Part I – Release to Press

Stevenage BOROUGH COUNCIL

Meeting: **AUDIT / EXECUTIVE**

Council Agenda Item: **12**

Portfolio Area: Resources

Date: **13 / 15 DECEMBER 2010**

TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY - MID-YEAR REVIEW REPORT 2010/11
(Finance)

NON-KEY DECISION

Author – Jean Cole Ext No. 2351
Lead Officer – Clare Fletcher Ext No. 2933
Contact Officer – Jean Cole Ext No. 2351

1. PURPOSE

1.1 To review the operation of the 2010/11 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 2010/11 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 Reason for Urgency (Audit Committee) – As the Committee has a designated scrutiny role in respect of Treasury Management this matter should be considered before it is submitted to the Executive on 15 December in order that any comments from the Audit Committee can be reported and be considered before recommendations to Council are agreed.

2. RECOMMENDATIONS

2.1 Audit Committee

2.1.1 That the Audit Committee notes the report and refers any comments on to the Executive

2.2 Executive

That subject to any comments from the Audit Committee -

2.2.1 That the Executive recommends Council to approve the 2010/11 Mid-year Treasury Management Strategy and Annual Investment Strategy Review.

2.2.2 That the Executive recommends Council to approve the increased borrowing requirement for 2010/11, in respect of the general fund capital programme. An additional borrowing requirement of £800,000 has been identified.

2.2.3 That the Executive 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 borrowing (increase £800,000), counterparty limits (amended down to £5m from £7.5m) and the limit for variable rate investments be revised to £25m (from £20m).

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 24 February.

3.2 The primary requirements of the code are:

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 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.

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 which in this Council is the Audit Committee.

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 2010/11 (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 2010/11, reflecting the Capital Strategy Update approved by Council in September (Section 7).
- A review of compliance with Treasury and Prudential Limits for 2010/11, and recommended amendments to limits, to keep in line with both the revised borrowing strategy and to recognise that in light of declining resources, lower counterparty limits are required to ensure that risk continues to be diversified, ensuring the security of our funds.

3.4 As part of the Comprehensive Spending Review, HM Treasury announced on 20 October that Public Works Loans Board (PWLB) borrowing rates will increase by 1% on average, and published immediately, revised borrowing rates. This will affect all PWLB rates (except premature redemption rates) from the time of the announcement. The effect of this change will be to increase the cost of borrowing by £10,000 p.a. per £1 million borrowed.

4. 2010/11 ECONOMIC & INTEREST RATE REVIEW

4.1 Global Economy

4.1.1 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. The problems for the aforementioned countries continues with the sovereignty rating for the Republic of Ireland down graded to A+ (November 2010) and a bail out package agreed.

4.1.2 The unexpectedly high rate of growth in quarter 2 of 2010 in the UK and the Euro zone was a one off particularly driven by strong growth in the construction sector catching up from inclement weather earlier in the year; general expectations are for anaemic (but not negative) growth next year in the western world.

4.2 UK Economy

4.2.1 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 and appears to have also hit the housing market as house prices have started on a negative trend during the summer of 2010. Mortgage approvals are also at very weak levels and declining, all of which indicates that the housing market is likely to be very weak next year.

4.2.2 **Economic Growth** – Gross Domestic Product (GDP) growth is likely to have peaked in the current period of recovery at 1.2% in quarter 2 of 2010. The outlook is for anaemic growth in 2011/12 although the Bank of England and the Office for Budget responsibility are forecasting much stronger growth than most forecasters are currently expecting.

4.2.3 **Unemployment** – the trend of falling unemployment (on the benefit claimant count) has now been replaced since July 2010 with small increases which are likely to be the start of a new trend for some years ahead of rising unemployment.

4.2.4 **Inflation and Bank Rate –** The Consumer Price Index has remained high during 2010. It peaked at 3.7% in April and has gradually declined to 3.1% in September (Retail Price Index 4.6%). Although inflation has remained stubbornly above the Monetary Policy Committee's (MPC) 2% target, the MPC is confident that inflation will fall back under the target over the next two years.

4.2.5 The Bank of England finished its programme of quantitative easing (QE) with a total of £200bn in November 2009. However, there is currently major expectation that there could be a second round of quantitative easing in late 2010 or early 2011 to help support economic growth.

4.2.6 The Council's Treasury Management Advisors (Sector) view, is that there is unlikely to be any increase in Bank Rate until the middle of 2011, which is line with the Council's current investment projections.

4.2.7 **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. If there is a second round of QE, it is likely to put further downward pressure on gilt yields and so on PWLB rates, or at the least, prolong the period they stay at these low levels.

4.3 The Forward View Of Our Treasury Advisors

4.3.1 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. The Council's advisor, 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.

4.3.2 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.

4.3.3 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.

4.4 HM Treasury September 2010

4.4.1 The current Q4 2010 and 2011 forecasts are based on the September 2010 report. Forecasts for 2010 – 2014 are based on 32 forecasts in the last quarterly forecast – in May 2010.

