Report to:

Cabinet

Council

Audit and Corporate Governance Committee

AGENDA ITEM NO 6

Report of: Head of Finance

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Treasury management outturn 2010/11

Recommendations to council

1) To approve the treasury management outturn report for 2010/11;

2) To approve the actual 2010/11 prudential indicators detailed in appendix 1.

Purpose of report

1. The purpose of this report is to advise councillors of the performance of the treasury management function (the management of our investments) for the financial year 2010/11. This complies with the requirements of the CIPFA treasury management code of practice and Treasury Management Practice 6 (TMP6).

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 enables resources to be available to meet the council's other strategic objectives.

Background

3. As part of the 2010/11 budget setting process, council approved the treasury management strategy for 2010/11 on 18 February 2010. 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 2010/11.

Economic conditions

5. In 2010/11 year the global financial markets were concerned with sovereign debt issues, particularly within the euro-zone, triggered by the threat of sovereign debt default by Greece and then Ireland. Both countries were forced to accept rescue packages from the European Union and the International Monetary Fund. Fears spread to Portugal towards the end of the 2010/11. The euro single currency mechanism had to be rescued from a total collapse in 2010/11 and the threat of foreign exchange and currency conflicts remain an issue.

6. In the UK, the new coalition Government announced the most severe package of public sector spending cuts since the Second World War, the effects of which will are expected to have an impact on local government for many years to come. Measures aiming to reduce national debt to sustainable levels will also reduce UK growth. Inflation has remained high throughout 2010/11 due to increases in world oil and food prices. International economic growth prospects also continue to impact on the UK growth forecasts.

7. The financial markets were reassured by the Government's debt reduction plans, however towards the end of 2010 markets were expecting a base rate rise in February / March 2011 as a result of rising inflation. These concerns led to deposit rates increasing slightly during the second half of the year. However slowing growth and weak growth prospects in March 2011 moved the market expectation of a rate rise from May 2011 to August 2011. The Bank of England (BoE) base rate remained at 0.5 per cent throughout 2010/11.

8. 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 2010/11. The European Commission carried out a stress test of the major financial institutions in July 2010. The objective was to assess the resilience of the EU banking sector against adverse effects as a result of a general economic downturn and movements in external variables such as interest rates, economic growth and unemployment. Although only a small number of banks failed the tests market concerns continue.

9. The BoE has forecast that inflation will remain above target throughout 2012 but will return to target by 2013/14. 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.

10. 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 periods. The downside of this is that investment returns remain low compared to what could be achieved if an alternative strategy was applied.

Base rate and LIBID rate

11. The London Interbank 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 three month LIBID rate started 2010/11 at 0.52 per cent and closed the year at 0.69 per cent, whilst base rate in comparison remained constantly at 0.50 per cent throughout 2010/11.

Icelandic bank collapse

12. The council had an investment of £2.5 million placed in July 2007, through fund managers, with Kaupthing Singer and Friedlander Ltd (KSF). The investment was due for repayment in December 2008. The bank went into administration at the start of October 2008 and as a result the repayment of the deposit was not made. The council is treated as a wholesale depositor and an unsecured creditor of KSF in the administration process and ranks equally with all other unsecured creditors.

13. Since July 2009 the council has received £1,526,139 in respect of the claim for £2.6 million (£2.5 million investment plus interest). 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 78p to 86p in the pound. In total terms this would mean receiving between £2,052,050 and £2,262,517. This is an increase from the previous report that indicated 75p to 84p in the pound.

Treasury activities in 2010/11

Investment income

14. The total interest earned on investments during 2010/11 was £1.9 million, compared to the original estimate of £1.8 million, as shown in table 1 below:

	Interest earned		
	Budget	Actual	Variation
Investment type	**£000**	**£000**	**£000**
Short term - cash deposits	1,252	1,175	(77)
Long term - unit trusts & corporate bonds	583	758	175
	1,835	**1,933**	**98**

15. The variation in investment earnings of £98,000 above the original estimate for 2010/11 is due to a number of reasons:

- Interest received on unit trusts was £175,000 higher than forecast due to the overall increase in the value during the year.

- Interest earned on cash deposits was £77,000 lower than originally forecast. This is because investments have been placed for shorter time periods due to the concerns over counterparty risk.

- The total actual average interest rate achieved for the year was 1.8 per cent. The increase above the estimate used in January 2010 of 1.7 percent equates to £0.1 million of additional interest.

Movement in the value of investments

16. Table 2 below shows the movement in value of the council's investments at the end of the year.

Table 2: investment portfolio values and movements.

