Agenda Item No:

Report to:	**Audit Committee**
Date of Meeting:	**27 September 2010**
Report Title:	**Treasury Management - Mid Year Report 2010-11**
Report By:	**Head of Financial Services**

Purpose of Report

This report advises the Committee of the Treasury Management activities and performance during the current year.

Recommendation(s)

1. **The Committee consider the report and draw any concerns or recommendations to Cabinet and subsequently Council.**

Reasons for Recommendations

The Code of Practice on Treasury Management requires, as a minimum, a mid-year review of Treasury Management Strategy and performance. This is intended to highlight any areas of concern that have arisen since the original strategy was approved (15 February 2010).

The investment returns achieved by the Council's fund manager in the year to date are significantly lower than that budgeted for. It is the intention to review the position with the fund manager and if significant returns can not be anticipated for the next 12 months, to then manage investments in-house.

The Audit Committee, as delegated by Council, is tasked with scrutinising the Treasury Management activities and to draw to Cabinet's attention any matters it considers important.

Introduction and Background

1. The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009 was adopted by this Council on 15th February 2010 and this Council fully complies with its requirements.

2. The primary requirements of the Code are as follows:

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

3. Treasury management in this context is defined as:

    "The management of the local authority'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. "

4. The purpose of this report is to meet one of the above requirements of the CIPFA Code, namely the Mid Year review of treasury management activities, for the financial year 2010/11.

    This mid-year report covers

    a) the Council's treasury position
    b the economy and interest rates in 2010/11;
    c) borrowing and debt rescheduling;
    d) investments in 2010-11;
    e) compliance with Treasury limits

The Council's Treasury Position – August 2010

5. The Council's debt and investment position at the beginning of the year was as follows:

TABLE 1	31st March 2010 Principal	Rate/ Return	Life yrs
-PWLB Loan1	£7.5m	4.80%	23yrs
-PWLB Loan2	£2.5m	1.54%	1yr
-Market	£2.0m	0.45%	Temp.

	£12.0m	4.07%	
-PWLB Loan 3 (variable Rate)	£2.0m	0.60%	9yrs
Total Debt	£14.0m	3.00%	
Investments:			
-In-House	£3.2m		
-With Managers	£16.6m		
Total Investments	£19.8m		

6. At the 31 August 2010 the Council had debt amounting to £12m (all PWLB debt),

In terms of investments the Council had £16.6m invested with its fund manager (Aviva -- previously Morley), and some £5.5m invested In-house (this level varies on a daily basis throughout the year).

The Economy and Interest Rates 2010/11

7. During 2010/11 Monetary Policy Committee (MPC) has continued to focus on helping the economy out of recession. The Bank Base Rate has been maintained at an unprecedented historical low of 0.5%. The level of liquidity in the economy, due to quantitative easing, has 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.

8. Inflation has not been a major concern of the MPC, albeit that it remains high (Consumer Price Index 3.1% in August 2010, Retail Price Index (RPI) and RPI-X both 4.7% in August 2010). Inflation is forecast by the Bank of England to fall significantly throughout the year despite the VAT increase in January 2011.

9. The Council's Treasury advisers (Sector) now expect bank base rates to stay at 0.5% until Q3 2011, at which point gradual increases in bank rate are expected. Capital Economics is pessimistic about the UK economy and sees scope for interest rates to remain unchanged for a further 2 years. Other economists still predict rates to start increasing early in 2011.

Borrowing and Debt Rescheduling

10. The Council has £12m of PWLB debt, and could potentially borrow up to some £16m.

11. Rates in the 25-50 years have been revised down to around 4.25%, and the Council's advisers consider there is scope for loans of < 10 years to be taken for around 3.3%.

12. Given the historically low PWLB rates, if loans were rescheduled there would currently be a large premium to pay. However, the rates are at historically low levels and it is an opportunity to borrow. The Council has a fixed rate loan of £2.5m maturing in January 2011. Consideration will be given to refinancing this whilst rates remain low.

Investments in 2010-11

13. Investment rates have fallen during the first half of the year. The Bank base rate is expected to remain at ½% for the next 12months.

14. Internally Managed Investments - the Council manages some investments in-house (currently some £5.5m) and invests with the institutions listed in the Council’s approved lending list. The Council invests for a range of periods from overnight to 364 days, dependent on the Council’s cash flows, its interest rate view, the interest rates on offer and durational limits set out in the approved investment strategy. The annualised return for 2010-11 is currently 1.05%.

15. Externally Managed Investments - the fund (£16.6m) is managed by Aviva. The Council’s Treasury Management advisers (Sector) have stated that "performance has been steady but appears to lack the opportunity to improve in the next year or so”. The return net of fees, was 0.11% for the quarter ending 30th June (some 0.44% for the year), and did not markedly improve in July (0.06% gross in the month). August performance is currently awaited.

16. During last year enhanced priority was given to security and liquidity in order to reduce counterparty risk to the maximum possible extent. In order to counter the downturn in investment rates part of the investment portfolio was held in liquidity accounts with main UK banks. These accounts offered both instant access and rates which were often double those available in the money markets through brokers for overnight money and higher than for most periods up to six months.

17. Currently there are a number of opportunities to invest cash out for periods of 1 to 3 years with the likes of Lloyds and Royal Bank of Scotland for circa 1.9% return

(1 year). Given that the investment returns being achieved by the fund manager are considerably lower than this, the ongoing use a fund manager is being reviewed. The implications for the Council's lending list remains unaltered (i.e. the institutions that HBC can invest with), other than the individual sums invested by HBC with any one institution would need to increase.

