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Meeting	Cabinet Resources Committee
Date	20 <sup>th</sup> June 2012
<b>Subject</b>	<b>Treasury Management Outturn for year ended 31 March 2012</b>
Report of	Cabinet Member for Resources and Performance
Summary	To report on Treasury Management activity for year ended 31 March 2012.
Officer Contributors	John Hooton - Assistant Director of Strategic Finance  Iain Millar – Head of Treasury and Pensions
Status (public or exempt)	Public
Wards affected	Not applicable
Enclosures	Appendix A – Money Market and PWLB Rates Appendix B – Deposits as at 31 March 2012 with Credit Ratings Appendix C – Compliance with Prudential Indicators Appendix D – List of School Banking Institutions
For decision by	Cabinet Resources Committee
Function of	Executive
Reason for urgency / exemption from call-in (if appropriate)	Not applicable
Contact for further information: Iain Millar, Head of Treasury and Pensions, 020 8359 7126.	

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## **1. RECOMMENDATIONS**

- 1.1 That the Treasury Management activity and position for the year ended March 2012 be noted.**
- 1.2 That the Committee notes the Council's response to continuing market uncertainty which is set out in sections 9.1.4 and 9.9.**
- 1.3 That the Committee consider any areas on which it would like to receive further information**

## **2. RELEVANT PREVIOUS DECISIONS**

- 2.1 Council, 1 March 2011 (Decision item 10) – Treasury Management Strategy 2011/12.
- 2.2 Cabinet Resources Committee 29 June 2011 (Decision item 6) - Treasury Management Outturn for the year ended 31 March 2011
- 2.3 Cabinet Resources Committee 27 September 2011 (Decision item 17) - Treasury Management Outturn for the quarter ended 30 June 2011.
- 2.4 Cabinet Resources Committee 14 December 2011 (Decision item 14) - Treasury Management Outturn for the quarter ended 30 September 2011
- 2.5 Cabinet Resources Committee 28 February 2012 (Decision item 10) Treasury Management Outturn for the quarter ended 31 December 2011
- 2.6 Council 6 March 2012, (Decision item 10) – Treasury Management Strategy 2012/13.

## **3. CORPORATE PRIORITIES AND POLICY CONSIDERATIONS**

- 3.1 The Treasury Management Strategy (TMS) ensures effective treasury management supports the achievement of the Council's corporate priority for 2011-2013, 'Better services with less money', through the strategic objective "manage resources and assets effectively and sustainably across the public sector in Barnet". The TMS is committed to the principles of achieving value for money in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

## **4. RISK MANAGEMENT ISSUES**

- 4.1 Borrowing and deposit rates are determined by the market and can be volatile at times. Officers mitigate this volatility by monitoring the interest rate market in conjunction with treasury advisors and brokers, and by actively managing the debt and deposit portfolios.

## **5. EQUALITIES AND DIVERSITY ISSUES**

- 5.1 Under the Equality Act 2010, the council must have due regard to the need to: a) eliminate discrimination, harassment, victimisation and any other conduct that is prohibited by or under the Act; b) advance equality of opportunity between those with a protected characteristic and those without; c) promote good relations between those with a protected characteristic and those without. The 'protected characteristics' referred to

are: age; disability; gender reassignment; pregnancy and maternity, race, religion or belief; sex; sexual orientation. It also covers marriage and civil partnership with regard to eliminating discrimination.

- 5.2 The management of the Council's cash flow ensures the availability of adequate monies to pay for the delivery of the authority's public duties.

## **6. USE OF RESOURCES IMPLICATIONS (Finance, Procurement, Performance and Value for Money, Staffing, IT, Property, Sustainability)**

- 6.1.1 The purpose of the treasury function is to maximise the Council's budget for investment return and minimise interest costs in accordance with the risk strategy set out in the TMS.
- 6.1.2 The total value of existing long term treasury loans as at 31 March 2011 was £202.50m and for the year ended 31 March 2012 was £201.50m. The average cost of borrowing for the 2011-12 was at 4.10%. New borrowing of £102.58 m was taken on 28<sup>th</sup> March 2012 to finance the Council Housing reform settlement at an average cost of 3.36%.
- 6.1.3 At 31 March 2011, deposits outstanding amounted to £165.096m (including £3.144m of Icelandic impairments), achieving an average rate of return of 0.53% (adjusted for Icelandic deposits) against a benchmark of 0.52%. A list of deposits outstanding and counterparty credit ratings as at year end 31 March 2012 is attached as Appendix B. The Council's budgeted investment income for the year had been estimated at £1.291m. And interest earned was £1.245m.
- 6.2 In response to market uncertainty the Council has further restricted its investment criteria which impacted on investment performance as short term money market rates remained at low levels through out the year.
- 6.3 The wider financial implications for the Council are dealt with in section 9 of this report.

