St Edmundsbury
BOROUGH COUNCIL

B120

Treasury Management Sub-Committee 19 July 2010

Annual Treasury Management Report 2009/2010 and Investment Activity 1 April to 30 June 2010

1. Introduction

1.1 The Council's treasury management function generates a substantial amount of income and therefore warrants regular Member consideration. To date, treasury management activities have been reported to Cabinet and Council, with no Scrutiny Committee involvement. However, latest guidance from the Chartered Institute of Public Finance and Accountancy (CIPFA), as set out in their 2009 Treasury Management Code of Practice (the Code), requires revised reporting arrangements, which include enhanced scrutiny arrangements. A summary of the key areas covered within the revised Code is provided at Appendix 1. Details of the revised reporting arrangements are provided at Appendix 2.

1.2 The new CIPFA Code was formally adopted by Council on 23 February 2010 (report A513 refers). In order to fulfil the enhanced scrutiny requirements of the Code it was resolved that a Treasury Management Sub-Committee of the Performance and Audit Scrutiny Committee be established. The Committee's terms of reference, membership and meeting arrangements were approved by the Performance and Audit Scrutiny Committee on 26 April 2010 (paper A637 refers), details of which are provided at Appendix 3. This is the inaugural meeting of that sub-committee.

2. Purpose of this Report

2.1 The purpose of this report is to:

a. Present the Annual Treasury Management Investment Report summarising the investment activities for the year 2009/10, and

b. Provide a summary of investment activity for the first three months of the 2010/11 financial year.

2.2 The Sub-Committee are asked to scrutinise the content of these reports and to make recommendations via the Performance and Audit Scrutiny Committee to Cabinet and Council, as appropriate.

3. Annual Report 2009/10

3.1 The Council's Treasury Management Annual Report for 2009/10 is attached at Appendix 4.

3.2 The total amount invested at 1 April 2009 was £46.55m and at 31 March 2010 £35.15m. The reduction in investment balances was due primarily to the net effect of the Council's capital expenditure and asset disposals programmes.

3.3 Despite the credit crunch and international banking crisis, the Council's treasury management activities during 2009/10 continued to exceed budgeted rates of return on investments. The Annual Treasury Management and Investment Strategy for 2009/10 (approved by Council on 24 February 2009 – paper Z517 refers) set out the Council's projections for the financial year, which were based upon interest rate forecasts provided by a range of market analysts and the advice of the Council's treasury management advisors - Sector Treasury Services Ltd (Sector). The budgeted income from investments in 2009/10 was £0.751m, equivalent to £19.87 for each Council Tax Band D property. As at 31 March 2010, interest earned amounted to £1.097m (equivalent to £29.03 for each Council Tax Band D property); a surplus of £0.346m. The reasons for the surplus over budget were due primarily to achieving a higher average rate of interest than anticipated together with slippage in the capital programme. The average rate of return on investments for the year was 2.32% compared to a target rate for the year of 2.20%. The actual level of capital expenditure during the year was £15.546m compared to an original budget of £25.388m.

3.4 Given the significant sums that are invested and the amount of interest earned, fluctuations in interest rates and in levels of planned capital expenditure and receipts have a major impact on the budget. The establishment of the Interest Equalisation Reserve (as agreed by Council in February 2005) is designed to assist in smoothing out the year-on-year impact of variations in planned investment returns, the idea being that budgetary surpluses in investment returns in one year can be used to help fund budgetary deficits in another. As at 31 March 2010 the balance on this reserve was £0.788m. In view of the comparatively healthy position of this reserve, the majority of the budgetary surplus for the year (ie £0.340m of the £0.346m surplus) was credited to the Council's general reserves to be used to support future years council tax levels. The remaining balance (£0.006m) was credited to other earmarked reserves to reflect gains attributable to the investment of these balances.

4. Investment Activity: 1 April 2010 to 30 June 2010

4.1 The total amount invested at 1 April 2010 was £35.15m and at 30 June 2010 £38.65m. The increase in balances over this period was due primarily to timing differences in respect of the collection of local taxes (Council Tax and Non Domestic Rates) and the payment of precepts (ie to Suffolk County Council, Suffolk Police and central government).

