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BODY:	**AUDIT & GOVERNANCE COMMITTEE**
DATE:	**5 December 2012**
SUBJECT:	**Treasury Management Mid-year Review Report**
REPORT OF:	**Chief Finance Officer**
Ward(s):	All
Purpose:	To provide Members with a mid year review of treasury management activity.
Contact:	Alan Osborne, Chief Finance Officer, Financial Services Telephone Number 01323 415149.
Recommendations:	Members are asked to note the contents of this report.

1.0 Introduction

1.1 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering maximising investment return.

1.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

1.3 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. "

1.4 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011 was adopted by Cabinet on 8 February 2012.

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

3. Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, and for Audit Committee a **Mid-year Review Report** and an Annual Report (stewardship report) covering activities during the previous year.

4. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

5. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is Audit Committee.

1.5 This mid year report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- An economic update for the first six months of 2012/13;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure (prudential indicators);
- A review of the Council's investment portfolio for 2012/13;
- A review of the Council's borrowing strategy for 2012/13;
- A review of any debt rescheduling undertaken during 2012/13;
- A review of compliance with Treasury and Prudential Limits for 2012/13.

2.0 Economic Update

2.1 Economic sentiment, in respect of the prospects for the UK economy to recover swiftly from recession, suffered a major blow in August when the Bank of England substantially lowered its expectations for the speed of recovery and rate of growth over the coming months and materially amended its forecasts for 2012 and 2013. It was noted that the UK economy is heavily influenced by worldwide economic developments, particularly in the Eurozone, and that on-going negative sentiment in that area would inevitably permeate into the UK's economic performance.

With regard to the Eurozone, investor confidence remains weak because successive "rescue packages" have first raised, and then disappointed, market expectations. However, the uncertainty created by the continuing Eurozone debt crisis is having a major effect in undermining business and consumer confidence not only in Europe and the UK, but also in America and the Far East/China.

In the UK, consumer confidence remains very depressed with unemployment concerns, indebtedness and a squeeze on real incomes from high inflation and low pay rises, all taking a toll. Whilst inflation has fallen considerably (CPI @ 2.6% in July), UK GDP fell by 0.5% in the quarter to 30 June, the third quarterly fall in succession. This means that the UK's recovery from the initial 2008 recession has been the worst and slowest of any G7 country apart from Italy (G7 = US, Japan, Germany, France, Canada, Italy and UK). It is also the slowest recovery from a recession of any of the five UK recessions since 1930 and total GDP is still 4.5% below its peak in 2008.

This weak recovery has caused social security payments to remain elevated and tax receipts to be depressed. Consequently, the Chancellor's plan to eliminate the annual public sector borrowing deficit has been pushed back further into the future. The Monetary Policy Committee has kept Bank Rate at 0.5% throughout the period while quantitative easing was increased by £50bn to £375bn in July. In addition, in June, the Bank of England and the Government announced schemes to free up banking funds for business and consumers.

On a positive note, despite all the bad news on the economic front, the UK's sovereign debt remains one of the first ports of call for surplus cash to be invested in and gilt yields, prior to the ECB bond buying announcement in early September, were close to zero for periods out to five years and not that much higher out to ten years.

2.2 **Outlook for the next six months of 2012/13**

The risks in economic forecasts continue unabated from the previous treasury strategy. Concern has been escalating that the Chinese economy is heading for a hard landing, rather than a gentle slowdown, while America is hamstrung by political deadlock which prevents a positive approach to countering weak growth. Whether the presidential election in November will remedy this deadlock is debatable but urgent action will be required early in 2013 to address the US debt position. However, on 13 September the Fed. announced an aggressive stimulus programme for the economy with a third round of quantitative easing focused on boosting the stubbornly weak growth in job creation, and this time with no time limit. They also announced that it was unlikely that there would be any increase in interest rates until at least mid 2015.

