Report to:

Audit and Governance Committee
Cabinet
Council

Report of: Head of Finance

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To: Audit and Governance Committee on: 26 September 2012
To: Cabinet on: 5 October 2012
To: Council on: 25 October 2012

Treasury management outturn 2011/12

That Audit and Governance Committee:

1) Scrutinise the report to ensure that the treasury activities are carried out in accordance with the treasury management strategy and policy.

That Cabinet:

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

1) Approve the treasury management outturn report for 2011/12;

2) Approve the actual 2011/12 prudential indicators detailed in the report.

Purpose of Report

1 The report fulfils the legislative requirements to ensure the adequate monitoring and reporting of the treasury management activities. This report is to advise Councillors of the performance of the treasury management function (the management of our investments) for the financial year 2011/12. 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

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 2011/12 budget setting process, Council approved the treasury management strategy for 2011/12 on 23 February 2011. The treasury management strategy sets the parameters within which officers manage the Council's treasury management activities.

4 This report details the performance of treasury activities against benchmarks and explains how background events in the financial markets and economy have affected investments and returns for 2011/12.

Economic conditions

5 The financial markets remained focused on the sovereign debt crisis throughout 2011/12. The Greek failure to implement austerity measures as part of their bailout agreement in July 2011 culminated in a real risk of Greece withdrawing from the European Union (EU). The European Central Bank (ECB) responded by providing credit lines of almost 1 trillion euros to address the liquidity crisis among the EU banks.

6 Despite a further bailout package for Greece in March 2012, concerns remain that these measures have just postponed the crisis and not solved it.

7 The UK coalition Government maintained a tight fiscal policy. Expectations of a base rate rise faltered as weak growth continued to prevail. The Monetary Policy Committee (MPC) increased quantitative easing (QE) by £75bn in October 2011 and a further £50bn in February 2012 in an attempt to increase liquidity in the banks and stimulate lending to businesses.

8 Inflation remained above the Bank of England (BoE) 2 per cent target for the whole year. It peaked at 5.2 per cent in September 2011 and fell to 3.2 per cent in March 2012.

9 Whilst the Bank of England (BoE) base rate remained at 0.5 per cent throughout 2011/12, risk has remained a constant factor in money market deposit rates beyond three months. Both short and long term rates remained at extremely low levels throughout the year compared to historic rates.

10 The economic environment remains volatile and concerns over investment counterparty risk persist.

Icelandic bank default – Landsbanki Islands hf

11 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. The UK Government is working

with the Icelandic Government to achieve this. The Local Government Association (LGA) is co-ordinating the efforts of all UK authorities through the Icelandic courts and the Council is anticipating to receive all of the claim back.

12 On 1 April 2011 the Reykjavik District Court confirmed that local authority claims qualified for priority under Icelandic bankruptcy legislation, this was challenged by other creditors but upheld. On this basis it is estimated that we will receive the full amount of the claim, although repayments will be received in stages up to 2018. The first distribution payment was made in December 2011. Members will be periodically informed on the latest developments as they become known.

Base rate and LIBID rate

13 The London Inter-bank 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 3 month LIBID rate started 2011/12 at 0.69 per cent, peaked at 0.96 per cent and closed the year at 0.90 per cent. Base rate in comparison remained constantly at 0.50 per cent throughout 2011/12.

