CABINET **12th JUNE 2008**

TREASURY MANAGEMENT ANNUAL REPORT 2007/08
(Report by the Head of Financial Services)

1. INTRODUCTION

1.1. During 2007/08 the Council continued to have significant investments but during the year the funds were withdrawn from Investec and managed as medium term investments in the in-house portfolio

Manager	April 2007 £m	March 2008 £m
Investec Asset Management	21.5	Nil
City Deposit Cash Managers (CDCM)	31.5	26.5
In-house medium term	Nil	12.0
In-house for cash flow	Nil	1.8

1.2 This report reviews the performance during 2007/08, considers if the strategy that the Council has adopted has been effective, and addresses any issues of risk and compliance with statutory and regulatory requirements. It also explains the reasons for reducing the number of fund managers from two to one and the preparations taken to borrow in advance should the right market conditions prevail.

2. PERFORMANCE OF FUNDS

2.1. Investec continued its run of poor performances into 2007/08 by not achieving its benchmark and the actual performance being significantly below that of CDCM.

PERFORMANCE FOR THE QUARTER APRIL 2007 – JUNE 2007					
	Performance %	Benchmark %	Variation from benchmark	Industry average %	Variation from average %
Investec	**0.92**	0.93 *	**-0.01**	1.16	**-0.24**
CDCM	**1.28**	1.42 **	**-0.14**	1.16	**+0.12**

2.2. The Capital Receipts Advisory Group met on 30th July 2007 with Chris Anthony from Butlers, our Treasury Management advisers. With market rates being above 6% and bearing in mind that the financial plan shows that the Authority will need funds in 1 to 2 years, it was considered to be the right time to bring funds managed by Investec back in-house. Investec accordingly returned £21.5m on 3 September 2007 and these funds were invested for periods between March 2008 and February 2009 at rates between 6.24% and 6.3%.

2.3. The performance of the funds with CDCM and managed in-house, for the whole year, are shown below:

PERFORMANCE FOR THE YEAR APRIL 2007 – MARCH 2008			
	Performance %	Benchmark %	Variation from benchmark
CDCM	**5.40**	5.85	**-0.45**
In-house	**6.23**	5.74	**+0.49**

2.4. The excellent performance of the in-house funds reflects the good rates available in September 2007 when the funds were returned from Investec and invested in time deposits.

2.5. CDCM did less well due to the rise in interest rates. Thus, whilst investments taken out in previous years have been providing good returns they have now fallen below market rates. Investments therefore need to be considered over their whole life to judge their true return. Over a longer time frame, CDCM has had a very satisfactory track record.

3. IN-HOUSE INVESTMENT OF FUNDS

3.1. In September 2007 the in-house portfolio included £20m invested until March 2008 and beyond. In March 2008 £8m matured and was used to finance the expenditure of the Authority.

3.2. In addition there are short term 'in-house' funds that fluctuate on a daily basis due to the volatility of the cash flow to and from the Authority. The cash position varied from total investments of £7.1m (excluding the £20m medium-term investments) to net borrowings of £1.9m.

4. STRATEGY

4.1. The Council agreed new broader mandates with the three Fund Managers in July 2000. The size of its reserves meant that the Authority could take the view that the Fund Managers should maximise the returns in the medium term, three years, rather than on an annual basis. To the end of March 2007 it can be seen that this strategy has been effective.

	CUMULATIVE PERFORMANCE SINCE START OF MANDATES JULY 2000* – MARCH 2007				
	Performance %	Benchmark %	Variation from benchmark %	Industry Average %	Variation from Average %
Investec	37.0	36.6	**+0.4**	35.3	**+1.7**
Alliance	37.7	36.0	**+1.7**	34.6	**+3.1**
CDCM	39.2	35.3	**+3.9**	35.3	**+3.9**

* The mandate with Alliance Capital started in August 2000
Returns are not compounded.

4.2. The above table of cumulative returns shows that the performance of Alliance Bernstein and Investec was quite close after nearly 7 years.

4.3. In March 2007 Alliance Bernstein wished to withdraw from the Local Government market and those funds not immediately needed were placed with CDCM.

4.4. The performance of Investec in 2007/08 resulted in their funds being withdrawn and managed in-house. However the reduction of fund managers from three to two to one was in-line with the strategy as it was recognised that investments would reduce as the reserves are need to fund capital expenditure.

4.5. The Annual Treasury Management Strategy includes the mandates for Fund Managers and in-house investments; copies of the mandates, in place as at March 2008, are attached at Annex A. No changes were made during the year to the mandates.

5. BORROWING IN ADVANCE

5.1 The 2006/07 MTP showed that from 2008/09 the Council would need to borrow to finance capital expenditure. Following discussion with external auditors, it was agreed, and included within the Treasury Management Strategy, that the Council would borrow in advance a maximum of the forecast borrowing during the MTP period as long as it was considered that the rates were attractively low, compared with future expectations of long term rates.

