AGENDA ITEM: 13

SUMMARY

Report for:	**Cabinet**
Date of meeting:	**24 April 2012**
PART:	**1**
If Part II, reason:	

Title of report:	**Treasury Management Strategy Amendments**
Contact:	Cllr Nicholas Tiley, Portfolio Holder for Finance & Resources Sally Marshall Corporate Director (Finance & Governance) Author/Responsible Officer: James Deane
Purpose of report:	To advise Cabinet on the challenges facing the Council's Treasury Team arising from the current economic climate, and to recommend amendments to the Treasury Management Strategy that could improve the Council's return on investments.
Recommendations	Cabinet is asked to recommend to Council the approval of the following amendments to the Council's Treasury Management Strategy (in the case of point 2, subject to approval of participation in the Local Authority Mortgage Scheme): 1. that the maximum investment limit for each institution rated 'blue' under the Sector creditworthiness scheme be raised from £10m to £12.5m; 2. that a cash-backed guarantee in support of the Local Authority Mortgage Scheme is permitted to be invested in a participating institution for a maximum period of 7 years. Cabinet is also asked to recommend to Council the approval of 'cash-backed' participation in the Local Authority Mortgage Scheme, in tandem with Hertfordshire County Council.
Corporate objectives:	

Implications: 'Value For Money Implications'	<u>Financial</u> The Council's return on investment provides a revenue stream and should be optimised within the context of the Council's risk appetite. <u>Value for Money</u> See above.
Risk Implications	Increasing investment in specific types of institution increases the risk of financial loss in the event of default by institutions within that category. This risk applies to all financial investments and is mitigated by spreading the risk across a range of institutions. Under current arrangements the advice by our financial adviser Sector is that investment is limited to the least risk categories (as defined by the Sector colour scheme). Increasing the threshold for investment in institutions within these groups, therefore represents a lower risk option than seeking higher returns at institutions outside of the schemes recommended by Sector. The risk can be further mitigated by spreading investments across the range of institutions within the group.
Equalities Implications	n/a
Health And Safety Implications	n/a
Monitoring Officer/S.151 Officer Comments	**Monitoring Officer:** The Treasury Management Strategy is a key element of the Council's budgetary framework. The TMS, and any amendments thereto, requires the approval of full Council. **S.151 Officer** This is a S151 Officer report
Consultees:	Hertfordshire County Council Sector Treasury Services
Background Papers:	Treasury Management Strategy Statement, Annual Investment Strategy 2012/13 (Appendix D to budget report), Cabinet 7th February 2012 Local Authority Mortgage Scheme – an introduction, Finance & Resources Overview & Scrutiny Committee 22nd November 2011
Glossary	Debt Management Office (DMO)

	Local Authority Mortgage Scheme (LAMS) Treasury Management Strategy (TMS)

1. Background

1.1 The Council's Treasury Management Strategy (TMS), approved by Full Council, determines the parameters within which Officers must operate when investing the Council's cash balances.

1.2 The TMS reflects the Council's risk appetite, which, in compliance with the CIPFA Treasury Management Code, observes the following investment priorities:

1. Security
2. Liquidity
3. Return

1.3 The economic downturn has brought increased risk of collapse to institutions that historically would have been considered safe investment opportunities for the Council.

1.4 In response to this increased risk, the Council, on the advice of Sector (its treasury advisors), has sought to optimise investment security by reducing the number of counterparties with whom it will invest to include only the lowest risk institutions. Lower risk institutions attract lower returns on investment.

1.5 The purpose of this report is to review the investment parameters set out in the current TMS, and to provide Members with an alternative model that may increase investment returns without attracting unacceptable levels of risk.

2. Current Treasury Management Policy

2.1 The Council's investment decisions are governed primarily by two key sections of the TMS; the Creditworthiness policy (paragraph 3.7.2), and the Country Limits policy (paragraph 3.7.3).

Creditworthiness policy

2.2 The creditworthiness policy is underpinned by the Sector credit rating system, which reflects institutions' credit ratings by the three main ratings agencies, supplemented by the Sector view.

