TONBRIDGE & MALLING BOROUGH COUNCIL

FINANCE and PROPERTY ADVISORY BOARD

26 May 2010

Report of the Director of Finance

Part 1- Public

Matters for Recommendation to Cabinet - Non-Key Decision

1 TREASURY MANAGEMENT UPDATE

This report provides an overview of treasury management activities undertaken during the financial year to-date in the context of the national economy and invites Members to recommend endorsement of the action taken to Cabinet.

1.1 Introduction

1.1.1 CIPFA issued the revised Code of Practice for Treasury Management in November 2009, following consultation with Local Authorities during the summer. 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.

1.1.2 As part of the adoption process I committed to reviewing and re-issuing our Treasury Management Practices (TMPs). I am pleased to advise Members the review will be completed shortly and that the new TMPs will be subject to scrutiny by the Audit Committee on 21 June 2010.

1.1.3 Members should be aware that Sector has offered a compliance audit service to their public sector clients at a cost of £2,500. Whilst I believe that our adoption of the revised Code of Practice and updated TMPs has addressed the compliance issues fully, I am conscious that confirmation of our doing so via an independent party may add a comfort factor that might be welcomed. Accordingly I would welcome learning of Members views on this matter.

1.1.4 Members might like to know that the Treasury Management Outturn Report for 2009/10 is to be considered by Cabinet on 16 June. Should any questions arise when the report is published, please contact my Exchequer Services Manager John Pickup on extension 6112 in the first instance.

1.2 Economic Background

1.2.1 The first four months of 2010 saw:

- The first official estimate of UK GDP for 2010 indicating the economy had managed to avoid a 'double-dip' recession and expand at 0.2% during the first quarter;
- Retail sales proving to be volatile after being hit by bad weather and the VAT increase in January and fell by 2.3% in April;
- The recovery continue to fail to create new jobs, despite which unemployment is expected to hold at 8% when the April figures are announced before starting to decline;
- Pay growth remaining weak;
- The UK's trade position begin to improve, helped by the weak pound;
- House prices edging upwards, perhaps more because of a shortage of supply rather than a general increase in prices. A view which seems to be borne out by the continued low volume of mortgage approvals;
- The former Chancellor revise downwards his forecast for public sector borrowing in the Budget;
- The Monetary Policy Committee pause QE and keep official interest rates on hold at 0.5% in May; and
- The CPI and RPI inflation indices reach 3.4% and 4.4% respectively.

1.2.2 The Monetary Policy Committee (MPC) response to all of the above signals was to vote to keep official interest rates on hold at 0.5% in May and to continue to pause its programme of quantitative easing (QE).

1.3 Interest Rate Forecast

1.3.1 The Council's Treasury Advisor, Sector, provides the following forecast:

	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
Bank rate	0.50%	0.50%	0.50%	1.00%	1.50%	2.00%	2.50%	3.00%	3.25%	3.75%	4.25%	4.50%
5yr PWLB rate	3.10%	3.15%	3.20%	3.40%	3.65%	4.00%	4.30%	4.50%	4.65%	4.75%	4.80%	4.85%
10yr PWLB rate	4.35%	4.45%	4.50%	4.60%	4.70%	4.75%	4.90%	4.95%	5.10%	5.10%	5.15%	5.15%
25yr PWLB rate	4.75%	4.80%	4.85%	4.90%	5.00%	5.05%	5.10%	5.20%	5.30%	5.35%	5.35%	5.35%
50yr PWLB rate	4.75%	4.80%	4.85%	4.90%	5.05%	5.10%	5.15%	5.15%	5.30%	5.30%	5.30%	5.30%

1.3.2 The forecast is based upon the following assumptions:

- Moderate economic recovery and MPC inflation forecast being below target in two years' time;
- The first Bank Rate increase coming in 2011; and reaching 4.5% by March 2013;

- Long term PWLB rates are expected to steadily increase to reach 5.30% by early 2013 due to huge gilt issuance, reversal of QE and investor concerns over inflation;
- The balance of risks is weighted to the downside; and
- There is still some risk of a “double dip” recession.

