Report to:
Cabinet
Council
Audit and Corporate Governance Committee

AGENDA ITEM NO 4

Report of Head of Finance

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To: Cabinet on: 2 December 2010
To: Council on: 24 February 2011
To: Audit and Corporate Governance Committee on: 14 December 2010

Treasury management mid year monitoring report 2010/11

Recommendation

That cabinet recommends council to:

1. Note the treasury management mid year monitoring report 2010/11.

That audit and corporate governance committee:

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

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 (PIs) are reported to council mid 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. An effective treasury management strategy 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. The council's treasury activities are strictly regulated by legislation. The CIPFA[1] Prudential Code and CIPFA Treasury Management Code were revised in December 2009, and introduced a requirement to provide a monitoring report mid year to council annually, which covers the treasury activity for the period 1 April to 30 September.

4. On 18 February 2010 the council agreed changes to the financial regulations that:

    - required the council to receive a treasury management mid year review report and

    - nominated audit and corporate governance committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

5. The 2010/11 treasury management strategy was approved by council on 18 February 2010. 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 4 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 the threat of foreign exchange and currency conflicts. 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. Commentators' projections conclude that any government 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.

12. The BoE has forecast that inflation will remain above target until 2012. However, despite this, 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.

13. 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 maturity periods. The downside of this is that investment returns remain very low.

Icelandic banks – Kaupthing Singer & Friedlander

14. As previously reported, the council invested £2.5 million with the failed Icelandic bank Kaupthing Singer & Friedlander (KSF). The council has received £1,184,072.98 to date, in respect of the claim for £2.6million (£2.5million investment plus interest).

15. The investment placed in July 2007 was due for repayment on 12 December 2008. As a wholesale depositor the council is treated as an unsecured creditor of KSF in the administration process, and ranks equally with all other unsecured creditors.

16. The Administrators intend to make further payments at regular intervals. The latest creditors' report now indicates that the estimated total amount to be recovered should be in the range of 75p to 84p in the pound. In total terms this would mean receiving between £1,950,000 and £2,184,000 of the claim. This is an increase from the previous report which indicated 65p to 78p in the pound. The Administrators' Progress Report for the period up to 7 October 2010 was

issued on 7 November 2010, and gave an indication that a further dividend would be paid in December 2010.

Current investments

17. The council's investment position as at 30 September 2010 is shown in table 1 below :

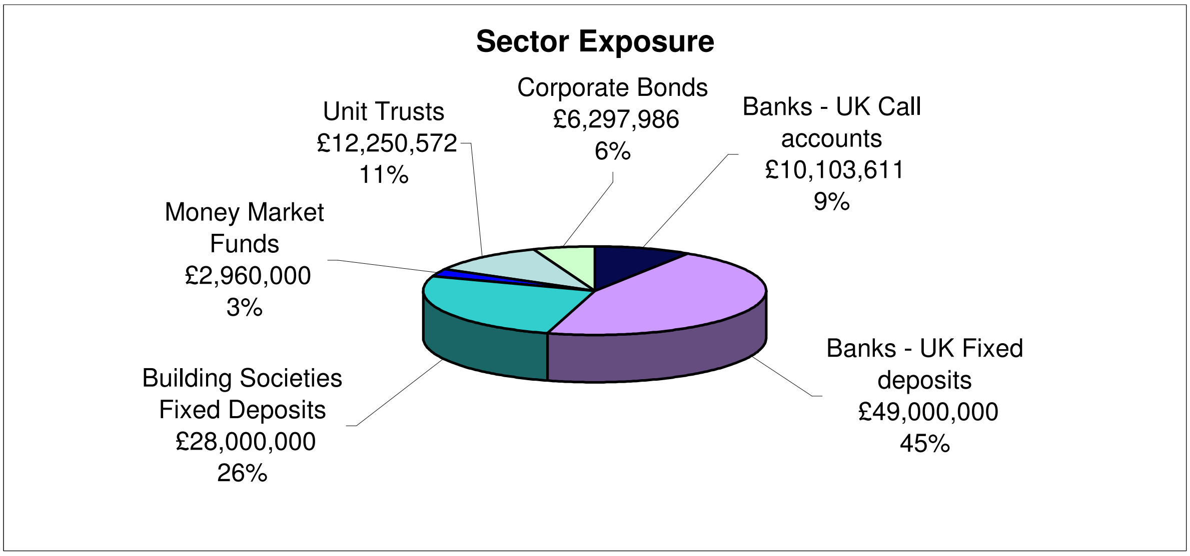
Table 1: maturity structure of investments (as at 30 September 2010):