Treasury activities in 2011/12

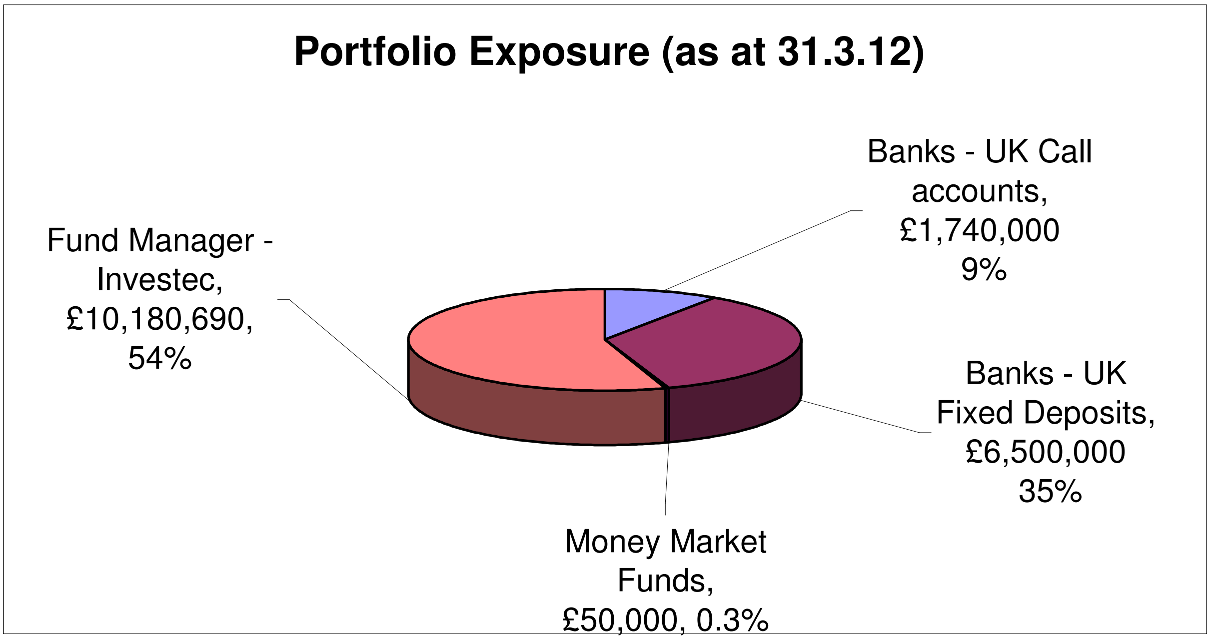
Council investments as at 31 March 2012

14 The Council's investments, analysed by age as at the end of 2011/12 is shown in table 1 below. The investment position 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.

Table 1: maturity structure of investments (as at 31 March 2012):

	Total	
	£000	**%**
Cash deposits:		
Call	1,740	9%
Up to 1 month	-	0%
3-4 Month	2,500	14%
4-6 Month	2,000	11%
6-12 Month	2,000	11%
Total cash deposits	**8,240**	**45%**
Fund Manager - Investec	10,181	54%
Money market funds	50	0%
Overall total	**18,472**	**100%**

15 The majority of the funds managed internally, are held in the form of fixed interest rate cash deposits. These provide some certainty over the investment return. The chart below shows in percentage terms how the portfolio is spread across investment types:



Investment income

16 The total investment income achieved in 2011/12 was £413,000, compared to the original budget estimate of £371,800 as shown in table 1 below:

Investment type	Interest Earned Actual £000's	Budget £000's	Variation £000's
Call accounts	15,358	15,000	358
Cash deposits	127,565	79,800	47,765
MMFs	12,932	12,000	932
Fund Manager	257,618	265,000	(7,382)
	413,473	**371,800**	**41,673**

17 The actual return achieved was 12 per cent higher than the original budget. This was due to :

- The average rates achieved on internally managed investments were higher than forecast. Investments were placed for longer maturity periods and advantage was made of special tranches available to local authorities, issued by some of the UK government backed banks.

- Average balances throughout the year were higher than forecast. The total actual average interest rate achieved for the year was 1.82 per cent.

18 Performance achieved for the portfolio as a whole is shown below and sets out the individual performance of internal and fund managed investments against the targets set at the start of the year and compared against the industry average for the year.

Cumulative performance against benchmark & industry Average - 211/12

	Internally Managed Funds %	Investec - Fund Manager %
Actual	**1.82**	**1.61**
Benchmark - 7 day LIBID	0.55	
Benchmarkl 110% 7 Day LIBID		0.61
Variance - (Under)/Over benchmark	1.27	1.00
Industry average	1.39	1.39
Variance - (Under)/Over Ind Average	0.43	0.22

Performance - In-house Investments

19 Investments held at the start of the year totalled £21.9m. Investments totalling £56.m were placed in fixed rate cash deposits over the year. In-house investment income in the year generated £155,856, which was 46 per cent above the budget. The weighted average return achieved of 1.82 per cent was 0.52 per cent above budget.

20 It was necessary to borrow twice in the year to cover temporary cash flow shortages; a total of £5m for a total 66 days at an average rate of 0.30%.

