Stevenage BOROUGH COUNCIL

Part I – Release to Press

Meeting: **EXECUTIVE / AUDIT / COUNCIL** **Audit Agenda Item:** **6**

Portfolio Area: Resources

Date: **20 NOVEMBER / 4 DECEMBER / 5 DECEMBER 2012**

TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY - MID-YEAR REVIEW REPORT 2012/13
(Finance)

NON-KEY DECISION

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1. PURPOSE

1.1 To review the operation of the 2012/13 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 note the revisions made to the 2012/13 Treasury Management Strategy presented to Council on 10 October 2012 for the Local Authority Mortgage Scheme.

1.3 To update the Treasury Management Strategy for the use of Money Market Funds and associated trading limits.

1.4 To update the Treasury Management Strategy to allow for unlimited funds to be placed with the Government's Debt Management Office (DMO), in recognition of their safe haven status.

2. RECOMMENDATIONS

2.1 That Council be recommended to approve the 2012/13 Mid-year Treasury Management Strategy and Annual Investment Strategy Review.

2.2 That the amendments made by Council on 10 October 2012 to the Treasury Management Strategy ahead of the implementation of the Local Authority Mortgage Scheme (para 6.11) ne noted, together with the updated authorised investments (Appendix B, revised Appendix A, attachment 3).

2.3 That the amended strategy for Urgent Decisions on (i) the safe haven status of the Governments Debt Management Office, and that unlimited funds may be placed with them; and (ii) the use of Money Market Funds up to a limit of 25% of total investments and limited to a maximum of £5Million in any one Money Market Fund, be noted.

2.4 That Council be recommended 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:

- Additional approvals to borrowing limits included in the September Capital Strategy; and
- Amending the variable rate investment limit from £25Million to £35Million, reflecting a higher level of balances and the risk associated with fixing investments in the current market.

3. BACKGROUND

3.1 The Chartered Institute of Public Finance & Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2011) was adopted by this Council on 29 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 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 2012/13 (Section 4).
- A review of the Treasury Management Strategy and Annual Investment Strategy (Section 5).
- A review of the Council's investment portfolio for 2012/13 (Section 6).
- A review and update of the Council's borrowing strategy for 2012/13, reflecting the Capital Strategy Update approved by Executive in September (Section 7).
- A review of compliance with Treasury and Prudential Limits for 2012/13, 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 HM Treasury announced that Public Works Loans Board (PWLB) borrowing rates would be set at 1% on average above the gilt rate. Following this in 2012, HMT announced a "certainty rate" – at 0.2% lower than PWLB rates, available from 1 November 2012 for authorities that provide additional capital information. The Council has signed up to reduced borrowing. There is currently consultation on a third "scrutiny rate" however it is not yet known whether this will be available to the Council nor what conditions may prevail.

4. 2012/13 ECONOMIC & INTEREST RATE REVIEW

4.1 Global Economy

4.1.1 With regard to the Eurozone, investor confidence remains weak because successive “rescue packages” have first raised, and then disappointed, market expectations. However, the uncertainty created by the continuing Eurozone debt crisis is having a major effect in undermining business and consumer confidence not only in Europe and the UK, but also in America and the Far East/China.

4.2 UK Economy

4.2.1 **Growth -** In August when the Bank of England substantially lowered its expectations for the speed of recovery and rate of growth over the coming months and materially amended its forecasts for 2012 and 2013. It was noted that the UK economy is heavily influenced by worldwide economic developments, particularly in the Eurozone, and that on-going negative sentiment in that area would permeate into the UK’s economic performance.

4.2.2 UK GDP fell by 0.5% in the quarter to 30 June, the third quarterly fall in succession. This means that the UK’s recovery from the initial 2008 recession has been the worst and slowest of any G7 country apart from Italy (G7 countries are US, Japan, Germany, France, Canada, Italy and UK). The current recovery is the slowest recovery from a recession of any of the previous five UK recessions since 1930 and total GDP is still 4.5% below its peak in 2008.

4.2.3 This weak recovery has caused social security payments to remain elevated and tax receipts to be depressed. Consequently, the Chancellor’s plan to eliminate the annual public sector borrowing deficit has been pushed back further into the future. The Monetary Policy Committee has kept the Bank of England Base Rate (known as the Bank Rate) at 0.5% throughout the six month period while quantitative easing was increased by £50bn to £375bn in July. In June, the Bank of England and the Government announced schemes to free up banking funds for business and consumers, in recognition of the current economic climate.

