Treasury Management Annual Report 2011/12

1.1 Introduction

1.1.1 This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2011/12 **[Appendix 1]**. 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).

1.1.2 During 2011/12 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year;
- a mid year treasury update report; and
- an annual review following the end of the year describing the activity compared to the strategy (this report).

In addition, treasury management update reports have been presented to each meeting of the Audit Committee throughout the 2011/12 financial year.

1.1.3 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.

1.1.4 This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Audit Committee before they were reported to the full Council. Member training on treasury management issues was undertaken during the year on 11 October 2011 in order to support Members' scrutiny role.

1.2 The Economy and Interest Rates

1.2.1 The financial year 2011/12 continued the challenging investment environment of previous years, namely low investment returns and continuing heightened levels of counterparty risk. The original expectation for 2011/12 was that the Bank Rate would start gently rising from quarter 4 of 2011. However, GDP growth in the UK was disappointing during the year under the weight of the UK austerity programme, a lack of rebalancing of the UK economy to exporting and weak growth in our biggest export market - the EU. The EU sovereign debt crisis grew in intensity during the year until February when a second bailout package was eventually agreed for Greece. Weak UK growth resulted in the Monetary Policy Committee increasing quantitative easing by £75bn in October and another £50bn in February. The Bank Rate ended the year unchanged at 0.5% while CPI inflation peaked in September at 5.2% but then fell to 3.5% in March, with further falls expected to below 2% over the next two years.

1.2.2 Gilt yields fell for much of the year, until February, as concerns continued building over the EU debt crisis. This resulted in safe haven flows into UK gilts which, together with the two UK packages of quantitative easing during the year, combined to depress PWLB rates to historically low levels.

1.2.3 Widespread and multiple downgrades of the ratings of many banks and sovereigns, continued Eurozone concerns, and the significant funding issues still faced by many financial institutions, meant that investors remained cautious of longer-term commitment.

1.3 Treasury Position at 31 March 2012

1.3.1 At the beginning and the end of 2011/12 the Council's debt and investment position was as follows:

	31 March 2011 £m	Rate / Return %	Average duration Years	31 March 2012 £m	Rate / Return %	Average duration Years
Variable rate debt:						
Overdraft	0.00	-	-	0.00	-	-
Total debt	**0.00**	-	-	**0.00**	-	-
Fixed rate investments:						
In-house cash flow Landsbanki	1.00	-	-	1.00	-	-
In-house core fund	2.50	6.25	0.16	0.00	-	-
Variable rate investments:						
In-house cash flow	3.10	0.80	0.01	4.20	0.82	0.01
Externally managed core fund	19.22	0.90	0.31	21.02	1.24	0.54
Total Investments	**25.82**	**1.43**	**0.26**	**26.22**	**1.17**	**0.45**

1.4 The Strategy for 2011/12

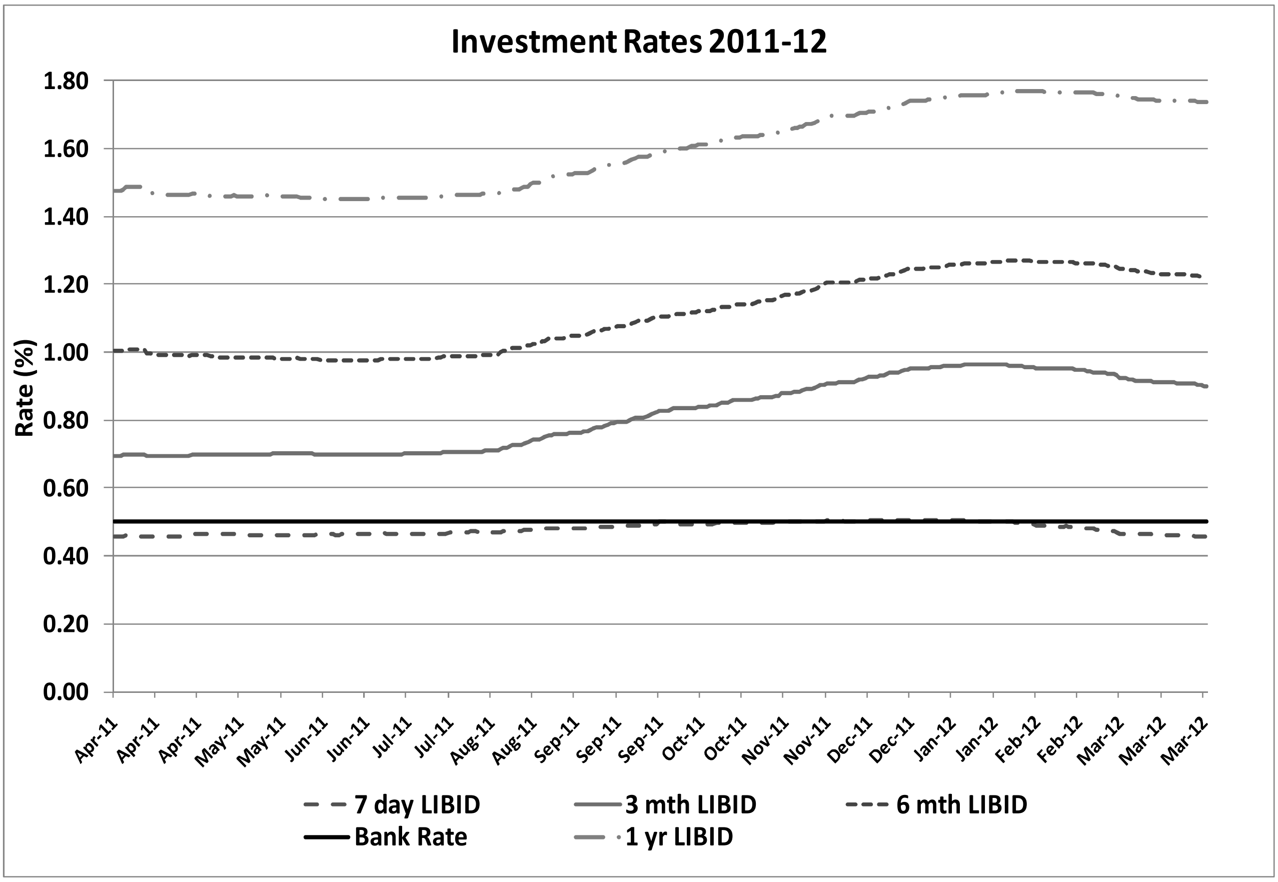
1.4.1 The expectation for interest rates within the strategy for 2011/12 anticipated low but rising Bank Rate starting in quarter 4 of 2011. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns.

