TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

17 June 2013

Report of the Director of Finance and Transformation

Part 1- Public

Matters for Recommendation to Cabinet - Council Decision

1 TREASURY MANAGEMENT UPDATE AND ANNUAL REPORT FOR 2012/13

This report provides details of treasury management activity undertaken during April and May of the current (2013/14) financial year within the context of the national economy. The treasury management outturn position for 2012/13 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 2013 and note the outturn position for 2012/13.

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 and subsequent updates.

1.2 Economic Background

1.2.1 Thus far in 2013/14:

- 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 2013 to May 2013.

- Moody’s downgraded the UK from AAA to Aa1 (equivalent to Fitch AA+) in February 2013 with a stable outlook. Key drivers to the rating action were continuing weakness in the UK’s medium-term growth outlook and deterioration in the government’s balance sheet caused by a high and rising debt burden. Fitch followed suite, downgrading the UK to AA+ in April.

- Early estimates of UK Gross Domestic Product (GDP) reflected a rise of 0.3% in the first quarter of 2013. This reverses the fall in the final quarter of 2012 and meant the UK avoided a treble-dip recession.

- The Chancellor in his 2013 budget confirmed the government would stick firmly to its current austerity policy to tackle the deficit but acknowledged that the national debt would continue to rise over the coming years to 85% of GDP before beginning to fall in 2017/18, two years later than originally envisaged when the coalition came to office.

- The Chancellor's budget introduced a number of initiatives intended to help stimulate economic growth including: a reduction in corporation tax and employers national insurance contributions; loans to support home buyers to acquire new-build properties and additional funding for infrastructure projects. In addition, the remit of the Monetary Policy Committee (MPC) would be updated to allow it to use "unconventional monetary instruments" to support the economy while keeping inflation stable. The existing remit will be changed to focus on growth as well as inflation.

- In April the Bank of England announced a 12 month extension to its "Funding for Lending" scheme which is now due to end in January 2015. Under the scheme banks receive funding at a very low rate of interest for onward lending to businesses and consumers.

- Also in April the Consumer Prices Index (CPI) and Retail Prices Index (RPI) fell for the first time in six months to 2.4% and 2.9%. CPI, whilst down from the 5.2% peak in September 2011, is expected to remain elevated above the 2.0% target over the next 12 to 18 months.

- Market concerns over the Euro zone eased in the latter part of 2012 following the announcement that the European Central Bank (ECB) would purchase unlimited quantities of sovereign bonds via its "Outright Money Transactions" programme. However, market reaction to the inconclusive outcome of the Italian elections in February 2013 and the Cyprus bank deposit saga in March 2013 are a reminder that the fundamental issues relating to the Euro zone debt crisis have yet to be resolved.

1.3 Interest Rate Forecast

1.3.1 The Council's Treasury Advisor (Sector) updated their interest rate forecast in May 2013. In common with our 2013/14 Annual Investment Strategy the forecast anticipates the Bank Rate will remain at the present level of 0.5% for a further 18 months before rising in the first quarter of 2015.

Rate	Now %	Jun-2013 %	Sep-2013 %	Dec-2013 %	Mar-2014 %	Jun-2014 %	Sep-2014 %	Dec-2014 %	Mar-2015 %	Jun-2015 %	Sep-2015 %	Dec-2015 %	Mar-2016 %
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25	1.50	1.70
3 Mth Libid	0.50	0.50	0.50	0.50	0.50	0.60	0.60	0.70	0.80	1.10	1.40	1.70	1.90
6 Mth Libid	0.50	0.60	0.60	0.60	0.60	0.70	0.80	0.90	1.00	1.20	1.50	1.80	2.10
12 Mth Libid	0.80	0.80	0.80	0.80	0.90	0.90	1.00	1.10	1.10	1.30	1.60	1.90	2.20
5yr PWLB	1.70	1.80	1.80	1.80	1.90	2.00	2.10	2.20	2.40	2.50	2.60	2.80	3.00
10Yr PWLB	2.70	2.90	2.90	2.90	3.00	3.10	3.20	3.30	3.50	3.60	3.80	3.90	4.10
25yr PWLB	3.90	4.10	4.10	4.10	4.20	4.20	4.30	4.40	4.60	4.60	4.80	4.90	5.00
50yr PWLB	4.10	4.20	4.20	4.20	4.40	4.40	4.50	4.60	4.70	4.80	4.90	5.00	5.10

