Report to:

Audit and Governance Committee
Cabinet
Council

Report of: Head of Finance

Author: Bob Watson

Tel: 01235 540429

E-mail: bob.watson@southandvale.gov.uk

Cabinet Member responsible: Matthew Barber

Tel: 07816 481452

E-mail: matthew.barber@southandvale.gov.uk

To: Audit and Governance Committee on: 24 September 2014
To: Cabinet on: 3 October 2014
To: Council on: 15 October 2014

Treasury management outturn 2013/14

That Audit and Governance Committee:

1. notes the treasury management outturn report 2013/14,
2. is satisfied that the treasury activities are carried out in accordance with the treasury management strategy and policy, and
3. make any comments and recommendations to cabinet as necessary.

That Cabinet:

Considers any comments from Audit and Governance Committee and recommends Council to:

1. approve the treasury management outturn report for 2013/14;
2. approve the actual 2013/14 prudential indicators within the report.

Purpose of Report

1. The report fulfils the legislative requirements to ensure the adequate monitoring and reporting of the treasury management activities and that the council's prudential indicators are reported to council at the end of the year. The report provides details of the treasury activities for the financial year 2013/14.

2. This complies with the requirements of the Chartered Institute of Public Finance and Accountancy (CIPFA's) Code of Practice on Treasury Management (revised) 2009.

Strategic Objectives

3. Effective treasury management is required in order to meet our strategic objective of managing our business effectively. Managing the finances of the authority in accordance with the treasury management strategy will help to ensure that the resources are available to deliver our services and meet the council's other strategic objectives.

Background

4. The council's treasury activities are strictly regulated by legislation. The CIPFA Prudential Code and CIPFA Treasury Management Code of Practice require a report to be provided to council at the end of the financial year. The report covers the treasury activity for 2013/14.

5. The 2013/14 treasury management strategy was approved by council on 20 February 2013. This report provides details on the treasury activity and performance for 2013/14 against the prudential indicators and benchmarks set for the year. Full council is required to approve this report.

6. An update on the economic conditions and interest rate forecasts is contained in appendix 'A'.

Icelandic bank default – Landsbanki Islands hf

7. As previously reported, the Council has an investment of £1m with Landsbanki. The Icelandic Government has stated its intention to honour all its commitments as a result of their banks being placed into receivership.

8. In April 2011 the Reykjavik District Court ruled that local authorities' claims qualified for priority under Icelandic bankruptcy legislation. The decision was appealed to the Icelandic Supreme Court who affirmed the district court's ruling in October 2011. Subsequently the Reykjavik District Court recognised the council's claim at £1,004,890.41 (being the principal sum plus interest due).

9. The Winding Up Board for Landsbanki Islands hf anticipate that final recovery will exceed the book value of the priority claims and as a result the Council is eventually likely to recover 100 per cent of their deposit, although repayments will be received in stages up to 2018. The first distribution payment was made in December 2011, with a further three payments to date; the council has received a total of £531,286 by 31 March 2014. Councillors will be periodically informed on the latest developments as they become known.

10. In December 2013 the majority of those local authorities who held Landsbanki priority creditor status, sold their claims to Deutsche Bank. The actual amount the claims were sold for is unknown due to confidentiality clauses, but is believed to be in the region of ninety-two pence in the pound for the entire claim amount. The council did not sell its claim, and remains one of thirteen local authority creditors holding on to their claims.

