COUNCIL

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TREASURY MANAGEMENT STRATEGY
MID-YEAR REVIEW REPORT 2012/13

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Summary

On the 23 February 2012, Full Council approved the 2012/13 Treasury Management Strategy. As part of that strategy and in line with the Chartered Institute of Public Finance Accountancy's (CIPFA) code of Practice for Treasury Management, there should be a review of that strategy at least half yearly. This report is the mid year review of the Treasury Management Strategy 2012/13.

1. Budget and Policy Framework

1.1 Business Support Overview and Scrutiny is responsible for the scrutiny of the Council's Treasury Management, Investment Strategy and Minimum Revenue Provision Policy Statement along with Treasury Management Practices and associated Schedules.

1.2 There needs to be, at a minimum, a mid year review of treasury management strategy and performance. This is intended to highlight any areas of concern that have arisen since the original strategy was approved.

1.3 The Mid Year report should be considered by Business Support Overview and Scrutiny Committee, Cabinet and Full Council.

2. Background

2.1 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 ensures this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering maximising investment return.

2.2 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 long-term cash flow surpluses, and on occasion, debt previously incurred may be restructured to meet Council risk or cost objectives.

2.3 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. "

2.4 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011 needs to be formally adopted by this Council (Appendix 1). This replaces the CIPFA Code of Practice on Treasury Management revised November 2009 which was adopted by this Council on 25 February 2010.

2.5 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 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.
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: Business Support Overview and Scrutiny Committee.

2.6 This mid year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, 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;
- 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; and
- A review of compliance with Treasury and Prudential Limits for 2012/13.

2.7 Recommendations

Recommend approval of the adoption of the CIPFA Code of Practice on Treasury Management 2011.

3. Economic update

3.1 <u>Economic performance to date</u>

3.1.1 The economic view on the prospect of the UK economy recovering swiftly from recession suffered a significant set back in August when the Bank of England lowered its expectations for the speed of recovery and rate of growth over the coming months and materially amended its forecast for 2012 and 2013. The UK economy is heavily influenced by worldwide economic developments, particularly in the Eurozone, and on-going negative sentiment in that area would impact on the UK's economic performance. Investor confidence remains weak for the Eurozone and the continuing Eurozone debt crisis is having a major effect in undermining business and consumer confidence in, America, the Far East/China, Europe and the UK.

3.1.2 UK consumer confidence remains low with unemployment concerns, indebtedness and pressure on real incomes from high inflation and low pay rises. Inflation has fallen considerably, however, this is the slowest recovery from a recession of any of the five UK recessions since 1930. The weak recovery has resulted in social security payments remaining at a high level and tax receipts low. The Monetary Policy Committee has kept the bank rate at 0.5% and quantitative easing was increased by £50 billion to £375 billion in July. In June the Bank of England and the Government also announced schemes to free up banking funds for business and consumers.

3.1.3 However, on a positive note the UK's sovereign debt remains one of the first ports of call for surplus cash to be invested in.

3.2 <u>Outlook for the next six months of 2012/13</u>

3.2.1 The risks in economic forecasts are ongoing from the previous treasury strategy. Concern has been escalating that the Chinese economy is heading for a sharp slow down rather than a gentle slowdown. America's presidential election in November prevented a positive approach to countering weak growth. Urgent action will be required early in 2013 to address the US debt position. On 13 September the Federal Reserve System (US central banking system) announced an aggressive stimulus programme for the economy with a third round of quantitative easing to boost growth in job creation and announced that interest rates were unlikely to increase until at least mid 2015.

3.2.2 Eurozone growth will remain weak due to austerity programmes in various countries. Greece has failed again to achieve deficit reduction targets and may require a third bail out. There is also a possibility that some of the northern European countries could push for the ejection of Greece from the Eurozone unless its financial prospects improve. A financial crisis was rapidly escalating over the situation in Spain however, in early September the European Central Bank announced that it would purchase unlimited amounts of shorter term bonds of Eurozone countries which have formally agreed the terms for a bailout. This support would be subject to conditions and include supervision from the International Monetary Fund. This has resulted in a surge in confidence in the Eurozone however it is not known whether Spain and Italy will accept the terms for a bailout.

