TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

10 April 2012

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 2011/12 financial year within the context of the national economy and invites Members to endorse the action taken by Officers and to note the treasury management position at 2 March 2012.

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 activity 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 and its subsequent updates.

1.2 Economic Background

- Whilst the UK economy grew by 0.8% during 2011, output fell by 0.2% in the final quarter. A fall in output is not expected in the first quarter of 2012 thus avoiding a technical recession (two consecutive quarters of negative growth). Growth is expected to remain low at 0.8% for 2012 as a whole and then rise in each year thereafter to reach 3% in 2015.
- The Bank of England (BoE) introduced a further round of quantitative easing in February 2012 to help stimulate the economy. This brings the total package of asset purchases to £375bn since 2009.
- Inflation as measured by the consumer price index (CPI) peaked at 5.2% in September 2011 (retail price index (RPI) peaked at 5.7%). CPI has since fallen to 3.4% in February 2012 (RPI 3.7%). Inflation is expected to reduce further over the coming months as the contributions of past rises in VAT and energy prices dissipate, and spare capacity weighs on wages and prices. The BoE forecast is for CPI to fall below 2% by the end of 2012.

- Unemployment remains high and is forecast to peak at 8.7% in 2012 before commencing a gradual decline to 6.3% by 2016.

- The UK's AAA rating was placed on negative outlook by Moody's in February and Fitch in March. France was downgraded to AA+ by S&P in January 2012 and joins the USA who were downgraded to AA+ by S&P in August 2011.

- Whilst there are promising signs of sustained economic recovery in the USA, Eurozone GDP, the UK's other major export market, is expected to contract during 2012.

- Greece, which proved a major source of instability in the financial markets throughout 2011, received agreement to a second bailout package in March 2012. The release of funds from the EU and IMF followed renegotiation of Greece's sovereign debt with its bondholders.

1.3 Interest Rate Forecast

1.3.1 The Bank Rate has remained at an emergency level of 0.5% for the last 3 years. Sector's latest forecast, updated in February 2012, anticipates the Bank Rate will remain at this level until the third quarter of 2013, a further 18 months.

Rate	Now %	Mar-12 %	Jun-12 %	Sep-12 %	Dec-12 %	Mar-13 %	Jun-13 %	Sep-13 %	Dec-13 %	Mar-14 %	Jun-14 %	Sep-14 %	Dec-14 %
Bank Rate	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.75**	**1.00**	**1.25**	**1.50**	**2.00**	**2.25**
5yr PWLB	**1.93**	**2.30**	**2.30**	**2.30**	**2.40**	**2.50**	**2.60**	**2.70**	**2.80**	**2.90**	**3.10**	**3.30**	**3.50**
10Yr PWLB	**3.10**	**3.30**	**3.30**	**3.40**	**3.40**	**3.50**	**3.60**	**3.70**	**3.80**	**4.00**	**4.20**	**4.40**	**4.60**
25yr PWLB	**4.18**	**4.20**	**4.20**	**4.30**	**4.30**	**4.40**	**4.50**	**4.60**	**4.70**	**4.80**	**4.90**	**5.00**	**5.10**
50yr PWLB	**4.20**	**4.30**	**4.30**	**4.40**	**4.40**	**4.50**	**4.60**	**4.70**	**4.80**	**4.90**	**5.00**	**5.10**	**5.20**

1.4 Investment Performance

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. We find ourselves in a very difficult investment market. Yields are very low, in line with the 0.5% Bank Rate, and continuing concerns over the level of Eurozone sovereign debt 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 Cash flow funds are available on a temporary basis and their amount varies from month to month and during the course of each month dependent on the timing of receipts (council tax, business rates, grants and other sources of income) and payments (precepts, NNDR pool contributions, benefits, staff and suppliers). The authority holds some £21m of core cash balances for investment purposes which are managed by our external fund manager. These funds which comprise our revenue and capital reserves are for the most part available to invest for more than one year.

1.4.3 As at the beginning of March 2012, funds invested and interest earned is set out in the table below:

	Funds invested at 2 March 2012 £m	**Average duration to maturity Days**	**Gross annualised return to 2 March 2012 %**	**7 day Libid benchmark %**	**Interest earned to 2 March 2012 £**
In-house cash flow – excl Landsbanki	9.8	3.8	0.93	0.56	90,850
In-house core fund	0.0	0.0	6.25	0.56	23,950
Externally managed core funds	20.9	186.1	1.62	0.56	304,600
Total	30.7	128.0	1.45	0.56	419,400

1.4.4 The authority out-performed the benchmark by 89 basis points. Key contributions 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' and from our external fund manager. In cash terms investment income is £54,500 better than expected when compared with the relevant proportion of our 2011/12 revised estimate (1 April 2011 to 2 March 2012).

In-house Managed Cash Flow and Core Fund Investments

1.4.5 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. During the 2011/12 financial year 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
0.5	Santander UK	3 Months	1.13%	09/06/11 – 09/09/11
1.5	National Westminster	3 Months	0.96%	30/11/11 – 29/02/12
2.0	Barclays	3 Months	0.94%	30/11/11 – 29/02/12

1.4.6 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 Annual Investment Strategy those funds were passed to our external fund manager.