Eurozone growth will remain weak as austerity programmes in various countries curtail economic recovery. A crunch situation is rapidly developing in Greece as it has failed yet again to achieve deficit reduction targets and so may require yet another (third) bail out. There is the distinct possibility that some of the northern European countries could push for the ejection of Greece from the Eurozone unless its financial prospects improve, which does not seem likely at this juncture. A financial crisis was also rapidly escalating over the situation in Spain. However, in early September the ECB announced that it would purchase unlimited amounts of shorter term bonds of Eurozone countries which have formally agreed the terms for a bailout. Importantly, this support would be subject to conditions (which have yet to be set) and include supervision from the International Monetary Fund. This resulted in a surge in confidence that the Eurozone has at last put in place the framework for adequate defences to protect the Euro. However, it remains to be seen whether the politicians in charge of Spain and Italy will accept such loss of sovereignty in the light of the verdicts that voters have delivered to the politicians in other peripheral countries which have accepted such supervision and austerity programmes. The Eurozone crisis is therefore far from being resolved as yet. The immediate aftermath of this announcement was a rise in bond yields in safe haven countries, including the UK. Nevertheless, this could prove to be as short lived as previous "solutions" to the Eurozone crisis.

The Bank of England Quarterly Inflation Report in August pushed back the timing of the return to trend growth and also lowered its inflation expectations. Nevertheless, concern remains that the Bank's forecasts of a weaker and delayed robust recovery may still prove to be over optimistic given the world headwinds the UK economy faces. Weak export markets will remain a drag on the economy and consumer expenditure will continue to be depressed due to a focus on paying down debt, negative economic sentiment and job fears. The Coalition Government, meanwhile, is likely to be hampered in promoting growth by the requirement of maintaining austerity measures to tackle the budget deficit.

The overall balance of risks is, therefore, weighted to the downside:

- We expect low growth in the UK to continue, with Bank Rate unlikely to rise in the next 24 months, coupled with a possible further extension of quantitative easing. This will keep investment returns depressed.
- The expected longer run trend for PWLB borrowing rates is for them to eventually rise, primarily due to the need for a high volume of gilt issuance in the UK and the high volume of debt issuance in other major western countries. However, the current safe haven status of the UK may continue for some time, tempering any increases in yield.
- This interest rate forecast is based on an assumption that growth starts to recover in the next three years to a near trend rate (2.5%). However, if the Eurozone debt crisis worsens as a result of one or more countries having to leave the Euro, or low growth in the UK continues longer, then Bank Rate is likely to be depressed for even longer than in this forecast.

2.3 **Sector's Interest rate forecast at 17th September 2012**

	17 Sept Actual	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14	Mar 15
BANK RATE	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.75	1.0
3m LIBID	0.55	0.6	0.6	0.6	0.6	0.6	0.6	0.7	0.9	1.1	1.4
6m LIBID	0.85	0.85	0.85	0.85	0.85	0.85	1	1.1	1.3	1.5	1.8
12m LIBID	1.3	1.3	1.3	1.3	1.4	1.5	1.7	1.9	2.1	2.3	2.6
5yr PWLB	1.89	1.5	1.5	1.5	1.6	1.7	1.8	1.9	2.0	2.1	2.3
10yr PWLB	2.91	2.5	2.5	2.5	2.6	2.7	2.8	2.9	3.0	3.2	3.3
25yr PWLB	4.15	3.7	3.7	3.7	3.8	3.8	3.9	4.0	4.1	4.2	4.3
50yr PWLB	4.32	3.9	3.9	3.9	4.0	4.0	4.1	4.2	4.3	4.4	4.5

The above Sector forecasts for PWLB rates incorporate the introduction of the **PWLB certainty rate** in November 2012 which will reduce PWLB borrowing rates by 0.20%. The actual PWLB rates on 17.9.12 ought therefore to be reduced by 20bps to provide a true comparison to the forecasts. This Council has applied for and received confirmation that having complied with Prudential Indicators the discounted rate will apply to future borrowing .

3.0 Treasury Management Strategy Statement and Annual Investment Strategy Update

3.1 The Treasury Management Strategy Statement (TMSS) for 2012/13 was approved by Cabinet on 8 February 2012. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as follows:

- Security of capital
- Liquidity.

There are no policy changes to the TMSS.

3.2 The Council aims to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity and to obtain an appropriate level of return which is consistent with the Council's risk appetite.

