Stevenage BOROUGH COUNCIL

Part I – Release to Press

Meeting: **AUDIT / COUNCIL** **Agenda Item:** **7**

Portfolio Area: Resources

Date: **29 NOVEMBER/13 DECEMBER 2011**

TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY - MID-YEAR REVIEW REPORT 2011/12
(Finance)

NON-KEY DECISION

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1. PURPOSE

1.1 To review the operation of the 2011/12 Treasury Management & Investment strategy for the first six months of the year, in accordance with the CIPFA Code of Practice on Treasury Management

1.2 To revise the 2011/12 Treasury Management Strategy in relation to counter party limits and the requirement for the Council to prudentially borrow to fund part of its capital programme.

1.3 To update members on the changes to the Treasury Management Strategy, taken under delegated authority.

2. RECOMMENDATIONS

2.1 Audit Committee

2.1.1 That Audit Committee recommends Council to approve the 2011/12 Mid-year Treasury Management Strategy and Annual Investment Strategy Review.

2.2.2 That Audit Committee recommends Council to approve the amendments made to the Treasury Management Strategy under Urgent Decision outside of the Budget and Policy Framework.

2.2.3 That Audit Committee recommends Council to approve the updated Treasury and Capital Prudential Indicators as shown in Section 8 and in Appendix A of this report. The changes are in respect of:

- fixed and variable limits for borrowing and investments presented and monitored separately, and
- operational limit for external debt reduced from £44.565M to £30.733M, and

- authorised limits for external debt reduced from £49.565M to £36.855M. This reflects the resolution of risks associated with lease classification.

3. BACKGROUND

3.1 The Chartered Institute of Public Finance & Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by this council on 23 February.

3.2 One of the primary requirements of the code includes:

> "Receipt by the Council of an annual treasury management strategy report, including the annual investment strategy report - for the year ahead, a midyear review report, and an annual review report of the previous year."

3.3 The 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 (Section 4).
- A review of the Treasury Management Strategy and Annual Investment Strategy (Section 5).
- A review of the Council's investment portfolio for 2010/11 (Section 6).
- A review and update of the Council's borrowing strategy for 2011/12, reflecting the Capital Strategy Update approved by Council in September (Section 7). This excludes any changes to the Treasury Management Strategy as a result of HRA Self Financing regulations.
- A review of compliance with Treasury and Prudential Limits for 2011/12, and recommended amendments to limits, to keep in line with both the revised capital strategy and a counterparty review to ensure that risk continues to be diversified, ensuring the security of our funds in a highly uncertain market.

3.4 In October 2010 as part of the Comprehensive Spending Review, HM Treasury announced that Public Works Loans Board (PWLB) borrowing rates would be set at 1% on average above the gilt rate. In September 2011, as a one off exception to this, Treasury have announced that the borrowing required to leave the housing subsidy system will be 0.11 to 0.15% above the gilt rate. This will reduce the cost to the HRA of self financing. The impact of this will be included in an update to the February Council.

4. 2010/11 ECONOMIC & INTEREST RATE REVIEW

4.1 Global Economy

4.1.1 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.

4.1.2 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.

4.2 UK Economy

4.2.1 **Growth** - 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.

4.2.2 **Inflation -** The announcement by the MPC on 6 October of a second round of Quantitative Easing (QE) 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.

4.2.3 **Gilts -** 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.

4.3 The Forward View Of Our Treasury Advisors

4.3.1 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

4.3.2 The overall balance of risks is weighted to the downside:

- Sector 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.

4.4 Interest Rate Review September 2011

4.4.1 At the time of setting the Strategy for 2011/12 (February 2011), our Treasury advisors were forecasting rates to be stable at 0.5% for the first two quarters, which they have. They were then forecasting that the base rate would rise to 0.75% for the third quarter and to 1.0% for the fourth quarter. These expectations have subsequently been revised. Rates are expected to remain at 0.5% until quarter three of 2013.

4.4.2 Sector's current interest rate forecast is shown in the table below.

Table One: Interest rate projections as at 7 October 2011.

	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**

The Council's medium term financial strategy assumed interest rates of 1% for investments and a rate of 4.35% borrowing for 2012/13.

