TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

12 April 2011

Report of the Director of Finance

Part 1- Public

Delegated

1 TREASURY MANAGEMENT UPDATE

This report provides an update of treasury management activity undertaken during the 2010/11 financial year in the context of the national economy and invites Members to recommend endorsement of the action taken to Cabinet.

1.1 Introduction

1.1.1 CIPFA issued a revised Code of Practice for Treasury Management in November 2009. The revised Code was adopted by the Council on 18 February 2010 and suggests that Members should be informed of Treasury Management activities at least twice a year, but preferably quarterly. This report, therefore, ensures this Council is embracing Best Practice in accordance with CIPFA's revised Code of Practice.

1.2 Economic Background

1.2.1 2010/11 saw:

- After four consecutive quarters of positive growth UK GDP entered negative territory in the final quarter of 2010 at -0.5%. The negative growth was attributed to heavy snow falls in December 2010;
- Following the Coalition Government's announcement of a £6.2bn savings package and emergency budget measures in June 2010, rating agencies confirmed the UK's 'AAA' status;
- Throughout 2010 the Monetary Policy Committee (MPC) paused its programme of quantitative easing (QE) and kept official interest rates on hold at 0.5%;
- CPI and RPI inflation indices peaked in April 2010 at 3.7% and 5.3% then fell throughout the remainder of the year before starting to rise again following the January 2011 increase in VAT. February 2011 figures are 4.4% and 5.5% respectively;

- In the March 2011 budget the Chancellor revised down growth expectations for 2011 from 2.1% to 1.7% and revised down the public sector borrowing forecast to £146bn, £2.4bn lower than expected.

1.2.2 The Monetary Policy Committee voted to keep official interest rates at a record low of 0.5% in March 2011 and continue to pause QE.

1.3 Interest Rate Forecast

1.3.1 The Council's Treasury Advisor, Sector, updated their forecast in February 2011 and anticipate the first rise in the Bank Rate will occur in the September 2011 quarter.

Rate	Mar-11 %	Jun-11 %	Sep-11 %	Dec-11 %	Mar-12 %	Jun-12 %	Sep-12 %	Dec-12 %	Mar-13 %	Jun-13 %	Sep-13 %	Dec-13 %	Mar-14 %
Bank Rate	0.50	0.50	0.75	1.00	1.00	1.25	1.50	2.00	2.25	2.50	3.00	3.25	3.25
5yr PWLB	3.70	3.70	3.70	3.80	3.90	4.00	4.10	4.20	4.30	4.50	4.60	4.70	4.80
10Yr PWLB	4.90	4.90	4.90	4.90	4.90	5.00	5.10	5.20	5.20	5.30	5.40	5.40	5.50
25yr PWLB	5.40	5.40	5.40	5.40	5.40	5.50	5.50	5.50	5.50	5.60	5.60	5.70	5.70
50yr PWLB	5.40	5.40	5.40	5.40	5.40	5.50	5.50	5.50	5.50	5.60	5.60	5.70	5.70

1.3.2 The forecast is based upon the following assumptions:

- Moderate economic recovery and MPC inflation forecast being below target in two years time;
- The first Bank Rate increase is expected in the September 2011 quarter and reaching 3.25% by the March 2014 quarter;
- Long term PWLB rates are expected to steadily increase to reach 5.50% by mid 2012 due to huge gilt issuance, reversal of QE and investor concerns over inflation;
- There are significant downside risks to these forecast and to the pace of both UK and world recovery; and
- Forecasts beyond a one year time horizon are likely to require amendment as and when world events and financial markets change.

1.3.3 There is considerable uncertainty in all forecasts due to the difficulties of forecasting the timing and amounts of QE reversal, the fiscal effect of the Government's savings and budget announcements, speed of recovery of banks profitability and balance sheet position, changes in the consumer saving ratio and the rebalancing of the UK economy in terms of export and import.

1.4 Treasury Management Performance

1.4.1 The Treasury Management Strategy Statement (TMSS) which applies to the 2010/11 financial year was approved by Council on 18 February 2010. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as follows:

- Security of Capital
- Liquidity.

1.4.2 The Council will also aim to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term, and to only invest with highly credit rated financial institutions, using Sector's suggested creditworthiness approach, including sovereign credit rating and Credit Default Swap (CDS) overlay information provided by them.

1.4.3 A full list of investments held on 25 March 2011 and our Internal Lending List of the same date are shown in **[Annexes 1 and 2]** of this report.

1.4.4 As illustrated in the economic background section above, investment rates available in the market are at an historical low point. The average level of cash flow funds available for investment purposes to the end of February 2011 was £13.2m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the capital programme. The authority holds £21.6m of core cash balances for investment purposes, of which £19.1m is managed by our external fund manager. These funds are for the most part available to invest for more than one year, albeit that around £2m will need to be recalled during April 2011 to top up our daily cash balances.

1.4.5 As at the end of February 2011 funds invested and interest earned is set out in the table below:

	Funds invested at 28 Feb 2011 £m	**Average duration to maturity Yrs**	**Gross annualised return to 28 Feb 2011 %**	**7 day Libid benchmark %**	**Interest earned to 28 Feb 2011 £**
In-house cash flow – excl of Landsbanki	10.8	0.01	0.89	0.52	107,950
In-house core funds	2.5	0.24	6.45	0.52	195,200
Externally managed core funds	19.2	0.33	1.04	0.52	173,750
Total	32.5	0.22	1.59	0.52	476,900

1.4.6 The authority outperformed the benchmark by 107 basis points (bp). The key contribution to that out-performance came from the internally managed core fund investments acquired prior to the 'credit crunch'.

