BABERGH DISTRICT COUNCIL

From: Director of Finance	**Report Number: L101A**
To: Overview and Scrutiny (Stewardship) Committee	**Date of meeting: 15 November 2011**

MID YEAR TREASURY MANAGEMENT REPORT

1. Purpose of Report

1.1 The Code recommends that Members are informed of Treasury Management activities at least twice a year. This report ensures the Council is embracing Best practice in accordance with CIPFA's recommendations.

1.2 This report provides the Committee with a comprehensive assessment of Treasury Management activities for the half-year and reports on the performance of the Prudential Indicators which were set in the 2011/12 Treasury Management Strategy.

2. Recommendations to Council

2.1 That the Treasury Management activity for the half-year as set out in Appendix A be noted.

2.2 Further that it be noted that performance in the first half-year is in line with the Prudential Indicators set for 2011/12.

3. Financial Implications

3.1 Current borrowing has been maintained at a level below the Capital Financing Requirement (CFR), i.e. utilising internal surplus funds for the capital programme.

3.2 In mid July The Council borrowed an additional £3m from the PWLB to take advantage of the low rate of 2.88%.

4. Risk Management

4.1 This report is most closely linked with the Council's Corporate / Significant Business Risk No. 6 – Performance and Cost Management. Key risks are set out below:

Risk Description	Likelihood	Impact	Mitigation Measures
Loss of investment	Low	Critical	Strict lending criteria for high credit rated institutions.
Poor return on investments	High	Marginal	Focus is on security and liquidity, therefore, careful cashflow management and budget monitoring in accordance with the Strategy, is undertaken.

Risk Description	Likelihood	Impact	Mitigation Measures
Liquidity problems	Unlikely	Marginal	Careful and regular cashflow monitoring to ensure this does not arise.
Higher than expected borrowing costs	Low	Marginal	Benchmark is to borrow from the Public Works Loan Board whose rates are very low and can be on a fixed or variable basis. Alternative of using internal surplus funds temporarily.

5. Consultations

5.1 None

6. Equality Analysis

6.1 None

7. Shared Service / Partnership Implications

7.1 None

8. Key Information

8.1 The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which requires local authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity.

8.2 Scrutiny of treasury policy, strategy and activity is delegated to Overview and Scrutiny (Stewardship) Committee and this Committee receives quarterly reports including the half-year and annual treasury reports. Full Council will receive, as a minimum, a mid year review and an annual report of the treasury management function.

8.3 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".

8.4 Overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

8.5 The Prudential Indicators and Limits were approved by full Council on 22 February 2011 as part of the Treasury Management Strategy 2011/12 and included a provisional sum for Housing Reform borrowing.

9. Appendices

Title	Location
(a) Treasury management activity – investment borrowing activity and Prudential indicators	Attached

10. Background Documents

10.1 CIPFA's code of Practice on Treasury Management ("the Code")

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1. Economic Background

Growth: Global growth prospects deteriorated considerably over the six months to September, moving from an expectation of modest expansion to the risk of a double-dip recession. Q1 2011 GDP in the UK was 0.5% but was just 0.2% in Q2. Even economies like Germany's, which were previously strong, began to flounder with growth registering 0.1% in Q2.

Inflation: Inflation remained stubbornly high. Annual CPI for September was 5.2%; RPI has remained higher at 5.6%. The Bank believed the elevated rate of inflation reflected the temporary impact of several factors: the increase in the VAT rate to 20%, past increases in global energy prices and import prices.

Central bankers' policies were driven by the feeble growth outlook rather than the upward trend in inflation. The Bank Rate has remained at 0.5% for 2½ years and Standard & Poor's have downgraded the US Sovereign rating from AAA to AA+.

The European sovereign debt crisis has also deepened. The agreement in July to address Greece's fiscal problems and broaden the mandate for the European Financial Stability Facility (EFSF) only bought time for the Eurozone as market pressure increased on Italy and Spain, but did little to address the issue of overburdened sovereign balance sheets.

The European Banking Authority released the results of the second of its stress tests in July. 8 banks (two Greek, one Austrian and five small domestic Spanish banks) out of 91 banks failed the tests. All of the UK and non-UK banks tested by the EBA and which are on the Council's lending list met the 'stressed' Core Tier 1 Ratio of 5%, none were adjudged as 'near-failed' (i.e. having ratios between 5% and 6%).

Gilt yields and money market rates: The economic uncertainty resulted in analysts postponing the likelihood of an increase in the UK Bank Rate until mid 2012. Gilts were considered a safe haven and benefited from market turmoil but gilt yields fell to their lowest levels in five years. 5-year gilt yields fell to 1.25%, 10-year yields to 2.2% and 20-year yields to 3.05%.

2. Debt Management

	Balance on 01/04/2011 £000s	**Debt Maturing £000s**	**Debt Repaid £000s**	**New Borrowing £000s**	**Balance on 30/09/2011 £000s**	**Increase/ Decrease in Borrowing**
Short Term Borrowing	-	-	-	-	-	-
Long Term Borrowing	3,000	-	(100)	3,000	5,900	2,900
TOTAL BORROWING	3,000	-	(100)	3,000	5,900	2,900
Average Rate %	2.63%	-		2.88%	2.77%	------

It should be noted that HRA Subsidy Reforms will result in an increase in the Council's external borrowing to approximately £90m by 31/3/2012. More details are provided in section 7.

