

TREASURY MANAGEMENT 2011/12 - Treasury Management Strategy Statement and Annual Investment Strategy Mid-Year Review Report

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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 in accordance with our strategy as amended in low risk counterparties, providing adequate security and liquidity before considering maximising investment return.

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 needs.

As a consequence 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."

Recommendations:

Executive is asked to:

1. Note the Mid Year Review
2. Note the treasury activity for the second quarter ended 30 September 2011.

1. INTRODUCTION

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by this Council on 14 December 2009.

The primary requirements of the Code are as follows:

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

- b) Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- c) 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, a **Mid-year Review Report** and an Annual Report (stewardship report) covering activities during the previous year.
- d) 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.
- e) 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 the Audit Committee:

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 2011/12;
- 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 2011/12;
- A review of the Council's borrowing strategy for 2011/12;
- A review of any debt rescheduling undertaken during 2011/12;
- A review of compliance with Treasury and Prudential Limits for 2011/12.

The Corporate Director for Resources and Transformation can report that the basis of the Treasury Management Strategy and the PIs have not materially changed. The Investment Strategy, however has been revised following advice from our Treasury Management advisors, Sector, in light of the heightened current uncertainty in the financial markets.

Members will recall a revision to the current Treasury Management Strategy presented at Executive on 13 October 2011 to revise the daily operation of the Treasury Management function.

The report outlined an increase in the level of investment with semi nationalised institutions (only) from £5m to £7.5m per counterparty. And additionally, granted within extreme circumstances, that the limit of £7.5m be further increased to an ultimate limit of £10m per counterparty, solely for short term investments and only with prior approval of the Director for Resources & Transformation.

The above report was approved and the amendments will be formalised and incorporated in the 2012 Treasury Management Strategy Statement which will be presented to Council prior to the start of the new financial year.

2. ECONOMIC UPDATE

2.1 Global economy

The Euro zone sovereign debt crisis continued with Spain, and particularly Italy, being the focus of renewed market concerns that they may soon join with Greece, Ireland and Portugal in needing assistance. This uncertainty and the lack of a co-ordinated or credible Euro zone response, left commentators concerned over the potential impact of sovereign default and resulting effect on the Euro zone banking sector. The approval by various countries of the €440bn bail out fund in September has brought temporary relief to financial markets but this does not provide a credible remedy to the scale of the Greek debt problem or the sheer magnitude of the potential needs of other countries for support.

This, coupled with political difficulties in the US over their plans to address the budget deficit, the size and control over the US sovereign debt, and the subsequent loss of the AAA credit rating from Standard and Poor's, has led to a much more difficult and uncertain outlook for the world economy. Growth prospects in the US, UK and the euro zone have been lower than expected, with future prospects similarly cut. Whilst not a central view, concerns of a double dip recession in some Western countries have increased. World stock markets fell in the second quarter of 2011/12 as a consequence.

2.2 UK economy

Following zero growth in the final half of 2010/11 the UK economy grew by a weaker than expected 0.1% in the first quarter of 2011/12, providing a knock on effect to future growth prospects. Growth prospects will be governed by UK consumer sentiment, which is currently subdued due to falling disposable income. Higher VAT, overhanging debt, high inflation and concerns over employment are likely to weigh heavily on consumers into the future.

The announcement by the MPC on 6 October of a second round of quantitative easing of £75bn emphasised how seriously the MPC now views recession as being a much bigger concern than inflation. Although inflation remains stubbornly high, the MPC's expectation of future falls resulting in an undershoot of its 2% target opened the way for this new round of QE.

International investors continue to view UK government gilts as being a safe haven from the EU sovereign debt crisis. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and sent PWLB borrowing rates to low levels.

2.3 Outlook for the next six months of 2011/12

There remain huge uncertainties in economic forecasts due to the following major difficulties:

- the increase in risk that the UK, US and EU could fall into recession
- the likely political gridlock in the US preventing significant government fiscal action to boost growth ahead of the Presidential elections in November 2012
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economies
- the degree to which government austerity programmes will dampen economic growth;
- the potential for further quantitative easing, and the timing of this in both the UK and US
- the speed of recovery of banks' profitability and balance sheet imbalances and the risk of substantial losses being incurred on EU sovereign debt

The overall balance of risks is weighted to the downside:

- We expect low growth in the UK to continue, with a low Bank Rate to continue for at least 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 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, postponing any increases until 2012.

