Report to:

Cabinet

Council

Audit and Corporate Governance Committee

AGENDA ITEM NO 4

Report of: Head of Finance

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To: Audit and Corporate Governance Committee on: 28 September 2010
To: Cabinet on: 9 September 2010
To: Council on: 23 September 2010

Treasury management outturn 2009/10

Recommendation to council

To approve the treasury management outturn report for 2009/10;

To approve the actual 2009/10 prudential indicators (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 2009/10. 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 2009/10 budget setting process council approved the treasury management strategy for 2009/10 on 18 February 2009. 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 2009/10.

Economic conditions

5. The past year has been extremely difficult. In 2008 the world economy entered the most severe recession since the Great Depression of the 1930's. This continued well into 2009, a year in which overall world GDP declined for the first time in 26 years. Around the world, governments and central banks took massive fiscal and monetary measures to limit the extent and duration of the recession. These measures have left a lasting legacy.

6. There are now signs that the worst of the global recession is over and the tentative recovery is in progress. For example, at the end of 2009 only the UK, Ireland and Spain were technically still in recession. Around the world, the recovery is in varying stages and is skewed towards emerging markets such as India, China and Brazil. However, there is concern about the sustainability of the recovery, given its reliance on quantitative easing and low interest rate monetary policy.

7. In the UK, 2009 started on a very uneasy footing. The economy was severely battered, public finances were in a poor state and the UK's sovereign rating was in question. While emergency packages had been launched in late 2008, all financial institutions were still considered highly vulnerable.

8. The government provided further support for the banking industry. Two major banks, RBS and Lloyds Group needed substantial cash injections, which resulted in majority ownership by the state. The Dunfermline Building Society was rescued from bankruptcy by the Nationwide, and Santander took over the Alliance & Leicester and Bradford and Bingley.

9. Bank lending and money supply were especially weak in 2009 despite a significant rise in bank reserves. Banks were particularly risk adverse given the depth of the recession and the losses encountered in 2008/09. During the next two years, the UK's largest banks will need to replace or refinance around £750-£800 billion of loans and liquid assets. UK banks will also need to extend the maturity of their wholesale funding, 60 per cent of which matures within one year. The timing and how this will affect the money markets is unknown, and creates further uncertainty for the year ahead. This therefore makes the prediction of future interest rates difficult.

10. The Bank of England base rate started the year at 0.5 per cent and remained at this historically low level throughout 2009/10. Monetary policy in the form of quantitative easing started in March 2009, with £125 billion followed by a further £50 billion in August and £25 billion in November 2009.

11. Both short and long term rates remained at extremely low levels throughout 2009/10.

12. The key to the Bank of England interest rate policy will be the outlook for inflation, which the latest Bank of England Quarterly Inflation Report forecasts to range between 1.5 per cent and 3.0 per cent. The central estimate places the years

rise in CPI to 1.8 per cent by mid 2012. Interest rates are expected to remain on hold for some time to come. Further quantitative easing could produce an increase in equity prices however the latest growth estimates could spark a fall in prices, if investors decide to take profits now. The markets do not anticipate significant growth for the next few years.

13. **Base rate and LIBID rate**

14. 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. As a result of the deterioration in economic conditions and in the banking sector, the banks became very reluctant to lend to each other, which had the effect of pushing up the LIBID rate. These conditions led to the difference between the bank base rate, and achievable market rates, becoming unusually wide. It also meant that the availability of counterparties (i.e. the institutions to whom we lend) paying above LIBID, who were also highly rated, was limited. The three month LIBID rate started 2009/10 at 1.5 per cent and closed the year at 0.52 per cent, whilst base rate in comparison remained constantly at 0.50 per cent throughout 2009/10.

15. The market conditions meant that for the first half of 2009/10 there was an unusually high differential between LIBID and the Bank of England base rate. This corrected itself during the last six months of the year.

16. In addition, the financial rescue packages provided to the banking institutions to provide cash in return for securities reduced the demand for banks to borrow in the wholesale markets (e.g. from local authorities), particularly in short-term maturity periods. This situation improved slightly during the last six months of 2009/10 as some stability emerged in the UK financial markets.

Icelandic bank collapse

17. The council had an investment of £2.5m placed in July 2007, through fund managers, with Kaupthing Singer and Friedlander Ltd. 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.

