APPENDIX 11

QUARTERLY TREASURY MANAGEMENT REPORT – MONTH 3

1. Background

Treasury Management (TM) is a complex subject but in summary the core elements of the strategy for 2011/12 are:

- To make use of short term variable rate debt to take advantage of the continuing current market conditions of low interest rates.
- To constantly review longer term forecasts and to lock in to longer term rates through a variety of instruments as appropriate during the year, in order to provide a balanced portfolio against interest rate risk.
- To secure the best short term rates for borrowing and investments consistent with maintaining flexibility and liquidity within the portfolio.
- To invest surplus funds prudently, the Council's priorities being:
  - Security of invested capital
  - Liquidity of invested capital
  - An optimum yield which is commensurate with security and liquidity.
- To approve borrowing limits that provide for debt restructuring opportunities and to pursue debt restructuring where appropriate and within the Council's risk boundaries.

In essence TM can always be seen in the context of the classic 'risk and reward' scenario and following this strategy will contribute to the Council's wider TM objective which is to minimise net borrowing cost short term without exposing the Council to undue risk either now or in the longer in the term.

The main activities undertaken during 2011/12 to date are summarised below:

- Investment returns during 2011/12 will continue to remain low as a result of low interest rates, with interest received estimated to be £1.2M in current year. However, the average rate achieved to date (1.40%) exceeds the performance indicator of the average 7 day LIBID rate (0.60%) mainly due to the rolling programme of yearly deals which was restarted in October 2010 following advice from our Treasury Advisors.
- In order to continue to balance the impact of ongoing lower interest rates on investment income we have continued to use short term debt which is currently available at lower rates than long term debt due to the depressed market. As a result the average rate for repayment of debt, (the Consolidated Loans & Investment Account Rate – CLIA), at 3.18% is lower than that budgeted for but slightly higher than last year

(2.99%) which is in line with reported strategy. The predictions based on all of the economic data are that this will continue for the remainder of the year but it should be noted that the forecast for longer term debt is a steady increase in the longer term and so new long term borrowing will be taken out above this rate, leading to an anticipated increase in the CRI (reaching 4.17% by 2013/14).

2. Economic Background

- Inflationary pressures continued to build as oil and other food commodities resumed their surge. Oil returned to record levels as tensions in the Middle East spilt over and OPEC (Organisation of Petroleum Exporting Countries) failed to agree supply levels at its June meeting. Consumer Price Inflation 4.2% in June which was down from 4.5% in May but still above the target of 2.0%. The Bank of England's May Inflation Report downgraded the UK's economic growth forecast whilst raising the potential inflation near term shocks.
- The focus of the Bank of England's Monetary Policy Committee was concentrated on the lacklustre outlook for economic growth. Although the economy grew by 0.5% in Q1 2011, over a six-month period to March, growth was flat. For households and the consumer there was little cheer as increases in wage growth were more than outstripped by inflation, mortgage approvals slumped in April to their lowest level since the data series began in 1993 and house prices remained in the doldrums. The concerns about growth were further triggered by a fall in the Purchasing Managers' Index (PMI) showed that manufacturing activity fell to a 20 month low. Official interest rates were maintained at 0.5%and the International Monetary Fund stated that monetary policy was "appropriate" in latest survey of the UK economy.
- In Europe, rates were also maintained by the European Central Bank (ECB) at 1.25% but ECB President, Jean-Claude Trichet, re-emphasised the ECB's vigilance towards inflationary pressures signalling a further tightening at its July meeting.
- Greece's funding woes became acute and the country's sovereign rating slid further down the non-investment scale. The second tranche of the IMF/EU bailout was conditional on passing, (and delivering), on the badly needed austerity plans and the sale of state assets. Portugal was downgraded to junk status by Moody's and the threat of contagion cast a shadow over the Eurozone and its financial institutions. Moody's also announced a review of over 14 UK institutions in June which the agency expected to take around three months to complete.
- UK Government gilts were the beneficiary of the poor growth outlook and the turmoil in Europe. This was manifested in 5-year gilt yields falling to 1.84% and 10-year yields falling to 3.13% on 24th June, their lowest levels in 2011.

