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Council
21 November 2011

Subject: Mid-Year Review of Treasury Management 2011/2012

Report by:	Deputy Chief Executive and Director of Resources
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Purpose / Summary:	The mid-year review report is a requirement of the Council's reporting procedures. This report also sets out the treasury management activity during the period 1 April to 30 September 2011.

RECOMMENDATION(S):	**1) That Members note the report** **2) That Members note the treasury management activity for the six months to 30 September 2011**

IMPLICATIONS

Legal: None arising as a result of this report.

Financial : The treasury management activities during the reporting period are disclosed in the body of this report.

Staffing : None arising as a result of this report.

Equality and Diversity: None arising as a result of this report.

Risk Assessment: This is a monitoring report only.

Climate Related Risks: This is a monitoring report only.

Background Papers :

The following background papers were used in the preparation of this report.

Title :	**Location of Background Papers:**
LGA Icelandic Banks updates	Financial Services section.

Call in and Urgency:

Is the decision one which Rule 14 of the Scrutiny Procedure Rules apply?

Yes		**No**	**x**

Key Decision:

Yes		**No**	**x**

1 Background

1.1 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering maximising investment return.

1.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the longer term cash flow planning to ensure the Council can meet its capital spending operations.

1.3 As a consequence 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."

1.4 This report is the mid-year review to full Council which is required by the Code of Practice.

2 Introduction

2.1 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 2011/12;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure (prudential indicators);
- A review of the Council's investment portfolio for 2011/12;
- A review of the Council's borrowing strategy for 2011/12;
- A review of compliance with Treasury and Prudential Limits for 2011/12.

3 Economic update (extract from Treasury Management Adviser's commentary)

3.1 **Global economy** - The Euro zone sovereign debt crisis continued with Spain, and particularly Italy, being the focus of renewed market concerns that they may soon join with Greece, Ireland and Portugal in needing assistance. This uncertainty and the lack of a co-ordinated or credible Euro zone response, left commentators concerned over the potential impact of sovereign default and resulting effect on the Euro zone banking sector. The approval by various countries of the £440bn bail out fund in September has brought temporary relief to financial markets but this does not provide a credible remedy to the scale of the Greek debt problem or the sheer magnitude of the potential needs of other countries for support.

This, coupled with political difficulties in the US over their plans to address the budget deficit, the size and control over the US sovereign debt, and the subsequent loss of the AAA credit rating from Standard and Poors, has led to a much more difficult and uncertain outlook for the world economy. Growth prospects in the US, UK and the Euro zone have been lower than expected, with future prospects similarly cut. Whilst not a central view, concerns of a double dip recession in some Western countries have increased. World stock markets fell in the second quarter of 2011/12 as a consequence.

3.2 **UK economy -** Following zero growth in the final half of 2010/11 the UK economy grew by a weaker than expected 0.2% in the first quarter of 2011/12, providing a knock on effect to future growth prospects. Growth prospects will be governed by UK consumer sentiment, which is currently subdued due to falling disposable income. Higher VAT, overhanging debt, high inflation and concerns over employment are likely to weigh heavily on consumers into the future.

Inflation remains stubbornly high, although the expectation of future falls, the external nature of the price increases (energy, oil, food etc.), and the negative impact a rate rise would have on the UK economy, is likely to stop the Monetary Policy Committee from raising the Bank Rate for some considerable time to come. An indicator of the worsening position arose from the Monetary Policy Committee minutes recently signalling a greater willingness to expand the quantitative easing programme.

International investors continue to view UK government gilts as being a safe haven from the EU sovereign debt crisis. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and sent PWLB borrowing rates to low levels.

3.3 **Outlook for the next six months of 2011/12 -** There remain huge uncertainties in economic forecasts due to the following major difficulties:

- the speed of economic recovery in the UK, US and EU;
- the likely political gridlock in the US preventing significant government fiscal action to boost growth ahead of the Presidential elections in November 2012
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economy
- the degree to which government austerity programmes will dampen economic growth;
- 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 overall balance of risks is weighted to the downside:

- We expect low and modest growth in the UK to continue, with a low Bank Rate to continue for at least 12 months, coupled with a possible extension of quantitative easing. This will keep investment returns depressed.
- The expected longer run trend for PWLB borrowing rates is for them to rise, primarily due to the need for a high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. However the current safe haven status of the UK may continue for some time, postponing any increases until 2012.

