Agenda Item No. 9

WEST OXFORDSHIRE DISTRICT COUNCIL

FINANCE AND MANAGEMENT OVERVIEW AND SCRUTINY COMMITTEE WEDNESDAY, 30 APRIL 2014

TREASURY MANAGEMENT ACTIVITY AND PERFORMANCE – 2013/14

REPORT OF THE GO SHARED SERVICE - HEAD OF FINANCE

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1. PURPOSE

To advise members of treasury management activity and the performance of internal and external fund managers for 2013/14.

2. RECOMMENDATION

That treasury management and the performance of in-house and external fund managers' activity for 2013/14 be noted.

3. BACKGROUND

3.1. The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which requires local authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities at least twice a year. This committee has received five reports between 1 April 2013 and 31 March 2014 regarding investment activities, performance, fundamental review of strategy and an annual treasury management report. In addition the Fund Manager gave a presentation of their performance, the state of the market and their forecast of where the global economy would be moving.

3.2. Treasury management 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."

3.3. The Overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

4. ALTERNATIVES/OPTIONS

Not applicable.

5. FINANCIAL IMPLICATIONS

5.1. The annual report for Treasury Management is a full review of the economic background and its impact on the financial markets, plus detail regarding the controls in place for the Council in its use of investment counterparties (credit risk). There is further detail of the investments and their performance the Council undertook during the year. Finally showing the Council has complied with the prudential indicators it set as part of its investment strategy, such as adhering to borrowing limits and how the capital programme was financed. All these factors are reported within Appendix A, B and C to this report.

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Date: 21st April 2014

Appendix A

Annual Treasury Management Report

1. Economic Background

1.1 At the beginning of the 2013-14 financial year markets were concerned about lacklustre growth in the Eurozone, the UK and Japan. Lack of growth in the UK economy, the threat of a 'triple-dip' alongside falling real wages (i.e. after inflation) and the paucity of business investment were a concern for the Bank of England's Monetary Policy Committee. Only two major economies – the US and Germany – had growth above pre financial crisis levels, albeit these were still below trend. The Eurozone had navigated through a turbulent period for its disparate sovereigns and the likelihood of a near-term disorderly collapse had significantly diminished. The US government had just managed to avoid the fiscal cliff and a technical default in early 2013, only for the problem to re-emerge later in the year.

1.2 With new Governor Mark Carney at the helm, the Bank of England unveiled forward guidance in August pledging to not consider raising interest rates until the ILO unemployment rate fell below the 7% threshold. In the Bank's initial forecast, this level was only expected to be reached in 2016. Although the Bank stressed that this level was a ***threshold*** for consideration of rate increase rather an automatic trigger, markets began pricing in a much earlier rise than was warranted and, as a result, gilt yields rose aggressively.

1.3 The recovery in the UK surprised with strong economic activity and growth. Q4 2014 GDP showed year-on-year growth of 2.7%. Much of the improvement was down to the dominant service sector, and an increase in household consumption buoyed by the pick-up in housing transactions which were driven by higher consumer confidence, greater availability of credit and strengthening house prices which were partly boosted by government initiatives such as Help-to-Buy. However, business investment had yet to recover convincingly and the recovery was not accompanied by meaningful productivity growth. Worries of a housing bubble were tempered by evidence that net mortgage lending was up by only around 1% annually.

1.4 CPI fell from 2.8% in March 2013 to 1.7% in February 2014, the lowest rate since October 2009, helped largely by the easing commodity prices and discounting by retailers, reducing the pressure on the Bank to raise rates. Although the fall in unemployment (down from 7.8% in March 2013 to 7.2% in January 2014) was faster than the Bank of England or indeed many analysts had forecast, it hid a stubbornly high level of underemployment. Importantly, average earnings growth remained muted and real wage growth (i.e. after inflation) was negative. In February the Bank stepped back from forward guidance relying on a single indicator – the unemployment rate – to more complex measures which included spare capacity within the economy. The Bank also implied that when official interest rates were raised, the increases would be gradual – this helped underpin the 'low for longer' interest rate outlook despite the momentum in the economy.

1.5 The Office of Budget Responsibility's 2.7% forecast for economic growth in 2014 forecast a quicker fall in public borrowing over the next few years. However, the Chancellor resisted the temptation to spend some of the proceeds of higher economic growth. In his 2013 Autumn Statement and the 2014 Budget, apart from the rise in the personal tax allowance and pension changes, there were no significant giveaways and the coalition's austerity measures remained on track.

