Report to:

Audit and Governance Committee
Cabinet
Council

Report no. 38/11

Report of: Head of Finance

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To: Audit and Corporate Governance Committee on: 28 September 2011
To: Cabinet on: 7 October 2011
To: Council on: 19 October 2011

Treasury management outturn 2010/11

Recommendation to council

To approve the treasury management outturn report for 2010/11;

To approve the actual 2010/11 prudential indicators (appendix 1).

To note the prospects for the return on investments from 2011/12 onwards.

Purpose of Report

1. The purpose of this report is to advise councillors of the performance of the treasury management function (the management of our investments) for the financial year 2010/11. This complies with the requirements of the CIPFA treasury management code of practice and the council's Treasury Management Practice 6 (TMP6).

Strategic Objectives

2. The report helps us to achieve our strategic objective of managing our business effectively by providing transparency and demonstrating effective management of our investments. The income from the investment portfolio contributes to the in-year revenue budget.

Background

3. As part of the 2010/11 budget setting process, council approved the treasury management strategy for 2010/11 on 17 February 2010. The treasury management strategy sets the parameters within which officers manage the council's treasury management activities.

4. This report outlines the performance over the last financial year of those funds managed in-house and those managed by *Investec Asset Management,* the Council's appointed investment manager. The Fund Manager's performance is reviewed by *Sector*, the Council's investment adviser. In addition, the report explains how background events in the financial markets and economy have affected investments and returns for 2010/11 and presents Members with a general overview of the current situation in the investment market.

Economic conditions in 2010/11 and looking forward

5. In 2010/11 the global financial markets were 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, the announcement by the US Federal reserve Bank that it intends to keep its central rate unchanged until mid 2013.

6. In the UK, the coalition Government announced the most severe austerity package of public sector spending cuts since the Second World War, the effects of which are expected to have an impact on local government for many years to come.

7. Deposit rates picked up modestly in the second half of the year as rising inflationary concerns, and strong first half growth, fed through market expectations of the prospects of an early increase in the BoE Bank Rate. However, in March 2011, slowing actual growth, together with projected weak growth prospects, saw a market consensus of expectations of the first UK rate rise move back from May to August 2011 despite high inflation. However, the disparity of expectations on domestic economic growth and inflation encouraged a wide range of views on the timing of the start of increases in Bank Rate in a band that ranged from May 2011 through to early 2013. This sharp disparity was also seen in MPC voting which, by year-end, had three members voting for a rise while others preferred to continue maintaining rates at ultra low levels.

8. The Bank of England base rate started the year at 0.5 per cent and remained at this historically low level throughout 2010/11.

9. Consequently, both short and long term investment rates remained at extremely low levels throughout 2010/11.

10. The BoE has forecast that inflation will remain above target throughout 2012 but will return to target by 2013/14. There is a general consensus amongst economic commentators that interest rates will rise only very gradually through to 2014. This view is opposed by a small number of commentators who are worried by the potential inflationary pressures further quantitative easing (QE) may generate.

11. The economic environment remains difficult for the council and concerns over investment counterparty risk persist. This means that the council continues to maintain investments with high quality counterparties for relatively short periods. The obvious downside of this is that investment returns continue to remain low.

Base rate and LIBID rate

12. The London Interbank Bid Rate (LIBID) is the benchmark used to compare treasury management performance against because historically it has reflected the market conditions at which rates the banks lend to each other. The 7 day LIBID rate started 2010/11 at 0.42 per cent and moved slowly to close the year at 0.45 per cent, whilst base rate in comparison remained constantly at 0.50 per cent throughout 2010/11.

Icelandic bank collapse

13. The Council still holds a fixed-term deposit of £1m with Landsbanki, one of the Icelandic banks in administration, which should have been repaid in October 2008. Recovery of these investments by public authorities is being pursued as a group action by the LGA through the Icelandic courts and the Council is still anticipating to receive a substantial proportion of this deposit (and accrued interest) back.

14. On 1 April 2011 the Reykjavik District Court confirmed that local authority claims qualified for priority under Icelandic bankruptcy legislation. On this basis the estimated recoverable amount has remained the same at 94.85% although repayments will be received in stages up to 2018 with the first amount due in December 2011.

