TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

11 October 2011

Report of the Director of Finance

Part 1- Public

Matters for Recommendation to Council

1 TREASURY MANAGEMENT MID-YEAR REVIEW 2011/12

This report reviews the 2011/12 Treasury Management Strategy Statement and Annual Investment Strategy. Treasury management activity undertaken during the period April 2011 to August 2011 is examined within the context of the national economy. No changes to the Strategy Statement or Investment Strategy are proposed and Members are invited to endorse the action taken by officers in respect of treasury management activity thus far in the current financial year.

1.1 Introduction

1.1.1 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by this Council on 18 February 2010.

1.1.2 The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the full Council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy - for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Audit Committee.

1.1.3 This mid-year report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- An economic update for the first six months of 2011/12.
- A review of the 2011/12 Treasury Management Strategy Statement and Annual Investment Strategy (TMSS & AIS).
- A review of the Council's investment portfolio.
- A review of the Council's borrowing.
- A review of compliance with Treasury and Prudential Limits for 2011/12.

1.2 Economic Background

Global economy

1.2.1 The Euro zone sovereign debt crisis continued with Spain, and particularly Italy, being the focus of renewed market concerns that they may soon join with Greece, Ireland and Portugal in needing assistance. This uncertainty and the lack of a co-ordinated or credible Euro zone response, left commentators concerned over the potential impact of sovereign default and resulting effect on the Euro zone banking sector.

1.2.2 This, coupled with political difficulties in the US over their plans to address the budget deficit, the size and control over the US sovereign debt, and the subsequent loss of the AAA credit rating from Standard and Poors, has led to a much more difficult and uncertain outlook for the world economy. Growth prospect in the US, UK and the Euro zone have been lower than expected, with future prospects similarly cut. World stock markets fell in the second quarter of 2011/12 as a consequence.

UK economy

1.2.3 Following zero growth in the final half of 2010/11 the UK economy grew by a weaker than expected 0.2% in the first quarter of 2011/12, providing a knock on effect to future growth prospects. Growth prospects will be governed by UK consumer sentiments, which are currently subdued due to falling disposable income. Higher VAT, overhanging debt, high inflation and concerns over employment are likely to weigh heavily on consumers into the future.

1.2.4 Inflation remains stubbornly high, although the expectation of future falls, the external nature of the price increases (energy, oil, food etc.), and the negative impact a rate rise would have on the UK economy, is likely to stop the Monetary Policy Committee from raising the Bank Rate for some time to come.

1.2.5 International investors continue to view UK government gilts as being a safe haven, bolstered by both the EU sovereign debt concerns and the US difficulties.

The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and sent PWLB borrowing rates to low levels.

Outlook for the next six months of 2011/12

1.2.6 There remain huge uncertainties in economic forecasts due to the following major difficulties:

- the speed of economic recovery in the UK, US and EU;
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economy;
- the degree to which government austerity programmes will dampen economic growth;
- the potential for more quantitative easing, and the timing of this in both the UK and US;
- the speed of recovery of banks' profitability and balance sheet imbalances;
- the overall balance of risks is weighted to the downside; and
- low growth in the UK is expected to continue for some time. With a low Bank Rate also expected to continue for at least 12 months investment returns will inevitably be subdued.

Sector's interest rate forecast

1.2.7 The current interest rate forecast was updated in August 2011. The first rise in the Bank Rate, which has remained at an emergency level of 0.5% for 30 consecutive months, is now expected to occur in the final quarter of 2012. This is some 12 months later than predicted when our TMSS & AIS was approved in February 2011.

Rate	Now %	Sep-2011 %	Dec-2011 %	Mar-2012 %	Jun-2012 %	Sep-2012 %	Dec-2012 %	Mar-2013 %	Jun-2013 %	Sep-2013 %	Dec-2013 %	Mar-2014 %	Jun-2014 %
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25	1.50	1.75	2.25	2.50
5yr PWLB	2.50	2.50	2.70	2.90	3.00	3.10	3.20	3.40	3.60	3.80	4.00	4.10	4.20
10Yr PWLB	3.71	3.80	4.00	4.10	4.30	4.40	4.50	4.60	4.70	4.80	4.90	5.00	5.10
25yr PWLB	4.76	5.00	5.00	5.10	5.10	5.10	5.20	5.20	5.30	5.40	5.40	5.50	5.50
50yr PWLB	4.81	5.00	5.00	5.10	5.10	5.10	5.20	5.20	5.30	5.40	5.40	5.50	5.50

1.3 2011/12 Treasury Management Strategy Statement and Annual Investment Strategy

1.3.1 Members will recall the detailed consideration that was given to the TMSS & AIS at the January 2011 meeting of the Audit Committee. Changes were made to our minimum counterparty credit rating, our recognition of AAA sovereigns and our counterparty, group and sovereign exposure limits were simplified. The Council only invests in highly credit rated institutions and requires investments to be diversified across a range of counterparties. Exposure to risk is constrained by:

