ANNUAL TREASURY MANAGEMENT REPORT 2011/12

Cabinet – 11 October 2012

Report of the:	Deputy Chief Executive and Director of Corporate Resources
Status:	For decision
Also considered by:	Performance and Governance Committee – 18 September 2012
Key Decision:	No

Executive Summary: This report provides the customary review of investment activity during 2011/12 as required by the Council's Financial Procedure Rules. The report outlines the strategy adopted during the year, shows the position of the investment portfolio at the beginning and the end of the year and gives details of how the fund performed in comparison with previous years and against various benchmarks.

This report supports the Key Aim of effective management of Council resources.

Portfolio Holder Cllr. Ramsay

Head of Service Group Manager - Financial Services – Mr. Adrian Rowbotham

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Recommendation: It be RESOLVED that the Annual Treasury Management Report for 2011/12 be approved.

Background

1 The Council is required through regulations issued under the Local Government Act 2003 to produce an annual treasury report reviewing treasury management activities and the actual prudential and treasury indicators for 2011/12. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

2 During 2011/12 the minimum reporting requirements were that the Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 16/12/2010)
- a mid year (minimum) treasury update report (Performance and Governance Committee 15/11/11, Cabinet 8/12/11)
- an annual report following the year describing the activity compared to the strategy (this report)

3 In addition, the Council received a quarterly treasury management update report (Performance and Governance Committee 27/9/11) and regular reports on progress were presented to the Finance Advisory Group.

4 Recent changes in the regulatory environment place a much greater onus on Members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by Members.

5 This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to treasury management reports before they were reported to the full Council. Member training on treasury management issues was undertaken on 27 January 2010 in order to support Members' scrutiny role.

6 The financial year 2011/12 continued the challenging environment of previous years with low investment returns and ongoing counterparty risk.

Introduction

7 This **annual treasury report** covers:

(a) the Council's treasury position at the beginning and end of the financial year;

(b) Investment Strategy for 2011/12;

(c) the economy and interest rates in 2011/12;

(d) compliance with treasury limits and prudential indicators;

(e) investment rates in 2011/12;

(f) investment outturn for 2011/12 and performance; and

(g) Icelandic bank defaults.

Treasury position at the beginning and end of the financial year

8 The Council's investment portfolio at the beginning and end of the financial year appears at Appendix A, whilst an analysis by maturity and repayment due dates appears at Appendix B.

Investment Strategy for 2011/12

9 The expectation for interest rates within the strategy for 2011/12 anticipated low but rising Bank Rate (starting in quarter 4 of 2011) with similar gradual rises in medium and longer term fixed interest rates over 2011/12. Variable or short-term rates were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

10 The actual movement in gilt yields meant Public Works Loan Board (PWLB) rates fell sharply during the year and to historically very low levels. This was caused by a flight to quality into UK gilts from EU sovereign debt and also from shares as investors became very concerned about the potential for a Lehmans type crisis in the financial markets if the Greek debt crisis were to develop into a precipitous default and exit from the Euro.

11 **Change in strategy during the year** – the strategy adopted in the original Treasury Management Strategy Report for 2011/12 approved by the Council on 16 December 2010 was subject to revision during the year due to the downgrading of counterparty credit ratings. The Council's minimum rating criteria for lending were reduced and the counterparty cash limit was increased as a result of a smaller pool of institutions meeting the minimum rating requirement.

The economy and interest rates in 2011/12

12 The financial year 2011/12 continued the challenging investment environment of previous years, namely low investment returns and continuing heightened levels of counterparty risk. The original expectation for 2011/12 was that Bank Rate would start gently rising from quarter 4 2011. However, economic growth in the UK was disappointing during the year due to the UK austerity programme, weak consumer confidence and spending, a lack of rebalancing of the UK economy to exporting and weak growth in our biggest export market - the European Union (EU). The UK coalition Government maintained its tight fiscal policy stance against a background of warnings from two credit rating agencies that the UK could lose its AAA credit rating. Key to retaining this rating will be a return to strong economic growth in order to reduce the national debt burden to a sustainable level, within the austerity plan timeframe. The USA and France lost their AAA credit ratings from one rating agency during the year. Weak UK growth resulted in the Monetary Policy Committee increasing quantitative easing by £75bn in October and another £50bn in February. Bank Rate therefore ended the year unchanged at 0.5% while CPI inflation peaked in September at 5.2%, finishing at 3.5% in March, with further falls expected to below 2% over the next two years. The EU sovereign debt crisis grew in intensity during the year until February when a second bailout package was eventually agreed for Greece.