3.3 As outlined in Section 2 above, there is still considerable uncertainty and volatility in the financial and banking market, both globally and in the UK. In this context, it is considered that the strategy approved on 8 February 2012 is still fit for purpose in the current economic climate.

4.0 The Council's Capital Position (Prudential Indicators)

4.1 Prudential Indicator for Capital Expenditure

The table below shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

Capital Expenditure	2012/13 Original Estimate	Position as at 30.9.12	2012/13 Revised Estimate

	£000	£000	£000
General Fund	13,950	1,982	10,350
HRA	7,591	2,317	7,494
Total	21,541	4,299	17,844

4.2 **Changes to the Financing of the Capital Programme**

The table below draws together the main strategy elements of the capital expenditure plans (above), and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	2012/13 Original Estimate £000	2012/13 Revised Estimate £000
Total spend	**21,541**	**17,844**
Financed by:		
Capital receipts	4,314	4,303
Capital grants	4,520	4,953
Capital reserves	4,000	3,412
Revenue	849	1,125
Total financing	**13,683**	**13,793**
Borrowing need	**7,858**	**4,051**

The reduction in the revised estimated capital spend in 2012-13 is mainly due to the reduction of Solar Panels by £4.74m, a new approved scheme of £1.25m for Future Models and re-profiling of previously approved schemes.

4.3 **Changes to the Prudential Indicators for the Capital Financing Requirement, External Debt and the Operational Boundary.**

The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period. This is termed the Operational Boundary.

	2012/13 Original Estimate £m	2012/13 Revised Estimate £m
Prudential Indicator – Capital Financing Requirement		
CFR – non housing	23.3	20.3
CFR – housing	37.0	36.7

Total CFR	60.3	57.0
Net movement in CFR	7.1	3.4
Prudential Indicator – External Debt / the Operational Boundary		
Borrowing	48.9	
Serco Paisa Loans	1.5	
Total debt 31 March	50.4	

The revised estimate has been reduced from the original forecast Capital Financing Requirement due to the reduction in borrowing for Solar Panels.

4.4 **Limits to Borrowing Activity**

One key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Net external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2012/13 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2012/13 Original Estimate £m	Position As at 30.9.12 £m	2012/13 Revised Estimate £m
Gross borrowing	48.9	32.2	39.2
Serco Paisa Loans	1.5	1.6	1.5
Less investments	(0.5)	(8.0)	(2.0)
Net borrowing	49.9	25.8	35.7
CFR (year end position)	60.3	54.1	57.0

No difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Authorised limit for external debt	2012/13 Original Indicator	Current Position
Borrowing	65.0	32.2
Other long term liabilities*	1.7	1.6
Total	66.7	33.8

5.0 Investment Portfolio 2012/13

5.1 The investment portfolio yield for the first six months of the year is 1.29% against a benchmark 7 day Libid rate of 0.42%.

5.2 A full list of investments held as at 30th September 2012, during the first six months of 2012/13 is shown in appendix 1, and summarised below:

Investments	30th September 2012	Rate of Return
Counterparty	£000	%
Foreign Banks	0	
British Banks	7,950	1.55
Building Societies	0	
Total	7,950	1.55

The above excludes £100,000 cash invested overnight on 30th September with the Council's own bankers, the Co-op.

Approved limits within the Annual Investment Strategy were not breached during the first six months of 2012/13.

5.3 As illustrated in the economic background section above, investment rates available in the market are at a historical low point. The average level of temporary funds available for investment purposes in the first six months of 2012/13 was £10.17m arising from the timing of precept payments, receipt of grants and progress on the capital programme.

5.4 Investment performance against bench mark was as follows:

Benchmark	Benchmark Return	Council Performance	Interest Earnings
7 day	0.42%	1.29%	£65,000

5.5 The authority outperformed the benchmark by 0.87%. The budgeted investment return for 2012/13 is £100,000. Performance for the year to date is above target, with the outturn likely to exceed the budget due to locking into higher rates for longer periods with Lloyds Bank.