5. TREASURY MANAGEMENT REVIEW

5.1 Update of 2011/12 Treasury Management Strategy and Annual Investment Strategy

5.2 The Treasury Management Strategy Statement (TMSS) for 2011/12 was approved by this Council on 23 February 2011. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as follows:

- Security of capital
- Liquidity
- Yield

The Council will always aim to achieve the optimum return (yield) on investments, however security and liquidity are the higher priority. In the current economic climate it is 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, our Treasury advisors.

5.3 On 8 September 2011 Sector issued a Newsflash to clients advising them to keep investments to a maximum of 3 months. Exceptions to this were semi-nationalised banks (12 months), money market funds and local government and similar bodies. This was consistent with our practice at that time.

5.4 On 13th October a credit update was issued on UK Banks, which included a downgrading of part-nationalised institutions from F1+ to F1. The Treasury Management Strategy was reviewed it was recommended to a Treasury Management Group (including members and officers) that investments be made in the following order:

- the council would favour F1+ institutions, and then
- F1 part-nationalised institutions, and then
- other F1 institutions,

in that order. The decision was taken by the Leader as an Urgent Decision Outside Budget & Policy Framework on 19th October 2011. The decision is shown as an Appendix to this report.

5.4 A breakdown of the Council's investment portfolio is shown in Section 6 of this report. This shows broadly stable investment balances, these levels have been maintained despite the Council not taking out any borrowing in the first six months of the year.

5.5 Borrowing rates have been at historically low rates during the first six months of the 2011/12 financial year. No new borrowing has been taken out yet, as the Council has managed within its cash balances. This is due to the uneven profile of some revenue receipts, where more is received in the earlier part of the year. Also, the uneven profile of capital expenditure, where more invoiced costs are expected in the latter part of the year.

5.6 Subject to statutory powers, the Council will be required to make a one off payment to the CLG to remove the HRA from the current housing subsidy system. The payment is expected to be in the region of £211M. This is a one off payment in compensation, ensuring the HRA will no longer make future subsidy payments to the CLG. It is expected that the overall impact of self financing is more beneficial than staying within the existing subsidy system. As the legislative framework is not yet in place, it is proposed that revised Prudential Indicators for 2011/12 taking into account housing reform are presented to the February Council, alongside our strategy for 2012/13. This will be ahead of the need to borrow on 28th March 2012.

5.7 The Prudential Indicators as shown in Appendix A have been updated to explicitly include:

- a limit on fixed rate investments of £10M (these are investments at fixed rate that are for 7 days or more duration). Previously, the indicator showed only a hedged position, netting off fixed borrowing.
- Other minor amendments have been made to items shown “net”, to include limits for both elements netted off.

6. INVESTMENT PORTFOLIO 2011/12

6.1 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.

6.2 The investment portfolio yield for the first six months of the year is 0.86%. This compares favourably against a benchmark of 0.51% for one month, and even the 3 month return of 0.72%.

6.3 A full list of investments held as at 1st April and at 30th September 2011, are shown below. The investments were all in accordance with Sector’s counterparty list, based on changes to Fitch, Moodys and S&P’s and credit default swap (CDS) credit ratings during the first six months of 2011/12, and the Council’s own criteria at that time of achieving a minimum of a Fitch F1+ short term rating. This was subsequently changed (see Para 5.4).

6.4 The table below shows that we had 50% of investments in call accounts in April – this has moved to only 25% at the end of September. The difference was due to fixing an investment for 3 months with the Nationwide, during September. This is because we had higher than planned cash balances, due primarily to the profile of expenditure and the level of uninvoiced works in the capital programme.