4.2 The 2010/11 Annual Treasury Management and Investment Strategy (approved by Council on 23 February 2010 – paper A513 refers) set out the Council's projections for the current financial year. The budget for investment income in 2010/11 is £0.566m, equivalent to £14.91 for each Council Tax Band D property. This represented a target rate of return on investments of 1.50%.

4.3 As at the end of June 2010 interest actually earned during the first quarter of the financial year amounted to £0.126m against the profiled budget for the period of £0.155m, a budgetary deficit of £0.029m. The under achievement of interest on investments during this period was due primarily to lower than expected interest rates. In the three month period covered by this report, the average rate of interest achieved was 1.25% against the target rate of 1.5%. This reflects the maturity of the Council's remaining higher yield longer term investments during the final quarter of 2009/10, including investments totalling £10m with the Royal Bank of Scotland, which exercised its right to repay monies prior to the full term of the investments. It also reflects the continued difficulties being experienced in finding attractive rates of interest with financial institutions that can deliver the required level of security.

4.4 Due to continuing concerns about the economic recession, Sector are currently predicting that the Bank of England's Monetary Policy Committee will hold bank base rates at their current historic low of 0.5% through to the end of the 2010/11 financial year. This situation is compounded by measures taken over the past year, on the recommendations of Sector, to ensure the security of funds during this volatile period by the tightening of the Council's credit criteria. This has had the effect of significantly restricting the number of organisations with which the Council can place funds and considerably reduced the approved duration of investments (ie very few organisations are now cleared for investments greater than one year, with most being restricted to period between 3 and 12 months). Placing funds with a smaller number of higher rated organisations and for shorter fixed term durations, has served to further reduce the rates that can be achieved on new Council investments. As a result, most new investments are now being made at rates below the average target rate for the year.

4.5 It is apparent therefore that in the short term, as more of the fixed term investments reach maturity, the average return on the Council's portfolio of investments may continue to reduce. This trend is likely to continue until such time as either general interest rates begin to climb, or our treasury management advisors are able to recommend a relaxation of the current stringent credit

criteria. If there is no improvement in interest rates that can be accessed by the treasury management team within the next 9 months, then the budgeted income from investments for 2010/11 may not be achieved. In this situation, any shortfall in budgeted income will be met from the interest equalisation reserve. Treasury management performance will continue to be closely monitored with quarterly performance reports being brought to this sub committee for scrutiny.

Appendix 1

Key Requirements the revised CIPFA Treasury Management Code of Practice 2009

The revised Code has emphasised a number of key areas of treasury management including the following: -

a) All councils must formally adopt the revised Code and associated clauses (for inclusion in the Council's Constitution).
b) The Council's Annual Treasury Management Strategy Report will affirm that the effective management and control of risk are prime objectives of the Council's treasury management activities.
c) The Council's appetite for risk must be clearly identified within the strategy report and will affirm that priority is given to security of capital and liquidity when investing funds and explain how that will be carried out.
d) Responsibility for risk management and control lies within the organisation and cannot be delegated to any outside organisation.
e) Credit ratings should only be used as a starting point when considering risk. Use should also be made of market data and information, the quality financial press, information on government support for banks and the credit ratings of that government support.
f) Councils need a sound diversification policy with high credit quality counterparties and should consider setting country, sector and group limits.
g) Borrowing in advance of need is only to be permissible when there is a clear business case for doing so and only for the current capital programme or to finance future debt maturities.
h) The main annual treasury management reports must be approved by Council.
i) There needs to be, at a minimum, a mid year review of treasury management strategy and performance. This is intended to highlight any areas of concern that have arisen since the original strategy was approved.
j) Each council must delegate the role of scrutiny of treasury management strategy and policies to a specific named body.
k) Treasury management performance and policy setting should be subjected to prior scrutiny.
l) Members should be provided with access to relevant training.
m) Those charged with governance are also personally responsible for ensuring they have the necessary skills and training.
n) Responsibility for these activities must be clearly defined within the organisation.
o) Officers involved in treasury management must be explicitly required to follow treasury management policies and procedures when making investment and borrowing decisions on behalf of the Council (this will form part of the updated Treasury Management Practices).