1.6 The Federal Reserve's then Chairman Ben Bernanke's announcement in May that the Fed's quantitative easing (QE) programme may be 'tapered' caught markets by surprise. Investors began to factor in not just an end to QE but also rapid rises in interest rates. 'Tapering' (a slowing in the rate of QE) began in December 2013. By March 2014, asset purchases had been cut from $75bn to $55bn per month with expectation that QE would end by October 2014. This had particular implications for global markets which had hitherto benefited from, and got very accustomed to, the high levels of global liquidity afforded by QE. The impact went further than a rise in the dollar and higher US Treasury bond yields. Gilt yields also rose as a consequence and emerging markets, which had previously benefited as investors searched for yield through riskier asset, suffered large capital outflows in December and January.

1.7 With the Eurozone struggling to show sustainable growth, the European Central Bank cut main policy interest rates by 0.25% to 0.25% and the deposit rate to zero. Markets were disappointed by the lack of action by the ECB despite CPI inflation below 1% and a looming threat of deflation. Data pointed to an economic slowdown in China which, alongside a weakening property market and a highly leveraged shadow banking sector, could prove challenging for its authorities.

1.8 Russia's annexation of the Ukraine in March heightened geopolitical tensions and risk. The response from the West which began with sanctions against Russia which is the second largest gas producer in the world and which supplies nearly 30% of European natural gas needs and is also a significant supplier of crude oil – any major disruption to their supply would have serious ramifications for energy prices.

1.9 ***Gilt Yields and Money Market Rates***: Gilt yields ended the year higher than the start in April. The peak in yields was during autumn 2013. The biggest increase was in 5-year gilt yields which increased by nearly 1.3% from 0.70% to 1.97%. 10-year gilt yields rose by nearly 1% ending the year at 2.73%. The increase was less pronounced for longer dated gilts; 20-year yields rose from 2.74% to 3.37% and 50-year yields rose from 3.23% to 3.44%. 3-month, 6-month and 12-month Libid rates remained at levels below 1% through the year.

2 Investment Activities

2.1 Both the CIPFA and the CLG's Investment Guidance require the Authority to invest prudently and have regard to the security and liquidity of investments before seeking the optimum yield. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2013/14. Investments during the year included:

- Investments in AAA-rated Stable Net Asset Value Money Market Funds
- Call accounts and deposits with Banks and Building Societies systemically important to UK banking system
- Pooled funds (collective investment schemes) meeting the criteria in SI 2004 No 534 and subsequent amendments
- Housing Associations
- Corporate Bonds

2.2 **Investment Background**

- The value of the portfolio held by Investec Asset Management, at 1 April 2013, was £22,978,786. In accordance with the Investment Strategy to invest longer term in Housing Associations and latterly to review the overall investment strategy model with Investec, funds were recalled in August, October and the remaining balance in March 2014. Investec no longer manage any of the Council's funds.
- The In house investment balance was nil at 1 April 2013 and the average balance of investments for the period to 31 March 2014 was £12.76 million excluding outstanding Icelandic deposits.
- The performance of all funds was continually monitored and compared against the 7-day rate.
- The criteria and lending list limits the Council adopted within its Treasury Management Strategy includes specified and non specified investments (i.e. investments up to one year and more than one year). The full counterparty list is maintained and updated by Arlingclose on a monthly basis in according to the Council's investment strategy; although amendments are informed to officers immediately they occur.

2.3 The investment income budget for 2013/14 was set at £550k assuming an average investment balance of £32.9m achieving an overall return of 1.67%; The Council's strategy anticipated adding value to returns by taking on long term investment with Housing Associations up to £10m achieving 3.75%. Although the timing of these investments took longer than scheduled, this was achieved with levels of return between 3.35% and 5% a total interest of £207,204 compared to a budgeted sum of £281,000.

Externally Managed Funds

2.4 The performance of the Fund Manager was continued to be hampered by the ongoing global economic position and extreme market reactions in the corporate bond market. Consequently, the combination of Pooled Funds struggled to add value and only achieved a return of 0.28% -

£48,692, this compares to budgeted sum of £194,000 and also incurred management fees of £43,836 for the same period.

