Report to:

Audit & Governance Committee
Cabinet

Report of Head of Finance **Report no. 62/11**

Author: Steve Lawrence

Telephone: 01235 540321

Textphone: 18001 01235 540321

E-mail: steve.lawrence@southandvale.gov.uk

Wards affected: all

Cabinet member responsible: Councillor Matthew Barber

Tel: 07816 481452

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

To:	AUDIT & GOVERNANCE COMMITTEE on CABINET on	18 January 2012 10 February 2012

Treasury management mid-year monitoring report 2011/12

Recommendations

That Audit and Governance Committee:

1. *notes the treasury management mid year monitoring report 2011/12, and*
2. *is satisfied that the treasury activities are carried out in accordance with the treasury management strategy and policy.*

That Cabinet:

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 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 treasury activities for the first six months of

2011/12, 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 code was revised in December 2009, and introduced a requirement to provide a report during the year on treasury activity for the period April to September.

4. The 2011/12 to 2013/14 treasury management strategy was approved by council on 23 February 2011. It outlined the expected prudential indicators for 2011/12 and set out the expected treasury management operations for the period. This report should be read alongside the 2011/12 Strategy and provides details on the economic issues and interest rate movements for the first six months of 2011/12, together with information on the treasury activity and performance against prudential indicators and benchmarks set for the year.

Treasury management advisers

5. 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. In October 2010, ICAP transferred Butlers to Sector Treasury Services Ltd and assigned the contract as allowed under the original agreement.

6. In July 2011 the contract was extended for three months whilst the contract was re-tendered and Sector were awarded the contract for three years from October 2011. 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.

7. 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

8. The Euro zone sovereign debt crisis is continuing and the lack of a co-ordinated or credible response has left commentators concerned over the potential impact of sovereign default and resulting effect on the Euro zone banking sector. The approval by various countries of the €440bn bail out fund in September has brought temporary relief to financial markets but this does not provide a realistic remedy to the scale of the Greek debt problem or the sheer magnitude of the potential needs of other countries for support.

9. This, coupled with political difficulties in the US over their plans to address the budget deficit, the size and control over the US sovereign debt, and the subsequent loss of the AAA credit rating from Standard and Poor's, has led to a much more difficult and uncertain outlook for the world economy.

10. Growth in the US, UK and the euro zone has been lower than original Government predictions and future growth forecasts have also been revised downwards. There is major disagreement amongst politicians and economists on what the appropriate policy should be. The potential for serious policy errors is substantial given the many uncertainties in the economic and financial outlook.

11. Following zero growth in the final half of 2010/11 the UK economy grew by a weaker than expected 0.1% in the first quarter of 2011/12. Growth prospects will be governed by UK consumer sentiment, which is currently subdued due to falling disposable income. Higher VAT, overhanging debt, high inflation and concerns over employment are likely to weigh heavily on consumers into the future. The Bank of England Monetary Policy Committee (MPC) now views recession as being a much bigger concern than inflation.

12. **Outlook**

There remain huge uncertainties in economic forecasts due to the following major factors:

- the increase in risk that the UK, US and EU could fall into recession;
- the likely political gridlock in the US preventing significant government fiscal action to boost growth ahead of the Presidential elections in November 2012;
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economies;
- the degree to which government austerity programmes will dampen economic growth;
- the potential for further quantitative easing, and the timing of this in both the UK and US;
- the speed of recovery of banks' profitability and balance sheet imbalances and the risk of substantial losses being incurred on EU sovereign debt;

Sector expect low growth in the UK to continue, with a low Bank Rate to continue for at least 24 months, coupled with a possible further extension of quantitative easing. This will keep investment returns depressed.

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. On 1 April 2011 the Reykjavik District Court confirmed the view of the Landsbanki Winding-up Board that local authority fixed-term deposit claims should be accorded priority status under Icelandic bankruptcy legislation and the appeal by other creditors has been rejected. This judgement now has to be extended from the test cases to all depositors in the group action. On this basis the estimated recoverable amount has remained the same at 94.85% although repayments will be received in stages up to 2018. The Board is preparing to make the first repayments very soon.

Current investments

15. The council's investments at 30 September 2011 were as follows (not including that with Landsbanki as above):

Cash deposits at 30 Sept. 2011, maturity period,	Total £'000	% holding
Money market fund (Instant access)	740	9%

Call account (instant access)	1,825	21%
Up to 1 week	--	
1 – 4 weeks	--	
1 – 2 months	1,500	17%
2 – 6 months	--	
6 months to 1 year	4,500	53%
Total in-house investments	8,565	100%
Investec Asset Management (see below)	13,603	

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

16. 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 three building societies and five banks. Of the in-house investments at 30 September, £0.74 m (9%) was with a Money Market Fund and £7.825 m (91%) was with UK banks as follows:

Cash deposits at 30 Sept. 2011		Amount £'000
Banks	Lloyds TSB Bank plc Cater Allen Ltd Santander UK plc	4,000 2,000 1,825
Money Market Fund	Goldman Sachs Asset Management	740
	Total	8,565

17. Some of the council's cash is held by a fund manager, Investec Asset Management, who 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 although this could mean a reduced return in some circumstances.

18. 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.

