Treasury Management Annual Report 2010/11

1.1 Introduction

1.1.1 This Council is required through regulations issued under the Local Government Act 2003 to produce an annual treasury report reviewing treasury management activities and the actual prudential and treasury indicators for 2010/11. This report meets the requirements of both the Chartered Institute of Public Finance and Accountancy's (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 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 member approved policies.

1.1.3 The CIPFA Code of Practice on Treasury Management 2009 was adopted by this Council on 18 February 2010. The primary requirements of the Code are the:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities;
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives;
- Receipt by the Cabinet / Council of an annual strategy report for the year ahead and an annual review report of the previous year;
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions; and
- Delegation by the Council of the role of scrutiny of treasury management strategy, policies and activities to a specific named body which in this Council is the Audit Committee.

1.1.4 Treasury management in this context is defined as:

"The management of the local authority's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks. "

1.1.5 This report summarises:

- The Council's treasury position at 31 March 2011;
- Performance measurement;
- The strategy for 2010/11;

- The economic background;
- Investment rates in 2010/11;
- Borrowing outturn for 2010/11;
- Compliance with treasury limits and prudential indicators;
- Investment outturn for 2010/11; and
- Icelandic investment.

1.2 Treasury position at 31 March 2011

1.2.1 The Council's debt and investment position is organised in order to ensure adequate liquidity for revenue and capital activities, security of investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting detailed in the introduction, and through officer activity detailed in the Council's Treasury Management Practices.

1.2.2 At the beginning and the end of 2010/11 the Council's debt and investment position was as follows:

	31 March 2010 £m	Rate / Return %	Average duration Years	31 March 2011 £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	5.00	6.65	1.23	2.50	6.25	0.16
Variable rate investments:						
In-house cash flow	2.85	0.80	0.01	3.10	0.80	0.01
Externally managed core fund	16.57	0.73	0.23	19.22	0.90	0.31
Total Investments	**25.42**	**1.87**	**0.41**	**25.82**	**1.43**	**0.26**

1.3 Performance measurement

1.3.1 One of the key requirements of the Code is the formal introduction of performance measurement relating to investments, debt and capital financing activities. The use of benchmarks for investments is considered appropriate to a portfolio of our size and these have been well developed and universally accepted. Internal and external investment performance is measured against the 7 day LIBID.

1.4 The strategy for 2010/11

1.4.1 The expectation for interest rates within the strategy for 2010/11 anticipated a low but rising Bank Rate (starting in quarter 3 of 2010) with similar gradual rises in medium and longer term fixed interest rates over 2010/11. 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.

1.4.2 The strategy adopted by the Council based upon the above forecast and uncertainty over the banking system was to:

- Transfer internally managed core funds to the external fund manager upon maturity in order to reduce counterparty risk. Cash flow surpluses available for longer than three months would also be placed with the external fund manager unless a better rate of return could be achieved without undue added risk;

- Use business reserve accounts, money market funds and short dated deposits (overnight to three months) to benefit from the compounding of interest; and

- Via our external fund manager, remain defensively positioned until yields start to rise and then look to increase duration by extending maturities in both gilts and money market instruments as yields become more compelling.

1.5 The economic background

1.5.1 2010/11 proved to be another watershed year for financial markets. Rather than a focus on individual institutions, market fears moved to sovereign debt issues, particularly in the peripheral Euro zone countries.

1.5.2 UK growth proved mixed over the year. The first half of the year saw the economy outperform expectations, although the economy slipped into negative territory in the final quarter of 2010 due to inclement weather conditions. The year finished with prospects for the UK economy being decidedly downbeat over the short to medium term while the Japanese disasters in March, and the Arab Spring, especially the crisis in Libya, caused an increase in world oil prices, which all combined to dampen international economic growth prospects.

1.5.3 The change in the UK political background was a major factor behind weaker domestic growth expectations. The new coalition Government struck an aggressive fiscal policy stance, evidenced through heavy spending cuts announced in the October Comprehensive Spending Review, and the lack of any “giveaway” in the March 2011 Budget. Although the main aim was to reduce the national debt burden to a sustainable level, the measures are also expected to act as a significant drag on growth.

1.5.4 Gilt yields fell for much of the first half of the year as financial markets drew considerable reassurance from the Government's debt reduction plans, especially in the light of Euro zone sovereign debt concerns. Expectations of further quantitative easing also helped to push yields to historic lows. However, this positive performance was mostly reversed in the closing months of 2010 as sentiment changed due to sharply rising inflation pressures. These were also expected (during February / March 2011) to cause the Monetary Policy Committee to start raising Bank Rate earlier than previously expected.

1.5.5 The developing Euro zone peripheral sovereign debt crisis caused considerable concerns in financial markets. First Greece (May), then Ireland (December), were forced to accept assistance from a combined EU / IMF rescue package. Subsequently, fears steadily grew about Portugal, although it managed to put off accepting assistance till after the year end. These worries caused international investors to seek safe havens in investing in non-Euro zone government bonds.

