MEETING:	**PENSIONS COMMITTEE**
DATE:	**28 SEPTEMBER 2012**
TITLE:	**TREASURY MANAGEMENT 2011/12**
PURPOSE:	**CIPFA's Code of Practice requires that a report be produced on the results of the Council's actual Treasury Management on behalf of the Pension Fund**
RECOMMENDATION:	**RECEIVE THE REPORT FOR INFORMATION**
AUTHOR:	**DAFYDD L EDWARDS, HEAD OF FINANCE**

1. Introduction and Background

CIPFA's revised Code of Practice on Treasury Management was adopted by the Council on 1st March 2011 and the Council fully complies with its requirements. The Code requires that I report on the results of the Council's actual treasury management in the previous financial year against that which was expected.

In accordance with the Welsh Assembly Government's Statutory Guidance on Local Government Investments, which requires an authority to produce an Annual Investment Strategy, it was considered best practice for the Gwynedd Pension Fund (the "Fund") to adopt Gwynedd Council's Treasury Management Strategy Statement (TMSS) for 2011/12, as amended for the purpose of the Pension Fund. The Pensions Committee approved the TMSS at its meeting on 22 March 2011. As a result, I am required to report to the Pensions Committee on the results of the actual treasury management in 2011/12 against that which was expected.

This report looks at the economic background and investment activity.

2. Economic Background

At the time of determining the strategy for 2011/12, there were tentative signs that the UK was emerging from recession with the worst of the financial crisis behind it. Recovery in growth was expected to be slow and uneven as the austerity measures announced in the 2010 Comprehensive Spending Review were implemented in order to bring down the budget deficit and government borrowing, and rebalance the economy and public sector finances. Inflation measured by the Consumer Price Index (CPI) had remained stubbornly above 3%. Unemployment was at a 16-year high at 2.5 million and was expected to rise further as the public and private sector contracted. There was also a high degree of uncertainty surrounding Eurozone sovereign debt sustainability.

During 2011-12 inflation remained high with CPI (the official measure) and RPI rising in September to 5.2% and 5.6% respectively, primarily due to escalating utility prices and the January 2011 increase in VAT to 20%. Inflation eased slowly with reductions in transport costs and food prices, intensifying competition amongst retailers and supermarkets and the VAT effect falling out in 2012, pushing February 2012's CPI down to 3.4% and RPI to 3.7%. This, however, was not enough to offset low wage growth and, as a result, Britons suffered the biggest drop in disposable income in more than three decades.

Growth, on the other hand, remained elusive. The Bank's Quarterly Inflation Reports painted a bleak picture as the outlook was downgraded to around 1% in 2011 and 2012 alongside. The unresolved problems in the Eurozone weighed negatively on global economic prospects. UK GDP was positive in only the first and third calendar quarters of 2011; annual GDP to December 2011 registered just 0.5%. Unemployment rose to 2.68 million and, worryingly, youth unemployment broke through the 1 million barrier. House prices struggled to show sustained growth and consumer confidence remained fragile.

It was not surprising that the Bank of England's Monetary Policy Committee maintained the status quo on the Bank Rate which has now been held at 0.5% since March 2009, but increased asset purchases by £75bn in October 2011 and another £50bn in February 2012 taking the Quantitative Easing total to £325bn.

The policy measures announced in the March 2012 Budget statement were judged to be neutral. The Westminster Government stuck broadly to its austerity plans as the economy was rebalancing slowly. The opinion of independent Office for Budget Responsibility (OBR) was that the government was on track to meet its fiscal targets; the OBR identified oil price shocks and a further deterioration in Europe as the main risks to the outlook for growth and in meeting the fiscal target.

The US economy continued to show tentative, positive signs of growth alongside a gradual decline in the unemployment rate. The US Federal Reserve (the Fed) committed to keeping policy rates low until 2014, although a modest shift in the Fed's language in March, alongside an improvement in economic activity, cast doubts about the permanence of the Fed's policy commitment.

In Europe, sovereign debt problems for some peripheral countries became critical. Several policy initiatives were largely ineffectual; two bailout packages were required, one for Greece and one for Portugal, and the contagion spread to Spain and Italy whose sovereign bonds came under increased stress in November. Standard & Poor's downgraded nine European sovereigns and the EFSF bailout fund. The successful Greek sovereign bond swap in March 2012, shortly after its second bailout package, allowed it to avoid bankruptcy later that month, but it was not a long-term solution. The ECB's €1.3 trillion Long-Term refinancing Operations (LTROs) flooded the financial markets with ultra-cheap 3-year liquidity, relieving much of the immediate funding pressure facing European banks in 2012, but markets ultimately took the view the LTROs simply served to delay a resolution of, rather than addressed, the fundamental issues underpinning Euroland's problems.

Market sentiment oscillated between ‘risk on’/’risk off’ modes, this swing becoming the norm for much of 2011/12 as investors shifted between riskier assets and the relative safety of higher quality government bonds. Gilts, however, were a principal beneficiary of the ‘risk-off’ theme which helped push yields lower. There was little market reaction to or impact on gilts by the decision by Fitch and Moody’s to change the outlook on the UK’s triple-A rating from stable to negative. Over the 12-month period from April 2011 to March 2012, 5-year gilt yields more than halved from 2.40% to 1.06%; 10-year gilt yields fell from 3.67% to 2.25%; 20-year yields fell from 4.30% to 3.20% and 50-year yields from 4.20% to 3.35%. PWLB borrowing rates fell commensurately, but the cost of carry associated with borrowing longer-term loans whilst investing the monies temporarily until required for capital financing remained high, in excess of 4.1% for 20-year PWLB Maturity borrowing.