The table below shows overall performance of three funds for past 9 months (April 2013 – December 2013

Gross Return	Investec Funds			
Monthly %	**Liquidity Fund**	**Short Bond Fund**	**Target Return Fund**	**Total average weighted return**
	5%	**65%**	**30%**	**100%**
Apr-13	0.03	-0.17	0.03	-0.10
May-13	0.03	0.2	0.51	0.28
Jun-13	0.03	-0.22	-0.4	-0.26
Jul-13	0.03	0.06	0.11	0.07
Aug-13	0.03	-0.10	-0.57	-0.23
Sep-13	0.04	0.28	0.17	0.24
Oct-13	0.02	0.20	0.37	0.24
Nov-13	0.03	0.07	-0.15	0.00
Dec-13	0.01	-0.13	0.29	0.00
9 months	0.25	0.19	0.36	0.24

The above only shows data to the end of December as it was not possible to include the final three months gross return data. As mentioned above the overall gross return on the fund was £48,692 but this is offset by management fees for the period of £43,836.

2.5 The performance of the Fund Manager during the year resulted in a fundamental review of the Council's Pooled Fund model and the decision was made to adopt an alternative investment strategy. Funds were withdrawn from Investec in March 2014. The alternative investment strategy has meant that the Council has put in place 7 new fund managers investing a total of £12m. The funds cover short term cash / bonds, Multi Asset Fund, Absolute Bonds and Equities. Only £10m had been placed with 5 new managers at 31 March 2014, although the full £12m has now been placed. There is no performance data for these funds as they were only placed over the last few days of March.

2.6 The In-house team were budgeted to achieve £75k for the year. Their actual was £67,018, averaging a return of 0.61% from fixed term deposits and 0.40% from Money Market Funds (MMFs) an overall return of 0.53%. The In-house team are constrained by having to meet cash

flow requirements to conduct the Council's business and consequently is investing for short time periods especially with Money Market Funds.

2.7 The Council held Icelandic investments of £2.2m at 1 April 2013 but did not budget for the return of these funds in terms of capital or interest. During the year a full settlement was agreed with the Landsbanki Investments. The outstanding liability now stands at £0.9 m. Interest accrued for 2013/14 from the Landsbanki, Glitnir and KSF investments totalled £112,654. In addition, the settlement of the Landsbanki account realised a further gain of £29,115 which is not shown in the table below.

Performance of Fund 1 April 2013 to 31 March 2014	**Investec**	**In-House**	**Hous Assoc / Bonds**	**Icelandic**	**Total**
Budget (£)	£194,000	£75,000	£281,000	Nil	£550,000
Budget (%)	1.26%	0.75%	3.75%		1.67%
Gross interest (£)	£48,692	£67,018	£207,204	£112,654	£435,568
Gross rate of Return (%)	0.28%	0.53%	3.88%		0.91%

2.8 The movement in cash between all the types of investments are shown in the table below:

Movement of Cash Balances 1 April 2013 – 31 March 2014

	Fund Manager Investec	**In-House**	**Managed Funds**	**Bonds**	**Housing Assoc**	**Total Cash**
	£	£	£	£	£	£
Fund Value/Cash at 1 April 2013	22,978,786	0	0	0	0	22,978,786
Cash Invest / Withdraw from Fund	-23,027,478	9,610,000	10,000,000	4,945,284	5,000,000	6,527,806
Increase/(Decrease) in Cash during the period	48,692			152,686		201,378
Fund Valuation /Cash At 31 March 2014	0	9,610,000	10,000,000	5,097,970	5,000,000	29,707,970

The cash investments for all funds as at 31 March 2014 are shown in Appendix B

3. Credit Risk / Liquidity and Yield

3.1 **Credit Risk:** The Authority assessed and monitored counterparty credit quality with reference to credit ratings; credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP and share price. The minimum long-term counterparty credit rating determined by the Authority for the 2013/14 treasury strategy was A- across rating agencies Fitch, S&P and Moody's.

3.2 The debt crisis in Cyprus was resolved by its government enforcing a 'haircut' on unsecured investments and bank deposits over €100,000. This resolution mechanism, in stark contrast to the bail-outs during the 2008/2009 financial crisis, sent shockwaves through Europe but allowed banking regulators to progress reform which would in future force losses on investors through a 'bail-in' before taxpayers were asked to support failing banks.

3.3 The Financial Services (Banking Reform) Act 2013 gained Royal Assent in December, legislating for the separation of retail and investment banks and for the introduction of mandatory bail-in in the UK to wind up or restructure failing financial institutions. EU finance ministers agreed further steps towards banking union, and the Single Resolution Mechanism (SRM) for resolving problems with troubled large banks which will shift the burden of future restructurings/rescues to the institution's shareholders, bondholders and unsecured investors.

3.4 Proposals were also announced for EU regulatory reforms to Money Market Funds which may result in these funds moving to a VNAV (variable net asset value) basis and losing their 'triple-A' credit rating wrapper in the future.