	31/3/10 £m	31/3/11 £m	Movement in investments
Cost values			
Bank & building society deposits	77.47	82.65	5.18
Unit trusts	14.23	13.32	(0.91)
Corporate bonds	6.52	5.23	(1.29)
	98.22	**101.20**	**2.98**

17. The value of investment deposits fluctuates through the year due to cash flow and spending patterns. The increase in investment balances is due to:

- The year end position for unit trusts shows a reduction of £0.91 million. In September 2010 when the market value peaked £2 million of the council's unit trust holdings were disposed of. Although there has been a subsequent fall in the last half of the year, overall there has been a net gain of £1.09 million. Further details of the movements in year are shown in paragraphs 30-35.

- A corporate bond matured in January 2011 with a value of £1 million. The remaining movement is due to a fall in values at the end of the year.

- Other movements are due to fluctuations in working capital and cashflow.

Performance

18. Table 3 below shows in summary the performance of the council's investments against benchmark returns as set out in the treasury management strategy.

	Benchmark return	Actual return	Growth (below)/above benchmark
Bank & building society deposits - internally managed	0.62%	1.30%	0.68%
Unit trusts	6.15%	4.93%	(1.22%)
Corporate bonds	0.50%	6.56%	6.06%
Total average return		1.80%	

Note: the benchmark return for unit trusts reflects the movement in capital value. All other benchmarks reflect earnings of investment income. The total actual return for the whole investment portfolio was 1.80 per cent. This is 0.91 percent above the industry average.

CASH DEPOSITS

19. As noted above, bank and building society deposits increased by £5.18 million during the year from £77.47 million as at 1 April 2010 to £82.65 million at the 31 March 2011.

20. Returns on internally managed cash deposits are benchmarked against the three month LIBID rate, which was an average of 0.62 per cent for 2010/11. The performance for the year of 1.30 per cent exceeded the benchmark by 0.68 per cent.

21. There are a number of limiting factors which affect the rate achievable on investments. Officers have restricted placing investments to only those organisations which have a high credit rating, although this is a moving target given the high number of credit rating changes throughout the year. In addition the maturity term of investments has mainly been kept short term in order to mitigate counterparty risk.

22. For the purposes of providing comparative performance indicators the market average rates of interest are shown in table 4. Local authority market rates for cash deposits have historically been around the same level as the three month LIBID rate. However, actual rates achieved are dictated by changeable factors such as cash flow and the market demand for funds. This meant that the rates available on money market deposits in the short term fluctuated between 0.40 per cent and 1.50 per cent.

Table 4: internally managed cash deposit performance achieved against benchmark

	Cumulative % returns
Actual (cash investments only)	**1.30**
Benchmark - 3 month LIBID	0.62
Variance - (under)/over benchmark	0.68
7 day LIBID annual average	0.43
Industry average (of external fund mana	0.89
Variance - (under)/over industry average	0.41

EXTERNAL FUND MANAGERS

23. The agreement with Tradition expired in October 2008. The head of finance decided, in consultation with the previous cabinet member for finance, not to re-tender the contract at that time. The major factor influencing this decision was that the economic conditions had required officers to restrict lending to only a few institutions and keep all investments within short-term maturity periods, in order to minimise risks.

24. The benefit of allowing a suitably qualified third party to manage a proportion of our cash balances is that not all of our investment decisions will be based on an

officers' viewpoint as to how the market may perform. During 2010/11 the cabinet member for finance and head of finance considered that the market is not yet at a point where they can recommend re-appointment of external fund managers. This will be reviewed on an ongoing basis

UNIT TRUSTS

25. The council has invested in unit trust equity investments ('shares' in unit trust form) because of good historical performance over the longer term. The current holdings are with the Legal & General (L&G) UK 100 Index Trust. 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. Securities in the FTSE 100 index are held with weightings generally proportionate to their company's market value.

26. The council's unit trusts are accounted for in the council's financial statements at fair value[1]. The opening value of unit trusts at 1 April 2010 of £14.23 million closed at £13.32 million by year end. The movement in capital value is shown in percentage terms in table 5 below:

Table 5: unit trusts - movement in capital value

	Carrying value as at 1/4/10 £000	Carrying value as at 1/4/11 £000	Disposal in year £000	Increase in capital value £000	Increase as % of carrying value
L&G UK Index Trust	14,228	13,323	2,000	1,095	7.70%

27. The carrying value is the amount quoted in the statement of accounts and includes adjustments for accrued interest. In order to assess the true unit trust performance an adjustment must be made to amend the market value[2]. Table 6 below shows the unit trust performance without the accounting adjustments required for the statement of accounts:

Table 6: unit trust performance in year:

Increase in FTSE all share was	6.15%
Increase in market value	4.93%
Under-performance	(1.22%)