3.2.3 The Bank of England Quarterly Inflation Report in August lowered inflation expectations and forecast a weaker and delayed robust recovery. Weak export markets will remain a drag on the economy and consumer expenditure will continue to be downcast due to a focus on paying off debt, negative economic sentiment and job fears.

The overall balance of risks is weighted to the downside:

- Sector expect low growth in the UK to continue, bank rate unlikely to rise in the next 24 months linked with a possible further extension of quantitative easing. This will keep investment returns low.
- Sector expect the longer run trend for Public Works Loan Board (PWLB) borrowing rates 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.
- Sectors 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.

3.3 <u>Sector's interest rate forecast</u>

	17.9.12 actual	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	0.50	0.75	1.00
3m LIBID	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.70	0.90	1.10	1.40
6m LIBID	0.85	0.85	0.85	0.85	0.85	0.85	1.00	1.10	1.30	1.50	1.80
12m LIBID	1.30	1.30	1.30	1.30	1.40	1.50	1.70	1.90	2.10	2.30	2.60
5yr PWLB	1.89	1.50	1.50	1.50	1.60	1.70	1.80	1.90	2.00	2.10	2.30
10yr PWLB	2.91	2.50	2.50	2.50	2.60	2.70	2.80	2.90	3.00	3.20	3.30
25yr PWLB	4.15	3.70	3.70	3.70	3.80	3.80	3.90	4.00	4.10	4.20	4.30
50yr PWLB	4.32	3.90	3.90	3.90	4.00	4.00	4.10	4.20	4.30	4.40	4.50

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% for most local authorities. The actual PWLB rates on 17 September 2012 are prior to the reduction of 20 basis points (bps).

4 Treasury Management Strategy Statement and Annual Investment Strategy update

4.1 The Treasury Management Strategy Statement (TMSS) for 2012/13 was approved by Council on 23rd February 2012. There are no policy changes to the TMSS.

4.2 Limits to Borrowing Activity

4.2.1 The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowing less investments) will only be for a capital purpose. Net external borrowing should not, except in the short term, exceed the total of Capital Financing Requirement (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	**Current Position 30 Sept 2012 £m**	**2012/13 Revised Estimate £m**
Gross borrowing	172.410	182.450	172.325
Plus other long term liabilities*		3.123	3.123
Less investments	(52.817)	(72.940)	(51.547)
Net borrowing	119.593	135.573	123.901
CFR (year end position)	257.489	253.991	253.991

4.2.2 On the 21 November 2012, £10 million PWLB loan was repaid, bringing the debt portfolio in line with the original estimate, and invested cash is likely to be in line with the original estimate producing a net borrowing figure of some £124 million – well within the CFR.

4.2.3 The Chief Finance Officer reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator for maintaining net borrowing to CFR.

4.2.4 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 longer-term scenario. It is a forecast of maximum borrowing requirement with some capacity for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The council’s authorised borrowing limit for 2012/13 is £440.545 million and it will not exceed this limit.

5 Investment Portfolio 2012/13

5.1 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 3, 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.

5.2 The investment portfolio yield for the first six months of the year for the in-house team is 1.71% (on an annual basis) and Investec is currently 0.61% (on an annual basis) however the outturn position for Investec is estimated to be between 0.8% and 1%.

5.3 The rates payable on investments have started to fall and there is a high risk that this trend will continue. The interest which was being paid on Svenska Handelsbanken 35 day notice account dropped from 0.875% to 0.475% on the 2 November 2012. NatWest have advised that they will be dropping the rate payable on their instant access account from 1.05% to 0.80% (base rate + 30 bps) on the 1 February 2013, and a further drop to 0.60% (base rate + 10 bps) from the 1 May 2013.

5.4 A full list of in house investments held as at 30 September 2012 is shown below:

Investments	**Principal 30 Sept 2012 £**	**Interest %**
Core Investments		
Svenska Handelsbanken	10,000,000	0.875%
Lloyds TSB	20,000,000	2.4%
Lloyds TSB	5,000,000	3.0%
Total In house Core Investments	35,000,000	
Liquid Investments		
Natwest Special Interest Account	15,000,000	1.05%
Total In house Liquid Investments	15,000,000	

5.5 The average balances, interest rate earned to 30 September 2012 and forecast average interest rate for 2012/13 comparing the performance of the externally managed fund to the In house team is shown below.