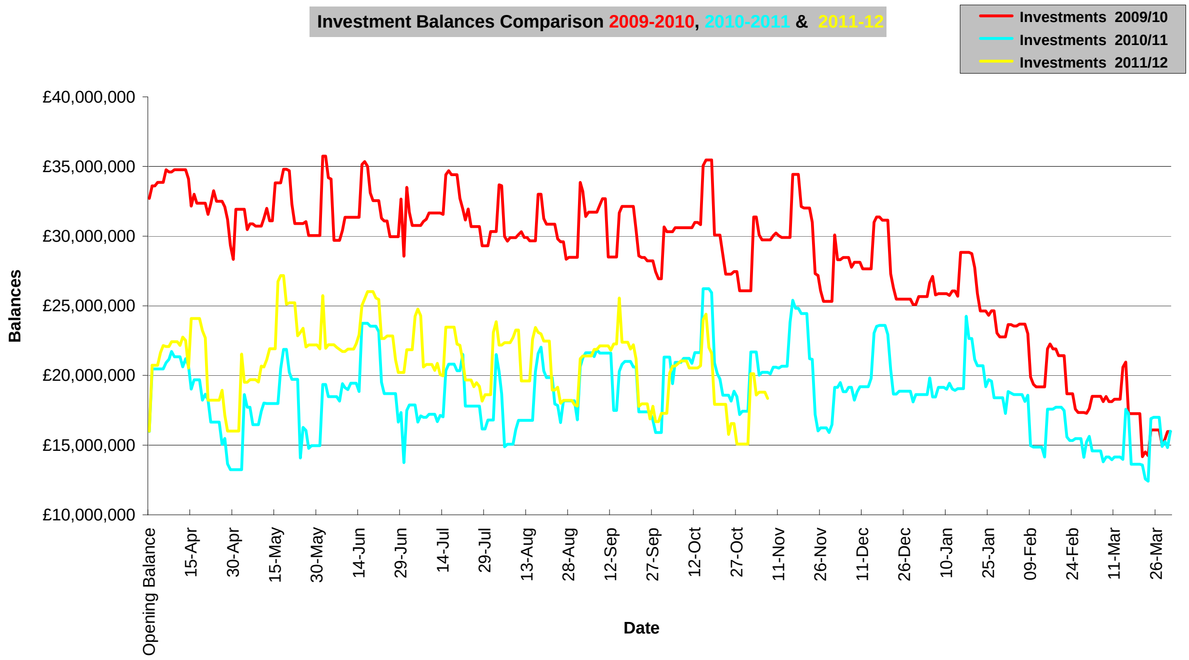
Investments	Country	1st April 2011	Average Rate of Return
Santander – Call Account	UK	3,360,000	0.88%
Bank of Scotland – Call Account	UK	1,780,000	0.75%
Nat West – Call Account	UK	2,850,000	0.85%
Handelsbanken – 35 day notice	Sweden	5,000,000	0.85%
Newcastle City Council -1yr fixed to December 2011	UK	3,000,000	1.35%
Total		**15,990,000**	
Investments		**30th September 2011**	**Average Rate of Return**
Santander – Call Account	UK	3,290,000	0.88%
Bank of Scotland – Call Account	UK	105,000	0.75%
Nat West – Call Account	UK	890,000	0.85%
Handelsbanken – 35 day notice	Sweden	5,000,000	0.85%
Nationwide Fixed – 3 month to Dec 2011	UK	5,000,000	0.84%
Newcastle City Council – 1 year fixed to 1/2/12.	UK	3,000,000	1.35%
Total		**17,285,000**	

6.4 There were no breaches of prudential indicators, during the first six months of the year.

6.5 As described in 5.4 above, an urgent decision was required to enable the Council to continue to invest in Natwest and Bank of Scotland. Their downgrade on 13th October resulted in them not meeting our investment criteria, and the temporary transfer of funds to the DMO account, although they were still assessed as a sound by our external advisors.

6.6 Investment rates available in the market remain at a historical low point. The average level of funds available for investment purposes in the first six months of 2011/12 was £21.403M, with balances fluctuating between £16.010M and £27.160M. These are funds available on a temporary basis, the level of funds available was determined by the timing of precept payments, receipt of grants and progress on the capital programme. There were no new PWLB loans taken out during the period.

6.7 A chart of investment balances for the 2011/12 year to date, and the comparative balances for the previous years are shown below.



6.8 The Council achieved returns for the first six months of the year of 0.89% on its investments.

6.9 Excluding the Newcastle City Council investment the return was 0.78%. It can be seen from the benchmark information provided by the Council's treasury advisers, that this return exceeds even the benchmark on three month investments, of 0.72%. The Council's portfolio for the period ranged from call accounts to 35 day deposits.

6.10 The benchmark 12 month rate (1.48%) exceeds our return from Newcastle City Council (1.35%), the benchmark rates were not available from any counterparties available to the Council.

