TONBRIDGE & MALLING BOROUGH COUNCIL

AUDIT COMMITTEE

9 October 2012

Report of the Director of Finance

Part 1- Public

Matters for Recommendation to Cabinet - Council Decision

1 TREASURY MANAGEMENT MID-YEAR REVIEW 2012-13

This report provides an update on treasury management activity undertaken during the period April to August of the current financial year. The risk parameters contained within the 2012-13 Treasury Management Strategy Statement and Annual Investment Strategy are also examined. Members are invited to endorse the action taken by officers in respect of treasury management activity and to endorse two changes that define the Council's risk appetite.

1.1 Introduction

1.1.1 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by this Council on 18 February 2010.

1.1.2 The primary requirements of the 2009 Code and its subsequent revisions are as follows:

- 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 full Council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy - for the year ahead, a Mid-year Review Report (this report) and an Annual Report (stewardship report) covering activities during 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.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Audit Committee.

1.1.3 This mid-year report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- An economic update and revised interest rate forecast.
- Investment performance for the period April to August of the 2012-13 financial year and the current investment portfolio.
- Borrowing.
- Compliance with Treasury and Prudential Limits for 2012-13.
- A review of the risk parameters contained in the 2012-13 Treasury Management Strategy Statement and Annual Investment Strategy (TMSS & AIS).

1.2 Economic Background

Performance to date

1.2.1 Economic sentiment, in respect of the prospects for the UK economy to recover swiftly from recession, suffered a major blow in August when the Bank of England (BoE) substantially lowered its expectations for the speed of recovery and rate of growth over the coming months and materially amended its forecasts for 2012 and 2013. It was noted that the UK economy is heavily influenced by worldwide economic developments, particularly in the Euro zone, and that on-going negative sentiment in that area would inevitably permeate into the UK's economic performance.

1.2.2 With regard to the Euro zone, investor confidence remains weak because successive "rescue packages" have first raised, and then disappointed, market expectations. However, the uncertainty created by the continuing Euro zone debt crisis is having a major effect in undermining business and consumer confidence not only in Europe and the UK, but also in America and other parts of the world including China.

1.2.3 In the UK, consumer confidence remains very depressed with unemployment concerns, indebtedness and a squeeze on real incomes from high inflation and low pay rises, all taking a toll. Whilst inflation fell in the 12 months to July, UK GDP also fell for the third successive quarter. The UK's recovery from the initial 2008 recession has been the second slowest of any G7 country, the slowest recovery from a recession of any of the five UK recessions since 1930 and total GDP remains 4.5% below its 2008 peak.

1.2.4 This weak recovery has caused social security payments to remain elevated and tax receipts to be depressed. Consequently, the Chancellor's plan to eliminate the annual public sector borrowing deficit has been pushed back further into the future. The Monetary Policy Committee has kept the Bank Rate at 0.5% throughout the period while quantitative easing was increased by £50bn to £375bn in July. In addition, in June, the BoE and the Government announced schemes to free up banking funds for business and consumers.

Outlook for the remainder of 2012-13

1.2.5 The risks in economic forecasts continue unabated from the previous treasury strategy. Concern has been escalating that the Chinese economy is heading for a hard landing and political deadlock in America prevents a positive approach to countering weak growth. In September the Federal Reserve (Fed) announced an aggressive stimulus programme for the economy with a third round of quantitative easing focused on boosting the stubbornly weak growth in job creation. They also announced an increase in interest rates was unlikely before mid 2015.

1.2.6 Euro zone growth will remain weak as austerity programmes in various countries curtail economic recovery. A crunch situation is rapidly developing in Greece as it has failed yet again to achieve deficit reduction targets and so may require yet further support. A financial crisis was also rapidly escalating over the situation in Spain. However, in early September the European Central Bank (ECB) announced that it would purchase unlimited amounts of shorter term bonds of Euro zone countries which have formally agreed the terms for a support package. Importantly, this support would be subject to conditions (which have yet to be set) and include supervision from the International Monetary Fund. The announcement resulted in a surge in confidence that the Euro zone has at last put in place the framework for adequate defences to protect the Euro. The immediate aftermath of this announcement saw a rise in bond yields in safe haven countries, including the UK. Whilst this development is extremely welcome there are political and economic issues which have yet to be resolved. As a consequence, the unsettling effect the Euro zone issue has on the markets is expected to continue for some time.

1.2.7 The BoE Quarterly Inflation Report in August pushed back the timing of the return to trend growth and also lowered its inflation expectations. Nevertheless, concern remains that the Bank's forecasts of a weaker and delayed recovery may still prove to be over optimistic given the world headwinds the UK economy faces. Weak export markets will remain a drag on the economy and consumer expenditure will continue to be depressed due to a focus on paying down debt, negative economic sentiment and job fears. The Coalition Government, meanwhile, is likely to be hampered in promoting growth by the requirement of maintaining austerity measures to tackle the budget deficit.