3.5 The material changes to UK banks' creditworthiness were (a) the strong progress made by the Lloyds Banking Group in strengthening its balance sheet, profitability and funding positions and the government reducing its shareholding in the Group to under 25%, (b) the announcement by Royal Bank of Scotland of the creation of an internal bad bank to house its riskiest assets (this amounted to a material extension of RBS' long-running restructuring, further delaying the bank's return to profitability) and (c) substantial losses at Co-op Bank which forced the bank to undertake a liability management exercise to raise further capital and a debt restructure which entailed junior bondholders being bailed-in as part of the restructuring.

3.6 In July Moody's placed the A3 long-term ratings of Royal Bank of Scotland and NatWest Bank and the D+ standalone financial strength rating of RBS on review for downgrade amid concerns about the impact of any potential breakup of the bank on creditors. As a precautionary measure the Authority reduced its duration to overnight for new investments

with the bank(s). In March Moody's downgraded the long-term ratings of both banks to Baa1. As this rating is below the Authority's minimum credit criterion of A-, the banks were withdrawn from the counterparty list for further investment. NatWest is the Authority's banker and will continue to be used for operational and liquidity purposes.

3.7 The Co-op's long-term ratings were downgraded by Moody's and Fitch to Caa1 and B respectively, both sub-investment grade ratings. The Co-op Bank's capital raising plans to plug a capital shortfall include a contribution from the Co-op Group which is committed to injecting £313m in 2014 of which £50m has been paid so far as at 16 April 2014. However, in order to cover future expected losses and to meet the Prudential Regulation Authority's capital targets, a further £400m is being sought from shareholders, of which Co-operative Group's share is approximately £120m. Given the Co-op Group's own financial position, payment of these sums is by no means certain, leaving the bank with a precarious capital position.

3.8 The Authority's counterparty credit quality has been maintained as demonstrated by the Credit Score Analysis summarised below.

Credit Score Analysis

Date	Value Weighted Average Credit Risk Score	Value Weighted Average Credit Rating	Time Weighted Average Credit Risk Score	Time Weighted Average Credit Rating	Average Life (days)
31/03/2012	5.67	A	5.63	A	22
30/06/2012	5.21	A+	5.68	A	37
30/09/2012	5.97	A	4.45	AA-	32
31/03/2014	5.12	A+	5.17	A+	573

The value weighted average reflects the credit quality of investments according to the size of the deposit. The time weighted average reflects the credit quality of investment according to the maturity of the deposit.

Long-Term Credit Rating	Score
AAA	1
AA+	2
AA	3
AA-	4
A+	5
A	6
A-	7
BBB+	8
BBB	9
BBB-	10

The Council aimed to achieve a score of 7 or lower, to reflect the Council's overriding priority of security of monies invested and the minimum credit rating of threshold of A- for investment counterparties. The average life in days is much higher than previous analysis but reflects the £5m investment with Hanover Housing Association fixed to July 2018. Other deposits range from 156 days to overnight in duration.

3.9 **Liquidity Management**: In keeping with the CLG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds / overnight deposits/ the use of call accounts. The Council operate cash flow forecasting to determine maximum period for which funds may be prudently committed.

3.10 **Yield:** The UK Bank Rate was maintained at 0.50% throughout the year. Short term money market rates also remained at very low levels as the performance of the In-house team highlighted in struggling to add significant value to investments. The average 3-month Libid rate during 2013/14 was 0.45%, the 6 month Libid rate averaged 0.53% and the 1 year Libid rate averaged 0.78%. The low rates of return on the Council's short dated money market investments reflect prevailing market conditions and the Council's objective of optimising returns commensurate with the principles of security and liquidity

4. Update on Iceland Investment

4.1 As of the 31 March 2014 the Council had received £8.094m of principal from Icelandic Banks. The table below shows the detailed repayments in respect of the specific investments:

	Principal (£)	Cash Received (£)	% Repayment
Landsbanki Island Group	2,500,000	2,543,707	1.00
Glitnir	5,000,000	4,225,794	0.85
Kaupthing Singer Friedlander	1,500,000	1,324,603	0.82
Total	9,000,000	8,094,104	0.90

4.2 KSF the Council received its eleventh repayment in December 2013 amounting to 2.5p in the £, taking the amount received to 81.5p in the £. The Administrator has estimated a recovery rate of to be 86.5p. It is estimated the next repayment will be sometime in June 2014.