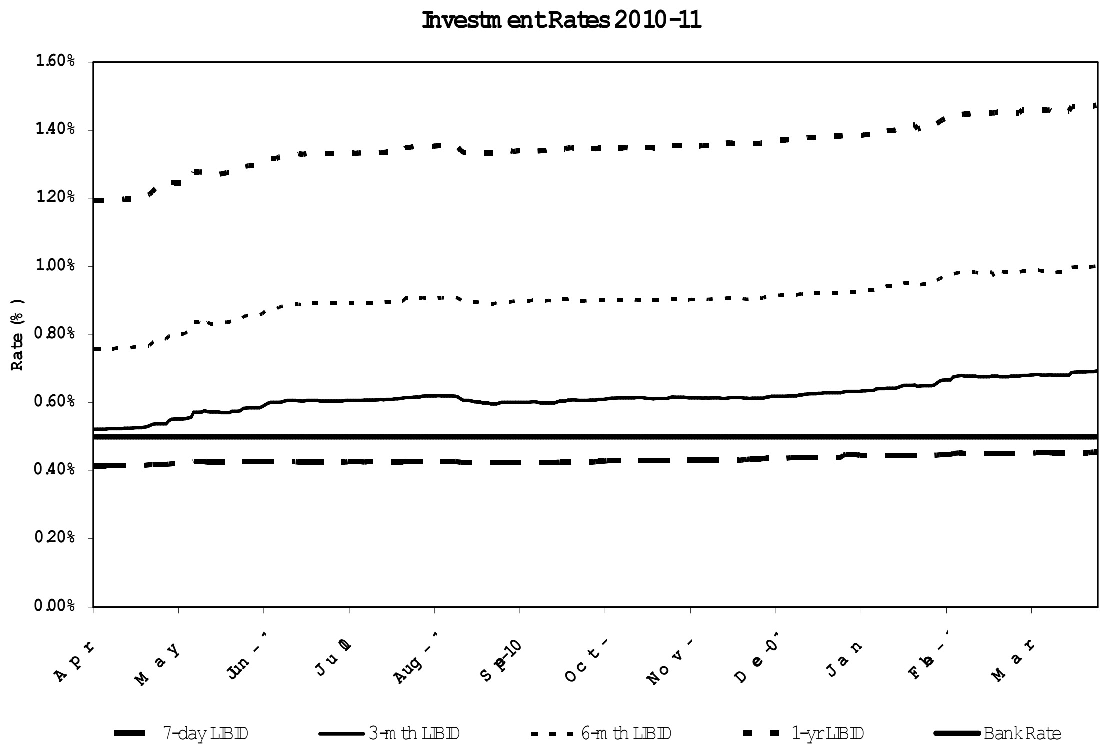
1.5.6 Deposit rates picked up modestly in the second half of the year as rising inflationary concerns, and strong first half growth, fed through to prospects of an earlier start to increases in Bank Rate. However, in March 2011, slowing actual growth, together with weak growth prospects, saw consensus expectations of the first UK rate rise move back from May to August 2011 despite high inflation. However, the disparity of expectations on domestic economic growth and inflation encouraged a wide range of views on the timing of the start of increases in Bank Rate in a band from May 2011 through to early 2013. This sharp disparity was also seen in MPC voting which, by year-end, had three members voting for a rise while others preferred to continue maintaining rates at ultra low levels.

1.5.7 Risk premiums were also a constant factor in raising money market deposit rates beyond 3 months. Although market sentiment has improved, continued Euro zone concerns, and the significant funding issues still faced by many financial institutions, mean that investors remain cautious of longer-term commitment. The European Commission did try to address market concerns through a stress test of major financial institutions in July 2010. Although only a small minority of banks "failed" the test, investors were sceptical as to the robustness of the tests, as they also are over further tests now taking place with results due in mid-2011.

1.6 Investment rates in 2010/11

1.6.1 The tight monetary conditions following the 2008 financial crisis continued through 2010/11 with little material movement in the shorter term deposit rates. Bank Rate remained at its historical low of 0.5% throughout the year, although growing market expectations of the imminence of the start of monetary tightening saw 6 and 12 month rates picking up.

1.6.2 Overlaying the relatively poor investment returns was the continued counterparty concerns, most evident in the Euro zone sovereign debt crisis which resulted in rescue packages for Greece, Ireland and latterly Portugal. Concerns extended to the European banking industry with an initial stress testing of banks failing to calm counterparty fears, resulting in a second round of testing currently in train. This highlighted the ongoing need for caution in treasury investment activity.



1.7 Borrowing outturn for 2010/11

1.7.1 The Annual Investment Strategy permits borrowing to support cash flow needs and thus ensure sufficient liquidity is maintained at all times to meet payment obligations. Borrowing within the authorised limit of £5m could be undertaken on a short term basis via a temporary extension to our overdraft limit. However, throughout 2010/11 no borrowing was required.

