

Treasury Management – Mid-Year Report 2010/11	Agenda No: 13
<p>Corporate Priority: We deliver excellent, cost effective and valued services Report presented by: Financial Services Manager Report prepared by: Phil Myers</p>	
<p>Background Papers: Treasury Management Strategy 2010/11 – 2013/14 approved by Council in February 2010</p>	Public
<p>Options:</p>	<p>Key Decision: NO</p>
<p>Executive Summary: Attached is the Mid-Year Treasury Management Report 2010/11 intended for Full Council, prepared in accordance with best practice requirements for the treasury management function. As part of its role in maintaining scrutiny of this function, Audit Committee are being presented with a draft for their consideration and, if necessary, to comment and/ or recommend any changes.</p> <p>The final report to Council will be accompanied with the latest Treasury Management Monthly Monitor (current version is contained under the Key Financial Indicators report separately on this agenda).</p> <p>The economic outlook remains relatively fragile with recovery slow leading to a prolonged period of low interest rates. Whilst concerns over sovereign ratings have receded, there are still worries over the state of some European nations and risks of contagion to other countries. In light of this, interest rate projections will need to be revised for the Councils financial planning.</p> <p>There is no change in strategy regarding borrowing for capital purposes. Investments have been concentrated over a small range of highly rated institutions, particularly those with high expectation of government support. Tightening of lending has been made with Santander UK in response to worsening economic conditions in Spain. New money market funds have been established to add diversity and to replace a facility previously used with Goldman Sachs following the negative publicity this institution has been receiving (rather than over concerns for security of funds). A greater use of the Debt Management Office (direct with UK Government) has been necessary in the first half of the year due to limits being reached with other counterparties. A rolling programme of one year deposits have been made to counter the low interest rates</p> <p>The mid-year report proposes a change to the criteria used for determining a “highly credit rated” bank/ building society for investment purposes. In essence this is a technical change which fulfils the requirements of the latest Treasury Management Code of Practice issued by the Chartered Institute for Public Finance & Accountancy (CIPFA)</p>	

and is not intended to change the current list of institutions deemed suitable for investment purposes.

Cash available for investment is expected to reduce from that previously assumed over the medium term due to capital commitments made relating to Causeway House, Witham Leisure Centre, and acquisition of Whitehorse Lane car park. Again, this change will need to be reflected in the updated financial plans for the authority.

To date the Council has recovered a total of £462,984 of principal and interest from monies held with Kaupthing Singer & Friedlander. The estimated total recovery still remains between 65p and 78p in the pound. Regarding Landsbanki and Glitnir, matters are progressing towards Icelandic court hearings to determine whether UK local authority deposits rank as priority claims under any distribution. The legal action is being taken jointly with all other UK local authority creditors and costs shared accordingly.

The Council has resisted offers to transfer the Council's claims in the administration of the Icelandic banks. This position has been taken on the basis that it is believed higher recovery is possible through the actions currently being pursued through the current legal processes. In the event that this position changes delegated authority is requested for the Corporate Director for Finance, in conjunction with the Cabinet Member for Efficiency & Resources (and where appropriate the Council's Monitoring Officer) to take whatever action is necessary to protect and maximise the recovery of sums at risk.

It can be confirmed that there have been no breaches of prudential limits approved by Council nor is it anticipated that limits will be exceeded over the remainder of the year.

The latest budget projection indicates a shortfall in interest receivable against budget of £241,000, of which £173,000 is borne by the General Fund and the balance charged against Housing Revenue Account balances. It is anticipated that most of the General Fund shortfall will be offset by a drawdown from the treasury management reserve.

Regular reporting on treasury management is in place and an additional report has been made to Overview & Scrutiny updating the committee on matters concerning the investments at risk. Currently benchmarking information is being developed by the Council's external treasury advisors which when available will be incorporated into the regular reporting processes.

Decision:

1. To recommend to Council the Mid-Year Treasury Management Report for 2010/11
2. To support the recommendations to Council to:
 - Revise the Council's minimum long-term credit rating criteria applied to banks/ building societies used for investment purposes to at least A+ (changed from AA-) and to apply a lowest common denominator approach where ratings are provided by all three leading credit rating agencies (Fitch, Moody's and Standard & Poor's).

