

## **Cabinet**

**16 November 2011**

## **Mid-Year Report on Treasury Management Service**



---

### **Report of Corporate Management Team**

**Don McLure, Corporate Director Resources**

**Councillor Alan Napier, Portfolio Holder for Resources**

---

#### **Purpose of the Report**

- 1 Revisions to the regulatory framework of treasury management has introduced a requirement that the Council receive a mid year treasury review, in addition to the forward looking annual treasury strategy and backward looking annual treasury report required previously.
- 2 As well as meeting the above requirement this report also incorporates the needs of the Prudential Code, which can be regarded as being best operational practice, to ensure adequate monitoring of the capital expenditure plans and the Council's prudential indicators (PIs). The treasury strategy and PIs were previously reported to Council as part of the Medium Term Financial Plan 2011/12 – 2014/15 on 23 February 2011.
- 3 The purpose of the report also supports the objective in the revised CIPFA Code of Practice on Treasury Management and the Communities and Local Government Investment Guidance. These state that Members should receive and scrutinise the treasury management service.

#### **Background**

##### **Global economy**

- 4 The Euro zone sovereign debt crisis continues with Spain, and particularly Italy, being the focus of renewed market concerns that these two countries 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 the resulting effect on the Euro zone banking sector.
- 5 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 United States (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 Poor's, has led to a much more difficult and uncertain outlook for the world economy.

- 6 Growth prospects in the US, United Kingdom (UK) and the Euro zone have been lower than expected, with future prospects similarly cut. Concerns of a double dip recession in some Western countries have increased and world stock markets fell in the second quarter of 2011/12 as a consequence.

### **UK economy**

- 7 Following zero growth in the final half of 2010/11 the UK economy grew by a weaker than expected 0.1% in the first quarter of 2011/12, which will have implications for future growth prospects. Growth prospects will be governed by UK consumer sentiment, which is currently subdued due to falling disposable income. Higher value added tax (VAT), overhanging debt, high inflation and concerns over employment are also likely to weigh heavily on consumers into the future.
- 8 The announcement by the Monetary Policy Committee (MPC) on 6 October of a second round of quantitative easing (whereby the Bank of England buys financial assets to inject a pre-determined quantity of money into the economy) of £75bn emphasised how seriously the MPC now views recession as being a much bigger concern than inflation. Although inflation remains stubbornly high, the MPC's expectation of future falls resulting in an undershoot of its 2% target opened the way for this new round of QE.
- 9 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 Public Works Loans Board (PWL) borrowing rates to low levels.

### **Forecast of Treasury Advisors (Sector)**

- 10 There remain huge uncertainties in economic forecasts due to the following major difficulties:
  - the increase in risk that the UK, US and European Union (EU) could fall into recession
  - 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 economies
  - the degree to which government austerity programmes will dampen economic growth;
  - the potential for further quantitative easing, and the timing of this in both the UK and US

- the speed of recovery of banks' profitability and balance sheet imbalances and the risk of substantial losses being incurred on EU sovereign debt

11 The overall balance of risks is weighted to the downside:

- Our professional treasury advisors, Sector, expect low growth in the UK to continue, with a low Bank Rate to continue for at least 24 months, coupled with a possible further 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.
- These predicted forecasts are shown in the table below:

