Report of the Service Director Finance

Agenda Item No:
Meeting 30 June 2010

NORTH LINCOLNSHIRE COUNCIL

AUDIT COMMITTEE

TREASURY MANAGEMENT AND INVESTMENT STRATEGY ANNUAL REPORT 2009/10

1. OBJECT AND KEY POINTS IN THIS REPORT

1.1 This is a report on treasury performance in 2009/10. The benchmark for measuring performance is the treasury strategy which the council set at its meeting on 25 February 2009.

1.3 The report covers

- The legal and regulatory framework
- How the council performed
- How the committee can draw assurance that proper processes were followed
- The latest position on our investments with Icelandic banks.

1.4 The key results were that the council

- Invested with a narrow range of counterparties
- Generated an average return of 0.6% for the year, 0.1% above base rate
- Deferred borrowing for the capital programme
- Kept the cost of borrowing below 6% of revenue stream
- Recovered further sums from Heritable bank, the UK subsidiary of Landsbanki.

2. BACKGROUND INFORMATION

The legal and regulatory framework

2.1 The annual treasury management and investment strategy was prepared in line with

- The CIPFA Code of Practice for Treasury Management (Chartered Institute of Public Finance and Accountancy)
- The Prudential Code
- The Local Government Finance Act 2003
- And guidance on Local Government Investments from the former Office of the Deputy Prime Minister (ODPM).

2.2 It also implemented *(see actions in italics below)* expected changes to the codes which were re-published in November 2009. The codes require

- Full council to receive a report on treasury strategy at the start and after the end of each financial year (*existing practice*), with a further mid-year review (*the first will be in 2011*)

- Cabinet or other designated body to take responsibility for regular monitoring (*incorporated in 2009/10 budget review reports)*

- Delegation of day to day implementation, in our case to the Service Director Finance (*existing practice*), and

- The allocation of the scrutiny role, in our case to the Audit Committee *(quarterly reports provided on treasury activity from September 2009)*

2.3 The adoption of the revised codes was formally approved by council on 24 February 2010. It is supported by revised and updated treasury management practices (TMPs) which underpin the day to day arrangements for the treasury management function from 2010/11. Cabinet approved these on 9 June 2010. The Audit Committee has responsibility to scrutinise the council's treasury management arrangements and seek assurances that the Code and TMPs are implemented effectively.

2.4 The Department for Communities and Local Government (CLG) worked with CIPFA to ensure that their investment guidance is complementary. Its revised guidance took effect from 1 April 2010, and does not apply for 2009/10:

- It makes clear that the investment priorities should be security and liquidity, rather than yield
- It confirms that investment strategies should go to full council at the start of each year, but authorities should consider submitting revised strategies at other times
- It recommends strategies are published
- It advises authorities not to rely solely on credit ratings but consider also other information on credit risk
- It requires treasury strategies to comment on the use of treasury management consultants
- and on the investment of money borrowed in advance of spending needs.

3. OPTIONS FOR CONSIDERATION

3.1 There are no options for consideration. However the performance against the approved strategy can be evaluated. The annual strategy covers:

- the investment strategy
- the borrowing strategy
- and prudential indicators for external debt and treasury management.

The investment strategy

3.2 The strategy for 2009/10 was based on the council's views on interest rates and on appropriate counterparties for investment and borrowing. This was based on experience, market intelligence including that provided by credit rating agencies, and a specially commissioned report from Sterling brokers.

The key projections were:
- An average bank base rate of 1%
- An average PWLB loan rate of 5% (25 year maturity)

3.3 Overall the investment strategy aimed to reduce risk by

- Investing for shorter periods (up to 3 months)
- In institutions with high credit ratings or with greater or equivalent security (see appendix 1)
- Applying a maximum limit of £5m (except RBS and DMO)
- The limit on the banking group not the individual institution (this tightened the previous policy)
- With the option of using Money Market Funds and high rated foreign banks when market conditions made it prudent to do so
- At the same time keeping an even maturity profile of investments from one to three months to minimize exposure to liquidity risk and interest rate risk.

The borrowing strategy

3.4 The overall borrowing strategy was

- To aim to borrow only to support the capital programme
- Retaining the option to borrow for cash flow purposes should this be necessary
- To borrow for capital investment purposes at a time which is most advantageous on cost
- To maximize long-term borrowing through the PWLB while this remains the best option (typically 25 years), while retaining the option to borrow for shorter periods and at variable rates
- To delay borrowing in the plan period and temporarily use cash balances and to consider debt rescheduling if prudent.