	Total	
	£000	**%**
Cash deposits:		
Call	7,854	7%
30 day notice	2,250	2%
Up to 1 month	22,000	20%
1 - 2 Months	16,000	15%
2-3 Month	5,000	5%
3-4 Month	2,500	2%
4-6 Month	10,000	9%
6-12 Month	7,500	7%
1 -2 Year	14,000	13%
2-5 Year	-	0%
Kaupthing Singer & Friedlander	1,316	1%
Total cash deposits	**88,420**	**81%**
Equities	12,251	11%
Corporate bonds	6,126	5%
Money market funds	2,960	3%
Overall total	**109,757**	**100%**

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

18. The council currently holds a high proportion of its total investments in the form of cash deposits, the majority of which have been placed for fixed terms with a fixed investment return. Table 1 above, shows that roughly nine per cent (of the entire investment portfolio) is held on call or in notice accounts, with 81% of the total investment portfolio held in cash deposits, which is considered to be a high exposure to one particular market.

19. The chart below shows in percentage terms how the portfolio is spread across the types on investments.



20. Total investment income is currently predicted to be around £1.8 million in 2010/11 as the council finances the capital programme, and interest rates continue to remain low. Table 1a shows the interest earned for the first six months. Officers are continuing to re-invest maturing deposits short term due to the current market conditions. This strategy is intended to protect against interest rate risk and counterparty risk in an uncertain market. The short-term maturity structure of the portfolio has increased the exposure of the investment returns to fluctuations in the market rates.

Table 1a: Investment interest earned by investment type

	Interest Earned Apr - Sep 2010			
	Annual	Profiled	Actual	Variation
Investment type	**budget**	**budget**	**to date**	
	£000	**£000**	**£000**	**£000**
Call accounts	120	60	55	(5)
cash deposits < 1 yr	990	495	312	(183)
Cash deposits > 1 yr	110	55	126	71
MMF	32	16	10	(6)
Corporate bonds	583	292	293	1
Equities*	0	0	193	193
	1,835	**918**	**989**	**71**

* Interest on equities si not included in annual budget as it is nondistributable

Cash deposits

21. It has remained difficult in the first six months of the year 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 these 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.

22. The impact of these changes is that the council has a reduced number of organisations to make investments with, and a reduced choice of maturity periods. The council's treasury management strategy does however allow scope to adapt, and in response to these changes we have increased the use of investment instruments such as Money Market Funds (MMFs). It will remain challenging to manage the exposure to the banking market over the remainder of the year.

23. We continue to look for opportunities to fix lending for longer periods with highly rated institutions, and increase the weighted average maturity of the portfolio, where it is prudent to do so, and with counterparties who have a higher security.

24. A list of the cash investments as at 30 September 2010 is shown at appendix A

Equities

25. The council invested in unit trust equity investments ('shares' in unit trust form) because of good historical performance over the longer term. The current holdings with Legal & General (L&G) UK 100 Index Trust were purchased in 2000/01 at an initial cost of £10 million. This is an authorised unit trust incorporated in the United Kingdom and regulated by the FSA. The trust's objective is to track the capital performance of the UK equity market as represented by the FTSE 100 index.

26. The unit trusts are accounted for at fair value. The value of the unit trusts fluctuate quite significantly. Last year they moved from £9.2 million to £14.3 million. From April 2010 the value fell to £12.6 million by the end of June 2010. In August 2010, as part of the on going treasury review, and in discussion with the cabinet member for finance, it was agreed that the council would dispose of £2 million of its holding when the value reached a target of £14 million.

27. The fund value continued to fluctuate but with a rising trend until it exceeded the target value of £14 million on the 13 September 2010. As a result, a £2 million disposal was made on the 14 September. Table 2 below shows the movement in capital value to the point of disposal and the valuation at 30 September 2010.