3. <u>Outlook for Quarter 2</u>

The economic interest rate outlook provided by the Council's treasury advisor, Arlingclose Ltd, as at July 2011 is detailed below. The Council will reappraise its strategy from time to time and, if needs be, realign it with evolving market conditions and expectations for future interest rates.

	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	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	0.50	0.75	1.00	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.00	3.00
Downside risk		-0.25	-0.25	-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50

- The higher inflation projection and the weaker outlook for growth increases the dilemma for the Bank of England.
- Given the precarious outlook for growth, rates will rise if there is firm evidence the economy has survived the fiscal consolidation or there is sustained inflationary pressure over the coming months.
- The war of nerves between the ECB, EU ministers, IMF and Greece will create volatility in the near term for the bond markets.
- CPI has remained persistently high, currently at 4.2% and despite the reduction in petrol prices, double digit gas and electricity price hikes could push inflation close to 5% in 2011. CPI is forecast to remain above the Bank of England's 2% inflation target throughout 2012.
- Retail sales are contracting and consumer spending has not shown any growth over the year due to a fall in disposable income, weak house price growth and a lack of consumer confidence. Unemployment is close to 2.5M and will increase as the public sector shrinks but private sector employment grows at only a modest pace.
- S&P has revised its outlook on the long-term rating for the US to negative amidst fears that the government will not agree a medium- and long-term strategy to tackle their fiscal challenges.

4. <u>Debt Management</u>

Activity within the debt portfolio up to Quarter is summarised below:

	Balance on 01/04/2011	Debt maturing or Repaid	New Borrowing	Balance on 30/06/2011	Increase/ (Decrease) in borrowing
	£000's	£000's	£000's	£000's	£000's
Short Term Borrowing	35,324	77,020	(61,240)	51,104	15,780
Long Term Borrowing	189,358	(45)	55,000	244,313	54,955
Total Borrowing	**224,682**	**76,975**	**(6,240)**	**295,417**	**70,735**

Public Works Loan Board (PWLB) Borrowing: Despite the issue of Circular 147 in October 2010, where new borrowing rates for fixed loans increased by approximately 0.87% across all maturities, the PWLB remains the preferred source of borrowing for the Council as it offers flexibility and control.

Whilst there are an increasing series of claims that a competitive, comparable equivalent to PWLB is readily available, the Council will 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, loan products and their related risk/reward trade off.

The Council use of internal resources (£64M) in lieu of borrowing has been the most cost effective means of funding past capital expenditure to date. This has lowered overall treasury risk by reducing both external debt and temporary investments. However, this position will not be sustainable over the medium term and the Council expects it will need to borrow £75M for capital purposes by 2013/14.

The Council is due to fund £15M of its capital expenditure from borrowing this year and to refinance £70M of existing loans, totalling £85M. New loans amounting to £55M have been raised to the end of June using PWLB10 year EIP, on the advice of our advisors to take advantage of the 10 year yield curve which is significantly below the 25 – 50 year rate. The Council's variable rate loans were borrowed prior to 20 October 2010 (the date of change to the lending arrangements of the PWLB post CSR) and are maintained on their initial terms and are not subject to the additional increased margin.

Variable rate borrowing is expected to remain attractive for some time as the Bank of England maintains the base rate at historically low levels and the Council is expected to borrow an addition £29M by the end of the year (assumed rate 1.7%). This strategic exposure to variable interest rates will be regularly reviewed and if appropriate reduced; by switching into fixed rate loans.

5. 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. The table below summarises activity during the year:

Capital Expenditure	Balance on 01/04/2011	Investments Repaid	New Investments	Balance on 30/06/2011	Increase/ (Decrease) in investment for Year
	£000's	£000's	£000's	£000's	£000's
Short Term Investments	29,300	(13,300)	44,800	60,800	31,500
Money Market Funds	40,575	(107,030)	151,350	84,895	44,320
EIB Bonds	6,000	0	0	6,000	0
Long Term Investments	36	0	0	36	0
Total Investments	**75,911**	**(120,330)**	**196,150**	**151,731**	**75,820**

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 TM Strategy Statement for 2011/12. This has restricted new investments to the following institutions:

- Other Local Authorities;
- AAA-rated Stable Net Asset Value Money Market Funds;
- Deposits with UK Banks and Building Societies
- Debt Management Office.