1.4 2013/14 Treasury Management Performance

1.4.1 The Treasury Management Strategy Statement (TMSS) which applies to the 2013/14 financial year was approved by Council on 14 February 2013. 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. The Council has adopted Sector's recommended creditworthiness approach which incorporates the credit ratings from each of the three main rating agencies and includes sovereign credit ratings and a market view of risk using credit default swap (CDS) data.

1.4.3 A full list of investments held on 31 May 2013 and our internal lending list of the same date are shown in **[Annexes 1 and 2]** of this report.

1.4.4 As illustrated 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 2013 was £10.1m. These funds were available on a temporary basis and the amount mainly dependent on the timing of precept payments, receipt of grants and progress on the capital programme. The Authority holds £15.4m 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 some funds will need to be recalled during March 2014 to top-up our daily cash balances.

1.4.5 As at the end of May 2013 funds invested and interest earned is set out in the table below:

	Funds invested at 31 May 2013 £m	Average duration to maturity Yrs	Weighted average rate of return %	Interest earned to 31 May 2013 £	Gross annualised return to 31 May 2013 %	7 day LIBID benchmark %
In-house cash flow excluding Landsbanki	9.1	0.31	0.70	11,700	0.69	0.41
Externally managed core funds	15.4	0.56	0.59	6,100	0.24	0.41
Total	24.5	0.47	0.63	17,800	0.42	0.41

1.4.6 Whilst the authority achieved its benchmark return, interest earned of £17,800 is £19,150 lower than our profiled budget for the same period. This underperformance against budget is attributed to the lower than expected return delivered by our external fund manager and is explored in more detail in paragraphs 1.4.11 and 1.4.12.

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. 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 mid-April the following fixed term investments were made:

£m	Bank / Building Society	Duration	Rate	Period
1.0	Bank of Scotland	12 Months	1.10%	12/4/13 – 11/4/14
1.0	Lloyds TSB	12 Months	1.10%	12/4/13 – 11/4/14
0.6	Lloyds TSB	11 Months	1.05%	12/4/13 – 11/3/14

1.4.8 The current cash flow forecast **[Annex 3]** indicates potential for further fixed term investment is likely in the second half of the financial year.

1.4.9 In addition to term deposits the opportunity to generate additional yield is also achieved by utilising notice accounts. At 31 May 2013, £2m was deposited in a National Westminster 95 day notice account at a rate of 0.80% per annum and £1.0m deposited in a 35 day notice account with Handelsbanken at 0.45% per annum.

1.4.10 Sector, our external treasury advisor, has recently expanded the service that they provide and introduced a benchmarking facility. For a second year Tonbridge & Malling has opted to take advantage of that facility. An extract from the latest benchmarking data is provided in the form of a scatter graph at **[Annex 4]**. The graph shows the return vs. the credit / duration risk associated with an authority's investments. As at 31 March 2013 both the return (vertical scale) on our in-house managed portfolio and our exposure to credit / duration risk (horizontal scale) were broadly in-line with the average for all authorities. The graph also demonstrates that, for the level of credit / duration risk that the Council was exposed to, our return was in-line with that predicted by the model (i.e. between the two diagonal lines).

1.4.11 **Externally Managed Core Funds**. In accordance with our 2013/14 Annual Investment Strategy all of the Council's core funds are being managed by our external fund manager. The fund manager currently anticipates a gross return (before the deduction of fees) for the 2013/14 financial year as a whole will be between 0.65% and 1.15%. The central case assumption of 0.90% is lower than the return used to prepare our income estimates for the year and takes into account the significant reduction in bank interest rate offerings following the introduction of the "Funding for Lending" scheme. This lower return implies a shortfall against budget for the year as a whole of some £20,000.

