South Oxfordshire District Council

Listening Learning Leading

Report to:
Cabinet
Council
Audit and Corporate Governance Committee

Report of: Head of Finance

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AGENDA ITEM NO 5

To: Audit and Corporate Governance Committee on: 27 September 2012
To: Cabinet on: 18 October 2012
To: Council on: 18 October 2012

Treasury management outturn 2011/12

That Audit and Corporate Governance Committee:

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

That Cabinet:

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

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

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

Purpose of report

1. The report fulfils the legislative requirements to ensure the adequate monitoring and reporting of the treasury management activities. This report is to advise Councillors of the performance of the treasury management function (the management of our investments) for the financial year 2011/12. This complies with the requirements of the Chartered Institute of Public Finance and Accountancy (CIPFA's) Code of Practice on Treasury Management (revised) 2009.

Strategic objectives

2. 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 2011/12 budget setting process, Council approved the treasury management strategy for 2011/12 on 24 February 2011. The treasury management strategy sets the parameters within which officers manage the Council's treasury management activities.

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

Economic conditions

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

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

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

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

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

10. The economic environment remains volatile and concerns over investment counterparty risk persist. The Council has continued to restrict investments to the UK throughout the year.

Icelandic bank default – Kaupthing Singer & Friedlander

11. As previously reported, the Council invested £2.5 million in July 2007, with the failed Icelandic bank Kaupthing Singer and Friedlander Ltd (KSF). The Council has received £1,920,829 to date, in respect of the claim for £2.6 million (£2.5 million investment plus interest).

12. As a wholesale depositor, the Council is treated as an unsecured creditor in the administration process, and ranks equally with all other unsecured creditors. 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 81p to 86p in the pound. In total terms this would mean receiving between £2,130,975 and £2,262,517. The amount shown below in table 1 of £579,000 is the balance remaining on the initial investment £2.500m less the amount received to date of £1.921m.

Base rate and LIBID rate

13. The London Inter-bank Bid rate (LIBID) is the benchmark used to compare treasury management performance against because historically it has reflected the market conditions at which rates the banks lend to each other. The three month LIBID rate started 2011/12 at 0.69 per cent, peaked at 0.96 per cent and closed the year at 0.90 per cent, whilst base rate in comparison remained constantly at 0.50 per cent throughout 2011/12.