Treasury activities in 2013/14

Council investments as at 31 March 2014

11. The council's investments at 31 March 2014 were as follows:

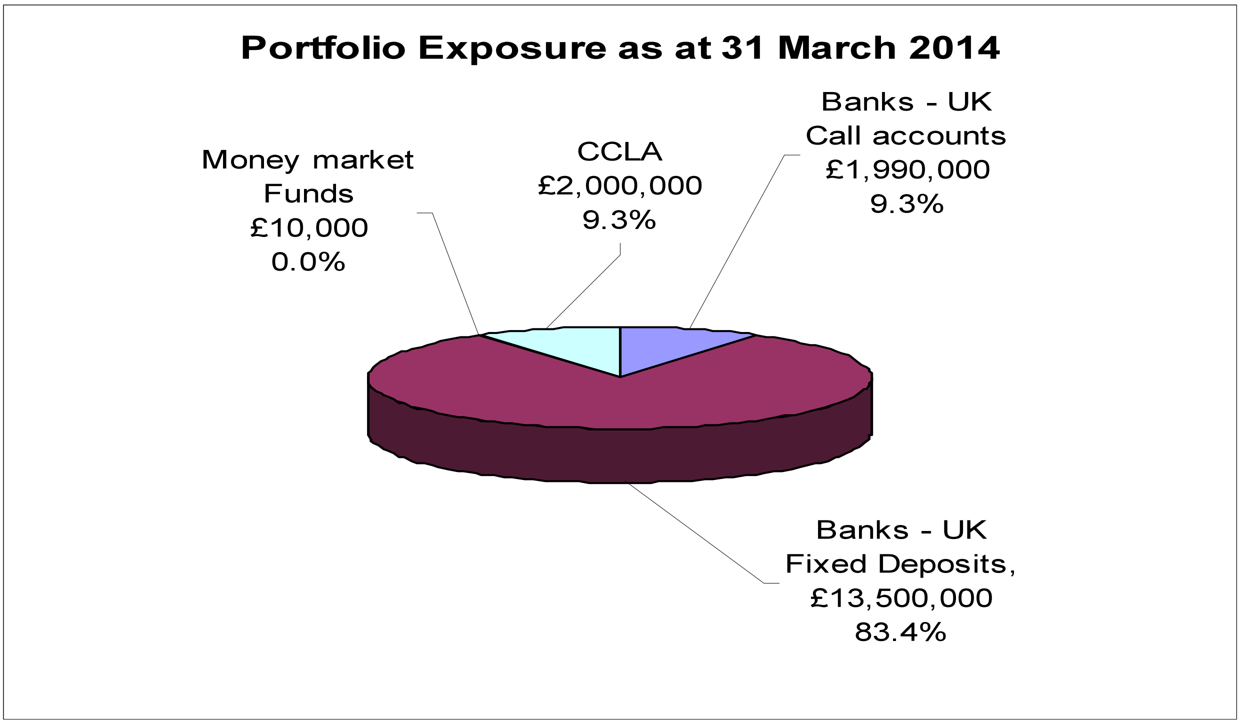
Table 1: maturity structure of investments at 31 March 2014:		
	£000's	**% holding**
Call	1,990	9%
Money market fund	10	0%
Up to 4 months	4,000	19%
5-6 months	1,000	5%
6 months to 1 year	8,500	40%
Over 1 year	4,000	19%
Total cash deposits	**19,500**	**91%**
CCLA Property fund	**2,000**	**9%**
Total investments	**21,000**	**100%**

12. The majority of the funds invested are held in the form of fixed interest rate and term cash deposits. These provide some certainty over the investment return. The investment profile is organised in order to ensure sufficient liquidity for revenue and capital activities, security of investments and to manage risks within all treasury management activities.

13. Money market rates over the year have remained very low and flat. One year rates have steadied and are now averaging just below one per cent. The government's Funding for Lending Scheme (FLS) has now completed, but there is still little demand for money in the markets which has perpetuated the low investment rates available. It continues to be difficult to find re-investment opportunities offering a return which also meet the security and risk criteria.

14. The weighted average maturity period at the end of the year was 623 days. This is mainly due to a long term investment with another local authority.

15. The chart below shows in percentage terms how the portfolio is spread across investment types:



Investment income

16. The total investment income achieved in 2013/14 was £478,217 compared to the original budget estimate of £356,025 as shown in table 2 below:

Table 2: Investment interest earned by investment type			
Investment type	**Actual Budget £000's**	**Actual Interest £000's**	**Variation £000's**
Call accounts	132	116	16
Cash deposits	104	257	(153)
MMFs	-	1	(1)
CCLA Property Fund	120	104	16
Total Interest	**356**	**478**	**(122)**

17. The actual return achieved was 39 per cent higher than the original budget. This was due to :

- The average rates achieved on internally managed investments were higher than originally forecast.
- The maturity period for investments was extended thereby attracting slightly higher rates.
- Average balances throughout the year have remained higher than forecast.

