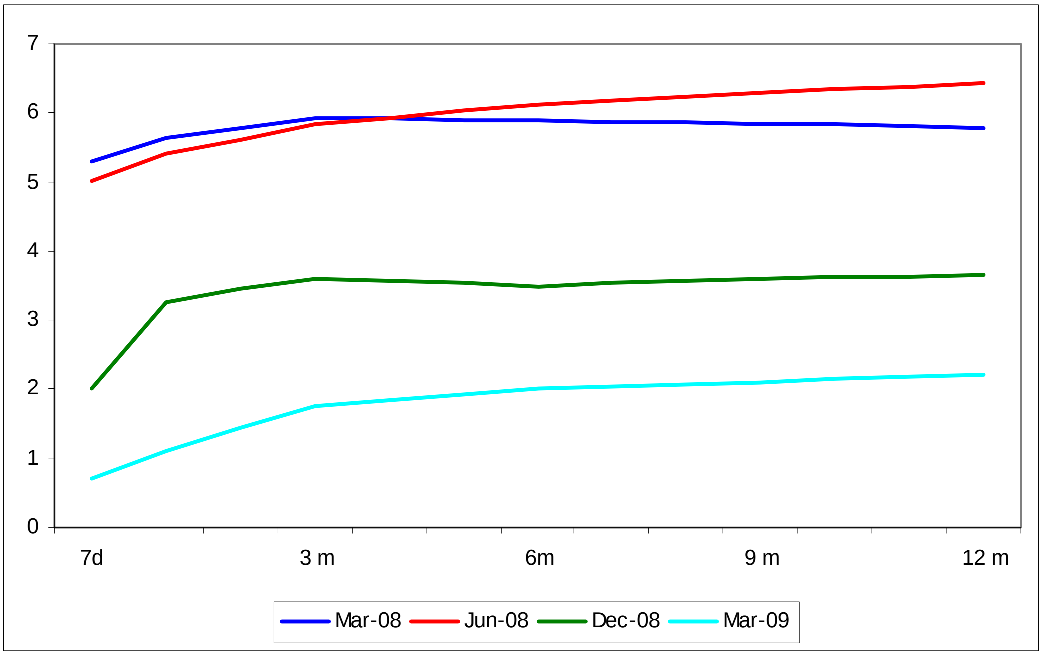
Market conditions remained very nervous and difficult in the early spring of 2008. The US authorities cut rates again in March (to 2.25%), a move that the authorities in the UK and euro-zone resisted, mainly because of inflation concerns. Uncertainty failed to abate; the banks' quarterly reporting season that ran from February to April, featured large-scale losses and write downs of asset bases. Indeed, the failure of US investment bank Bear Stern (rescued by JP Morgan Chase), while providing some assurances that rescues would be put in place in dire circumstances, did compound the atmosphere of fear and suspicion in the banking sector.

Fear and suspicion dominated the markets. Banks possessed plenty of liquidity on an individual basis, but their wholesale reluctance to lend to each other meant that money markets failed to function normally. One major sticking point was the fear that banks still held a large number of financial instruments on their balance sheets that were backed by asset that were worthless (many by sub-prime mortgage loans).

The Bank of England announced a Special Liquidity Scheme aimed at alleviating this problem in April. This enabled eligible organisation to swap high quality asset backed securities for Treasury bills in the hope that these would trigger a return to more normal trading conditions. The Scheme proved very popular and the anticipated £50bn take-up of the swap arrangements turned out in reality to be nearer £100bn.

But this failed to provide the desired panacea and markets remained very illiquid, evidence of which was provided by low turnover and the persistence of a very wide margin between official bank rate (now at 5%) and market rates. This remained around a full percentage point.

Yield Curves



Over the summer months conditions began to ease very gradually and there were tentative signs of a return to a slightly more normal market disposition. That said, this was still very far removed from conditions that prevailed in the pre-credit crunch days of early 2007. Official policy remained on hold. While the signs of economic slowdown were plain for all to see, concerns about the dangers of an inflationary spiral developing in 2009 supported a steady stance.

This development proved to be a false dawn: indeed, it was the calm before the storm. The next phase of the credit crunch – the descent into panic – was triggered by the US authorities' decision, in mid-September, to allow investment bank, Lehman Brothers, to fail. Market liquidity dried up completely and even well regarded institutions were driven towards bankruptcy. UK bank HBOS was a high profile casualty of the inability to fund obligations and was rescued from the brink by a proposed, and officially supported, takeover by Lloyds TSB.