18. The proposed limit is £5m with any one institution (currently £3m), thus representing a level of up to 25% of the investment portfolio with any one institution or group at any one time. It is also necessary, at times, to invest sums of this size in order to attract the larger institutions which have the higher credit ratings. The Deputy Chief Executive and Director or Corporate Resources has the authority to amend the limits.

Compliance with Treasury Limits

19. During the financial year to date the Council has operated within the treasury limits and Prudential Indicators set out in the Council's annual Treasury Strategy Statement and in compliance with the Council's Treasury Management Practices. The Prudential Indicators are reproduced in Appendix 1.

Financial Implications

20. The Council's 2010/11 budget estimated a 1% return for externally managed funds and a 0.8% return for internally managed funds (lower value, shorter periods, no Gilts). Based on current performance of the fund manager (Aviva) an annual return of 0.45% rather than 1% budgeted would result in a reduction of £91,000 of interest receivable for 2010/11.

21. Whilst there is no guarantee that the special rates open to Councils will continue to be available, the opportunity to invest at rates of up to 1.9% for 1 year periods would help to offset any reduction in 2010/11 and also secure a modest rate of interest for 2011/12. The Council has the Interest Equalisation Reserve available to help offset any reduction in interest receivable.

22. The Council has the opportunity to make investments in the market that are not open to the Fund Manager. Investments in longer periods could potentially achieve a return of more than 1% in a full year above that currently being achieved by the Fund manager.

Risk Management

23. The Council spreads its risk on investments by limiting the amount of monies with any one institution or group and limiting the timeframe of the exposure. In determining the level of the investment and period the Council considers formal credit ratings (IBCA) along with its own advisers (Sector) ratings advice.

24. The security of the principal sum remains of paramount importance to the Council. However the level of return being achieved by the fund Manager justifies the

return of treasury management to the in-house team with little or no additional risk to the Council, given that the limits that could be invested by HBC and the fund manager were not mutually exclusive i.e. Aviva could invest £3m and HBC could potentially invest £3m with the same institution at the same time.

Wards Affected

Ashdown, Baird, Braybrooke, Castle, Central St. Leonards, Conquest, Gensing, Hollington, Maze Hill, Old Hastings, Ore, Silverhill, St. Helens, Tressell, West St. Leonards, Wishing Tree

Area(s) Affected

Central Hastings, East Hastings, North St. Leonards, South St. Leonards

Policy Implications

Please identify if this report contains any implications for the following:

Equalities and Community Cohesiveness	No
Crime and Fear of Crime (Section 17)	No
Risk Management	Yes
Environmental Issues	No
Economic/Financial Implications	Yes
Human Rights Act	No
Organisational Consequences	No

Background Information

1. Treasury Management and Annual Investment Strategy 2010/11 (Cabinet, 15 February 2010)
2. Annual Treasury Management Report (Audit Committee, 28 June 2010)
3.Treasury Management in the Public services (Cipfa, Code of Practice and Cross-Sectoral Guidance Notes, Rev. Edition 2009)

Officer to Contact

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APPENDIX 1 Prudential & Treasury Indicators

PRUDENTIAL INDICATOR	2008/09	2009/10	2010/11	2011/12	2012/13
(1). EXTRACT FROM BUDGET	£'000	£'000	£'000	£'000	£'000
	Actual	Actual	Estimate	Estimate	Estimate
Capital Expenditure	£6,820	£6,449	£10,091	£2,771	£2,521
Ratio of financing costs to net revenue stream	1.3%	-0.7%	-0.7%	-0.7%	0.6%
Net borrowing requirement	£2,264	£1,016	£2,653	£0	£0
Capital Financing Requirement as at 31 March	£13,165	£13,849	£16,113	£15,676	£15,240
Annual change in Capital Financing Requirement	£2,074	£684	£2,229	£-437	£-436
Incremental impact of capital investment decisions Increase in council tax (band D) per annum	£1.92	£0.93	£5.55	£11.05	£7.62

PRUDENTIAL INDICATOR	2008/09	2009/10	2010/11	2011/12	2012/13
(2). TREASURY MANAGEMENT PRUDENTIAL INDICATORS	£'000	£'000	£'000	£'000	£'000
	Actual	Actual	Estimate	Estimate	Estimate
Authorised Limit for external debt - borrowing other long term liabilities	 £45,000 £0	 £20,000 £0	 £20,000 £10,000	 £20,000 £10,000	 £20,000 £10,000
TOTAL	£45,000	£20,000	£30,000	£30,000	£30,000
Operational Boundary for external debt - borrowing other long term liabilities	 £30,000 £0	 £20,000 £0	 £20,000 £10,000	 £20,000 £10,000	 £20,000 £10,000
TOTAL	£30,000	£20,000	£30,000	£30,000	£30,000

Upper limit for fixed interest rate exposure Net principal re fixed rate borrowing / investments OR:-	100 %	100 %	100 %	100 %	100 %
Upper limit for variable rate exposure Net principal re fixed rate borrowing / investments OR:-	100 %	100 %	100 %	100 %	100 %
Upper limit for total principal sums invested for over 364 days	£0	£0	£0	£0	£0

Maturity structure of fixed rate borrowing during 2010/11	upper limit	lower limit
under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%