

## **BUSINESS SUPPORT OVERVIEW AND SCRUTINY COMMITTEE**

**4 NOVEMBER 2010**

### **TREASURY MANAGEMENT STRATEGY MID-YEAR REVIEW REPORT 2010/11**

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#### **Summary**

On the 25 February 2010 full Council approved the 2010/11 Treasury Management Strategy. Part of that strategy and in line with the Chartered Institute of Public Finance Accountancy's (CIPFA) code of Practice for Treasury Management is that there should be a review of that strategy at least half yearly. This report is the mid year review of the Treasury Management Strategy 2010/11.

#### **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 The Treasury Management Strategy requires there 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, Cabinet and full Council.

#### **2. Background**

- 2.1 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. "

- 2.2 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 25 February 2010.
- 2.3 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, 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 the Business Support Overview and Scrutiny Committee.
- 2.4 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 2010/11
  - A review of the Treasury Management Strategy Statement and Annual Investment Strategy
  - A review of the Council's investment portfolio for 2010/11
  - A review of the Council's borrowing strategy for 2010/11
  - A review of any debt rescheduling undertaken during 2010/11
  - A review of compliance with Treasury and Prudential Limits for 2010/11

The report also includes information from Sector, the Council's financial advisor, and Investec, the Fund Manager used by the Council.

### **3. Economic update**

#### **3.1 Global economy**

- 3.1.1 The sovereign debt crisis peaked in May 2010 prompted, in the first place, by major concerns over the size of the Greek government's total debt and annual deficit. However, any default or write down of Greek debt would have substantial impact on other countries, in particular, Portugal, Spain and Ireland. This crisis culminated in the EU and IMF putting together a €750bn support package in mid May.
- 3.1.2 Growth in the US, UK and the Euro zone in quarter 2 of 2010 was particularly driven by strong growth in the construction sector catching up from inclement weather earlier in the year and is unlikely to be repeated; general

expectations are for much more subdued figures for the remainder of 2010. Market expectations for all three sectors of the economy is that these have all peaked and are pointing downwards, though not necessarily in to negative territory.

## 3.2 UK economy

- 3.2.1 Following the general election in May 2010, the coalition government has put in place an austerity plan to carry out correction of the public sector deficit over the next five years. The inevitable result of fiscal contraction will be major job losses during this period, in particular in public sector services. This will have a knock on effect on consumer and business confidence. House prices have started a negative trend during the summer and mortgage approvals are at very weak levels and also declining.
  - 3.2.2 Economic Growth – GDP growth is likely to have peaked at 1.2% in quarter 2 of 2010.
  - 3.2.3 Unemployment – the trend of falling unemployment (on the benefit claimant count) has now been replaced since July with small increases which are likely to be the start of a new trend of rising unemployment.
  - 3.2.4 Inflation and Bank Rate – The Consumer Price Index (CPI) has remained high so far during 2010. It peaked at 3.7% in April and has fallen back to 3.1% in August. The Retail Price Index (RPI) remains high, at 4.7% in August. Although inflation has remained stubbornly above the MPC's 2% target, the MPC is confident that inflation will fall back under the target over the next two years. The last quarterly Inflation Report in August showed a significant undershoot after the end of 2011.
  - 3.2.5 The Bank of England finished its programme of quantitative easing with a total of £200bn in November 2009 (although there is currently some increase in expectations that there might be a second round of quantitative easing).
  - 3.2.6 Sector's view is that there is unlikely to be any increase in Bank Rate until the middle of 2011.
  - 3.2.7 AAA rating – prior to the general election, credit rating agencies had been issuing repeated warnings that unless there was a major fiscal contraction, then the AAA sovereign rating was at significant risk of being downgraded. Sterling was also under major pressure during the first half of the year. However, after the Chancellor's budget on 22 June, Sterling has strengthened against the US dollar and confidence has returned that the UK will retain its AAA rating. In addition, international investors now view UK government gilts as being a safe haven from EU government debt. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and PWLB rates.
- ## 3.3 Sector's view for the next six months of 2010/11
- 3.3.1 It is currently difficult to have confidence as to exactly how strong the UK economic recovery is likely to be, and there are a range of views in the market. Sector has adopted a moderate view. There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas:
    - the speed of economic recovery in the US and EU
    - the degree to which government austerity programmes will dampen economic growth

- the speed of rebalancing of the UK economy towards exporting and substituting imports
- changes in the consumer savings ratio
- the potential for more quantitative easing, and the timing of this in both the UK and US
- the speed of recovery of banks' profitability and balance sheet imbalances
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economy

3.3.2 The overall balance of risks is weighted to the downside and there is some risk of a double dip recession and deleveraging, creating a downward spiral of falling demand, falling jobs and falling prices, although this is currently viewed as being a small risk.

