Division(s): N/A

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TREASURY MANAGEMENT MID TERM REVIEW 2012/13

Report by Assistant Chief Executive and Chief Finance Officer

Introduction

1. The Chartered Institute of Public Finance and Accountancy's (CIPFA's) Code of Practice on Treasury Management (Revised) 2011 recommends that members are informed of Treasury Management activities at least twice a year. This report ensures this authority is embracing Best Practice in accordance with CIPFA's recommendations.

2. The following annexes are attached:

Annex 1	Lending List Changes
Annex 2	Debt Financing 2012/13
Annex 3	PWLB Debt Maturing
Annex 4	Prudential Indicator Monitoring
Annex 5	Arlingclose Quarter 2 Benchmarking

Strategy 2012/13

3. The approved Treasury Management Strategy for 2012/13 was based on an average base rate forecast of 0.50%.

4. The Strategy for Long Term Borrowing was to use internal balances up the value of 25% of the investment portfolio.

5. The Strategy included the continued use of the services of external fund managers, Investec and Scottish Widows Investment Partnership.

Economic Background

6. The world economy has continued to struggle over the first six months of the financial year to September 2012. The Eurozone, with the exception of Germany, failed to show discernable growth while the US economy grew slowly.

7. The UK GDP estimates for Q2 (April to June) were disappointing and showed the economy contracting by 0.4%, not helped by an extra bank holiday due to the Queen's Diamond Jubilee. In contrast, early estimates for Q3 GDP (July to September) show that the economy grew by 1% and indicate that the UK

economy had moved out of recession. The current early estimate is based on around 45% of data and is likely to be subject to future revision. Some analysts have sounded a note of caution that much of the growth may be attributable to the Olympics rather than a true turn-around in the fortunes of the economy and reflecting the Bank of England's statement that this will be a 'zig-zag' year for UK growth. Concerns also remain about the construction industry which continued to contract by 3% in Q2 and 2.5% in Q3 based on initial estimates.

8. Inflation slowly began to fall and CPI dipped below 3% in May 2012 for the first time in two and a half years. The CPI data for September 2012 revealed that inflation had fallen to 2.2%, slightly above the Bank of England's target of 2%. The greatest downward pressure came from the fall out of significant increases in fuel and energy costs in September 2011.

9. In July, against the back drop of weak growth forecasts but improving inflation, the Bank of England announced a further £50bn of asset purchases taking the total amount of quantitative easing (QE) to £375bn. There was also speculation about a potential 0.25% reduction in base rate after minutes of the Bank's Monetary Policy Committee revealed that this was discussed at the meetings in June and July. This has not been realised and The Bank of England's base rate has remained fixed at 0.5%.

10. The UK Labour market statistics released in October showed that, at the end of the quarter June to August 2012, employment was at 71.3%, up 0.5% on the previous quarter for March to May. For the same period, the unemployment rate was down 0.2% to 7.9%.

11. In the US, the Federal Reserve extended QE through 'Operation Twist', in which it buys longer dated bonds with the proceeds of shorter dated US Treasuries. In addition to this, poor employment data released in August prompted a commitment from the Federal Reserve to purchase $40 billion of agency backed mortgage securities each month until the outlook for the labour market substantially improves. The Federal Reserve has also pledged to keep interest rates low until mid-2015.

12. The Eurozone has continued to worry the markets with Spanish and Italian borrowing costs hitting concerning levels in June 2012. The Spanish Government was forced to officially seek a bailout for its domestic banks.

13. In September the European Central Bank (ECB) responded to the continuing turbulence by announcing the Outright Monetary Transactions Facility (OMT). This allows the ECB to buy unlimited amounts of 1-3 year sovereign bonds provided that the sovereign first asks for assistance and adheres to strict conditionality attached to the assistance.

14. Against the backdrop of continuing concern about the Eurozone, the UK has retained its 'safe haven' status. Partly as a result of this UK gilt yields continued to fall sharply, raising the prospect that very short-dated yields could turn negative. Lows of 0.48% and 1.45% were achieved for 5 and 10

year gilts respectively. Other supportive factors included the large scale purchases by banks to comply with the FSA's liquidity requirements and the Bank of England's continued purchases of gilts under the extended QE programme.