The failure of key markets to function, and the drying up of banking lines, hit smaller banks the hardest. The Irish Government announced a near-blanket guarantee of deposits with its country's banks and this was sufficient to stem the rot. Depositors with the Icelandic banks were less fortunate and the wholesale failure of these organisations in early October saw deposits frozen.

The financial markets descended into free-fall and concerns over a total collapse of the world's financial system increased by the day. Governments and monetary authorities launched rescue programmes, including the US Administration's $700bn TARP scheme and the UK's ground-breaking plan. The latter, potentially totalling £400bn, included the recapitalisation of many of the high street banking groups at a cost of partial nationalisation, the extension of the Special Liquidity Scheme and the offer to guarantee marketable security issues. In the US, the rescue moves stretched to a bail-out and partial nationalisation of banking leviathan Citigroup, a move that would have been considered totally out of keeping with the country's capitalist ideology jut a few months earlier.

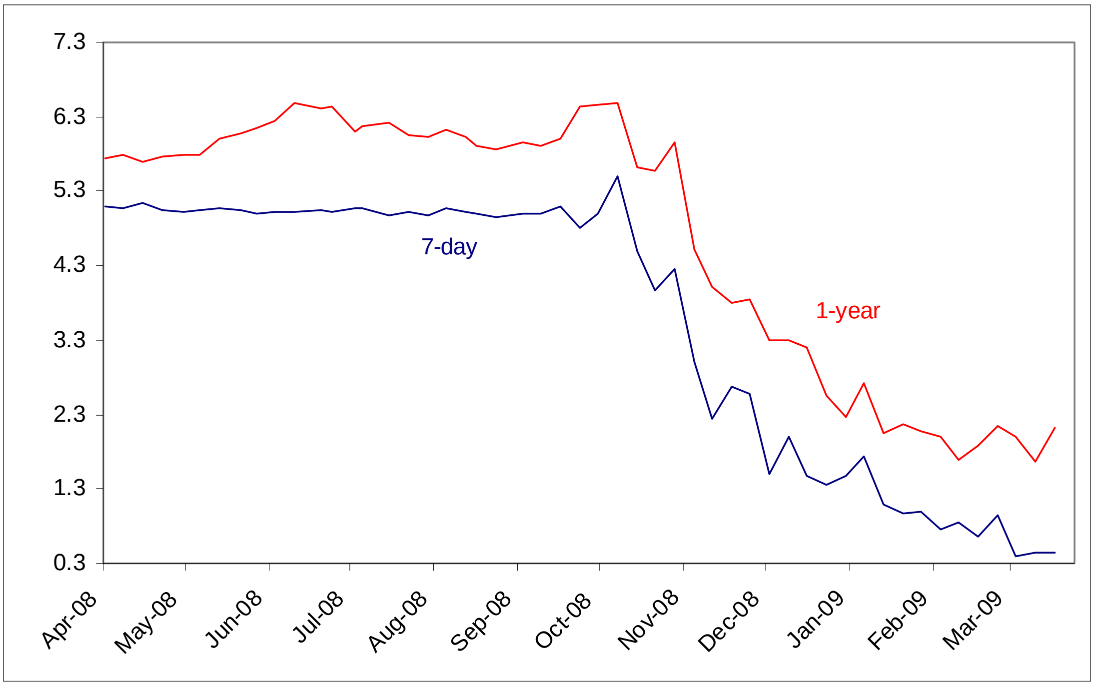
Official rescue packages were followed by fiscal measures designed to stem the decline to deep recession and significant monetary easing. In the US, official interest rates were cut to a range between zero and 0.25%. In the UK, the Bank of England, in the knowledge that the UK economy was declining into deep recession and inflation was set to fall sharply, instituted a series of interest rate cuts. By the close of the calendar year, Bank Rate had been cut to its previous historic low position of 2% with strong hints that there was more to come in 2009.

The nervousness of the world's financial markets continued to dominate sentiment for a good deal of the final quarter of the financial year, although by the end of the period there were a few signs that the situation was moving to a more stable footing. This had required a great deal of additional assistance by governments in the bulk of major industrialised countries at very considerable cost to budgets.

The New Year failed to herald a change in the fortunes of the banking sector. Hopes were pinned upon a more healthy set of quarterly performance results following all the asset write downs of the past year and the assistance packages that had been put in place in the preceding months. But this failed to materialise and the stream of bad news on profits and problem banks continued during the January/February reporting season.

