Appendix 2

Treasury Management Annual Report 2009/10

PURPOSE OF REPORT

To receive information on treasury management performance and compliance with treasury management policy during 2009/10 as required by the Treasury Management Code of Practice.

1 Executive Summary

Introduction

1.1 The CIPFA Code of Practice on Treasury Management which this Council has adopted requires an Annual Report to be presented to the Executive at the end of each financial year.

1.2 The actual return on investments for 2009/10 was £2.03m compared with a budget of £2.82m a negative variance of £0.79m. The budget was based on an average investment balance of £84m and an interest rate of 3.35 %. The actual average balance was £75m which attracted an average return of 2.70 %.

Proposals

1.3 The Executive receives the report as required by the Code of Practice and notes performance for 2009/10.

Conclusion

1.4 The Council's investment performance was 28% lower than anticipated in the 2009/10 budget. This was due to the Bank of England base rate remaining low at 0.5% and a worse than anticipated performance for our Fund Managers Investec. The approved policy was adhered to throughout the financial year.

1.5 Pending the issuance of revised CIPFA and statutory investment guidance expected towards the end of the year, and in the light of continuing stresses on the world banking system, enhanced priority was given to security and liquidity in order to reduce counterparty risk to the maximum possible extent. Accordingly, some of the investment portfolio was moved into lower earning investment instruments due to their lower level of counterparty risk.

Background Information

2 Overall Performance

2.1 The actual return on investments for 2009/10 was £2.03m compared with a budget of £2.82m a negative variance of £0.79m. The budget was based on an average investment balance of £84.2m and an interest rate of 3.35%.

The actual average balance was £75.3m which attracted an average return of 2.70%.

2.2 The Council's investments are spread over three different operations: in-house and two fund managers. Their relative performance can be summarised as follows:

£000	**Balance 1.4.09 £s**	**Balance 31.3.10 £s**	**Average Balance £s**	**Return £s**	**Return (%)**
In House	31,670	22,320	21,109	394	1.87
Tradition	29,000	25,000	29,000	1,300	4.73
Investec	26,230	20,344	25,340	337	1.33
Total	**86,900**	**67,664**	**104,075**	**2,031**	**2.70**

Fund Manager Performance

2.3 As a consequence of the coalition government's determination to tackle the budget deficit, our Fund Managers Investec, have changed their investment strategy to reflect the likelihood of an extended period of low interest rates. The strategy has been to sell the majority of Cash Deposits with a maturity of less than 3 months and purchase 12 month Cash Deposits at yields between 1% and 1.45%. The yields vary considerably depending on the counterparty, but the strategy is to have a mix to maintain a certain amount of liquidity found in those banks deemed better quality and achieve some extra yields in those banks less fortunate. This process will continue as Cash Deposits fall under 3 months to maturity. This will lengthen the portfolio and increase the yield on the portfolio over time.

The Strategy for 2009/10

2.4 The treasury strategy for 2009/10 was based on the view that there was an intensifying global recession which would not only require central bank rates to be cut to unprecedented historically low levels, but could also require further action from central banks to reverse the downward path of economies.

Bank Rate was expected to continue falling from 2.0% in December 2008 to 0.5% in March 2009 and then stay there throughout 2009/10 before starting to rise in the second quarter of 2010. However, there was a downside risk to this forecast if the recession proved even deeper and longer than expected at that time; this would mean that the first rise in Bank Rate would be delayed.

The effect on interest rates for the UK was therefore expected to be as follows:

- **Shorter-term interest rates** - The "average" City view anticipated that Bank Rate would fall to 0.5% and remain there at the end of 2009 due to the scale of the recession before starting to rise back towards more normal levels in 2010, though it would be 2012 before Bank Rate returned to around 4.5%.
- **Longer-term interest rates** - The view on longer-term fixed interest rates, 50 years, was that they would remain around 3.90 – 3.95% during 2009/10 with the 25 year rate being about 10 – 15 basis points (bps) higher.

2.5 The adopted treasury strategy put to the Council based upon the above forecast was that:

2.5a The major issue for treasury management in 2009/10 has been the huge difference between investment rates and borrowing rates that has emerged during this recession due to: -

- ❖ the unprecedented fall in Bank Rate
- ❖ the disappearance during the year of the margins over more normal investment rates caused by the credit crunch as the Bank of England's quantitative easing operations had the desired effect of easing the supply and cost of credit in the economy during 2009.

2.5b A further strong theme has been the major emphasis on mitigating risk by giving heightened preference to security and liquidity at a time when the world banking system was still under stress and pending the issue, later in 2009, of new CIPFA and statutory guidance on investing. This has therefore resulted in more of our investment portfolio being moved into investment instruments with lower rates of return but higher security and liquidity. This has compounded the significant fall in total investment earnings compared to previous years.

The Economy & Interest Rates

2.6 During 2009/10 the Monetary Policy Committee (MPC) was focused on helping the economy to turn around from plunging into the deepest and longest recession the UK economy had experienced for many years.

Despite keeping Bank Rate at an unprecedented historical low of 0.5% all year, the MPC also had to resort to extreme measures in terms of pumping liquidity into the economy through quantitative easing by purchasing £200bn gilts and corporate bonds. This had the effect of boosting prices for gilts and corporate bonds and therefore bringing down yields, so also reducing borrowing costs for both the corporate and public sector.