19. Interest earned in-house in the first six months of the year totalled £62,470 on an average balance of £10.948 m. This equates to an annual rate of 1.14%. Investec made £167,717 before fees on £15.247 m, equivalent to an annual rate of 2.2% (2.02% after fees). The benchmark for the period (7 day LIBID) was equivalent to an annual rate of 0.54%. Income to the fund is irregular. Some is interest but some comes from buying and selling. The fund manager says that he actually looking at a 3 year time frame. Profit was taken in the period on a holding of index-linked stock and the fund manager does not expect to maintain that rate of return over the whole year. He has predicted making between 1.45% and 1.55% in the whole year.

Cash deposits

20. It has been difficult to place investments during the first six months of the year due to the volatility of the markets. There has been a raft of credit rating changes since April 2011 following the events in US and Europe.

21. The market has been expecting rates to rise next year so we have been looking for opportunities to extend the deposit periods with top quality counter parties. This has been achieved to an extent in the first six months and the weighted average maturity period of investments at 30 September was 176 days.

Interest rate movements

22. UK short-term interest rates have fluctuated within a very narrow range during the first six months of the financial year. The Bank of England base rate has remained at 0.5%, whilst inflation has been above target. Long-term interest rates peaked in the April, but have remained low for the last six months as investors seek security in government bonds. This has kept interest rates low for investments.

23. Investment rates have remained quite flat with a range between 0.50 percent to around 1.5 percent for up to a year's maturity. The short term rates from one month to six months offer very little differential with six month rates ranging between 0.70 percent and 1.20 percent.

24. At the start of the year, market expectations were that the MPC would need to raise interest rates to counter the effects of price increases in fuel and food. The MPC have been reluctant to raise rates as their view is that as growth in the economy slows, the rate of inflation will also fall back to their target of 2%. Over the last six months the economy has showed signs of reducing growth. Weak consumer growth, job uncertainty and a desire to reduce personal debt are key factors affecting expenditure growth. The MPC's latest decision to try boosting the available credit with further quantitive easing (QE) of £75 billion, will postpone a rate rise which is now not expected before September 2013.

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

Medium term interest rate estimates (mid year)

	Base rate	Estimated earnings rates for investments up to 3 months duration	PWLB rates (borrowing)		
			5 yr	10 yr	50 yr
2011/12	0.50%	0.70%	2.30%	3.30%	4.30%
2012/13	0.50%	0.70%	2.30%	3.40%	4.40%
2013/14	0.75%	1.00%	2.70%	3.70%	4.70%
2014/15	2.00%	1.60%	3.30%	4.40%	5.10%

Performance

26. 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 (average, uncompounded) 7 day LIBID (the rate at which banks lend to each other) and, for the fund manager, the average performance of comparable funds – net of fees. These indicators are now provided by Sector.

Investment returns half year to 30 September 2011

All rates annual equivalent	Actual return	Benchmark return	Above benchmark	Benchmark used
In house team	1.14%	0.47%	0.67%	7 day LIBID
Investec Asset Management	2.02% 2.02%	0.52% 1.54%	1.50% 0.48%	110% 7 day LIBID industry average

Treasury management limits on activity

27. 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. At 30 September this authority had no variable rate investments, no sums invested for more than one year and no borrowing, fixed or variable. The limits are shown below:

Liquidity and yield

28. The current position against the original benchmarks approved in February 2011 is:

	Target*	April – Sept 2011
Bank overdraft – average amount	£nil	£nil
Number of days when £0.5 million not available next day if needed.	none	none
Weighted average life of investments - maximum - average	 182 days 21 days	 204 days 87 days

*In the case of weighted average life of investments this is more an indicative figure and based on past experience. In the current challenging environment the in-house team has managed to find value by making some longer term investments with good quality counter parties. This has pushed the average up. There have been no investments made outside of the limits set by the Annual Investment Strategy.

Credit risk - security

29. 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 years. (The Code envisages a much greater portfolio and looks for credit risk exposure up to 5 years). At 30 September all the authority's investments were for less than a year.

Debt activity during 2011/12

30. 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 2011-12 the authority borrowed £2 million for 34 days at 0.27%.

Recommended changes to the treasury management strategy

31. Council approved the 2011/12 treasury management strategy on 23 February 2011 and there is no recommendation from officers for any changes to the strategy at this time.

Financial implications

32. This time last year forecasts were that inflationary pressures would mean that interest rates would have to start rising towards the end of 2011. This hasn't 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. Good performance by the in-house team and the fund manager means that the out-turn for 2011-12 should be close to the budget but the estimated investment income going forward will be less than expected and this will be reflected in the council's medium term financial plan (mtfp):

	2011/12 £'000	2012/13 £'000	2013/14 £'000	2014/15 £'000	2015/16 £'000
Original budget 2011/12	371.8	669.7	993.7	1,213.3	1,213.3
Revised for budget 2012/13	409.5	417.9	537.0	742.6	1,128.7
Difference	37.7	(251.8)	(456.7)	(470.7)	(84.6)

Legal implications

33. 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.

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

Conclusion

35. This report provides details of the treasury management activities for the period 1 April 2011 to 30 September 2011 and the mid year prudential indicators to council.

36. 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 2011/12 to 2013/14 (A&G 12 January 2011, Executive 11 February 2011, Council 23 February 2011)
- VWHDC Fund Manager review April to September 2011 published by Sector 11/11/11