3.3.3 Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries.

3.3.4 As part of the Spending Review 2010 it was announced that PWLB rates would be linked to 1% above gilts. The effect of this will be to increase PWLB rates across the board. Table 3.4 below, shows Sector's predicted Bank and PWLB rates through to quarter June 2013. Sector are in the process of updating table 3.4 below to incorporate these changes, in the interim officers have been advised to add 0.85% from Dec 2010 onwards for 5,10 and 25 year PWLB and 0.75% for 50 year PWLB. These changes have been incorporated into table 3.4. Sector are also in the process of examining the period that they believe bank rate will remain at 0.50%, with a view to amending. Members will be updated at the meeting of any material changes from the table below.

#### 3.4 Sector's interest rate forecast

|           | Sep-10 | Dec-10 | Mar-11 | Jun-11 | Sep-11 | Dec-11 | Mar-12 | Jun-12 | Sep-12 | Dec-12 | Mar-13 | Jun-13 |
|-----------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Bank Rate | 0.50%  | 0.50%  | 0.50%  | 0.50%  | 0.75%  | 1.00%  | 1.25%  | 1.50%  | 2.00%  | 2.50%  | 3.00%  | 3.25%  |
| 5Yr PWLB  | 2.20%  | 3.05%  | 3.05%  | 3.25%  | 3.45%  | 3.65%  | 3.85%  | 4.15%  | 4.45%  | 4.65%  | 4.95%  | 5.25%  |
| 10Yr PWLB | 3.30%  | 4.15%  | 4.15%  | 4.25%  | 4.55%  | 4.75%  | 4.85%  | 5.15%  | 5.25%  | 5.45%  | 5.45%  | 5.75%  |
| 25yr PWLB | 4.20%  | 5.05%  | 5.15%  | 5.15%  | 5.25%  | 5.35%  | 5.55%  | 5.55%  | 5.65%  | 5.85%  | 5.85%  | 5.85%  |
| 50yr PWLB | 4.20%  | 4.95%  | 5.05%  | 5.05%  | 5.15%  | 5.25%  | 5.45%  | 5.45%  | 5.55%  | 5.75%  | 5.75%  | 5.75%  |

## 4 Treasury Management Strategy Statement and Annual Investment Strategy update

4.1 The Treasury Management Strategy Statement (TMSS) for 2010/11 was approved by this Council on 25<sup>th</sup> February 2010. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as follows:

- Security of capital
- Liquidity

- 4.2 The Council will also aim to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity. In the current economic climate it has been considered appropriate to keep investments short term, and only invest with highly credit rated financial institutions, using Sector's suggested creditworthiness approach, including sovereign credit rating and credit default swap (CDS) overlay information provided by Sector. However, as the market and advice is envisaging that that interest rates will stay at historically low levels until perhaps quarter 3 2011, officers are considering investing some monies for up to 12 months, such investments could be made in partially Nationalised banks at rates approaching 2%.
- 4.3 A breakdown of the Council's investment portfolio is shown in Section 5 and appendix 2 of this report.
- 4.4 The Council also uses a Fund Manager Investec to manage approximately £22m of our portfolio. Investec adopt a different strategy to the in-house team with Investec having more of a trading stance with gilts and certificates of deposits. As such the in-house team and Investec will compile, use and be responsible for their own counterparty lists. However, the Council must equally ensure that it is satisfied that the method used to compile both the in-house and Investec counterparty lists is robust enough to ensure that the Council's position is protected as much as possible given the overall investment strategy adopted. This was approved at Council on 25 February 2010.
- 4.4 Borrowing rates have been at historically low rates during the first six months of the 2010/11 financial year. Any new external borrowing undertaken has been identified in Section 6 of this report.
- 4.5 Investments and borrowing during the first six months of the year have been in line with the strategy, and there have been no deviations from the strategy.
- 4.6 As outlined in Section 3 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 25 February 2010 is still fit for purpose in the current economic climate.