4.2.4 **Inflation -** In the UK, whilst inflation has fallen (with CPI at only 2.2% in September), consumer confidence remains very depressed with unemployment concerns, indebtedness and a squeeze on real incomes as a result of the recent high inflation and low pay rises, all taking their toll.

4.2.5 **Gilts -** On a positive note, despite all the bad news on the economic front, the UK’s sovereign debt remains one of the first ports of call for surplus cash to be invested in. Gilt yields, prior to the European Central Bank (ECB) bond buying announcement in early September, were close to zero for periods out to five years and not that much higher out to ten years.

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 (Sector)

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

- the current political deadlock in the US prevents a positive approach to countering weak growth ahead of the presidential elections in November 2012, although the Federal Reserve have announced a third round of quantitative easing, and that interest rates are likely to remain unchanged until mid 2015.
- the potential for a major EU sovereign debt crisis remains unresolved, with Greece failing to achieve its deficit reduction targets possibly requiring a third bail out. This could put pressure on for their ejection from the Eurozone. Spain is also suffering an escalating crisis.
- Although the ECB have announced that it would purchase unlimited shorter term bonds in any country that formally accept the terms for a bailout, it remains to be seen if the imposition of austerity measures overseen by the International Monetary Fund (IMF) would be acceptable in the affected countries.
- the Bank of England Quarterly Inflation Report in August pushed back the timing of the return to trend growth and lowered its inflation expectations, even this may prove to be over optimistic given the world headwinds the UK economy faces.

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 expectation for long term PWLB borrowing rates is for them to rise, due primarily to the need for a high volume of gilt issues in the UK, and the high volume of debt issues in other major western countries. However the current safe haven status of the UK may continue for some time, postponing any increases until 2014.
- This interest rate forecast is based on an assumption that growth starts to recover in the next three years at a rate of 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 Sector's forecast.

4.4 Interest Rate Review September 2012

4.4.1 At the time of setting the Strategy for 2012/13 (February 2012), our Treasury advisors were forecasting rates to be stable at 0.5% for the year, rising to 0.75% in the third quarter of 2013. The rates have remained stable, but the revised forecast is that they will not rise until the fourth quarter of 2014.

4.4.2 Sector's current interest rate forecast is shown in the following table:

Table One: Interest rate projections as at 17 September 2012.

	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

5. TREASURY MANAGEMENT REVIEW

5.1 Update of 2012/13 Treasury Management Strategy and Annual Investment Strategy

5.2 The Treasury Management Strategy Statement (TMSS) for 2012/13 was approved by Council on 29 February 2012. 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

5.3 The Council will always aim to achieve the optimum return (yield) on investments, however security and liquidity have a 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 considering the appropriateness on a counterparty basis of credit default swap (CDS) overlay information provided by Sector, our Treasury advisors (most of our investments are in overnight accounts of the highest quality, presenting a low risk).

5.4 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 and has remained in place throughout 2012/13.

5.5 Following the downgrading of part-nationalised institutions from F1+ to F1 in October 2011, the Treasury Management Strategy was updated to include 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,

5.6 It has became increasingly difficult during the current financial year to find high quality institutions in which to invest the Council's higher cash balances compounded by counterparty limits of £5million. The higher cash balances are partly due to the effect of housing self financing reforms, whereby interest and principal payments are made every six months, but the rents funding them are received regularly throughout the year, together with significant slippage in the first half year on the capital programme (capital expenditure on the HRA is £8.3million lower at the end of September than if the programme was spent evenly throughout the year).

5.7 An option would be to use Triple A rated Money Market Funds which provide an excellent alternative to individual banks, in that they invest in high quality institutions. A Treasury Management Member group was convened on 24th October to consider the use and appropriate limits for the Money Market Funds. It was resolved that two Money Market Funds would be used with the following limits:

- Preferred Money Market Fund – Limit £5million; and
- Additional Money Market Fund – Limit £2million; and

5.8 A breakdown of the Council's investment portfolio is shown in Section 6 of this report. This shows the sharp rise in investment balances, despite the Council not taking out any borrowing in the first six months of the year. The balances shown represent end of month balances. In the early part of the month cash balances peak at above £30 million, requiring the placement of funds with the Debt Management Office with a return of only 0.25%, due to counterparty limits being exceeded.

5.9 Borrowing rates have remained at historically low rates during the first six months of the 2012/13 financial year. No new borrowing has been taken out for the capital programme as the Council has managed within its cash balances.