1.8 Compliance with treasury limits and prudential indicators

1.8.1 Throughout the financial year the Council operated within the treasury limits and prudential indicators set out in the Council's Treasury Management and Annual Investment Strategy. These and other prudential indicators relevant to this report are shown at **[Appendix 1]**.

1.9 Investment outturn for 2010/11

Investment policy

1.9.1 The Council's investment policy is governed by CLG guidance, which has been implemented in the Annual Investment Strategy approved by Council. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies including use of rating outlooks and rating watches. In addition, the assessment of counterparty credit worthiness incorporates market data derived from credit default swaps.

Internally managed Investments

1.9.2 The Council manages its short term cash flow surpluses and a small proportion of core fund investments in-house. Throughout 2010/11 new investments were only placed with those institutions listed on the Council's approved lending list and in full compliance with approved counterparty, group, sovereign and durational limits.

1.9.3 A significant proportion of our daily cash flow balances are required to satisfy regular monthly payment needs (NNDR to government, precepts, housing benefit, staff and general creditors) and as a consequence are invested in bank reserve accounts and money market funds which allow funds to be recalled at short notice. The opportunity was taken, when surpluses permitted, to undertake a series of 6 and 9 month fixed term investments using surplus cash flows.

1.9.4 A major contribution to In-house investment performance came from two core fund investments with Barclays and Nationwide. In accordance with the 2010/11 Annual Investment Strategy the Barclays investment was transferred to the external fund manager upon maturity. Throughout most of 2010/11 the time to maturity for the Nationwide investment exceeded the duration rating which would have been applicable in respect of any new investment with them. Members of the Finance and Property Advisory Board (26 May 2010) and Audit Committee (21 June 2010) endorsed the decision by officers not to call for early repayment.

1.9.5 Returns achieved on internally managed cash flow and core fund investments significantly bettered the 7 day LIBID target rate of 0.52% by 0.37% and 5.9% respectively. Detailed performance figures are provided at paragraph 1.9.9.

Externally managed Investments

1.9.6 The substantive share of the Council's core fund is managed externally by Investec Asset Management Ltd. In anticipation of a Bank Rate rise part way through 2010/11 the Fund Manager's initial stance was to keep duration short. Duration was extended as the year unfolded in line with revised Bank Rate expectations. As a consequence yields improved as the year progressed and were bolstered further by opportunistic gilt trades during the summer. Despite a difficult year for fund managers generally, returns for the year as a whole are in line with Investec's average long term performance.

1.9.7 The gross return for the year exceeded the 7 day LIBID benchmark of 0.52% by 0.50%. Detailed performance figures are provided at paragraph 1.9.9.

1.9.8 In addition to a fund management agreement the Fund Manager participates in the review of our annual strategy and is required to observe its detailed requirements. The strategy aims to protect the Council's funds by adopting a diversification policy which covers counterparties, groups of related counterparties and sovereign limits. The strategy also specifies approved investment instruments and associated durational limits. On a limited number of occasions some of these requirements (counterparty / sovereign and durational limits) were "technically" breached by our external fund manager. Detailed reports were submitted to the Audit Committee responsible for the scrutiny of treasury management activities (reports dated 12 October 2010 and 12 April 2011 refer). The Treasury Management Team is content that no investments were placed with institutions that did not meet the Council's very high credit quality requirements and that at no time were the Council funds at undue risk. Further, none of the issues referred to would be regarded as breaches under the current 2011/12 Annual Investment Strategy.

Investment performance for 2010/11

1.9.9 The actual results for the three parts of our portfolio are summarised in the table below:

	Average investment £m	Income achieved £	Gross rate of return %	Benchmark return %
Internally managed cash flow (excluding Landsbanki)	12.7	113,050	0.89	0.52
Internally managed core funds	3.3	208,900	6.42	0.52
Externally managed core funds (excluding year end valuation gains / losses)	18.3	187,600	1.02	0.52

1.9.10 Total investment income of £509,550 compares well against the revised estimate of £491,400.

1.9.11 The Council's year end financial statement incorporates adjustments to the figures quoted above to reflect notional interest on the defaulted Landsbanki investment (£45,000) and unrealised gains / losses arising on year end valuation of the externally managed portfolio (£33,300). These two adjustments raise the overall level of investment income reported in our final accounts and revenue outturn booklet to £587,840. This is only £12,810 lower that the original estimate for 2010/11 of £600,650. The original estimate was established using forecasts, which in common with most predictions, anticipated a rise in the Bank Rate part way through the financial year. Given that emergency rates (0.5%) prevailed throughout 2010/11 and continue at the time of writing, the end result is a pleasing one.

1.10 Icelandic investment

1.10.1 The Council invested £1m in a 3 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 which should aid recovery of a high proportion of the £1m deposit. The other parties involved in the case have appealed against the ruling of the Icelandic District Court and as a consequence the judgement is to be referred to the Icelandic Supreme Court. Members will be updated as new information becomes available.

1.10.2 Legal costs incurred by the Council since the commencement of the joint action to 31 March 2011 total £6,726. Participation in the joint action is considered the most effective way of recovering our deposit and represents good value for money.