Report to:

Audit & Governance Committee
Cabinet
Council

Report of Head of Finance

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Wards affected: all

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To:	AUDIT & GOVERNANCE COMMITTEE on	30 January 2013
	CABINET on	8 February 2013
	COUNCIL on	20 February 2013

Treasury management mid-year monitoring report 2012/13

Recommendations

That Audit and Governance Committee:

1. Notes the treasury management mid year monitoring report 2012/13, 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 approve 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 2012/13 and an update on the current economic conditions with a view to the remainder of the year.

Strategic objectives

2. An 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 deliver its services and meet the council's other strategic objectives.

Background

3. The council's treasury activities are strictly regulated by legislation. The CIPFA Prudential Code and CIPFA Treasury Management Code of Practice requires a monitoring report to be provided mid year to council. The report covers the treasury activity for the period 1 April to 30 September.

4. The 2012/13 Treasury Management Strategy was approved by council on 23 February 2012. This report provides details on the treasury activity and performance for the first six months of 2012/13 against prudential indicators and benchmarks set for the year. It is also an opportunity to review and revise the limits if required. Full council is required to approve this report and amendments to the Treasury Management Strategy.

The economy and interest rates

5. An update on the economic conditions and interest rate forecasts is in appendix A.

Icelandic banks – Landsbanki

6. The council has now received £473,786 in respect of the claim for £1 million (plus interest due of £4,890) from the investment made with the failed Icelandic bank Landsbanki Islands hf. There have been three repayments to date. The Icelandic Supreme Court found in favour of UK local authorities to be paid before non-priority creditors and the council now expects to get back 100 per cent of the money deposited in Landsbanki.

Investments

7. The council's investments at 30 September 2012 were as follows (not including that with Landsbanki as above):

Table 1: Maturity structure of investments at 30 Sept 2012.	Total £'000	% holding
Money market fund (Instant access)	100	0.3%
Call account (instant access)	6,070	21%
Up to 4 months	9,000	31%
5 - 6 months	5,000	17%
6 months to 1 year	9,000	31%
Total investments	29,170	100%

8. The council currently holds all of its investments in the form of cash deposits, the majority of which have been placed for fixed terms with a fixed investment return. Twenty one per cent of the investment portfolio is held in call accounts.

9. It was clear early in 2012, that the returns achieved through direct investments in-house were considerably better than the performance of the cash invested with the fund manager Investec Asset Management.

10. Although the Investec fund can 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 issued by the Treasury), the volatility in the financial markets had led to an increased demand by investors in high security investments. This demand had led to a fall in the yields on such investments. The situation has been compounded by the many credit rating downgrades of financial institutions over the last year. In order to manage this risk and maintain liquidity in the fund, the manager has to keep a spread of investments in the portfolio. This adversely impacted on the returns on the fund.

11. Officers monitored the position and a decision was made to bring the cash funds managed by Investec back in-house at the end of July 2012. These funds were reinvested directly in fixed term deposits with banks that are guaranteed by the UK government. This has produced an increase in investment income for the current year. It has also produced savings of approximately £19,000 in management fees for the year.

12. The investment income earned for the first six months is shown in table 2 below.

Table 2: Investment interest earned by investment type

	Interest Earned Apr - Sep 2012			
Investment type	**Annual Budget £000's**	**Actual To date £000's**	**Annual Forecast £000's**	**Forecast Variation £000's**
Call accounts	177	15	50	(127)
Cash deposits	0	189	433	433
MMF	0	6	6	6
Investec – Fund Mgmt	240	47	47	(193)
Total Interest	**417**	**257**	**536**	**119**

Treasury activity

13. Interest earned in-house in the first six months of the year totalled £257,230 on an average balance of £25 million. The forecast for the year is now estimated at £536,000. This equates to an average rate of return of 2.06 per cent. Funds invested with Investec earned £46,879 on £10 million, equivalent to an annual rate of 1.08 per cent after fees. The benchmark for the period (7 day LIBID) was equivalent to an annual rate of 0.47 per cent.

14. Re-investment opportunities are not nearly as attractive as six months ago. One year rates have dropped by over 1.25 per cent. There is currently little incentive to

reinvest in longer term periods. The governments Funding to Lending Scheme has lowered bank funding costs and been extended to building societies. This access to cheaper borrowing is a key factor in the fall in market rates now available.

15. The weighted average maturity period of investments is now 156 days. As a result of the many banking downgrades, there are now fewer financial institutions meeting the council's investment criteria. When it is possible investments will be placed with highly rated institutions with a view to increasing the weighted average maturity of the portfolio.