Sector's interest rate forecast

1.2.8 The current interest rate forecast was updated in August 2012. The first rise in the Bank Rate, which has remained at an emergency level of 0.5% for over three years, is now expected to occur in the final quarter of 2014. This is some 15 months later than predicted when our current TMSS & AIS was approved in February 2012.

1.2.9 Sector, the Council's external treasury advisor, believe the overall balance of risks is weighted to the downside:

- Low growth in the UK is expected to continue, with the Bank Rate unlikely to rise in the next 24 months. This coupled with a possible further extension of quantitative easing will keep investment returns depressed.
- The expected longer run trend for PWLB borrowing rates is for them to eventually rise, primarily due to the need for a high volume of gilt issuance in the UK and the high volume of debt issuance in other major western countries. However, the current safe haven status of the UK may continue for some time, tempering any increases in yield.
- The interest rate forecast is based on an assumption that growth starts to recover in the next three years to a near trend rate of 2.5%. However, if the Euro zone debt crisis worsens as a result of one or more countries having to leave the Euro, or low growth in the UK continues longer, then the Bank Rate is likely to be depressed for even longer than projected below.

Rate	Now %	Sep-2012 %	Dec-2012 %	Mar-2013 %	Jun-2013 %	Sep-2013 %	Dec-2013 %	Mar-2014 %	Jun-2014 %	Sep-2014 %	Dec-2014 %	Mar-2015 %
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00
5yr PWLB	1.63	1.70	1.50	1.50	1.50	1.60	1.70	1.80	1.90	2.00	2.10	2.30
10Yr PWLB	2.65	2.70	2.50	2.50	2.50	2.60	2.70	2.80	2.90	3.00	3.20	3.30
25yr PWLB	3.85	3.90	3.70	3.70	3.70	3.80	3.80	3.90	4.00	4.10	4.20	4.30
50yr PWLB	4.05	4.10	3.90	3.90	3.90	4.00	4.00	4.10	4.20	4.30	4.40	4.50

1.3 Investment Portfolio

1.3.1 In accordance with the CIPFA Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As set out in Section 1.2, it is a very difficult investment market. Yields are very low, in line with the 0.5% Bank Rate, and the continuing Euro zone sovereign debt crisis prompts a low risk and short term strategy. Within this risk adverse environment investment returns will remain low relative to pre 2008 'credit crunch' levels.

1.3.2 A full list of investments held on 31 August 2012 and our Internal Lending List of the same date are shown in **[Annexes 1 and 2]** of this report.

1.3.3 The average level of cash flow funds available for investment purposes to the end of August 2012 was £9.8m. 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. At the end of August the authority held £19.1m 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 a proportion will need to be recalled during the financial year to top up our daily cash balances.

1.3.4 As at the end of August 2012 funds invested and interest earned is set out in the table below:

	Funds invested at 31 Aug 2012 £m	Average duration to maturity Yrs	Gross annualised return to 31 Aug 2012 %	7 day Libid benchmark %	Interest earned to 31 Aug 2012 £
In-house cash flow excluding Landsbanki	9.7	0.13	1.16	0.51	47,100
Externally managed core funds	19.1	0.25	1.32	0.51	106,200
Total	28.8	0.21	1.26	0.51	153,300

1.3.5 The authority out-performed the 7-day LIBID benchmark by 75 basis points.

In-house managed cash flow

1.3.6 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. Thus far in this financial year the following fixed term investments have been made:

£m	Bank/Building Society	Duration	Rate	Period
1.0	Bank of Scotland	12 Months	3.00%	11/04/12 – 11/04/13
1.0	Lloyds TSB	12 Months	3.00%	11/04/12 – 11/04/13

1.3.7 Further fixed term Investments will be undertaken when cash flow surpluses permit.

Externally managed core funds

1.3.8 Our external fund manager is currently performing above the level anticipated in our 2012-13 TMSS & AIS (annualised gross return at the end of August was 1.32% vs an expected 1.25% for the year as a whole).

1.4 Borrowing

1.4.1 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 & AIS. The authority is debt free and uses a combination of reserves and revenue contributions to finance the Capital Plan. Borrowing on a temporary basis using overdraft facilities may be required from time to time to meet liquidity needs. No borrowing was undertaken in the period April 2012 to August 2012.

1.5 Compliance with 2012-13 TMSS and AIS

1.5.1 During the financial year to date the Council has operated within the treasury limits and prudential indicators set out in the 2012-13 TMSS & AIS and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators can be found at **[Annex 3]** to this report.

1.5.2 Throughout the period April 2012 to August 2012 all of the requirements contained in the 2012-13 TMSS & AIS 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 Review of the risk parameters contained within the 2012-13 Treasury Management Strategy Statement and Annual Investment Strategy

1.6.1 Members will recall the detailed consideration that was given to the TMSS & AIS at the January 2012 meeting of the Audit Committee. In response to the downgrading of a significant number of financial institutions by the rating agencies changes were made to our minimum counterparty credit rating and our counterparty, group and sovereign exposure limits. The Council only invests in highly credit rated institutions and requires investments to be diversified across a range of counterparties.