2.4 Sector's interest rate forecast

	NOW	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
BANK RATE	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25	1.50	2.00	2.25	2.50
3 month LIBID	0.75	0.70	0.70	0.70	0.70	0.70	0.75	0.80	0.90	1.20	1.40	1.60	2.10	2.40	2.60
6 month LIBID	1.00	1.00	1.00	1.00	1.00	1.00	1.10	1.20	1.40	1.60	1.80	2.00	2.50	2.70	2.90
12 month LIBID	1.50	1.50	1.50	1.50	1.50	1.60	1.70	1.80	1.90	2.20	2.40	2.60	3.10	3.20	3.30
5 yr PWLB	2.30	2.30	2.30	2.30	2.30	2.40	2.50	2.60	2.70	2.80	2.90	3.10	3.30	3.50	3.70
10 yr PWLB	3.30	3.30	3.30	3.30	3.40	3.40	3.50	3.60	3.70	3.80	4.00	4.20	4.40	4.60	4.80
25 yr PWLB	4.20	4.20	4.20	4.20	4.30	4.30	4.40	4.50	4.60	4.70	4.80	4.90	5.00	5.10	5.20
50 yr PWLB	4.30	4.30	4.30	4.30	4.40	4.40	4.50	4.60	4.70	4.80	4.90	5.00	5.10	5.20	5.30

3. Treasury Management Strategy Statement and Annual Investment Strategy update

The Treasury Management Strategy Statement (TMSS) for 2011/12 was approved by this Council on 22 February 2011.

The underlying TMSS approved previously required revision in the light of economic developments during the year.

As detailed in Section 1, an amendment to the current strategy was approved by Full Council on 13 October 2011 to increase with immediate effect the level of investment with UK semi nationalised institutions (only)

from a daily operational limit of £5m to a new limit of £7.5m per counterparty or £10m only with the prior approval of the Corporate Director for Resources & Transformation.

4. The Council's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

4.1 Prudential Indicator for Capital Expenditure

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

Capital Expenditure	2011/12 Original Estimate £000's	Current Position £000's	2011/12 Revised Estimate £000's
Total	4,998	554	3,427

Council approved on 22 February 2011 a gross capital programme budget for 2011/12 of £4,998,428. This was later increased to £5,906,689 to account for slippage at outturn (31/03/11) and further amended by £133,000 at Executive on 27 September 2011 to £6,039,689 in relation to the additional works at Bransty. The forecast position for the financial year 2011/12 as at 30 September 2011 is capital expenditure of £3,426,605. This information is contained within the Capital Programme 2011/12 Budget Monitoring Report Quarter 2 which will be presented at Executive on 22 November 2011.

4.2 Changes to the Financing of the Capital Programme

The table overleaf draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, 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	2011/12 Original Estimate £000's	Current Position £000's	2011/12 Revised Estimate £000's
Supported	4,998	554	3,427
Unsupported	0	0	0
Total spend	4,998	554	3,427
Financed by:			
Capital receipts	1,831		1,726
Other Reserves & Contributions	19		7
External Funding	3,148		1,694
Total financing	4,998		3,427
Borrowing need	0		0

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

The table 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.

4.4 Prudential Indicator – Capital Financing Requirement

We are on target to achieve the amended forecast Capital Financing Requirement.

4.5 Prudential Indicator – External Debt / the Operational Boundary

	2011/12 Amended Estimate £000's	2011/12 Revised Estimate £000's
Prudential Indicator – Capital Financing Requirement		
CFR – non housing	8,809	8,420
Net movement in CFR	0	0
Prudential Indicator – External Debt / the Operational Boundary		
Borrowing	5,100	5,100
Other long term liabilities*	7,216	6,827
Total debt 31 March	12,316	11,927

* - On balance sheet PFI schemes and finance leases etc

- 4.5.1 The CFR that was presented to Members on 22 February 2011 within the Treasury Management Strategy 2011/12 was £10,462,000, this has reduced to the amended estimate of £8,809,000 shown above. The production of the 2010/11 financial statements saw a change in accounting standards which resulted in some of the Council's leases (predominantly vehicle leases) having to be accounted for as a finance lease (included on balance sheet and counted as Capital) as opposed to their previous operating lease status (not included on balance sheet and not included in capital). This has resulted in an increase in the CFR but members are asked to note that this is purely an accounting transaction and the Council's liabilities have not increased. This

coupled with the removal of the Council's funding (replaced by external funding) in relation to the Albion Square Project which reduced the CFR to the amended estimate of £8,809,000 above.

4.6 Limits to Borrowing Activity

The first 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 2011/12 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 and necessary.

	2011/12 Amended Estimate £000's	2011/12 Revised Estimate £000's
Gross borrowing	5,000	5,000
Plus other long term liabilities*	7,216	6,827
Less investments	(18,858)	(17,133)
* Net borrowing	(6,642)	(5,306)
CFR (year end position)	8,809	8,420

* - includes on balance sheet PFI schemes and finance leases.