Performance measurement

16. A list of investments as at 30 September is shown in appendix B. All investments were with approved counterparties. The average level of investments held was £25 million and the average return on these investments is shown below in table 3. This 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 for each type of investment.

Table 3: investment returns achieved against benchmark				
	Benchmark return	Actual return	Growth (below)/above benchmark	Benchmarks
	%	%	%	
Bank & building society deposits - managed in house	0.43%	2.06%	1.63%	7 day LIBID
Investec Asset Management	0.47%	1.08%	0.61%	110% 7 day LIBID
Industry average	0.47%	0.32%	-0.15%	Quarter 1 April - June

Treasury management limits on activity

17. 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. The limits and our performance are shown in appendix C.

Recommended changes to the treasury management strategy

18. In the volatile economic climate it has become increasingly difficult to find suitable investments that meet the approved investment criteria. Most financial institutions have all been downgraded in some way over the last few years. As a result less banks are available for the council to invest in. A review of limits during the year resulted in changes made to the limits for government backed banks and eligible institutions. These amendments were reported to audit and governance committee on 11 July 2012. An extract is provided in appendix D. Full council is required to approve these amendments.

Debt activity during 2012/13

19. During the first six months of 2012/13 there has been no need for the council to borrow. 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

20. This time last year forecasts were that inflationary pressures would mean that interest rates would have to start rising towards the end of 2012. This hasn't happened and the current outlook for growth for the UK economy means interest rates are very low and likely to remain so. Investments made early in 2012 should increase the interest earned on investments for 2012/13 by over £100,000. However from 2013 income may reduce for a year or so until market rates rise. This will be reflected in the council's medium term financial plan (mtfp).

	2012/13 £'000	2013/14 £'000	2014/15 £'000	2015/16 £'000	2016/17 £'000
Revised budget – Feb 2012	410	418	537	743	1129
Revised forecast - Jan 2013	536	356	376	659	952

Legal implications

21. 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 ODPM Local Government Investment Guidance provides assurance that the council's investments are, and will continue to be, within its legal powers.

22. 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.

Conclusion

23. This report provides details of the treasury management activities for the period 1 April 2012 to 30 September 2012 and the mid year prudential indicators to council.

24. 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

- CIPFA Treasury Management in the Public Services Code of Practice and Cross Sectoral Guidance Notes (revised 2011)
- CIPFA Prudential Code for Capital Finance in Local Authorities
- Various committee reports, principally:-

  I. Treasury Management Investment Strategy 2012/13 (cabinet 10 February 2012, council 22 February 2012)
  II. Amendments to the Treasury management Strategy (Audit and Governance committee 11 July 2012)

[1] Chartered Institute of Public Finance and Accounting (CIPFA)

Appendices

A – Economic update and interest rates
B – List of investments as at 30.9.12
C – Prudential Indicators
D - Amendments to the Treasury Management Strategy Extract

Economic Update and interest rates

25. The Bank of England lowered its expectations for the speed of recovery and rate of growth in August. The growth in the UK economy remains weak and forecasts for growth have been reduced for the next two years. Forty per cent of the UK output depends on overseas trade. The euro zone (EZ) economies remain weak and concerns persist that some EZ countries are falling into negative growth.

26. Higher unemployment, job fears, high inflation eroding disposable incomes, small or no pay increases are all factors contributing to consumers ability to spend and overall living standards have fallen in real terms due to the sharp price rises relative to wages. Average real wages have fallen every month since June 2008. The squeeze on households' income will remain a critical factor in the economy over the next few years. Inflation is the main cause and will continue to have the greatest impact on living standards as real income will continue to decline. The weak recovery has meant that social security payments remain high and tax income is low.

27. Looking ahead the EZ crisis is far from resolved as Greece has failed to achieve the deficit reduction targets so a third bail out may be required. Northern EU countries may not agree to support this. Economic growth is forecast to remain low for the next 24 months and the base rate will not be increased whilst growth is low. This means that investment returns will also remain low.

28. The government Funding for Lending Scheme has been introduced to improve access to mortgages at lower rates. This has affected 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 to happen in the next 12 to 24 months.

29. 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.

30. The interest rate forecast is based on the assumption that growth starts to recover in the next three years. If the EZ crisis worsens or low growth in the UK continues the base rate is likely to remain low for longer than this forecast.

31. 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.

Appendix A

Interest rates

32. The Bank of England changed its forecast significantly in the August Inflation report and reduced growth to 1% in 2013 and 2% in 2014.

33. **Bank rate** - remained unchanged at 0.5% throughout the first half of 2012/13. The earlier forecast of a rate rise in September 2013 has been postponed until Q4 in 2014.