How the council performed

3.5 The key investment statistics follow with further detail at appendix 2:

- The average balance invested was £50m
- With a range of UK banks, building societies, local authorities and the government’s Debt Management Office
- Short –term only (from overnight up to 3 months fixed)
- In the form of 250 separate investments totalling £440m

- Generating an average return of 0.61% for the year compared to a target of average base plus 0.1% i.e. 0.6%
- The closing balance was £31.441m, an increase on the starting balance of £26.083m.

3.6 The key borrowing statistics were (and see related performance indicators at appendix 3):

- Overall capital spending of £46.5m against a revised budget of £45.7m
- Debt financing costs of 5.21% of revenue stream, within the council's guideline of 6%, in part due to the decision to defer new borrowing
- Total debt within the authorised and operational boundaries set in the strategy
- And the maturity profile of debt also within the limits set

3.7 The decision to defer new borrowing for capital purposes continues the practice started in 2008/09. This avoids the short-term cost of paying the differential between the rates at which we can borrow (c 4.5%) and rate of return on our investment (c 0.5%). It makes temporary use of cash balances which would otherwise be exposed to potential loss in volatile financial markets. To date £19.8m of borrowing has been deferred. The strategy will be followed as long as it is prudent to do so, while cash reserves are sufficient. Borrowing to fund the capital programme is still required, but is simply deferred until more favourable conditions return.

Assurance

3.8 As explained in section 2 the council operates its treasury management function within a legal and regulatory framework. It has done so by adopting and implementing the relevant Codes and practices and by setting a treasury strategy which only makes use of approved financial instruments.

3.9 The audit committee received regular reports during the year on performance, as did the cabinet. It was also briefed on the developing guidance which ultimately was formalised in the new Codes of practice referred to in section 2 of this report. Training was offered to audit committee members in September 2009 to equip its members for the scrutiny role. More is planned for 2010/11.

3.10 Assurance that proper process is followed is given by testing the arrangements for the evaluation, authorisation and recording of treasury decisions as set out in treasury management practices. These are tested each year by the council's internal audit section. The audit for 2009/10 gave significant assurance on the arrangements in place and no recommendations for improvement were considered necessary. The audit commission as part of its annual audit of the accounts forms its own opinion on the adequacy of arrangements and raised no issues of concern in its last review.

3.11 Given the continuing instability in the financial markets specific measures were taken to reduce risk in the portfolio in 2009/10. Within the framework of

Council's approved strategy there were two reviews of day to day lending policy during the year, in April 2009 and in September 2009. Specifically

- A maximum term of one month was applied to investments until September 2009
- As markets stabilised the approved investment term of up to 3 months was reinstated making full use of the flexibility to achieve a wider spread of investments and a better return
- The downgrade of Ireland's sovereign debt confirmed the logic of no new investments in foreign banks because of the uncertainty over the readiness and ability of the governments of those countries to guarantee deposits
- The insolvency and break-up of the Dunfermline Building Society and the takeover of the Chelsea Building Society demonstrated the weakness of the building society sector. Investment was therefore restricted to those building societies which achieve the same minimum credit ratings applied to banks
- To reduce risk further where an institution was given a negative rating watch or was under review for a possible downgrade no new investments were made
- Except for institutions backed by the UK government liquidity and capitalization scheme, where overnight and seven day deposits were made as in effect cash is on call. This included the council's own bankers National Westminster Bank Plc.
- A range of information sources were used to determine the financial health of institutions. This includes the CIPFA treasury forum, financial press, stock market data and other market intelligence as credit ratings cannot be relied upon in isolation.

Icelandic Investments

3.12 The council has investments with two Icelandic owned institutions, Landsbanki and Heritable. These investments pre-date the collapse of Lehman brothers, and the systemic threat to the world banking system which followed. Our Icelandic investments were frozen in October 2008 and joint action to recover these funds continues in concert with other local authorities through the Local Government Association.

3.13 To date we have received £1.23m against our claim of £3.52m from administrators who are winding up the affairs of Heritable. We expect the return of most of our investment in due course. On 28 January 2010, the administrators of Heritable wrote to creditors to advise that they were increasing their estimates of recoveries. Current projections now suggest a base case estimated return of 79-85p in the pound (up from 70-80p). A third interim payment was made on 30 March 2010 of £0.218m.