Appendix 2

CIPFA Code: Revised Reporting Arrangements

The below table provides a summary of the current and new reporting arrangements as required by the revised CIPFA Code:

Current Reporting Arrangements	Future Reporting Arrangements (from 2010/11)
Cabinet / Council: • Revised Code and TM Policy (as required) • Annual Treasury Management and Investment Strategy (prior to start of financial year)	**Cabinet / Council:** • Adopting of revised Code and TM Policy (as required) • Annual Treasury Management and Investment Strategy (prior to start of financial year) • Mid year treasury management review (new report) • Annual outturn report
Cabinet only: • Quarterly treasury management performance reports • Annual outturn report (annually after year end)	**Cabinet only:**
Treasury Management Sub-Committee:	**Treasury Management Sub-Committee:** • Adoption of revised Code and TM Policy (as required) • Quarterly treasury management performance reports • Annual Treasury Management and Investment Strategy • Mid year treasury management review • Annual outturn report

Appendix 3

Treasury Management Sub-Committee – Terms of Reference and Meeting Arrangements

Terms of Reference

The primary role of the Treasury Management Sub-Committee is to fulfil the enhanced monitoring and scrutiny requirements of the revised CIPFA Code. The Sub-Committee receives and scrutinises quarterly treasury management strategy, performance and monitoring reports, and make recommendations to Cabinet and Council, as appropriate. Specifically the Sub-Committee is responsible for the scrutiny of:

- the Council's responses to changes in statutory and regulatory requirements and guidance,
- the Annual Treasury Management and Investment Strategy,
- on-going revisions to treasury management strategies and policies,
- the mid year treasury management review,
- quarterly reports on treasury management performance,
- the annual report on treasury management performance, including the effects of the decisions taken and the transactions executed in the past year, and on the circumstances of any non-compliance with the organisations treasury management policy statements.

Membership and Meeting Arrangements

- The Sub-Committee will comprise up to 3 Members of the Performance and Audit Scrutiny Committee, together with one non-voting invitee (normally the responsible portfolio holder),
- The Sub-Committee will be appointed annually by the Performance and Audit Scrutiny Committee, and will appoint its own Chairman,
- The Sub-Committee will meet at least three times each year in accordance with a schedule of ordinary meetings approved by the Council, although meetings may be cancelled due to lack of business. Special meetings of the committee may also be called as necessary,
- In order to help streamline the comprehensive treasury management reporting requirements of the CIPFA Code, where possible meetings will be held to coincide with existing reporting requirements.

Appendix 4

Annual Treasury Report 2009/2010

1 Introduction

1.1 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009 (the Code) was adopted by Council on 23 February 2010.

1.2 The primary requirements of the Code are as follows:

a. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
b. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
c. Receipt by Council of an Annual Treasury Management Strategy Report for the year ahead, a mid year review report (as a minimum) and an annual review report of the previous year.
d. 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.
e. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body which in this Council is the Treasury Management Sub-Committee.

1.3 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.'

1.4 The purpose of this report is to meet one of the above requirements of the CIPFA Code, namely the annual review report of treasury management activities, for the financial year 2009/10.

2 The Council's Debt Free Status

2.1 The Council became debt free in 1992 and since then has refrained from any borrowing apart from the temporary use of overdraft facilities. This was continued in 2009/10 with the result that the Council had no Prudential Code indicators so far as borrowing was concerned in the year. During the financial year all the Council's investments were managed by in-house staff.

3 Investment Strategy for 2009/10

3.1 The Council's Annual Treasury Management and Investment Strategy was approved by Full Council on 24 February 2009 (report Z517 refers). The investment priorities for 2009/10 were to give priority to the security and liquidity of investments whilst at the same time seeking to optimise the return on investments.