## **5 Investment Portfolio 2010/11**

- 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.
- 5.2 The investment portfolio yield for the first six months of the year for the in-house team is 0.88% against a budget build of 2% and Investec is 0.90% against a budget of 2%. The variance between actual performance and budget is dealt with in the budget monitoring reports, however, by utilising the rate equalisation account it is envisaged that overall the Finance and Interest budgets overall will break even for 2010/11.
- 5.3 A full list of investments held as at 30 September 2010 by the in-house team, compared to Sector's counterparty list, and changes to Fitch, Moodys and

S&P's credit ratings during the first six months of 2010/11 is shown in appendix 2, and summarised below:

| Investments              | 1 <sup>st</sup> April 2010 | Average Rate of Return |
|--------------------------|----------------------------|------------------------|
| Svenska Handelsbanken    | 10,000,000                 | 0.825%                 |
| Barclays                 | 1,000,000                  | 0.780%                 |
| Natwest Special Interest | 9,300,000                  | 1.050%                 |
| Santander Money Market   | 20,000,000                 | 0.800%                 |
| Natwest Flippable        | 10,000,000                 | 0.955%                 |
| Bank of Scotland         | 5,000,000                  | 1.100%                 |
| Bank of Scotland         | 5,000,000                  | 1.140%                 |
| Bank of Scotland         | 5,000,000                  | 1.120%                 |
| <b>Total</b>             | <b>65,300,000</b>          | <b>0.936%</b>          |
| Investments              | 30th September 2010        | Average Rate of Return |
| Svenska Handelsbanken    | 10,000,000                 | 0.825%                 |
| Barclays FIBCA           | 20,000,000                 | 0.850%                 |
| Natwest Special Interest | 10,000,000                 | 1.050%                 |
| Clydesdale Base Tracker  | 20,000,000                 | 0.800%                 |
| Santander Money Market   | 15,500,000                 | 0.800%                 |
| Natwest Flippable        | 10,000,000                 | 1.080%                 |
| <b>Total</b>             | <b>85,500,000</b>          | <b>0.880%</b>          |

- 5.4 As illustrated in the economic background section above, investment rates available in the market are at a historical low point. The average level of funds available for investment purposes in the first six months of 2010/11 was £80m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the capital programme.

| Benchmark | Benchmark Return | Council Performance | Investec Performance |
|-----------|------------------|---------------------|----------------------|
| 7 day     | 0.42%            | 0.88%               | 0.90%                |

- 5.5 Investec are benchmarked against "7 day local Authority Deposit Rates" and the in-house team. As can be seen although they are performing below target they are currently exceeding their benchmark. It is envisaged that by year end they will achieve over 1%. In the Treasury strategy Investec were anticipating a return of between 1% and 2% for 2010/11.

## 6 New External Borrowing:

- 6.1 The Council's capital financing requirement (CFR) for 2010/11 is £233m. 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.

- 6.2 Sector's central target rate for new external long term borrowing (25 years) for the first six months of 2010/11 started at 4.65% and fell progressively to 4.20%.
- 6.3 Within our Borrowing strategy due to the very low interest rates being earned on investments and restrictions to mitigate counterparty risk, officer will be repaying existing and deferring taking out new debt. 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.
- 6.4 As outlined below, the general trend has been a reduction in interest rates during the six months, across all bands, with the low points occurring in the middle to end of August. The high points were in early to mid April.
- 6.5 It is anticipated that no external borrowing will be undertaken during this financial year, unless it is found to be advantageous as mentioned in 6.3.
- 6.6 The 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:

