Report No. RES11055	**London Borough of Bromley**	**Agenda Item No.**

PART 1 - PUBLIC

Decision Maker:	**Executive & Resources PDS/Resources Portfolio Holder Council**		
Date:	**12 July 2011** **24 October 2011**		
Decision Type:	Non-Urgent	Non-Executive	Non-Key
Title:	**TREASURY MANAGEMENT - ANNUAL REPORT 2010/11**		
Contact Officer:	Martin Reeves, Group Accountant (Technical) Tel: 020 8313 4291 E-mail: martin.reeves@bromley.gov.uk		
Chief Officer:	Mark Bowen, Director of Resources		
Ward:	All		

1. Reason for report

1.1 This report summarises treasury management activity during the March quarter and includes the Treasury Management Annual Report for 2010/11, which is also required to be reported to full Council. The report also includes an update on the Council's investment with Heritable Bank (paragraph 3.11).

RECOMMENDATION(S)

The PDS Committee, the Portfolio Holder and full Council are asked to:

2.1 Note the Treasury Management Annual Report for 2010/11 and

2.2 Approve the actual prudential indicators within the report.

Corporate Policy

1. Policy Status: Existing policy. To seek to achieve the highest rate of return on investments whilst maintaining appropriate levels of risk, particularly security and liquidity.

2. BBB Priority: Excellent Council.

Financial

1. Cost of proposal: N/A

2. Ongoing costs: N/A.

3. Budget head/performance centre: Interest on balances

4. Total current budget for this head: £2.923m (net) in 2010/11; £2.691m (net) in 2011/12

5. Source of funding: Net investment income

Staff

1. Number of staff (current and additional): 0.3 fte

2. If from existing staff resources, number of staff hours:

Legal

1. Legal Requirement: Non-statutory - Government guidance.

2. Call-in: Call-in is not applicable. The report does not involve an Executive decision

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Customer Impact

1. Estimated number of users/beneficiaries (current and projected): n/a

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Ward Councillor Views

1. Have Ward Councillors been asked for comments? N/A.

2. Summary of Ward Councillors comments:

3. COMMENTARY

General

3.1 The 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 CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

3.2 During 2010/11, the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 15/2/10)
- a mid year (minimum) treasury update report (Council 25/10/10)
- an annual report following the year describing the activity against the strategy (this report)

In addition, the Executive and Resources PDS Committee received treasury management update reports on 27/10/10 and 26/1/11.

3.3 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 policies previously approved by members. The Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Executive and Resources PDS Committee before they were reported to the full Council.

Treasury Performance in the Quarter and Year Ended 31st March 2011

3.2 **Borrowing:** There was one small loan (£800k) taken out in March 2011 for just one day to cover a short-term cashflow shortage, but otherwise there was no borrowing during the whole of 2010/11.

3.3 **Investments:** The following table sets out details of investment activity during the March quarter and over the whole year:-

	March Qtr		**Year 2010/11**	
Main investment portfolio	**Deposits**	**Ave. Rate**	**Deposits**	**Ave. Rate**
	£m	**%**	**£m**	**%**
Core investments b/fwd	160.0	1.70	140.0	3.21
Investments made in period	41.5	1.99	176.0	1.59
Investments redeemed in period	-40.0	1.35	-154.5	1.91
Total "Core" Investments 31/03/11	161.5	1.86	161.5	1.86
Money Market Funds/Instant Access	6.9	0.77	6.9	0.77
Total Investments as at 31/03/11	**168.4**	**1.82**	**168.4**	**1.82**
Heritable – frozen (see para 3.11)	5.0	6.42	5.0	6.42

3.4 Details of the outstanding investments at 31st March 2011 are shown in maturity date order in <u>Appendix 1</u> and by individual counterparty in <u>Appendix 2</u>. The average return on all new "core" investments during the March quarter was 1.99% which may be compared with the average 3 month LIBID rate of 0.67% and the average 7 day rate of 0.45%. With regard to the whole of