Externally Managed Core Funds

1.4.7 Our external fund manager is currently performing above the level anticipated in our 2011/12 Annual Investment Strategy. Annualised gross return at the beginning of March was 1.62% vs a revised estimate of 1.39% (1.31% original estimate). This better than expected performance is primarily attributed to the opportunistic purchase and disposal of gilts during the summer months. The disposals took advantage of price increases when the UK was (and still is) seen as a safe haven given concerns over Eurozone sovereign debt.

Current Investments

1.4.8 A full list of investments held on 2 March 2012 is provided at **[Annex 1]** of this report. The yields on the total sum invested of £30.7m exclusive of Landsbanki is 1.13% comprising internally managed investments of £9.8m at 0.78% and externally managed investments of £20.9m at 1.30%.

1.4.9 Members will recall my report to the January 2012 meeting of this Committee when the Treasury Management Strategy Statement and Annual Investment Strategy for 2012/13 was considered in detail. One of the recommendations in that report was a relaxation of our minimum counterparty credit criteria to allow continued investment with a number of well know, highly rated, financial institutions. Following a spate of downgrades, over the Winter months, a number of UK institutions including Barclays and Nationwide **[Annex 1]** no longer meet our 2011/12 minimum credit criteria and as a consequence do not feature on our current internal lending list **[Annex 2]**. However, they do comply with the minimum credit requirements of our new 2012/13 investment strategy (Fitch A, F1, C (bbb-), 1 or green duration band using Sector's creditworthiness methodology). The Treasury Management Team maintains their view that the investments with Barclays and Nationwide should be allowed to run to maturity.

1.4.10 Members will also recall from my report in January 2012, that as a consequence of heightened concerns in the week leading up to the November 2011 EU Leaders Summit meeting, the Treasury Management Team took the decision to transfer our money market fund investments to the UK Debt Management Office. The joint action taken by Central Banks at the end of November 2011 and the €489bn three year loans provided by the ECB to Eurozone banks in December 2011 provided some respite to the growing liquidity problems facing European banks and as a consequence our use of money market funds was resumed in January 2012. A further tranche of three year loans in February 2012 followed by a restructuring of Greek debt in March 2012 have calmed markets at least in the short term. Further measures are needed to satisfactorily resolve the Eurozone debt crisis and officers remain vigilant to the risks posed to European and global banking systems in the months ahead.

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 Treasury Management Strategy Statement. In this regard it is confirmed that no borrowing was undertaken in the period 1 April 2011 to 2 March 2012.

1.6 Legal Implications

1.6.1 In respect of our "defaulted" £1m investment with Landsbanki the Landsbanki test case appeal hearings took place in the Supreme Court of Iceland on 14 and 15 September 2011. We are delighted the Icelandic Supreme Court has found in favour of UK local authorities and other UK wholesale depositors. This judgement means that UK local authorities' claims have been recognised as deposits with priority status over other creditors' claims.

1.6.2 We are currently liaising with the winding-up board in order to clarify the amount of interest to which we believe we are entitled. Once we have agreed that amount with the winding-up board we anticipate that a court settlement in relation to our claim recognising and approving our claim as a priority claim, following the decision of the Icelandic Supreme Court in the test cases, will be filed at, and approved by, the Icelandic District Court. The funds that are currently held in escrow in respect of our portion of the first distribution to priority creditors will then be released to us.

1.6.3 We anticipate that we will recover almost all (98%) of the £1m we had on deposit with the failed Icelandic bank Landsbanki. The way in which the LGA and our legal advisors have co-ordinated the legal action with other local authorities has minimised legal costs whilst enabling us to advance the strongest possible arguments to secure this excellent result. The cost of the litigation to date amounts to less than 1 per cent of the amount we expect to recover.

1.7 Financial and Value for Money Considerations

1.7.1 When our annual investment strategy for 2011/12 was prepared there was an expectation that interest rates would rise part way through the 2011/12 financial year. Despite the Bank Rate remaining at a historical low (0.5%) throughout the financial year investment income has exceeded expectations. Investment income is currently £54,500 better than predicted in our revised 2011/12 estimates (£104,200 better than predicted in our original estimates for 2011/12).

1.7.2 The performance of our fund manager is monitored against all of the players in the public sector cash management market place using data provided by Sector

Treasury Services. In addition, the performances of both externally and internally managed investments are monitored against relevant benchmarks.

1.8 Risk Assessment

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

1.9 Equality Impact Assessment

1.9.1 See 'Screening for equality impacts' table at end of report.

1.10 Recommendations

1.10.1 Members are **RECOMMENDED** to:

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

2) Note the treasury management position as at 2 March 2012; and to

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

Background papers: contact: Michael Withey

Forecasts provided by Sector Treasury Services.

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

Screening for equality impacts:		
Question	**Answer**	**Explanation of impacts**
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.