To give delegated authority to the Corporate Director for Finance, in conjunction with the Cabinet Member for Efficiency & Resources (and where appropriate the Monitoring Officer for the Council) to take whatever action is necessary in order to protect and maximise the Council's recovery of sums at risk with the Icelandic banks.

Purpose of Decision:

The purpose of the decisions are:

1. To demonstrate scrutiny by the Audit Committee of the treasury management

- function prior to reporting to Council
2. To bring the Council's credit criteria into line with the approach recommended by the CIPFA without altering the Council's current approach to selecting investment counterparties.
 3. To provide appropriate delegated authority in order that prompt action can be taken concerning the investments at risk with Icelandic banks to protect and maximise the amounts recoverable, including decisions on litigation and transfer of claims to a third party.

Any Corporate implications in relation to the following should be explained in detail	
Financial:	<p>Changes to financial assumptions regarding investments will be addressed in updates to the Council's medium term financial plans.</p> <p>Decisions taken over investments at risk with Icelandic banks could impact on the amounts finally recovered. Latest estimates of recovery levels are set out in the report; however, these are subject to legal process and complex financial matters that could alter the amounts significantly.</p>
Legal:	The Council is currently party to joint legal action being taken in the Icelandic courts over securing priority status of UK local authority deposits. The Council's Monitoring Officer is party to the confidential legal privilege assigned to these matters and is therefore able to advise the Council accordingly.
Equalities/Diversity	N/a
Customer Impact:	N/a
Environment and Climate Change:	N/a
Consultation/Community Engagement:	N/a
Risks:	The Treasury Management Policies and Practices, and Procedures are intended to manage the inherent risks within the treasury management function. Specific risks relating to the recovery of sums from investments at risk with Icelandic banks are set out in the report.
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Mid-Year Treasury Management Report 2010/11

Background

The treasury management service is an important part of the overall financial management of the Council's affairs, including the effective funding of the council's capital programme decisions. There are specific treasury prudential indicators covering this area of activity.

The Council's treasury activities are strictly regulated by statutory requirements and by the Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes (the Code) issued by the Chartered Institute of Public Finance & Accountancy (CIPFA).

One of the key recommendations of the Code is that, along with an annual strategy report, considered prior to commencement of the financial year, and annual report issued after the financial year-end, the Council should receive a mid-year report to update them on treasury management matters.

The current treasury management strategy was approved by Council at its meeting in February 2010, as part of the annual budget and council tax setting.

Treasury Management Policy

Policy Statement:

The Council defines its treasury management activities as:

“the management of the Council's investments and 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.”

The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of its treasury management activities will focus on their risk implications for the Council.

The Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance management techniques, within the context of effective risk management.

Current Treasury Position

Attached¹ to this report is a copy of the latest in-year treasury management report which is prepared monthly for Finance Management and the Cabinet Member for Efficiency & Resources (and his deputies), and submitted to the Audit Committee as part of its regular monitoring of a range of Key Financial Indicators.

Economic Outlook and Interest Rates

Since the treasury strategy was considered in February the UK has continued to emerge from recession albeit the pace is slow. Inflation has declined, although it still

¹ Attached for Council only as already included on separate agenda item for Audit Committee

remains at a level above the official target. In the coming month's higher food and fuel prices, along with the planned increase in VAT to 20% from January, raise the risk that we may not see inflation fall much more until 2011 and that it remains above target for longer than expected. The Bank of England has maintained the Bank Rate at 0.5% and continues its programme of quantitative easing. The formation of a coalition government has addressed the uncertainty of a hung parliament and the new government's Emergency Budget has set in motion the austerity measures designed to tackle the UK's budget deficit through a combination of spending cuts and increases in tax.