BANK RATE FORECASTS	Bank Rate	Quarter end		Annual ave. Bank Rate				
	actual	Q4 2010	Q4 2011	ave. 2010	ave. 2011	ave. 2012	ave. 2013	ave. 2014
Median	0.50%	0.50%	1.30%	0.60%	1.40%	2.60%	3.50%	3.80%
Highest	0.50%	1.20%	3.20%	0.90%	2.80%	4.20%	4.60%	4.90%
Lowest	0.50%	0.50%	0.50%	0.50%	0.50%	1.70%	2.00%	1.80%

4.4.2 Although these indicators reflect the expected movement in borrowing costs and investment returns available in the market, they could not for instance, forecast the announcement on 20 October of an average increase in 1% across all PWLB rates. Thus the effect on local authorities may differ from market forecasts.

5. TREASURY MANAGEMENT REVIEW

5.1 Update of 2010/11 Treasury Management Strategy and Annual Investment Strategy

5.1.1 The Treasury Management Strategy Statement (TMSS) for 2010/11 was approved by this Council on 24 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

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 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.

5.1.2 A breakdown of the Council's investment portfolio is shown in Section 6 of this report. This shows broadly stable investment balances.

5.1.3 Borrowing rates have been at historically low rates during the first six months of the 2010/11 financial year. New external borrowing undertaken, and a new borrowing requirement for the general fund has been identified in Section 7 of this report.

5.1.4 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. However, an additional need to borrow has been identified and included within the capital strategy update report approved at the September Executive. The shortfall arises as a result of the Council not being able to realise capital receipts as soon as expected, or at the anticipated value.

5.1.5 As outlined in Section 4 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 24 February 2010, whilst remaining fit for purpose in the current economic climate, be amended to reflect:

- Investment limits in any one counterparty not to exceed £5m. This will reduce counterparty risk, in line with the Council's overriding treasury objective of securing the principal invested. This to allow for a sufficient spread of counterparties with a reduced level of investments.

- Approval is sought to borrow £800,000 for the General Fund in 2010/11. A review of the Capital Strategy in September identified the need to prudential borrow to support part of the capital programme. Every effort is being made by officers to ensure that capital schemes due to be funded by receipts are not commenced until capital receipts are realised.

6. INVESTMENT PORTFOLIO 2010/11

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 0.98%. This compares favourably against a benchmark of 0.86% which we would expect on investments fixed for 6 months. At the same time, this provides greater security and liquidity than a 6 month investment.

6.3 A full list of investments held as held at 1st April and at 30th September 2010, 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 2010/11.

Balances at 1st April are shown in the table immediately below, the balances at 30th September are shown in the table following on from that.

Investments	1st April 2010	Average Rate of Return
Santander (Alliance and Leicester) – Call Account	3,220,000	0.88%
Bank of Scotland – Call Account	2,395,000	0.75%
Nat West – Call Account	2,790,000	0.85%
Clydesdale – Call Account	1,870,000	0.75%
Handelsbanken – 10 day notice	1,700,000	0.75%
Handelsbanken – 35 day notice	2,000,000	0.85%
Nationwide – 2 yr fixed to May 2010	2,000,000	5.46%
Total	**15,975,000**	

Investments	30th September 2010	Average Rate of Return
Santander (Alliance and Leicester) – Call Account	3,520,000	0.88%
Bank of Scotland – Call Account	1,300,000	0.75%
Nat West – Call Account	3,690,000	0.85%
Handelsbanken – 35 day notice	3,400,000	0.85%
Nationwide Fixed – 6 month to Dec 2010	2,000,000	0.94%
Bank of Scotland Fixed – 6 month to Dec 2010.	2,000,000	1.26%
Total	**15,910,000**	

6.4 There was one breach of prudential indicators, which occurred on 17th - 20th May inclusive. This concerned the prudential limit placed on variable rate investments of £20m. At 1 April the council had one fixed term investment, which expired on 12 May 2010. This investment was not replaced by further fixed term investments until June 15th, due to the poor rates on offer. Thus all of the Council's surplus cash was at variable rates, and this exceeded £20m on four days, reaching £21.875m. The breach had no unfavourable implications for the Council's overriding treasury objectives, of security of funds and liquidity of funds. The fixed rates on offer for a few days would have yielded no benefit to the Council. As this position is expected to happen more frequently whilst market interest rates are low, it is recommended that Council approve an amendment to the Prudential Indicators, allowing variable rate investments of up to £25,000,000.

6.5 On 15th June, the Council took out two fixed term deposits, totalling £4m.

6.6 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 £18.533m.

6.7 The lowest investment balances during the period were £13.325m and the highest were £26.230m. 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, and cash inflows from PWLB loans.

6.8 The Council achieved returns for the first six months of the year of 0.98% on its investments. It can be seen from the benchmark information provided by our treasury advisers, that this exceeds the benchmark return for 6 month investments, by 12 basis points. Only £4m of Council balances are in six month accounts.