2.3 This exercise results in a colour coding system which designates a colour to each institution based on its credit quality. Sector then recommend a maximum timeframe for investments in each colour group.

2.4 The Sector Credit List provides weekly credit updates on institutions, unless more urgent attention is required, in which case ad hoc updates are provided. Table 1 below shows the current number of institutions within each colour group, together with the conditions allocated to that colour group:

Table 1: investment limits by Sector colour band

Colour	Max Duration	Max Investment	No. of Institutions
Yellow	5 years	£10m	0
Purple	2 years	£10m	0
Blue	1 year*	£10m	2
Orange	1 year	£10m	0
Red	6 months	£9m	0
Green	3 months	£7m	10
No Colour	not to be used	n/a	n/a

*applies only to UK institutions with a level of state ownership deemed by Sector to be significant.

Country limits

2.5 As a further prudential measure, the Council does not currently invest in any institutions outside of the UK, regardless of the colour rating allocated by Sector.

3. Reviewing the current strategy

3.1 Due to the current economic climate and the resulting increased credit risk, the Sector list of investable counterparties continues to reduce. The far right column in Table 1 shows the number of counterparties open to the Council when the colour scheme is combined with the country limits policy.

3.2 In practice, the number of green counterparties is reduced from ten to two because the preferred business models of eight green rated institutions are not consistent with other elements of the Council's strategy. For example, HSBC is rated as green, but does not generally accept investments of less than one year; Standard Chartered Bank is also green but will not generally accept investments of less than £10m.

3.3 An effective counterparty list of four investable institutions means that the Treasury team must increasingly invest in lower rate options such as other Local Authorities (current average interest yield 0.46%) or the Debt Management Office (DMO) an agency of HM Treasury which offers returns of 0.25% regardless of duration or amount of investment.

3.4 The Council's Treasury Team has broadened the investment portfolio beyond traditional counterparties, whilst remaining within the TMS, in order to mitigate the impact of diminishing counterparties on the Council's investment returns. This includes use of Money Market Funds (average 0.68% yield), and internal lending to the HRA for the purposes of Self Financing (average 0.92% yield).

3.5 The Treasury Team is currently exploring the further use of Money Market Funds in line with the TMS, together with the viability of investing in building societies subject to credit risk analysis. Members will receive an update on this research at the next review of the TMS.

3.6 Despite these new initiatives, as longer-term investments continue to mature and more funds flow back into the Council, there is increasing pressure to make use of low rate investments such as other Local Authorities and the DMO.

4. Options for policy amendments to increase the rate of return

4.1 It is recommended that the Council retains the colour-based control structure of its existing investment strategy rather than providing for exceptions. The following proposed changes to the TMS combine potential for improved return on investment with the retention of the current structure.

Increase the cash limits with colour counterparties

4.2 The colour scheme, together with recommendations on investment duration, is provided by Sector. However, the cash limits applied to each colour banding are set by the Council.

4.3 It is recommended that the counterparty limit for the blue category is raised from £10m to £12.5m. The blue category governs the recommended treatment for UK banks with significant state ownership, currently the Lloyds and RBS groups.

4.4 An extra £5m invested with these institutions could generate extra income of £120k per annum based on currently available rates, whilst still retaining the relative security provided by a state-owned institution. This measure will be kept under review for any changes to the rating system that currently categorises only state-owned banks as blue.

4.5 The proportion of available Council funds invested in these institutions will also be monitored to mitigate the credit risk of overexposure in a small number of institutions, and the liquidity risk of having too high a proportion of funds invested for up to one year. As the largest contributor to investment funds, the rate of expenditure in the Council's capital programme will be closely monitored in this respect.

Amend the country limits policy

4.6 The Sector rating system considers institutions from a range of countries. If the Council was to lift the country limits policy this would broaden the range of counterparties available and further reduce reliance on low return investments.

4.7 At this stage it is not proposed to amend the country limit policy. However, it will be kept under review in line with developments in the Eurozone and wider economic markets, and further proposals brought to Members if required.