Internationally, the US Federal Reserve has kept rates on hold following signs of a slowdown in American growth. The European Central Bank has maintained its low stance on interest rates. On-going concerns exist over sovereign weakness in the 'PIIGS' nations (Portugal, Italy, Ireland, Greece and Spain) and exposure of the continent's banking sector to the sovereign and corporate debt of these nations and the risks of contagion extending to other countries.

Results of recent EU Bank Stress Tests brought some comfort with the majority of banks successfully passing the adverse scenario tests (those failing were 2 Greek, 1 German, and 4 Spanish "caja" banks). However, whilst seen as a helpful step forward, there were some doubts as to whether the tests imposed were far-reaching or demanding enough.

Against this backdrop the outlook remains as follows:

- Recovery in growth is likely to be slow and uneven, more "W" than "V" shaped. The Bank of England will stick to its lower-for-longer stance on interest rate policy.
- The path of base rates reflects the fragile state of the recovering economy and the significantly greater fiscal tightening of the emergency budget.
- The potential for downgrades to sovereign ratings has receded, but the negative outlook will remain for now.

Latest forecasts for the Official Bank Rate (with those set out in the original strategy) are as follows:

	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
Forecast for the Official Bank Rate – as at July 2010											
Upside			0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central	0.50	0.50	0.50	0.50	0.75	1.00	1.25	1.50	2.00	2.50	2.75
Downside					-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
Previous Forecast for the Official Bank Rate – as at Nov 2009											
Central	0.50	1.00	1.50	2.25	3.00	4.00	4.00				

Source: Arlingclose

For the purposes of the 2010/11 budget and medium term forecasts, a re-investment rate of 1.5% had been assumed for 2010/11 rising to 2.25% in 2011/12 and 3% for the next two years and these projections will need to be revised in light of actual experience and updated expectations for the path of interest rates.

Borrowing

There are no changes currently anticipated in the Council's strategy towards borrowing – i.e. the capital programme is assumed to be fully funded from resources other than borrowing, and whilst the remaining debt still has some years to run before maturity, there may be opportunity to redeem earlier in either of the following circumstances:

- The lender exercises the option to vary the interest rate.
- A negotiated exit fee (which could be funded from capital resources) is agreed and which is deemed appropriate in order to reduce on-going revenue interest costs.

Any actions taken on existing debt will be undertaken in conjunction with advice from the Council's external treasury advisors.

The Council's capital financing requirement (which is a balance sheet measure of the Council's underlying need to borrow for capital purposes) is currently a negative amount of £1.882 million, supporting the position of not undertaking new borrowing and repaying debt as the opportunity arises. This negative CFR effectively provides some "headroom" to incur capital expenditure (not previously planned), or deal with a delay in receipt of anticipated capital funding against the approved programme without having to resort to new borrowing. This capacity has been used in the last couple of year to optimise financing arrangement for acquisition of refuse vehicles that would otherwise have been traditionally financed by lease (i.e. by payment of an annual revenue sum).

Investments

Investment policy

The Council's overriding policy objective remains to invest its surplus funds prudently. Investment priorities are:

- **Security;**
- **Liquidity** i.e. having funds available when required

Having ensured that these two objectives have been met, the Council will then consider highest yield commensurate with these priorities.

Investment Strategy

Whilst the approved treasury management strategy set out a range of instruments that could be used for investment purposes (defined between specified and non-specified according to their relative risk profile), essentially activity has been focused around using the following:

- Highly credit rated UK banks/ building society (as determined by the credit criteria approved by Council in February)
- Money Market Funds (triple A rated)
- Debt Management Office (i.e. direct with UK Government)
- Co-operative Bank (own bank used solely for overnight or next working day deposits to manage immediate cash flow requirements)

During the year specific responses to market events have been taken as follows:

- Cessation of use of Goldman Sachs Money Market Fund – this was in response to the negative coverage this institution was receiving rather than concern over the security of investment or operation of the fund, which are segregated completely from the banking entity. The re-introduction of this fund for use will be kept under review as matters between Goldman Sachs and the financial regulators progress.
- Limiting the duration of deposit made with Santander UK to a maximum of one month whilst assessment is on-going of the effects of the worsening economic conditions of Spain. (No investments are made with any other Spanish

domiciled banks)