- Counterparties must be regulated by a AAA Sovereign as recognised by at least two out of the three main rating agencies (Fitch, Moodys or Standard & Poors).
- Whilst 100% of funds can be invested in the UK, exposure to non-UK banks is limited to no more than 25% of funds per AAA Sovereign.
- Counterparties must have a minimum Fitch rating of: long term AA-, short term F1+, individual C and support 1.
- Exposure to individual counterparties / groups of related counterparty must not exceed 25% of funds.
- Duration of in-house managed investments must not exceed that recommended by Sector's credit worthiness approach (modelling approach which combines the output from all three rating agencies including credit watches / outlooks and Credit Default Swap data).
- Money Market funds should be rated Fitch AAAmmf or equivalent and exposure limited to no more that 25% per fund.

1.3.2 Despite the current volatility and uncertainty in the financial markets the Council's Treasury Management Team is satisfied that the parameters set out at paragraph 1.3.1 continue to achieve a prudent balance between risk and practicality. No changes are considered necessary at this time.

1.4 Investment Portfolio

1.4.1 In accordance with the CIPFA Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As set out in Section 1.2, it is a very difficult investment market. Yields are very low, in line with the 0.5% Bank Rate, and the continuing Euro zone sovereign debt crisis prompts a low risk and short term strategy. Within this risk adverse environment investment returns will remain low relative to pre 2008 'credit crunch' levels.

1.4.2 A full list of investments held on 16 September 2011 and our Internal Lending List of the same date are shown in **[Annexes 1 and 2]** of this report.

1.4.3 The average level of cash flow funds available for investment purposes to the end of August 2011 was £8.2m. 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 £20.9m 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.

1.4.4 As at the end of August 2011 funds invested and interest earned is set out in the table opposite:

	Funds invested at 31 Aug 2011 £m	Average duration to maturity Yrs	Gross annualised return to 31 Aug 2011 %	7 day Libid benchmark %	Interest earned to 31 Aug 2011 £
In-house cash flow – excl of Landsbanki	10.4	0.12	0.97	0.53	33,150
In-house core funds	0.0 [1]	0.00	6.25	0.53	23,950
Externally managed core funds	20.9	0.77	1.80	0.53	153,600
Total	31.3	0.55	1.51	0.53	210,700

[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.

1.4.5 The authority out-performed the benchmark by 98 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'.

In-house Managed Cash Flow

1.4.6 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. 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. Thus far in this financial year the following fixed term investments have been 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 Bank	6 Months	1.04%	24/05/11 – 24/11/11
0.5	Santander UK	3 Months	1.13%	09/06/11 – 09/09/11

1.4.7 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. However, primarily as a consequence of Euro zone concerns the current three month duration limit on all banks (other than the UK nationalised / semi-nationalised banks) will dampen returns going forward.

In-house Managed Core Funds

1.4.8 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 TMSS & 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.

Externally Managed Core Funds

1.4.9 Despite the delay in the expected Bank Rate rise to late 2012 at the earliest, our external fund manager is currently performing above the level anticipated in our 2011/12 TMSS & AIS (annualised gross return at the end of August of 1.80% vs an expected 1.31% for the year as a whole). This better than expected performance is primarily attributed to the opportunistic disposal of gilts in late July. The disposals took advantage of a blip in prices when the UK was (and still is) seen as a safe haven given concerns over Euro zone sovereign debt and at the time, the USA's debt ceiling.

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 & AIS. The authority is debt free and uses a combination of reserves and revenue contributions to finance the Capital Plan. Borrowing on a temporary basis using overdraft facilities may be required from time to time to meet liquidity needs. No borrowing was undertaken in the period April 2011 to August 2011.

1.6 Compliance with 2011/12 TMSS and AIS

1.6.1 During the financial year to date the Council has operated within the treasury limits and prudential indicators set out in the 2011/12 TMSS & AIS and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators can be found at **[Annex 3]** to this report.

1.6.2 Throughout the period April 2011 to August 2011 all of the requirements contained in the 2011/12 TMSS & 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.

1.7 Legal Implications

1.7.1 The Council invested £1m in a three 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 (in respect of a limited number of test cases) 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 appealed against the ruling of the Icelandic District Court and as a consequence the judgement has been referred to the Icelandic Supreme Court. The outcome of the appeal is imminent and 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 August 2011 of £210,700 is better than predicted in our 2011/12 estimates by some £60,000. Given the current market concerns relating to the Euro zone and the recent downgrading of growth forecasts for the UK and other major western economies, enhanced returns for the remainder of the financial year are unlikely. However, an increase in our estimate of investment income is expected as we move toward the preparation of our revised 2011/12 estimates.

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) Note that no changes are considered necessary to 2011/12 Treasury Management Strategy Statement and Annual Investment Strategy.

2) Endorse the action taken by officers in respect of treasury management activity for the period April to August 2011.

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.