Table 2: unit trusts - movement in capital

	£	£
Market value as at 13.9.10		14,254,054
Less:		
Dividends received in year	193,605	
Management rebates	-	
		(193,605)
Amended market value as at 14.9.10		14,060,449
Amended market value as at 31.3.10		13,822,115
Increase in market value in year		238,334
Disposal 14/9/10		(2,000,000)
Valuation as at 30/09/10		**12,250,573**

Note: amended market value is net of dividends.

28. The following table shows the unit trust performance against the benchmark, the FTSE all share index, since April 2010. In terms of performance the unit trust holdings have outperformed the benchmark by £419,404 to the 14 September 2010.

Table 3: unit trust performance 1.4.10 - 14.9.10

Increase in FTSE all share was	-1.31%
Increase in market value	1.72%
Out-performance	3.04%
	£
Market value (amended at 31.3.10)	13,822,115
less 1.31% FTSE decrease	(181,070)
Benchmark market value at 14.9.10	13,641,045
Market value (amended at 14.9.10)	14,060,449
Out-performance 1.4.10 to 14.9.10	**419,404**

Corporate bonds

29. The council continues to maintain holdings of corporate bonds previously acquired, on the basis that returns on these securities over their remaining lives should out perform the current bond markets and returns from fund management, given the view that interest rates and yields are forecast to remain low in the near term. The strategy permits investments of up to £10 million in corporate bonds (measured at the time of purchase). The current value of corporate bonds held is £6,271,207.

30. The remaining bonds are providing an excellent rate of return. However, two bonds are due to mature in 2011 and as bond prices tend toward par as they approach maturity, there would ordinarily be an optimum point at which each

bond provides the best return versus the deterioration in capital value. However, Sector has reviewed our current holdings and the analysis shows that in the current interest rate environment they should be held until maturity.

31. Sector also explored the possibility of lengthening the maturity profile to maintain the higher rates of return. It was concluded that a reinvestment in bonds at this time would not be made because the price suggests that the risk of investment in the long term bonds on offer was too high, given the current uncertainty in the banking sector.

Money market funds (MMFs)

32. MMFs are commercially run, pooled investments. They work rather like unit trusts, but whereas the latter are based upon shares in companies, MMFs rely on loans to companies. As their pooled funds have a high total value better rates of returns can be obtained. Legislation allows authorities to access only those MMFs with the highest possible credit rating (AAA).

33. The maximum limit to be invested in this type of instrument is £20 million. Access to and liquidity of these instruments is extremely flexible. They operate on a similar basis to call deposit accounts in that the funds can be placed or withdrawn with a minimum amount of notice, but tend to achieve better rates than short-term cash deposits placed in the market over similar periods, particularly in a declining or flat interest rate environment.

34. The council currently invests in three MMFs as follows, as shown in table 4 below:

Table 4: money market funds

Money market fund	Amount £000
Henderson	2,900
Blackrock	50
Goldman Sachs	10
Total	**2,960**

35. Officers are currently reviewing a fourth fund. The fund under review is a Sterling Reserve Fund provided by Payden and Rygel Global Ltd. The fund has a AAAF rating from Standard & Poors.

Interest rate movements

36. 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. Long-term interest rates peaked in the early part of the financial year. This rise was reversed in May.

37. 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 QE.

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

39. Table 5 below shows Sector's forecast of the expected movement in medium term interest rates:

Table 5: medium-term interest estimates (averages)

Annual Average	Bank Base Rate	Money market rates %		PWLB Rates*		
		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

* Borrowing Rates.

Source: Sector Forecast 15 November 2010

Performance

40. Table 6 below shows in summary the performance of the council's investments against the benchmarks set out in the treasury management strategy. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. These benchmarks are used to assess and monitor the council's investment performance for each type of investment instrument, however security of investments will always take precedence over returns.

Table 6: investment returns achieved against benchmark

	Benchmark return %	Actual return %	Growth (below)/above benchmark %	Benchmarks
Bank & building society deposits - non-managed	0.59%	1.23%	0.64%	3 Month LIBID
Equities	-1.32%	1.72%	3.04%	FTSE all shares index
Corporate bonds	0.50%	7.59%	7.09%	BoE base rate

Note: the benchmark return for unit trusts reflects the movement in capital value. All other benchmarks reflect earnings of investment income.

