TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

20 June 2011

Report of the Director of Finance

Part 1- Public

Delegated

1 TREASURY MANAGEMENT UPDATE

This report provides details of treasury management activity undertaken during April and May of the current (2011/12) financial year within the context of the national economy. The treasury management outturn position for 2010/11 is due to be reported to the June meeting of Cabinet and is also included in this report. Members are invited to endorse the action taken in respect of treasury management activity for April and May 2011 and note the outturn position for 2010/11.

1.1 Introduction

1.1.1 The Chartered Institute for Public Finance and Accountancy (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 Thus far in 2011/12:

- UK Gross Domestic Product (GDP) grew by 0.5% in the first quarter of 2011 reversing the -0.5% fall in the final quarter of 2010;
- The Monetary Policy Committee (MPC) continued to pause its programme of quantitative easing (QE) and kept official interest rates on hold at 0.5% at its monthly meetings throughout January 2011 to April 2011;
- Consumer Prices Index (CPI) and Retail Prices Index (RPI) inflation indices continue to rise standing at 4.5% and 5.2% in April 2011. The high levels of inflation are attributed to the January 2011 VAT increase, high costs of energy and increasing food costs;

- 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; and
- Eurozone issues continue with concerns that further support packages may be needed for Ireland, Greece and Portugal.

1.2.2 The Monetary Policy Committee voted (6:3) to keep official interest rates at a record low of 0.5% in May 2011 and continue to pause QE. The Bank Rate has now remained at this “emergency level” for 26 consecutive months.

1.3 Interest Rate Forecast

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

Rate	Now %	Jun-2011 %	Sep-2011 %	Dec-2011 %	Mar-2012 %	Jun-2012 %	Sep-2012 %	Dec-2012 %	Mar-2013 %	Jun-2013 %	Sep-2013 %	Dec-2013 %	Mar-2014 %
Bank Rate	**0.50**	**0.50**	**0.50**	**0.75**	**1.00**	**1.25**	**1.50**	**1.75**	**2.00**	**2.25**	**2.50**	**2.75**	**3.00**
5yr PWLB	**3.26**	**3.40**	**3.55**	**3.65**	**3.75**	**3.90**	**4.00**	**4.15**	**4.25**	**4.45**	**4.60**	**4.65**	**4.75**
10Yr PWLB	**4.47**	**4.60**	**4.75**	**4.75**	**4.80**	**4.95**	**4.95**	**5.00**	**5.05**	**5.15**	**5.20**	**5.25**	**5.25**
25yr PWLB	**5.19**	**5.30**	**5.40**	**5.40**	**5.40**	**5.40**	**5.40**	**5.45**	**5.50**	**5.50**	**5.50**	**5.60**	**5.65**
50yr PWLB	**5.14**	**5.30**	**5.40**	**5.40**	**5.40**	**5.40**	**5.40**	**5.45**	**5.50**	**5.50**	**5.50**	**5.60**	**5.65**

1.3.2 The forecast is based upon the following assumptions:

- An anaemic recovery of the UK economy which, emanating from a financial crisis, will be slower and more protracted than normal business cycle recoveries;
- The first Bank Rate increase is expected in the December 2011 quarter and reaching 3.00% by the March 2014 quarter;
- Long term Public Works Loan Board (PWLB) rates are expected to steadily increase to reach 5.40% 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 2011/12 Treasury Management Performance

1.4.1 The Treasury Management Strategy Statement (TMSS) which applies to the 2011/12 financial year was approved by Council on 17 February 2011. The Council's Annual Investment Strategy (AIS), 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 27 May 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 May 2011 was £6.8m. 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 £20.7m of core cash balances for investment purposes which are managed by our external fund manager. These funds are for the most part available to invest for more than one year, albeit that around £2.5m will need to be recalled during March 2012 to top up our daily cash balances.

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

	Funds invested at 27 May 2011 £m	Average duration to maturity Yrs	Gross annualised return to 27 May 2011 %	7 day Libid benchmark %	Interest earned to 27 May 2011 £
In-house cash flow – excl of Landsbanki	5.3	0.38	0.80	0.53	8,450
In-house core funds	0.0 [1]	0.00	6.25	0.53	23,950
Externally managed core funds	20.7	0.38	1.24	0.53	39,350
Total	26.0	0.38	1.27	0.53	71,750

[1] The In-house managed core fund investment of £2.5m with the Nationwide Building Society matured on 27 May 2011 and was transferred on the same day to our external fund manager. The table above shows the position at the end of that day.

1.4.6 The authority outperformed the benchmark by 74 basis points. A key contribution to that out-performance came from the internally managed core fund investment with the Nationwide Building Society which was acquired prior to the 'credit crunch'.

