TONBRIDGE & MALLING BOROUGH COUNCIL

FINANCE and PROPERTY ADVISORY BOARD

29 September 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 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.

1.2 Economic Background

1.2.1 The first six 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 0.3% 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 continued to fail to create new jobs, despite which unemployment is expected to hold at 8% 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%;
- The CPI and RPI inflation indices peak in April at 3.7% and 5.3% falling to 3.1% and 4.7% in August.

1.2.2 The Monetary Policy Committee (MPC) voted to keep official interest rates on hold at 0.5% in September 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, updated their forecast in August and now anticipate the first rise in the Bank Rate will be delayed until the September 2011 quarter.

Rate	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.50%	3.00%	3.25%	3.25%
5yr PWLB	1.94%	2.20%	2.20%	2.20%	2.40%	2.60%	2.80%	3.00%	3.30%	3.60%	3.80%	4.10%	4.40%	4.40%
10yr PWLB	3.20%	3.30%	3.30%	3.30%	3.40%	3.70%	3.90%	4.00%	4.30%	4.40%	4.60%	4.60%	4.90%	4.90%
25yr PWLB	4.14%	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.70%	4.70%	4.80%	5.00%	5.00%	5.00%	5.00%
50yr PWLB	4.17%	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.70%	4.70%	4.80%	5.00%	5.00%	5.00%	5.00%

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 is expected in the September 2011 quarter and reaching 3.25% by the June 2013 quarter;
- Long term PWLB rates are expected to steadily increase to reach 5.00% by late 2012 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 the Government's £6.2 billion savings and emergency budget announcements, 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 Performance

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 them.

1.4.3 A full list of investments held as at 10 September 2010, a copy of the most recent counterparty lists and the Sector monthly report on internally managed investments to the end of August, 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 to the end of August 2010 was £11.0m. 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 £21.6m of core cash balances for investment purposes, of which £19.1m 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.

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

	Funds invested at 31 August £m	**Average maturity Yrs**	**Gross annualised return to 31 August**	**7 day Libid benchmark %**	**Interest earned £**
In-house cash flow – excl of Landsbanki	13.7	0.28	0.86	0.50	39,750
In-house core funds	2.5	0.74	6.58	0.50	118,600
Externally managed core funds	19.1	0.55	0.92	0.50	66,900
Total	35.3	0.46	1.36	0.50	225,250

1.4.6 The authority outperformed the benchmark by 86 basis points (bp). The key contribution to that out-performance came from the internally managed core investments.

1.4.7 **Cash Flow Funds**. 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 to identify opportunities to make fixed term investments and take advantage of the higher yields available. The majority of our cash flow surpluses are invested overnight in bank deposit accounts and money market funds to ensure sufficient short term liquidity. However, the following fixed term investments have been made:

£m	Bank / Building Society	Duration	Rate	Period
1.5	Bank of Scotland	9 Months	1.48%	01/06/10 – 01/03/11
1.5	Lloyds TSB	9 Months	1.48%	01/06/10 – 01/03/11
1.5	Barclays	6 Months	0.97%	10/06/10 – 10/12/10
1.5	Nationwide	6 Months	0.94%	16/06/10 – 16/12/10
1.5	Barclays	6 Months	1.00%	15/09/10 – 15/03/11

1.4.8 **In-house Managed Core Funds**. As reported verbally to the last meeting of this board, the highly beneficial Investment with Barclays (£2.5m at 7.05%, 17/7/08 – 16/7/11) was recalled by them in July. In accordance with this year's approved strategy those fund were passed to our external fund manager. The remaining in-house core fund investment with Nationwide (£2.5m at 6.25%, 28/5/08 – 27/05/11) is not recallable prior to maturity in May of next year.

1.4.9 Attention is drawn to the fact that the time to maturity for the Nationwide investment exceeds the duration rating suggested by Sector and, therefore, applicable to any new investment. The Treasury Management Team continues to monitor this investment closely and considers that the implicit support of HMG for this counterparty provides sufficient comfort not to call for premature repayment.

1.4.10 **Externally Managed Core Funds**. Investec's performance to the end of August has shown a marked improvement over the figures to the end of May reported to the last meeting of this Board. Given that the next rate rise is now forecast to be some months away Investec have opted to extend duration.

1.4.11 As a consequence of a misinterpretation of our duration limits a modest holding in 10 year gilts was purchased by Investec in late June, July and August. Our strategy stipulates the maximum duration to maturity for any investment should not exceed 5 years. The system error that allowed the purchase to be attributed to the T&MBC element of the fund has now been corrected. The £0.5m gilt holding returned a profit when it was sold in August.

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 the period April to August 2010.

1.6 Legal Implications

1.6.1 The position regarding the Council's Landsbanki deposit is as reported to the May meeting of this Advisory Board. 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.**

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 to the end of August fell short of the budgeted investment return of £281,400 by just over £56,000. Members should be aware that the shortfall is likely to increase as the year progresses if, as is now expected, interest rates remain abnormally low for the remainder of the financial year.

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.

1.8 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 investment with 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;

2) Note the temporary breach in duration limit following the purchase of 10 year gilts by the external fund manager; and to

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

Background papers: contact: Mike Withey

Nil

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