3.14 The prospects for the return of our £2m investment in Landsbanki remain good, but the recovery is likely to take longer. Bevan Brittan solicitors acting on behalf of local authorities through the LGA are defending the decision by the Winding Up Board to award priority status to local authority claims. This has been challenged by other creditors in the Icelandic courts. In the meantime, the winding up board has agreed to refer all the non-test cases to court (which includes our claim). This is positive as it should facilitate the earliest possible resolution of matters for all authorities with exposure to Landsbanki. In line with LAAP Bulletin 82 (May 2010) published by CIPFA a return of 95p in the pound is expected if local authority claims retain priority; this could fall to 38p in the pound if they do not.

4. ANALYSIS OF OPTIONS

4.1 This is a report on past performance and there are no options to consider.

5. RESOURCE IMPLICATIONS

5.1 The financial implications to this report are reflected in the 2009/2010 Statement of Accounts elsewhere on today's agenda.

5.2 More staff time has been dedicated to the treasury function to sustain and build up research capacity and to inform borrowing and investment decisions. The council has been an active member of the CIPFA Treasury Forum throughout 2009/10.

6. OTHER IMPLICATIONS

6.1 The 2003 Local Government Act and associated regulations provide the statutory accounting framework.

6.2 Council adopted the CIPFA Code of Practice Fully Revised Second Edition 2009 and The Prudential Code Fully Revised Second Edition 2009. Cabinet approved revised Treasury Management Practices on 9 June 2010.

7. OUTCOMES OF CONSULTATION

7.1 Not applicable

8. RECOMMENDATIONS

8.1 The Audit Committee considers the assurance provided by the Treasury Management and Investment Strategy Annual Report 2009/10 on the adequacy of treasury management arrangements

8.2 The Audit Committee notes the Treasury Management and Investment Strategy Annual Report 2009/10.

SERVICE DIRECTOR FINANCE

Pittwood House
Ashby Road
SCUNTHORPE
North Lincolnshire
DN16 1AB

Author: PF/DL
Date: 9 June 2010

Background Papers used in the preparation of this report

CIPFA Code of Practice in the Public Service Fully Revised Second Edition 2009
CIPFA The Prudential Code Fully Revised Second Edition 2009
DCLG Guidance, April 2010
Local Government Act 2003

COUNTERPARTY LIST **Appendix 1**

BANKS	Fitch Ratings		Moody's		Counterparty Limit
	ST	LT	ST	LT	
Canada					£m
Bank of Montreal	F1+	AA-	P1	Aa1	5,000,000
Bank of Nova Scotia	F1+	AA-	P1	Aa1	5,000,000
Canadian Imperial Bank of Commerce	F1+	AA-	P1	Aa2	5,000,000
National Bank of Canada	F1	A+	P1	Aa2	3,000,000
Royal Bank of Canada	F1+	AA	P1	Aaa	5,000,000
Toronto-Dominion Bank	F1+	AA-	P1	Aaa	5,000,000
Denmark					
Danske Bank	F1+	AA-	P1	Aa1	5,000,000
France					
Groupe Caisse Federal de Credit Mutuel	-	-		-	5,000,000
Credit Industriel et Commercial	F1+	AA-	P1	Aa3	
Groupe Caisse D'Epargne	-	-		-	3,000,000
Banque Palatine	F1+	AA	P1	A1	
Credit Foncier de France	F1	A+	P1	Aa3	
Groupe Credit Agricole	-	-		-	5,000,000
Calyon	F1+	AA-	P1	Aa1	
Credit Agricole	F1+	AA-	P1	Aa1	
Societe Generale	F1+	AA-	P1	Aa2	
BNP Paribas	F1+	AA	P1	Aa1	
Natixis	F1+	AA-	P1	Aa3	
Germany					
Commerzbank Group	-	-		-	3,000,000
Dresdner Bank	F1	A	P1	Aa3	
Commerzbank	F1	A	P1	Aa3	
Eurohypo AG	F1	A	P1	A1	
Landesbank Baden-Wuerttemberg	F1+	A+	P1	Aa1	
Bayerische Landesbank	F1+	A+	P1	Aa2	
Bremer Landesbank	F1	A	P1	Aa2	
Deutsche Bank	F1+	AA-	P1	Aa1	
DZ Bank AG	F1	A+	P1	Aa3	
HSH Nordbank	F1	A	P1	Aa3	
Landesbank Berlin	F1+	AA-	P1	A1	
Landesbank Hessen-Thuringen	F1+	A+	P1	Aa2	