Treasury activities in 2011/12

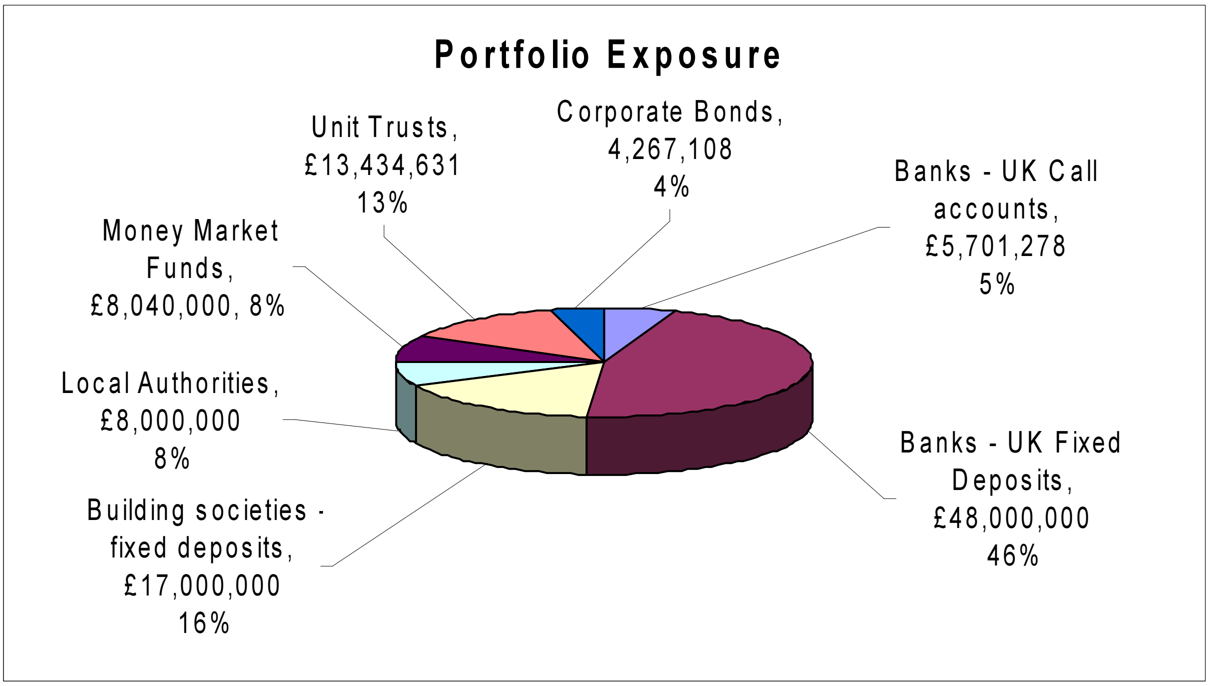
Council investments as at 31 March 2012

The Council's investment s, analysed by age as at the end of 2011/12 is shown in table 1 below. The investments position is organised in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities.

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

	Total £000	**%**
Cash deposits:		
Call	5,701	5%
30 day notice	1,482	1%
Up to 1 month	6,500	6%
1 - 2 Months	3,500	3%
2-3 Month	1,000	1%
3-4 Month	8,500	8%
4-6 Month	7,000	7%
6-12 Month	9,000	9%
1 -2 Year	31,500	30%
2-3 Year	2,000	2%
3-5 Year	3,000	3%
Kaupthing Singer & Friedlander*	579	1%
Total cash deposits	**79,762**	**76%**
Equities	13,435	13%
Corporate bonds	4,267	3%
Money market funds	8,040	8%
Overall total	**105,505**	**100%**

A significant proportion of the portfolio is held in the form of fixed interest rate cash deposits. These provide some certainty over the investment return. The chart below shows in percentage terms how the portfolio is spread across the investment types:



Investment income

14. The total interest earned on investments during 2011/12 was £2.5 million, compared to the original estimate of £1.8 million, as shown in table 1a below:

Table 1a: Investment interest earned by investment type

	Interest Earned		
Investment type	**Actual £000's**	**Budget £000's**	**Variation £000's**
Short term - Cash Deposits	1,570	1,150	420
Long term - Equities & Corporate Bonds	943	713	230
	2,513	**1,863**	**650**

15. The variation in investment earnings of £650,000 above the original estimate for 2011/12 is due to a number of reasons:

- Interest received on unit trusts was £400,000 higher than forecast due to the overall increase in the value during the year.
- Interest earned on corporate bonds was £169,000 lower due to maturities that were not reinvested in corporate bonds
- Interest earned on cash deposits was £420,000 higher than forecast due to longer dated investments combined with higher interest rates achieved.
- The total actual average interest rate achieved for the year was 2.12 per cent. The increase above the estimate used in January 2011 of 0.26 per cent equates to £0.26 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.

	31/03/2011 £m	31/3/2012 £m	Movement in Investments
Cost Values (£m's)			
Bank & Building Society deposits	82.65	87.22	4.57
Equities	13.32	13.43	0.11
Corporate Bonds	5.23	4.27	(0.96)
	101.20	104.92	3.72

The value of investment deposits fluctuates throughout the year due to cash flow and spending patterns.

Performance

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

Table 3: Investment returns achieved against benchmark[1]

	Benchmark Return	Actual Return	Growth/ (Below) above Benchmark	Benchmarks
Bank & Building Society deposits - internally managed	0.82%	1.80%	0.98%	3 Month LIBID
Unit trusts	(2.82%)	(4.06%)	(1.24%)	FTSE All Shares Index
Corporate Bonds	0.50%	6.56%	6.06%	Bank of England Base Rate
Total average return		**2.12%**		

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 2.12 per cent. This is 0.72 per cent above the industry average.

Cash deposits

18. As noted above, bank and building society deposits increased by £4.5 million during the year from £82.85 million as at 1 April 2011 to £87.22 million at the 31 March 2012.