4.3 Glitnir – The Council received £4.225m cash on 15/16 March 2012, the distribution currencies were; Kroner, Euros, US $, £ sterling and Norwegian Krona. The outstanding claim is to be repaid in ISK currency and is held in the Glitnir winding up board escrow account. It cannot be released until Icelandic currency restrictions are lifted. Bevan Brittan continue to liaise with the Central Bank of Iceland on behalf of a number of local authorities but in the meantime these funds remain in Iceland held in an escrow account accruing interest at the rate of 4.20% p.a.

4.4 Landsbanki – The account was repaid at the end of January 2014.

5 Compliance with Prudential Indicators

The Council can confirm that it has complied with its Prudential Indicators for 2013/14, which were set in February 2013 as part of the Council's Treasury Management Strategy. 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 2013/14. None of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

The Prudential Indicators include:

- Authorised and Operational Boundary for External Debt
- Upper limits for fixed interest rate exposure and variable interest rate exposure
- Upper limit for total principal sums invested over 364 days

Appendix C reports the approved capital expenditure for 2013/14, the actual year end figures and how the capital programme has been funded, and the impact it has on the Ratio of Financing Costs to the Net Revenue Stream. The accounts for 2013/14 are still in the process of being closed down and may be subject to some minor change. However, even should the final figures show any change it is not anticipated this will impact on full compliance with Prudential Indicators.

Appendix B

SCHEDULE OF CASH INVESTMENTS OUTSTANDING AT 31 MARCH 2014

NAME OF COUNTERPARTY	VALUE DATE	NOMINAL AMOUNT (£)	MATURITY DATE	RATE OF INTEREST	Fitch Credit Rating
IN HOUSE MANAGEMENT					
Invesco MMFs	31.03.14	1,150,000	01.04.14		
Goldman Sachs MMF	31.03.14	4,360,000	01.04.14		A, F1, A
Lloyds TSB	04.02.14	1,100,000	04.08.14	0.70%	A, F1, A, 1
Lloyds TSB	03.03.14	2,000,000	03.09.14	0.70%	A, F1, A, 1
Nationwide BS	03.02.14	1,000,000	06.06.14	0.47 %	A, F1, a, 1
Hanover Housing Association	24.07.13	5.000.000	24.07.18	3.35%	
TOTAL IN-HOUSE INVESTMENTS		**14,610,000**			

ICELANDIC BANK DEPOSITS					
GLITNIR	27.06.07	236,166	29.06.09	6.520%	
Kaupthing Singer Friedlander	02.07.07	175,397	02.07.09	6.590%	
GLITNIR (Tradition)	31.08.07	538,041	28.08.09	6.350%	
TOTAL ICELANDIC DEPOSITS		**949,604**			

BONDS		BOOK COST(£)	MARKET VALUE (£)
A2D Bond (4.75%)		2,500,000	2,665,375
Place for People Bond (5%)		2,445,276	2,432,595
TOTAL VALUE OF BONDS		**4,945,286**	**5,097,970**

MANAGED FUNDS		NOMINAL VALUE (£)	MARKET VALUE (£)
SWIP Absolute Return Bond Fund	25.03.14	4,000,000	4,000,000
Payden Sterling Reserve Fund	27.03.14	2,000,000	2,000,000
M&G Global Dividend Fund	27.03.14	1,000,000	1,000,000
Threadneedle Global Equity Fund	27.03.14	1,000,000	1,000,000
Insight Liquidity Plus Fund	31.03.14	2,000,000	2,000,000
TOTAL VALUE OF FUND		**10,000,000**	**10,000,000**

Appendix C

Capital Expenditure 2013/14

1. Capital Expenditure – this indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits, and, in particular, to consider the impact on council tax.

Capital Expenditure	2013/14 Approved £000	2013/14 Actual £000	2014/15 Estimate £000	2015/16 Estimate £000
General Fund	3,720	2,256	2,883	2,842

2. Capital expenditure has been and will be financed or funded as follows:

Capital Financing	2013/14 Approved £000	2013/14 Actual £000	31/03/2015 Estimate £000	31/03/2016 Estimate £000
Capital receipts	2,138	1,448	1,890	391
Government Grants /Contributions	1,382	608	593	251
Revenue contributions	200	200	400	2,200
Total Financing	3,720	2,256	2,883	2,842

3. Ratio of Financing Costs to Net Revenue Stream – this is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs. The ratio is based on costs net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2013/14 Approved %	2013/14 Actual %	31/03/2015 Estimate %	31/03/2016 Estimate %
General Fund	-7%	-6%	-7%	-9%

As the Council is in a net investment position the ratio is showing negative results.