Audit & Governance Committee 12 January 2011

Report of Head of Finance

Report No. 92/10

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To:	AUDIT & GOVERNANCE COMMITTEE on	12 January 2011
	EXECUTIVE on	11 February 2011
	COUNCIL on	23 February 2011

Treasury management mid-year monitoring report 2010/11

Recommendations

That Audit and Governance Committee:

1. *notes the treasury management mid year monitoring report 2010/11, and*
2. *is satisfied that the treasury activities are carried out in accordance with the treasury management strategy and policy.*

That the Executive:

Considers any comments from Audit & Governance Committee and recommends council to note the report.

Purpose of report

1. The report fulfils the legislative requirements to ensure the adequate monitoring of the treasury management activities and that the council's prudential indicators are reported to council in year. The report provides details of the treasury activities for the first six months

of 2010/11, provides an update on the current economic conditions affecting treasury management decisions and looks ahead at the activities for the remainder of the year.

Strategic objectives

2. 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 resources are available to meet the council's other strategic objectives.

Background

3. Part one of the Local Government Act 2003 introduced the *Prudential Code for Capital* Finance *in Local Authorities*, under which local authorities are required to comply with the *CIPFA Code of Practice on Treasury Management in the Public Services*. This was revised in December 2009, and introduced a requirement to provide a half yearly monitoring report on treasury activity.

4. The 2010/11 to 2012/13 treasury management strategy was approved by council on 17 February 2010. It outlined the expected prudential indicators for 2010/11 and set out the expected treasury management operations for the period. It also nominated Audit and Governance Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

5. This report provides details on the economic issues and interest rate movements for the first six months of 2010/11, together with information on the treasury activity and performance against prudential indicators and benchmarks set for the year.

Treasury management advisers

6. The council has used Butlers as its treasury management consultants. Butlers are a business division of ICAP Securities Limited. On the 4th October, ICAP plc announced its decision to transfer the services provided by Butlers to Sector Treasury Services Limited following a strategic review of the provision of treasury consultancy services.

7. Sector is a subsidiary of the Capita Group plc and is a leading independent provider of treasury advisory services to the public sector. From the 25 October the council's contract with Butlers was assigned to Sector in its entirety.

8. Sector will continue to perform and execute the obligations under the contract, which will formally terminate on the contract renewal date, July 2011. The majority of Butlers' staff transferred to Sector on 25 October 2010 and we therefore do not expect there to be a disruption to the service provided. Whilst the advisers provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice the final decision on treasury matters remains with the council.

9. Sector's services include the provision of credit rating information, strategic advice including a review of the investment and borrowing strategies and policy documents, advice to assist the council to formulate a view on interest rates, performance indicators and fund management performance monitoring.

Economic conditions

10. This year the global financial markets have been concerned with the financial crisis in the euro-zone, triggered by the threat of sovereign debt default by Greece, a last minute rescue from a total collapse of the euro single currency mechanism and, more recently, a second victim of the debt crisis in Eire. In the UK, the Government has announced the

most severe package of public sector spending cuts since the Second World War, the effects of which will be felt by local government for many years to come.

11. Any policy decisions will have a major impact on the movement in interest rates. There continues to be exceptional uncertainty about the future direction of the economy which is evidenced by members of the Bank of England (BoE) Monetary Policy Committee (MPC) having opposing views on the direction the BoE base rate should move, if at all.

12. The BoE has forecast that inflation will remain above target until 2012. However, despite this, there is a general consensus that interest rates will rise only very gradually through to 2014. This view is qualified by some who are worried by the potential inflationary pressures further quantitative easing (QE) may generate.

13. The economic environment remains difficult and concerns over investment counterparty risk mean that the council continues to restrict itself to short term investments with high quality counterparties. This means that investment returns remain very low.

Icelandic banks – Landsbanki

14. The council had an investment of £1 million (plus interest due of £4,890) with the failed Icelandic bank Landsbanki Islands hf. There have been no repayments to date. The Landsbanki Winding-up Board are of the view that fixed-term depositors such as local authorities have priority status as creditors. This has been challenged by other creditors who would not have priority status and this issue is scheduled to start being heard by the Icelandic court in February 2011.

15. The latest estimate of the recoverable amount with priority status is 95%. If the council does not receive priority status the estimate for expected repayments is below 40%. Any recovered amount is likely to be paid in instalments over a number of years.