18. The total actual average interest rate achieved for the year was 1.39 per cent.

Performance measurement

19. A list of investments as at 31 March 2014 is shown in appendix B. The average level of investments held throughout the year was £34.4 million and the average return on these investments is shown below in table 3.

Table 3: investment returns achieved against benchmark				
	Benchmark return	Actual return	Growth (below)/above benchmark	Benchmarks
	%	%	%	
Bank & building society deposits - managed in house	0.40%	1.39%	0.99%	3 month LIBID
Industry average*	0.40%	0.26%	-0.14%	

*Source : Capita Asset Services weighted average of 5 fund managers' results covering 22 funds

20. The table shows in summary the performance of the council's investments against the benchmarks set out in the treasury management strategy. These benchmarks are used to assess and monitor the council's investment performance. The annual investment strategy set the benchmark target for internal cash invested as the 3 month LIBID. The performance for the year of 1.39% exceeded the benchmark by 0.99 per cent and was 1.13 per cent above the industry average.

21. The council uses short-term investments to meet daily cash-flow requirements and has also aims to invest a proportion of the portfolio over longer dated cash deposits where possible. The weighted average life (WAL) of the council's investments has increased to 623 days from 45 days in 2012/13. The council has kept much of its funds in call accounts as the rates on these are have been exceeding the fixed term deposit rate for 12 month deposits; to balance the investment portfolio the council has issued some longer term loans to local authorities, which has increased the average life of the investments.

Land and Property

22. The council holds a portfolio of non-operational assets, which includes land, offices and shops that are let on a commercial basis. These assets had a net book value of £20.6 million at 31 March 2014 (£20.8 million as at 31 March 2013) and generated income of £1.5 million (£1.5 million in 2012/13). This is equivalent to a gross return of 7.2% (2012/13, 7.2%), which excludes costs such as maintenance and management fees. Due to movement in property values and the exclusion of whole life costs, these rates of return should not be taken as a direct comparison with the treasury rates. The Economy, Leisure and Property (ELP) team manages investment property ensuring that rent is collected and rent reviews are implemented. The performance of the investment property portfolio is assessed annually by the property team to determine if assets should be retained or disposed of.

Treasury management limits on activity

23. The council is required by the Prudential Code to report on the limits set each year in the treasury management strategy. The purpose of these limits is to ensure that the activity of the treasury function remains within certain parameters, thereby mitigating risk and reducing the impact of an adverse movement in interest rates. However, if these limits are set to be too restrictive they will impair the opportunities to reduce costs/improve performance. During the year none of these limits were exceeded. These limits are shown in appendix C.

Liquidity and yield

24. The benchmarks for liquidity are set to ensure that sufficient funds can be accessed at short notice. These are targets and not limits. The weighted average life (WAL) in days sets a benchmark for how long investments should be made and the maximum benchmark is a target set to ensure that investments are not made for too long. For example the amount to be maintained for liquidity was £10m and the actual of £11m was above the benchmark. The actual year end position for the WAL of 623 days was higher than the benchmark of 150 days – this benchmark is set in the annual treasury management strategy as a guide to the average investment length in order to ensure a balanced investment portfolio. The reason the benchmark has been exceeded stems from a conscious decision to increase the length of some core investments in order to provide some balance to the overall portfolio of investments and to increase the return for the council. These long-term investments are balanced by a level of short-term cash holdings, which are being kept high due impending business rate refunds.