5. Local Authority Mortgage Scheme (LAMS)

5.1 A report on the LAMS was provided to the Finance & Resources Overview and Scrutiny Committee in November 2011. A summary of that report, outlining the risks and opportunities with the scheme, is attached in Appendix A. The basics of the scheme are outlined below, together with relevant updates.

5.2 The scheme is designed to address an increasing problem faced by many potential first-time buyers. Although able to afford monthly mortgage repayments, they are often unable to save the 25% deposit required by the majority of mortgage lenders.

5.3 The basis of the scheme is that if an applicant has a 5% deposit, the Council would 'top it up', (through acting as guarantor) from 5% to 25%. From the lender's perspective this provides an effective deposit of 25%, thereby meeting their more stringent lending requirements and enabling the buyer to borrow 95% of the value of the property. The Council's indemnity would be in place for 5 years, extendable by 2 years if the mortgage was in arrears at the end of the period.

5.4 If the mortgage borrower were to default during the indemnity period, the Council could be required to pay the lender up to the value of the guarantee provided on that property.

5.5 Hertfordshire County Council has recently announced that it is prepared to provide £1m for each District within Herts in order to stimulate the LAMS across the county. Dacorum Council has the opportunity to match this contribution, thereby providing the maximum £2m guarantee permitted under the terms of the scheme.

5.6 If it were to participate, the Council could choose whether to provide a cash-backed guarantee, or whether simply to provide a written guarantee. The cash-backed option would require the Council to invest funds for the full indemnity period of 5 years, for which it would receive a premium over and above the current commercial interest rate for that period. Lloyds is the largest of the 8 participating lenders, and currently offers a 0.7% premium. If the Council chose the non-cash-backed option, it would simply receive a £500 payment from the lender for each mortgage guaranteed.

5.7 The decision to approve a LAMS should not be considered wholly a treasury decision. Rather, it should be seen primarily as a corporate decision relating to the Council's broader objectives, with added treasury opportunity. However, should Members decide to implement a cash-backed scheme, an amendment to the TMS would be required to permit the lodging of funds for the 5-year term of the indemnity.

Appendix A

Summary of report to F&R OSC in November 2011.

Introduction

The Local Authority Mortgage Scheme (LAMS) provides the Council with an opportunity to:

- Help first-time buyers onto the property ladder;
- Stimulate the local housing market;
- Demonstrate commitment to housing within the Borough;
- Reduce the growing pressure on the Council housing list.

This paper outlines how the scheme works and focuses on salient points for the Council to consider in deciding whether to adopt the scheme.

Background

The recent high level of uncertainty in the economy has resulted in banks adopting a cautious approach to mortgage-lending. Typically, this has meant that home-buyers are now required to provide a larger deposit than in the past – where previously a 5% deposit could have secured a mortgage, a home-buyer is now likely to require a deposit of 20%-25%.

The requirement for larger deposits combined with house prices remaining high, has created an environment where first-time buyers who could comfortably afford monthly mortgage repayments are unable to access the property ladder because they cannot save the amount required for the deposit.

The challenge of saving a deposit is evidenced by the fact that the average price of a terraced house in Dacorum is currently £237k, meaning a first-time buyer in the Borough would need to save a deposit of £59k (25%) in order to secure a mortgage.

The LAMS is designed to help the increasing number of potential first-time buyers who could afford monthly mortgage repayments, but not the initial deposit required to get on the property ladder.

How does it work?

The basis of the scheme is that if an applicant has a 5% deposit, the Council would 'top it up' from 5% to 25%. From the lender's perspective this provides an effective deposit of 25%, thereby meeting their more stringent lending requirements and enabling the buyer to borrow 95% of the value of the property. (The Council can set a cash limit on the amount of support it is prepared to offer on each property.)

Continuing with the example of a terraced house in Dacorum, this would reduce the deposit the buyer had to provide from £59k (25%) to a more affordable £12k (5%).

The ‘top-up’ provided by the Council would be via guarantee, and could be cash backed or non-cash backed:

- Cash backed
  The Council lodges a cash deposit with the mortgage lender, which, as an incentive from the bank to partake in the scheme, generates investment income at a premium rate (e.g. for Lloyds this is currently 0.7% above normal rates).