Treasury activities in 2010/11

Investment income

15. The actual investment income achieved in 2010/11 was £0.262 million. This was below the original budget forecast of £0.490 million by £0.228 mmillion, although actual outturn was ahead of the revised forecast made in February 2011 by £21,900.

Out-turn compared with budget – investment income earned

	Fund manager	In-house team	total
Original budget 2010-11	£ 309,000	£ 180,900	£ 489,900
Actual out-turn 2010-11	£ 181,060	£ 80,840	£ 261,900
Out-turn short of budget by:	£ 127,940	£ 100,060	£ 228,000

The actual return achieved was 53.5% of the budget. This was largely due to the fact that interest rates have held at an historic low; this was not anticipated when the budget for 2010/11 was being drawn up in December 2009. The majority of forecasters were predicting that interest rates would have to start rising to combat rising inflation, probably reaching 4.8% in 2012. In the event rates have hardly moved at all and are not expected to for some time. Also because of the turmoil in the financial markets the council was restricting investments in order to reduce counterparty risk.

In-house Investment Performance

16 At the beginning of 2010/11 the in-house team had a debit balance of £1.843m due to the need to borrow short-term over the year-end. During the year the maximum investment holding was £24.2m and the total of investments made (turnover) was £88.64m. In-house investment income in the year amounted to £80,840 on an average invested balance of £11.968m - an average return of 0.675%. On 31 March 2011 the in-house team had a debit balance of £0.477m (again as a result of short-term borrowing at year-end).

17 It was necessary to borrow 3 times in the year to cover temporary cash flow shortages; a total of £3.5m for a total 29 days at an average 0.48%.

18 It is difficult to set targets for this sort of operation which aims to maximise returns within the constraints of security, liquidity and flexibility. Some measure of achievement can be obtained by looking at the rates achieved compared to a benchmark. The annual investment strategy says the target should be the widely published 7-day LIBID rate which is appropriate to the short-term nature of the council's investments.

In-house investment performance against benchmark.

Rate of return:	2008/09	2009/10	2010/11
In-house investment team	4.84%	1.07%	0.675%
In-house investment team (incorporating Landsbanki capital loss)	4.44%		
7 day LIBID	3.60%	0.37%	0.42%
LIBID exceeded by:	1.24 or 0.84%	0.70%	0.255%

19 The Council only holds funds to meet its daily cash-flow requirements and also invests the council tax and business rate receipts for a short temporary period until they are due to be paid over to precepting authorities or central government. In 2010/11 the weighted average life (WAL) of the council's investments was 22 days (2009/10, 19 days). WAL on any day is the remaining period of investments adjusted for the different amounts. The current, restricted availability of suitable counter-parties (i.e. the financial institutions to whom we are willing to lend) and the present very low rates available has meant that it has not been possible to achieve the rates of return seen in previous years.

20 Another performance target for the in-house team is the full investment of balances held. The low rates available mean that it costs more to lend £400,000 overnight than the interest received so funds are left in the bank accounts. The average balance at the bank at the end of the day during 2010/11 was £228,319.

External Fund Managers

21 The performance in 2010/11 is set out below showing the fund manager's return before payment of fees.

Sum Managed at 1.4.2010	£15,313,518
Sum Managed at 31.3.2011	£15,494,584
Increase in value during year (gross)	£ 181,066

The Council's money is held in what is known as a 'cash plus' fund; because of the nature and spread of the fund, the manager will generally hold a wider range of investments than the in-house team; these are within the legal constraints that apply to local authorities and the requirement for security mentioned above. This includes certificates of deposit (CDs) and government-issued stock (gilts) which may be held with the intention of making a return, not just from the yield, but from changes in value over a period. For this reason the return above may be unrealised at the year-end and the fund manager is allowed to retain this increased value within the fund until it is needed to be paid over to the council. This longer-term view can also mean that the fund might have investments temporarily showing a loss. These will rise in value as the maturity date approaches.

22 The result for *Investec* shown above equates to a gross rate of return (i.e. before fees) of 1.18% (1.00% after fees). References to fees relate to the actual charges made per quarter. In accordance with industry practice the fund manager deducts the fees from the sums held but these are accounted for as a revenue cost by the Council.