Central banks continued to ease monetary policies in an attempt to reduce borrowing rates and hence alleviate some of the cost pressures being experienced by financial institutions and, more to the point, the corporate and household sectors. These latter areas were faced with an increasingly severe recession, triggered initially by the monetary squeeze courtesy of the credit crunch and asset price deflation.

Money Market Rates



With official interest rates in the US already at close to zero at end-2008, the Bank of England was at the forefront of policy easing. Bank Rate was cut in successive monthly moves from 2% at the outset of 2009 to the historically low level of 0.5% in March. Thereafter, the governor of the Bank indicated no further cuts would be contemplated. Policy ease going forward would take the form of quantitative measures where the stock of money would be expanded via a mechanism of buying securities from investment institutions in exchange for cash. This so-called quantitative easing commenced in early March and is expected ultimately to amount to £150bn, the full amount sanctioned by the Chancellor of the Exchequer.

Aside from Bank of England assistance, the central government launched the second phase of its support operations for the banking industry during the second half of January. This failed to allay fears that even more aid might have to be extended to the banking industry before the crisis is over. During the course of the quarter, two major banks, RBS and Lloyds Group, needed substantial cash injections, action that led the public sector to assume near-full ownership. In addition to this, the Dunfermline Building Society was rescued from bankruptcy.

The problems of the financial markets since late 2007 had clearly spread to other parts of the economy. Economic data confirmed that the UK was in deep recession and the latest Bank of England Inflation Report (published in mid-February) registered a marked change in official forecasts for 2009 and 2010. Economic activity was expected to decline sharply (GDP was forecast to contract by more than 4% in 2009) and inflation was projected to fall into negative territory. Both these forecasts were seen as justifying the shift to a more aggressive approach to monetary policy.

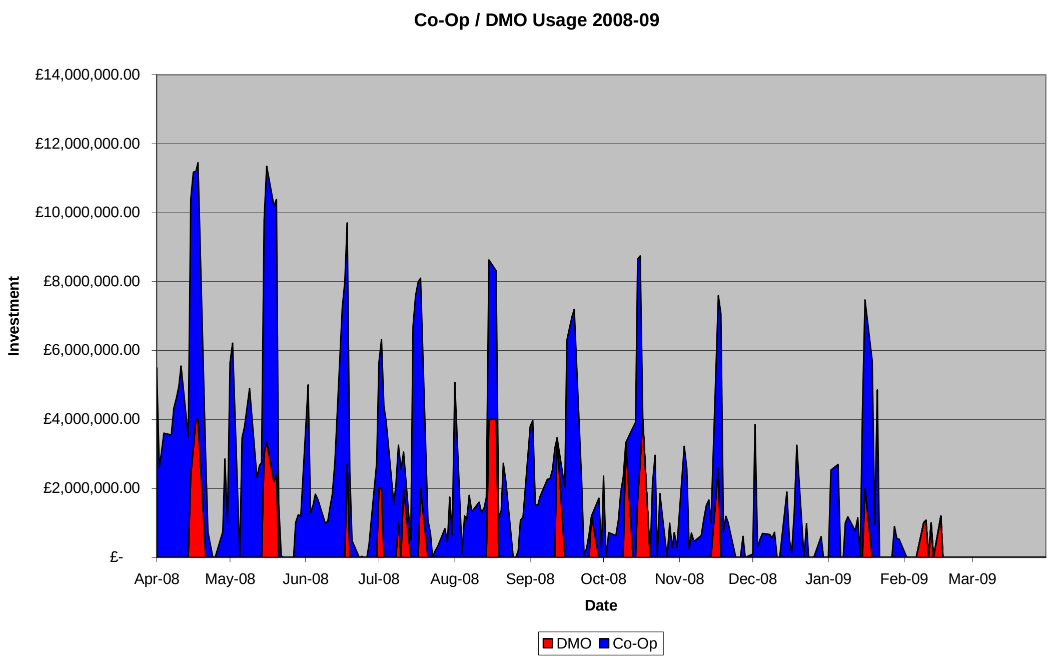
The generally uncertain backdrop to the UK and the financial markets prevented a marked easing in overall money market liquidity. While the situation did show some signs of improving as the quarter progressed, the margin between official interest rates and those quoted in the inter-bank market for periods longer that 1-month remained very wide.

Investment Activity

The table below shows that activity during 2008-09 was concentrated with the Council's own bank, Co-operative. This is much in line with previous years. When investments with the DMO are also considered almost 80% of all transactions were undertaken with either DMO or Co-op.