Public Works Loan Board Borrowing (PWLB): The PWLB remained the lowest cost source of borrowing for the Council, providing flexibility and control, and the Council took advantage of this by borrowing an additional £3m in July, a 10-year EIP loan at 2.88%.

Whilst there are several claims that a competitive, comparable equivalent to PWLB borrowing is readily available, the Council will continue to adopt a cautious and considered approach to funding from the capital markets. The Council's treasury advisor, Arlingclose, is actively consulting with investors, investment banks, lawyers and credit rating agencies to establish the attraction of different sources of borrowing, including bond schemes and other loan products and their related risk/reward trade off.

3. Investment Activity

The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

	Balance on 01/04/2011 £000s	Investments Made £000s	Investments Repaid £000s	Balance on 30/09/2011 £000s	Increase/ Decrease in Investments
Short Term Investments	3,908	53,520	(46,315)	11,113	7,205
Long Term Investments	-	-	-	-	-
TOTAL INVESTMENTS	3,908	53,520	(46,315)	11,113	7,205

Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2011/12.

Counterparty credit quality is assessed and monitored with reference to: Credit Ratings (the Council's minimum long-term counterparty rating of A+ (or equivalent) across rating agencies Fitch, S&P and Moody's); credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; sovereign support mechanisms /potential support from a well-resourced parent institution; share price.

Credit Risk

Counterparty credit quality has been maintained through the first half of the year, as can be demonstrated by the Credit Score Analysis summarised below:

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating
31/03/2011	2.43	AA+	2.89	AA
30/06/2011	3.84	AA-	3.13	AA
30/09/2011	3.04	AA	4.19	AA-

A credit risk score of 5 or lower reflects the Council's current investment approach to focus on security. The highest rating is AAA and currently the Council's minimum criteria is A+. The value/time weighted scores and average credit ratings shown above exceed these performance and security criteria.

(Note: The Value Weighted Average reflects the credit quality of the investment according to size of the deposit. The Time Weighted Average reflects the credit quality of investments according to the maturity of the deposit. The scores show a slight increase from March to September to reflect the use of Money Market Funds and whilst these are AAA rated, they are instant access accounts and considered to be overnight deposits. The remainder of investments in September are with A+ investments compared to March when investments included a term deposits with AAA rated local authorities.)

Counterparty Update

The lack of real progress in resolving the sovereign debt crisis in Europe began to affect even the stronger Eurozone nations and their banking systems. Market volatility, as measured by the VIX index, spiked sharply in August, banks' share prices fell sharply. Having reviewed all credit indicators the Council, advised by Arlingclose, believed that there were no solvency issues with the banks on the recommended lending list. Nevertheless the share price moves were too sharp to ignore and a prudent response to the tensions and negativity in the markets was required.

The Council responded to the growing stress by scaling back maturities for new investments on the advice of the Council's treasury advisors. This has resulted in no new term deposits with UK banks. In October the opportunity within the banking sector for new investments was further limited. The following institutions are now temporarily suspended for new investments – Lloyds Banking Group, National Westminster Bank, Nationwide Building Society and Royal Bank of Scotland following downgrade. Barclays Bank has also been suspended for new investments as it has been placed on negative watch by the credit rating agency Fitch.

One new Money Market Fund with Goldman Sachs was opened in September and this provides further options for investments as major banks are removed from the counterparty list. There were seven breaches of the Investment Strategy where the balance on the Co-Op PSR account exceeded £2m as the funds were required for cash flow purposes within 2/3 days.

The Council continues to exercise a very cautious approach to investments.

Budgeted Income and Outturn

The Council's budgeted investment income for the year has been estimated at £50k. The average cash balances were £9.9m during the first half of the year and the average interest rate was 0.8%.

The UK Bank Rate has been maintained at 0.5% since March 2009 and is not expected to rise until the end of 2012. Short-term money market rates have remained at very low levels. It is anticipated that investment income for the year will be slightly higher than the budget at £71k.

4. Compliance with Prudential Indicators

The Council has complied with its Prudential Indicators for 2011/12, which were set in February 2011 as part of the Council's Treasury Management Strategy Statement Details can be found in sections 8 to 10.

5. Outlook for Q3-Q4

At the time of writing this activity report in November 2011, given the precarious outlook for growth it is believed the Bank of England would only raise rates after there was firm evidence that the economy had survived the fiscal consolidation. Therefore, the outlook is for official interest rates to remain low for an extended period, at least until late 2012.

	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14
Official Bank Rate													
Upside risk				0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.75**	**0.75**	**1.00**	**1.25**	**1.50**	**1.75**	**2.00**	**2.25**
Downside risk						-0.25	-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50

6. Summary

In compliance with the requirements of the CIPFA Code of Practice, this report provides Members with a summary report of the treasury management activity during the first half of 2011/12. As indicated in this report none of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

7. Other Information

Reform of Council Housing Finance: In its publication "Implementing self-financing for council housing" issued in February 2011, the CLG set out the rationale, methodology and financial parameters for the initiative. The Localism Bill has now received Royal Assent and the final self-financing determinations are expected in January 2012.