25. The year end position against the original benchmarks approved in February 2013 is shown below:

Table 11: Risk-liquidity against benchmark		
	2013/14 Benchmark £m	**2013/14 Actual £m**
Bank overdraft	0.5	0
Short term deposits - minimum available within 1 week	10	11
	2013/14 Benchmark	**2013/14 Actual**
Weighted average life (days)	150.0	623.0

Debt activity during 2013/14

26. During 2013/14 there was one occasion when the council had to borrow for short term cash flow needs – this was for four days in March 2014 and was fully repaid before year end. The council will continue to take a prudent approach to its debt strategy. The prudential indicators and limits set out in appendix C provide the scope and flexibility for the council to borrow in the short-term up to the maximum limits, if such a need arose within the cash flow management activities of the authority, for the achievement of its service objectives.

Financial implications

27. Although there was talk of a rise in interest rates a year ago, the reduction in inflationary pressures has meant that interest rates have remained at their historic low. The current outlook for growth in the UK economy means that there may start to be an increase in rates towards the end of 2014/15, but any increases (if they occur) are likely to be gradual and in small steps. The investments made in 2013/14 ensured that the council earned interest of £478,000 (2012/13: £533,000), however from 2014, income is anticipated to remain stable with no real increase until market rates maintain a sustained rise. This will be reflected in the council's 2015/16 budget and its medium term financial plan.

Legal implications

28. There are no significant legal implications as a result of the recommendations in this report. Compliance with the CIPFA Code of Practice for Treasury Management in the Public Services, the DCLG Local Government Investment Guidance provides assurance that the council's investments are, and will continue to be, within its legal powers.

Conclusion

29. As at 31 March 2014, the council's financial investments portfolio had a value of £21.5 million. As a result of proactive management of investments held, and despite the continuing low market interest rates, during 2013/14 these investments generated £478,217 in investment income, which was £122,192 above the £356,025 original budgeted estimate.

30. The financial year 2013/14 continued to provide a challenge to treasury management. Concerns for counterparty risk continue to present the council with a difficult environment to invest in. The main implications of these factors were:

    - low investment returns and difficulty to forecast;
    - increased counterparty risk – reduced choice of counterparties
    - Interest rate exposure risk – due to investments held in short-term maturity periods.

31. Despite the continued uncertainty the overall investment performance was above the industry average for 2013/14. Investments were made in the year that provided a reasonable return whilst maintaining security and liquidity.

Background papers

- Chartered Institute of Public Finance and Accounting (CIPFA) code of practice for treasury management in the public sector.

- CIPFA treasury management in the public services code of practice and cross sectoral guidance notes

- Treasury Management Strategy 2013/14 – Council 20 February 2013.

Appendices

A – Economic update and interest rates
B – List of investments as at 31 March 2014
C – Prudential indicators
D – Glossary of terms

Economic update and interest rates as at July 2014

A1. The UK returned to strong growth during 2013/14 and indications are this will continue through 2014/15.

A2. Inflation has fallen sharply and expectations are that inflation will continue to be subdued. However, real incomes are still having an affect on households as wages have not risen with inflation. The squeeze on households' income will remain a critical factor in the economy over the next few years. The slow recovery has meant that social security payments remain high and tax income is low.

A3. Deflation is now a threat in the Eurozone. The ECB took some action in June 2014 to loosen monetary policy in order to promote growth.

A4. The government's Funding for Lending Scheme (FLS) has been introduced to improve access to mortgages at lower rates. This has reduced lenders need to borrow and money market rates have fallen considerably as a result. There will be a need to increase interest rates and reverse the government bond purchases at some stage, but it is unlikely that the latter will happen in the next 12 to 24 months.

A5. Investor demand in UK gilts as a 'safe haven' continues to keep yield increases down. Long term rates will eventually rise, mainly due to the fact that high volumes of gilts have been issued already in the UK and also in other major western countries.

A6. Following comments from the MPC and Mark Carney, along with the prospect of good economic recovery in 2014, interest rates are forecast to rise from 2015.

A7. Concerns over investment counterparty risk remain because of the volatile economic conditions. However the council's current treasury management policy manages this risk down to a low level.

Interest rates

A8. The Bank of England Inflation report upgraded its growth predictions to 3.4% in 2014 and 2.9% in 2015.