Year	**2006-07**	**2007-08**	**2008-09**
Total number of investments	622	533	333
Total number with Co-op / DMO	405 (65.1%)	395 (74.1%)	261 (78%)
Overall average size	£2.06m	£2.2m	£1.9m
Overall return	4.892%	5.934%	4.204%
Co-op / DMO return	4.827%	5.552%	3.972%
Overall average investment length	25 days	34 days	25 days
Co-op / DMO average investment length	1 day	1 day	1 day

This reliance on the Council's own bank can be viewed in a number of ways. From a counterparty perspective over-reliance on one institution heightens the threat to Council funds if the institution in question were to fail. The graph below outlines investments made during the year and shows that until the final months (where few, if any, investments were made at all – see table below) there was almost a constant use of Co-op. Note that this graph does not exclude bank holidays which would account for some of the gaps.



Although the average maturity of investments was just over 1 day, any form of failure on the part of the counterparty could still leave the Council exposed to potential losses, especially given the almost constant use of the counterparty. The economic and financial market background has seen the threat of counterparty failure rise significantly. Although the UK authorities have rescued a number of UK institutions already, it does not automatically follow that all would be “rescued” in cases of financial difficulty.

The merger between Co-op (currently rated F1 short term by Fitch) and Britannia Building Society (F2) will likely result in the new entity having an F2 short term rating. This is outside of the main credit rating criteria used in the Council’s current investment strategy. This rating change would again urge caution against the Council having an almost constant exposure to its own bank.

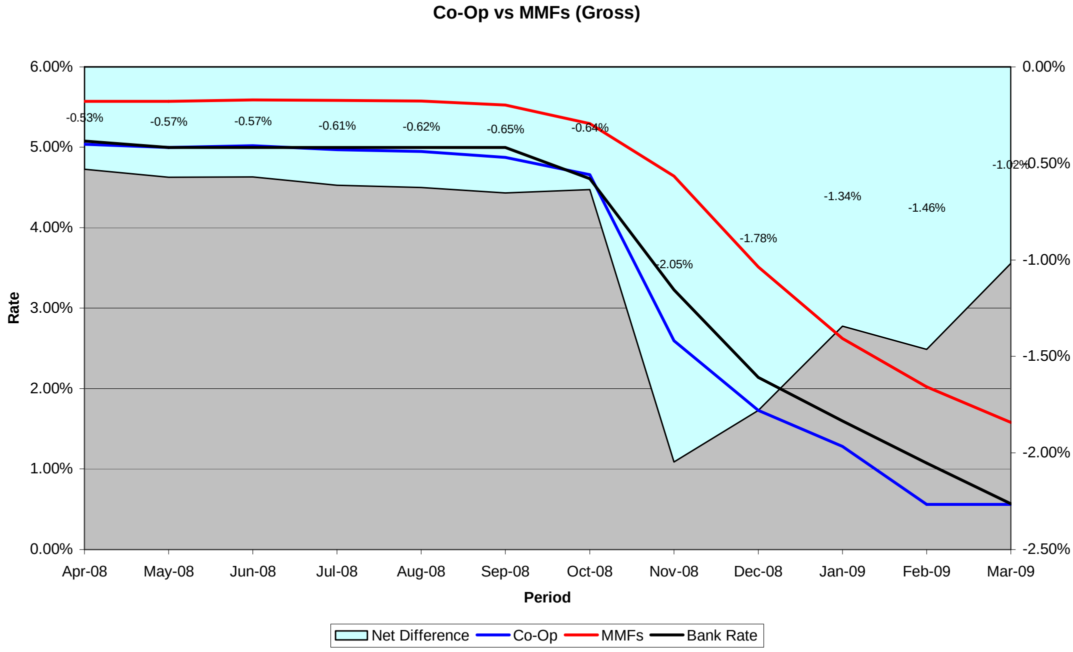
However, the short term nature of the investments is beneficial. It means that barring an overnight collapse, then the Council is not faced with the liquidity risk posed by longer term investments. Any change in circumstance for the institution can therefore be acted upon by officers quickly. What should be looked at therefore is alternative methods for liquidity-type investing.

The investment report for the last financial year identified other types of investment that the Council could use as alternatives to its reliance on Co-op. A number of UK and overseas banks operate call account facilities with return linked to bank rate. The Council has made use of these in the past and still maintains a facility with Abbey National. Another alternative is Money Market Funds (MMFs). These investments have grown markedly in popularity during the credit crisis.