Current investments

16. The council's investments at 30 September 2010 were as follows (not including that with Landsbanki as above):

Cash deposits at 30 Sept. 2010, maturity period,	Total £'000	%
Money market fund (Instant access)	2,550	21%
Up to 1 week	1,000	8%
1 – 2 weeks	4,500	37%
2 – 3 weeks	--	
3 – 4 weeks	--	
1 – 2 months	2,000	17%
2 – 3 months	--	
3 – 4 months	2,000	17%
greater than 4 months	--	
Total in-house investments	12,050	100%
Investec Asset Management (see below)	15,376	

(maturity periods refer to time remaining to end of term).

17. The council currently holds all of its cash investments in the form of cash deposits which have been placed for fixed terms with a fixed investment return. During the first half-year investments have been made with nine building societies, three banks and a local authority. Of the in-house investments at 30 September, £2.55 m (21%) was with the Money market fund, £3.5 m (29%) was with UK banks and £6.0 m (50%) with building societies as follows:

Cash deposits at 30 Sept. 2010		Amount £'000
Banks	Close Brothers Ltd Santander UK plc	1,000 2,500
Building Societies	Coventry Kent Reliance Norwich & Peterborough	2,000 3,000 1,000
Money Market Fund	Goldman Sachs Asset Management	2,550
	Total	12,050

18. Some of the council's cash is held by a fund manager, Investec Asset Management, which is allowed to use a wider range of investments, such as certificates of deposit (CDs - fixed term securities issued by financial institutions) and Government stock (also known as gilts and similar to CDs but issued by the Treasury) which can be traded and whose value fluctuates as interest rates move and the maturity date approaches. Some of these investments could have nominal maturities of up to five years, however, from the council's point of view this whole sum can be regarded as almost instant access since the fund manager operates in such a way, and deals with sufficient volumes, that he could repay our holding at short notice if required.

19. The council's total investments shown above at 30 September exceed the total cash-backed reserves and balances in the accounts. This is because council tax and non-domestic rate income is received earlier in the year than the dates it has to be paid over to precepting authorities or the government.

20. Interest earned in-house in the first six months of the year totalled £44,600 on an average balance of £12.193 m. This equates to an annual rate of 0.63%. Investec made £76,970 before fees, equivalent to an annual rate of 1.0% (0.82% after fees). As part of the budget setting process the accountancy team attempt to gauge income and expenditure patterns for this, and future, years and the most likely rate of return in the year in order to predict investment income for the MTFP.

Cash deposits

21. It has continued to remain difficult to place investments because of the reduced number of counterparties that meet the council's credit criteria. The Financial Services Authority (FSA) has introduced liquidity regulations for banks and building societies. The regulations restrict the amount of highly liquid type investments the organisations can hold. As a direct result of this, these organisations are changing the types of short term cash investments offered. Call accounts in particular are being wound down, and notice deposit accounts are being offered as alternatives. In addition building societies have reduced their demand in the wholesale money markets, because they are lending between themselves instead of coming to the wholesale money markets for funds, particularly for short term maturity periods of between three and six months.

Interest rate movements

22. UK short-term interest rates have fluctuated in a very narrow range during the first six month of the financial year. The bank rate has remained at 0.5%, whilst inflation has been above target (increase in RPI for the year to September 2010 was 4.6%). Long-term interest rates peaked in the early part of the financial year.

23. Weak consumer growth, job uncertainty and a desire to reduce personal debt are key factors affecting expenditure growth. Increases in VAT and national insurance will also affect consumer spending. The BoE MPC is considering whether to continue to boost the available credit with further quantitative easing (QE).

24. Market expectations are that the BoE MPC will need to raise interest rates to counter the effects of external costs pressures coming through in commodity prices in 2010. In the longer term rates are still uncertain.

25. Sector's forecast of the expected movement in medium term interest rates:

Medium-term interest estimates (averages)

Annual Average	Bank Base Rate	Forecast lending rates %		PWLB Rates (borrowing)		
		3mth	12mth	5yr	10yr	50yr
2010/11	0.5	0.7	1.5	2.6	3.7	4.7
2011/12	0.7	1.0	1.8	3.3	4.3	5.4
2012/13	1.7	2.0	2.8	4.2	4.8	5.6
2013/14	3.1	3.2	3.7	4.8	5.3	5.7
2014/15	4.0	4.2	4.5	5.6	5.6	5.8
2015/16	4.0	4.2	4.2	5.3	5.4	5.5

Source: Sector Forecast 15 November 2010

26. Whilst the current market uncertainties remain the recommended strategy in general is to lend for relatively short periods but to look for opportunities to fix lending for longer periods with highly rated institutions. Because of the limited scope of the in-house operation this is the usual strategy anyway. As always, other investment opportunities are assessed and reviewed as they appear but they are generally only suitable for larger amounts and much longer periods than can be made use of. One possibility being assessed is bringing some of the money currently with the fund manager back in-house and investing it for a longer period at a fixed rate. Current economic conditions are making it very difficult for fund managers in general to achieve good returns and are also encouraging them to be very cautious. There are still advantages in using a fund for the diversity and the quality of counterparty but if the right opportunity can be found, a higher return might be obtained and give more certainty of return over the next year or two.