6. INVESTMENT PORTFOLIO 2012/13

6.1 In accordance with the Code, the Council's priority is 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 A full list of investments held as at 1st April and at 30th September 2012, are shown below in Table two. The investments were all in accordance with Sector's counterparty list, based on changes to Fitch, Moodys and S&P's credit ratings and giving consideration to the effect of credit default swap (CDS) credit ratings during the first six months of 2012/13 on term deposits, and the Council's own criteria of achieving a minimum of a Fitch F1 short term rating.

6.3 The table two below shows that we had 57% of investments in call or overnight accounts in April – this has moved to 55% at the end of September. The Council fixed an investment for £5million with the Bank of Scotland on 26 September until 14 February 2013 in place of its call account investment.

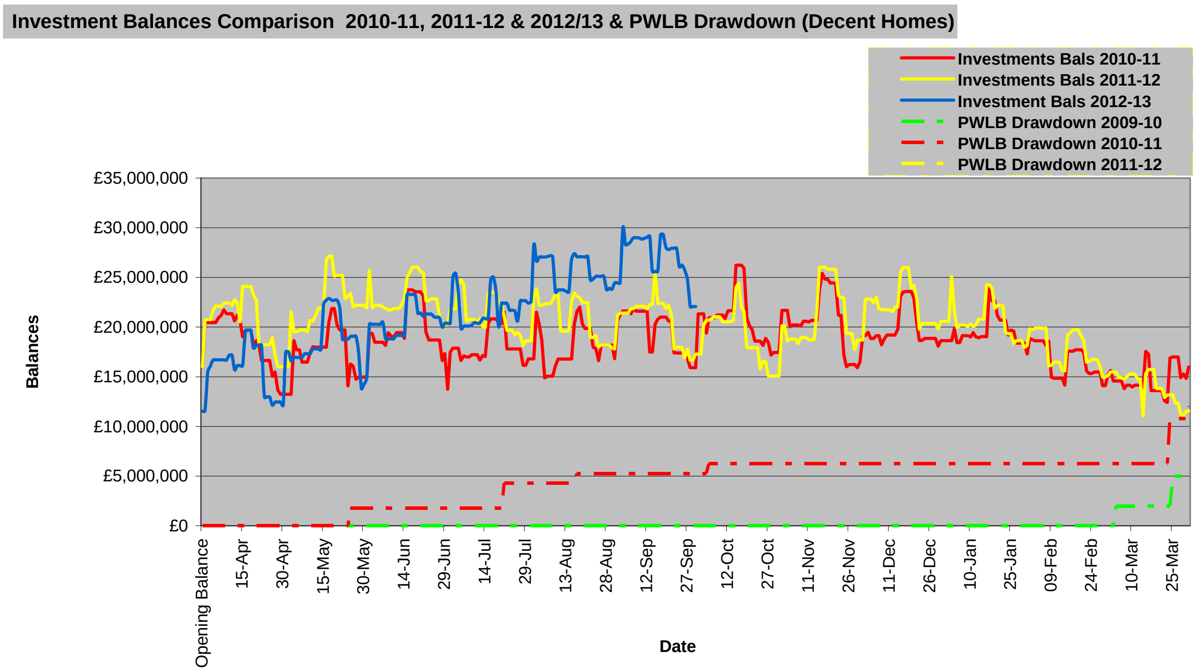
Table two

Investments	Country	1st April 2012	Average Rate of Return
Bank of Scotland – Call Account	UK	1,560,000	0.75%
Nat West – Call Account	UK	5,000,000	0.85%
Handelsbanken – 35 day notice	Sweden	5,000,000	0.85%
Total		**11,560,000**	
Investments		**30th September 2012**	**Average Rate of Return**
Santander – Call Account	UK	5,000,000	0.88%
Bank of Scotland – Fixed 26/9/12 to 14/2/13	UK	5,000,000	1.75%
Nat West – Call Account	UK	5,000,000	0.85%
Handelsbanken – 35 day notice	Sweden	5,000,000	0.85%
HSBC overnight	UK	2,060,000	0.28%
Total		**22,060,000**	

6.4 There were no breaches of prudential indicators, during the first six months of the year. There was however a "technical breach", where deposits exceeding £5million were placed overnight with the Government's Debt Management Office, in the absence of alternative counterparties. The Treasury Management Strategy has now been amended to allow unlimited deposits with the Government's Debt Management Office in recognition of its safe haven status.