Counterparty credit quality is assessed and monitored with reference to: Credit Ratings. The council's minimum long-term counterparty rating is A+ (or equivalent) across rating agencies Fitch, S&P and Moody's. A break down of investments as at 30 June 2011 by current credit rating and maturity profile can be seen below:

Credit Rating	Less than 1 Month	1 - 3 Months	3 - 6 Months	6 - 9 Months	9 - 12 Months	Over 12 Months	Total
	£000's	£000's	£000's	£000's	£000's	£000's	£000's
A-							0
A+	9,800		5,000	9,000	6,000		29,800
AA-	3,000	5,000	12,000	10,000			30,000
AA+							0
AAA	84,895			1,000		6,036	91,931
	97,695	**5,000**	**17,000**	**20,000**	**6,000**	**6,036**	

Counterparty Update

- The Council added Sweden and one Swedish bank, Svenska Handelsbanken, meeting the minimum criteria to the approved counterparty list for 2011/12.

- Following the growing problems facing peripheral Europe, the Council brought down the maturity limit for new investments with non-UK banks from two years to a maximum of one year on 23 May 2011.

Similarly, following the growing problems facing Greece and the Eurozone, the Council decided to restrict new investments with approved UK institutions (except for Santander UK plc and Clydesdale) to one year from 23 June 2011.

New deposits with Santander UK plc remain restricted to six months, and new deposits with Clydesdale Bank are now restricted to one week.

Credit Issues

During Quarter 1 Moody's placed the ratings of a number of UK institutions on review for possible downgrade. This is to align their ratings with evolving systemic support post credit crisis. The review is likely to take three months and will assess the extent of available systemic support and the ability of the regulators to deal with a failure. It will also look at the political impact of further taxpayer support for the banking system and the UK government's ability to take on additional liabilities.

This review could lead to downgrades of counterparties on the Council's lending list. The Council will keep the situation under review, and discuss any implications with it's advisors. The outcome of the review could lead to a review of the Council's minimum credit criteria, as set out in its TM Strategy Statement.

The maturity profile of the Council's short term investments, together with the long and short term credit ratings of the institutions with which funds have been deposited is shown below. The authority does not expect any losses from non-performance by any of its counterparties in relation to its investments.

The Council's investment income for the year is estimated to be £0.8M against a budget of £0.6M. The UK Bank Rate has been maintained at 0.5% since March 2009 and short-term money market rates have remained at very low levels. New deposits for periods up to one year have been made at a weighted average rate of 0.76%. Last October we reintroduced a rolling programme of yearly deals to support our core balances, to date we have £21M invested at an average rate of 1.55%.

6. Reform of the Council Housing Subsidy System

In its publication Implementing self-financing for council housing issued in February 2011, the Department for Communities and Local Government (CLG) set out the rationale, methodology and financial parameters for the initiative. Subject to the Localism Bill receiving Royal Assent and a commencement order being passed, the proposed transfer date is Wednesday 28 March 2012.

CLG and CIPFA are both expected to issue further information on the housing reform transaction in July of Quarter 2. Any new information will be incorporated into the 30 year business plan and the treasury implications addressed in conjunction with the Council's advisors.

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, which is approximately £63M. This will require the Council 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 treasury management implications of housing reform and an appropriate strategy to manage the process are being actively reviewed with the Council's Treasury Advisor including the issues surrounding any early prefunding of the significant settlement payment (primarily the powers to borrow and the cost of carry).