19. Returns on internally managed cash deposits are benchmarked against the three month LIBID rate, which was an average of 0.82 per cent for 2011/12. The performance for the year of 1.80 per cent exceeded the benchmark by 0.98 per cent.

20. When opportunities arose in the first six months of year investments were made to other local authorities. A total of £8m was invested in local authorities in the year. In the second half of the year it became more difficult to find opportunities

[1] The figures in this table were amended at the Audit and Corporate Governance committee meeting to correct the unit trust figures. The totals in the unamended table were correct in the papers originally circulated.

that provided added value, in this sector as lower PWLB rates have driven returns down considerably. During the year officers aimed to extend the deposit periods and increase the weighted average life of the Council's investments. Opportunities were taken to invest £20 million primarily between October 2011 and January 2012 with the highest rated UK banks. In addition, officers also made use of special tranches of investment rates available to local authorities early in 2011. These combined investments have earned an additional £420,000 investment income for the year. The weighted average maturity period has been increased from 222 at the 30 September 2012 to 298 days at the end of March 2012.

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 remained a moving target given the frequency of credit rating changes throughout the year.

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.

Table 4: Cumulative performance against benchmark & industry average

	Cumulative % returns
Actual	**2.12**
Benchmark - 3 Month LIBID	0.82
Variance - (Under)/Over benchmark	1.30
Industry average*	1.40
Variance - (Under)/Over Ind Average	0.72

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

Equities

23. 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 the 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.

24. The unit trusts are accounted for in the Council's financial statements at fair value[1]. The opening value of unit trusts at 1 April 2011 of £13.32 million closed at £13.43 million by March 2012. The value has recovered from a low of £12 million in September 2011. This volatility is expected in the current economic climate where investors move out of equities into 'safer' sectors such as gilts until markets look calmer. Table 5 below shows the movement in capital value:

Table 5: Unit Trusts - Movement in capital

	£	£
Market Value as at 31.3.12		13,434,630
Less:		
Dividends received in year	417,170	
Accrued dividends	235,306	
		(652,476)
Amended market value as at 31.3.12		12,782,154
Market value as at 1.4.11		13,323,490
Decrease in Market Value in year		(541,336)

25. The value quoted in the statement of accounts 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 1.4.11 - 31.3.12

Decrease in FTSE all share was	(2.82%)
Decrease in Market Value	(4.06%)
Under-performance	(1.24%)
	£
Market Value 1.4.11)	13,323,490
less 2.82% FTSE decrease	(375,722)
Benchmark Market Value at 31.3.12	12,947,768
Market Value (amended at 31.3.12)	12,782,154
Under performance 1.4.11 to 31.3.12	**(165,614)**

28. Unit trusts fluctuated quite a lot throughout the year, as volatility in the markets has driven investors to move to safer havens such as gilts.

29. Dividends received of £0.4 million were reinvested to acquire additional fund units. Since the end of March 2012 the value rose to £13.52 million in July. 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 under-performed the benchmark in 2011/12 by £165,614 as shown in table 6 above.

Corporate Bonds

30. The Council's corporate bonds are also accounted for in the financial statements at fair value. The opening carrying value[3] for 1 April 2011 was £5.1 million. The closing carrying value at 31 March 2012 was £4.2 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 1/4/11 £000	Carrying value as at 1/4/12 £000	Market value at 1/4/12 £000
Santander 11.50%	422	270	348	335	304
Lloyds 9.125%	901	750	790	0	0
RBS 9.625%	1,973	1,500	1,713	1,621	1,672
Halifax 11.5%	2,942	2,000	2,288	2,178	2,201
			5,139	**4,209**	**4,104**

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

31. The Council continues to maintain holdings of corporate bonds. The returns on these securities over their remaining lives should out perform the current bond markets given the current economic forecasts that interest rates and yields will continue to remain low. One bond matured in 2011/12 for the nominal value of £750,000.

32. The weighted average return on the Council's corporate bonds for 2011/12 was 5.89 per cent, which significantly exceeded the benchmark return.