Benchmark	Benchmark Return
7 day	0.47%
1 month	0.51%
3 months	0.72%
6 months	1.01%
12 months	1.48%

6.11 The forecast return for the year is 0.89%, compared to the Council's original budgeted investment return for 2011/12 of 0.94%.

7. Review of External Borrowing

7.1 The Decent Homes programme for the Housing Revenue Account (HRA) has been financed from £17.004M supported borrowing as at 31st March 2011. The Council has a further approved supported borrowing limit of £5.929M to fund its 2011/12 decent homes programme. As at 30th September, the Council had not taken out any new supported borrowing for the year, managing instead to keep within cash balances.

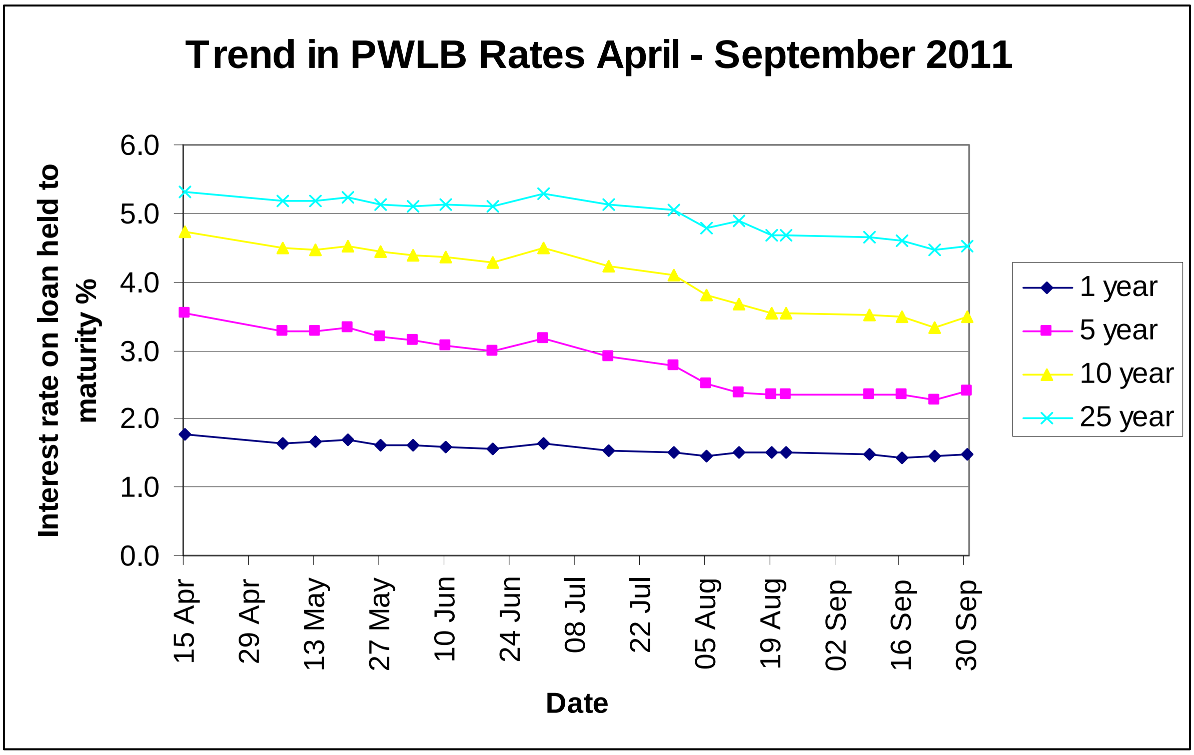
7.2 The Capital Financing Requirement (CFR) denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions.

7.3 The opening CFR for 2011/12 was £17.004M, which represented the Council's underlying need to borrow to fund the decent homes programme.

7.4 The Council's current loan portfolio is shown below Sector's central target rate for new external long term borrowing (25 years) for the first six months of 2011/12 remained fairly stable at 4.20%. The Council's weighted average cost of borrowing for the period was 3.84% on the £17.004M borrowed.