3.4 **Interest rate forecast**

The Treasury Management and Investment strategies were set against a prediction of an average 0.75% interest rate level for 2011/12.

Taking account of the changes in the economic outlook the Council's Treasury Management advisors' latest forecast movement in interest rates is as follows:-

Date	Bank Rate	Libid			PWLB Rates		
		3 mth	6 mth	12 mth	5 yr	25 yr	50 yr
2011 Sep	0.50	0.70	1.00	1.50	2.50	5.00	5.00
Dec	0.50	0.70	1.00	1.50	2.70	5.00	5.00
2012 Mar	0.50	0.70	1.00	1.50	2.90	5.10	5.10
Jun	0.50	0.70	1.20	1.60	3.00	5.10	5.10
Sep	0.50	0.70	1.30	1.80	3.10	5.10	5.10
Dec	0.75	0.90	1.50	2.00	3.20	5.20	5.20

4 Treasury Management Strategy Statement and Annual Investment Strategy update

4.1 The Treasury Management Strategy Statement (TMSS) for 2011/12 was approved by the Council on 7th March 2011.

- There are no policy changes to the TMSS, the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

5 The Council’s Capital Position (Prudential Indicators)

5.1 This part of the report is structured to update:-

- The Council’s capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow: and
- Compliance with the limits in place for borrowing activity.

5.2 **Prudential Indicator for Capital Expenditure** – This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

Capital Expenditure	2011/12 Original Estimate £m	Current Position £m	2011/12 Revised Estimate £m
Total	1.502	1.195	4.595

The revised estimate includes capital project slippage from earlier years of £3.093

5.3 **Changes to the Financing of the Capital Programme**

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	2011/12 Original Estimate £m	2011/12 Revised Estimate £m
Total spend	1.502	4.595
Financed by:		
Capital receipts	1.127	1.842
Capital grants	0.210	1.798
Capital reserves	-	-
Revenue	-	0.790
Total financing	1.337	4.430
New finance leases	0.165	0.165
Total	**0**	**0**

5.4 **Changes to the Prudential Indicators for the Capital Financing Requirement, External Debt and the Operational Boundary** - The table shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period. This is termed the Operational Boundary.

Prudential Indicator – Capital Financing Requirement – There are no proposed changes to the financing plans.

Prudential Indicator – External Debt/the Operational Boundary

	2011/12 Original Estimate £m	**Current Position £m**	**2011/12 Revised Estimate £m**
Prudential Indicator - Capital Financing Requirement			
Total CFR	2.422	1.994	1.886
Net movement in CFR	0.165	0.012	(0.096)
Prudential Indicator - External Debt/the Operational Boundary			
Borrowing	0	0	0
Other long term liabilities*	0.165	0.012	(0.096)
Total debt 31 March	**0.165**	**0.012**	**(0.096)**

***On balance sheet finance leases**

The change in the CFR from the original estimate reflects the de-recognition of liabilities previously recognised for assets held at peppercorn rents.

5.5 **Limits to Borrowing Activity**

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Net external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2011/12 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2011/12 Original Estimate £m	**Current Position £m**	**2011/12 Revised Estimate £m**
Gross borrowing	0	0	0
Plus other long term/current liabilities*	1.357	0.929	0.821
Less investments	10.540	17.678	14.000
Net borrowing	(9.183)	(17.311)	(13.468)
CFR* (year end position)	2.422	1.994	1.886

*Includes on balance sheet finance leases

The Financial Services Manager (Chief Finance Officer) reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Authorised limit for external debt	**2011/12 Original Estimate £m**	**Current Position £m**	**2011/12 Revised Estimate £m**
Borrowing	5.000	5.000	5.000
Plus other long/current term liabilities*	1.600	1.600	1.600
Total	**6.600**	**6.600**	**6.600**

*Includes on balance sheet finance leases

6 Investment Portfolio 2011/12

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. As set out in Section 3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. The continuing Euro zone sovereign debt crisis, and its potential impact on banks, prompts a low risk and short term strategy. Given this risk adverse environment, investment returns are likely to remain low.