- Introduction of three money market fund providers: Royal Bank of Scotland (offering both a sterling liquidity fund and UK Government fund), Ignis Asset Management, and Henderson Global Investors. The purpose of these funds is to provide diversity across both money market funds and investment instruments applied. The funds were selected on the basis of their individual investment philosophies and approaches, albeit all funds operate within the same set of stringent rules applied to triple A rated money market funds (also referred to as collective investments schemes).
- Greater use of the Debt Management Office account has been necessary as limits set by Council have been reached with individual/ group counterparties – this is likely to ease in the second half of the year as cash balances would normally be expected to reduce.
- To protect against the prolonged period of low interest rates a rolling programme of 1 year deposits have been made where both counterparty limits and liquidity requirements have permitted.
- Investment opportunities at advantageous interest rates with the Co-operative Bank plc have been rejected as the banks credit rating does not currently meet the minimum criteria stated in the Council’s investments policy.
- The Council’s treasury management advisor, Arlingclose, is now providing enhanced creditworthiness information to the Council for assessing counterparties for investment purposes. This includes information on Credit Default Swaps, indicators of Gross Domestic Product (GDP) of countries in which institutions operate, country’s net debt, Sovereign support mechanisms/ potential support from well-resourced parent institutions, and share prices. Whilst the information is provided periodically to the Council, Arlingclose monitor the information via Bloomberg and where appropriate will provide immediate updates, along with advice on what actions should be taken with regards client lending policies.

Proposed Revision to Criteria for Determining a “Highly Credit Rated” Bank/ Building Society for investment purposes

Under the approved strategy a “highly credit rated” bank/ building society is one that has the following ratings from at least two of the leading credit rating agencies:

Rating	Comment
Short-term rating of F1 or F1+ (capacity for repayment over 13mth horizon)	Strongest categories
Long-term rating of at least AA-	Very strong and extremely strong categories
Support rating (from sovereign/ strong parent) of either 1 or 2	Extremely high and high categories

This condition was drafted prior to finalisation of the revised CIPFA Code of Practice for Treasury Management. In the Code, CIPFA has indicated that where institutions are rated by more than one rating agency, local authorities are recommended to adopt a lowest common denominator approach. As typically, Standard & Poor’s set

ratings lower than the other two major rating agencies (Fitch and Moody's) implementing this approach whilst retaining the above minimum credit rating criteria would effectively reduce further the number of counterparties that the Council could invest with, resulting in operational difficulties for the function and impacting adversely on the level of return the Council can achieve by requiring greater use of the Debt Management Office facility, rather than been able to place funds with other highly rated UK Government supported institutions. Therefore, based on the advice of the Council's external treasury advisor (Arlinglclose), and in order to demonstrate full compliance with the CIPFA Code, it is suggested that the Council's minimum credit rating criteria applied to banks/ financial institutions should be modified to read as the follows:

Rating	Comment
Short-term rating of F1 or F1+ (capacity for repayment over 13mth horizon)	Strongest categories
Long-term rating of at least A+	High credit quality with expectation of low risk i.e. institution is assessed as having strong capacity to meet financial commitments
Support rating (from sovereign/ strong parent) of either 1 or 2	Extremely high and high categories

In essence the proposed change will not alter the list of counterparties that the Council currently uses for investment purposes as funds will continue to be placed only with those institutions that have a long-term rating of at least AA- with at least two of the leading credit rating agencies. In the event that it is proposed to change this approach and utilise counterparties where they are long-term rated A+ by more than one of the three leading rating agencies the Cabinet Member for Efficiency & Resources will be consulted prior to any investments being made.

Cash available for investment

Since the treasury management strategy was approved decisions have been taken which affect the level of cash available for investment purposes for 2010/11 and over the medium term:

	Projections			
	2010/11	2011/12	2012/13	2013/14
	£000	£000	£000	£000
Average Invested original estimate	39,810	36,412	35,978	37,442
Causeway House refurbishment	(950)	(3,800)	(3,800)	(3,800)
Increased provision for new Witham Leisure Centre	(1,540)	(3,082)	(3,082)	(3,082)
Acquisition of Whitehorse Lane Car Park	(581)	(775)	(775)	(775)
Average Invested	36,739	28,755	28,321	29,785

This reduction in cash balances will impact on the overall investment income for each year, which will be taken into account in updates to the medium term financial strategy.