5.6 **Investment Counterparty criteria**
The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

6.0 Borrowing

6.1 The following temporary debt has been repaid during the first 6 months :

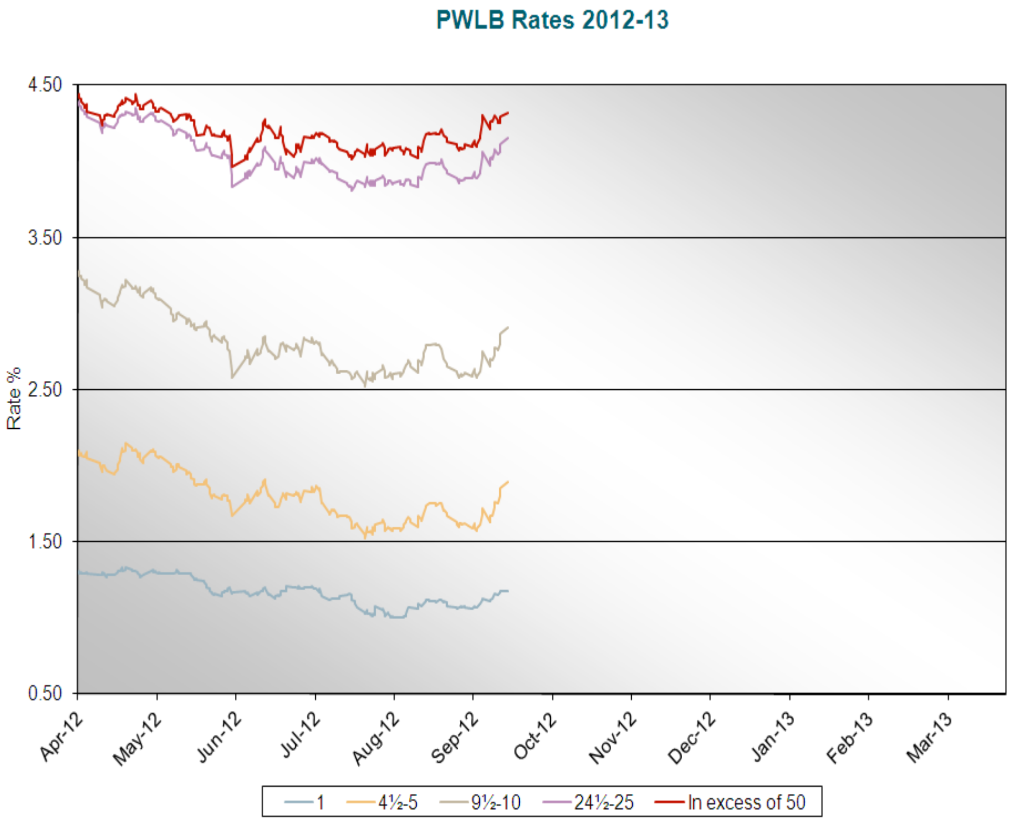
- £3m – 16 April 2012
- £3m – 28 September 2012

The following new debt has been taken during the first 6 months :

- £2m on 11 May 2012 @ 1.96% matures 25 May 2017
- £2m on 22 May 2012 @ 1.87% matures 25 May 2017.

6.2 The Council's revised estimated capital financing requirement (CFR) for 2012/13 is £57.0m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Table above (see 5.4) shows the Council has borrowings of £33.8m and has utilised £20.3m of cash flow funds in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate.

6.3 The graph below shows the movement in PWLB rates for the first six months of the year.



7.0 Debt Rescheduling

7.1 Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. No debt rescheduling was undertaken during the first six months of 2012/13.

8.0 Compliance with Treasury and Prudential Limits

8.1 It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits". Council's approved Treasury and Prudential Indicators (affordability limits) are outlined in the approved TMSS.

8.2 During the financial year to date the Council has operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices.

9.0 <u>Consultation</u>

9.1 None.

10.0 <u>Resource Implications</u>

10.1 None

Alan Osborne
Chief Finance Officer

Background Papers:

The Background Papers used in compiling this report were as follows:

CIPFA Treasury Management in the Public Services code of Practice (the Code)

To inspect or obtain copies of background papers please refer to the contact officer listed above.