5.2 Advice was taken as to a target low level for this borrowing. However during both 2006/07 and 2007/08 rates had not fallen to that level but the rates continue to be monitored daily.

6. RISK IMPLICATIONS

6.1 The Treasury Management Policy approved by the Cabinet on 27th February 2002, emphasises the importance of controlling risk i.e. returns should be maximised but only at an acceptable level of risk.

6.2 There are three main elements of risk:

- that the borrower will be unable to return the loan when it is due
- that the Fund Managers will take the wrong view on interest rate movements leading to poor returns
- that the investments are not sufficiently liquid to be able to be sold to meet the cash flow needs of the Authority.

These were important considerations when the mandates were first agreed in 2000.

6.3 The Authority has minimised these risks in the following ways:

Risk of the borrower being unable to repay the investment
A rigid system of credit rating ensures that only the very safest organisations (those with high credit ratings) are dealt with, together with limits on the value placed with one issuer. CDCM is highly attuned to any market intelligence that might suggest a borrower is likely to have their credit rating reduced in the future and the Treasury Management Advisers provide regular updates on changes to credit rating. That said, the credit rating agencies did not predict the problems faced by Northern Rock in the summer of 2008. The Council already had £5m of investments with Northern Rock which matures between February and November 2009, however as they are now backed by the Government they actually have the highest credit rating of all counterparties. None of the treasury management transactions during the year have compromised the rules that have been set.

Risk of the wrong view on interest rates being taken
All CDCM investment recommendations are referred to the Council before the deal is made so the authority can question the proposal if they have any concerns. Advice from the Council's advisers ensures that reasonable views are taken.

All investments are, since September, in time deposits rather than gilts and CDs which had higher volatility and hence higher risk.

The mandates limit the duration of the investments which reduces the impact on the value if the interest rate view turns out to be incorrect.

Risk of the funds not being available to be returned to the Council
The mandate for CDCM allows it to invest a maximum of 25% of the fund, (currently £5m) for longer than 3 years and requires 50% to be repayable within 12 months. The 2008/09 Treasury Management Strategy introduces a change whereby the amount that needs to be available each year is clearly stated to reflect the fact that most of the funds will need to be returned in a staged manner over the coming years.

Seeking Professional Advice
Butlers were employed as our Treasury Management Consultants until December 2007 and their advice was sought before it was decided to withdraw Investec's funds. Sterling Consultancy Services were appointed from 1 January 2008.

Active monitoring
As well as reports to Cabinet, your officers monitor returns each month.

7. COMPLIANCE WITH REGULATIONS AND CODES

7.1 All the treasury management transactions have been carried out in accordance with the legislation and regulations concerning treasury management.

7.2 The Council met the requirements of the CIPFA Code of Practice on Treasury Management by adopting a Policy Statement in February 2002 and Treasury Management Practices in 2003/04. These assist both Members and Officers in the effective management and control of treasury management activities.

7.3 In 2003/4 CIPFA introduced the Prudential Code for Capital Finance and the DCLG brought out new guidance on Local Government investments. Both of these became effective from 1 April 2004. These require the Council to approve Prudential Indicators and an annual Treasury Management Strategy. Those for 2007/08 were approved at the Council meeting on 21st February 2007. Annex B shows the relevant indicators and the actual results.

7.4 One prudential indicator monitors the limit on investments that cannot be redeemed within 364 days; this is to manage the risk of funds not being returned when required. The limit was £14m based on funds invested by CDCM some of which were not repayable within a year. When Investec returned its funds, the dates on which funds would be required were re-assessed and accordingly some monies were invested for more than 1 year to maximise returns. This meant that £21.5m matured in excess of 1 year in September 2007 and thus the limit was exceeded. However there was no increase in risk to the Authority as funds were invested to ensure they were available when needed. As at 31 March 2008 £10m will mature after 364 days.

8. CONCLUSION

8.1 Investec’s performance was disappointing and their funds were withdrawn and added to the in-house portfolio in September 2007. CDCM’s performance was below the benchmark but their investment decisions may prove to be sound over the life of the investments.

8.2 Due to the nature of the Authority’s strategy, performance cannot be judged on the basis of a single year. The results from the start of the new broader mandates show that the Authority has adopted a sound strategy and selected Fund Managers that have exceeded their benchmarks and the industry average over the seven years.

8.3 The Authority has carried out its treasury management activities with due regard to minimising risk, and in accordance with legislation. It has adopted the CIPFA Code on Treasury Management, the Prudential Code for Capital Finance and the DCLG’s guidance on Local Government investments.

