COUNCIL

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TREASURY MANAGEMENT STRATEGY MID-YEAR REVIEW REPORT 2011/2012

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Summary

On 24 February 2011 Full Council approved the 2011/2012 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 there should be a review of that strategy at least half yearly. This report is the mid year review of the Treasury Management Strategy 2011/2012.

1. Budget and Policy Framework

1.1 The Treasury Management Strategy requires 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.

1.2 The Mid Year report should be considered by Business Support Overview and Scrutiny, 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 (revised November 2009) 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 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: Business Support Overview and Scrutiny Committee

2.6 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
- R 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

3. Economic update

3.1 Global economy

3.1.1 The outlook for the global economy remains clouded with uncertainty with the UK economy struggling to generate sustained recovery that offers any optimistim for the outlooks for 2011 and 2012, or possibly even into 2013. Consumer and business confidence levels are low and with little to boost sentiment, it is not easy to see potential for a significant increase in the growth rate in the short term.

3.1.2 At the centre of much of the uncertainty is the ongoing Eurozone sovereign debt crisis which has intensified, rather than dissipated throughout 2011. The main problem has been Greece, where, even with an Eurozone/IMF/ECB bailout package and the imposition of austerity measures aimed at deficit reduction, the lack of progress and the ongoing deficiency in addressing the underlying lack of competitiveness of the Greek economy, has seen an escalation of their problems. These look certain to result in a default of some kind but it currently remains unresolved if this will be either “orderly” or “disorderly”, and/or also include exit from the €uro bloc.

3.1.3 As if that were not enough there is growing concern about the situation in Italy and the risk that contagion has not been contained. Italy is the third biggest debtor country in the world but its prospects are limited given the poor rate of economic growth over the last decade and the lack of political will to address the need for fundamental reforms in the economy. The Eurozone now has a well established track record of always doing too little too late to deal with this crisis; this augurs poorly for future prospects, especially given the rising level of electoral opposition in northern EU countries to bailing out profligate southern countries.

3.1.4 The US economy offers little to lift spirits. With the next Presidential elections due in November 2012, the current administration has been hamstrung by political gridlock with the two houses split between the main parties. In quarter 3 the Federal Reserve started “Operation Twist” in an effort to re-ignite the economy in which growth is stalling. High levels of consumer indebtedness, unemployment and a moribund housing market are weighing heavily on consumer confidence and so on the abiltity to generate sustained economic growth.

3.1.5 Hopes for broad based recovery have, therefore, focussed on the emerging markets but these areas have been struggling with inflationary pressures in their previously fast growth economies. China, though, has maintained its growth pattern, despite tightening monetary policy to suppress inflationary pressures, but some forward looking indicators are causing concern that there may not be a soft landing ahead, which would then be a further dampener on world economic growth.

3.2 UK economy

3.2.1 The Government’s austerity measures, aimed at getting the public sector deficit into order over the next four years, have yet to fully impact on the economy. However, coming at a time when economic growth has virtually flatlined and concerns at the risk of a technical recession (two quarters of negatibe growth) in 2012, it looks likely that the private sector will not make up for the negative impact of these austerity measures given the lack of an export led recovery due to the downturn in our major trading partner – the EU. The housing market, a gauge of consumer confidence, remains weak and the outlook is for house prices to be little changed for a prolonged period.

3.2.2 Economic Growth. GDP growth has, basically, flatlined since the election of 2010 and, worryingly, the economic forcecasts for 2011 and 2012 have been revised lower on a near quarterly basis as the UK recovery has, effectively, stalled. With fears of a potential return to recession the Bank of England embarked on a second round of Quantitive Easing to stimulate ecomnomic activity.

3.2.3 Unemployment. With the impact of the Government's austerity strategy impacting the trend for 2011 of steadily increasing unemployment, there are limited prospects for any improvement in 2012 given the deterioration of growth prospects.

3.2.4 Inflation and Bank Rate. For the last two years, the MPC's contention has been that high inflation was the outcome of temporary external factors and other one offs (e.g. changes in VAT); that view remains in place with CPI inflation standing at 5.2% at the start of quarter 4 2011. They remain of the view that the rate will fall back to, or below, the 2% target level within the two year horizon.