## **7. LEGAL ISSUES**

- 7.1 These are addressed in the body of this report and, in particular, in sections 5.1, 9.4 and 9.6.

## **8. CONSTITUTIONAL POWERS**

- 8.1 Financial Regulations (Part 1, Section 7) within the Council Constitution state:
- (1) This organisation adopts the key recommendations of CIPFA's Treasury Management in the Public Services Code of Practice (the Code), as described in Section 4 of that Code.
  - (2) Cabinet Resources Committee will create and maintain a Treasury Management Policy Statement, stating the policies and objectives of its treasury management activities.
  - (3) The Chief Finance Officer will create and maintain suitable Treasury Management Practices (TMP's) setting out the manner in which the Authority will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.
  - (4) The content of the policy statement and TMP's will predominantly follow the recommendations contained in Section 6 and 7 of the Code, subject only to

amendment where necessary to reflect the particular circumstances of the organisation. Such amendments will not result in the authority materially deviating from the Code's key recommendations.

- (5) Cabinet Resources Committee will receive reports on its treasury management policies, practices and activities, including an annual strategy and plan in advance of the year, and an annual report after its close in the form prescribed in the TMP's. These reports will incorporate the prudential borrowing limits and performance indicators.

- 8.2 Constitution - Responsibilities for Functions, Section 3.6 states that a function of the Cabinet Resources Committee is to "consider reports on Treasury Management Strategy and activity, including creating and maintaining a Treasury Management Policy Statement."

## **9. BACKGROUND INFORMATION**

### **9.1 Treasury Management Strategy**

- 9.1.1 The Council's amended Treasury Management Strategy 2010/11 was approved at Cabinet Resources Committee on 30 November 2010. The TMS 2010/11 reflected the Council Budget 2010-2011 Financial Forward Plan and Capital Programme and set out the timeframes and credit criteria for placing cash deposits and the parameters for undertaking any further borrowing.

- 9.1.2 The key changes introduced by the amended TMS 2010/2011 were:

- (i) The extension of the maximum permissible duration of investments from 92 days to 364 days to bring the strategy in line with that of other local authorities and to enable a higher rate of return on investments.
- (ii) The adoption of the Arlingclose (the Council's treasury advisors) counterparty list which includes the Debt Management Account Deposit Facility, T-Bills, UK local authorities, UK and non-UK banks and AAA-rated Money Market Funds.

- 9.1.3 The TMS 2011/12 was approved by Council on the 1<sup>st</sup> of March 2011 and incorporated the key changes set out in 9.1.2. above.

- 9.1.4 The TMS 2012/13 was approved by Council on 6 March 2012.

- 9.1.5 The TMS is under constant review to reflect market conditions and the financing requirements of the Council. The Council's treasury advisers Arlingclose are not recommending we adjust or tighten the current strategy. Arlingclose have recommended reducing maximum duration for new investments from 365 days to 3 months for approved Australian, Canadian and US banks and no new investment In European banks.

- i) However given current market uncertainty, officers have followed an even more cautious strategy than has been recommended by Arlingclose for new investments. The Council's investments are temporarily restricted to 14 days duration. Any investment proposed beyond 14 days must be approved by the Deputy Chief Executive.
- ii) Tightening counterparty criteria. Treasury Officers are restricted to investing only with UK, Canadian and Australian institutions who meet the required minimum credit rating in accordance with the treasury management strategy.

- iii) Since October 2011, Money Market Funds(MMF) have been opened to diversify cash investments in highly liquid financial instruments with the highest credit rating. Arlingclose have recommended that MMF investments are restricted to 10% of the Council's total cash (previously 15%), in any one MMF. Investments must be diversified between a minimum of two funds and exposure limited to 0.5% of each MMF's total funds under management. The Council is currently investing in two MMF's with less than 10% of total cash in these accounts.
- iv) Use of the Debt Management Office because of market uncertainty and counterparty restrictions set out above.