Norddeutsche Landesbank	F1	A	P1	Aa2	
West LB	F1	A-	P1	A2	
Ireland					
Bank of Ireland	F1+	A	P1	Aa2	5,000,000
Allied Irish Banks	F1+	A	P1	Aa2	5,000,000
Anglo Irish Bankcorp	F1+	A-	P1	A2	5,000,000
Netherlands					
ING Bank NV	F1+	AA-	P1	Aa2	5,000,000
Rabobank Group	F1+	AA+	P1	Aaa	5,000,000
Norway					
DnB NOR Bank	F1	A+	P1	Aa1	3,000,000
Singapore					
Development Bank of Singapore	F1+	AA-	P1	Aa1	5,000,000
Spain					
Banco Santander Group	-	-	-	-	5,000,000
Abbey National	F1+	AA-	P1	Aa3	
Banco Espanol de Credito (Banesto)	F1+	AA	P1	Aa2	
Banco Santander	F1+	AA	P1	Aa1	
Alliance & Leicester	F1+	AA-	P1	Aa3	
BBVA Group	-	-	-	-	5,000,000
Banco Bilbao Vizcaya Argentaria	F1+	AA-	P1	Aa1	
Banco de Credito Local de Espana	F1+	AA-	P1	Aa1	
Banco Popular Espanol	F1+	AA	P1	Aa2	
La Caixa	F1+	AA-	P1	Aa1	
Sweden					
Nordea Bank Group	-	-	-	-	3,000,000
Nordea Bank AB	F1+	AA-	P1	Aa1	
Nordea Bank Finland plc	F1+	AA-	P1	Aa1	
Skandinaviska Enskilda Banken (SEB)	F1	A+	P1	Aa2	
Svenska Handelsbanken	F1+	AA-	P1	Aa1	
Swedbank	F1	A+	P1	Aa3	
Switzerland					
Credit Suisse	F1+	AA-	P1	Aa1	5,000,000
UBS AG	F1+	A+	P1	Aa2	5,000,000
United Kingdom					
Barclays Bank	F1+	AA-	P1	Aa3	5,000,000
Co-operative Bank	F1	A	P1	A2	3,000,000
HSBC Bank plc	F1+	AA	P1	Aa1	5,000,000
Lloyds Banking Group	-	-	-	-	5,000,000
Bank of Scotland	F1+	AA-	P1	Aa1	

Lloyds TSB Bank	F1+	AA-	P1	Aaa	
RBS Group	–	–	–	–	10,000,000
First Active Plc	F1+	A+	P1	A1	
National Westminster Bank	F1+	AA-	P1	Aa3	
Royal Bank of Scotland	F1+	AA-	P1	Aa3	
Ulster Bank Ireland Ltd	F1+	A+	P1	A1	
Ulster Bank Ltd	F1+	A+	P1	A1	
Northern Rock	F1+	A-	P1	A2	5,000,000
Standard Chartered Bank	F1	A+	P1	A2	3,000,000
United States of America					
Bank of America NA	F1+	A+	P1	Aa2	5,000,000
Bank of New York Mellon	F1+	AA-	P1	Aaa	5,000,000
Citibank NA	F1+	A+	P1	Aa3	5,000,000
J P Morgan Chase Bank	F1+	AA-	P1	Aa1	5,000,000
State Street Bank & Trust Co	F1+	A+	P1	Aa2	5,000,000
Wachovia Bank NA	F1+	AA	P1	Aa1	5,000,000

BUILDING SOCIETIES	Assets	Fitch Ratings		Moody's		Counterparty Limit
	£m	ST	LT	ST	LT	£m
Nationwide	178,482	F1+	AA-	P1	Aa2	5,000,000
Britannia	32,377	F2	A-	P1	A2	3,000,000
Yorkshire	23,137	F1	A	P1	A2	3,000,000
Coventry	14,908	F1	A	P1	A2	3,000,000
Chelsea	13,017	F1	A-	P1	A2	3,000,000
Skipton	11,967	F1	A	P1	A2	3,000,000
Leeds	9,199	F1	A	P1	A2	3,000,000
West Bromwich	8,651	F2	A-	P2	A3	3,000,000
Principality	5,826	F2	A-	P2	A3	3,000,000
Newcastle	4,699	F1	A-	P2	A3	3,000,000
Norwich & Peterborough	4,310	F1	A-	P1	A2	3,000,000
Dunfermline	3,309			P2	Baa2	3,000,000
Stroud & Swindon	3,156					3,000,000
Nottingham	3,024			P2	A3	3,000,000
Scarborough	2,876			P2	A3	3,000,000
Kent Reliance	2,334					3,000,000
Progressive	1,495					3,000,000
Cumberland	1,476					3,000,000
National Counties	1,157					3,000,000
Cambridge	848					3,000,000
Furness	845					3,000,000
Leek United	799					3,000,000
Manchester	765					3,000,000
Saffron	784					3,000,000
Hinckley & Rugby	712					3,000,000
Darlington	687					3,000,000
Monmouthshire	606					3,000,000
Newbury	604					3,000,000
Money Market Funds						5,000,000
GOVERNMENT INSTITUTIONS						
Debt management office						unlimited
Local authorities						3,000,000

