BABERGH DISTRICT COUNCIL

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| **From: Head of Corporate Resources** | **Report Number: M111** |
| **To: Overview and Scrutiny (Stewardship) Committee** | **Date of meeting: 13 November 2012** |

**MID YEAR REPORT ON TREASURY MANAGEMENT 2012/13**

**1. Purpose of Report**

1.1 The revised Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management requires local authorities to present a mid-year report on treasury management activity to those Members charged with scrutinising this area of activity. This report fulfils that requirement and sets out treasury management activity, including performance on Prudential Indicators, for the first half of 2012/13.

1.2 The Treasury Management Strategy for 2012/13 was agreed by Council on 23 February 2012.

**2. Recommendations**

2.1 That the Treasury Management activity for the year as set out in paragraph 11.3 be noted.

2.2 That it be noted that performance was in line with the Prudential Indicators.

The Committee is asked to make a recommendation to full Council on the above matters.

**3. Financial implications**

3.1 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 The General Fund began 2012/13 debt free as all borrowing was transferred to the Housing Revenue Account (HRA) from 1st April 2012 as part of Council House Reform.

**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. |

| Risk Description | Likelihood | Impact | Mitigation Measures |
|---|---|---|---|
| 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 required. |
| 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 Quarterly meetings are held, in conjunction with Mid Suffolk, with our treasury advisers to discuss current treasury management issues and to ensure the Strategy fits with the Councils ongoing and future plans.

## 6. Equality and Diversity Impact

6.1 None.

## 7. Shared Service / Partnership Implications

7.1 The equivalent report for Mid Suffolk District Council will be presented to their Scrutiny Committee on 1 November 2012.

## 8. Background

8.1 The Treasury Management Strategy for 2012/13 is based on the adoption of the CIPFA Code of Practice on Treasury Management ("the Code"). This reflects the likely financing and investment activity for the forthcoming financial year.

8.2 The Code also recommends that members are informed of Treasury Management activities at least twice a year. This report therefore ensures the Council is embracing best practice in accordance with CIPFA's recommendations.

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."

## 9. Economic Background

9.1 **Growth:** The UK and the Eurozone (with the exception of Germany) struggled to show growth whilst the US economy grew slowly. UK GDP contracted by 0.3% in the first calendar quarter of 2012 and by 0.4% in the second, reflecting the difficult economic conditions faced domestically and globally.

9.2 **Inflation:** Inflation, which had remained high throughout 2011, slowly began to fall. The annual Consumer Price Index (CPI) dipped below 3% for the first time in two and half years in May 2012 and fell to the lowest level since November 2009 in June 2012, with a reading of 2.4%. It increased slightly to 2.5% in August 2012.

9.3 **Employment**: rose by 236,000 in the three months to July 2012 and the employment rate was at its highest since the three months to April 2009. Whilst the effect of the Olympics undoubtedly played a part, despite its temporary nature, the underlying data pointed to a more resilient and optimistic outlook for the economy.

9.4 **Money Market Rates**: PWLB borrowing rates fell proportionately in line with the gilt yield (the Board maintained the +0.90% margin above the equivalent gilt yield for new borrowing). Money market rates also fell over the six month period by between 0.2% to 0.6% for 1-12 month maturities.

## 10. Debt Management

10.1 The table below shows the level of activity on short and long term borrowing between 1 April 2012 and 30 September 2012:

| | Balance 01/04/12 £000 | New Borrowing £000 | Debt Repaid £000 | Debt Maturing £000 | Balance 30/09/12 £000 | Increase/ (Decrease) £000 |
|---|---|---|---|---|---|---|
| Short term borrowing | 0 | 0 | 0 | 0 | 0 | 0 |
| Long term borrowing | 89,297 | 0 | 250 | 0 | 89,047 | (250) |
| **Total Borrowing** | **89,297** | **0** | **250** | **0** | **89,047** | **(250)** |

10.2 The average interest rate paid on PWLB borrowing by Babergh is 3.26%. Details of the individual loans are given in the table below.