9.1.6 European banking uncertainty has resulted in further down grading of the credit rating of some of the major UK institutions:- RBS, Bank of Scotland, Lloyds TSB, National Westminster Bank and Clydesdale Bank which ceased to meet the minimum lending criteria set out in the Treasury Management Strategy and new investments with these banks was temporarily suspended. In practice this means that there were only a limited number of counterparties left with the required credit rating.

9.1.7 Changes set out in the 2012-2013 TMS amended the counterparty criteria to allow investment with banks which have systemic importance to the global banking system. This allows new investment with the main UK clearing banks which have been removed from the current counterparty list. Investment continues to be subject to an operational overlay to manage credit risk. There would be limits to investment duration and the counterparty list would be restricted to the key UK banks and subject to regular review.

9.1.8 Restrictions on duration of investment and exclusions from the counterparty list are expected to be a temporary measure. This report therefore asks the Committee to note the cautious approach to investment during the year.

## **9.2 Icelandic Bank Deposits**

9.2.1 In December 2011, the Supreme Court of Iceland upheld the District Court judgment for the test cases that local authorities' claims are deposits that qualify in full for priority in the bank administrations. Securing priority creditor status means that authorities with deposits in Glitnir are set to recover 100 per cent of their money, whilst those with deposits in Landisbanki are estimated to recover 98 per cent. These decisions are now final and there is no further right of appeal.

9.2.2. Sufficient cash has already been realised in the winding up, to repay the entire principal due from the Glitnir deposits. In March 2012 approximately 82% was recovered in a mixture of sterling, Euro and US dollar payments with conversion a spot rate into sterling. The remaining 18% is held in an escrow account in Icelandic Krona.

9.2.3. In February 2012, 30% was recovered from Landisbanki in a mixture of sterling, Euro, Norwegian Krona and US dollar payments with conversion a spot rate into sterling. The remaining 2% is held in an escrow account in Icelandic Krona. Regular annual payments are expected to pay the outstanding balance until December 2018.

9.2.4 The Council has reduced impairment in its accounts against Icelandic Bank losses to £3.144 million. The latest indications are that the Council will recover almost the entire principal and a proportion of the interest due on maturity. Most of the recoverable deposits and interest due will be paid from escrow accounts in Icelandic and Norwegian Kroner, Euros, and US Dollars. Fluctuations in currency rates against sterling since 2009

are likely to result in a potential shortfall on the deposits and interest expected to be returned to the Council. The potential shortfall can be met from within the existing risk reserve.

### 9.3 Economic Background

- 9.3.1 The 2011-12 Treasury Management Strategy forecast slow recovery and uneven recovery from the recession. Inflation measured by the Consumer Price Index (CPI) was above 3%, Unemployment was expected to rise from 2.5 million and there was a high degree of uncertainty surrounding Euro zone sovereign debt uncertainty.

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**Inflation:** During 2011-12 inflation remained high. Annual CPI rose to 5.2% due to rising utility prices and the impact of the increase in VAT to 20% in January 2011. By February 2012, CPI had fallen to 3.4%. Inflation fell due to the combined effect of reduced transport costs and food prices. But low wage growth meant that the UK had the biggest drop in disposable income in more than three decades.

- 9.3.2 **Growth, Employment / Consumer Confidence:** Unemployment rose to 2.68 million and youth unemployment reached 1 million. Growth was forecast to be 1% in 2011 and 2012 but annual GDP was only 0.5% to December 2011. Real wages (i.e. after inflation) have been negative for over three years resulting in lower disposable income. Housing prices struggled to show sustained growth and consumer confidence remained fragile.

- 9.3.3 **Monetary Policy.** Central bankers' policies were driven by the feeble growth outlook rather than the upward trend in inflation. The slowdown in the global economy, a deterioration in the economic outlook, the severe strains in the bank funding markets and a continued lack of supply of credit were the reasons given by the Monetary Policy Committee's decision at its meeting in October to increase asset purchases (QE) by £75bn and another £50 billion in February 2012 to a cumulative total of £325 billion, whilst maintaining the Bank Rate at 0.5%. The European Central Bank also opted for unconventional monetary policy by substantially increasing its refinancing operations. The ECB reintroduced year-long loans for banks and its main refinancing programme would be made available until at least July 2012, both of which are intended to provide much-needed liquidity for its banking sector.