Performance

27. Security of investments will always take precedence over returns but in order to assess and monitor the council's investment performance the treasury management strategy benchmarks returns against 7 day LIBID (the rate at which banks lend to each other) and, for the fund manager, the average performance of comparable funds. These indicators are now provided by Sector.

Investment returns half year to 30 September 2010

All rates annual equivalent	Actual return	Benchmark return	Above/(below) benchmark	Benchmark used

In house team	0.63%	0.50%	0.13%	7 day LIBID
Investec Asset Management	0.82% 0.82%	0.55% 0.84%	0.27% (0.02%)	110% 7 day LIBID industry average

Treasury management limits on activity

28. In accordance with the statutory guidance and codes of practice the annual strategy contains targets for benchmarks relating to security and liquidity. 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. They are aimed at large authorities with much more extensive treasury operations than the Vale. This authority has no variable rate investments, no investments over more than one year and no borrowing of any sort. The limits are shown below:

Liquidity and yield

29. The current position against the original benchmarks approved in February 2010 is:

	Target	April – Sept 2010
Bank overdraft - amount	£nil	£nil
Minimum amount available next day	£0.5 million	£0.895 million
Weighted average life of investments - maximum - average	 182 days 21 days	 54 days 25 days

All investments have been made within the limits set by the Annual Investment Strategy.

Credit risk - security

30. Credit risk arises from deposits with banks and financial institutions, as well as exposure to the council's customers. Deposits are not made with banks and financial institutions unless they meet the minimum requirements set out in the Annual Investment Strategy. Investments with very good quality counterparties would be allowed for up to three years and it is possible, using historic default tables, to calculate an average risk of default as a percentage of the portfolio for annual periods up to three. During the first half of 2010-11 the authority has had no investment for a period greater than 6 months.

Debt activity during 2010/11

31. The council does not have any long term debt and current policy is not to borrow to fund capital expenditure. The Treasury Management Strategy sets a limit on borrowing of £5 million to provide the scope and flexibility for the council to cope with any temporary cash shortage. During the first half year 2010-11 the authority borrowed £2 million for 5 days at the beginning of April to cover the usual shortage of cash at the end of March.

Recommended changes to the treasury management strategy

32. Council approved the 2010/11 treasury management strategy on 17 February 2010 and there is no need for any changes to the strategy at this time.

Financial implications

33. This time last year forecasts were that inflationary pressures would mean that interest rates would have to start rising through 2010-11 to 2012-13. This hasn't yet happened

and the current outlook for growth for the UK economy means that financial institutions are not lending and interest rates are very low and likely to remain so. This, coupled with changes to the timing of expected capital receipts and increased capital spending means that the budget for investment income forecast now is well down on that done in February 2010 and this is reflected in the current medium term financial plan:

	2010/11 £'000	2011/12 £'000	2012/13 £'000	2013/14 £'000	2014/15 £'000
Original budget 2010/11	489.9	773.9	1,498.5	1,450.6	1,450.6
Revised for budget 2011/12	240.0	371.8	669.7	993.7	1,213.3
Difference	249.9	402.1	828.8	456.9	237.3

Legal implications

34. The council must approve any amendment to the treasury management strategy and annual investment strategy in accordance with the Local Government Act 2003, the CIPFA Code of Practice for Treasury Management in the Public Services, the ODPM Local Government Investment Guidance under Section 15(1) (a) Local Government Act 2003 and CIPFA Prudential code for capital finance.

35. All the council's investments are, and will continue to be, within its legal powers.

Conclusion

36. This report provides details of the treasury management activities for the period 1 April 2010 to 30 September 2010 and the mid year prudential indicators to council.

37. These details confirm that treasury activities have operated within the agreed parameters set out in the approved treasury management strategy, and provides the monitoring information for Audit and Governance Committee to fulfil the role of scrutinising treasury management activity.

Background papers

- Chartered Institute of Public Finance and Accounting (CIPFA) Treasury Management in the Public Services Code of Practice and Cross Sectoral Guidance Notes
- CIPFA Prudential code for capital finance in local authorities
- Treasury Management and Investment Strategy 2010/11 to 2012/13 (Executive 5 February 2010, Council 17 February 2010)
- VWHDC Fund Manager review April to September 2010 published by Butlers 27/10/10