| **PWLB Borrowing at 30 September 2012** | | | | |
|---|---|---|---|---|
| **Loan Type** | **Date Borrowed** | **Loan Period** | **Interest Rate** | **£000** |
| Maturity | 26/01/2006 | 50 years | 3.70% | 1,100 |
| EIP | 24/08/2010 | 10 years | 2.01% | 1,600 |
| EIP | 14/07/2011 | 10 years | 2.88% | 2,700 |
| Maturity | 28/03/2012 | 13 years | 2.82% | 6,000 |
| Maturity | 28/03/2012 | 14 years | 2.92% | 6,000 |
| Maturity | 28/03/2012 | 19 years | 3.26% | 25,000 |
| Maturity | 28/03/2012 | 24 years | 3.42% | 46,647 |
| **Total** | | | | **89,047** |

10.3 The Public Works Loan Board (PWLB) remains the most attractive source of borrowing for the Council as it offers flexibility and control. The large downward move in gilt yields in the second quarter resulted in PWLB rates falling across all maturities as shown in the table below:

| | PWLB Borrowing Rates: Fixed rate, maturity loans | | | | | |
|---|---|---|---|---|---|---|
| **Change Date** | **4½-5 yrs** | **9½-10 yrs** | **19½-20 yrs** | **29½-30 yrs** | **39½-40 yrs** | **49½-50 yrs** |
| 02/04/2012 | 2.07 | 3.25 | 4.22 | 4.43 | 4.46 | 4.41 |
| 29/06/2012 | 1.84 | 2.83 | 3.79 | 4.11 | 4.19 | 4.16 |
| 28/09/2012 | 1.67 | 2.64 | 3.71 | 4.12 | 4.20 | 4.14 |

10.4 In August 2012 HM Treasury announced details of the “Certainty Rate” which will enable “eligible authorities” to access cheaper PWLB funding, with a 0.2% reduction on the standard PWLB borrowing rate. Initially announced in the March 2012 Budget, HM Treasury have introduced this initiative to incentivise local authorities to provide robust forecasts on borrowing plans. This rate is expected to be introduced in November 2012. The Council has completed the required pro-forma projecting the Council’s likely borrowing requirement over a three year period and returned it to CLG by the deadline of 17 September 2012. On the 2 October the Council received confirmation from CLG that it was on the list of authorities that will qualify for the Certainty Rate from 1 November 2012 to 31 October 2013.

10.5 **Alternative Sources:** Whilst there are several claims that a competitive, comparable equivalent to long-dated PWLB borrowing is readily available, the Council will continue to adopt a cautious and considered approach to funding from the capital markets, taking advice from their treasury advisors, Arlingclose.

10.6 Where possible the Council makes use of internal resources in lieu of external borrowing to fund its capital expenditure as this lowers the overall treasury risk by reducing both external debt and temporary investments. The Council has budgeted to borrow £1m for capital purposes by 30 March 2013 based on the approved capital programme for 2012/13 including carry forwards from 2011/12. This additional borrowing may not be necessary if capital expenditure is below that planned.

## 11. Investment Activity

11.1 The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council confirms that it considers security, liquidity and yield, in that order when making investment decisions.

11.2 In terms of which banks and building societies are included on the Council’s counterparty list, the advice of our treasury management advisors Arlingclose is used in conjunction with other market data. As market conditions and credit ratings change during the year, institutions will either be taken off or put onto the list of counterparties that meet the Councils lending criteria.

11.3 **Investments**: The table below shows the activity on investments between 1 April 2012 and 30 September 2012. During this period the Council has only made short term investments.

| | Balance on 01/04/2012 £000 | Investments Made £000 | Investments Repaid £000 | Balance on 30/09/2012 £000 | Decrease in Investments £000 |
|---|---|---|---|---|---|
| Investments (All short term) | 4,925 | 49,616 | (43,132) | 11,409 | 6,484 |

The following table provides an analysis for quarter 2 of the interest received:

| Analysis of Investments from April to September 2012 | | | | |
|---|---|---|---|---|
| | **Deposits** | **Redemptions** | **Average interest rate (year to date)** | **Interest** |
| | **£** | **£** | | **£** |
| Balance on 1 April 2012 | 4,925,170 | | | |
| Quarter 1 | 22,870,835 | 18,841,330 | 0.89% | 18,024 |
| Quarter 2 | 26,745,410 | 24,290,806 | 0.79% | 24,035 |
| Balance on 30 September 2012 | 11,409,279 | | | |

Security of capital remains 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 2012/13. New investments can be made with the following institutions/instruments:

- Other Local Authorities;
- AAA rated Stable Net Asset Value Money Market Funds;
- Deposits with UK banks and building societies;
- Deposits with the Debt Management Account Deposit Facility; and
- Treasury Bills.