1.4.7 **In-house Managed Cash Flow**. Our daily cash flow balances for the year ahead are modelled at the start of the financial year **[Annex 3]**. That cash flow model is then updated daily and reviewed on a regular basis. The majority of our cash flow surpluses are invested overnight in bank deposit accounts and money market funds to ensure sufficient short term liquidity to meet payment obligations. However, when cash surpluses permit, fixed term investments are undertaken to take advantage of the higher yields available. In late May the following fixed term investments were made:

£m	Bank / Building Society	Duration	Rate	Period
1.0	Bank of Scotland	9 Months	1.80%	24/05/11 – 24/02/12
1.0	Lloyds TSB	9 Months	1.80%	24/05/11 – 24/02/12
1.0	Barclays	6 Months	1.04%	24/05/11 – 24/11/11

1.4.8 All fixed term cash flow investments will need to mature prior to the financial year end on 31 March 2012. Further fixed term Investments are expected to be undertaken throughout the year as and when surpluses permit. As a consequence yields are expected to rise from the current 0.8% as we progress through the financial year.

1.4.9 **In-house Managed Core Funds**. Our last remaining core fund investment matured on 27 May 2011 (Nationwide £2.5m at 6.25%, 28/05/08 - 27/05/11). In accordance with the 2011/12 AIS those funds were passed to our external fund manager. No further In-house core fund investments are expected to be undertaken during 2011/12.

1.4.10 **Externally Managed Core Funds**. Some 40% of the core fund is currently invested in UK government gilts. The remainder is invested in certificates of deposit predominantly with UK banks and building societies. The fund manager anticipates the return for the year as a whole will be between 1.25% and 1.75% depending on when the next Bank Rate rise occurs.

1.5 Compliance with 2011/12 TMSS and AIS

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 to May 2011.

1.5.2 During the financial year to date the Council has operated within the treasury limits and prudential indicators set out in the TMSS and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators will be included for review as part of the Treasury Management Update report to the Audit Committee meeting in October 2011.

1.5.3 Throughout the period April to May 2011 all of the requirements contained in the 2011/12 AIS intended to limit the Council's exposure to investment risks (minimum sovereign and counterparty credit rating; durational limits; exposure limits in respect of counterparties, groups of related counterparty and sovereigns; and specified and non-specified investment limits) have been fully complied with.

1.6 2010/11 Treasury Management Outturn

1.6.1 A detailed report covering treasury management activity for the whole of 2010/11 is being submitted to Cabinet on 22 June 2011 as part of the Revenue and Capital Outturn 2010/11 report. The Treasury Management Annual Report for 2010/11 included in the outturn report is appended at **[Annex 4]** for Members information.

1.6.2 The investment performance for the three parts of our portfolio summarised in the annual report are as follows:

2010/11 Financial Year	Average investment £m	Income achieved £	Gross rate of return %	Benchmark return %
Internally managed cash flow (excluding Landsbanki)	12.7	113,050	0.89	0.52
Internally managed core funds	3.3	208,900	6.42	0.52
Externally managed core funds (excluding year end valuation gains / losses)	18.3	187,600	1.02	0.52

Total investment income of £509,550 betters the 2010/11 revised estimate of £491,400 by £18,150.

1.6.3 The Annual Report **[Annex 4]** includes reference to "technical" breaches of some of the detailed requirements contained in the 2010/11 AIS (paragraph 1.9.8 of the Annual Report). Although none of the issues were considered significant they were nevertheless reported to Members (Treasury Management reports to Audit Committee 12 October 2010 and 12 April 2011 refer).

1.7 Legal Implications

1.7.1 The Council invested £1m in a 3 month fixed term deposit with the Icelandic bank, Landsbanki. The bank went into administration a few days prior to the investments intended maturity in October 2008. The Council has participated in a joint action co-ordinated by the Local Government Association to recover the investment and associated interest. In April 2011 the Icelandic District Court ruled that such deposits have **priority status** which should aid recovery of a high proportion of the £1m deposit. The other parties involved in the case have appealed against the ruling of the Icelandic District Court and as a consequence the judgement is to be referred to the Icelandic Supreme Court. Members will be updated as new information becomes available.

1.8 Financial and Value for Money Considerations

1.8.1 Interest earned to the end of May 2011 of £71,750 is in line with the 2011/12 original estimate. At the present time, the full year estimate for 2011/12 of £336,950 is expected to be achieved.

1.9 Risk Assessment

1.9.1 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.

1.9.2 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 investment and associated interest.

1.10 Recommendations

1.10.1 Members are **RECOMMENDED** to:

1) Endorse the action taken by officers in respect of treasury management activity for the period April to May 2011;

2) Note the 2010/11 outturn position; 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.