Report No. RES13151	**London Borough of Bromley**	**Agenda Item No.**

PART 1 - PUBLIC

Decision Maker:	**Resources Portfolio Holder** **Council**		
Date:	**For pre-decision scrutiny by Executive and Resources PDS Committee on 4th September 2013** **Council meeting 23rd September 2013**		
Decision Type:	Non-Urgent	Non-Executive	Non-Key
Title:	**TREASURY MANAGEMENT - ANNUAL REPORT 2012/13 & PERFORMANCE Q1 2013/14**		
Contact Officer:	Martin Reeves, Principal Accountant (Technical & Control) Tel: 020 8313 4291 E-mail: martin.reeves@bromley.gov.uk		
Chief Officer:	Peter Turner, Director of Finance		
Ward:	All		

1. Reason for report

1.1 This report includes the Treasury Management Annual Report for 2012/13, which is required to be reported to full Council, and also contains details of investment performance in the 1st quarter of 2013/14. The report also includes an update on the Council's investment with Heritable Bank (paragraphs 3.14 and 3.15) and proposes changes to the Council's Annual Investment Strategy in the form of an increase in the maximum duration for loans to other local authorities from 2 years to 3 years and the inclusion of collective (pooled) investment schemes as eligible investment vehicles (see paragraphs 3.18 to 3.24). These changes will require the approval of full Council. Investments as at 31st March 2013 totalled £201.1m (excluding the balance of the Heritable investment) and £259.1m as at 30th June 2013. There was no external borrowing in the whole of 2012/13 or in the 1st quarter of 2013/14.

RECOMMENDATION(S)

The PDS Committee and the Portfolio Holder are requested to:

(a) Note the Treasury Management Annual Report for 2012/13;

(b) Approve the actual prudential indicators within the report; and

(c) Recommend to Council that the limit for investments with other local authorities be increased from 2 years to 3 years and that collective (pooled) investment schemes be included as eligible investment vehicles in the Council's Investment Strategy with an

overall limit of £25m and a maximum duration of 5 years (see paragraphs 3.18 to 3.24); and

(d) Subject to approval of (c) above, any investment in a collective (pooled) investment scheme will require the approval of the Director of Finance in consultation with the Resources Portfolio Holder.

Council is requested to:

(a) Note the Treasury Management Annual Report for 2012/13;

(b) Approve the actual prudential indicators within the report;

(c) Consider comments from the PDS Committee; and

(d) Approve an increase in the limit for investments with other local authorities from 2 years to 3 years and agree that collective (pooled) investment schemes be included as eligible investment vehicles in the Council's Investment Strategy with an overall limit of £25m and a maximum duration of 5 years.

Corporate Policy

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

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: £2,691k (net) in 2012/13 (final outturn £2,673k); Budget £1,591k in 2013/14 (currently on target)

5. Source of funding: Net investment income

Staff

1. Number of staff (current and additional): 0.25 fte

2. If from existing staff resources, number of staff hours: 9 hours per week

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Legal

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

2. Call-in: Call-in is applicable

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: N/A

3. COMMENTARY

General

3.1 Under the requirements of the CIPFA Code of Practice on Treasury Management, the Council is required, as a minimum, to approve an annual treasury strategy in advance of the year, a mid-year review report and an annual report following the year comparing actual activity to the strategy. In practice, the Director of Finance has reported quarterly on treasury management activity for many years, as well as reporting the annual strategy before the year and the annual report after the year-end. This report includes details of investment performance in the final quarter of 2012/13 and in the 1st quarter of 2013/14, as well as the annual report for 2012/13. It also proposes changes to the investment criteria that form part of the Council's Annual Investment Strategy in the form of an increase in the maximum duration for loans to other local authorities from 2 years to 3 years and the inclusion of collective (pooled) investment schemes as eligible investment vehicles (see paragraphs 3.18 to 3.24).

3.2 Recent changes in the regulatory environment place a much greater onus on members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members. The Director of Finance confirms that he 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 2013 and in the quarter ended 30th June 2013

3.3 <u>Borrowing:</u> The Council's healthy cashflow position continued through the whole of 2012/13 and into 2013/14, as a result of which no borrowing has been required at all since 2010/11, when one small overnight loan (for £800k) was taken out (in March 2011).