11.4 **Budgeted Income and Outturn:** The UK Bank Rate has been maintained at 0.5% since March 2009 and is not expected to rise until 2015/16. Short-term money market rates remained at very low levels with new deposits being made at an average rate of 0.79%. The Council anticipates an investment outturn of £63k in line with the budget for 2012/13.

11.5 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, Standard and Poor’s 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;
- any other available market information.

11.6 **Credit (Security) Risk:** The aim is to have an average credit rating of A or higher, with a score of six or lower, to reflect the current investment approach with the main focus being on security of the investment.

| Date | Value Weighted Average – Credit Risk Score | Value Weighted Average – Credit Rating | Time Weighted Average – Credit Risk Score | Time Weighted Average – Credit Rating |
|---|---|---|---|---|
| **31/03/2012** | 2.84 | AA | 2.02 | AA+ |
| **30/06/2012** | 5.40 | A+ | 5.47 | A+ |
| **30/09/2012** | 3.69 | AA- | 5.52 | A |

Scoring
Value weighted average reflects the credit quality of investments according to the size of the deposit. Time weighted average reflects the credit quality of investments according to the maturity of the deposit.
AAA = highest credit quality = 1
D = lowest credit quality = 15
The time weighted score shows an upward trend as the proportion of longer term deposits with banks and building societies has increased. These institutions are not AAA rated.

11.7 ***Counterparty Update:*** In June 2012 Moody's (credit rating agency) completed its review of banks with global capital market operations, downgrading the long-term ratings of all of them. The banks on the Council's lending list which were affected by the ratings downgrades were Barclays, HSBC and Royal Bank of Scotland. Separately, the agency also downgraded the ratings of Lloyds TSB, Bank of Scotland, National Westminster Bank and Santander UK plc. None of the long-term ratings of the banks on the Council's lending list were downgraded to below the Council's minimum A- credit rating threshold.

11.8 The institutions on the Council's investment counterparty list as 30 September 2012, based on latest Arlingclose advice, are:

- Barclays Bank, Lloyds TSB, Bank of Scotland and Nationwide Building Society for a maximum period of 100 days;
- Approved European Banks for a maximum period of 100 days;
- HSBC Bank and Standard Chartered for a maximum period of 12 months;
- Approved Australian and Canadian banks for a maximum period of 12 months;
- Approved Money Market Funds;
- Other Local Authorities;
- DMADF.

11.9 The Council set up a custody account with Kings and Shaxson in September 2012. By opening a custody account with them, the Council now has the ability to use a number of approved investment instruments as outlined in the 2012/13 Treasury Strategy and diversify the investment portfolio. Investment instruments requiring a custodian facility include Treasury Bills, Certificates of Deposit, Gilts, Corporate Bonds and Supranational Bonds.

11.10 By establishing custody arrangements, the Council will be better-placed to consider the use of alternative investment instruments in response to evolving credit conditions and to consider longer term investments.

## 12. Compliance with the Strategy and Prudential Indicators

12.1 The Council set its Prudential Indicators in February 2012 as part of the Council's Treasury Management Strategy Statement (Council 23 February 2012 – Paper L132R as amended). Appendix A shows the position on the Prudential Indicators for the first six months of 2012/13.

12.2 There were 8 breaches of the Strategy in the six months to September 2012 when the Co-Op PSR limit of £2m was exceeded (the maximum breach was £370k). This is the Council's preferred option where other investment opportunities are limited. The Council's S151 Officer was informed.

12.3 The Council can confirm that it has complied with all Prudential Indicators for 2012/13 to date.

## 13. Outlook for Quarter Three and Four

13.1 At the time of writing this activity report in October 2012, economic growth remains elusive. Tight credit conditions and weak earnings growth are constraining consumer and corporate spending. The outlook is for official interest rates to remain low for an extended period, as shown below:

| | Dec-12 | Mar-13 | Jun-13 | Sep-13 | Dec-13 | Mar-14 | Jun-14 | Sep-14 | Dec-14 | Mar-15 | Jun-15 | Sep-15 | Dec-15 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Official Bank Rate | | | | | | | | | | | | | |
| Upside risk | | | | 0.25 | 0.25 | 0.25 | 0.25 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| Central case | **0.50** | **0.50** | **0.50** | **0.50** | **0.50** | **0.50** | **0.50** | **0.50** | **0.50** | **0.50** | **0.50** | **0.50** | **0.50** |
| Downside risk | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 |

## 14. Summary

14.1 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 2012/13.