- 9.3.4 **Gilt yields and money market rates** The very poor outlook for global 5-year growth has pushed back expectations for a rise in the UK bank rate to 2014/2015. Gilts once again benefited from their safe haven status and yields, which had already fallen to lows in the previous quarter, fell further in the fourth quarter of 2011. Public Works Boards Loans Board (PWLBB) loan rates fell commensurately

- 9.3.5 **March 2012 Budget.** The monetary policy measures in the March 2012 budget statement were judged to be neutral as the government maintained its austerity plans to rebalance the economy. The Office for Budget Responsibility identified oil price shocks and further deterioration in Europe as the main risks to the outlook for growth and in meeting the fiscal target.

- 9.3.6 **Europe.** The political impasse in the Euro zone threatened to derail peripheral nations and it was not surprising that the rating agencies' warnings became more strident. Moody's said that it would review the ratings of all European Union sovereigns in the first quarter of 2012 after December's summit failed to produce decisive policy measures. Fitch placed the ratings of several sovereigns including Italy, Spain, Belgium and Ireland on rating watch negative based on its view that a comprehensive solution to the crisis was technically and politically beyond reach. In Europe sovereign debt problems for some countries became critical. Two bail-out packages were required for Greece, and

one for Portugal and the sovereign bonds of Spain and Italy came under increased stress. The markets took the view that Long Term re-financing Operations delayed resolution rather than addressed the sovereign debt crises in Europe

- 9.3.7 **Credit.** The deterioration in prospects for real growth had implications for earnings and profit growth and banks' creditworthiness. The slow down in debt and equity capital market activity also had implications for banks' funding and liquidity. These principal factors as well as re-assessment by the ratings agencies of future sovereign support for banks resulted in down grades to the long-term ratings of several UK and non UK financial institutions in autumn 2011.
- 9.3.8 The TMS will be kept under review specifically in terms of market conditions, benchmarks and yields.

#### **9.4 Debt Management and the Reform of Council Housing Finance**

- 9.4.1 The Localism Act passed into law in November 2011 which enabled the reform of council housing finance. The Housing Revenue Account subsidy system has now been abolished and replaced with self-financing whereby authorities support their own housing stock from their own income. This reform required a readjustment of each authority's housing-related debt based on a valuation of its council housing stock. Settlement date for the Self Financing transaction was Wednesday 28th March 2012.
- 9.4.2 As the Council's debt level generated by the housing reform model was higher than the Subsidy Capital Financing Requirement (SCFR), the Council was required to pay the CLG the difference between the two, which was £102.58m. This required the Council to fund the settlement primarily through borrowing. A preferential set of PWLB rates at 13bps above the equivalent gilt yield were available for this transaction on 26<sup>th</sup> March only, for settlement on 28<sup>th</sup> March. Given the one-off nature of the PWLB funding window and the advantages offered in terms of rate, loan structure and administration, the Council took the decision to fund through new borrowing from the PWLB.
- 9.4.3 Loan structures and maturities were discussed and analysed with the Council's Treasury Advisors to fit in with the Council's HRA business plan and strategy, funding costs, as well as the Council's existing treasury management position and risk profile. The Council will henceforth adopt a two pool approach in relation to the allocation of debt between the General Fund and HRA.
- 9.4.2 The total value of long term loans as at 31 March 2011 was £202.50m and for the year ended 31 March was £201.50m. The average cost of borrowing for the year to March 2012 was 4.10%. (Excluding Housing Finance Settlement borrowing). There was no other borrowing in the year
- 9.4.3 Given the significant cuts to local government funding putting pressure on Council finances, the decision was taken to minimise debt interest payments without compromising the longer-term stability of the portfolio. The differential between the cost of new longer-term debt and the return generated on the Council's temporary investment returns was significant (just over 3%). The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding capital expenditure. This has, for the time being, lowered overall treasury risk by reducing both external debt and temporary investments. There is no benefit from taking new long term debt while borrowing costs are forecast to remain at current levels.

9.4.4 The Council's long term debt position to the end of the quarter ended 31 December 2011 was as follows:

	31 March 2012		31 March 2011	
	Principal	Average Rate	Principal	Average Rate
PWLB	£139.00m	4.19%	£140.00m	4.19%
Market	£ 62.50m	3.91%	£ 62.50m	3.91%
Total	£201.50m	4.10%	£202.50m	4.10%
PWLB HRA self-financing	£102.58m	3.36%	-	
Total	£304.08m			

9.4.5 The Council's long-term debt portfolio is a mixture of PWLB and market loans in the form of Lender's Option Borrower's Option, (LOBO's) loans that are at a fixed interest rate for an initial period, following which the lender can change the interest rate but the borrower has the option to repay the loan if the rate is changed and not considered value for money.