Europe’s banking sector was inextricably linked with the sovereign sector. Sharp moves in sovereign CDS and bond yields were fairly correlated with the countries’ banking sector performance. The deterioration in the prospects for real growth had implications for earnings and profit growth, and banks’ creditworthiness. The European Banking Authority’s banking stress tests of 70 EU banks undertaken in October 2011 identified a collective €106 billion shortfall to banks’ Core Tier 1 ratio of 9%. The slowdown in debt and equity capital market activity also had implications for banks’ funding and liquidity. These principal factors, as well as a reassessment by the rating agencies of future sovereign support for banks, resulted in downgrades to the long-term ratings of several UK and non-UK financial institutions in autumn 2011.

3. Investment Activity

The Welsh Government’s (WG) revised investment guidance came into effect on 1st April 2010 and reiterated the need to focus on security and liquidity, rather than yield. It also recommended that strategies include details of assessing credit risk, reasons for borrowing in advance of need, and the use of treasury advisers.

	Balance on 31/03/2011 £m	Balance on 31/03/2012 £m
Pension Fund Cash Balances	10.0	3.4

The reduction in cash balances at 31 March 2012 was due to the transfer of surplus cash to two investment managers during March 2012.

As requested by the Pensions Committee on 23 March 2011, the pension fund's money was pooled with the Council's general cashflow. The table below shows a summary of where this pooled money was invested.

Investments	Balance on 01/04/2011 £m	Investments made £m	Maturities/ Investments sold £m	Balance on 31/03/2012 £m
Short Term Investments	63.1	319.0	(329.5)	52.6
Investments in Pooled Funds	5.0	98.8	(103.8)	0
TOTAL INVESTMENTS	**68.1**	**417.8**	**(433.3)**	**52.6**
Increase/ (Decrease) in Investments £m				(15.5)

Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2011/12. Investments during the year included:

- Deposits with other local authorities;
- Investments in AAA-rated stable net asset value Money Market Funds;
- Call accounts and deposits with banks and building societies systemically important to each country's banking system (UK, Australia, Canada, Finland, France, Germany, Netherlands, Spain, Switzerland and the US).

Credit Risk

Counterparty credit quality was assessed and monitored with reference to credit ratings; credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; any potential support mechanisms and share price. The minimum long-term counterparty credit rating determined for the 2011/12 treasury strategy was A+/A1 across rating agencies Fitch, S&P and Moody's.

This particular criterion was amended on 15 December 2011 by the full Council to A-/A3, in response to downgrades in credit ratings below A+ of many institutions considered to be systemically important to the financial system. The downgrades were driven principally by the agencies' view the extent of future Government support (flowing from the recommendations to the Government from the Independent Commission on Banking) rather than a deterioration in the individual institutions' creditworthiness.

Counterparty credit quality has progressively reduced as demonstrated by the Credit Score Analysis summarised below. This is due to the amendment of the minimum credit quality of counterparties to A-/A3. The table in the Appendix explains the credit score.

Date	Value Weighted Average Credit Risk Score	Value Weighted Average Credit Rating	Time Weighted Average Credit Risk Score	Time Weighted Average Credit Rating	Average Life (days)
31/03/2011	3.69	AA-	2.26	AA+	109
30/06/2011	3.49	AA	2.70	AA	152
30/09/2011	3.07	AA	2.50	AA+	80
31/12/2011	3.57	AA-	3.58	AA-	64
31/03/2012	4.98	A+	4.93	A+	27

Liquidity
In keeping with the WG Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds, overnight deposits and the use of call accounts.

Yield
The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate was maintained at 0.5% through the year.

The Council considered an appropriate risk management response to uncertain and deteriorating credit conditions in Europe was to shorten maturities for new investments. Short term money market rates also remained at very low levels, which had a significant impact on investment income.

Update on the Council's Investment with Heritable Bank
It is expected that at least 88p/£ will be recovered overall. 67.9% has been recovered to date, a further 14.3% is expected in 2012/13, and 5.8% or more is expected in 2013/14.

4. Recommendation

The Pensions Committee is asked to receive the report for information on investment of the Fund's cash, pooled with the Council's cash, in 2011/12.

Appendix

Credit Score Analysis

Scoring:

Long-Term Credit Rating	**Score**
AAA	1
AA+	2
AA	3
AA-	4
A+	5
A	6
A-	7
BBB+	8
BBB	9
BBB-	10
Not rated	11
BB	12
CCC	13
C	14
D	15

The value weighted average reflects the credit quality of investments according to the size of the deposit. The time weighted average reflects the credit quality of investments according to the maturity of the deposit

Originally the Council aimed to achieve a score of 5 or lower, reflecting the Council's overriding priority of security of monies invested (and the minimum credit rating of threshold of A+ for investment counterparties), although this target reduced to 7 or lower following the reduction of the minimum credit rating of threshold of A- for investment counterparties.