18. Since July 2009 the council has received four dividend payments which total £1,184,072. This represents 45 per cent of the total claim for £2,630,834. The administrator intends to make further payments at regular intervals. The latest creditors report published 27 April 2010, indicates that the total estimate to be recovered should be in the range of 65p to 75p in the pound. This is an increase from the previous report which indicated 60p to 70p in the pound. Further details on future dividends will be provided in the administrators' progress report for the period up to 7 October 2010, which is due to be published by 7 November 2010.

Changes to the treasury management strategy during the year

19. Council agreed at its meeting in June 2009 to amend the treasury management strategy and investment strategy as follows:

    1. Banks and building societies – the council will use banks and building societies which have at least the following Fitch, Moody's and Standard and Poors ratings:

        - Short Term – F1/P1/A-1
        - Long Term – A /A3
        - Individual / Financial Strength – C (Fitch / Moody's only)
        - Support – 3 (Fitch only)

    2. Eligible Institutions - the council will use institutions which are approved under the UK Government criteria, but will restrict the maturity period to no more than six months.

    3. To amend the UK government guarantee rated AAA to take account of negative rating watches, subject to consultation and agreement with the cabinet member responsible for finance;

    4. Rating Outlook – the council will continue to use institutions which meet all other minimum criteria, but will restrict the maturity period subject to consultation and agreement with the cabinet member responsible for finance;

    5. Rating Watch – where a negative rating watch is issued and the counterparty is at the bottom of acceptable criteria, the council will suspend its use from the approved counterparty list;

    6. Rating Watch – the council will continue to use institutions where a negative rating watch is issued if the counterparty meets/or exceeds all the minimum criteria, but will restrict the maturity period to no more than six months until the position is clear.

20. During the financial year the council operated these limits. There were no instances of non-compliance

Treasury activities in 2009/10

Investment income

21. The total interest earned on investments (ie bank, building society and corporate bond holdings) during 2009/10 was £2.9m million, compared to the original estimate of £1.7m , as shown in the following table:
22.

Table 1: Investment interest earned by investment type

Investment type	Interest Earned Actual £000's	Estimate £000's	Variation £000's
Short term - Cash Deposits	2,102	991	1,111
Long term - Equities & Corporate Bonds	829	700	129
	2,931	**1,691**	**1,240**

23. The variation in investment earnings of £1.2 million above the original estimate for 2009/10 is due to a number of reasons:

- the actual average interest rate achieved for the year was 2.18 per cent. The increase above the estimate used in January 2009 of 1.3 per cent equates to £671,000 of additional interest.

- the estimate of 1.3 per cent was set at a time of great turmoil in the financial markets. The base rate had fallen from by 3 per cent between October and December 2008. It fell a further 1.5 per cent between January and March 2009. Similarly money market rates had declined at an alarming rate. However the rates we were actually able to lend at during 2009/10 were generally above our worst case scenario on which the budget had been set.

- amendments to the strategy were required in June 2009, in order to continue to lend to organisations that had been given government support. During this period it was impossible to forecast how long the council would need to restrict investments in order to manage counterparty risk. It was not until late 2009 and early 2010 that investments were again placed with UK banks. Of the £170m fixed deposit investments made in the year, only £37m was invested with banks. During this period, the majority of investments were made with building societies as the building society sector was not exposed to the sub-prime debt losses that the banks were.

- as stability returned as a result of the government's support, the council was able to start to place investments for slightly longer maturity periods and achieve a higher rate of return. Investments placed throughout the last two quarters of 2009/10 were made at rates higher than the forecast in early 2009.

- active management of short-term deposits in the year produced an average rate of return of 1.46 per cent, which is 0.75 per cent above the benchmark.

- £439,750 of the variation is due to the actual amount of investments on average throughout the year being £20m higher than the amount used to estimate the average investments. The estimate was based on an average of £90m, whereas the actual average amount of investments held throughout the year was £110m. This produced higher investment returns than budgeted. The value of investments throughout the year fluctuates because of cashflow and spending variations.

- investments placed before 2009/10 were invested at higher interest rates and for longer maturity periods, this has helped to offset the lower rates earned on investments placed in 2009/10.

- interest earned on long term investments is higher than the estimate by £129k. The income from corporate bonds remains fixed and constant, however the earnings on equities held fluctuate with the movements in the market. Further details are provided in paragraphs 35 – 40.

Movement in the value of investments

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

Table 2: Investment portfolio values and movements.