3.2 The target rate of return for investments for 2009/10 was 2.2%. This target rate was based upon investment rate projections for the year provided by Sector (the Council's treasury management advisors), together with consideration of the profile of the Council's portfolio of investments (i.e. mixture of liquid and fixed term investments). Based upon the anticipated funds available for investment in the year (taking into account planned capital expenditure and receipts from asset disposals) this gave a target investment income of £0.751m, equivalent to £19.87 for each Council Tax band D property. This figure was used in the preparation of the Council's budget for 2009/10.

3.3 At the time when the strategy was set, Sector was predicting a fall in the base rate to 0.5%, staying at this historic low level throughout the financial year. In view of this outlook for interest rates, investments were to be made with reference to cash flow requirements during the year (including the need to fund the Council's substantial capital programme expenditure plans) and also to take advantage of opportunities to invest for longer periods in order to provide certainty of investment income from a proportion of the Council's investments and maintain overall returns at the target level.

3.4 The major issue for treasury management in 2009/10 has been the unprecedented fall in the bank base rate and the disappearance during the year of the margins over more normal investment rates caused by the credit crunch and the Bank of England's quantitative easing operations (which had the desired effect of easing the supply and cost of credit in the economy). A further theme, necessitated by the banking crisis and the collapse of the Icelandic banks, has been the increased emphasis on managing credit risk by giving heightened preference to security and liquidity at a time when the world banking system was still under stress. The need to ensure security and liquidity of funds during this difficult period was further reinforced later in 2009 with the issue of CIPFA and statutory guidance on investing.

Changes in Lending Criteria

3.5 The Council's Annual Treasury Management and Investment Strategy requires that deposits are only placed with a limited number of high quality banks and building societies whose credit rating is independently assessed as sufficiently secure by the Council's treasury advisers (Sector) or, for non rated building societies, subject to their meeting minimum financial criteria (based on asset base size).

3.6 The unprecedented nature of the current banking crisis forced all local authorities to actively review their lending criteria (ie their approach to assessing the credit-worthiness of banks and financial institutions together with the maximum duration and value of investments).

3.7 The Council's original lending criteria for 2009/10 was set out in the Annual Treasury Management and Investment Strategy 2009/10 which was approved by the Cabinet on 11 February 2009 (paper Z517 refers). The criteria were subject to two formal reviews by the Council's Cabinet during the year; in July 2009 (paper A145 refers) and October 2009 (paperA252 refers). The reviews resulted in a significant tightening of the Council's credit worthiness criteria (thereby reducing the number of organisations with which the Council can place investments) together with substantial reductions in the duration and value of investments that can be held with individual institutions (in order to limit and spread credit risk). This resulted in more of the investment portfolio being moved into investment instruments with lower rates of return but higher security and liquidity.

3.8 The below tables shows the credit criteria applicable at the 1 April 2009 and 31 March 2010:

Credit Criteria: Rated Banks and Institutions

Sector Colour Code Key*	Credit Criteria 1/4/09	Credit Criteria 1/4/10
Purple	£10m for max 5 years	Max 20% portfolio (approx £9m) for max 2 years
Orange	£10m for max 2 years	£6m for max 1 year
Red	£10m for max 1 year	£5m for max 6 months
Green	£5m for max 3 months	£3m for max 2 months
Blue (nationalised / substantially owned by the UK government)	n/a	£9m for max 2 years

Credit Criteria: Rated Building Societies

Sector Colour Code Key*	Credit Criteria 1/4/09	Credit Criteria 1/4/10
Red	£10m for max 5 years	£5m for max 6 months
Green	£5m for max 5 years	£3m for max 2 months

Credit Criteria: Non- Rated Building Societies

Asset Base**	Credit Criteria 1/4/09	Credit Criteria 1/4/10
Asset base > £2,500m	£5m for max 3 years	£3m for max 6 months
Asset base > £1,000m	£5m for max 3 years	£2.5m for max 6 months

* In order to simplify the complex system of commercial credit ratings, Sector has developed a system of colour codings which reflect the relative strengths of individual banking institutions. Details of these colour codings are provided in the Council's Annual Treasury Management and Investment Strategy.
** Further restrictions on non-rated building societies include a requirement for societies to be covered by the Government's banking support package.