6.2 The Council held £12.7m of investments as at 30 September 2011 (£9.7m at 31 March 2011) and the investment portfolio yield for the first six months of the year is 0.475% against a benchmark 7 Day LIBID of 0.468%.

6.3 The Financial Services Manager (Chief Financial Officer) confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2011/12.

6.4 The Council's budgeted investment return for 2011/12 is £85k, and performance for the year to date is £18k above budget.

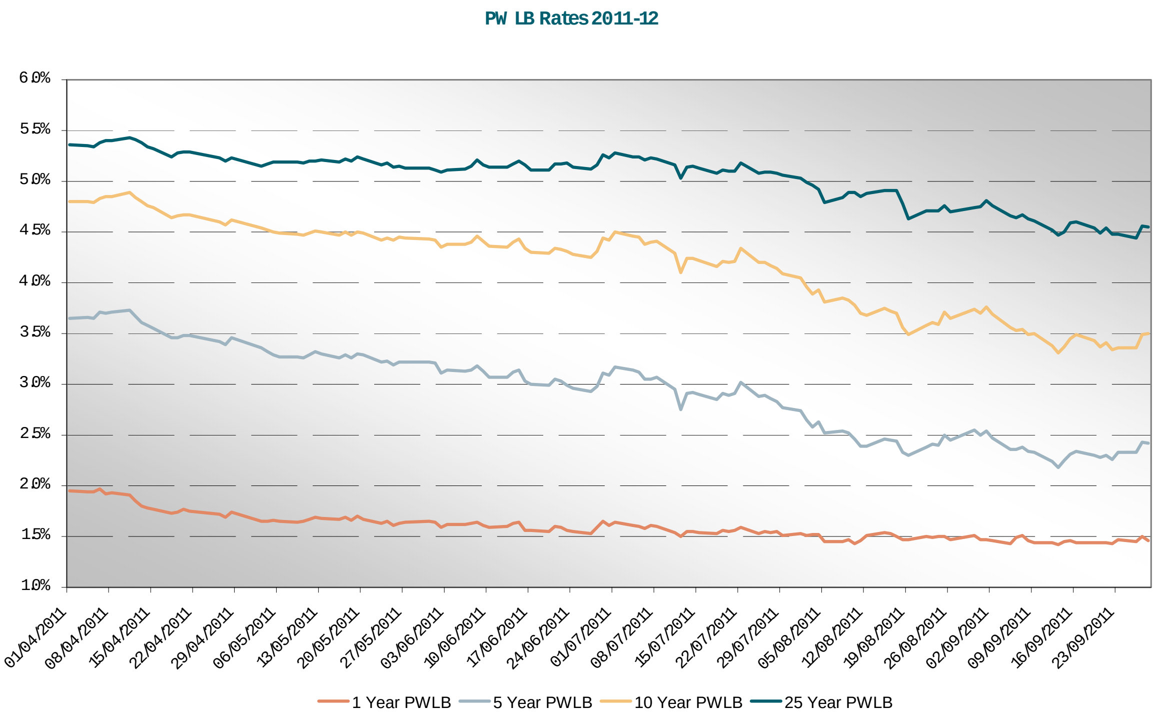
6.5 **Investment Counterparty criteria** – The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

7 Borrowing

The Council's strategy is not to undertake any long term borrowing although temporary borrowing for cash flow purposes, on a short term basis, may occasionally take place. The Council has recognised this possibility by setting its Authorised Borrowing Limit for 2011/12 at £5m.

During the six months to 30 September, no borrowing – either long or short term, took place. However, credit arrangements such as finance leases are classified as borrowing under the capital control arrangements for local authorities. The Council procures replacement vehicles and certain other assets (printers, fuel tanks) through finance lease arrangements which count as credit arrangements. The liability to pay the finance leases are disclosed as other long term liabilities in the Council's accounts. The operational limit that has been approved for long term liabilities for 2011/12 is £1.357m.

The graph and table below show the movement in PWLB rates for the first six months of the year and provide benchmarking data showing high and low points etc:



8 Treasury Activity to 30 September 2011

8.1 Action Summary 1 April 2011 to 30 September 2011

The investments placed over the six months for one week or more:-

Lloyds TSB Bank	16 May 11	184 days	1.42%	£1,000,000
Lloyds TSB Bank	10 Jun 11	94 days	1.20%	£1,000,000
Lloyds TSB Bank	21 Jun 11	402 days	2.65%	£ 500,000
Lloyds TSB Bank	12 Sep 11	91 days	1.25%	£1,000,000

The investments maximised the use of the liquid cash available, working with our cash flow forecast and programmed precept dates.