3.2.5 AAA rating. The ratings agencies have recently reaffirmed the UK's AAA sovereign rating and have expressed satisfaction with Government policy at deficit reduction. They have, though, warned that this could be reviewed if the policy were to change, or was seen to be failing to achieve its desired outcome. This credit position has ensured that the UK government is able to fund itself at historically low levels and with the safe haven status from Eurozone debt also drawing in external investment the pressure on rates has been down, and looks set to remain so for some time.

3.3 Outlook for the next six months of 2011/2012

3.3.1 Economic forecasting remains troublesome with so many extermal influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains weak and whilst there is still a broad range of views as to potential performance, they have all been downgraded throughout 2011. Key areas of uncertainty include:

- a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;
- the impact of the Eurozone crisis on financial markets and the banking sector;
- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to exporting manufactured goods;
- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that inceasingly seem likely to be undershot;
- a continuation of high levels of inflation ;
- the economic performance of the UK's trading partners, in particular the EU and US, with some analysts suggesting that recession could return to both;
- stimulus packages failing to stimulate growth;

- elections due in the US, Germany and France in 2012 or 2013;
- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China.

3.3.2 The overall balance of risks remains weighted to the downside. Lack of economic growth, both domestically and overseas, will impact on confidence putting upward pressure on unemployment. It will also further knock levels of demand which will bring the threat of recession back into focus.

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 Given the weak outlook for economic growth, Sector sees the prospects for any interest rate changes before mid-2013 as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

3.4 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**

4 Treasury Management Strategy Statement and Annual Investment Strategy update

4.1 The Treasury Management Strategy Statement (TMSS) for 2011/12 was approved by this Council on 24 February 2011.

4.2 Officers are currently investigating the options available to the Council for funding the HRA reform. Although the size of the cost to Medway is comparatively small (when compared against other Kent Authorities), it is still a material sum. The Government has recently announced preferential rates for the funding of the HRA reform. In light of this it may be in the best interest of Medway to obtain funding via the Governments preferential rates to fund the HRA reform. With this possible exception, there are no policy changes to the TMSS. The details in this report update the position in the light of the updated economic position and budgetary changes already approved.

4.3 HRA Reform

4.3.1 The reform of the HRA subsidy arrangements are expected to take place on 28 March 2012. This will involve the Council paying funds to the CLG which will remove the Council from the HRA subsidy system. The most recent estimated payment is £19.485m which is an increase from the current strategy assumption of £15m. Originally we had also assumed the payment would occur in 2012/13 however, it will now be in the current financial year to ensure that opening balances for 2012/13 are correct. This will therefore impact on both the capital structure of the Council (as the HRA Capital Financing Requirement will rise by the size of the CLG payment), the timing of the payment and the treasury management service will need to consider the funding implications for the borrowing, fundamentally whether to borrow externally or internally. The Council's prudential indicators shown within appendix 1 will need to be revised to reflect these changes. Officers are currently investigating the implications of the HRA reform and will be putting forward revisions to the prudential indicators 2011/12 when presenting the Treasury Strategy for 2012/13.

4.4 Limits to Borrowing Activity.

4.4.1 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 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.

	2011/12 Original Estimate £m	**Current Position 30 Sept 2011 £m**	**2011/12 Revised Estimate £m**
Gross borrowing	163.325	173.230	163.194
Plus other long term liabilities*		4.045	4.045
Less investments	-74.293	-102.508	-89.267
Net borrowing	89.032	74.767	77.972
CFR (year end position)	231.556	239.624	239.624

- *- On balance sheet PFI schemes and finance leases etc*

4.4.2 On the 21 November 2011 £10million PWLB loan will be repaid, bringing the debt portfolio in line with the original estimate, however invested cash is likely to exceed the original estimate producing a net borrowing figure of some £78 million – well within the CFR.

4.4.3 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.

4.4.4 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 on a very short-term basis, but is not sustainable in any long-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 2011/12 is £414.22m. We will not exceed this limit.

5 Investment Portfolio 2011/2012

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 1.34% (on an annual basis) and Investec is 2.04% (on a annual basis).