15. Money market rates fell over the six month period by between 0.2% and 0.6% for one to 12 month maturities.

Treasury Management Activity

Debt Financing

16. Oxfordshire County Council's (the Council) debt financing to date for 2012/13 is analysed in Annex 2.

17. The 2012/13 borrowing strategy is to use internal balances to fund new or replacement borrowing up to the value of 25% of the portfolio. This is intended to reduce the cost of carry (the difference between borrowing rates and investment returns) in the low interest rate environment and reduce counterparty risk by minimising the level of cash balances.

18. There has been no change to this strategy.

19. The Council's cumulative total external debt has decreased from £420.73m on 1 April 2012 to £417.38m by 30 September 2012, a net decrease of £3.35m. No new debt financing has been arranged during the year. The total forecast external debt for 31 March 2013, after repayment of loans maturing during the year is £412.38m. The forecast debt financing position for 31 March 2013 is shown in Annex 2.

20. At 30 September 2012, the authority had 69 PWLB[1] loans totalling £367.38m and 10 LOBO[2] loans totalling £50m. The combined weighted average interest rate for external debt as at 30 September 2012 was 4.52%.

Maturing Debt

21. The Council repaid £3.346m of maturing PWLB loans during the first half of the year. The details are set out in Annex 3.

Debt Restructuring

22. There has been no restructuring of Long Term Debt during the year to date.

[1] PWLB (Public Works Loans Board) is a Government agency operating within the United Kingdom Debt Management Office and is responsible for lending money to Local Authorities.
[2] LOBO (Lender's Option/Borrower's Option) Loans are long-term loans which include a re-pricing option for the bank at predetermined intervals.

Investment Strategy

23. The security and liquidity of cash was prioritised above the requirement to maximise returns. The Council continued to adopt a cautious approach to lending to financial institutions and continuously monitored credit quality information relating to counterparties.

24. A mixture of short term fixed deposits of up to 12 months and longer term fixed deposits of greater than 12 months have been arranged throughout the first half of the financial year. All deposits with banks have been restricted to a maximum duration of twelve months. Deposits over twelve months have been made exclusively with other Local Authorities. The majority of these deposits have been made for the maximum duration of three years to tie in to high credit quality counterparties over the longer term and to maximise the return available. This was also intended to take advantage of the relatively buoyant local to local market before the introduction of the PWLB certainty rate on 1 November which gives local authorities the opportunity to borrow at a lower rate from the PWLB. This is expected to reduce the number of local authorities looking to borrow from other local authorities and the rate at which they will be willing to borrow.

25. The approved Treasury Management Lending List has remained constrained by the poor credit quality of financial institutions. The policy of lending longer term to other Local Authorities has continued to help limit the impact of this. Exposure to a more diverse cross section of financial institutions has been achieved through the use of AAA rated money market funds which provide relatively good security and liquidity for overnight deposits.

26. In addition to fixed deposits with Local Authorities and banks, call accounts and Money Market Funds, the Council also used structured and callable products to deposit its in-house temporary cash surpluses during the first half of 2012/13.

27. The Council received a third distribution from the Landsbanki winding up board on 9 October 2012. A total of £2.312m has now been received. The latest CIPFA guidance assumes that the full amount may be recovered by 2018, although the timings and amounts of future distributions remain unknown.

The Council's Lending List

28. The Council's in-house cash balances were deposited with institutions that meet the Council's approved credit rating criteria. The approved Lending List was regularly updated during the period to reflect changes in bank and building society credit ratings. Changes were reported to Cabinet each month. Annex 1 shows the amendments incorporated into the Lending List during the first half of 2012/13, in accordance with the approved credit rating criteria and additional temporary restrictions.

29. In August 2012, the authorised lending limit of £10m for Lloyds TSB was breached by £6.8m as a result of a training issue relating to the checking of primary records. This was identified during a routine reconciliation and the excess funds, which were held in an overnight deposit facility, were withdrawn immediately. The Council has not incurred any loss as a result of the breach and the training requirement has been addressed.

Investment Performance

30. The average daily balance of temporary surplus cash invested in-house in the six months to 30 September was £296.9m. The Council achieved an average in-house return for that period of 1.03%, producing gross interest receivable of £1.528million (excluding interest accrued on Landsbanki deposits). Temporary surplus cash includes; developer contributions; SAP school balances; council reserves and balances; trust fund balances; and various other funds to which the Council pays interest at each financial year end, based on the average earned on all balances.

31. The Council uses the three month inter-bank sterling bid rate as its benchmark to measure its own in-house investment performance. During the first half of 2012/13 the average three month inter-bank sterling rate was 0.73%. The Council's average in-house return of 1.03% exceeded the benchmark by 0.30%. The Council operates a number of call accounts and instant access Money Market Funds to deposit short-term cash surpluses. The average balance held on overnight deposit in money market funds or call accounts in the 6 months to 30 September was £68.0million or 23% of the total in house portfolio.