4 Compliance with Treasury Limits

4.1 During the financial year the Council operated within the Treasury limits and Prudential Indicators set out in the Council's Treasury Policy Statement and Annual Treasury Strategy Statement. In addition no institutions in which investments were made had any difficulty in repaying investments and interest in full during the year.

5 Investment Outturn 2009/10

5.1 Investments were made with counterparties that met the agreed lending criteria and investment periods. Investment periods range from overnight to two years (one year for new investments), dependent on the Council's cash flows, the view on interest rates and the actual interest rates on offer.

5.2 Market investments in the year are summarised as follows:

	Number	Value (£m)
Opening balance 1st April 2009	32	46.55
Add: Investments made during the year	97*	97.30
Sub Total		143.85
Investments realised during the year	97**	108.70
Balance at 31st March 2010	32	35.15

* Includes 17 investments into Business Reserve Accounts
** Includes 16 withdrawals from Business Reserve Accounts

5.3 Where possible, investments were made in fixed term investments in order to lock into interest rates which exceed the Council's budgeted rate and to provide some certainty of return for a proportion of the Council's investments.

5.4 As at 1st April 2009 the Council held callable deposits totalling £10m, the longest of which could run to March 2011, with interest rates varying from 3.40% to 4.85%. However, all these higher yielding longer term deposits were repaid to the Council during the final quarter of 2009/10 as the relevant financial institutions exercised their right to repay funds before the expiry of the full investment return.

5.5. During the year, for cash flow generated balances, use was made of the instant access and 30 day notice business reserve accounts with Santander UK, Clydesdale Bank and the Bank of Scotland. At 31st March 2010, in order to maintain liquidity whilst at the same time achieving earnings in excess of base rate, £6.65m was held in these accounts at interest rates between 0.50% and 0.85%.

5.6 At the financial year end the balance of the portfolio, £28.5m, was held in 29 separate investments maturing before the end of March 2011, in rates varying from 0.84% to 2.70%.

5.7 The average daily investment for the year was £47.28m and ranged from a high of £53.40m in November 2009 to a low of £35.15m in March 2010.

5.8 The total interest earned in 2009/10 from the Council's investments amounted to £1.097m against a budget of £0.751m, an excess of £0.346m. Overall this is a return in the period of 2.32% compared to the original target of 2.20%. This level of interest represents an income per Council Tax Band D equivalent property of £29.03 in 2009/10 compared to a budgeted income of £19.87.

6 The Economy and Interest Rates in 2009/10

6.1 Sector Treasury Services Ltd has provided the following commentary on the performance of the economy and interest rates in 2009/10:

Financial Commentary 2009/10

6.2 2008 was a momentous year when one financial institution after another in America either collapsed or was taken over in the wake of the credit crunch, culminating in the catastrophic failure of Lehman's Brothers in September 2008 which then triggered in October the collapse of the Icelandic banks and the near collapse of three major UK banks. These three banks then needed another round of major Government support in January 2009. This prolonged financial shock to the core of the world's financial systems caused a worldwide recession to gather in pace and intensity during 2009/10 which dragged the UK economy down into its deepest and longest recession for many years.

6.3 During the autumn of 2008, the Monetary Policy Committee (MPC) had been preoccupied with the alarming escalation of the rate of inflation propelled by earlier increases in the price of oil, commodities and energy. Inflation peaked in September 2008 on CPI at 5.2%, way over the target rate of 2%. However, the

MPC soon had to radically change course as it became ever clearer that inflation would rapidly decline as the credit crunch would plunge world economies into a major recession. An unprecedented cut of 1.5% in Bank Rate in November 2008 was followed by a 1% cut in December 2008 to 2.0% and then further cuts of 0.5% each month until 0.5% was reached in March 2009.

6.4 The 2009/10 financial year started with markets still badly disrupted, the real economy suffering from a lack of credit, short to medium term interest rates at record lows and a great deal of anxiety as to how or when recovery would take place.