1.4.2 UK Gilt yields fell sharply during the year caused by a flight to quality from EU sovereign debt and also from shares as investors became concerned about the potential for a repeat of the 2008 banking crisis. These concerns were driven in the main by fears that Greece would default on its sovereign debt obligations and leave the Euro.

1.5 Investment Rates in 2011/12

1.5.1 The tight monetary conditions following the 2008 financial crisis continued through 2011/12 with little material movement in the shorter term deposit rates. However, one month and longer rates rose significantly in the second half of the year as the Eurozone crisis grew. The Bank Rate remained at its historic low of 0.5% throughout the year while market expectations of the imminence of monetary tightening were gradually pushed further and further back during the year to the second half of 2013 at the earliest.

1.5.2 Overlaying the relatively poor investment returns were the continued counterparty concerns generated by the Eurozone sovereign debt crisis.



1.6 Investment Outturn for 2011/12

1.6.1 The Council's investment policy is governed by CLG guidance, which was implemented in the 2011/12 Annual Investment Strategy approved by the Council on 17 February 2011. 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 information including rating outlooks and credit default swap data.

1.6.2 The investment activity during the year conformed to the approved strategy. No liquidity issues were experienced resulting in nil borrowing throughout 2011/12.

1.6.3 **Cash Flow Investments held by the Council** - the Council maintained an average balance of £10.3m of internally managed cash flow funds. These funds earned an average rate of return of 0.92%. The comparable performance indicator is the average 7-day LIBID rate which was 0.55%. This compares with a revised budget assumption of £9.0m investment balances earning an average rate of 0.90%.

1.6.4 The majority of cash flow funds are required to meet our regular payment obligations and as a consequence are invested overnight in bank deposit accounts and money market funds allowing next day access. However, the opportunity to invest for longer durations and generate additional yield is taken when cash flow surpluses arise.

1.6.5 **Core Fund Investments held by the Council** - the Council held one core fund investment which matured part way through the financial year. In accordance with the 2011/12 Investment Strategy the maturing principal of £2.5m was reinvested by the Council's external fund manager. This investment which was taken out prior to the 2008 "credit crunch" earned a rate of return of 6.25%. The comparable performance indicator is the average 7-day LIBID rate which was 0.55%. The return achieved matches that anticipated in the revised 2011/12 budget assumption.

1.6.6 **Core Fund Investments held by the Fund Manager** - the Council uses Investec Asset Management to invest its core fund cash balances. The manager earned an average rate of return of 1.63% on an average balance of £20.4m against a benchmark return of 0.55%. This compares with a budget assumption of an average investment balance of £20.3m at a return of 1.39%.

1.6.7 Unlike cash flow, core fund balances are not required to meet our regular payment obligations and are therefore available to invest for durations exceeding one year. This added flexibility is reflected in the better return that core funds generate over cash flow returns.

1.6.8 Performance for the financial year as a whole, excluding £1m Landsbanki investment, is summarised in the table below:

	2011/12 Average Balance £	Return %	2011/12 Interest Earned £	2011/12 Revised Estimate £	Variance Better (worse) £
In-house Cash Flow	10,347,000	0.92	95,550	81,000	14,550
In-house Core Fund	384,000	6.25	23,950	23,950	0
Externally Managed Core Fund	20,390,000	1.63	331,800	286,050	45,750
Total	31,121,000	1.45	451,300	391,000	60,300

1.6.9 The performance of both internally and externally managed funds has generated an additional £60,300 of income over our revised estimate predictions. These figures are adjusted at year end to account for unrealised gains / losses on our externally managed portfolio and to incorporate notional interest on the defaulted Landsbanki investment. In total, our investment income for year end reporting purposes is calculated at £441,600 vs a revised estimate total of £357,700 which is £83,900 better than expected.

1.7 Icelandic Bank Defaults

1.7.1 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.

1.7.2 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.

1.7.3 It is now considered likely that UK local authorities will recover 100% of their deposits with the failed Icelandic bank Landsbanki, subject to potential future exchange rate fluctuations. As a consequence, we anticipate that we will recover all of the £1m we had on deposit, together with the interest that was due had the deposit been repaid on time. 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.