**PWLB BORROWING RATES 2010/11 for 1 to 50 years**

|           | 1          | 2          | 3          | 4          | 5          | 10         | 25         | 50         |
|-----------|------------|------------|------------|------------|------------|------------|------------|------------|
| 1. 4.2010 | 0.81%      | 1.37%      | 1.91%      | 2.40%      | 2.84%      | 4.14%      | 4.62%      | 4.65%      |
| 30.9.2010 | 0.64%      | 0.91%      | 1.22%      | 1.55%      | 1.88%      | 3.14%      | 3.95%      | 4.01%      |
| HIGH      | 0.93%      | 1.52%      | 2.07%      | 2.56%      | 2.99%      | 4.27%      | 4.73%      | 4.74%      |
| LOW       | 0.60%      | 0.89%      | 1.20%      | 1.52%      | 1.84%      | 3.06%      | 3.92%      | 3.93%      |
| spread    | 0.33%      | 0.63%      | 0.87%      | 1.04%      | 1.15%      | 1.21%      | 0.81%      | 0.81%      |
| average   | 0.73%      | 1.15%      | 1.58%      | 1.99%      | 2.37%      | 3.65%      | 4.35%      | 4.35%      |
| high date | 26/04/2010 | 26/04/2010 | 26/04/2010 | 26/04/2010 | 26/04/2010 | 12/04/2010 | 12/04/2010 | 26/04/2010 |
| low date  | 15/06/2010 | 24/08/2010 | 25/08/2010 | 31/08/2010 | 31/08/2010 | 31/08/2010 | 31/08/2010 | 31/08/2010 |

## 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 our 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. The Prudential and Treasury Indicators are shown in appendix 1.

8.3 During August 2010 one breach occurred to our counterparty limits. On Friday 27 August we were in breach of the £20m overall investment limit with Natwest by £2.8m. We initially had £10m invested in our Natwest Special Interest Account and £10m in a fixed term deposit. At 3.20pm we received a further receipt of an unexpected CHAPS payment from the PCT £2.8m. At that time the only available deposit was our Nat West Special Interest Account therefore a further £2.8m was invested. This took the sum held in the Natwest Group to £22.8m. £2.8m was transferred out of the Natwest Special Interest Account on 31 August 2010, which was the next working day.

## **9 Risk management**

9.1 As stated within the Treasury Strategy, a key driver for the review of the CIPFA code has been the exposure to risk evidenced by the Icelandic investments and more generally by the financial crisis. Risk and the management thereof is a feature throughout the strategy and in detail within the treasury management Practices 1 within the Treasury strategy.

## **10. Financial and legal implications**

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

## **11. Recommendations**

11.1 Members are requested to scrutinise this report, note it's contents and pass comments onto Cabinet and Council.

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### **Background papers**

Financial records and documents held Finance Support Team  
Investec reports  
Sector reports.



## APPENDIX 1

### Prudential and Treasury Indicators

| <b>Prudential indicators</b>  | <b>2010/11</b>  | <b>2011/12</b>  | <b>2012/13</b>  |
|---|-----------------|-----------------|-----------------|
|   | <b>estimate</b> | <b>estimate</b> | <b>estimate</b> |
|   | £'000           | £'000           | £'000           |
| <b>Capital Expenditure</b>  |                 |                 |                 |
| Non - HRA   | 103,363         | 6,574           | 3,776           |
| HRA (applies only to housing authorities)                               | 4,150           | 4,150           | 4,150           |
| <b>TOTAL</b>  | <b>107,513</b>  | <b>10,724</b>   | <b>7,926</b>    |
| <b>Ratio of financing costs to net revenue stream</b>                   |                 |                 |                 |
| Non - HRA   | 3.19%           | 2.94%           | 2.69%           |
| HRA (applies only to housing authorities)                               | 14.53%          | 14.64%          | 14.72%          |
| <b>Net borrowing requirement</b>  |                 |                 |                 |
| brought forward 1 April   | 94,363          | 100,077         | 104,668         |
| carried forward 31 March  | 100,077         | 104,668         | 109,268         |
| in year borrowing requirement   | 5,714           | 4,591           | 4,600           |
| <b>In year Capital Financing Requirement</b>                            |                 |                 |                 |
| Non - HRA   | (5,258)         | 3,176           | (726)           |
| HRA (applies only to housing authorities)                               | 735             | 735             | 735             |
| <b>TOTAL</b>  | <b>(4,523)</b>  | <b>3,911</b>    | <b>9</b>        |
| <b>Capital Financing Requirement as at 31 March</b>                     |                 |                 |                 |
| Non - HRA   | 211,211         | 214,387         | 213,661         |
| HRA (applies only to housing authorities)                               | 21,939          | 22,674          | 23,409          |
| <b>TOTAL</b>  | <b>233,150</b>  | <b>237,061</b>  | <b>237,070</b>  |
| <b>Incremental impact of capital investment decisions</b>               | £ p             | £ p             | £ p             |
| Increase in Council Tax (band D) per annum                              | (4.53)          | (9.52)          | (9.26)          |
| Increase in average housing rent per week<br>(housing authorities only) | 2.53            | 2.33            | 2.65            |