Investments at Risk

Latest update

The latest position regarding investments at risk with Icelandic Banks is as follows:

Kaupthing Singer & Friedlander (KSF) (claim £1m plus interest)

Monies have been paid out by the administrators dealing with the administration of KSF – to date 45% of claims have been paid which amounts to £450,000 of principal plus £12,984 of interest to the Council. The administrator's latest estimate of the likely level of recovery is between 65p and 78p in the £ pound.

Landsbanki (claim £3 million + interest) and **Glitnir** (claim £1 million = interest)

Following contradictory positions taken by the two Winding-up Boards dealing with the administration for these two banks over whether or not local authority deposits (along with other claims) rank as priority claims (rather than general unsecured) matters are now being progressed through the Icelandic Courts. UK Local authority creditors were asked to sign up to joint litigation – defending priority status awarded for the deposits held with Landsbanki, and seeking to gain priority status for those deposits held with Glitnir. Agreement to participate in the joint legal action was made by the Solicitor to the Council, after taking advice from Financial Services and seeking confirmation from the Cabinet Member for Efficiency & Resources.

The costs involved with taking this action is being shared amongst all local authority creditors, the amount for Braintree is estimated to be £13,019. The costs may ultimately be recoverable, however, there it should be noted that there is also the risk that adverse costs may be awarded and which could be of a similar order (in terms of share for Braintree). In the first instance, costs are to be met from the earmarked treasury management reserve.

The outcome of the legal cases will ultimately determine the percentage recovery for these deposits – if priority status is confirmed recovery is estimated to be 94.85% and 100% for Landsbanki and Glitnir respectively. If priority status is not confirmed the estimated recovery rates reduce to 38.21% and 29% respectively.

Reports are received from the legal advisors and the Local Government Association (LGA) updating on how matters are progressing, which are either circulated accordingly, or reported on through the regular monthly treasury monitor and reports to the Audit Committee. However, it should be noted that certain matters remain subject to legal privilege and cannot be circulated or reported to prevent damage to the case for local authorities.

Offers for transfer of claims

The Council is receiving offers to purchase the Council's claims in the administration of the Icelandic banks (mainly in respect of Landsbanki and Glitnir). Whilst the LGA has issued some guidance to all local authority creditors on matters that they should consider in relation to such offers it remains the case that individual authorities need to reach their own views and decisions about whether or not they wish to take up an offer to transfer their claim.

To date the Council's response to such offers has been not to engage in negotiations to transfer. This approach has been taken for the following reasons:

- Indicative offers are significantly below the value that the Council could recover in the event that priority status for local authority deposits is upheld by Icelandic Courts.
- Confidence in the legal position currently being promoted on behalf of all UK local authority creditors towards gaining successful resolution in favour of priority status. Through collective actions the Council is accessing highly experienced legal and financial advice, yet at a cost that is relatively modest against the sums at risk.
- Collectively, local authorities have been an influential force in the administration of the Icelandic banks, and in conjunction with other creditors from the UK and Dutch public sectors, form the majority of depositor creditors for these banks. At present it is understood that no UK local authority has transferred their claims to a third party and clearly it is in the interest of all public sector depositors that this collective stance is retained. Should transfers of claims be made this could dilute the collective influence of the remaining public sector depositors.

However, in taking this approach the Council needs to be aware of the risks involved which could result in the Council achieving a lower rate of recovery:

- The risk of an adverse legal outcome resulting in priority status not being upheld – this could result in recovery levels that may be below offers for transfer that are currently being received.
- Recovery values (whether or not priority status is upheld or not) are affected by a range of complex matters: value of asset realisations, performance of financial compensation arrangements between the 'old' banks and the 'new' banks (the latter created to maintain the retail banking system in Iceland), foreign currency exchange movements, and the outcome of claims for interest and costs associated with pursuing recovery of claims.