Risk constraints

1.6.2 Exposure to risk is constrained in the 2012-13 TMSS and AIS by the following:

- Counterparties must be regulated by a "AAA" Sovereign as recognised by at least two out of the three main rating agencies (Fitch, Moody's or Standard & Poor's).
- Whilst 100% of funds can be invested in the UK, exposure to non-UK banks is limited to no more than 20% of funds per "AAA" Sovereign.
- Counterparties must have a minimum Fitch rating of: long term A, short term F1, viability bbb- and support 1.
- Exposure to individual counterparties / groups of related counterparty must not exceed 20% of funds.
- Duration of In-house managed investments must not exceed that recommended by Sector's credit worthiness approach (modelling approach which combines the output from all three rating agencies including credit watches / outlooks and Credit Default Swap data).

- Money Market funds should be rated Fitch AAAmmf or equivalent and exposure limited to no more that 20% per fund.

Sovereign credit ratings

1.6.3 The starting point for any investment is to confirm that the sovereign regulating the financial institution that we plan to invest with meets our “AAA” requirement. Over the last 18 months there have been a number of adverse rating notifications issued against the USA, UK and key Euro zone "AAA" rated sovereigns. The USA was actually downgraded from “AAA” to “AA+” with a negative outlook by S&P in August 2011. S&P applied the same rating to France in January 2012. The UK "AAA" rating was given a negative outlook by Moody's in February 2012 and Fitch in March 2012. More recently negative outlooks have been given against Germany, Luxembourg and the Netherlands by Moody's in July 2012.

1.6.4 An update on the rating agency view of the “AAA” sovereigns is provided at **[Annex 4]**. The implications for our internal lending list and, in particular, that of our external fund manager should the negative outlooks be resolved with a downgrade to “AA+” is also detailed in **[Annex 4]**.

1.6.5 The outcome of the negative outlooks will depend on a blend of political and economic factors which will take time to resolve. As a precautionary measure Treasury Management Team believe that investment in UK institutions should be exempt from the “AAA” sovereign requirement. This approach is supported by Sector and a recommendation for its adoption appears at the end of this report.

1.6.6 Our external fund manager is able to access a broad range of counterparties including numerous highly rated foreign banks. Following one or more sovereign downgrades any reduction in our fund manager’s lending list is expected to arise in the 2013-14 financial year. As a consequence, the decision to relax our current “AAA” requirement for non-UK sovereigns can be considered at the January meeting of the Audit Committee when we determine next year’s TMSS & AIS.

UK nationalised and semi-nationalised banks

1.6.7 As a consequence of the increased risks arising from the Euro zone crisis Sector recommend that the duration of an investment with any bank other than a UK nationalised or semi-nationalised bank be limited to no more than three months. Whilst our external fund manager will acquire tradable instruments such as certificates of deposit, In-house investment will typically be fixed term. Fixed term deposits, by their nature, are deemed higher risk and therefore our TMSS & AIS requires all In-house investment to observe Sector’s recommended duration limits.

1.6.8 Sector’s recommended duration limit for the UK nationalised and semi-nationalised banks is one year. This is based on the premise that state involvement, which runs to many £billions, cannot be unwound in the short term and that tax payer’s interest, should the banks experience further difficulty, would be best served by providing the banks with additional state support.

1.6.9 Treasury Management Team are of the opinion that state involvement in the UK nationalised and semi-nationalised banks is such that a higher exposure limit to these institutions can be tolerated and that for these banks the pre 2012-13 TMSS & AIS exposure limit of 25% should be re-introduced. For all other banks the current 20% exposure limit should be retained. This approach is increasingly being adopted by other local authorities, who like ourselves, find their lending lists bereft of UK financial institutions. Again Sector is supportive of this approach and a recommendation for its adoption appears at the end of this report.

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, co-ordinated 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.

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. 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.

1.8 Financial and Value for Money Considerations

1.8.1 Interest earned to the end of August 2012 of £153,300 is better than predicted in our 2012-13 estimates by some £30,000. Market concerns relating to the Euro zone continue and recent initiatives taken by central banks to stimulate economic growth and ease liquidity have resulted in a lowering of interest rates being offered by financial institutions. Enhanced returns for the remainder of the financial year are considered unlikely. However, it is hoped that our revised estimates will incorporate the gains made thus far in the financial year.

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 the end of this 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 August 2012.

2) Exempt investment in the UK from the current "AAA" sovereign requirement.

3) Increase the counterparty / group exposure limit from the current 20% to 25% for the UK nationalised and semi-nationalised banks.

Background papers: contact: Mike Withey

Nil

Sharon Shelton
Director of Finance

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.