A9. Bank rate remained unchanged at 0.5% throughout 2013/14. The earlier forecast of a rate rise in Q4 of 2016 has been revised to Q1 in 2015. This follows comments from the MPC and the fact economic recovery is likely to be robust.

A10. Investment rates have remained flat with a range between 0.5 per cent to around 1.0 per cent for up to a year's maturity. This has dropped significantly as banks and building societies were offered further cheap cash supply via the FLS. The short term rates from one month to six months offer very little differential with six month rates ranging between 0.37 per cent and 0.55 per cent.

A11. Capita Asset Services' forecast of the expected movement in medium term interest rates:

	NOW	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
BANK RATE	0.50	0.50	0.50	0.75	0.75	1.00	1.00
3 month LIBID	0.50	0.50	0.60	0.80	0.80	1.10	1.10
6 month LIBID	0.58	0.60	0.80	0.90	1.00	1.15	1.20
12 month LIBID	0.80	0.80	1.00	1.00	1.20	1.30	1.40
5 yr PWLB	2.70	2.70	2.80	2.90	3.00	3.00	3.10
10 yr PWLB	3.50	3.70	3.70	3.80	3.90	4.00	4.00
25 yr PWLB	4.10	4.40	4.40	4.50	4.60	4.70	4.70
50 yr PWLB	4.10	4.40	4.40	4.50	4.60	4.70	4.70
	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
BANK RATE	1.25	1.25	1.50	1.75	2.00	2.00	2.00
3 month LIBID	1.30	1.40	1.60	1.90	2.10	2.25	2.25
6 month LIBID	1.40	1.50	1.80	2.00	2.20	2.30	2.30
12 month LIBID	1.70	1.80	2.10	2.20	2.30	2.40	2.40
5 yr PWLB	3.20	3.30	3.30	3.40	3.50	3.60	3.60
10 yr PWLB	4.10	4.20	4.20	4.30	4.40	4.40	4.40
25 yr PWLB	4.80	4.80	4.90	4.90	4.90	5.00	5.00
50 yr PWLB	4.80	4.80	4.90	4.90	4.90	5.00	5.00

Appendix B

Investments as at 31 March 2014

Counterparty	eposit Ty	Maturity Date	Principal	Rate
Hull City Council	Fixed	January 2021	2,000,000	2.50%
Hull City Council	Fixed	August 2020	2,000,000	2.70%
Close Brothers Ltd	Fixed	November 2014	1,000,000	1.05%
Lloyds TSB Bank Plc	Fixed	June 2014	3,000,000	1.01%
National Counties Building Society	Fixed	June 2014	1,000,000	1.00%
Lloyds TSB Bank Plc	Fixed	December 2014	2,000,000	0.98%
Manchester Building Society	Fixed	October 2014	2,000,000	0.90%

Prudential indicators as at 31 March 2014		
	2013/14 Original estimate £m	**31.03.2014 Actual £m**
Authorised limit for external debt		
Borrowing	10	0
Other long term liabilities	5	0
	15	**0**
Operational boundary for external debt		
Borrowing	5	0
Other long term liabilities	0	0
	5	**0**
Investments		
Interest rate exposures		
Limits on fixed interest rates	50	23
Limits on variable interest rates	10	0
Maximum principal sums invested > 364 days		
Upper limit for principal sums invested > 364 days	20	4