9.4.6 In order to comply with accounting standards for financial instruments, some of the market loans in the debt portfolio have been recalculated on an effective interest rate basis as opposed to being calculated on an amortised cost basis. The total value of loans in question before re-measurement was £9.5m; an additional charge of £0.36m was added to the carrying value of these loans.

9.4.7 Money Market data and PWLB rates are attached at Appendix A.

9.4.8 PWLB Borrowing: Despite the issue of Circular 147 in October 2010, where new borrowing rates for fixed loans increased by approximately 0.87% across all maturities, the PWLB remains the preferred source of borrowing for the Council as it offers flexibility and control.

## 9.5 Investment Performance

9.5.1 The DCLG's revised Investment Guidance came into effect on 1 April 2010 and reiterated the need to focus on security and liquidity, rather than yield. Security of capital remained the Authority's main investment objective. This was maintained by following and complying with the counterparty policy as out in the TMS 2010/11.

9.5.2 Counterparty credit quality was assessed and monitored with reference to credit ratings (Council's minimum long-term counterparty rating of A+ across all three rating agencies, Fitch, S&P and Moody's); credit default swaps; Gross Domestic Product (GDP) of the country in which the institution operates; the country's net debt as a percentage of GDP; any potential support mechanisms and share price.

9.5.3 The Deposits are managed internally. At 31 March 2012, deposits outstanding amounted to £165.096 million (£3.144m being Icelandic impairments), achieving an average rate of return of 0.53% (adjusted for Icelandic deposits) against a benchmark of 0.52%. A list of deposits outstanding and counterparty credit ratings as at quarter end 31 December 2011 is attached as Appendix B.



- 9.5.4 The benchmark, the average 7-day LIBID rate, is provided by the authority's treasury advisors Arlingclose. The LIBID rate or London Interbank Bid Rate is the rate that a Euromarket bank is willing to pay to attract a deposit from another Euromarket bank in London.

## **9.6 Prudential Indicators**

- 9.6.1 The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of its indebted status. This is a statutory limit which should not be breached. The Council's Authorised Limit (also known as the Affordable Borrowing Limit) was set and approved at £463.818 million.
- 9.6.2 The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included with the Authorised Limit. The Council's Operational Boundary for 2011/2012 was set and approved at £448.818million
- 9.6.3 During the year to 31 March 2012 there were no breaches of the Authorised Limit and the Operational Boundary.
- 9.6.4 Further details of compliance with prudential indicators are contained in Appendix C.

## **9.7 Compliance**

- 9.7.1 The current 2011/2012 TMS was approved by Council on 1 March 2011. The TMS demands regular compliance reporting to this Committee to include an analysis of deposits made during the review period. This also reflects good practice and will serve to reassure this Committee that all current deposits for investment are in line with agreed principles as contained within the corporate TMS.
- 9.7.3 All Deposits placed during the year ended 31 March 2012 were compliant with the TMS as approved on 1 March 2011, and the revised TMS approved on 6 March 2012.
- 9.7.4 Treasury management procedures are monitored and reviewed in light of CIPFA guidance and current market conditions.
- 9.7.5 Update on schools banking - current position. The Department of Education changed their guidance on schools banking arrangements. The new guidance requires schools to bank with institutions that meet the requirements of approved counterparties as identified in the TMS. Appendix D contains a list of schools that currently bank with institutions that fall outside the TMS. Work is underway to transfer bank accounts to the approved list of banks and close bank accounts with those banks not on the approved list. Four schools were in discussion to transfer funds from Allied Irish Bank. Three of the schools have now transferred surplus funds from Allied Irish Bank. Accounts for two schools have also been opened with the Co-operative Bank. Work is in progress to open accounts and transfer accounts for the remaining school.

## **10. Summary**

In compliance with the requirements of the CIPFA Code of Practice this report provides Members with a summary report of the treasury management activity during the financial year 2011/12. None of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

## **11. LIST OF BACKGROUND PAPERS**

11.1 None.

Legal – SCS  
CFO – MC/JH