14.2 As indicated in paragraph 12.2 a counterparty limit was breached, the S151 Officer informed and immediately corrected the following day. A prudent approach has also been taken in relation to investment activity with priority being given to security and liquidity over yield.

## 15. Appendices

| Title | Location |
|---|---|
| (a) Prudential Indicators | Attached |

## 16. Background Documents

16.1 Council 23 February 2012 – Paper L132R (as amended)

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

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**Capital Financing Requirement**

Estimates of the Council's cumulative maximum external borrowing requirement for 2011/12 to 2013/14 are shown in the table below:

| | 31/03/2011 Actual £000 | 31/03/2012 Estimate £000 | 31/03/2013 Estimate £000 | 31/03/2014 Estimate £000 |
|---|---|---|---|---|
| Capital Financing Requirement | 7,907 | 92,846 | 94,009 | 94,459 |
| **Less:** Existing Profile of Borrowing | (3,000) | (89,297) | (88,797) | (88,297) |
| Other Long Term Liabilities | (218) | (109) | 0 | 0 |
| **Cumulative Maximum External Borrowing Requirement** | **4,689** | **3,440** | **5,212** | **6,162** |

**Balances and Reserves**

Estimates of the Council's level of Balances and Reserves for 2012/13 to 2014/15 are as follows:

| | 31/03/2012 Actual £000 | 31/03/2013 Estimate £000 | 31/03/2014 Estimate £000 | 31/03/2015 Estimate £000 |
|---|---|---|---|---|
| **Total Balances and Reserves** | **5,141** | **5,138** | **3,435** | **3,502** |

**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, irrespective of their indebted status. This is a statutory limit which should not be breached.
- The Council's Affordable Borrowing Limit was set at £106m for 2012/13 which includes the borrowing for the Housing Revenue reforms.
- 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 2012/13 was set at £104m.
- The Corporate Manager – Financial Services (S151 Officer) confirms that there were no breaches to the Authorised Limit and the Operational Boundary during the year; borrowing at its peak was £89.297m to 30 September 2012.

**(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. The limits for 2012/13 mean that we can have all of our loans/ investments at a fixed rate, but only 30% at a variable rate.

| | Limits for 2012/13 % |
|---|---|
| **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 30/09/12 £000s | % Fixed Rate Borrowing as at 30/09/12 £000s | Compliance with set limits? |
|---|---|---|---|---|---|
| Under 12 months | 50 | 0 | 500 | 0.56% | Yes |
| 12 to < 24 months | 50 | 0 | 500 | 0.56% | Yes |
| 24 months to < 5 years | 50 | 0 | 1,500 | 1.68% | Yes |
| 5 years to <10 years | 100 | 0 | 1,800 | 2.02% | Yes |
| 10 years and above | 100 | 0 | 84,747 | 95.18% | Yes |

**(d) Total Principal Sums Invested for Periods Longer than 364 Days**

- This indicator allows the Council to manage the risk inherent in investments longer than 364 days.
- The limit for 2012/13 was set at £0m because the Council did not want to manage the risk inherent in investments longer than 364 days.
- The council had no investments longer than 364 days in the six month period to 30 September 2012.

**(e) HRA Limit on Indebtedness**

The purpose of this indicator is for the Council to report on the level of the limit imposed at the time of implementation of self-financing by the Department for Communities and Local Government.

| **HRA Limit on Indebtedness** | 31/03/2012 Actual £000s | 31/03/2013 Estimate £000s | 31/03/2014 Estimate £000s | 31/03/2015 Estimate £000s |
|---|---|---|---|---|
| HRA CFR | 89,848 | 89,348 | 88,848 | 88,348 |
| HRA Debt Cap (as prescribed by CLG) | 97,849 | 97,849 | 97,849 | 97,849 |
| Difference | 8,001 | 8,501 | 9,001 | 9,501 |