CABINET – 13 OCTOBER 2011

ANNUAL TREASURY MANAGEMENT REPORT 2010/11

Report of the:	Deputy Chief Executive & Director of Corporate Resources
Also to be considered by:	Performance and Governance Committee – 27 September 2011
Status:	For decision

Executive Summary: This report provides the customary review of investment activity during 2010/11 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: efficient management of the Council's resources.

Portfolio Holder Cllr. Ramsay – Finance and Resources

Head of Service Head of Finance and Human Resources – Mrs. Tricia Marshall

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Recommendation: It be RESOLVED that the Annual Treasury Management Report for 2010/11 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 2010/11. 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 2010/11 the minimum reporting requirements were that the Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 23/2/2010)
- a mid year (minimum) treasury update report (Performance and Governance Committee 16/11/10, Cabinet 13/12/10)
- 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 7/9/10).

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 during the previous financial year on 27 January 2010 in order to support Members' scrutiny role.

6 During 2010/11, 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:

	2009/10 Actual (£000)	2010/11 Original (£000)	2010/11 Actual (£000)
Actual capital expenditure	2,128	3,549	2,786
Total Capital Financing Requirement:			
• Non-HRA	-	-	-
• HRA	-	-	-
• Total	-	-	-
Net borrowing	-	-	-
External debt	-	-	-
Investments			
• Longer than 1 year	-		2,000
• Under 1 year	18,500		19,300
• Total	18,500		21,300

7 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.

8 The financial year 2010/11 continued the challenging environment of previous years; low investment returns and continuing counterparty risk.

Introduction

9 This **annual treasury report** covers:

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

(b) Investment Strategy for 2010/11;

(c) the economy and interest rates in 2010/11;

(d) compliance with treasury limits and prudential indicators;

(e) investment rates in 2010/11;

(f) investment outturn for 2010/11 and performance; and

(g) Icelandic bank defaults.

Treasury position at the beginning and end of the financial year

10 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 2010/11

11 The expectation for interest rates within the strategy for 2010/11 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 2010/11. 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.

12 The actual movement in interest rates broadly followed the expectations in the strategy, as detailed in the following section.

13 **Change in strategy during the year** – the strategy adopted in the original Treasury Management Strategy Report for 2010/11 approved by the Council on 23 February 2010 was subject to revision during the year due to a lack of suitable counterparties in the market .

The economy and Interest rates in 2010/11

14 2010/11 proved to be another watershed year for financial markets. Rather than a focus on individual institutions, market fears moved to sovereign debt issues, particularly in the peripheral Euro zone countries. Local authorities were also presented with changed circumstances following the unexpected change of policy on Public Works Loan Board (PWLB) lending arrangements in October 2010. This resulted in an increase in new borrowing rates of 0.75 –

0.85%, without an associated increase in early redemption rates. This made new borrowing more expensive and repayment relatively less attractive.

15 UK growth proved mixed over the year. The first half of the year saw the economy outperform expectations, although the economy slipped into negative territory in the final quarter of 2010 due to inclement weather conditions. The year finished with prospects for the UK economy being decidedly downbeat over the short to medium term while the Japanese disasters in March, and the Arab Spring, especially the crisis in Libya, caused an increase in world oil prices, which all combined to dampen international economic growth prospects.

16 The change in the UK political background was a major factor behind weaker domestic growth expectations. The new coalition Government struck an aggressive fiscal policy stance, evidenced through heavy spending cuts announced in the October Comprehensive Spending Review, and the lack of any "giveaway" in the March 2011 Budget. Although the main aim was to reduce the national debt burden to a sustainable level, the measures are also expected to act as a significant drag on growth.

17 Gilt yields fell for much of the first half of the year as financial markets drew considerable reassurance from the Government's debt reduction plans, especially in the light of Euro zone sovereign debt concerns. Expectations of further quantitative easing also helped to push yields to historic lows. However, this positive performance was mostly reversed in the closing months of 2010 as sentiment changed due to sharply rising inflation pressures. These were also expected (during February / March 2011) to cause the Monetary Policy Committee to start raising Bank Rate earlier than previously expected.