	Average Balance 30 Sept 2012 £	Average Interest Rate 30 Sept 2012 %	Forecast Average Interest Rate 2012/13 %
Externally Managed			
Investec (excluding fees)	22,959,474	0.61%	0.8% - 1%
Managed In-House			
In-house Core Investments	29,010,989	2.28%	2.21%
In-house Liquid Investments	23,532,088	1.01%	0.93%
Total In-House		1.71%	1.70%

5.6 The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2012/13.

5.7 The Council's budgeted investment return for 2012/13 is £1.175 million and performance for the year to date is in line with the budget.

5.8 Investment Counterparty Criteria

The current investment counterparty criteria selection approved in the Treasury Strategy is meeting the requirement of the treasury management function.

6 Borrowing

6.1 The Council's capital financing requirement (CFR) for 2012/13 is £253.991 million. 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. The table in section 4.21 shows the Council has external borrowings of £182.45 million against a CFR of £253.991 million.

6.2 The current borrowing strategy is to repay debt rather than enter into new borrowing as a consequence of the relationship between investment and borrowing interest rates. Using invested funds to repay debt also has the benefit of mitigating counterparty risk. This policy has been adhered to for the first six months of this financial year. However, as specified within the strategy, in the event that it was deemed advantageous to borrow then we will evaluate the economic and market factors to form a view on future interest rates so as to determine the manner and timing of decisions to borrow.

6.3 The general trend has been a reduction in interest rates during April to October, across all maturity bands.

6.4 It is anticipated that no external borrowing will be undertaken during this financial year, unless it is found to be advantageous as mentioned in paragraph 6.2.

7 Debt Rescheduling

7.1 Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. During the first six months of the year, no debt rescheduling was undertaken and it is not envisaged that any will occur before the end of the financial year. However, officers and the council's financial advisers 'Sector' will continue to monitor the situation and opportunities will be carefully considered.

8 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 Business Support Overview and Scrutiny Committee

9.1 The committee considered this report at its meeting held on 6 December 2012. Members discussed the performance of the in-house and externally managed funds and asked if officers had considered managing the whole fund in-house, as it had out-performed the external fund manager in the current financial year. Officers advised that the two forms of fund management adopted different tactics in order to spread the risk. The internal funds were placed in 'safe' bank deposits with variability in earnings dependant on market opportunities and availability of funds at a point in time, whereas the external fund manager was also able to trade in gilts and bonds, and take opportunities presented by the markets in these areas to make gains (or suffer losses) as global markets react. The return on internal funds was easier to predict and less volatile but equally less able to respond to volatility in the market place and take a risk premium.

9.2 Members asked about the fees paid to the external fund manager, counter-party protection with regard to creditworthiness, how Investec was chosen as the council's external fund manager and the cash flow of the council. Following the committee's concern at the breakdown of the Nat West banking system earlier in the year, Members also discussed the council's contract with Nat West to act as its main bank. Members were informed that the contract with Nat West was due to end in September 2013 and invitations to tender for this business would be issued soon. Part of the tender would include qualitative issues, including the processes the applicant had set in place to overcome technical difficulties.

9.3 The committee noted the report and recommended to Council the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011.

10 Cabinet

10.1 The Cabinet considered this report on 18 December 2012 and noted the contents of this report (including the views of the Business Support Overview and Scrutiny Committee) and recommended the report to Full Council. The Cabinet also recommended to Full Council the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, as set out in Appendix 1 to the report.

11 Risk management

11.1 Risk and the management thereof is a feature throughout the strategy and in detail within the treasury management Practices 1 within the Treasury strategy.

12 Financial and legal implications

12.1 The Finance and Legal implications are highlighted throughout this report.

13 Recommendations

13.1 Council is asked to note the report.

13.2 Council is asked to adopt the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, as set out in Appendix 1 to the report.

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Background papers

Treasury Strategy 2012/13:
http://democracy.medway.gov.uk/ieIssueDetails.aspx?IId=7574&Opt=3

Investec report – September 2012