6.5 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 2012/13 was £21.587 million, with balances fluctuating between £11.56million and £30.00million. These are funds available on a temporary basis, the level of funds available is determined by the timing of precept payments, principal and interest payments, receipt of grants and progress on the capital programme.

6.6 A chart of investment balances and PWLB drawdowns for the 2012/13 year to date, and the comparative balances for the previous years are shown below.



6.7 The Council achieved returns for the first six months of the year of 0.77% on its investments, which exceeds the 7 day LIBOR benchmark rate of 0.61%. The LIBOR benchmark rates are shown in table three.

Table three

Benchmark	Benchmark Return
7 day	0.61%
1 month	0.69%
3 months	0.94%
6 months	1.24%
12 months	1.72%

6.8 The Council has secured a return of 1.75% on its £5million investment, of less than five months duration, with the Bank of Scotland. This exceeds the LIBOR benchmark return expected on an investment of 12 months duration of 1.72%, also shown in table three.

6.9 The forecast interest rate return for the year is projected to be 0.77%, compared to the Council's original budgeted investment return for 2012/13 of 0.80%. The Council is earning more interest than originally forecast due to higher than planned cash balances, but the shortage of high quality counterparties has meant investing with the Debt Management Office (DMO).

6.10 The forecast return takes into account the fixed investment with the Bank of Scotland and also that the Council's notice deposit with Handlesbanken will be subject to a reduced rate of 0.5% for the remainder of the year. There has also been an increased need to invest in the DMO at 0.25%, in the absence of high quality counterparties (as mentioned in para 5.6).

6.11 In addition to the Council's treasury investments, covered by the specified and non-specified investment policy, the Council has also undertaken to make a deposits to guarantee mortgage advances agreed under the Local Authority Mortgage (LAM) Scheme. This forms part of the Council's capital expenditure, as this is a fully funded scheme there will be no impact on the Council's capital finance requirement (CFR). The LAM scheme is not classified as an investment and as such is not subject to the Treasury Management Strategy.

7. Review of External Borrowing

7.1 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.

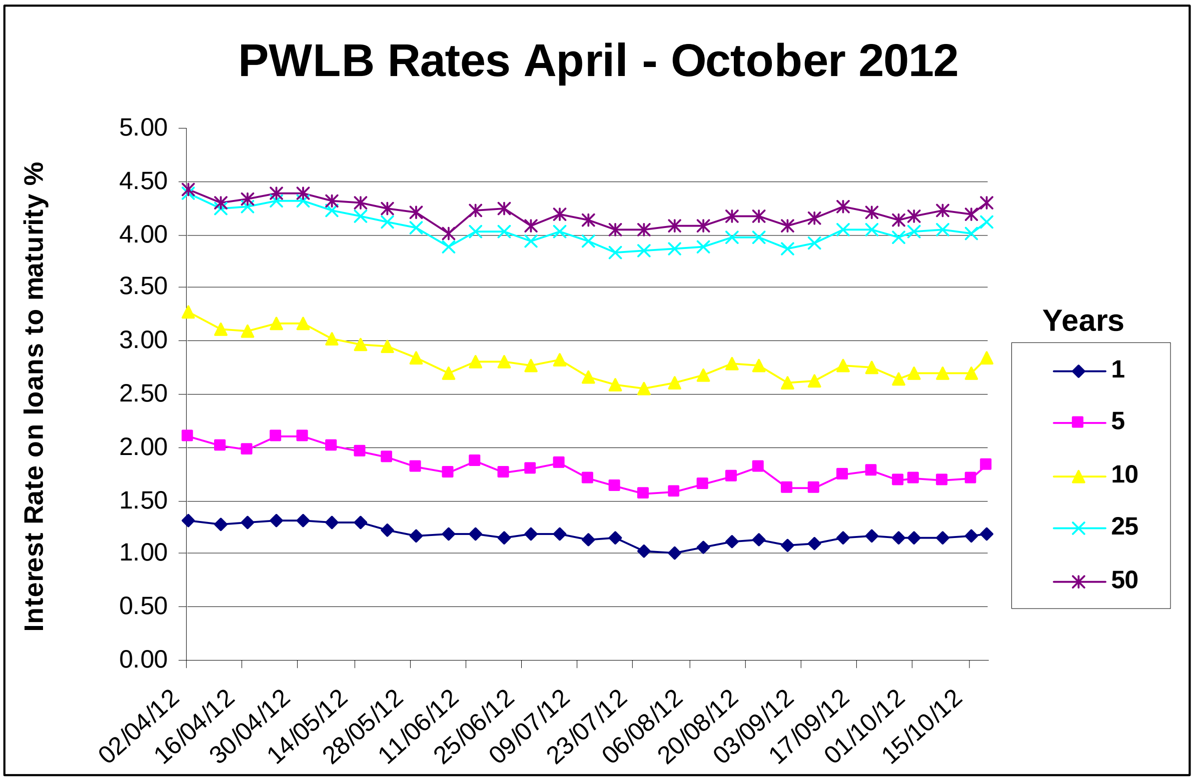
7.2 The opening CFR for 2012/13 was £224.647million of which £217.655million relates to the Housing Revenue Account (HRA). The **HRA CFR** is made up of external borrowings of £17.004million decent homes and £199.911million self financing debt. It also includes £0.77million internal borrowing (through the use of investment balances). The **General Fund CFR** totals £6.992million.