33. 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%
RBS	9.63%	1,973	1500	22/06/2015	6.20%
Halifax	11.50%	2,942	2000	17/01/2014	5.25%

Money market funds (MMFs)

34. Money market funds 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 return can be obtained. Legislation allows authorities to access only those MMFs with the highest possible credit rating (AAA).

35. Access and liquidity together with high security have meant these funds have been used throughout the year. The Council currently invests in three MMFs and the amount held in each at the 31st March 2012 is shown below:

Table 9: Money market funds

	31/03/2012 £000
Deutsche Bank	2,540
Black rock	3,950
Goldman Sachs	1,550
	8,040

Other investments

PENSION FUND CONTRIBUTIONS

36. The Council made two contributions of £5 million to the Oxfordshire County Council pension fund, one in April 2005, the other in April 2008. The Council made these payments to reduce the 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 is able to invest far larger amounts than we do and therefore can attract higher rates of return.

37. 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 2012, the long term rate of return per annum expected on the funds assets was 5.7 per cent (6.8 per cent as at 31 March 2011).

LAND AND PROPERY

38. 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 £16.3 million at 31 March 2012 (£16.2 million at 31 March 2011) and generated income of £0.9 million in 2011/12 (£0.9million in 2010/11).

39. 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 advisers

40. Together with Vale of White Horse District Council, the Council jointly re-tendered the contract for treasury advisors in October 2011. The contract was awarded to Sector Treasury Services Ltd for a period of three years. The joint procurement provided annual savings to both Councils. 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.

41. Whilst the treasury 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.

42. The services provided 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.

Treasury management limits on activity

43. 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 10 below:

Table 10: treasury management limits on activity

	2011/12 Actual £m	2011/12 Limit £m
Investments		
Interest rate exposures		
Limits on fixed interest rates	78	100
Limits on variable interest rates	27	30
Maximum principal sums invested > 364 days		
Upper Limit for principal sums invested > 364 days	36.5	50
Limit to be placed on investments to maturity:		
1 - 2 years	31.5	70
2 - 5 years	5	50
5 years +	0	50
Debt		
Interest rate exposures		
Maximum fixed rate borrowing	0	10
Maximum variable rate borrowing	0	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

44. The benchmarks for liquidity are set to ensure that sufficient funds can be accessed at short notice. These are targets and not limits. 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. For example the amount to be maintained for liquidity was £10m and the actual of £17m was above the benchmark. The actual for the WAL of 298 days exceeded the benchmark of 182.5 days and did not exceed the maximum of 1095 days.

45. The year end position against the original benchmarks approved in February 2011 is shown below:

Table 11: risk-liquidity against benchmark

	2011/12 benchmark £m	2011/12 actual £m
Bank overdraft	0.5	0
Short term deposits - minimum available within 1 week	10	17
	2011/12 benchmark days	**2011/12 actual days**
Weighted average life (days)	182.5	298.0
Weighted average life - maximum	1095.0	298.0

Debt activity during 2011/12

46. During 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 12: prudential indicators - authorised limit for external debt

	2011/12 Original Estimate £m	31.3.2012 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**

47. 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.

48. 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.

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

Financial implications

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

Legal implications

51. Under the Local Government Act 2003 and relevant secondary legislation and associated guidance, the Council agreed the treasury management strategy for 2011/12 at its meeting of 24 February 2011.

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

53. There are no other legal implications of this report.

Conclusion

54. As at 31 March 2012, the Council's financial investments had a cost value of approximately £104 million. During 2011/12 investments generated £2.513 million in investment income which was £650,000 above the £1.863 million original estimate. This was as a result of proactive management of investments held and extending the maturity structure of investments during the year, by investing in fixed term deposits at higher rates.

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

    - sums at risk with an Icelandic institution in administration;
    - low investment returns and difficulty to forecast;
    - increased counterparty risk – reduced choice of counterparties;
    - Interest rate exposure risk – due to investments held in short-term maturity periods.

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

Background papers

- Chartered Institute of Public Finance and Accounting (CIPFA) code of practice for treasury management in the public sector.
- CIPFA treasury management in the public services code of practice and cross sectoral guidance notes
- Treasury Management Strategy 2011/12 – Council 18 February 2011.

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] 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.

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