- Non-cash backed
  The Council is not required to lodge a cash deposit with the mortgage lender, and is paid a flat rate payment of c£500 by the lender for each mortgage let under the scheme.

The guarantee would be in place for the first 5 years of each mortgage, after which the Council’s liability on that mortgage would end.

<u>What are the potential benefits?</u>

The scheme enables the Council to stipulate post-code based qualifying criteria for those applying for assistance. This would enable the Council to support the development of key strategic areas within the Borough.

Making first-time property purchase a more feasible option could slow the growing pressure on affordable housing within the Borough.

Support for the scheme would demonstrate the Council’s commitment to supporting the affordability of housing within the Borough and to supporting community development.

<u>What are the risks?</u>

Financial risk

If a property is sold for less than the amount of the mortgage provided, the Council is liable for up to the amount of the guarantee (i.e. the value of the top-up) it provided for that property.

For example, if a property valued at £100k with a mortgage of £95k and a Council guarantee of £20k was sold for £70k, the Council would lose the full value of its guarantee. If the same property was sold for £90k the Council would lose £5k of the guarantee provided.

Whilst there is no specific data on first-time buyers, repossessions by mortgage lenders in 2010 was running at 0.3% of all mortgages. If one doubles this to 0.6% (to reflect increased first-time buyer risk) and assumes the full guarantee is forfeit in the event of a repossession this would equate to the Council losing £6k for each £1m guaranteed.

This risk is partially mitigated through the credit checks carried out by the banks in advance of the mortgage being granted. Each applicant will be assessed on the basis of their ability to afford repayments on a 95% mortgage, despite the fact that in reality their repayments will reflect terms usually associated with 75% mortgage terms.

Interest rate risk

Under the terms of LAMS, new applicants may take an initial mortgage for a period that is less than the 5-year duration of the Council's guarantee. This means that the borrower would be required to renegotiate at prevailing interest rates for the remaining years of the Council's guarantee period.

The current volatility of the money markets means that attempting to predict interest rates at the time the mortgage would need to be renegotiated is inherently risky. If interest rates have increased significantly, the monthly repayments on the renegotiated mortgage could be significantly higher, which would, in turn, increase the Council's risk exposure.

This could be partly mitigated by the Council focussing its support to mortgage lenders offering 5-year fixed rate mortgages, thereby offering the Council more certainty over the extent its risk for the full duration of the guarantee. For example, of the three mortgage lenders currently offering loans nationally, as opposed to locally, Lloyds currently offers a maximum 3 year mortgage product, whereas Leeds BS currently offers a 5-year product. Assessed purely on this basis, the Leeds deal would offer reduced risk to the Council.

Reputational risk

All things being equal, the quantifiable financial risk at this stage appears relatively low. However, depending on the Council's approach to managing the reputational risks associated with the scheme, the financial impact could rise significantly.

For example, the Council should consider the reputational impact of allowing a scheme beneficiary to lose their home. Whilst the Council is unable to control the circumstances that may lead to a default (e.g. changing financial markets or circumstances of the individual), it may face pressure to provide support to that individual to help them keep their home.

Based on the assumed 0.6% repossession rate, the Council would have to support around 170 purchases before suffering a default. Given that a guarantee of £1m would support only 21 purchases (based on an average property guarantee of £47k) the risk of the Council supporting enough purchases to suffer a default would remain low.

<u>What happens at the end of the 5-year period?</u>

Under normal circumstances, the Council's role as a guarantor ends after a period of five years. However, this can be extended by a further two years if the mortgage is in arrears at the end of the 5-year period.

Based on a typical mortgage repayment period of 25 years, and assuming no change in house prices over the period, the borrower will have around 17% equity in their property after the first 5 years, when the Council's guarantee period ends.

However, the removal of the Council guarantee would not cause the borrower to revert back to the unfavourable rates associated with lower deposits, i.e. below 25%. This is because, unlike when a first-time buyer undertakes their first mortgage, the borrower would have 5 years' proven creditworthiness enabling lenders to offer future mortgage products based on affordability rather than proportion of deposit.