Treasury management limits on activity

41. The purpose of these limits are 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 are shown in table 7 below:

Table 7: treasury management limits

	2010/11	**2011/12**	**2012/13**
Interest rate exposures			
	Upper	Upper	Upper
Limits on fixed interest rates	£100m	£90m	£80m
Limits on variable interest rates	£30m	£30m	330m
Maximum principal sums invested > 364 days			
	2010/11	**2011/12**	**2012/13**
Principal sums invested > 364 days – upper limit	£50m	£50m	£50m
Limit to be placed on investments to maturity > 1 year			
1 – 2 years	£70m	£70m	£60m
2 – 5 years	£50m	£50m	£50m
5 years +	£50m	£50m	£50m

(Note: interest rate exposure limits identify the maximum limits that can be invested with fixed interest rate and a variable interest rate. Total principal funds invested for greater than 364 days – these limits are set with regards to the council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year end.

Liquidity and yield

42. The benchmarks for liquidity are set to ensure that sufficient funds can be accessed at short notice. The weighted average life in days sets a benchmark for how long investments should be made and the maximum benchmark is a target set to ensure that investments are not made for too long. The current position against the original benchmarks approved in February 2010 is shown below:

Table 8: risk-liquidity against benchmark

	2010/11 benchmark £m	Current position £m
Bank overdraft	0.5	0
Short term deposits - minimum available within 1 week	10	11
	2010/11 benchmark days	**Current position days**
Weighted average life (days)	182.5	189.4
Weighted average life - maximum	1,095.0	189.4

Credit risk - security

43. Credit risk arises from deposits with banks and financial institutions, as well as credit exposures 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. The council's maximum security risk benchmark for the current portfolio, when compared to the historic default tables as a percent of historic risk of default for each individual year is shown in table 9 below:

Table 9: Credit risk exposure against benchmark

	1 year	2 years	3 years	4 years	5 years
Maximum benchmark per £m	0.03%	0.15%	0.30%	0.44%	0.65%
Actual exposure per £m	0.01%	0.06%	0.00%	0.01%	0.21%

This is an average risk of default measure, and would not constitute an expectation of loss against a particular investment.

Debt activity during 2010/11

44. During the first six months of 2010/11 there has been no need for the council to borrow. The council will continue to take a prudent approach to its debt strategy. It is not expected to enter into any significant borrowing in the medium or long term. The prudential indicators and limits set out in table 10 below 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. The Local Government Act 2003 requires the council to produce prudential indicators and monitor activity against them.

Table 10: prudential indicators - authorised limit for external debt

	2010/11 Original estimate £m	Current position £m	2010/11 Revised estimate £m
Authorised limit for external debt			
Borrowing	5	0	5
Other long term liabilities	5	0	5
	10	**0**	**10**
Operational boundary for external debt			
Borrowing	2	0	2
Other long term liabilities	3	0	3
	5	**0**	**5**

45. The authorised limit of £10 million is set to provide for any short-term borrowing that could be required temporarily to deliver the treasury management strategy. This is the statutory limit determined under section 2(1) of the Local Government Act 2003. It is not anticipated that there will be a need to enter into any long-term borrowing, but there may on occasion be a need to borrow sums as part of the routine operation of its financial management.

46. This operational boundary is set below the authorised limit and a figure of £5 million is reasonable to allow the flexibility to borrow short-term for cash-flow variations if the need arose within the day to day treasury management activities of the authority.

Recommended changes to the treasury management strategy

47. Council approved the 2010/11 treasury management strategy on 18 February 2010. There are no proposed changes to the strategy for 2010/11 at this time.

Financial implications

48. The council's investments have historically been in excess of £100 million, and in recent years have generated over £6.5 million in investment income annually. Returns on investments in 2010/11 are projected to be around £1.8 million. The reduction is mainly due to falling investment rates; however it is in part due to the reduction in balances as a result of capital spending. Investments are projected to fall to approximately £74 million by 2014/15. Should investment rates recover to three percent then annual returns will be around £2.2 million.

Legal implications

49. 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.

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

Conclusion

51. 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.

52. 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 corporate 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
- CIPFA Prudential Code for Capital Finance in Local Authorities
- Various committee reports, principally:-

  I. Treasury Management Policy Statement, Treasury Management Practices (cabinet 7 March 2002)
  II. Recommendation of amendment to delegated authority (council 28 October 2004)
  III. Treasury Management Investment Strategy 2010/11(cabinet February 2010, council 18 February 2010)

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