The Corporate Director for Resources and Transformation reports that 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	2011/12 Original Indicator	2011/12 Revised Indicator
Borrowing	9,000	9,000
Other long term liabilities*	8,000	8,000
Total	17,000	17,000

* Includes on balance sheet PFI schemes and finance leases.

5 Investment Portfolio 2011/12

In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As set out in Section 2, it is a very difficult investment market in terms of earning the level of interest rates

commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. The continuing Euro zone sovereign debt crisis, and its potential impact on banks, prompts a low risk and short term strategy. Given this risk adverse environment, investment returns are likely to remain low.

The Council's budgeted investment return for 2011/12 is £252,822, and the expected performance for the year to date is forecast as £35,069 below budget. This is shown in the table below:

Investment Return 2011/12:

Budget	Received to Date	Forecast to 31/03/2012	Total Forecast	Variance
£	£	£	£	£
252,822	171,211	46,542	217,753	(35,069)

This position has increased by £23,626 from a below budget position of £11,442 at Quarter 1 when we had considerably more counterparties to deal with and were anticipating placing money for longer periods to gain higher rates of interest. The significant reduction in the number of counterparties that we are happy to place investments with, means we have far fewer institutions to invest. We also have self-imposed limits on values of investment with any one counterparty which has resulted in much of our portfolio being held in Call accounts/Money Market Funds that are very liquid but provide a lower rate of return.

The Council held £22.58m of investments as at 30 September 2011, of this £6.08m were held in instant access Call accounts/Money Market Funds (and therefore would be deemed as cash equivalent within the year end accounts) and the investment portfolio yield for the first six months of the year is 1.07 % against current base rate of 0.5%.

The Director for Resources and Transformation confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2011/12.

A full list of investments held as at 30th September 2011 is detailed within Appendix A.

5.1 Investment Counterparty criteria

The Council's investment strategy is safeguarding the re-payment of the principal and interest of its investments on time – the investment return being a secondary objective. The current investment climate, as detailed in Section 2, has one over-riding risk consideration, that of counterparty risk.

Due to the current increasing uncertainty in the financial markets and acting within the Treasury Management Strategy, the pool of available counter-parties within the approved criteria (i.e. those financial

institution/organisations that we can place money with), was restricted to safer instruments and institutions. Currently this involves the use of AAA rated Money Market Funds and institutions with higher credit ratings than those outlined in the investment strategy or which are provided support from the Government. Also, all recent investments have been made for a maximum 3 months (subject to comments in section 5)

In addition to this, the Council is in the process of opening two further Money Market Funds. These are highly rated institutions (AAA) and offer a safe haven in the current uncertain economic climate as well as providing instant access to our funds. These will be opened at no cost to the Council. Not only do they provide another counterparty option (a necessity due to the current restrictions on the counterparty list) but we are able to place deposits up to £5m with each of these institutions with a significant reduction in risk compared to for instance, building society deposits.

The current counterparty criteria is under regular review, however no further amendments to the Treasury Management and Investment Strategies are sought at this time. The revised draft Treasury Management and Investment Strategy for 2012/13 will be presented and approved prior to the start of the new financial year.

5.2 Borrowing

The Council's amended capital financing requirement (CFR) for 2011/12 is £8,809,000. The CFR denotes the Council's underlying need to borrow for capital purposes. The Council's underlying need to borrow is supported by finance leases for both the PFI (Copeland Centre) and vehicles.

Members will recall the 2009/10 accounts saw the PFI being brought onto the balance sheet as an asset to be depreciated over its useful life i.e. life of the agreement and a corresponding financial liability representing Copeland's obligations to make payments under PFI was also recognised on the balance sheet. In a continuance of the application of IFRS Accounting Standards the 2010/11 accounts saw the reclassification of many of our vehicle leases from operating to finance, which requires inclusion of the assets and corresponding liabilities on the balance sheet.