Benchmark	Benchmark Return
7 day	0.42%
1 month	0.44%
3 months	0.59%
6 months	0.86%
12 months	1.31%

6.9 The forecast return for the year is 0.93%, the variation from budget reflects the revised expectations on interest rate movements provided by our treasury advisers. The Council's budgeted investment return for 2010/11 was 1.34%, based on the expectation that interest rates would rise, which has not been the case

7. Review of External Borrowing

7.1 The Council has an approved supported borrowing limit of £11.563m to fund its 2010/11 decent homes programme. The 2009/10 programme was financed through a mixture of £5m borrowing, and an allocation of £6.122m of capital receipts which had previously been 'set aside' before the council became debt free in 2001.

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 impact on the opening CFR for 2010/11 is that although the Council had a supported borrowing requirement of £11.563m, reflected in the movement in the CFR calculation, from negative £6.263m to positive £6.207m, the actual borrowing undertaken was only £5.0m. The funding of the difference was achieved through the release of receipts which had been previously set aside.

7.4 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%. The Council's weighted average cost of borrowing for the period was 4.11%. Due to the overall financial position and the underlying need to borrow for capital purposes (the capital financing requirement - CFR), new external borrowing of £5.263m was undertaken from the PWLB, bringing total loans to £10.263m.

Terms of loan taken out	**From**	**To**	**Amount borrowed (Principal) £**	**Rate %**	**Interest payable in 2010/11**	**Weighted Principal (days for 2010/11)**	**Average cost of borrowing %**
Repay on maturity	04/03/10	04/03/35	2,000,000	4.75	95,000	2,000,000	4.75
Repay on maturity	25/03/10	25/09/35	3,000,000	4.65	139,500	3,000,000	4.65
Repay on maturity	25/05/10	25/05/35	1,800,000	4.28	65,431	1,528,767	4.28
Repay on maturity	21/07/10	21/07/15	2,500,000	2.25	39,606	1,760,274	2.25
Repay on maturity	17/08/10	17/08/35	963,000	4.24	25,282	596,268	4.24
			10,263,000		364,819	8,885,310	4.11

7.5 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. However, PWLB were instructed by HM Treasury to increase rates across all bands by an average of 1%, following the Chancellor's announcement of the spending review on 20 October 2010. It is assumed that new borrowing will be at a rate of 5.2%.

7.6 Further borrowing will be required during the year, to finance both the decent homes and general fund capital programmes.

7.7 The council has taken PWLB supported borrowing of £5.263m to finance its decent homes programme. This is from the approved limit for the year of £11.563m.

7.8 In addition, a further approval is sought to enable prudential borrowing of £800,000 to take place this year for the General Fund. (See paragraph 5.1.5).

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).	-£20,000	-£21,875 [1]
Net sums invested at fixed interest rates. (i.e. fixed rate borrowings of £10.263m, less fixed rate investments of £4.0m.).	-£30,000	+£6,263 [2]
Principal sums invested for more than 364 days.	£10,000	NIL [3]
Authorised Borrowing Limit	£38,920	£10,263 [4]
Operational Boundary for borrowing	£33,920	£10,263 [4]
[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 current need for security and liquidity, and our increased need for funds to meet the Council's capital programme, results in there being a limited benefit to the variable upper limit. The Council is achieving in excess of the 6 month benchmark rate on its investments, whilst having a more secure and more liquid resource. The rates available make it uneconomic to put out further fixed rate investments at this time. It is therefore recommended that an increase to £25,000,000 be approved, to avoid future breaches. [2] **The sums are defined as variable rate principal borrowed less variable rate investments. The movement to positive reflects that the council has moved from being debt free, having taken out £10,263,000 of fixed rate debt, and had		

£4,000,000 of fixed rate investments.

[3] It is recommended that the £10,000,000 limit for long term investments be amended to £2,000,000. this is more in accordance with the Council's investment strategy. It also assists in minimising the need to borrow.

[4] The amendments to authorised debt balances reflect the 2009/10 outturn and also the new requirement to borrow £800,000 for the general fund capital programme. It should be noted that the authorised limit includes £15m headroom. This enables us to deal with any fall-out from IFRS work, which may require the treatment of leases differently, and as a form of borrowing.

8.2 With the exception of the "Net sums invested at variable rate limit" of £20,000,000, the Council has complied with treasury limits throughout the year. The details of the breach are included in section 6.4 of this report. The only benefits to entering into fixed rate investments are increased certainty of return, and slightly higher rates of interest. As it is not beneficial to the council to lock into historically low interest rates, the risk of loss to the council is minimal. The council is also enjoying greater security and liquidity by not fixing investments for longer. It is therefore recommended that the limit be increased to £25,000,000, and that it will be kept under review.

8.3 In addition prudential borrowing of £800,000 on the General fund will take place this year. It is expected that borrowing will be required in the final quarter. This would result in a revised authorised borrowing limit for the year of £26,800,000 and operational limit of £21,800,000.

9. IMPLICATIONS

9.1 Financial Implications

This report is of a financial nature and reviews the treasury management function for the 2010/11 financial year.

9.2 Legal Implications

None

9.3 Equality and Diversity Implications

There are no Equality Impact implications identified within the report.

BACKGROUND DOCUMENTS

- Treasury Management Reports
- Sector Reports

APPENDICES

- Appendix A – Prudential and Treasury Indicators