	31/3/09 £m's	31/3/10 £m's	Movement in Investments
Cost values (£m's)			
Bank & Building Society deposits	77.01	77.47	0.46
Equities	9.25	14.23	4.98
Corporate bonds	5.39	6.52	1.13
	91.65	98.22	6.57

25. The value of investment deposits fluctuates through the year due to cash flow and spending patterns. The increase in investment balances is primarily due to the increase in market value of equities and corporate bonds.

Performance

26. Table three 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

	Benchmark Return	Actual Return	Growth/ (Below) above Benchmark	Benchmarks
Bank & Building Society deposits - internally managed	0.72%	2.18%	1.46%	3 Month LIBID
Unit trusts	46.67%	57.78%	11.11%	FTSE All Shares Index
Corporate bonds	0.50%	7.59%	7.09%	Bank of England Base Rate

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

CASH DEPOSITS

27. Banks and building society deposits increased by £0.46m during the year from £77.0m as at 1 April 2009 to £77.5m at the end of March 2010.

28. Cash deposits were managed both internally and externally until 2008/9, when the council decided that there was no advantage in maintaining a fund manager purely for cash deposits given the current market environment. All investments previously placed through the fund manager have now matured, except the investment placed with Kaupthing Singer and Friedlander.

29. Returns on internally managed cash deposits are benchmarked against the three month LIBID rate, which was an average of 0.72 per cent for 2009/10. The

performance for the year of 2.18 per cent exceeded the benchmark by 1.46 per cent.

30. There are a number of limiting factors which affect the rate achievable on investments. Officers have restricted placing investments to higher rated organisations, and the maturity term of investments has primarily been kept short term in order to mitigate counterparty risk.

31. For the purposes of providing comparative performance indicators the market average rates of interest are shown in table four. 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. As the government's rescue packages have provided cash to banks during 2009, the demand from banks for cash funds fell. This meant that the rates available on money market deposits in the short term fluctuated between 0.20 per cent and 1.5 per cent.

Table 4 - internally managed cash deposit performance achieved against benchmark

Cumulative performance against benchmark & industry Average - 2009/10

	Cumulative % returns
Actual	**2.18**
Benchmark - 3 month LIBID	0.72
Variance - (under)/over benchmark	1.46
7 day LIBID annual average	0.37
Industry average (of external fund managers)	1.39
Variance - (under)/over ind average	0.79

32. Throughout the year, officers took care to invest cash deposits with borrowers with top credit ratings. Investments were kept primarily short–term in order to mitigate counterparty risk. Inevitably, attempting to minimise risk meant that it was not possible to achieve the best rates available in the market. A higher proportion of investments held in short-term maturity periods to minimise exposure risk led to an increase in the interest rate exposure risk. This is the risk that returns on investments will be influenced to a greater extent by movements in interest rates.

External fund managers

33. The agreement with Tradition expired in October 2008. The head of finance decided, in consultation with the 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.

34. 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. The cabinet member for finance and head of finance consider that the market is not yet at a point where they can recommend re-appointment of external fund managers but will continue to review the position.

Unit Trusts

35. 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.

36. 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 2009 of £9.25 million rose to £14.23 million by year end. The movement in capital value is shown in percentage terms in the following table:

Table 5: Unit trusts - movement in capital value

	Carrying Value as at 1.4.09 £000's	Carrying Value as at 1.4.10 £000's	Increase in Capital Value £000's	Increase as % of carrying value	FTSE all share index increase %
L&G UK Index Trust	9,251	14,228	4,977	53.80%	46.67%

37. 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]. The following table 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	46.67%
Increase in Market Value	57.78%
Out-performance	11.11%
	£
Market Value (amended at 31.3.09)	8,760,251

plus 46.67%r FTSE increase	4,088,409
[3]Benchmark Market Value at 31.3.10	12,848,660
Market Value (amended at 31.3.10)	13,822,115
Out-performance for 2009/10	**973,455**

38. The increase in value by 57.78 per cent was exceptional and reflects the level of adjustments in the market experienced during 2009/10, as a result of the preceding year's exceptional fall (for comparison, the value fell by 29.61 per cent in 2008/09). Dividends received of £0.395 million were reinvested to acquire additional fund units. Since the end of 2009/10 the benchmark value has risen further and stood at £13.77 million in August.

39. 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 outperformed the benchmark by £973,455, as shown in the table 8 above.

40. The council's unit trust equity investments were purchased in 2000/2001 at an initial cost of £10m as a long term investment. Although shares values have fluctuated over the past 10 years it has not been felt there has been an opportune moment to sell. The council's five year 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 £14m, the head of finance will consider disposing of a proportion of the holding for reinvestment .