Note: credit ratings correct as at 2nd February 2009

INVESTMENT RECORD 2009/10			APPENDIX 2
Investments at start and end of year	**Limit**	**01.04.09**	**31.03.10**
	£	£	£
UK Clearing Banks			
LLOYDS BANKING GROUP	5,000,000	1,420,402	4,918,941
ABBEY NATIONAL PLC/SANTANDER	5,000,000	3,953,449	4,986,980
RBS GROUP	10,000,000	6,209,237	7,259,059
BARCLAYS BANKING GROUP	5,000,000	0	5,000,000
Building Societies			
NEWCASTLE BUILDING SOCIETY	5,000,000	1,000,000	0
SKIPTON BUILDING SOCIETY	5,000,000	1,000,000	0
NATIONWIDE BUILDING SOCIETY	5,000,000	5,000,000	0
LEEDS BUILDING SOCIETY	3,000,000	1,000,000	0
Local Authorities			
BASILDON DISTRICT COUNCIL	3,000,000	0	3,000,000
STIRLING DISTRICT COUNCIL	3,000,000	0	2,000,000
Other Investment Institutions			
LANDSBANKI ISLANDS	5,000,000	2,000,000	2,000,000
HERITABLE BANK LIMITED	5,000,000	3,500,000	2,275,731
CLOSE BROTHERS LIMITED	5,000,000	1,000,000	0
TOTAL INVESTED		**26,083,087**	**31,440,711**
Other organisations where funds were deposited during the year			
DEBT MANAGEMENT OFFICE	UNLIMITED		
HSBC BANK PLC	5,000,000		
NORTHERN ROCK PLC	5,000,000		
CITY OF NEWCASTLE UPON TYNE MBC	3,000,000		
FALKIRK COUNCIL	3,000,000		
HALTON BOROUGH COUNCIL	3,000,000		
LEEDS CITY COUNCIL	3,000,000		
LONDON BOROUGH OF BRENT	3,000,000		
LONDON BOROUGH OF HILLINGDON	3,000,000		
NORTH WARWICKSHIRE BOROUGH COUNCIL	3,000,000		
SALFORD CITY COUNCIL	3,000,000		
SOUTHEND ON SEA BOROUGH COUNCIL	3,000,000		
STOCKPORT METROPOLITAN BOROUGH COUNCIL	3,000,000		
THE HIGHLAND COUNCIL	3,000,000		
WEST YORKSHIRE FIRE AND RESCUE SERVICE	3,000,000		
WEST YORKSHIRE POLICE AUTHORITY	3,000,000		

PRUDENTIAL GUIDELINE INDICATORS **APPENDIX 3**

	2009/10	2009/10
	Budget	Actual
	£'000	£'000
(i) capital expenditure	45,711	46,485
(ii) General Fund ratio of financing costs to the net revenue stream	5.63%	5.21%
	£'000	£'000
(iii) The capital financing requirement	126,652	123,906
(iv) the authorised limit for external debt including borrowing and other long term liabilities	219,000	119,216
(v) the operational boundary for external debt including borrowing and other long term liabilities	143,000	119,216
	%	%
(vi) upper limit for fixed rate exposure	100	95.5
(vii) upper limit for variable rate exposure	20	4.5
(viii) upper and lower limits for maturity structure of borrowing		
UPPER LIMIT		
under 12 months	15	1
12 months and within 24 months	15	5
24 months and within 5 years	50	4
5 years and within 10 years	75	14
10 years and above	90	76
LOWER LIMIT		
under 12 months	0	
12 months and within 24 months	0	
24 months and within 5 years	0	
5 years and within 10 years	0	
10 years and above	25	
(ix) total principal sums invested for periods longer than 364 days	none	none