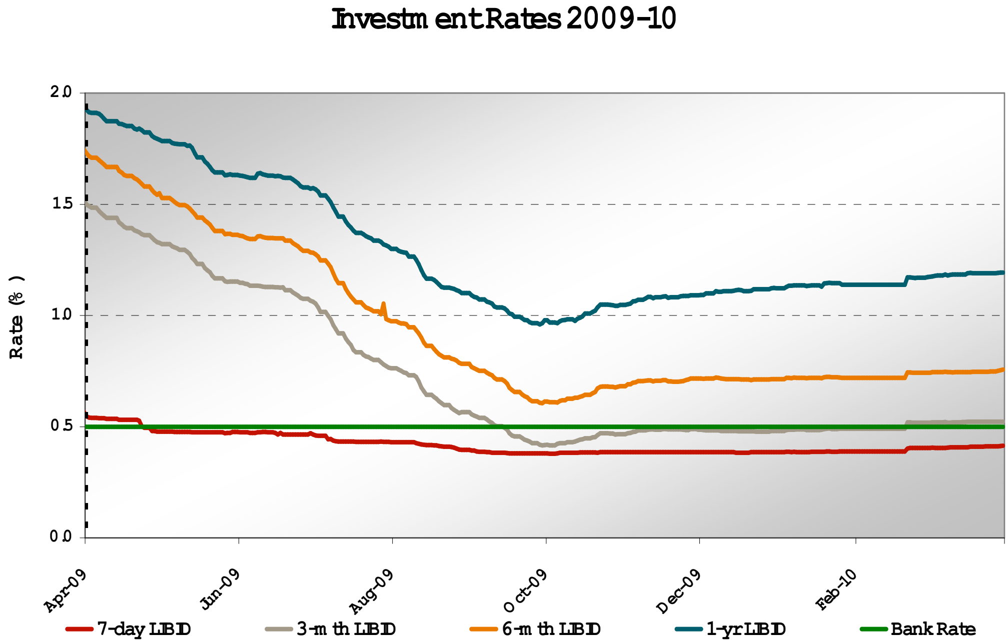
It was notable that the increase in money supply in the economy generated by this programme brought the credit crunch induced spread between Bank Rate and 3 month LIBID (investment rate that depositors could earn) down from 0.95% at the beginning of the financial year to zero during August 2009.

The dominant focus in 2009/10 was on quarterly GDP growth figures. The recession bottomed out in quarter 1 of 2009. There was then major disappointment that the end of the recession failed to materialise in quarter 3 2009 but the fourth quarter of 2009 did then see economic growth return at +0.4%.

Inflation has not been a major concern of the MPC 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 was expected to fall out of the inflation index and inflation was forecast by the Bank of England to fall back under target by the end of 2010.

The graph below shows the investment rates against the bank rate for 2009/10.



Iceland Investments

2.7 The Council is one of over 100 local authorities that were affected by the collapse of Icelandic banking institutions. The Council currently has a total of £6.5 million in 3 investments with Glitnir and is in the process of trying to recover these funds through the applicable legal process.

The Icelandic Government has stated its intention to honour all its commitments as a result of their banks being placed into receivership. The U.K. Government is working with the Icelandic Government to help bring this about. At the current time, the process of recovering assets is still ongoing with the Administrators. The Local Government Association is coordinating the efforts of all UK authorities with Icelandic investments. Members will be periodically updated on the latest developments on these efforts.

Decisions on the priority status of local authority deposits will be made by the Icelandic courts. Allowing for the court cases to be heard, and for the appeals process to run its course, it is considered unlikely that there will be a settled position on priority status before the second quarter of 2011.

The Government, the National Assembly of Wales and the Scottish Parliament have all issued regulations to allow local authorities to delay recognising any loss on these investments that may eventually be incurred until the financial year 2010/11. This authority made an application for capitalisation of these losses in December 2009, but unfortunately we were refused on the grounds that the

Council has enough reserves to cover the losses. Following this, the Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2009 allowed the Council to defer the impact of the impairment charge relating to the 3 Icelandic investments until 2010/11. The Council has decided to take advantage of the Regulations and has accounted for the Icelandic Investments in accordance with CIPFA`s LAAP Bulletin Update 82. Any outstanding credits authorised by the regulation must be reversed in the 2010/11 accounts.

The Local Authority Accounting Panel considers, on the basis of the legal advice obtained by local authorities and advice provided by the Local Government Association, that it remains the most likely outcome that the claims will enjoy priority status. Based on this assessment, the Local Authority Accounting Panel recommends that the estimated recoverable amount to be included in the balance sheet is based on the assumption that local authority deposits will enjoy priority status.

The value (recoverable amount) of these deposits at 31 March 2010 has been reassessed in line with FRS 26 - Financial Instruments which states that the recoverable amount of financial assets carried at amortised cost is the present value of the expected future cash flows discounted at the instrument's original effective interest rate.

In line with guidance provided and latest available information on the likelihood of recovery the Council has reassessed the future cash flows of the deposits with Glitnir on the assumption that we receive preferential creditor status and receive 100% of principal and interest by June 2011 and this results in an impairment charge.

Although the Council remains confident of getting all of its investment back as a priority creditor the Council has considered the possibility of an outcome where we only receive 29% of the principle. This strategy has been built into our Medium Term Financial Forecast.

The non-return of the deposit has not caused any immediate cash flow problems for the Council except for the loss of investment income due to its non-availability for reinvestment.

Compliance with Code

2.8 There has been one instance of non-compliance during 2009/10. We breached our limit with Barclays due to sharing limits in-house and with Investec. This was rectified by increasing the limit with Barclays to £8m on 1st May 2009. It was agreed by the Portfolio Holder for Resources and Organisational Development.

2.9 In light of the change of limits from £8m to £15m we have recently agreed with Investec that they will limit their exposure to any UK Clearer to 10% of their allocation of the fund (£2m) which will allow in-house & TUK a maximum of £13m.