External Fund Managers and Pooled Funds

32. The Council has continued to use the services of one external fund manager: Investec Asset Management Limited. Proportions of the £12.1m portfolio are invested in three different types of investment fund. The Council has invested in the 'Dynamic Model' where 5% of the portfolio is invested in a Liquidity Fund, 65% is invested in a Short Dated Bond Fund and the remaining 30% is invested in a Target Return Fund. The Target Return fund is the most volatile aspect of the portfolio, carrying greater risk but also the most opportunity for significant returns.

33. Investec's annualised return for the first six months of the year (net of management charges) was 1.19%, compared with a benchmark of 1.65%. Although the return for the period has failed to achieve the benchmark it has achieved a higher return than the in-house deposits. Failure to achieve the benchmark has primarily been due to the underperformance of the Target Return element of the portfolio.

34. At the end of 2011/12, and as reported in the Treasury Management Outturn Report 2011/12, the decision was made to end the segregated mandate with Scottish Widows Investment Partnership (SWIP) and to invest £12.0m of the

balance directly in the SWIP Short dated bond fund. This transaction was completed on 30 March 2012 and has allowed the Council to save the minimum annual management fee of £20,000 for 2012/13 while maintaining the same portfolio diversification and return.

35. SWIP's annualised return for the first six months of the year was 1.51% (net of management charges) compared to their annualised benchmark of 0.47%.

Prudential Indicators for Treasury Management

36. During the first six months of the financial year the Council operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Strategy Report. The outturn for the Prudential Indicators is shown in Annex 4.

External Performance Indicators and Statistics

37. The County Council is a member of the CIPFA Treasury and Debt Management benchmarking club and receives annual reports comparing returns and interest payable against other authorities. The benchmarking results for 2011/12 showed that Oxfordshire County Council had achieved an average return of 1.14% compared with an average of 1.13% for their comparative group of County Councils and an average of 1.19% for all 84 members. Through conversation with a sample of authorities with higher than average interest rates it was established that in general they had benefitted from high interest rate long term deposits which had been placed in early 2008/09 and matured during 2011/12.

38. The average interest rate paid for all debt during 2011/12 was 4.54%, lower than the 4.73% average for the comparative group of 19 County Councils but marginally higher than the all member average of 4.49%. Oxfordshire County Council had a higher than average proportion of its debt portfolio in PWLB loans. Oxfordshire County council had 12% of its debt in LOBO loans at 31/3/2012 compared with an all member average of 19% and a comparative group average of 18%.

39. Arlingclose also benchmark the Council's investment performance against its other clients on a quarterly basis. The results of the quarter 2 benchmarking to 30 September 2012 for 2012/13 are included at Annex 5.

40. The benchmarking results show that the Council has achieved higher than average interest on deposits at 30 September 2012. This has been achieved by placing deposits over a longer than average duration with institutions that are of better than average credit quality. This reflects the current investment strategy to place long term deposits with other local authorities to maximise the security of cash.

Training

41. On 17 October 2012 members and officers were invited to attend a three hour Treasury Management training seminar. The Council's Treasury Management advisors Arlingclose explained the risk and return of in house deposits. The Council's external fund managers, Investec Asset Management, reported on the performance and management of the Council's fund. This was an opportunity for members and officers to challenge Investec on the volatile performance of the fund.

Reporting

42. Due to changes to the frequency of the Financial Monitoring and Business Strategy Delivery Report, updates regarding changes to the lending list, current Treasury Management performance and breaches will now be reported to Cabinet on a bi-monthly basis.

Financial and Legal Implications

43. Interest payable and receivable in relation to Treasury Management activities are only two parts of the overall Strategic Measures budget.

44. The 2012/13 budget for interest receivable is £2.449m. The forecast outturn for interest receivable is £2.963m giving net forecast excess income of £0.514m. The increased forecast in interest receivable is due to higher average cash balances due in part to the front loading of government grants and the timings of capital and revenue expenditure.

45. The 2012/13 budget for interest payable is £18.806m. The forecast outturn for interest payable is £18.843m giving a net forecast overspend of £0.037m.

RECOMMENDATION

46. **The Cabinet is RECOMMENDED to note the report, and to RECOMMEND Council to note the Council's Mid Term Treasury Management Review 2012/13.**

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