13 Gilt yields fell for much of the year, until February, as concerns continued building over the EU debt crisis. This resulted in safe haven flows into UK gilts which, together with the two UK packages of quantitative easing during the year, combined to depress PWLB rates to historically low levels.

14 As far as investment rates were concerned, risk premiums were a constant factor in raising money market deposit rates for periods longer than 1 month. Widespread and multiple downgrades of the ratings of many banks and sovereigns, continued Eurozone concerns, and the significant funding issues still faced by many financial institutions, meant that investors remained cautious of longer-term commitment.

Compliance with treasury limits and prudential indicators

15 During 2011/12, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

	2010/11 Actual (£000)	2011/12 Original (£000)	2011/12 Actual (£000)
Actual capital expenditure	2,786	2,628	2,348
Total Capital Financing Requirement:			
• Non-HRA	-	-	-
• HRA	-	-	-
• Total	-	-	-
Net borrowing	-	-	-
External debt	-	-	-
Investments			
• Longer than 1 year	2,000		-
• Under 1 year	19,300		24,231
• Total	21,300		24,231

16 The investment figures relate to the time left to maturity, not the length at the commencement date and exclude accrued interest. The Landsbanki investment has also been excluded.

17 During the year the Council operated within the treasury limits and prudential indicators set out in its Treasury Policy Statement and Annual Treasury Strategy Statement with one exception. It came to light that there was a period of seven days in August 2011, during which the Council had balances between £6.6m and £7.8m invested with Santander UK plc. This was in the form of a single £1m fixed deposit and the remainder in a Money Market call account. At the time the limit was £5m in fixed deposits or £6m in combined fixed deposits and call accounts. This occurred while the Principal Accountant (the usual Treasury Management Officer) was out of the office and other officers were administering treasury business. This was a one-off error and was corrected by the Principal Accountant on his return by withdrawing funds from the call account to bring the balance in line with the limits. Procedures have since been put in place to prevent a recurrence of this event.