Currently most UK Banks and Building Societies have credit ratings below those specified in the Council's strategy but the strategy also allows the use of any Banks or Building Societies eligible to participate in the government's Credit Guarantee Scheme (CGS). The Council also applies a stricter credit rating scheme within the universe of eligible institutions under the CGS and as at 30 September this allowed the Council to include Lloyds TSB Bank, Bank of Scotland plc, Royal Bank of Scotland, Santander UK plc, Clydesdale Bank, Barclays Bank and the Nationwide Building Society on the current lending list.

8.2 **Investments**

a) The Council's investment policy for 2011/12 was approved at the Council's meeting on 7 March 2011.

b) All surplus funds are managed internally, as at 30 September 2011, the position was as follows:-

Banking Group	Counterparty	Period	Interest Rate	Banking Group Total	Amount	Period	Interest Rate	Banking Group Total	Amount
					£000's				£000's
			As at 1st April 2011				As at 30th September 2011		
	Heritable Bank*	To 08 Oct 2008	5.55%		495	To 08 Oct 2008	5.55%		391
	Heritable Bank*	To 17 Oct 2008	5.88%		495	To 17 Oct 2008	5.88%		391
	Landsbanki Islands Ldn**	To 17 Oct 2008	5.88%		1000	To 17 Oct 2008	5.88%		1,000
	Landsbanki Islands Ldn**	To 17 Oct 2008	5.80%		1500	To 17 Oct 2008	5.80%		1,500
	Landsbanki Islands Ldn**	To 21 Nov 2008	5.89%		1500	To 21 Nov 2008	5.89%		1,500
	GLITNIR**	To 06 Feb 2009	5.45%		1000	To 06 Feb 2009	5.45%		1,000
					5,990				**5,782**
			As at 1st April 2011				As at 30th September 2011		
Royal Bank of Scotland Group	The Royal Bank of Scotland - Liquidity Select	Open	0.85/0.95%		3,000	Open	0.85/0.95%		4,990
Group Total				**3,000**				**4,990**	
National Australia Bank Group	Clydesdale Bank Plc t/a Yorkshire Bank - Base Rate Tracker Plus 15 day notice	Open	0.75%		2,000	Earliest withdrawal date 15 Oct 2011	0.75%		2,000
Group Total				**2,000**				**2,000**	
Barclays Bank	Barclays Bank - BPA+	Open	0.60%		1,000	Open	0.60%		1,905
Group Total				**1,000**				**1,905**	
Lloyds Banking Group	Lloyds TSB - Deposit Account	Open	0.75%		2,700	Open	0.75%		1,300
	Lloyds TSB	To 16 May 2011	1.21%		1,000				
	Lloyds TSB					To 16 Nov 2011	1.42%		1,000
	Lloyds TSB					To 12 Sept 2011	1.20%		1,000
	Lloyds TSB					To 27 Jul 2012	2.65%		500
Group Total				**3,700**				**3,800**	
					9,700				**12,695**
Average return					**0.83%**				**0.95%**

All the above Group Limits are £5m

* Heritable Bank is in UK administration – two repayments have been received between April 2011 and September 2011.

** Landsbanki and GLITNIR Banks are in Icelandic receivership.

c) The following table sets out investment income earned to 30 September 2011 compared with the approved estimate. The figures below exclude the Icelandic bank investments marked * and ** in the table above.

Full year Estimate	£ 85,000
Estimated profile to 30 September 2011	42,500
Interest Earned	60,544
Variation	18,044
Average Return for 6 months to 30 September 2011	0.45%
Estimated Annual Return	0.90%

9 Treasury Management Prudential Indicators

9.1 The Prudential Code for Capital Finance in Local Authorities was introduced in April 2004.

a. The key objectives of the Prudential Code are to ensure, that the capital investment plans of local authorities are affordable, prudent and sustainable, or, in exceptional cases, to demonstrate that there is a danger of not ensuring this, so that the local authority can take remedial action.