3.4 <u>Investments:</u> The following table sets out details of investment activity during the March and June quarters and during the whole of 2012/13:-

	Qtr ended 31/3/13		Year ended 31/3/13		Qtr ended 30/6/13	
Main investment portfolio	**Deposits**	**Ave Rate**	**Deposits**	**Ave Rate**	**Deposits**	**Ave Rate**
	£m	**%**	**£m**	**%**	**£m**	**%**
Balance of "core" investments b/f	150.00	1.93	152.50	2.23	167.50	1.88
New investments made in period	120.00	0.64	321.50	1.12	32.50	0.73
Investments redeemed in period	-102.50	1.62	-306.50	1.50	-35.00	0.73
"Core" investments at end of period	167.50	1.88	167.50	1.88	165.00	1.00
Money Market Funds	6.10	para xxx	6.10	para xxx	64.10	para xxx
RBS 95 day notice account	12.50	para xxx	12.50	para xxx	15.00	para xxx
Payden Sterling Reserve Fund	15.00	para xxx	15.00	para xxx	15.00	para xxx
Total investments at end of period	**201.10**	**n/a**	**201.10**	**n/a**	**259.10**	**n/a**
Heritable deposit - frozen (para xxxx)					5.00	6.42

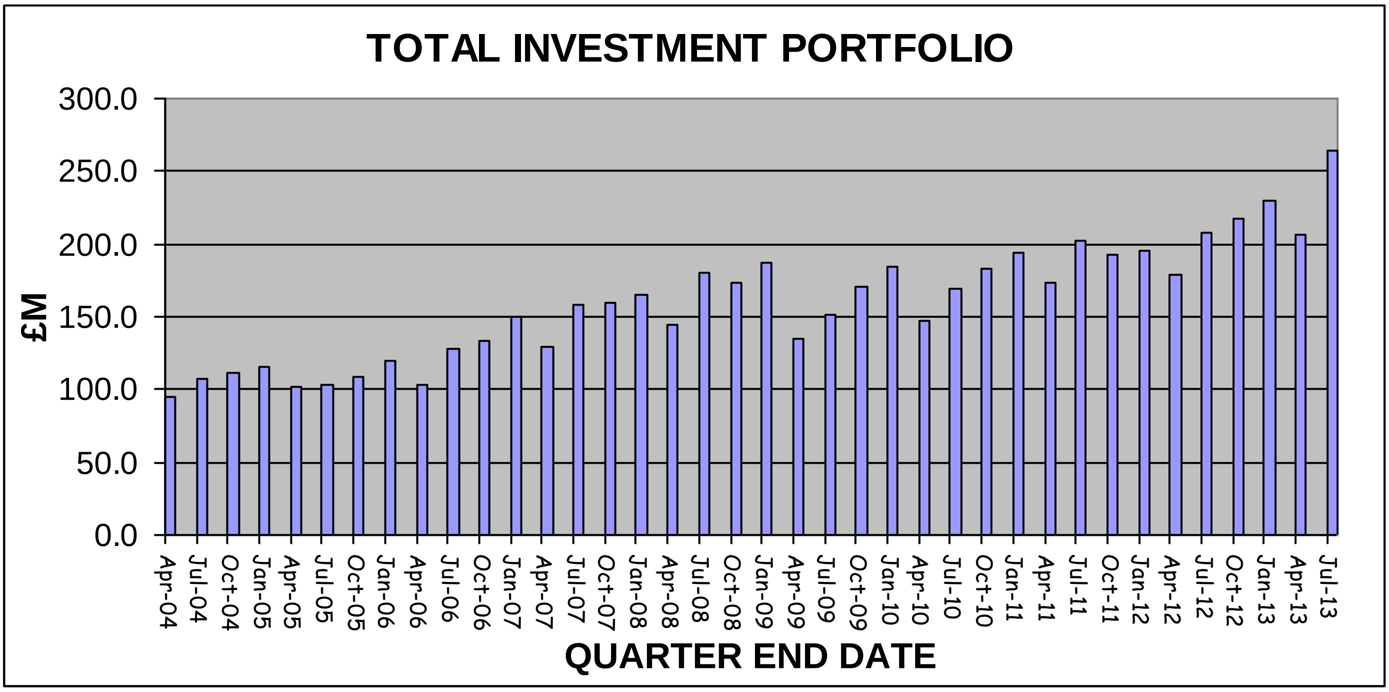
3.5 Details of the outstanding investments at 31st March 2013 are shown in maturity date order in Appendix 1 and by individual counterparty in Appendix 2. The average return on all new "core" investments during the March quarter was 0.64% which may be compared with the average 3 month LIBID rate of 0.38% and the average 7 day rate of 0.36%. The average return on new investments placed in the year 1st April to 31st March 2013 was 1.12% compared to the average 3 month rate of 0.56% and the average 7 day rate of 0.39%. In the latest quarter (ended 30th June 2013), the average return on new investments was 0.73%, compared to the average 3 month and 7 day rates of 0.38% and 0.36% respectively. Investments held as at 30th June 2013 are shown in Appendices 3 and 4.