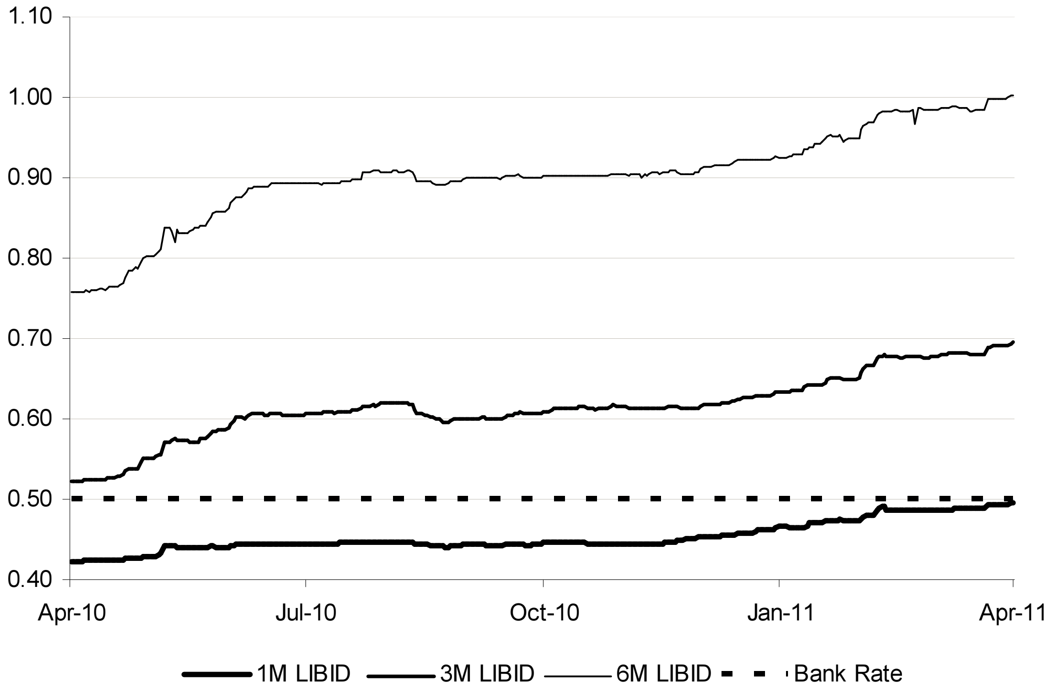
18 The developing Euro zone peripheral sovereign debt crisis caused considerable concerns in financial markets. First Greece (May), then Ireland (December), were forced to accept assistance from a combined EU / IMF rescue package. Subsequently, fears steadily grew about Portugal, although it managed to put off accepting assistance till after the year end. These worries caused international investors to seek safe havens in investing in non-Euro zone government bonds.

19 Deposit rates picked up modestly in the second half of the year as rising inflationary concerns, and strong first half growth, fed through to prospects of an earlier start to increases in Bank Rate. However, in March 2011, slowing actual growth, together with weak growth prospects, saw consensus expectations of the first UK rate rise move back from May to August 2011 despite high inflation. However, the disparity of expectations on domestic economic growth and inflation encouraged a wide range of views on the timing of the start of increases in Bank Rate in a band from May 2011 through to early 2013. This sharp disparity was also seen in MPC voting which, by year-end, had three members voting for a rise while others preferred to continue maintaining rates at ultra low levels.

20 Risk premiums were also a constant factor in raising money market deposit rates beyond 3 months. Although market sentiment has improved, continued

Euro zone concerns, and the significant funding issues still faced by many financial institutions, mean that investors remain cautious of longer-term commitment. The European Commission did try to address market concerns through a stress test of major financial institutions in July 2010. Although only a small minority of banks "failed" the test, investors were highly sceptical as to the robustness of the tests, as they also are over further tests now taking place with results due in mid-2011.

Bank Rate v LIBID investment rates



Compliance with treasury limits

20 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. The lending list was kept under constant review throughout the year in response to credit rating changes arising from the financial crisis. 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.

21 No institutions in which investments were made during 2010/11 had any difficulty in repaying investments and interest in full during the year.