Bank rate

	Now	Previously
Q1 2013	0.50%	0.50%
Q1 2014	0.50%	0.50%
Q1 2015	0.75%	1.00%

34. **Deposits rates** have fluctuated in a very narrow range during the first six months of the financial year. Investment rates have remained flat with a range between 0.5 per cent to around 1.5 per cent for up to a year's maturity. This has dropped significantly as banks and building societies were offered further cheap cash supply . 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 0.63 per cent.

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

Sector's interest rate forecast

	Now	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
Bank base rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%
3m LIBID	0.50%	0.50%	0.60%	0.50%	0.50%	0.50%	0.50%	0.60%	0.60%	0.70%	0.80%	1.10%
6m LIBID	0.70%	0.70%	0.70%	0.70%	0.70%	0.70%	0.70%	0.80%	0.90%	1.00%	1.10%	1.30%
12m LIBID	0.70%	1.00%	1.00%	1.00%	1.00%	1.00%	1.10%	1.10%	1.20%	1.30%	1.30%	1.50%
5 yr PWLB rate	1.60%	1.50%	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%	2.30%
10 yr PWLB rate	2.50%	2.50%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.30%
25 yr PWLB rate	3.80%	3.70%	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%	4.40%
50yr PWLB rate	3.90%	3.90%	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%	4.60%

Appendix B

Investments as at 30 September 2012

Counterparty	Deposit Type	Principal	Rate
Manchester Building Society	Fixed	2,000,000	1.50%
National Counties Building Society	Fixed	3,000,000	1.50%
West Bromwich Building Society	Fixed	2,000,000	1.40%
Cambridge Building Society	Fixed	2,000,000	1.40%
Lloyds TSB Bank Plc	Fixed	2,000,000	3.10%
Lloyds TSB Bank Plc	Fixed	3,000,000	3.00%
Lloyds TSB Bank Plc	Fixed	2,500,000	3.00%
Lloyds TSB Bank Plc	Fixed	2,500,000	3.00%
Royal Bank of Scotland	Fixed	4,000,000	2.25%
Royal Bank of Scotland	Call	4,000,000	1.05%
Santander	Call	2,070,000	0.80%
Goldman Sachs	MMF	100,000	Variable
Total Investments		29,170,000	

Appendix C

Prudential indicators as at 30th September 2012		
	2012/13	Actual as at
	Original Estimate	30-Sep
Debt	£m	£m
Authorised limit for external debt		
Borrowing	5	0
Other long term liabilities	0	0
	5	**0**
Operational boundary for external debt		
Borrowing	2	0
Other long term liabilities	0	0
	2	**0**
Interest rate exposures		
Maximum fixed rate borrowing	5	**0**
Maximum variable rate borrowing	5	**0**
Investments		
Interest rate exposures		
Limits on fixed interest rates	50	23
Limits on variable interest rates	10	6
Principal sums invested > 364 days		
Upper limit for principal sums invested >364 days	20	0

Extract from:
Audit and Governance Committee Report 11 July 2012

Changes to the Treasury Management Strategy

3. Current financial rules provide delegated authority for the chief financial officer to make any executive decision around treasury investments and borrowing. Paragraph 16 of Appendix A of the TMS allows him to vary the counterparty list and report to council these changes.

4. Since the TMS was agreed by council in February, it has been necessary to make two amendments to the strategy. The reason for these amendments is due to the current financial climate and recent spate of downgradings of banks by the main ratings agencies, there is an increasing difficulty in finding suitable counterparties for our funds - particularly the medium to longer term investments; this has necessitated a review of the counterparty criteria.

    a. The first amendment was to increase the limit on Government backed institutions, namely Lloyds Group and RBS from £5 million to £10 million.

    b. The second amendment was to re-insert the “Banks 3” paragraph in the ‘eligible institutions’ part of Appendix A. When the Treasury Management Strategy (TMS) for 2012/13 was approved earlier this year the Eligible Institutions (Banks 3) was omitted, possibly due to following the Sector template upon which we base our TMS, as this did not include them either. The recent review of the credit ratings, has meant that our counterparty list is reducing and to not re-insert “Banks 3” would not allow us to use staple partners such as Santander UK and Close Brothers Bank. The following amendment was proposed and agreed by the chief financial officer:

    Appendix A Paragraph 19. Insert new sub-para after 'Banks 2' as follows:

    - “Banks 3 – Eligible Institutions - the organisation is an Eligible Institution for the HM Treasury Credit Guarantee Scheme initially announced on 13 October 2008, with the necessary short and long term ratings required in Banks 1 above. These institutions have been subject to suitability checks before inclusion, and have access to HM Treasury liquidity if needed.”
    - Rename current "Banks 3" to "Banks 4".