9. RECOMMENDATION

9.1 It is recommended that the content of this report be noted

BACKGROUND INFORMATION

2006/07 cash management files and working papers

Quarterly reports to the Cabinet

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ANNEX A

EXTERNAL FUND MANAGER MANDATE

CDCM

Duration of investments	50% must be repayable within 12 months Up to and including 5 years maximum maturity No more than 25% may be invested for longer than 3 years
Types of investments	Fixed Deposits Deposits at call, two or seven day notice
Credit Ratings	F1+ by FITCH IBCA or equivalent
Maximum limits	£5m per institution and group for English and Scottish Clearing Banks and their subsidiaries, and Overseas Banks on list of authorised counterparties. Building Societies With assets more than £2,000m £5m With assets more than £1,000m £3m Other building societies in the top 25 £2m
Benchmark	3 month LIBID

IN-HOUSE FUND MANAGEMENT

Duration of investments	Fixed deposits up to and including 1 year
Types of investments	Fixed Deposits Deposits at call, two or seven day notice Money Market Funds
Credit Ratings and Maximum limits	See below The credit rating is the short-term rating issued by FITCH unless otherwise indicated
Benchmark	LGC 7 day rate

COUNTER-PARTY LIST

LIMIT £2.5M **BANKS (Rated F1 or better)**	**SHORT TERM RATINGS**
Abbey National plc	F1+
Alliance and Leicester	F1+
Barclays	F1+
Bradford and Bingley	F1
Co-Operative	F1
HBOS	F1+
HSBC	F1+
Kleinwort Benson	P1*
Lloyds TSB Group	F1+
Northern Rock	F1
Royal Bank of Scotland	F1+

LIMIT £2.5M **BUILDING SOCIETIES (Assets over £5 billion – Rated F1 or better)**	SHORT TERM RATINGS
Britannia	F1
Chelsea	F1
Coventry	F1
Leeds	P1*
Nationwide	F1+
Portman	F1
Skipton	F1
West Bromwich	F1
Yorkshire	F1
ALL LOCAL AUTHORITIES, POLICE AND FIRE AUTHORITIES	N/A

* Moody's equivalent credit rating

LIMIT £1.5M	SHORT TERM RATINGS
BANK SUBSIDIARIES Wholly owned by F1 Rated banks	
RBS Trust Bank Ltd	F1+
Ulster Bank Limited	A1**
Ulster Bank Ireland	A1**
OTHER BANKS	
Allied Irish Bank	F1+
Anglo-Irish	F1
Bank of Ireland	F1+
Bank of Scotland (Ireland)	F1+
Bristol and West	F1
Close Brothers	F1
DePfa Bank	F1+
Dexia Banque Internationale a Luxembourg	A1+**
HFC Bank	F1
Irish Intercontinental Bank	F1
KBC Bank NV	F1+
Singer and Friedlander	F1
OTHER INSTITUTIONS	
3i Group Limited	A1**
Irish Life and Permanent plc	F1
BUILDING SOCIETIES (Assets over £2 billion)	
Cheshire	
Dunfermline	
Newcastle	
Norwich and Peterborough	
Nottingham	
Principality	
Stroud and Swindon	

LIMIT £1M	SHORT TERM RATINGS
BUILDING SOCIETIES (Assets over £1 billion) Scarborough	

** Standard and Poor's credit rating

Prudential Indicators for 2007/08 relating to Treasury Management
Comparison of actual results with limits

The authorised limit for external debt.
This is the maximum limit for borrowing and is based on a worst-case scenario.

2007/8 Limit £000	**2007/8 Actual £000**
41,700	**3,400**

The operational boundary for external debt.
This reflects a less extreme position. Although the figure can be exceeded without further approval it represents an early warning monitoring device to ensure that the authorised limit (above) is not exceeded.

2007/8 Limit £000	**2007/8 Actual £000**
36,700	**3,400**

Both of these items reflect the fact that long term rates were not considered low enough to borrow long-term in advance.

Adoption of the CIPFA Code
The Prudential Code requires the Authority to have adopted the CIPFA Code of Practice for Treasury Management in the Public Services.
This has been adopted.

Exposure to investments with fixed interest and variable interest.
These limits are given as a percentage of total investments.

	2007/8 Limit
Upper limit on fixed rate exposure	100%
Upper limit on variable rate exposure	84%

The limit is based on the mandates for the Fund Managers. As they did not breach the mandates, this prudential indicator has been within the limits

Borrowing Repayment Profile
The proportion of 2007/8 borrowing that will mature in successive periods.

	Upper limit	**Actual**	Lower limit	**Actual**
Under 12 months	100%	**100%**	100%	**100%**
12 months and within 24 months	0%	**0%**	0%	**0%**
24 months and within 5 years	0%	**0%**	0%	**0%**
5 years and within 10 years	0%	**0%**	0%	**0%**
10 years and above	0%	**0%**	0%	**0%**

In 2007/8 all the borrowing was temporary for cash flow purposes

Investment Repayment Profile
Limit on the value of investments that cannot be redeemed within 364 days.

2007/8 Limit £000	**2007/8 Actual- maximum £000**	**2007/8 Actual – 31/3/08 £000**
14,000	**21,500**	**10,000**

This reflects time deposits invested by CDCM and 'in-house'. The limit was exceeded in September 2007 when some of the funds returned from Investec were invested for longer than 364 days to match the projected need for funds in future years.