The Funds are only permitted to purchase high quality investments (Minimum 50% F1+/P-1/A-1+ with remainder at F1/P-1/A-1). In addition, these investments have to be short term in nature and spread amongst a wide range of counterparties. Typically the limits applied by Funds is no more than 5% per any one counterparty.

Due to the type and nature of the investments within the Funds, they receive a “AAA” credit rating. The rating from the agency is covering the Fund as a whole rather than a rating for each component. They are essentially saying that investing in the Fund is akin (credit wise) to investing in “AAA” securities.

These Funds are created for security and liquidity purposes with limited risk. They are not designed to chase yield through excessive risk taking, either in terms of credit or market/interest rate risk. Nevertheless, the advent of the credit crunch and the dislocation between official and market rates has enabled the Funds to outperform investments tied to Bank Rate.



The graph above shows average performance of MMFs (gross) versus the average Co-op interest rate and Bank Rate during 2008-09. Overall, the average outperformance of MMFs was 0.99%. Fees will normally be in the region of 15bps, but even taking these into account, the Council would not have lost out in terms of return by using MMFs. The lowest performing MMF achieved an average gross rate of 4.72% for the year, while the best achieved a gross rate of 5.46%.

With the dislocation between official and market rates set to continue through 2009-10, it would suggest that performance should remain in excess of that achieved through Bank Rate-related investments.

Month	Wtd Principal	Wtd Return	Cumulative Rtn	Benchmark	Net Performance
April	£ 36,381,941.67	4.172%	4.172%	5.070%	-0.898%
May	£ 34,213,035.48	4.042%	4.106%	5.041%	-0.999%
June	£ 31,397,986.00	3.903%	4.039%	5.055%	-1.152%
July	£ 35,773,492.58	4.071%	4.047%	5.036%	-0.965%
August	£ 33,415,045.16	4.006%	4.039%	5.020%	-1.014%
September	£ 35,332,333.33	4.045%	4.040%	5.156%	-1.111%
October	£ 36,412,516.13	4.464%	4.101%	4.605%	-0.141%
November	£ 36,883,933.33	4.557%	4.157%	2.964%	1.593%
December	£ 37,597,048.39	4.356%	4.180%	1.708%	2.649%
January	£ 36,228,096.77	4.293%	4.191%	1.370%	2.923%
February	£ 30,261,178.57	4.586%	4.224%	1.020%	3.566%
March	£ 27,483,870.97	4.575%	4.254%	0.700%	3.875%

The table above shows that Council performance versus the benchmark (7-day LIBID) was divided through the year. Overall performance moved gradually higher through the year, but it was the "performance" of the benchmark which was most stark. In the first six months, the generally cautious nature of investing by the Council led to underperformance. However, from October through to March, while Council returns were generally improving, the benchmark was falling substantially in reaction to the credit crunch and official policy moves. Stability provided by longer term deals either already in place or made through the year allowed Council performance to remain steady and not suffer as official rates were slashed.

The table below shows that new investment rates did fall dramatically in the second half of the year. However, this was offset by the fact that few investments were made, and of these, they were mainly of a liquid, short-term, nature.

The onset of the full-blown credit crunch in the second half of the year urged caution for investors. This view was mirrored by the Council investments in the main. Although cash flow requirements would have played a major part in dictating investment activity, the cautious approach of investing was prudent given market circumstances.

Month	No. Deals	Av Rate	Av Length	Max Length	No. long
April	41	4.58%	47	732	2
May	36	4.74%	88	732	3
June	34	4.56%	22	365	1
July	39	4.77%	29	365	1
August	31	4.88%	23	185	0
September	40	4.78%	38	365	2
October	40	4.46%	26	367	2
November	27	3.33%	111	1461	2
December	20	1.71%	7	90	0
January	21	1.21%	7	81	0
February	4	0.56%	1	1	0
March	0	n/a	n/a	n/a	n/a

Conclusions

2008-09 has been a traumatic year for investors. Security and liquidity were the only priorities following the collapse of Lehman Brothers in September. However, the Council did benefit from some longer-term investments made previous to, and during 2008-09 in terms of performance versus its benchmark. As these unwind so overall performance will drop in 2009-10, but given the still uncertain background, the search for yield is of secondary importance. It is the return of, rather than the return on your money which is most important.

Market sentiment, although improving, is still fragile and for that reason we are recommending that investments remain short term and with high quality counterparties where available.

Dan Willson
May 2009