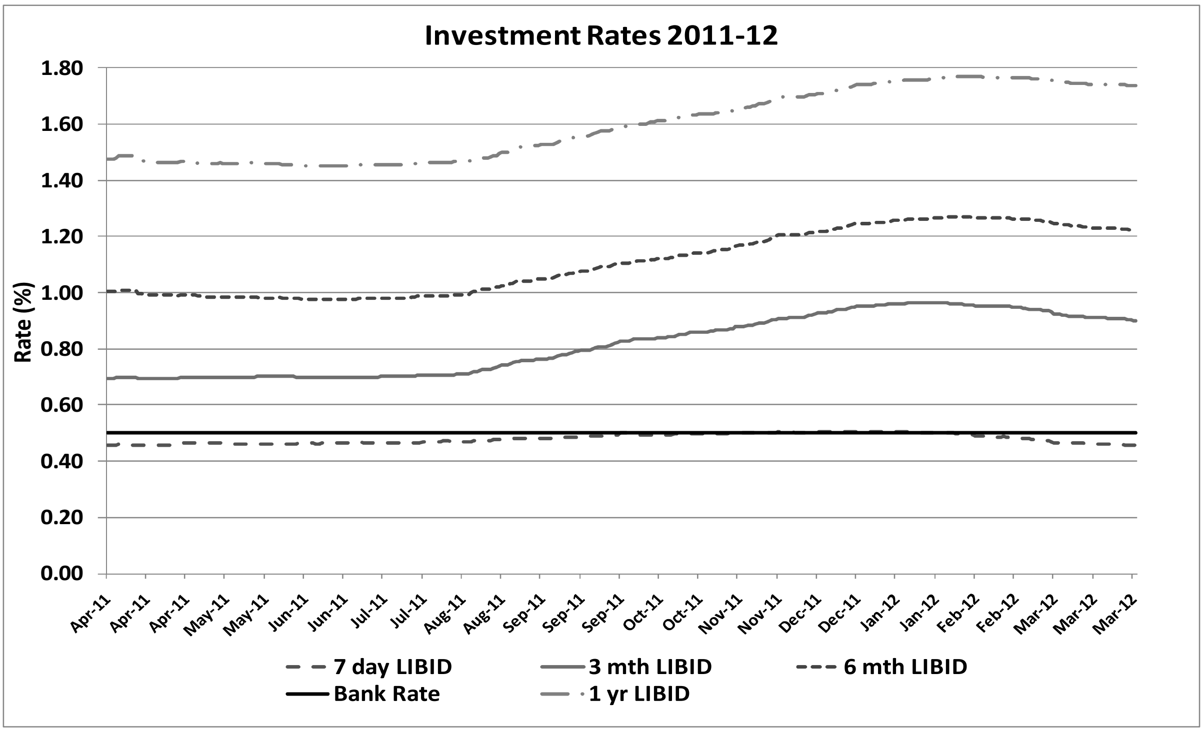
18 The lending list was kept under constant review throughout the year in response to credit rating changes arising from the financial crisis. As detailed above, the opportunity was taken to increase the lending limit for individual institutions meeting the Council's lending criteria, as difficulty was being experienced in placing investments within the restricted number of counterparties. A copy of the latest lending list appears at Appendix C.

19 No institutions in which investments were made during 2011/12 had any difficulty in repaying investments and interest in full during the year.

Investment rates in 2011/12

20 The tight monetary conditions following the 2008 financial crisis continued through 2011/12 with little material movement in the shorter term deposit rates. However, one month and longer rates rose significantly in the second half of the year as the Eurozone crisis grew. Bank Rate remained at its historic low of 0.5% throughout the year while market expectations of the start of monetary tightening were gradually pushed further and further back during the year to the second half of 2013 at the earliest.

21 Overlaying the relatively poor investment returns were the continued counterparty concerns generated by the Eurozone sovereign debt crisis.



Investment outturn for 2011/12 and performance

22 The Council's investment policy is governed by Department of Communities and Local Government (CLG) guidance, which has been implemented in the annual investment strategy approved by the Council on 16 December 2010. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.). The strategy was amended later in the financial year, as mentioned earlier in this report, to deal with issues around the restricted number of counterparties.

23 With the one exception mentioned above, the investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties, which might have led to the need to borrow.

24 Appendix D shows the performance of the fund during 2011/12 both in table and graphical form. The table shows the average percentage return on the fund, both monthly and for the whole year and compares them with the average 7-day and 3-month London Interbank Bid (LIBID) rates. The average return achieved by each broker is only a very basic measure of performance, because returns will depend on the number and length of each investment he/she is asked to carry out. If a particular broker is only asked to place short term investments, he/she may well not achieve the same overall rate as a broker who predominantly handles longer term investments for us.

25 The graph shows actual monthly receipts for 2009/10, 2010/11 and 2011/12 plus budgeted monthly receipts for 2011/12. The monthly interest budget has been profiled in line with the previous year's monthly weighted average principal.

26 Over the course of the year interest receipts amounted to £0.308m compared with a budget of £0.186m. The main reasons why the budget was exceeded were that the Council had locked into some longer investments at higher interest rates than planned for in the budget plus the positive impact on cash flow of delayed capital expenditure.