Investec Performance over 3 years (net of fees)

Rate of return:	2008/09	2009/10	2010/11
Investec Asset Management	7.42%	1.31%	1.00%
7 day LIBID	3.60%	0.37%	0.42%
LIBID exceeded by:	3.82%	0.94%	0.58%
Comparable LA funds average*	6.48%	1.37%	0.89%
Average exceeded/(short) by:	0.94%	(0.06%)	0.11%

23 The Council's investment advisers (*Sector*) provide the comparative figures* and have reported on the state of the market and the performance of the fund manager (*Investec*). They commented that the uncertain economic climate led fund managers generally to take a very cautious approach.

Looking Forward

24 The outlook for returns on cash investments in 2011/12 is still poor. Markets are continuing to remain volatile and unpredictable. Economic recovery is likely to be slow and prolonged with the Monetary Policy Committee becoming more concerned with poor economic growth and downplaying inflation concerns.

25 The estimate of investment income for the 2011/12 budget was based on economic predictions in December 2010, which had the BoE base rate starting to rise in 2011-12 and reaching 4% in 2014. The most recent forecasts are that base rate will not start to rise until the last quarter of 2012 and will only reach 2.5% by 2014. This will not have much effect on the estimate for 2011-12 which was based

on rates staying low but will mean a reduction in the predicted income over the 5 years of the medium term financial plan.

Land and Property

26 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 £30.7 million (£29.0 million as at 31 March 2009) and generated income of £1.52 million (£1.65 million in 2009/10). This is equivalent to a return of 5.0% (2009/10, 5.7%). At March 2011 the ratio of property to cash investments was 66:34.

27 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 is assessed annually to determine if assets should be retained or disposed of.

Treasury Management Advisors

28 Together with South Oxfordshire District Council, we appointed Butlers, a business division of ICAP Securities Ltd, as our treasury advisors in July 2008. We awarded a three year contract to July 2011 which has been extended until 2012; this costs £9,375 in the current year and has produced efficiency savings for both councils over the contract period in terms of costs for South Oxfordshire District Council, and in terms of an increased range of services for the Vale of White Horse District Council. In October 2010, ICAP transferred Butlers to Sector Treasury Services Ltd and assigned the contract as allowed under the original agreement.

Prudential Indicators

29 As part of the 2010/11 budget setting process the council set a number of prudential indicators. These indicators establish the parameters within which we manage the overall capital and treasury management functions.

30 The Council is debt free and has no borrowing so the majority of the indicators are negative and therefore prove to be difficult to relate to the day-to-day treasury management activities. This does not mean however that the council should not still monitor its performance against the indicators

31 During 2010/11 the council has performed within all the parameters set out under the prudential code during 2010/11. The details of the actual indicators against the budget are shown in appendix one.

Financial Implications

32 The report gives financial information to help Members oversee the treasury management function.

Legal Implications

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

34 There are no other legal implications of this report.

Risks

35 Treasury investments are made using the following principles (listed in order of priority):

- Security – certainty of return of the principal invested.
- Liquidity – the principal is returned at the time required for effective cashflow management.
- Yield – the Council achieves the best return on investment as possible without unnecessary exposure to risk.

36 Treasury Management Practices are recommended by CIPFA and are reviewed on a regular basis. These advocate the best practice to follow in order to reduce the level of risk involved in the treasury activities as much as possible; however, with the volatility of the markets, there will always be an element of exposure to risk. To reduce risk to its absolute minimum would mean that the level of return on investments will severely impact upon the revenue income of the Council.

Conclusion

37 The return on cash invested in 2010/11 was lower than initially anticipated due to the sustained very low interest rates – the outturn position was close to that expected during budget monitoring revisions.

38 The budgeted net income for 2011/12 is £371,800 and the current view is that this may still be achieved. Any variation will be shown in the in-year budget monitoring reports. However, the income over the next 4 years will be reduced from that forecast in the medium term financial plan and this will be reflected in the 2012-13 budget-setting process.

Appendix

1. Outturn against Prudential Indicators 2010/11

Background Papers

- CIPFA Code of Practice for Treasury Management in the Public Sector.
- Chartered Institute of Public Finance and Accounting (CIPFA) Treasury Management in the Public Services Code of Practice and Cross Sectoral Guidance Notes
- Treasury Management Strategy 2010/11 – Council 17 February 2010.
- Fund Manager review March 2011 issued by Sector 11 August 2011.