| <b>Treasury management indicators</b>   | <b>2010/11</b>  | <b>2011/12</b>  | <b>2012/13</b>  |
|---|-----------------|-----------------|-----------------|
|   | <b>estimate</b> | <b>estimate</b> | <b>estimate</b> |
|   | <b>£'000</b>    | <b>£'000</b>    | <b>£'000</b>    |
| <b>Authorised Limit for external debt -</b>   |                 |                 |                 |
| borrowing   | 418,165         | 420,267         | 418,077         |
| other long term liabilities   | 8               | 8               | 8               |
| <b>TOTAL</b>  | <b>418,173</b>  | <b>420,275</b>  | <b>418,085</b>  |
| <b>Operational Boundary for external debt -</b>   |                 |                 |                 |
| borrowing   | 380,150         | 382,061         | 380,070         |
| other long term liabilities   | 8               | 8               | 8               |
| <b>TOTAL</b>  | <b>380,158</b>  | <b>382,069</b>  | <b>380,078</b>  |
| <b>Actual external debt</b>   | 173,361         | 163,325         | 153,312         |
| <b>Upper limit for fixed interest rate exposure</b>   |                 |                 |                 |
| expressed as either:-   |                 |                 |                 |
| Net principal re fixed rate borrowing / investments OR:-                                      | 100%            | 100%            | 100%            |
| Net interest re fixed rate borrowing / investments  |                 |                 |                 |
| <b>Upper limit for variable rate exposure</b>   |                 |                 |                 |
| expressed as either:-   |                 |                 |                 |
| Net principal re variable rate borrowing / investments OR:-                                   | 40%             | 40%             | 40%             |
| Net interest re variable rate borrowing / investments   |                 |                 |                 |
| <b>Upper limit for total principal sums invested for over 364 days</b><br>(per maturity date) | 150,000         | 150,000         | 150,000         |

| <b>Maturity structure of new fixed rate borrowing during 2010/11</b> | <b>upper limit</b> | <b>lower limit</b> |
|--|--------------------|--------------------|
| under 12 months  | 50%                | 0%                 |
| 12 months and within 24 months                                       | 50%                | 0%                 |
| 24 months and within 5 years   | 50%                | 0%                 |
| 5 years and within 10 years  | 50%                | 0%                 |
| 10 years and above   | 100%               | 25%                |

## Appendix 2

### Current Investments and changes in ratings over the last six months

| Bank                     | Principal<br>£ | Term                | Changes since 01/04/2010                   |  |   |     |
|--------------------------|----------------|---------------------|--|--|---|-----|
|                          |                |                     | Sector<br>Recommended<br>Investment Period | Fitch  | Moody's   | S&P |
| Svenska Handelsbanken    | 10,000,000     | 35 day notice       | Up to 1 year                               |  |   |     |
| Barclays FIBCA           | 20,000,000     | Call                | Up to 6 months                             |  |   |     |
| Natwest Special Interest | 10,000,000     | Call                | Up to 1 year                               | 14/07/10 Individual rating<br>upgraded to C/D from D/E | 15/07/10 Financial strength<br>rating changed to stable<br>from negative C- |     |
| Clydesdale Base Tracker  | 20,000,000     | 15 day notice       | Up to 3 months                             |  |   |     |
| Santander Money Market   | 15,500,000     | Call                | Up to 6 months                             |  |   |     |
| RBS Flippable            | 10,000,000     | Fixed<br>26/09/2011 | Up to 1 year                               | 14/07/10 Individual rating<br>upgraded to C/D from D/E | 15/07/10 Financial strength<br>rating changed to stable<br>from negative C- |     |