b. To demonstrate that the local authority has fulfilled these objectives, the Prudential Code sets out the indicators that must be used, and the factors that must be taken into account. It does not include suggested indicative limits or ratios as these are for each authority to set for itself.

c. On 7 March 2011 the Council set the following Prudential Indicators:

	2011/2012 Upper	2012/2013 Upper	2013/2014 Upper
Maximum principal sum invested for more than 364 days	£2m	£2m	£2m
Limits on fixed interest rates	100%	100%	100%
Limits on variable interest rates	25%	25%	25%
	2011/2012	**2012/2013**	**2013/2014**
Authorised Limit for External Debt			
Borrowing	£5m	£5m	£5m
Other Long Term Liabilities	£1.6m	£2m	£2.25m
Total	£6.6m	£7m	£7.25m
Operational Limit for External Debt			
Borrowing	£0	£0	£0
Other Long Term Liabilities	£1.357m	£1.760m	£2.056m
Total	£1.357m	£1.760m	£2.056m
Capital Expenditure	£1.502m	£3.160m	£1.796m
Capital Financing Requirement (CFR)	£2.422m	£2.825m	£3.121m

Maturity Structure of fixed interest rate borrowing		
	Lower	**Upper**
Under 12 months	0%	0%
12 months to 2 years	0%	0%
2 years to 5 years	0%	0%
5 years to 10 years	0%	0%
10 years and above	0%	0%

9.2 The Section 151 Officer has a legal responsibility for ensuring compliance with the above indicators and is required to report to members any breach of the limits. There were no limits beached in the three months to 30 September 2011.

10 Icelandic Banks update

10.1 As previously reported, £7m of the Council's funds were invested in 'failed' Icelandic banks £2m with Heritable Bank, £4m with Landsbanki and £1m with Glitnir. The Council has registered its claims with the receivers and administrators acting for all three banks.

10.2 The Local Government Association (LGA) and legal advisers are coordinating activity in respect of recovering the investments in default from all the banks. Set out below is an update on developments since the previous report to this Committee.

10.3 Following the issue of an update to LAAP 82 in September there has been one increase in the estimated forecast return for Heritable Bank since the previous report. The expected recovery has been increased from 85% to 88%.

10.4 Actual recoveries are likely to differ from the current estimates for a number of reasons, asset valuations, currency fluctuations, creditor status, winding up costs, the state of wider financial markets and the outcomes of various legal actions.

10.5 **Landsbanki** ***(anticipating recovery of 95% by December 2018 with priority status, 38% without priority status)***

The Reykjavik District Court on 1 April 2011 confirmed the previous decision by the Landsbanki winding-up board to grant priority status to UK local authority claims. The decision related to a number of test cases brought on behalf of the Local Government Association who are co-ordinating the UK local government claims.

The Landsbanki winding-up board and the general unsecured creditors appealed the decision of the District Court in the test case claims to the Icelandic Supreme Court. The LGA's legal advisers responded to the appeal in September 2011.

The cases were heard in September and the Icelandic Supreme Court upheld the decision of the District Court in a judgement issued at the end of October. Decisions are now awaited on how the judgements will be applied to all local authority cases.

10.6 **Glitnir *(anticipating a recovery 100% by December 2011, 29% without priority status)***

The Reykjavik District Court on 1 April 2011 overturned the Glitnir winding-up board's decision in December 2009 that local authority claims would not have priority status. The Glitnir winding-up board has now appealed the decision of the District Court in the test case claims. As in the case of Landsbanki the LGA's legal advisers responded to the appeal. The cases were heard in September and the Icelandic Supreme Court upheld the decision of the District Court in a judgement issued at the end of October. Decisions are now awaited on how the judgements will be applied to all local authority cases.

10.7 **Heritable (*anticipating a recovery of 88% by January 2013)***

The administration of Heritable Bank is taking place in the Scottish courts and a claim of £2,016,573.15 (includes interest) was made on the Council's behalf. To date eight payments totalling £1,218,339.38 (60.41% of the claim) have been made. Further payments are expected during the current calendar year and up to 88% of the claim is expected to be recovered by January 2013.

10.8 **Conclusion**

The test cases for Glitnir and Landsbanki have now been decided. The treatment of local authorities as preferential depositor creditors was crucial to the value of any recoveries. The Council's accounts already reflect the expectation that the claims will have priority status and the recent decision supports these assumptions.