3.6 Base rate has now been 0.5% since March 2009 and the recently updated forecast by Sector is for it to remain at that level until 2016. This is clearly also the view of the Bank of England, whose governor, Mark Carney, has said that the Bank will not consider raising interest rates until the jobless rate has fallen to 7% or below. This would require the creation of around 750,000 jobs and could take 3 years or more. The estimated date for the next increase in base rate has slipped back significantly in the last two years and it is possible that it will slip further. Reports to previous meetings, most recently to the January meeting, have highlighted the fact that options with regard to the reinvestment of maturing deposits have become seriously limited due to bank credit rating downgrades. Changes to lending limits and eligibility criteria have in the past been temporarily successful in alleviating this, but we are now back in the position of not having many investment options other than placing money with instant access accounts at relatively low interest rates. Active UK banks on our list now comprise only Lloyds TSB, RBS, HSBC, Barclays, Santander UK and Nationwide and all of these have reduced their interest rates significantly.

3.7 Our external advisers, Sector, have continued to recommend caution and, between September 2011 and January 2013, were recommending that no investment be placed for longer than 3 months with any bank other than Lloyds and RBS (a maximum of 1 year was recommended in their case). In January 2013, however, they lifted their temporary investment duration cap due to a perceived improvement in market conditions, namely a reduction in some of the excess fears surrounding the continued existence of the Eurozone and improvements in liquidity in financial markets. This enabled us to invest in the final quarter of 2012/13 with some of our eligible UK counterparties for up to 6 months instead of 3, which will have had a small beneficial impact on interest earnings. In the final quarter of 2012/13, we also placed investments with three other local authorities: two for two years at 0.85% and one for one year at 0.50%. In July, we dealt forward with another local authority for two years out of April 2014 at a rate of 1.14%. While these rates do not sound particularly attractive, they are better than we are currently able to obtain elsewhere in the market and are, in the view of Sector and other experts, likely to prove good deals in the fullness of time.

3.8 Lloyds TSB has consistently offered better rates than other UK banks, but has reduced its rates significantly in the last year and is currently offering 0.70% for 3 months up to 1.01% for 1 year (they were paying 3.00% for 1 year as recently as July 2012). All the other UK banks and building societies on our lending list are now paying around 0.45% for 3 months (the maximum period Sector have, until recently, been recommending) and around 0.53% for 6 months. The "core" investments placed during the last quarter of 2012/13 and the 1st quarter of 2013/14 were all placed for between 3 months and a year (in accordance with Sector's advice) or in instant access money market funds. The Director of Finance will continue to monitor rates and counterparty quality and take account of external advice prior to any investment decisions.

3.9 The graph below shows total investments (including the Icelandic bank deposit with Heritable Bank) 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.



Other accounts

3.10 Money Market Funds

The Council currently has 7 AAA-rated Money Market Fund accounts, with Prime Rate, Ignis, Insight, Morgan Stanley, Blackrock, Fidelity and Legal & General, all of which have a maximum investment limit of £15m. In common with market rates for fixed-term investments, interest rates on money market funds have fallen considerably in recent years. The Ignis, Prime Rate and Morgan Stanley funds currently offer the best rate (0.42% to 0.43%), which is around the level currently being offered for 3 months by most of our eligible UK banks and building societies. The total balance held in Money Market Funds (£64.1m as at 30th June 2013) has increased significantly in the past year as bank credit rating downgrades have restricted counterparty eligibility.

Money Market Fund	Date Account Opened	Ave. Rate 2012/13	Ave. Daily Balance 2012/13	Actual Balance 31/03/13	Actual Balance 30/06/13	Ave. Rate Q1 2013/14	Actual Balance 20/08/13	Current Rate 20/08/13
		%	£m	£m	£m	%	£m	%
Prime Rate	15/06/2009	0.61	14.7	-	15.0	0.44	15.0	0.42
Ignis	25/01/2010	0.62	14.0	6.1	15.0	0.43	15.0	0.43
Insight	03/07/2009	0.54	11.4	-	15.0	0.39	-	0.39
Morgan Stanley	01/11/2012	0.44	3.9	-	15.0	0.40	9.9	0.42
Legal & General	23/08/2012	0.46	4.5	-	4.1	0.34	-	0.34
Blackrock	16/09/2009	0.46	3.7	-	-	0.31	-	0.31
Fidelity	20/11/2002	0.41	0.3	-	-	-	-	0.31
TOTAL			52.5	6.1	64.1		39.9	

3.11 Notice Accounts

In April 2012, the Council placed £15m in a 35-day notice account with Svenska Handelsbanken (Sweden). The total of £15m remained invested until mid-December when it was withdrawn following a reduction in the interest rate from 0.85% to 0.40% and then to 0.30%. The average daily balance from April to December 2012 was £10.1m. In March 2013, RBS announced a new 95-day notice account paying a rate of 0.80%. The Council made an initial deposit of £12.5m in

March and has since increased this to £15m, but notice has recently been received that the rate will reduce to 0.60% in October, at which point the deposit will be reviewed.