7. Compliance with Prudential Indicators

All indicators in Quarter 1 complied with the Prudential Indicators approved. Details of the performance against key indicators are shown below:

7.1. Capital Financing Requirement

The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose. In order to ensure that over the medium term net borrowing will only be for a capital purpose, the Council ensures that net external borrowing does not, except in the short term, exceed the CFR in the preceding year, plus the estimates of any additional capital financing requirement for the current and next two financial years. It differs from actual borrowing due to decisions taken to use internal balances and cash rather than borrow. The following table shows the actual position as at 31 March 2010 and the estimated position for the current and next two years based on the capital programme being submitted to council on the 16 February:

Capital Financing Requirement	2010/11 Actual £M	2011/12 Estimate £M	2011/12 Forecast £M	2012/13 Estimate £M	2013/14 Estimate £M
Balance B/F	**310**	**360**	**360**	**369**	**371**
Capital expenditure financed from borrowing	59	11	19	11	8
Revenue provision for debt Redemption.	(6)	(8)	(7)	(7)	(7)
Movement in Other Long Term Liabilities	(3)	(3)	(3)	(2)	(4)
Cumulative Maximum External Borrowing	**360**	**360**	**369**	**371**	**368**

The above limits are set to allow maximum flexibility within TM, for example a full debt restructure, actual borrowing is significantly below this as detailed below:

	Balance on 01/04/2011 £M	Balance on 30/06/2011 £M	2011/12 Estimate £M	2012/13 Estimate £M	2013/14 Estimate £M
Borrowing	224,677	295,417	277,302	279,863	266,858
Other Long Term Liabilities	71,722	71,722	71,657	73,886	78,153
Total Borrowing	**296,399**	**367,139**	**348,959**	**353,749**	**345,011**

7.2. Balances and Reserves

Estimates of the Council's level of overall Balances and Reserves for 2010/11 to 2012/13 are as follows:

	2010/11 Actual £M	2011/12 Estimate £M	2012/13 Estimate £M	2013/14 Estimate £M
Balances and Reserves	56	46	36	20

7.3. 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 £486M for 2011/12.
- 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 £471M.
- The Chief Financial Officer (CFO) confirms that there were no breaches to the Authorised Limit and the Operational Boundary and during the period to the end of June 2011 borrowing at its peak was £295M.

7.4. 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	50
Compliance with Limits:	Yes

7.5. 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.

	Lower Limit %	Upper Limit %	Actual Fixed Debt as at 30/06/11 £000's	Average Fixed Rate as at 30/06/11 %	% Fixed Rate as at 30/06/11 %	Compliance with set Limits?
Under 12 months	0	45	59,384	1.87	23.55	Yes
12 months and within 24 months	0	45	5,000	4.08	1.98	Yes
24 months and within 5 years	0	50	10,000	2.78	3.97	Yes
5 years and within 10 years	0	50	112,733	3.23	44.71	Yes
10 years and within 20 years	0	50	0	0.00	0.00	Yes
20 years and within 30 years	0	75	10,000	4.68	3.97	Yes
30 years and within 40 years	0	75	30,000	4.62	11.90	Yes
40 years and within 50 years	0	75	25,000	0.04	9.92	Yes
50 years and above	0	100	0	0.00	0.00	Yes
			252,117	**3.45**	**100.00**	

7.6. 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.

Upper Limit for total principal sums invested over 364 days	2010/11 Actual £M	2011/12 Approved £M	2012/13 Estimate £M	2013/14 Estimate £M	2014/15 Estimate £M
	50	50	50	50	50

7.7. Ratio of Financing Costs to Net Revenue Stream

This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet borrowing costs. The definition of financing costs is set out at paragraph 87 of the Prudential Code. The ratio is based on costs net of investment income.

Ratio of Financing Costs to Net Revenue Stream	**2010/11 Actual** %	**2011/12 Approved** %	**2011/12 Estimate** %	**2012/13 Estimate** %	**2013/14 Estimate** %
General Fund	4.89	7.09	5.01	8.43	9.09
HRA	4..46	5.75	5.77	7.50	8.69
Total	**6.01**	**7.49**	**6.61**	**8.25**	**8.47**

8. 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 up to the 30 June 2011. 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.