Terms of loan taken out	**From**	**To**	**Amount borrowed (Principal) £**	**Rate %**	**Interest payable in 2011/12**
Repay on maturity	04/03/10	04/03/35	2,000,000	4.75	95,000
Repay on maturity	25/03/10	25/09/35	3,000,000	4.65	139,500
Repay on maturity	25/05/10	25/05/35	1,800,000	4.28	77,040
Repay on maturity	21/07/10	21/07/15	2,500,000	2.25	56,250
Repay on maturity	17/08/10	17/08/35	963,000	4.24	40,831
Repay on maturity	5/10/10	5/10/15	1,000,000	1.94	19,400
Repay on maturity	24/3/11	24/3/16	2,000,000	3.53	70,600
Repay on maturity	24/3/11	24/3/18	2,500,000	4.11	102,750
Repay on maturity	31/3/11	31/3/18	1,241,000	4.11	51,005
			17,004,000	3.84	652,376

7.5 The general trend has been a reduction in PWLB interest rates during the six months, across all bands, with the lowest points occurring in September. The high points were at the start of the year, and the gradual downward decline was only thwarted for a short period at the end of June, and early part of July, as can be seen from the chart below.



7.6 The Council has approved borrowing limits for the capital programme for the year of £8.729M. This includes £5.929M supported borrowing for the decent homes programme, and £2.800M prudential borrowing for the General Fund.

7.7 The Council has not yet taken any of its approved borrowing limit for 2011/12 – either for the General Fund or Decent Homes capital programmes.

7.8 The Council will aim to minimise borrowing for the year through close management of cash balances (internal borrowing) where possible, in order to minimise borrowing costs to the Council. It should be noted that the actual borrowing taken out is not the same as the council's underlying need to borrow, as reflected in the capital financing requirement.

8. Review of compliance with Treasury and Prudential Limits

8.1 The Treasury Management Prudential Indicators are shown in full at Appendix A. Where proposed amendments have been identified, these are included in the table below.

Treasury management prudential indicators for SBC:	**Approved limits £'000**	**Actual to 30th September £'000**
Net sums invested at variable interest rates. (i.e. variable principal borrowed less variable rate investments).	-£25,000	-£19,840 [1]
Net sums invested at fixed interest rates.	£30,565	+£14,004 [2]
Principal sums invested for more than 364 days.	£2,000	NIL [3]
Authorised Borrowing Limit Operational Boundary for borrowing	£49,565 £44,565	£17,004 [3] £17,004 [3]
[1] The variable upper limit exists as a prudential indicator, to enable the council to have a mixture of investments which are not all exposed to the market rates of interest. The indicator has been amended to show the limits on investments and borrowing separately, in Appendix A, to provide greater transparency and clarity. We have not had any variable rate borrowing in year. The figure is negative because our investments exceed our borrowing. [2] The sums are defined as fixed rate principal borrowed less fixed rate investments. The movement to positive reflects that the council has moved from being debt free. The indicator has been amended to show the limits on investments and borrowing separately, in Appendix A, to provide greater transparency and clarity. This includes £17.004M borrowing and £3.000M investments at the highest point. [3] Considerable headroom existed within the original borrowing limits, to ensure adequate coverage for any potential finance leases, to be found as part of our IFRS review.		

8.2 We do not propose at amend any of the limits ahead of housing Self financing. However, we would recommend that the fixed exposure and variable exposure indicators are approved as separate limits. Officers will continue to monitor the net, to ensure that we are not over exposed one-way.

9. IMPLICATIONS

9.1 Financial Implications

This report is of a financial nature and reviews the treasury management function for the 2011/12 financial year.

9.2 Legal Implications

None

9.3 Equality and Diversity Implications

There are no Equality Impact implications identified within the report.

9.4 Risk Management Implications

There is a risk that counterparties will further diminish with the global economic position	Action has been taken to ensure that sufficient credit worthy counterparties are available, on a sliding scale of credit-worthiness.	Low risk – currently running investment balances down, to minimise borrowing requirement. This will minimise amounts available to invest.
There is a risk that gilt rates may move, affecting adversely the borrowing cost to the council.	Market sentiment at present shows sterling as sound. At present the pressure on gilts looks downward.	Medium risk – difficult to hedge, as would need to borrow early to minimise risk, at extra cost.

BACKGROUND DOCUMENTS

- Treasury Management Reports
- Sector Reports
- Urgent Order Decision

APPENDICES

- Appendix A – Prudential and Treasury Indicators
- Appendix B – Urgent Order Decision