The Council's position regarding these claims will be kept under review. In the event that any information comes to light which may warrant a change in the position adopted, delegated authority would need to be given to the Corporate Director for Finance, in conjunction with the Cabinet Member for Efficiency & Resources (and if appropriate the Council's Monitoring Officer), to take whatever action is necessary in order to protect and maximise the Council's recovery of sums at risk with the Icelandic banks.

Treasury Management Prudential Indicators

The approved treasury management strategy contained a range of Prudential Indicators that are designed to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of adverse movement in interest rates. These indicators comprised:

- Limits to borrowing activity (authorised limit and operational limit)
- Maximum aggregate amount that will be invested in Non-specified investments (taken as the limit on principal sums invested for periods of longer than 364 days)
- Upper limits on fixed and variable rate exposure

- Maturity structures of borrowing

It can be confirmed that there have been no breach of the limits set, nor is it anticipated that the limits will be exceeded over the remainder of the financial year.

Investments and Borrowing subject to options

The Council has no investments at present that are subject to options.

The Council's outstanding long-term debt is subject to options which can be exercised semi-annually by the lender to vary the interest rate and therefore the Council treats the borrowing as variable rate. Should the lender exercise their option the Council would be entitled to repay the debt without any penalty. The risk of funds not being available should the options be called is mitigated by maintaining investments on a rolling maturity term that coincides with the option call dates.

Call dates are scheduled for March/ September – it is not anticipated that the lender will exercise their option in the near term due to the current interest rate environment.

Treasury Management Budgets and Latest Projection for 2010/11

The following table provides a summary of the treasury management budgets, including latest projection for the current year.

	2008/09 Actual	2009/10 Actual	2010/11 Budget	2010/11 Latest Projected
<u>Investments</u>				
Average sum invested	£45.9m	£43.7m	£39.8m	£36.7m
Overall investment return	5.51%	2.26%	1.91%	1.42%
Gross Interest receivable	£2.533m	£0.987m	£0.762m	£0.521m
<u>Borrowing</u>				
Average debt	£8.4m	} £6.0m	£6.0m	£6.0m
Debt outstanding at 31 st March*	£6.0m			
Average interest rate	4.74%	4.70%	4.70%	4.70%
Interest payable – General Fund	£0.400m	£0.282m	£0.282m	£0.282m
Net Interest receivable	£2.133m	£0.705m	£0.480m	£0.239m

* Subject to 6-monthly lender call options

'Overall investment return' takes into account investments contracted in earlier years.

Allocation of net interest receivable across funds:

	2008/09 Actual	2009/10 Actual	2010/11 Budget	2010/11 Latest Projected
<u>Fund:</u>				

General Fund	£1.417m	£0.413m	£0.230m	£0.057m
Housing Revenue Account	£0.653m	£0.285m	£0.238m	£0.170m
Other Funds	£0.063m	£0.007m	£0.012m	£0.012m
Net Interest receivable	£2.133m	£0.705m	£0.480m	£0.239m

Reporting of Treasury Performance

Since the approval of the treasury management strategy the following reports have been made:

- Monthly Treasury Management Monitor to Finance Management and the Cabinet Member for Efficiency & Resources
- Treasury Management Monitor to all Audit Committee meetings, forming part of the regular Key Financial Indicators monitored by the Committee.
- Annual report for 2009/10 – considered by Audit Committee at their meeting on 30th June 2010, and recommended on to Council
- Report to Overview & Scrutiny on 14th July 2010 – providing an annual update on investments at risk with Icelandic banks.

The approved strategy commented on the cessation of benchmarking of the treasury management function via the IPF Benchmarking Club due its focus being on yield, rather than adopting an approach that considered the overall management of risk. The Council's external treasury advisor is developing some benchmarking information across clients, which considers both risk (measured via counterparty credit ratings and investment duration) as well as yield or return. When this service becomes available consideration will be given as to how this information will usefully be incorporated into the monthly treasury management monitor and other treasury management reporting.