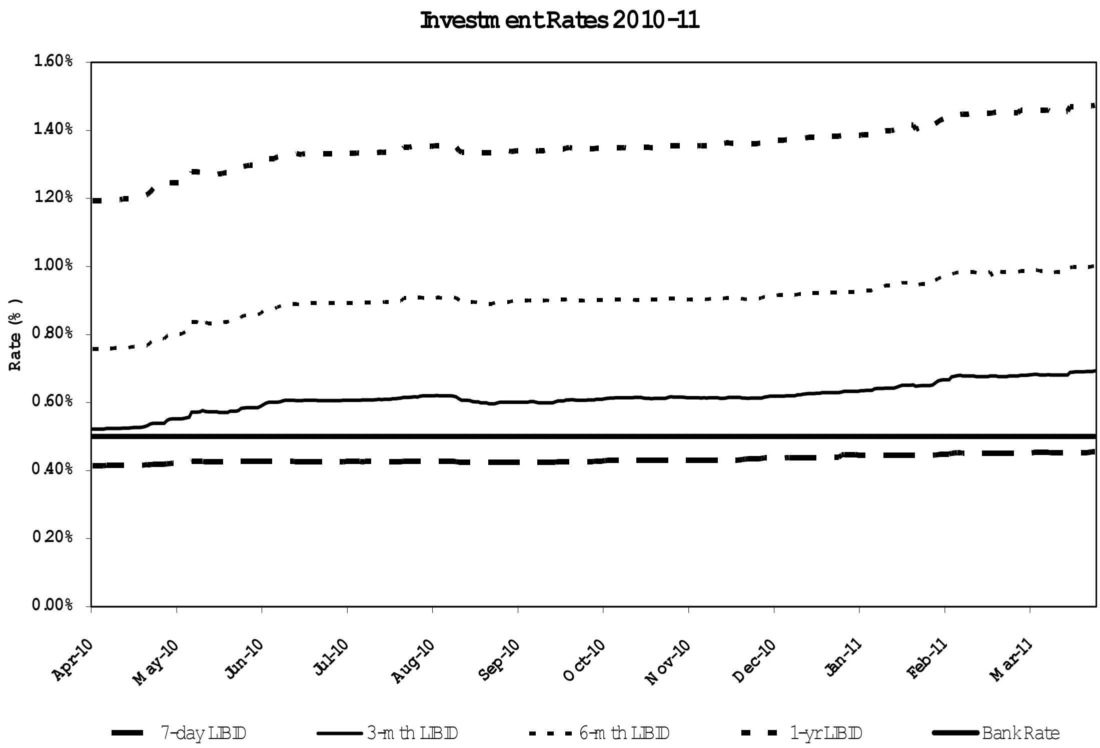
Investment rates in 2010/11

22 The tight monetary conditions following the 2008 financial crisis continued through 2010/11 with little material movement in the shorter term deposit rates. Bank Rate remained at its historical low of 0.5% throughout the year,

although growing market expectations of the imminence of the start of monetary tightening saw 6 and 12 month rates picking up.

23 Overlaying the relatively poor investment returns was the continued counterparty concerns, most evident in the Euro zone sovereign debt crisis which resulted in rescue packages for Greece, Ireland and latterly Portugal. Concerns extended to the European banking industry with an initial stress testing of banks failing to calm counterparty fears, resulting in a second round of testing currently in train. This highlighted the ongoing need for caution in treasury investment activity.

	Overnight	7 Day	1 Month	3 Month	6 Month	1 Year
01/04/2010	0.41%	0.41%	0.42%	0.52%	0.76%	1.19%
31/03/2011	0.44%	0.46%	0.50%	0.69%	1.00%	1.47%
High	0.44%	0.46%	0.50%	0.69%	1.00%	1.47%
Low	0.41%	0.41%	0.42%	0.52%	0.76%	1.19%
Average	0.43%	0.43%	0.45%	0.61%	0.90%	1.35%
Spread	0.03%	0.04%	0.07%	0.17%	0.24%	0.28%
High date	31/12/2010	30/03/2011	31/03/2011	31/03/2011	31/03/2011	31/03/2011
Low date	01/04/2010	01/04/2010	01/04/2010	01/04/2010	01/04/2010	01/04/2010



Investment outturn for 2010/11 and performance

24 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 23 February 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.

25 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.

26 The Council's longer term cash balances comprise, primarily, revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources comprised as follows, and met the expectations of the budget:

	31/3/2010 (£m)	31/3/2011 (£m)
Balances	3.713	3.713
Earmarked reserves	14.156	14.169
Provisions	2.621	2.719
Usable capital receipts	0.537	0.763
Total	21.387	21.364

27 Appendix D shows the performance of the fund during 2010/11 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.

28 The graph shows actual monthly receipts for 2008/09, 2009/10 and 2010/11 plus budgeted monthly receipts for 2010/11. The monthly interest budget has been profiled in line with the previous year's monthly weighted average principal.

29 Over the course of the year interest receipts amounted to £0.336m compared with a budget of £0.225m. 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.

30 In 2010/11 the percentage return on the Council's investments was marginally lower than that of our neighbouring authorities. For 2010/11 our overall rate of return was 1.18% compared with 1.43% for Tonbridge & Malling Borough Council and 2.36% 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.

31 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 0.433%
- 3-month LIBID uncompounded 0.615%

Icelandic bank defaults

32 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.

33 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. At the current time, the process of recovering assets is still ongoing with the Administrators. The Local Government Association is coordinating the efforts of all UK authorities with Icelandic investments. Members have been periodically updated on the latest developments in these efforts.

Key Implications

Financial

34 These are detailed in the report and appendices. The interest earned on the Council's investments supports the revenue budget.

Legal, Human Rights etc.

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

Risk Assessment Statement

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.

Sources of Information:	Reports from treasury management advisers
	Current and repaid investment records
	2009 CIPFA Code of Practice for Treasury Management in the Public Services
	Investment Monitoring Files
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