1.4.7 **Cash Flow Funds**. Our daily cash flow balances for the year ahead are modelled at the start of the financial year. That cash flow model is then updated daily and reviewed on a regular basis to identify opportunities to make fixed term investments and take advantage of the higher yields available. The majority of our cash flow surpluses are invested overnight in bank deposit accounts and money market funds to ensure sufficient short term liquidity. However, in 2010/11 the following fixed term investments have been made:

£m	Bank / Building Society	Duration	Rate	Period
1.5	Bank of Scotland	9 Months	1.48%	01/06/10 – 01/03/11
1.5	Lloyds TSB	9 Months	1.48%	01/06/10 – 01/03/11
1.5	Barclays	6 Months	0.97%	10/06/10 – 10/12/10
1.5	Nationwide	6 Months	0.94%	16/06/10 – 16/12/10
1.5	Barclays	6 Months	1.00%	15/09/10 – 15/03/11

1.4.8 **In-house Managed Core Funds**. As reported to the October 2010 meeting of this Committee, the highly beneficial Investment with Barclays (£2.5m at 7.05%, 17/07/08 - 16/07/11) was recalled by them in July. In accordance with the 2010/11 approved strategy those funds were passed to our external fund manager. The remaining in-house core fund investment with the Nationwide (£2.5m at 6.25%, 28/05/08 - 27/05/11) is not recallable prior to maturity in May 2011.

1.4.9 **Externally Managed Core Funds**. Our external fund manager's performance has improved as the year has progressed. The improvement derives in part from extending duration as existing investments matured and part from capital gains made on gilt trades.

1.4.10 Members will recall that the investment parameters contained in our annual investment strategy were reviewed at the January 2011 meeting of this Committee. Our 2011/12 strategy, effective from 1 April 2011, introduces a modest relaxation to our minimum counterparty credit rating and ensures a consistent approach to the sovereign, group and counterparty exposure limits applied to both cash flow and core fund investments. The strategy also allows 100% of funds to be invested in UK institutions if that is considered appropriate.

1.4.11 The changes introduced in the new strategy resolve the practical difficulties that our external fund manager has experienced in attempting to comply in full with the requirements of our 2010/11 strategy. On a number of occasions our 2010/11 requirement to invest 25% of core funds with non-UK institutions was not met. On other occasions when it was, it was at the expense of too high a proportion of funds being invested with particular foreign banks. In addition, a modest holding of 3 month certificates of deposit were held in an Australian bank. Although the bank in question met our very high credit quality requirements, Australia itself failed our Fitch ‘AAA’ sovereign requirement.

1.4.12 Technically the issues referred to above constitute a breach of our 2010/11 requirements. However, the Treasury Management Team is content that there was no undue risk to the Council’s funds and that none of the issues referred to would have arisen had the requirements of our new strategy been in place during 2010/11.

1.5 Borrowing

1.5.1 It is a statutory duty for the Council to determine and keep under review the “Affordable Borrowing Limits” by way of the Prudential Indicators (affordability limits) set out in the approved TMSS. In this regard it is confirmed that no borrowing was undertaken in the period April 2010 to February 2011.

1.6 Legal Implications

1.6.1 The contract with Landsbanki remains in default and action is now being taken by Bevan and Brittan, our legal advisors, to confirm local authority depositors’ status as **priority creditors.**

1.6.2 Our case along with those of other UK local authorities and wholesale depositors is being considered by the Icelandic District Court. It is too early to pre-judge the outcome of the trial and an appeal to the Supreme Court is a real possibility given the sums at stake. If an appeal arises a final decision is not expected until late summer 2011 and it is unlikely any distributions to creditors will be made before then.

1.7 Financial and Value for Money Considerations

1.7.1 Interest earned to the end of February 2011 of £476,900 is some £20,000 better than predicted in our 2010/11 revised estimates.

1.8 Risk Assessment

1.8.1 The application of best practice, in the form of regular reporting and scrutiny of treasury management activities, as identified by the CIPFA Code is considered to be the most effective way of mitigating the risks associated with treasury management.

1.8.2 In respect of the Landsbanki investment participation in the joint action co-ordinated by the Local Government Association is still thought to offer the greatest chance of recovering the defaulted loan and associated interest.

1.9 Recommendations

1.9.1 Members are **RECOMMENDED** to:

1) Endorse the action taken by officers in respect of treasury management activity;

2) Note the technical breaches referred to at paragraph 1.4.11; and to

3) **RECOMMEND** that Cabinet do likewise.

Background papers: contact: Mike Withey

Nil

Sharon Shelton
Director of Finance

Screening for equality impacts:		
Question	**Answer**	**Explanation of impacts**
a. Does the decision being made or recommended through this paper have potential to cause adverse impact or discriminate against different groups in the community?	No	N/A
b. Does the decision being made or recommended through this paper make a positive contribution to promoting equality?	No	N/A
c. What steps are you taking to mitigate, reduce, avoid or minimise the impacts identified above?		N/A

In submitting this report, the Chief Officer doing so is confirming that they have given due regard to the equality impacts of the decision being considered, as noted in the table above.