1.4.12 The actual gross annualised return at the end of May of 0.24% is substantially below the underlying yield (weighted average rate of return) of the current portfolio at 0.59%. The portfolio comprises mainly short duration (three / six month) certificates of deposit but also includes a small proportion of UK gilts and European Investment Bank bonds. The fund manager is expected to deliver improved performance as the year progresses both from the underlying yield and via capital profits on gilt trades. Opportunity for the latter is entirely dependent on external events generating volatility in the gilt market.

1.5 Compliance with 2013/14 TMSS and AIS

1.5.1 "Affordable Borrowing Limits" by way of the Prudential Indicators (affordability limits) are set out in the approved Treasury Management Strategy Statement. In this regard it is confirmed that no borrowing was undertaken in the period April to May 2013.

1.5.2 During the financial year to date the Council has operated within the treasury limits and prudential indicators set out in the Treasury Management Strategy Statement 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 2013.

1.5.3 Throughout the period April to May 2013 all of the requirements contained in the 2013/14 Annual Investment Strategy 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 2012/13 Treasury Management Outturn

1.6.1 A detailed report covering treasury management activity for the last financial year is being submitted to Cabinet on 19 June 2013 as part of the Revenue and Capital Outturn report for 2012/13. A copy of the Treasury Management Annual Report is provided at **[Annex 5].**

1.6.2 A summary of the investment performance included in the report is as follows:

2012/13 Financial Year	Average investment £m	Gross rate of return %	Interest earned £	Revised budget £
Internally managed cash flow (excluding Landsbanki)	10.9	1.08	117,100	95,500
Externally managed core funds (excluding year end valuation gains / losses)	18.2	1.10	202,800	227,000
Total	29.1	1.09	319,900	322,500

1.6.3 Total investment income of £319,900 is marginally below the 2012/13 revised estimate by £2,600 (£26,500 better than expected when measured against our original 2012/13 estimate). The gross return for the year of 1.09% exceeds the 7-day LIBID benchmark by 63 basis points.

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, coordinated 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**. Following an appeal, this ruling was upheld by the Icelandic Supreme Court in September 2011. Agreement to the Council's settlement was approved by the Icelandic District Court in May 2012 and payment of our first distribution of funds received in June 2012. A further distribution of funds was made in October 2012 bringing the total recovery to date to just under £491,000.

1.7.2 Subject to exchange rates, we anticipate that we will recover all of the £1m we had on deposit with Landsbanki, together with the interest that was due had the deposit been repaid on time. In addition, this Council was one of a limited number of authorities who submitted a demand for repayment. The validity of our demand has been recognised by the award of additional interest (gap interest for the period October 2008 to April 2009). The way in which the LGA and our legal advisors have coordinated 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.

1.8 Financial and Value for Money Considerations

1.8.1 Investment income for 2012/13 fell short of the revised estimate by £2,600 (£26,500 better than expected when measured against our original 2012/13 estimate). Interest earned to the end of May 2012 of £17,800 represents a shortfall against profiled budget of £19,150. Interest rates being offered by banks fell significantly in the second half of last financial year following the introduction of the "Funding for Lending" scheme by the Bank of England. The scheme, intended to help stimulate economic recovery, is expected to be in place until January 2015. As a consequence there is unlikely to be any significant improvement in investment rates in the near future. Income from our externally managed portfolio is expected to undershoot the 2013/14 budget by £20,000.

1.8.2 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. The performance of the Council's in-house managed portfolio is compared to other local authorities using benchmarking data provided by Sector.

1.9 Risk Assessment

1.9.1 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.

1.10 Equality Impact Assessment

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

1.11 Recommendations

1.11.1 Members are invited to **RECOMMEND** that Cabinet:

1) Endorse the action taken by officers in respect of treasury management activity for the period April to May 2013; and

2) Note the 2012/13 outturn position.

Background papers: contact: Mike Withey

Interest Rate Forecast provided by Sector (May 2013)

Sharon Shelton
Director of Finance and Transformation

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.