7.3 The Council's current loan portfolio is at Appendix B. It includes nine HRA Decent Homes loans taken out up to 31st March 2011 of £17.004 million and a further 17 self financing loans of £199.911million taken out in March 2012. The HRA is currently £29,541 below its debt cap of £217,685,000.

7.4 The average interest payable on all debt is 3.31%. The decent homes proportion is 3.84% and the self financing average rate is 3.27%. The lower self financing rate being a result of the Government's one off discounted rate available for the self financing transaction.

7.5 The Council was currently under borrowed by £7.732 million at the beginning of the year, preferring to use internal cash balances rather than take on external debt. This is because the returns on investments at 0.77% are so low compared with the cost of borrowing. The Council intends to continue with this policy and will not borrow £3.836million for the General Fund capital programme in 2012/13.

7.6 The general trend has been a reduction in PWLB interest rates during the last six months, across all borrowing terms (as shown below), with the most marked reductions being in the ten year rates. The rates during the six months have been undulating but it can be noted from the chart below that the rates have increased in October 2012 at a higher rate than in recent months, a reversal of the downward trend seen earlier in the year.



7.7 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 (CFR).

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 four below. Other amendments are also included below:

Table four:Treasury management prudential indicators for SBC:	**Approved limits proposed £'000**	**Actual to 30th September £'000**
Use of Money Market Funds (approved in 24 October 2012) [1]	5,000 1st choice fund 2,000 2nd choice fund	0
Investments with the Government's Debt Management Office (DMO) [2]	unlimited	5,250
The exclusion of fund deposits for the Local Authority Mortgage Scheme from investment counterparties. (Service capital expenditure rather than investment).	N/A	N/A

[1] The Council has struggled to identify sufficient high quality counterparties through the use of individual banks. It has however identified high quality AAA Money Market Fund (MMF) counterparties with which to invest. Although the use of MMF was within the existing strategy, it was not our current practice, and no limits were included on their use. This has since been agreed at 24 October with a maximum counter party limit of £5million in first choice MMF and a limit of £2million in second MMF and up to 25% of the investment portfolio.

[2] The DMO (the governments own borrowing arm) is a safe haven account for placing sums which could not be invested with banks, as they had ceased to meet the Treasury Management Strategy minimum credit quality. If a crisis was to hit any of the Council's counterparties the Council would transfer sums to this account. However, despite the inference, the DMO account has never been formally excluded from counterparty limits, although acknowledgement has been made by officers of its safe haven status whenever the £5million has been exceeded. The above change formalises the practice adopted of allowing for unlimited deposits with the DMO in the absence of other suitable counterparties. This is required to protect the Council in the event of further banking crises.

8.2 Having approved the use of Money Market Funds in accordance with the limits set out in para 5.7 and in the previous table, officers will review the effectiveness of these limits and will be report back to Members as part of the Treasury Management Strategy 2013/14 in February 2013 with any recommendations to changes in the MMF limits.

9. IMPLICATIONS

9.1 Financial Implications

This report is of a financial nature and reviews the treasury management function for the 2012/13 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

- BD1 -Treasury Management Reports
- BD2 -Sector Reports (Part 2)
- BD3 -Minutes of meeting 24th October 2012

APPENDICES

- Appendix A – Prudential and Treasury Indicators
- Appendix B – Updated specified and unspecified investment schedule (Treasury Management Strategy, Appendix A attachment 3)