Corporate Bonds

41. The council's corporate bonds are also accounted for in the financial statements at fair value. The opening carrying value[4] for 1 April 2009 was £6.90 million. The closing carrying value at 31 March 2010 was £6.74m million. The carrying values and market values for the corporate bonds are shown below:

Table 7: Corporate bond values						
Bonds	Original cost £000's	Nominal Value £000's	Carrying Value as at 1.4.09 £000's	Carrying Value as at 1.4.10 £000's	Market value at 1.4.10	Market value 09.08.10
Abbey 11.50%	422	270	372	360	352	349
Lloyds 9.125%	901	750	825	808	806	793
Lloyds 12%	1,407	1,000	1,446	1,440	1,058	1,030
RBS 9.625%	1,973	1,500	1,796	1,755	1,723	1,746
Halifax 11.5%	2,942	2,000	2,462	2,375	2,352	2,332
	7,645	5,520	6,902	6,737	6,292	6,249
Notes:						
1. Original costs = 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 EIR calculation.						
4. Market value = sale value at specific date						
5. Table 7 above will not reconcile to Table 2 because the carrying value includes interest based on EIR, whilst Table 2 includes actual interest received.						
6. Effective Interest Rate - see end note 3 for definition						

42. 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 than the purchase price depending on when the bond was bought. 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 2009/10 was 7.59 per cent, which significantly exceeded the benchmark return.

43. 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 eight 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's	Nominal Value £000's	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%

44.

45. The changes in the financial markets have meant that it has been difficult to identify the optimum point of sale where there is a maximum income and

minimum loss of capital. This has not been the case in the last two years as markets have not operated 'normally'. 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

46. 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.

47. 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 2010, the long term rate of return per annum expected on the funds assets was 6.8 per cent (5.8 per cent as at 31 March 2009). The final accounts for the pension fund will not be available until the annual accounts are approved by the Pension Committee in November 2010.

LAND AND PROPERY

48. The council holds a portfolio of non-operational assets, which includes land, industrial estates, depots, garages and shops that are used on a commercial basis. These assets had a net book value of £15.9 million (£10.7 million as at 31 March 2009) and generated income of £1.0 million (£1.1 million in 2008/9).

49. 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

50. Together with Vale of White Horse District Council, we appointed Butlers as the our treasury advisors in July 2008. We awarded a three year contract to July 2011, which 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.

Prudential Indicators

51. As part of the 2009/10 budget setting process the council set a number of prudential indicators. These indicators set the parameters within which we manage the overall capital and treasury management functions.

52. The Council is debt free and has no borrowing so 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

53. During 2009/10 the council has performed within all the parameters set out under the prudential code during 2009/10. The details of the actual indicators against the budget are shown in appendix one.

Financial Implications

54. Details of the financial implications are set out in the attached report.

Legal Implications

55. Under the Local Government Act 2003 and relevant secondary legislation and associated guidance, the council agreed the Treasury Management Strategy for 2009/10 at its meeting of 18 February 2009.

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

Conclusion

57. As at 31 March 2010, the council's financial investments had a cost value of approximately £98.22 million. During 2009/10 cash and bond investments generated £2.9 million in investment income which was £1.2m above the £1.7 million original estimate.

58. The financial year 2009/10 provided exceptional circumstances with regard to treasury management. The fluctuations in the markets and downturn in the economy, together with continued counterparty risk presented the council with a difficult environment to invest in. The main implications of the unusual circumstances were:

    - sums at risk with an Icelandic institution in administration;
    - reducing 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.

59. Against this turbulent backdrop investment performance was good. Cash deposits generated a good return, exceeding the benchmark and industry averages. As the markets stabilised, investments were made in the year that provided a good return above the benchmark, whilst maintaining security.

60. 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 a significant recovery in value as confidence in the longer term outlook provided a boost to share price. Holding these investments continues to be viewed as a long

term hold and to spread portfolio risk. The values will continue to be monitored and disposal considered if market conditions are more favourable.

Background Papers

- CIPFA Code of Practice for Treasury Management in the Public Sector.
- Chartered Institute of Public Finance and Accounting (CIPFA) Treasury Management in the Public Services Code of Practice and Cross Sect oral Guidance Notes
- Treasury Management Strategy 2009/10 – council 18 February 2009.
- Treasury Management: 2008/09 outturn and variation to the strategy 2009/10 – cabinet & council
- 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.

[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 Effective Interest Rate 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.