	£
Market value (amended at 31/3/10)	14,228,476
plus 6.15% FTSE increase	875,051
[3]Benchmark market value at 31/3/11	15,103,527
Market Value (amended at 31/3/11)	14,929,484
Under-performance for 2010/11	**(174,043)**

28. Unit trusts fluctuated quite a lot throughout the year. The overall increase in value of 4.93% does not reflect the level of adjustments in the market experienced during 2010/11. The value fell by £1.6 million in June 2010 and then rose back to above the £14 million level by September 2010. A disposal of £2 million was made to take advantage of the increase. There has been a general increase in the value in the last half of 2010/11, but the overall increase has not performed as well as the increase in the benchmark.

29. Dividends received of £0.394 million were reinvested to acquire additional fund units. Since the end of March 2011 the value rose to £13.6 million in July but has fallen by £2 million in the last month due to the latest turmoil in the financial markets and stood at £12.1 million at the end of August.

30. The unit trusts are benchmarked against the FTSE All Shares Index, which represents 98-99 per cent of the UK market capitalisation. The index shows the performance of all eligible companies listed on the London Stock Exchange main market and today covers 630 constituents with a combined value of nearly £1.6 trillion. It is recognised as the main benchmark for unit trusts. In terms of performance the council's unit trusts underperformed the benchmark by £174,043, as shown in table 6 above.

31. The council's unit trust equity investments were purchased in 2000/2001 at an initial cost of £10 million as a long term investment. The medium term cash flow forecast does not identify a need to call on these investments and so they will continue to be held for the long term. When the value reaches the target value of £14 million, the head of finance will consider disposing of a proportion of the holding for reinvestment .

CORPORATE BONDS

32. The council's corporate bonds are also accounted for in the financial statements at fair value. The opening carrying value[4] for 1 April 2010 was £6.7 million. The closing carrying value at 31 March 2011 was £5.1 million. The carrying values and market values for the corporate bonds are shown in table 7 below:

Table 7: corporate bond values

Bonds	Original cost £000	Nominal value £000	Carrying value as at 1/4/10 £000	Carrying value as at 1/4/11 £000	Market value at 1/4/11 £000
Santander 11.50%	422	270	360	348	330
Lloyds 9.125%	901	750	808	790	773
Lloyds 12%	1,407	1,000	1,440	0	0
RBS 9.625%	1,973	1,500	1,755	1713	1,672
Halifax 11.5%	2,942	2,000	2,375	2288	2,257
	7,645	**5,520**	**6,737**	**5,139**	**5,031**

Notes:

1. Original cost = principal value
2. Nominal value = capital value to be paid if held to maturity
3. Carrying value = carrying value brought forward plus interest due in year based on Effective Interest Rate calculation.
4. Market value = sale value at specific date

33. The holding of corporate bonds is a long term investment and the performance of these bonds should not be viewed for one year only. Interest is paid annually at a fixed rate (see table 8 below). If the bonds are held until the redemption date, the value repaid will be the nominal value. This is different to the original purchase price as the original purchase price is influenced by market conditions. It could also be lower than the purchase price depending on when the bond was bought.

34. This ‘loss’ in capital value is reflected in the interest rate paid. The true amount of interest earned on the investment, which takes account of both the interest paid and the reduction in capital value, is shown in table 8 as the “redemption yield”. This is the amount of interest earned in total from the date of purchase to the redemption date. The weighted average return on the council’s corporate bonds for 2010/11 was 6.56 per cent, which significantly exceeded the benchmark return.

35. The corporate bonds mature on dates between 2011 to 2017. Annual interest earned will remain the same for the whole period a bond is held. Table 8 below shows the redemption yield of the bonds if kept until the redemption date.

Table 8: corporate bond redemption yields if held to maturity

Bank	Interest rate %	Original cost £000	Nominal value £000	Redemption date	Redemption yield
Santander	11.50%	422	270	04/01/2017	5.59%
Lloyds	9.13%	901	750	17/10/2011	6.51%
Lloyds	12.00%	1,407	1000	02/01/2011	6.37%
RBS	9.63%	1,973	1500	22/06/2015	6.20%
Halifax	11.50%	2,942	2000	17/01/2014	5.25%

36. It has been difficult to identify the optimum point of sale which will deliver the most income for both interest and capital due to the constant changes in the financial markets. We will continue to review and assess the holdings and take any appropriate action as opportunities arise when markets stabilise.