5.3 A full list of investments held as at 30th September 2011 compared against 1 April 2011 by the in-house team is shown below:

Investments	1st April 2011	Average Rate of Return as at 1 April 2011
Svenska Handelsbanken	10,000,000	0.875%
Natwest Special Interest	8,700,000	1.050%
Natwest Flippable	10,000,000	1.166%
Lloyds TSB	20,000,000	1.95%
Total	**48,700,000**	**1.407%**
Investments	30th September 2011	Average Rate of Return as at 30 September 2011
Svenska Handelsbanken	10,000,000	0.875%
Natwest Special Interest	25,000,000	1.050%
Santander Money Market	19,800,000	0.800%
Lloyds TSB	20,000,000	1.95%
Lloyds TSB	5,000,000	2.10%
Total	**79,800,000**	**1.257%**

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 2011/2012 was £72.5m. 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.

5.5 The Council uses the services of Investec as a Fund Manager also investing some £22.7m (30 Sept 11) on the Councils behalf it is anticipated that Investec will achieve a 1.5% return for 2011/2012.

Benchmark	Benchmark Return	Council Performance	Investec Performance
7 day	**0.23%**	0.67%	1.02%

5.6 Investec are benchmarked against the "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

6 Borrowing

6.1 The Council's capital financing requirement (CFR) for 2011/12 is £239.624m. 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 5.41 shows the Council has external borrowings of £173.23m against a CFR of £239.624m.

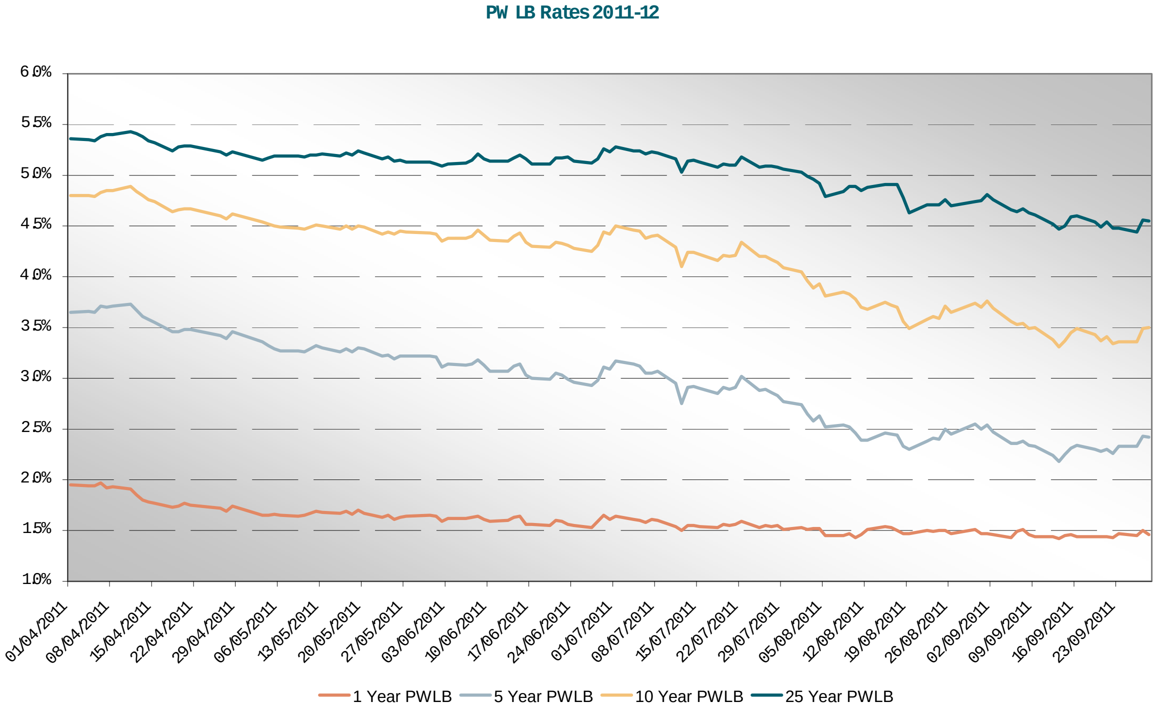
6.2 The current borrowing strategy is to repay debt rather than enter into new borrowing as a consequence of the relationship between investment and borrowing interest rates. Using invested funds to repay debt also has the benefit of mitigating counterparty risk. This policy has been adhered to for the 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. This will be particularly relevant to decisions around the HRA reform to be made at the end of this financial year.