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 a general election, 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 Treasury Management Strategy Statement

1.4.1 The Treasury Management Strategy Statement (TMSS) for 2010/11 was approved by Council on 18 February 2010. The Council’s Annual Investment Strategy, 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 Sector.

1.4.3 A full list of investments held as at 7 May 2010, a copy of the most recent counterparty lists and the Sector monthly report on internally managed investments, are shown in **[Annexes 1 to 3]** 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 in April 2010 was £7.0m. 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 £21.5m of core cash balances for investment purposes, of which £16.5m is managed by our external fund manager. These funds are for the most part available to invest for more than one year, albeit that around £3m will need to be recalled during 2010/11 to fund the capital programme.

Performance for the month of April together with current balance and interest earned is set out in the table below:	**Funds invested at 30 Apr 10 £m**	**Average maturity years**	**Gross return %**	**7 Day Libid Benchmark %**	**Interest earned £**
In-house cash flow – excl of Landsbanki	8.24	0.01	0.74	0.48	4,250
In-house core funds	5.00	1.14	6.65	0.48	27,350
Externally managed core funds	16.58	0.73	0.77	0.48	10,550
Total	29.82	0.60	1.80	0.48	42,150

1.4.5 As illustrated, the authority outperformed the benchmark by 132 basis points (bp).

1.4.6 One of the key contributions to the 132bp level of out-performance came from the two internally managed core investments with Barclays and Nationwide. Attention is drawn to the fact that the time to maturity exceeds the 6 month duration rating suggested by Sector and, therefore, applicable in respect of new investments undertaken in accordance with the Treasury Management Strategy for 2010/11.

1.4.7 The Treasury management team continue to monitor these investments closely and consider that the implicit support of HMG for those counterparties provides sufficient comfort to not call for premature repayment.

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. In this regard it is confirmed that no borrowing was undertaken in April 2010.

1.6 Legal Implications

1.6.1 The contract with Landsbanki remains in default and action is now being taken by Bevan and Brittan, our legal advisors, to confirm local authority depositors’ status as **priority creditors**. It is expected local authorities’ cases will be referred to court shortly. A number of authorities have been selected by the Winding Up Boards as “Test Cases” in order to allow the full range of issues to be argued before the Icelandic courts. The subsequent judgements will not be automatically binding on other cases. Therefore, to ensure the earliest possible resolution of matters for all authorities, the winding up boards have been invited to refer all authorities’ claims to the court now.

1.6.2 As the court processes in Iceland are likely to take around 12 months, it is not expected that any part of the defaulted investment will be repaid during this financial year.

1.7 Financial and Value for Money Considerations

1.7.1 Despite the outperformance against the benchmark returns for the month of April fall short of the budgeted investment return of £50,100 by just under £8,000. Members should be aware that a shortfall at this level is likely to persist if, as is now expected, interest rates remain abnormally low for the remainder of the financial year and Barclays exercise their option to seek to repay their high coupon loan in July.

1.7.2 A variation to the budget for investment income is, therefore, likely and this will be brought forward to Members for consideration at the revised estimate stage.

1.7.3 Budget provision of £2,500 will need to be made if it is decided to proceed with the Sector compliance audit of the treasury management function.

1.8 Risk Assessment

1.8.1 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.

1.8.2 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 loan and associated interest.

1.8.3 At this time the added risk associated with continuing to hold the in-house core investments with Barclays and Nationwide beyond the duration rating suggested by Sector is not thought to outweigh the loss of income that would result from seeking early repayment.

1.9 Recommendations

1.9.1 Members are **RECOMMENDED** to:

1) Endorse the action taken by officers in respect of recent treasury management activities; and to

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

Background papers: contact: John Pickup

Correspondence/email with the Local Government Association
Reporting template provided by Sector Treasury Services.

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