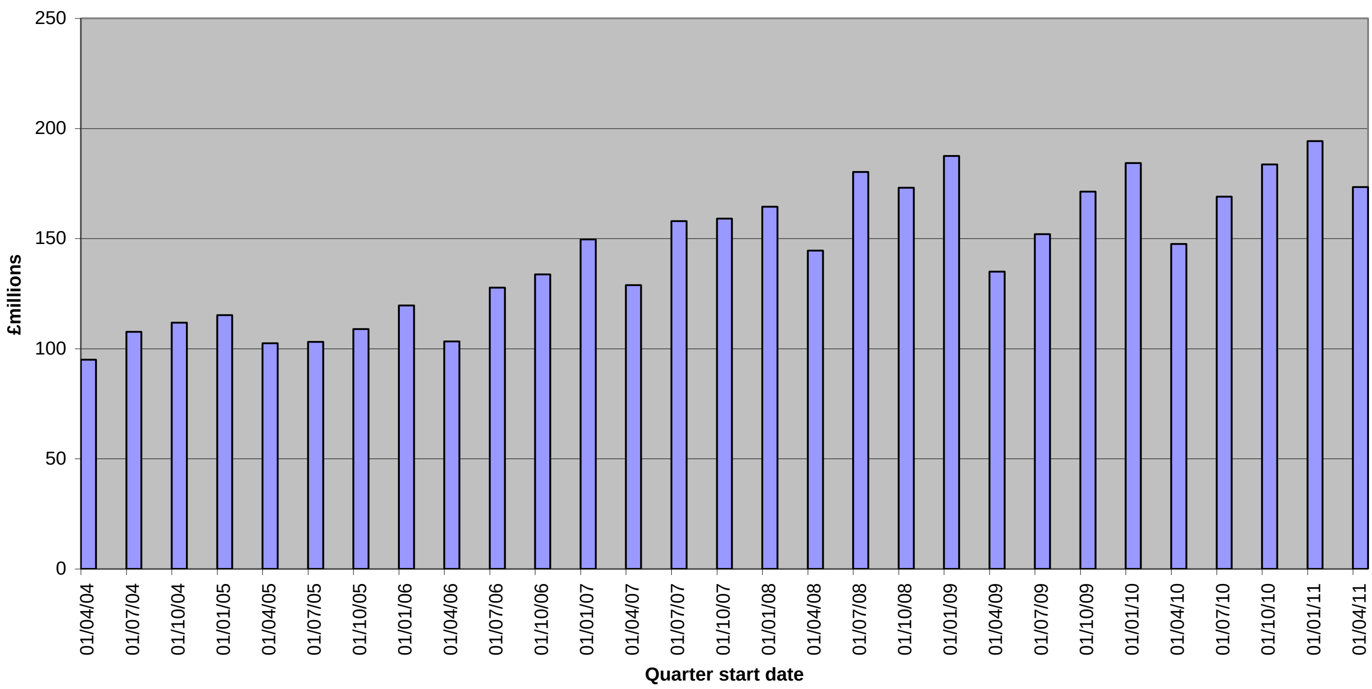
2010/11, an average return of 1.59% was achieved on new investments compared to the average 3 month LIBID rate of 0.62% and the average 7 day rate of 0.43%.

3.5 Market rates at the beginning of April 2010 stood at around 0.9% for 3 months and 2.2% for 1 year. Similar rates are still available for the longer period, but only with banks and building societies that are no longer eligible counterparties following credit rating downgrades in the last year. Most of the institutions that remain on our lending list at this time are offering around 0.75% for 3 months up to 1.5% for 1 year, which are both slightly higher than in April. Better rates (around 1.25% for 3 months up to 2.1% for a year) are available from Lloyds TSB and Santander are currently offering 1.13% and 1.96% respectively. In February 2010, the Portfolio Holder agreed changes to the Council's investment strategy, which permitted investment for up to 2 years with the largely-government owned Lloyds TSB and Royal Bank of Scotland (since November 2008, following the Icelandic banking crash, investments had been limited to a maximum period of 1 year). In practice, most "core" investments placed during 2010/11 were placed for between 6 months and a year (anticipating no rise in interest rates until mid-2011 at the earliest) or in instant access money market funds. In the second half of the financial year, however, the Council took advantage of 2-year deals with RBS and Lloyds at between 2.4% and 2.75% and will continue to monitor rates and counterparty quality prior to any investment decisions.

3.6 Credit ratings changes, particularly since the Icelandic banking crash in October 2008, resulted in the removal of many of our established counterparties from our lending list and it has since been difficult to identify institutions to place money with. As a result, much greater use has been made of Money Market Funds, which provide a safe haven and instant access, but offer considerably lower interest rates.