The self-financing model provides an indicative sustainable level of opening housing debt. As the Council's debt level generated by the model is higher than the Subsidy Capital Financing Requirement (SCFR), the Council will be required to pay the CLG the difference between the two. This was previously estimated at £81m but has subsequently been revised to £84m. The Council will be required to fund this amount in the medium term through internal resources and/or external borrowing. The Council has the option of borrowing from the PWLB or the market. The proposed date for the transfer of funds to the Government is 28th March 2012.

Subsequent updates from CLG and CIPFA are being assessed by the Council, in conjunction with Arlingclose and its Housing Consultants. The treasury management implications of HRA reform and an appropriate strategy to manage the process are being actively reviewed.

On 20th September, following an announcement by HM Treasury, the PWLB confirmed that the interest rate offered to local authorities would be temporarily reduced to allow councils to borrow at lower levels for their one-off HRA reform settlement payment. The latest announcement is that the lower rates will be available on one day only, 26th March 2012.

8. Prudential Indicators

The Prudential Indicators below do not include the amendments required as a consequence of the increase in debt due to HRA Subsidy Reform. These will be updated further in due course.

Capital Financing Requirement

Estimates of the Council's cumulative maximum external borrowing requirement for 2011/12 to 2013/14 are shown in the tables below. These will be updated as part of the current strategic and financial planning round:

CURRENT BORROWING REQUIREMENT	**31/03/2011 Actual £000s**	**31/03/2012 Estimate £000s**	**31/03/2013 Estimate £000s**	**31/03/2014 Estimate £000s**
Capital Financing Requirement	7,907	10,571	11,734	12,184
Less: Existing Borrowing	(3,000)	(5,650)	(5,150)	(4,650)
Less: Other Long Term Liabilities	(218)	(109)	-	-
Cumulative Maximum External Borrowing Requirement	**4,689**	**4,812**	**6,584**	**7,534**

Balances and Reserves

Estimates of the Council's level of Balances and Reserves for 2011/12 to 2013/14 are as follows. These will also be updated as part of the current strategic and financial planning round:

	31/03/2011 Actual £000s	**31/03/2012 Estimate £000s**	**31/03/2013 Estimate £000s**	**31/03/2014 Estimate £000s**
Balances and Reserves	5,141	3,198	3,407	3,474

9. Prudential Indicator Compliance

(a) Authorised Limit and Operational Boundary for External Debt

- The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit. This is a statutory limit which should not be breached.
- The Council's Affordable Borrowing Limit was set at £90.1m for 2011/12 and included an initial estimate of likely borrowing for Housing Reform.

- The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit.
- The Operational Boundary for 2011/12 was set at £88m, which also included an initial estimate of borrowing for Housing Reform.
- The Director of Finance confirms that there have been no breaches of the Authorised Limit and the Operational Boundary with external borrowing to date this year not exceeding £6m.

(b) Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

- These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates.
- The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of investments.

	Limits for 2011/12 £ / %
Upper Limit for Fixed Rate Exposure	100
Compliance with Limits:	Yes
Upper Limit for Variable Rate Exposure	30
Compliance with Limits:	Yes

(c) Maturity Structure of Fixed Rate Borrowing

- This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

Maturity Structure of Fixed Rate Borrowing	**Upper Limit %**	**Lower Limit %**	**Actual Fixed Rate Borrowing as at 30/09/11**	**% Fixed Rate Borrowing as at 30/09/11**	**Compliance with Set Limits?**
Under 12 months	50	0	£0.5m	8	Yes
12 months and within 24 months	50	0	£0.5m	8	Yes
24 months and within 5 years	50	0	£1.5m	25	Yes
5 years and within 10 years	100	0	£2.3m	39	Yes
10 years and above	100	0	£1.1m	20	Yes

(d) Total principal sums invested for periods longer than 364 days

The Council's policy response since the onset of the credit crunch in 2007 has been to keep investment maturities to a maximum of 12 months. Investments made for greater than 6 months require the prior approval of the Director of Finance and no investments exceeded this period during the first half of the year.

10. Authorised Limit and the Operational Boundary Amendments

Current estimates are provided below. These will be updated further at the Council meeting in February 2012 when the final HRA reform debt take on is known:

Authorised Limit	**Estimate 2011/12 £m**	**Estimate 2012/13 £m**	**Estimate 2013/14 £m**
Current authorised Limit	90.1	88.6	87.6
Plus potential adjustment - HRA debt take on	5.0	7.0	9.0
Potential Revised Authorised Limit	**95.1**	**95.6**	**96.6**

Operational Boundary	**Estimate 2011/12 £m**	**Estimate 2012/13 £m**	**Estimate 2013/14 £m**
Current operational Boundary	88.0	86.4	85.7
Plus potential adjustment - HRA debt take on	7.0	9.0	10.0
Potential Revised Operational Boundary	**94.0**	**95.4**	**95.7**

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