3.12 Payden Sterling Reserve Fund

At its meeting on 12th November 2012, the Council approved the addition of corporate bonds (minimum credit rating AA-, maximum period 5 years) and the Payden Sterling Reserve Fund to our lending list. To date, no corporate bond issues have been considered sufficiently attractive in consultation with our external advisers, Sector, but, later in November 2012, £15m was invested in the Payden Fund. The longer-term nature of the Payden Fund means that a better return will be secured by holding to maturity, although we could at any time withdraw our money by giving 3 days' notice. As at 31st March 2013, the value of the Council's investment had increased to £I5,086k and, as at 31st July 2013, to £15,097k. In a commentary on the Fund's performance to 30th June 2013, Payden states:

"The Fund remained invested in a diversified range of sterling-denominated, highly-rated and very liquid government agency securities and corporate fixed- and floating-rate and covered bonds. During the quarter, duration was reduced by about 0.3 years to 0.9 years. The portfolio's structure remained broadly unchanged as we continued to favour highly-rated quasi-government and corporate securities and covered bonds as they provide attractive yield pick-ups over Gilts and money market instruments. We reduced our exposure to government agency notes in favour of a higher allocation to covered bonds.
The Fund delivered a small negative return during the quarter, the first negative quarterly return since the Fund's inception. However, returns for 2013 are in excess of returns achievable by money market funds and bank deposits. The Fund performed well in April, supported by its duration positioning and the relatively attractive yields. However, the unexpectedly sharp rise in bond yields in May and June and the associated credit spread widening in all non-government bond market sectors more than offset these gains, resulting in minor losses in May and June".

3.13 External Cash Management

External cash managers, Tradition UK Ltd, currently manage £20m of our cash portfolio and provide useful advice and information on treasury management matters. In 2012/13, Tradition UK achieved a return of 1.53% (mainly as a result of two longer term investments placed with Lloyds TSB in August 2011 and July 2012, when rates were around 3%, both of which matured in the 2nd quarter of 2013/14). Tradition UK work to the same counterparty list as the Council's in-house team and so have also been constrained by strategy changes approved after the Icelandic Bank crisis and by recent ratings downgrades. Details of externally managed funds placed on deposit as at the time of writing this report are shown below.

Bank	Sum	Start Date	Maturity	Period	Rate
HSBC	£12.5m	26/03/13	26/03/14	1 year	0.65%
Lloyds TSB	£2.5m	04/07/13	04/07/14	1 year	1.01%
Lloyds TSB	£5m	16/08/13	18/08/14	1 year	1.01%

3.14 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. An initial dividend was paid to the Council in July 2009 and, since then, a further 13 dividends have been received. To date, 94.0% (£4,783k) of our total claim (£5,087k) has been returned to us, leaving a balance of £304k (6.0%). Council officers and our external advisers remain hopeful of a full recovery.

3.15 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 that 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. An improvement in the administrator's recovery estimate in 2011 to between 86% and 90% (previously it was between 79% and 85%) enabled us to reverse a further £730k of the impairment in 2011/12. The Council's accounts include a provision for a net loss of £610k as at 31st March 2013 (12% of the claim, based on the midpoint of the administrator's estimate), but, as we have now recovered 94%, we will be able to reverse more of the impairment in 2013/14. We are currently waiting for an update from the administrator.

Actual prudential indicators for 2012/13

3.16 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 2012/13 were approved by the Executive and the Council in February 2012 and Appendix 5 sets out the actual performance against those indicators.

Economic Background (provided by Sector)

3.17 Comments on the economic background during 2012/13 and the first quarter of 2013/14 are attached at Appendix 6.

Proposed changes to the Annual Investment Strategy

3.18 As outlined in paragraphs 3.6, counterparty credit rating downgrades in recent years have resulted in the removal of many of our established counterparties from our lending list and it has become increasingly difficult to identify institutions to place money with. The restrictions on our lending list have resulted in large sums being placed in low interest accounts (in instant access money market funds) and this has had a significant impact on the Council's interest earnings. Around £55m is currently invested in instant access accounts (including £40m in money market funds), £15m is invested in 95-day notice money and a further £15m in the Payden Sterling Reserve Fund. These are currently earning an overall average rate of around 0.53% (£450k in a full year).