3.7 The graph below shows total investments at quarter-end dates back to 1st April 2004 and shows how available funds have increased steadily over the years, largely due to increased and earlier government funding. This has been a significant contributor to the over-achievement of investment income against budget in recent years, although this has now been fully factored into the revenue budget.

QUARTERLY INVESTMENT BALANCES



Other accounts

3.8 Money Market Funds

The Council currently has 6 Money Market Fund accounts, with Aviva, Fidelity, Prime Rate, Insight, Blackrock and Ignis. The Prime Rate, Blackrock and Ignis accounts were opened during 2009/10 in order to provide a degree of added flexibility and following consultation with our external advisers. In common with market rates for fixed-term investments, interest rates on money market funds have also fallen considerably. In November 2008, Aviva changed the valuation arrangement for its fund, moving from a constant net asset value of £1 per share to a mark-to-market basis (i.e. a variable net asset value). The Director of Resources has not invested in the fund at all since then and will not do so while this valuation arrangement continues, as there is a potential for loss of principal sums. Following the changes to the investment strategy approved by Council in October 2009, in February 2010 and, more recently, in October 2010, investments were moved away from money market funds into fixed term deposits, enabling the Council to improve returns. As expected, the balance in these funds reduced considerably during the last two months of 2010/11 as funds were withdrawn to cover diminishing Council Tax receipts and increasing expenditure in the final quarter.

Money Market Fund	Date Account Opened	Ave. Rate 2010/11	Ave. Daily Balance 2010/11	Actual Balance 31/3/11	Actual Balance 06/06/11	Current Rate 06/06/11
		%	£m	£m	£m	%
Prime Rate	15/06/09	0.84	12.9	6.9	15.0	0.81
Ignis	25/01/10	0.67	5.9	-	11.6	0.78
Insight	03/07/09	0.64	0.7	-	-	0.65
Blackrock	16/09/09	0.53	0.1	-	-	0.61
Fidelity	20/11/02	-	-	-	-	0.60

3.9 35-day Notice Account

In April 2010, the Council placed £10m in a 35-day notice account with Svenska Handelsbanken (Sweden) and a further £5m was deposited in May. The total of £15m remained invested at a rate of 0.85% until it was withdrawn at the end of January 2011 to help with cashflow in the last two months of the year. The average daily balance in the year was £11.5m. A total of £5m was also deposited, in May, in a 30-day notice account with Clydesdale Bank, earning 0.85%. This was withdrawn and re-invested in a fixed term deposit in September and the average daily balance in the year was £1.7m.

3.10 External Cash Management

External cash managers, Tradition UK Ltd and Sterling International Brokers Ltd, were both appointed to manage £10m of our cash portfolio in August 2003. The Portfolio Holder agreed, in February 2010, that the arrangement with one of them, Sterling International Brokers Ltd, be terminated and that their £10m fund be transferred to Tradition UK, bringing their total up to £20m. This followed a detailed review of the relative performance of both cash managers and the Council's in-house treasury team. In 2010/11, Tradition UK achieved a return of 1.73% (mainly bolstered by one remaining long-term investment for 2 years at 6.10% that matured on 30th September 2010), compared to the in-house team's return of 1.86%. They manage investments within the same parameters as the Council's in-house team and have been equally constrained by strategy changes approved after the Icelandic Bank crisis. They have, however, been more constrained by counterparty limits than the in-house team because we effectively receive first refusal and at times their options have been severely limited. Details of externally managed funds placed on deposit as at 31st March 2011 are shown below. Members will note that the whole £20m is set to mature around mid-2011 as this was when Tradition UK expected interest rates would begin to rise. There is still no real sign of this happening and the view from Tradition UK is that rates will not now begin to increase until November 2011 at the earliest.