Appendix D

GLOSSARY OF TERMS

Basis Point (BP)	1/100th of 1%, i.e. 0.01%
Base Rate	Minimum lending rate of a bank or financial institution in the UK.
Benchmark	A measure against which the investment policy or performance of a fund manager can be compared.
Bill of Exchange	A non-interest-bearing written order used primarily in international trade that binds one party to pay a fixed sum of money to another party at a predetermined future date.
Callable Deposit	A deposit placed with a bank or building society at a set rate for a set amount of time. However, the borrower has the right to repay the funds on pre agreed dates, before maturity. This decision is based on how market rates have moved since the deal was agreed. If rates have fallen the likelihood of the deposit being repaid rises, as cheaper money can be found by the borrower.
[Cash] Fund Management	Fund management is the management of an investment portfolio of cash on behalf of a private client or an institution, the receipts and distribution of dividends and interest, and all other administrative work in connection with the portfolio.
Certificate of Deposit (CD)	Evidence of a deposit with a specified bank or building society repayable on a fixed date. They are negotiable instruments and have a secondary market; therefore the holder of a CD is able to sell it to a third party before the maturity of the CD.
Commercial Paper	Short-term obligations with maturities ranging from 2 to 270 days issued by banks, corporations and other borrowers. Such instruments are unsecured and usually discounted, although some may be interest bearing.
Corporate Bond	Strictly speaking, corporate bonds are those issued by companies. However, the term is used to cover all bonds other than those issued by governments in their own currencies and includes issues by companies, supranational organisations and government agencies.
Counterparty	Another (or the other) party to an agreement or other market contract (e.g. lender/borrower/writer of a swap/etc.)

Credit Default Swap (CDS)	A swap designed to transfer the credit exposure of fixed income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller of the swap.
Capital Financing Requirement (CFR)	The amount the council has to borrow to fund its capital commitments.
CIPFA	Chartered Institute of Public Finance and Accountancy.
CLG	[Department for] Communities and Local Government.
Derivative	A contract whose value is based on the performance of an underlying financial asset, index or other investment, e.g. an option is a derivative because its value changes in relation to the performance of an underlying stock.
Debt Management Account Deposit Facility (DMADF)	Deposit Account offered by the Debt Management Office, guaranteed by the UK government
European Central Bank (ECB)	European Central Bank – sets the central interest rates in the EMU area. The ECB determines the targets itself for its interest rate setting policy; this is the keep inflation within a band of 0 to 2%. It does not accept that monetary policy is to be used to manage fluctuations in unemployment and growth caused by the business cycle.
European and Monetary Union (EMU)	The Economic and Monetary Union (EMU) is an umbrella term for the group of policies aimed at converging the economies of all member states of the European Union.
Equity	A share in a company with limited liability. It generally enables the holder to share in the profitability of the company through dividend payments and capital appreciation. Equity values can decrease as well as increase.
Forward Deal	The act of agreeing today to deposit funds with an institution for an agreed time limit, on an agreed future date, at an agreed rate.
Forward Deposits	Same as forward dealing (above).
Fiscal Policy	The government policy on taxation and welfare payments.

GDP	Gross Domestic Product.
[UK] Gilt	Registered UK government securities giving the investor an absolute commitment from the government to honour the debt that those securities represent.
LIBID	London inter-bank bid rate
LIBOR	London inter-bank offered rate.
Money Market Fund	A well rated, highly diversified pooled investment vehicle whose assets mainly comprise of short-term instruments. It is very similar to a unit trust, however in a MMF.
Monetary Policy Committee (MPC)	Government body that sets the bank rate (commonly referred to as being base rate). Their primary target is to keep inflation within plus or minus 1% of a central target of 2.5% in two years time from the date of the monthly meeting of the committee. Their secondary target is to support the government in maintaining high and stable levels of growth and employment.
Other Bond Funds	Pooled funds investing in a wide range of bonds.
PWLB	Public Works Loan Board.
QE	Quantitative Easing.
Retail Price Index	Measurement of the monthly change in the average level of prices at the retail level weighted by the average expenditure pattern of the average person.
Sovereign Issues (excl UK Gilts)	Bonds issued or guaranteed by nation states, but excluding UK government bonds.
Supranational Bonds	Bonds issued by supranational bodies, e.g. European Investment Bank. The bonds – also known as Multilateral Development Bank bonds – are generally AAA rated and behave similarly to gilts, but pay a higher yield (“spread”) given their relative illiquidity when compared with gilts.
Treasury Bill	Treasury bills are short-term debt instruments issued by the UK or other governments. They provide a return to the investor by virtue of being issued at a discount to their final redemption value.