Other investments

PENSION FUND CONTRIBUTIONS

37. The council made two contributions of £5 million to the Oxfordshire County Council pension fund, one in April 2005, the other in April 2008. We made these payments to reduce our ongoing contributions to the fund. Based on historical performance statistics, the return earned by the pension fund has been better than that achieved by the council. The pension fund invests far larger amounts than we do and therefore can attract higher rates of return.

38. The value of the pension fund assets and liabilities is based on a series of actuarial assumptions. Based on the actuarial valuation as at the 31 March 2011, the long term rate of return per annum expected on the funds assets was 6.8 per cent (6.8 per cent as at 31 March 2010).

LAND AND PROPERY

39. The council holds a portfolio of investment property, which includes land, industrial estates, depots, garages and shops that are used on a commercial basis. These assets had a net book value of £16.2 million at 31 March 2011 (£15.7 million at 31 March 2010) and generated income of £1.0 million in 2010/11 (£0.9million in 2009/10).

40. 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 by ELP to determine if assets should be retained or disposed of and agree any actions to improve or enhance the value of the investment property holdings.

Treasury management advisors

41. Together with Vale of White Horse District Council, we appointed Butlers as our treasury advisors in July 2008. The contract expires in October 2011 and costs an average of £9,291 per annum. This produced efficiency savings for both councils over the contract period in terms of costs for South Oxfordshire District Council, and in terms of increased services for the Vale of White Horse District Council. Sector Treasury Services took over the services provided by Butlers on 4 October 2010. The majority of staff transferred to Sector on 25 October 2010, and we have not experienced any disruption to the service provided.

Prudential indicators

42. As part of the 2010/11 budget setting process the council set a number of prudential indicators. These indicators set the parameters within which the capital and treasury management functions are managed.

43. The council is debt free and has no borrowing. This means the majority of the indicators are negative and therefore prove to be difficult to relate to the day to day treasury management activities. This does not mean however that the council should not still monitor its performance against the indicators

44. During 2010/11 the council has performed within all the parameters set out under the prudential code during 2010/11. The details of the actual indicators against the budget are shown in appendix 1.

Financial implications

45. Details of the financial implications are set out in the report.

Legal implications

46. Under the Local Government Act 2003 and relevant secondary legislation and associated guidance, the council agreed the treasury management strategy for 2010/11 at its meeting of 18 February 2010.

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

Conclusion

48. As at 31 March 2011, the council's financial investments had a cost value of approximately £101.2 million. During 2010/11 investments generated £1.9 million in investment income which was £98,000 above the £1.8 million original forecast.

49. The financial year 2010/11 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 difficult to forecast;
    - increased counterparty risk – reduced choice of counterparties;
    - increased interest rate exposure risk – due to a higher proportion of investments held in short-term maturity periods.

50. Despite the continued uncertainty the overall investment performance was above the industry average for 2010/11. When periods within the markets stabilised, investments were made in the year that provided a good return whilst maintaining security.

51. The total return on corporate bonds is still high, despite a fall in their carrying values in the year. Officers will continue to assess at what point the bonds may be best sold as they near maturity. The council's unit trust investment saw significant fluctuations in value during the year. A disposal took advantage of a market peak in year as confidence in growth prospects provided a boost to share price. Although the value has since fallen these investments spread portfolio risk and are viewed as a long term holding. The values will continue to be monitored and disposal considered if market conditions are more favourable.

Background papers

- Chartered Institute of Public Finance and Accounting (CIPFA) code of practice for treasury management in the public sector.
- CIPF treasury management in the public services code of practice and cross sectoral guidance notes
- Treasury management strategy 2010/11 – council 18 February 2010.
- Treasury management strategic & operational framework report – cabinet 7 March 2002.

Definitions

[1] Fair value: is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction. In some cases this will be the amount paid for purchasing the investment. This may not always be the case, where there have been substantial transaction costs (as in an investment fund), or where interest payable does not reflect market rates or obligations (as in corporate bonds).

[2] Market value: this is the price that would be paid on a specific date.

[3] Benchmark value: this is the value that should be achieved if the investment has grown in line with the benchmark. E.g. : for unit trusts the benchmark is the FTSE Allshare index.

[4] Carrying value: the accounting treatment of investments will depend on the financial asset category within which they are deemed to be. For some categories the amount carried in the balance sheet will be either written up or down over the term of the investment. This is done to reflect things such as transaction costs or deferred interest payments and is required to spread the effect equally over the life of the investment. The adjusted value is the carrying value.

5. Effective Interest Rate (EIR): corporate bonds must be accounted for using the EIR method which calculates the amortised cost of a financial asset and allocates the interest over a relevant period. The EIR rate discounts the estimated future cash receipts through the expected life of the investment. This means that the amount of actual interest received in a year will differ to the accounting entry for accrued interest.