3.19 A proposal to the Executive on 19th October 2011 to increase the lending limit for the two part-nationalised banks (Lloyds TSB and RBS) from £40m to £60m was approved, "subject to this being implemented after 3 months dependent on the prevailing financial position". This would currently enable an extra £40m to be invested with these two banks at around 1% for a year. The position has been kept under review since that decision was made and no further action is proposed at this time.

3.20 In order to provide a degree of extra flexibility and potentially to earn additional interest at no added risk, it is proposed that the Strategy be amended as follows:

- Increase the limit for local authorities from 2 years to 3 years.
- Include Collective (pooled) Investment Schemes as a specific category of approved investments.

3.21 Limits for investments with other local authorities

The 2013/14 Strategy includes deposits with other local authorities as approved investments with a total limit of £15m per authority and a maximum duration of 2 years. While most local authorities do not have a credit rating, they are considered to be very secure and investments with them are considered to be low risk. Historically, they have offered lower rates than banks and building societies, but the “gap” has narrowed in recent years. To give Members an idea of the current local authority market, we have recently dealt forward for 2 years out of April 2014 at 1.14% and have had an “offer” to invest for 5 years at 2.25%. It is proposed that the duration limit for investments with other local authorities be extended to 3 years to provide extra flexibility in future. Any potential deals will continue to be discussed in advance with Sector.

3.22 Collective (pooled) investment schemes

These are currently included in our Strategy as “specified investments” – i.e. we are only permitted to invest for up to a year. The category includes money market funds and the Payden Sterling Reserve Fund. It is proposed that pooled investment funds that meet the definition of a collective investment scheme as defined in the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 as amended by SI 2004 No 534, SI 2007 No 573 and SI 2012 No 265 (i.e. investments would not count as capital expenditure) be added to the list of permitted investments with a total monetary limit of £25m and a duration limit of 5 years. This could include property, equity and bond funds and would diversify the portfolio from pure cash investments, add value and spread risk over a variety of asset classes. Investment opportunities will be considered on a case-by-case basis, taking account of Sector’s advice, and it is proposed that investments will be subject to the approval of the Director of Finance in consultation with the Resources Portfolio Holder.

3.23 Prior to the “credit crunch” period of 2007/08, the Council regularly placed investments for up to 5 years. The fragility of the banking sector has, however, resulted in shorter term lending of up to 1 year to reflect the risk to the capital sum.

3.24 In considering a Treasury Management Strategy, the key factors are security, liquidity and yield (in that order), which reflects CIPFA guidance. With current lending rates so low, there is effectively a capital risk as a result of the Council receiving returns lower than inflation. The Strategy has previously been revised to include corporate bonds and this report proposes the inclusion of additional collective investment vehicles that meet the following unique requirements:

- In recognition of the need to protect capital, a longer term period of 3 – 5 years will be required, where the capital risk is expected to be minimal;
- The returns will be expected to be higher than normal secured fixed term lending to eligible financial institutions by at least 2%;
- Investments must be able to be sold within 6 months (9 months for property), which provides more flexibility than lending to banks for longer periods;
- The investment vehicle must have a proven track record over a 3 – 5 year period, although it is accepted that looking back is no guarantee of returns for the future;
- Historically, volatility has been low; and
- The Council’s external advisers, Sector, must support the proposals using their extensive financial expertise.

Regulatory Framework, Risk and Performance

3.25 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.

3.26 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 1.31% was achieved in 2012/13, including 1.12% 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 2012/13 was £2,673k compared to the budget of £2,691k. In June 2012, the Executive agreed that the 2011/12 actual surplus of £1,185k be transferred into a new earmarked reserve, The Interest Rate Risk Reserve, with the intention of mitigating potential future interest losses.

5.2 With regard to 2013/14, an average rate of 1% has been assumed for interest on new investments in the 2013/14 revenue budget, in line with the estimates provided by the Council's external treasury advisers, Sector, earlier in the year and with officers' views. The Bank of England base rate is still expected to rise, but the expected start of the rise has been put back to 2016 and could be even later. The latest financial forecast assumes 1% for new investments in all years from 2013/14 to 2016/17. A variation of 0.25% in these assumptions would result in a variation in interest earnings of around £400k pa from 2013/14. At this stage in the year, it is forecast that the 2013/14 outturn will be broadly in line with the budget.

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 External advice from Sector Treasury Services