Sum	Start Date	Maturity	Period	Rate
Tradition UK				
£2.5m	09/11/10	17/05/11	6 months	1.01%
£2.5m	17/08/10	17/05/11	9 months	1.58%
£5m	10/09/10	10/06/11	9 months	1.13%
£5m	12/11/10	12/08/11	9 months	1.25%
£5m	17/08/10	17/08/11	1 year	2.05%

3.11 Investment with Heritable Bank

Members will be aware from regular updates to the Resources Portfolio Holder and the Executive that the Council had £5m invested with the Heritable Bank, a UK subsidiary of the Icelandic bank, Landsbanki, when it was placed in administration in early-October 2008 at which time our investment was, and still is, frozen. The latest estimate given by the administrators, Ernst & Young, indicates a likely return of between 79% and 85% of our claim. This estimate has not been updated since this time last year. An initial dividend of 16.13p in the pound (£820k) was paid to the Council in July 2009 and further dividends were received in December 2009, March 2010, July 2010, October 2010, January 2011 and April 2011. A further dividend is due to be received in July 2011. To date, around 56% of our claim (a total of £2,867k) has been returned to us and the Council and its advisers are hopeful of a full return in time.

For information, the claim we were obliged to submit consisted of the principal sum (£5m) plus interest due to the date on which Heritable was placed in administration (around £87,000). We were not able to lodge a claim for the full amount of interest (£321,000) that would have been due at the original investment maturity date (29/6/09). In accordance with proper accounting practice and guidance from CIPFA, we made provision in our 2008/09 accounts for an impairment loss of £1.64m and met this from the General Fund in the year. In line with revised guidance from CIPFA relating to the 2009/10 accounts, we were able to reduce the impairment by £300k and this sum was credited to the General Fund. No adjustment was made to the impairment in 2010/11.

Actual prudential indicators for 2010/11

3.12 The old capital control system was replaced in April 2004 by a prudential system based largely on self-regulation by local authorities themselves. At the heart of the system is The Prudential Code for Capital Finance in Local Authorities, developed by CIPFA. The Code requires the Council to set a number of prudential indicators designed to monitor and control capital expenditure, financing and borrowing. The indicators for 2010/11 were approved by the Executive and the Council in February 2010 and Appendix 3 sets out the actual performance against those indicators.

Economic Background for 2010/11

3.13 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. Local authorities were also presented with changed circumstances following the unexpected change of policy on Public Works Loan Board (PWLB) lending arrangements in October 2010. This resulted in an increase in new borrowing rates of 0.75 – 0.85%, without an associated increase in early redemption rates. This made new borrowing more expensive and repayment relatively less attractive.

3.14 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.

3.15 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.

3.16 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.

3.17 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.

3.18 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.

3.19 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 highly sceptical as to the robustness of the tests, as they also are over further tests now taking place with results due in mid-2011.

Regulatory Framework, Risk and Performance

3.20 The Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance:

- The Local Government Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity;

- The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (although no restrictions were made in 2009/10);

- Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act;

- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities;

- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services;

- Under the Act the CLG has issued Investment Guidance to structure and regulate the Council's investment activities;

- Under section 238(2) of the Local Government and Public Involvement in Health Act 2007 the Secretary of State has taken powers to issue guidance on accounting practices. Guidance on Minimum Revenue Provision was issued under this section on 8th November 2007.

3.21 The Council has complied with all of the above relevant statutory and regulatory requirements which limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means both that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

4. POLICY IMPLICATIONS

4.1 In line with government guidance, the Council's policy is to seek to achieve the highest rate of return on investments whilst maintaining appropriate levels of risk, particularly security and liquidity.

5. FINANCIAL IMPLICATIONS

5.1 These are contained in the body of the report. An average rate of interest of 1.69% was achieved in 2010/11, including 1.59% on all new "core" investments placed during the year (compared to the budget assumption of 1.5%). The final outturn for net interest on investments and borrowing in 2010/11 was £2,921k, just £2k below the budget.

5.2 With regard to 2011/12, an average rate of 1.75% has been assumed for interest on new investments in the 2011/12 revenue budget, in line with the estimates provided by the Council's external treasury advisers, Sector, earlier in the year. Sector have recently revised their estimates and are now forecasting an average rate of 1.5% in 2011/12 followed by average rates of 2.5% in 2012/13 and 3.5% in 2013/14. A variation of 0.25% in these assumptions would result in a variation in interest earnings of around £200k in 2011/12 and £400k thereafter. The latest forecast for 2011/12 is that there will be a shortfall of around £170k on the budget of £2,691k.

Non-Applicable Sections:	Legal and Personnel Implications
Background Documents: (Access via Contact Officer)	CIPFA Code of Practice on Treasury Management CIPFA Prudential Code for Capital Finance in Local Authorities CLG Guidance on Investments Capital Outturn 2010/11 report to Executive 22/6/11 External advice from Sector