27 In 2011/12 the percentage return on the Council's investments was marginally lower than that of our neighbouring authorities. Our overall rate of return was 1.05% compared with 1.45% for Tonbridge & Malling Borough Council and 2.15% for Tunbridge Wells Borough Council. It should be noted, however, that investment returns are notoriously difficult to compare as they have often been compiled on a different basis (for example, whether or not interest has been compounded, whether or not cashflow generated balances have been included, whether or not externally managed funds have been included and whether or not the figures are net of borrowings). In addition, although we had locked into a few longer term investments at higher interest rates, it transpires that the other two authorities had committed a greater part of their portfolios to such investments, thereby improving their overall rates of return.

28 Our treasury management advisers, Sector Treasury Services Ltd, recommend the 3-month LIBID figure as a benchmark. This reflects a more realistic neutral investment position for core investments with a medium term horizon and a rate which is more stable with less fluctuation caused by market liquidity. Historically, this rate has been slightly higher than the 7-day rate and therefore more challenging a comparator, but one which does not necessitate a significantly increased level of risk. The figures calculated by Sector for these two benchmarks are as follows:

- 7-day LIBID uncompounded 0.480%

- 3-month LIBID uncompounded 0.817%

Icelandic bank defaults

29 This authority currently has an investment of £1m frozen in Landsbanki Islands hf. The investment was placed on 25 June 2007 at 6.32%, to mature on 25 June 2009.

30 The Icelandic Government has stated its intention to honour all its commitments as a result of their banks being placed into receivership. The U.K. Government is working with the Icelandic Government to help bring this about. The Local Government Association is coordinating the efforts of all UK authorities with Icelandic investments.

31 At the current time, the process of recovering assets is still ongoing with the administrators. Investments outstanding with the two Iceland–domiciled banks (Glitnir Bank hf and Landsbanki Islands hf) have been subject to decisions of the Icelandic Courts. Following the successful outcome of legal test cases in the Icelandic Supreme Court in late 2011, the Administrators have now commenced the process of dividend payments in respect of both of these banks. At the time of writing, in excess of £400,000 of our investment has been recovered and the indications are that 100% of the deposit plus interest up to April 2009 will be recovered eventually.

32 Members have been periodically updated on the latest developments in these efforts.

Key Implications

Financial

33 The management of the Council's investment portfolio and cash-flow generated balances plays an important part in the financial planning of the authority. The security of its capital and liquidity of its investments is of paramount importance.

Community Impact and Outcomes

34 There are no community impacts arising from this report.

Legal, Human Rights etc.

35 Under Section 151 of the Local Government Act 1972, the Section 151 Officer has statutory duties in relation to the financial administration and stewardship of the authority, including securing effective arrangements for treasury management.

36 This annual review report fulfils the requirements of The Chartered Institute of Public Finance & Accountancy's Code of Practice on Treasury Management 2009.

Conclusions

37 The overall return on the Council's investments exceeded the budget in 2011/12 by approximately £120,000.

38 The economic situation both globally and within the Eurozone in particular remains volatile with inevitable consequences for the UK economy. Treasury management in the past financial year was conducted against this background and with a cautious investment approach.

39 Recovery of the Icelandic deposit is ongoing and further updates will be provided as and when monies are received.

Risk Assessment Statement

40 Treasury Management has two main risks :

- Fluctuations in interest rates can result in a reduction in income from investments; and
- A counterparty to which the Council has lent money fails to repay the loan at the required time.

41 Consideration of risk is integral in our approach to treasury management. However, this particular report has no specific risk implications as it is not proposing any new actions, but merely reporting performance over the last year.

Appendices:

Appendix A – Investment portfolio at start and end of financial year

Appendix B – Analysis of investment portfolio by maturity and repayment due dates

Appendix C – Current counterparty lending list as at August 2012

Appendix D - Investment performance in 2011/12

Background Papers:

Treasury Management Strategy for 2011/12 - Council 16 December 2010

Sector Treasury Services Ltd – economic updates, annual treasury management review, credit rating lists

2009 CIPFA Code of Practice for Treasury Management in the Public Services

Investment monitoring files and current/repaid investment records

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