6.5 However, even the precipitous slashing of Bank Rate before the beginning of the year was unable to make much impact on the rate at which the economy was falling headlong into recession. Consequently, in March 2009 the MPC resorted to starting a programme of quantitative easing to pump liquidity into the economy in order to stimulate growth, by purchasing gilts and corporate bonds; this had the effect of boosting their prices and therefore reducing yields, so also lowering borrowing costs for both the corporate and public sectors. This programme of quantitative easing was progressively expanded during 2009 until it reached a total of £200bn of purchases in November. For the rest of the financial year, the MPC adopted a cautious approach of leaving further quantitative easing on hold in case growth in the economy needed further support. It was notable that the increase in money supply in the economy generated by this programme brought the credit crunch induced spread between Bank Rate and 3 month LIBID (investment rate that depositors could earn) down from 0.95% at the beginning of the financial year to zero during August 2009. Bank Rate itself remained unchanged at 0.5% all year.

6.6 The dominant focus in 2009/10 was on quarterly GDP growth figures. The recession in the UK bottomed out in quarter 1 of 2009. There was major disappointment that the end of the recession failed to materialise in Q3 2009 and the first figure issued for Q4 2009 was a further huge disappointment at only +0.1%. However, subsequent revisions saw that revised upwards to first +0.3% and then +0.4%.

6.7 Inflation has not been a major concern of the MPC during the year as it fell back below the 2% target level from June to November. However, it did spike upwards to reach 3.5% on the back of the unwinding of the temporary cut in VAT to 15% on 1 January 2010. This was not seen as a cause for alarm as this spike would fall out of the inflation index after one year and inflation was forecast by the Bank of England to fall back below target by the end of 2010 and to stay below 2% during 2011 and 2012 due to the large amount of surplus capacity in the economy which would keep wage inflation well damped down.

6.8 The year was marked by a tussle between two opposing outlooks in the financial markets. The pessimists expect weak UK growth, or even a double-dip recession, to depress economic activity and hence corporate profits and share

prices, so causing gilt prices to rise and long term gilt yields and PWLB borrowing rates to therefore linger at historically low levels for a prolonged period.

6.9 On the other hand, the optimists expect a lively return to growth in the UK led by a rebalancing of the economy resulting from increased exports driven by rapid recovery in the US, EU and the rest of the world. This would boost corporate profits and share prices and so depress gilt prices, hence causing long term gilt yields to rise to much higher levels which would then be under pinned by major concerns about the total level of debt issuance by the Government to finance the annual deficit. Accordingly, there have been fluctuations in rates during the year as first one camp and then the other gained ascendancy.

6.10 The financial year ended with markets gradually gaining in confidence and optimism that the economy was indeed on the path to recovery, although it appeared to be fragile, and with some residual risk that there could still be a double-dip recession. This optimism was further enhanced by a return to strong economic growth in the US towards the end of 2009. The year also saw a major resurgence in share prices in the US, UK and Europe from a very depressed level in March 2009 on the back of this rise in optimism.

6.11 There were concerns in the US and UK that consumers would be reluctant to spend as they would be focusing on reducing their bloated levels of debt and would struggle to pay mortgages when they end their short term discounted rates at a time when switching mortgages to cheaper rates is still not a readily available option. Consumers were also mindful of the increases in taxation coming up and the threat to jobs from impending public sector reductions in expenditure. The UK needs to see strong growth in the EU, its major trading partner, in order for the UK economy to rebalance its economy towards export led growth. However, the continuing reluctance of EU consumers to spend leaves an uncomfortable question mark in this area.

6.12 On the positive side, the supply of credit had improved considerably during the year and the credit crunch induced spread between Bank Rate and 3 month LIBID had evaporated. The equity market ended in buoyant mode with shares being at their highest level for nearly two years. The reverse side of this coin though was that gilt prices had fallen and long term yields (and so PWLB long term borrowing rates) were getting near to their peak for the year. The bond markets ended the year with chronic fears about a possible Greek government debt default and commentators were remarking that both Greece and the UK were running similar size annual deficits as a percentage of GDP (expected to be over 12%). However, the UK was in a much stronger position than Greece e.g. due to its much lower level of total debt. However, there were frequent comments from credit rating agencies around a possible threat that the UK government could lose its AAA credit rating if after the general election there was not a credible plan for how the promised reductions in the annual budget deficit would actually be achieved.