6.3 As outlined below, the general trend has been a reduction in interest rates during the six months, across all 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 6.2.

6.5 The graph shown on the next page shows the movement in PWLB rates for the first six months of the year and provide benchmarking data showing high and low points etc:

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

9 Business Support Overview and Scrutiny Committee – 1 December 2011

9.1 The Chief Finance Officer introduced the report advising that this was a mid-year review of the strategy. He informed the Committee that the mid-year report was intended to highlight any areas of concern that had arisen since the original strategy was approved. However, there had been no changes within the past six months to investments and the Council continued to use cash raised during the year to repay its debts.

9.2 Members were also advised of the reform of the Housing Revenue Account (HRA) subsidy arrangements, which would take place in March 2012, as set out in the report. Officers also suggested that a further report was submitted about this matter for Members consideration at the next meeting of this Committee.

9.3 Some Members voiced their concern about the Council making investments with Santander (paragraph 6.3 of the report) but the Chief Finance Officer advised that officers worked with external financial advisors, who were very cautious, and were keeping a close watch on the future of this investment.

9.4 Members also asked about the interest rates for the repayment of debt within the Housing Revenue Account and were advised that this currently stood at 4% of the total of £24 million of debt.

10 Cabinet – 20 December 2011

10.1 The Cabinet considered this report on 20 December 2011. It noted the report and referred it to Council for consideration.

11 Risk management

11.1 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.

12 Financial and legal implications

12.1 The financial and legal implications are highlighted throughout this report.

13 Recommendation

13.1 Council is asked to consider and note the report.

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Background papers

Various records and documents held within Finance
Investec reports
Sector reports.

APPENDIX 1

Prudential and Treasury Indicators

PRUDENTIAL INDICATORS	2011/2012	2012/2013	2013/2014
Extract from budget and rent setting report	**estimate** **£'000**	**estimate** **£'000**	**estimate** **£'000**
Capital Expenditure			
Non - HRA	48,923	12,452	3,854
HRA (applies only to housing authorities)	5,572	6,705	5,060
TOTAL	54,495	19,157	8,914
Ratio of financing costs to net revenue stream			
Non - HRA	2.96%	2.82%	2.65%
HRA (applies only to housing authorities)	14.39%	13.92%	13.63%
Net borrowing requirement			
brought forward 1 April	93,013	89,032	132,804
carried forward 31 March	89,032	132,804	128,141
in year borrowing requirement	-3,980	43,772	-4,663
Capital Financing Requirement as at 31 March			
Non – HRA	209,543	201,845	195,464
HRA	22,013	37,613	37,613
TOTAL	231,556	239,455	233,077
Annual change in Cap. Financing Requirement			
Non – HRA	-165	-7,701	-6,378
HRA	735	15,600	0
TOTAL	570	7,899	-6,378
Incremental impact of capital investment decisions	**£ p**	**£ p**	**£ p**
Increase in council tax (band D) per annum	-9.46	-8.49	-8.30
Increase in average housing rent per week	1.35	3.14	2.46

TREASURY MANAGEMENT INDICATORS	2011/2012	2012/2013	2013/2014
	estimate	**estimate**	**estimate**
	£'000	**£'000**	**£'000**
Authorised Limit for external debt -			
borrowing	414,212	420,701	411,485
other long term liabilities	8	8	8
TOTAL	414,220	420,709	411,493
Operational Boundary for external debt -			
borrowing	376,556	382,455	374,077
other long term liabilities	8	8	8
TOTAL	376,564	382,463	374,085
Actual external debt	163,325	153,312	143,312
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing / investments	100%	100%	100%
Upper limit for variable rate exposure			
Net principal re variable rate borrowing / investments	40%	40%	40%
Upper limit for total principal sums invested for over 364 days (per maturity date)	£150,000	£150,000	£150,000

TABLE 7: Maturity structure of fixed rate borrowing during 2011/2012	upper limit	lower limit
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%	0%