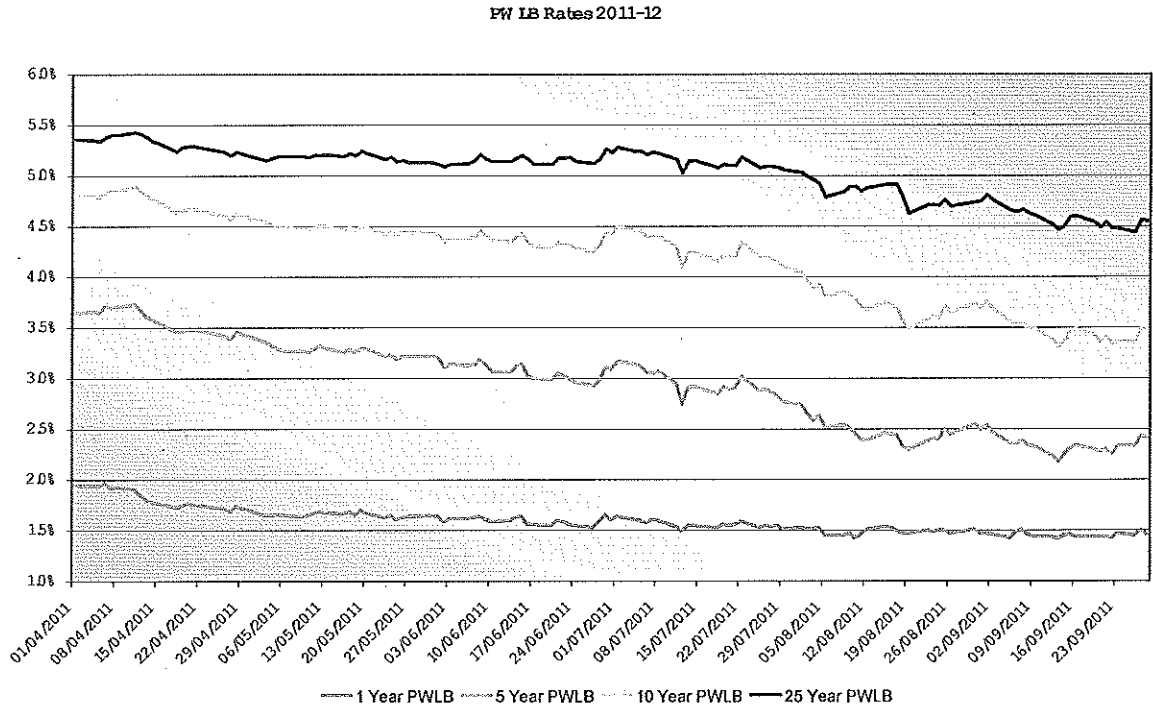
Members are reminded that the CFR has originated from a result of change in accounting practices only and that the Council's liabilities have not increased.

The Council's debt portfolio contains one remaining Market Loan of £5 million. We continually assess the position of this loan with our Treasury Consultants, Sector, to see whether we are securing the best terms for the Council. At the current time, the advice is to leave this loan in its present form, as the penalty for repaying early would be prohibitive.

In the event that borrowing is necessary, the Corporate Director for Resources and Transformation, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time and taking into account contemporaneous forecasts.

Executive agreement would be sought and any amendment to the Treasury Management Strategy would be sought from Council.

The graph and table below show the movement in PWLB rates for the first six months of the year and provide benchmarking data showing high and low points etc:



6. STATUTORY OFFICER COMMENTS

The Monitoring Officer's comments are: No comment

The Section 151 Officer's comments are: Comments Contained in the report

EIA Comments: EIA completed as part of the budget setting process

Other consultee comments, if any:

7. HOW WILL THE PROPOSALS BE PROJECT MANAGED AND HOW ARE THE RISKS GOING TO BE MANAGED?

The Treasury Management function is continually monitored and is reported to Executive throughout the year. It also forms part of the revenue monitoring report distributed to Heads of Service on a monthly basis. The principles set out in the Treasury Management Strategy ensure that we have a balance between security and liquidity of funds and the yield achieved, with security being the principle concern particularly in the current economic climate.

8. WHAT MEASURABLE OUTCOMES OR OUTPUTS WILL ARISE FROM THIS REPORT?

As stated above the position will continue to be closely monitored and the Treasury Management Strategy 2012 will be written incorporating any changes highlighted in this report. This will be presented to Full Council for approval prior to the start of the new financial year.

List of Appendices

Appendix A: Investments as at 30 September 2011

List of Background Documents:

Treasury Management Strategy 2011/12, Annual Investment Strategy 2011/12, Minimum Revenue Provision Statement 2011/12 to Executive 15 February 2011, Treasury Management Strategy 2011/12 Amendment to Council on 13 October 2011.

INVESTMENTS AS AT 30 SEPTEMBER 2011

As at 30 September 2011 the Council held investments totalling £22,581,000.

The spread of these accounts were as follows:-

Account Type	Amount Deposited £
Instant Access Call Account	2,000,000
Money Market Funds	4,081,000
Deposits (Banks & Building Societies)	16,500,000
TOTAL	22,581,000

All of which were with the following institutions:-

- Bank of Scotland/Lloyds
- Royal Bank of Scotland
- Barclays
- Royal Bank of Scotland Money Market Fund (RBS MMF)
- Santander
- Principality Building Society