Report to:

Cabinet

Council

Audit and Corporate Governance Committee

South Oxfordshire District Council

Listening Learning Leading

AGENDA ITEM NO 11

Report of Head of Finance

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To: Cabinet on: 13 February 2012
To: Council on: 23 February 2012
To: Audit and Corporate Governance Committee on: 31 January 2012

Treasury management mid year monitoring report 2011/12

Recommendation

That cabinet recommends council to:

1. Note the treasury management mid year monitoring report 2011/12.

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 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. 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. The 2011/12 treasury management strategy was approved by council on 24 February 2011. This report 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. Sector Treasury Services Limited 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 2010 the council's contract with Butlers was assigned to Sector in its entirety.

6. Sector have continued to perform and execute the obligations under the contract, which ended on the 16 October 2011. The contract has been re-tendered and Sector have been awarded the contract for a further three years. 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 level and future funding of government, corporate and personal debt are the central issue in the world economy. The sovereign debt crisis has been focused on the Euro zone. The euro zone bail out fund of 440bn euros approved in September, has brought only temporary relief to the financial markets. The markets remain on edge pending the euro zones agreement on what to do about the Greek debt. Concerns have turned from Greece to Italy and in turn could threaten the French AAA

sovereign rating as concerns focus on the size of each country's debt to their GDP ratio (their ability to earn income to pay for their debt).

9. In the United States, the deficit and medium term debt position were highlighted as unsustainable and the financing of the Federal budget deficit culminated in the down grading of the US AAA credit rating by Standard & Poors.

10. There is major disagreement amongst politicians and economists on what the appropriate policy should be. In addition the governments are running out of policy instruments. The potential for serious policy errors are substantial given the many uncertainties in the economic and financial outlook.

11. In the UK, there are real concerns that the economy may only just escape recession in the next two years. Forty percent of the UK GDP is dependent on overseas trade. 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 been cut 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 be a critical factor in the economy over the next two years. Inflation is the main cause and will continue to have the greatest impact on living standards as real income will continue to decline.

12. The UK forecasts for growth have been reduced for the next two years. Over the last 12 months, the UK economy has under-performed all leading economies except for tsunami hit Japan. The risk is that fiscal cuts weaken growth in the economy which in turn makes it more difficult to meet the Government's fiscal targets. The outlook is dominated by exceptional uncertainty.

13. Concerns over investment counterparty risk continue due to the volatile economic conditions. The council has continued to restrict investments to UK counterparties keeping maturity periods short and only extending investment periods with higher quality counterparties.

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 £1,657,702.16 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 79p to 86p in the pound. In total terms this would mean receiving between £2,052,050 and £2,262,517 of the claim. The Administrators' Progress Report for the period up to 7 October 2011 was issued on 3 November 2011. This indicated that the eighth dividend will be paid in March/April 2012.

Current investments

17. The council's investment position as at 30 September 2011 is shown in table 1 below

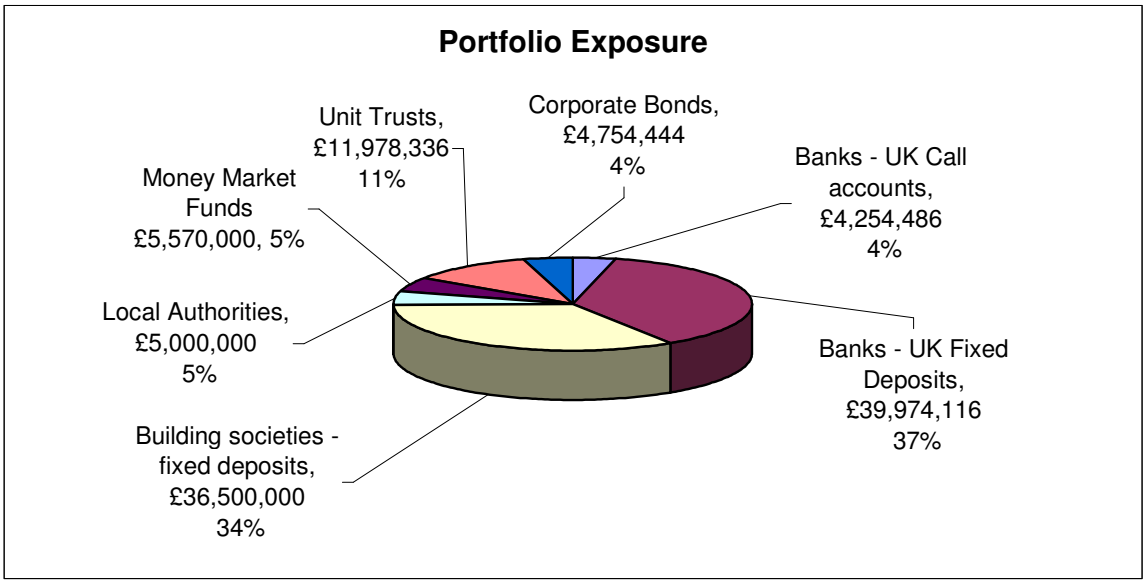
Table 1: maturity structure of investments (as at 30 September 2011):