21 The annual investment strategy sets the benchmark target for internal cash invested as the 7-day LIBID.

22 The Council uses short-term investments to meet daily cash-flow requirements and has also invested a proportion of the portfolio over longer dated cash deposits in 2011/12. This has increased the weighted average life (WAL) of the Council's investments from 22 days in 2010/11 to 139 days for 2011/12.

External Fund Managers

23 The Council's money is invested in a 'cash plus' fund. The fund will generally hold a wider range of investment types than the in-house team. 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.

24 The performance in 2011/12 is set out below, excluding fees:

Table 6: Investec - Cumulative performance against benchmark & industry Average

2011/12	Actual % return on portfolio	Benchmark 110% 7 day LIBID	Variance- under/over b'mark %	*Industry Average%	Variance- vs Average %
Quarter 1: April - June	0.19	0.14	0.05	0.26	(0.07)
Quarter 2: July - Sept	0.81	0.15	0.66	0.51	0.30
Quarter 3: Oct - Dec	0.29	0.17	0.13	0.26	0.03
Quarter 4: Jan - Mar	0.32	0.14	0.18	0.36	(0.04)
Cumulative	**1.61**	**0.61**	**1.01**	**1.39**	**(0.39)**

* Source : Sector -weighted average of 7 fund managers results covering 38 funds

25 The value of investments managed by the fund was £15,494,584 in April 2011. It was identified in August 2011 that the rate of return on the funds managed had fallen considerably. Officers withdrew two amounts in the year totalling £5,000,000. This was re-invested internally in fixed rate cash deposits earning between 2.65% and 3.10%. The value of the funds managed at 31 March 2012 was £10,127,697.

26 The results of the managed funds shown above equates to a gross rate of return (i.e. before fees) of 1.61 %. 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. The cost charged to manage the funds in 2011/12 was £22,133.

27 The funds that remain managed by Investec of £10 million, were closely monitored after the year end. Performance did not improve significantly. As a result officers took the decision to withdraw the remaining funds at the end of July 2012. Further details will be reported in the mid year treasury management report for 2012/13.

Land and Property

28 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 £29.4 million at 31 March 2012 (£30.7 million as at 31 March 2011) and generated income of £1.4 million (£1.6 million in 2011/10). This is equivalent to a gross return of 4.7% (2010/11, 5.3%), excluding cost such as maintenance and management fees. 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 limits on activity

29 The limits which are set each year in the treasury management strategy, are a requirement of the prudential code. (They are sometimes referred to as prudential indicators). The purpose of these limits is to ensure that the activity of the treasury management 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 opportunities to reduce costs/improve performance.

30 During 2011/12 the Council has performed within all the limits set out in the Treasury Management Strategy 2011/12. The Council is debt free and has no borrowing to support capital assets.

Financial Implications

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

Legal Implications

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

33 There are no other legal implications of this report.

Risks

34 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 cash flow management.
- Yield – the Council achieves the best return on investment as possible.

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. The officers therefore balance the three principles above to achieve the best return possible without unnecessary exposure to risk, whilst providing sufficient cash flow for operational purposes.

Conclusion

35 As at 31 March 2012, the council's financial investments had a cost value of £18.4m. During 2011/12 investments generated £413,473 in income which was £41,673 above the original £371,800 forecast. This was a result of prudent management of the internally managed funds, despite the low interest rates and difficulties in the financial markets that prevailed throughout the year. Officers identified mid year that the external funds were under performing and took steps to bring back a portion of these funds and re-invest in fixed term deposits at higher rates.

36 The financial year 2011/12 provided volatile conditions with regard to treasury management. There was very little material movement in interest rates throughout the year and fluctuations in the markets have moved with expectations of growth in the economy. Concerns for counterparty risk continue to present the council with a difficult environment to invest in. The main implications of these factors were:

- sums at risk with an Icelandic institution in administration;
- 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.

37 Despite the continued uncertainty the overall investment performance was above the industry average for 2011/12. Investments were made in the year that provided a good return whilst maintaining security and liquidity.

Background Papers

38 CIPFA Code of Practice for Treasury Management in the Public Sector.

39 Chartered Institute of Public Finance and Accounting (CIPFA) Treasury Management in the Public Services Code of Practice and Cross Sectoral Guidance Notes

40 Treasury Management Strategy 2011/12 – Council 23 February 2011.

41 Fund Manager Review March 2012 issued by Sector August 2012.