	Total	
	£000	**%**
Cash deposits:		
Call	2,778	3%
30 day notice	1,474	1%
Up to 1 month	4,500	4%
1 - 2 Months	22,000	20%
2-3 Month	3,000	3%
3-4 Month	7,500	7%
4-6 Month	14,500	14%
6-12 Month	8,000	7%
1 -2 Year	11,000	10%
2-3 Year	10,000	9%
Kaupthing Singer & Friedlander	974	1%
Total cash deposits	**85,726**	**79%**
Equities	11,978	11%
Corporate bonds	4,754	4%
Money market funds	5,570	5%
Overall total	**108,030**	**100%**

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

18. The council currently holds a significant proportion of its 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 four per cent (of the entire investment portfolio) is held on call or in notice accounts, with 75% of the total investment portfolio held in cash deposits.

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 £1.9 million in 2011/12 against a budget of £1.8million. Table 1a shows the interest earned for the first six months. Officers are continuing to re-invest maturing deposits in general over the short term due to the current market conditions. Where possible maturity periods have been extended to the two to three year periods. This strategy aims to minimise counterparty risk. The overall short-term maturity structure of the portfolio does increase the exposure of the investment returns to fluctuations in the market rates.

Table 1a: Investment interest earned by investment type

	Interest Earned Apr - Sep 2011			
Investment type	**Annual Budget £000's**	**Actual To date £000's**	**Profiled Budget £000's**	**Variation £000's**
Call accounts	75	25	38	(13)
cash deposits < 1 yr	476	233	238	(5)
Cash deposits > 1 yr	586	458	293	165
MMF	3	21	1.5	20
Corporate bonds	463	233	232	2
Transferred Debt	10	0	5	(5)
Equities*	250	167	125	42
	1,863	**1,137**	**932**	**206**

* Interest on equities not included in annual budget as non-distributable

Cash deposits

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

22. Against this backdrop we are actively monitoring the markets with a view to extending the deposit periods between the one and three year maturity periods when opportunities arise. This has been achieved in the first six months and the weighted average maturity period has been increased to 222 days. In addition we have managed to incorporate some investments to other local authorities in the early part of this year. The investments are lower in terms of interest rates but offer a higher security. Lower PWLB rates have meant that it has been more difficult to find further lending opportunities in this sector in the latter half of the six month period.

23. We continue to look for opportunities to fix investments 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 investments as at 30 September 2011 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 has fluctuated quite significantly this year. The value has moved from £13.3 million at the start of April down to £12.0 million at the end of September. The value has recovered to £12.7m at the end of October 2011. This movement is expected in the current volatile markets where investors are moving between safer havens such as gilts and moving back into equities when the markets look calmer.

27. Table 2 below shows the movement in capital value for the first six months of the year:

Table 2: Unit Trusts - Movement in capital

	£	£
Market value as at 1.4.11		13,323,490
Less:		
Dividends received in year	167,433	
Management rebates	7,888	
		(175,321)
Amended market value as at 1.4.11		13,148,169
Amended market value as at 30.9.11		11,978,336
Decrease in market value in year		1,169,833

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 2011. In terms of performance the unit trust holdings have out-performed the benchmark by £681,429 to the 30 September 2011.

Table 3: Unit Trust performance 1.4.11 - 30.9.11	
Decrease in FTSE all share was	(14.08%)
Decrease in market value	(9.77%)
Out-performance	4.32%
	£
Market value (amended at 1.4.11)	13,148,169
less 14.08% FTSE decrease	(1,851,262)
Benchmark market value at 30.9.11	11,296,907
Market value (amended at 30.9.11)	11,978,336
Out-performance 1.4.11 to 30.9.11	**681,429**

Corporate bonds

29. The council continues to maintain holdings of corporate bonds previously acquired. The 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 £5,033,928.

30. These bonds are providing an excellent rate of return in the current low interest rate environment. 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 in the current interest rate environment the bond holdings are being held until maturity.

31. The option of lengthening the maturity profile to maintain the higher rates of return has been considered. The current uncertainty and risks of re-investment in this type of instrument is considered too high at present.

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, and can achieve better rates than short-term cash deposits placed in the market over similar periods. They offer the highest security.

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	1,800
Blackrock	720
Goldman Sachs	3,050
Total	**5,570**

Interest rate movements

35. UK short-term interest rates have fluctuated in a very narrow range during the first six months of the financial year. The bank rate has remained at 0.5%, whilst inflation has been above target. Long-term interest rates peaked in 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.

36. Investment rates have remained quite flat with a range between 0.5 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 0.7 percent and 1.2 percent.

37. At the start of the year, market expectations were that the BoE 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 BoE MPC latest decision to try boosting the available credit with further quantitative easing of £75 billion, will postpone a rate rise which is now expected to be in September 2013.

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

Table 5: Medium term interest rate forecast.

	Now	2011/12	2012/13	2013/14	2014/15
Bank base rate	0.50%	0.50%	0.50%	0.88%	2.00%
5 yr PWLB rate	2.41%	2.30%	2.38%	2.75%	3.40%
10 yr PWLB rate	3.46%	3.30%	3.40%	3.78%	4.50%
50yr PWLB rate	4.42%	4.30%	4.30%	4.75%	5.15%

Performance

39. 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.

40.

Table 6: investment returns achieved against benchmark

	Benchmark return	Actual return	Growth (below)/above benchmark	Benchmarks
	%	%	%	
Bank & building society deposits - non-managed	0.72%	1.60%	0.88%	3 Month LIBID
Equities	-14.08%	-9.77%	4.31%	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 limits are set each year in the Treasury Management Strategy. 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 on activity

Investments	**2011/12 Estimate £m**	**2012/13 Estimate £m**	**2013/14 Estimate £m**	**2014/15 Estimate £m**
Interest rate exposures				
Limits on fixed interest rates	100	90	80	80
Limits on variable interest rates	30	30	30	30
Maximum principal sums invested > 364 days				
Upper Limit for principal sums invested > 364 days	50	45	40	40
Limit to be placed on investments to maturity:				
1 - 2 years	70	70	70	70
2 - 5 years	50	50	50	50
5 years +	50	50	50	50
Debt				
Interest rate exposures				
Maximum fixed rate borrowing	10	10	10	10
Maximum variable rate borrowing	10	10	10	10

(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 2011 is shown below:

Table 8: prudential indicators - authorised limit for external debt

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

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	0.02%	0.05%	0.06%	0.12%	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 2011/12

44. During the first six months of 2011/12 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

	2011/12 Original estimate £m	Current position £m	2011/12 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 2011/12 treasury management strategy on 24 February 2011. There are no proposed changes to the strategy for 2011/12 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 2011/12 are projected to be around £1.9 million. The reduction is mainly due to low investment rates. 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 2011 to 30 September 2011 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 2011/12(cabinet 14 February 2011, council 24 February 2011)

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