|                  | NOW  | Dec-11 | Mar-12      | Jun-12 | Sep-12 | Dec-12 | Mar-13      | Jun-13 | Sep-13 | Dec-13 | Mar-14      | Jun-14 | Sep-14 | Dec-14 | Mar-15      |
|------------------|------|--------|-------------|--------|--------|--------|-------------|--------|--------|--------|-------------|--------|--------|--------|-------------|
| <b>BANK RATE</b> | 0.50 | 0.50   | <b>0.50</b> | 0.50   | 0.50   | 0.50   | <b>0.50</b> | 0.50   | 0.75   | 1.00   | <b>1.25</b> | 1.50   | 2.00   | 2.25   | <b>2.50</b> |
| 3 month LIBID    | 0.75 | 0.70   | <b>0.70</b> | 0.70   | 0.70   | 0.70   | <b>0.75</b> | 0.80   | 0.90   | 1.20   | <b>1.40</b> | 1.60   | 2.10   | 2.40   | <b>2.60</b> |
| 6 month LIBID    | 1.00 | 1.00   | <b>1.00</b> | 1.00   | 1.00   | 1.00   | <b>1.10</b> | 1.20   | 1.40   | 1.60   | <b>1.80</b> | 2.00   | 2.50   | 2.70   | <b>2.90</b> |
| 12 month LIBID   | 1.50 | 1.50   | <b>1.50</b> | 1.50   | 1.50   | 1.60   | <b>1.70</b> | 1.80   | 1.90   | 2.20   | <b>2.40</b> | 2.60   | 3.10   | 3.20   | <b>3.30</b> |
| 5 yr PWLB        | 2.30 | 2.30   | <b>2.30</b> | 2.30   | 2.30   | 2.40   | <b>2.50</b> | 2.60   | 2.70   | 2.80   | <b>2.90</b> | 3.10   | 3.30   | 3.50   | <b>3.70</b> |
| 10 yr PWLB       | 3.30 | 3.30   | <b>3.30</b> | 3.30   | 3.40   | 3.40   | <b>3.50</b> | 3.60   | 3.70   | 3.80   | <b>4.00</b> | 4.20   | 4.40   | 4.60   | <b>4.80</b> |
| 25 yr PWLB       | 4.20 | 4.20   | <b>4.20</b> | 4.20   | 4.30   | 4.30   | <b>4.40</b> | 4.50   | 4.60   | 4.70   | <b>4.80</b> | 4.90   | 5.00   | 5.10   | <b>5.20</b> |
| 50 yr PWLB       | 4.30 | 4.30   | <b>4.30</b> | 4.30   | 4.40   | 4.40   | <b>4.50</b> | 4.60   | 4.70   | 4.80   | <b>4.90</b> | 5.00   | 5.10   | 5.20   | <b>5.30</b> |

## Treasury Management Strategy Statement and Investment Strategy Update

- 12 The Treasury Management Strategy Statement (TMSS) for 2011/12 was approved by the Council on 23 February 2011.
- 13 The underlying TMSS approved previously requires revision in the light of economic and operational movements during the year. The proposed changes and supporting detail for the changes are set out below.
- 14 The Council currently has over £320m in loans and over £150m of cash investments and the table of approved time and monetary limits that we have been operating within for the first half of this year is shown in the table at Appendix 2.
- 15 We continue to be of the opinion that deposits with Royal Bank of Scotland and Lloyds TSB, both with significant Government holdings, provide a good level of security and return in the current climate and we will continue to invest in each for periods up to 364 days for a maximum sum of £50m.
- 16 Subject to statutory powers, the Council will be required to make a one off payment to the CLG to remove the Housing Revenue Account (HRA) from the current housing subsidy system. The payment is expected to be £28m. This one off payment is compensation paid to government, ensuring the HRA will no longer make future annual payments to the CLG. It is expected that the

overall impact will be beneficial to the Council. Whilst the legislative framework is not yet in place, by agreeing to these revised prudential indicators the Council is ensuring the necessary local requirements are in place well before the payment is required on the 28th March 2012. Members are therefore requested to approve the following key changes to the 2011/12 prudential indicators:

| Prudential Indicator 2011/12 | Original (£m) | Impact of HRA Reform (£m) | Revised Prudential Indicator (£m) |
|------------------------------|---------------|---------------------------|-----------------------------------|
| Authorised Limit             | 591.500       | 28.000                    | 619.500                           |
| Operational Boundary         | 354.289       | 28.000                    | 382.289                           |

### Capital Expenditure

- 17 This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed by Council.

| Capital Expenditure by Service        | 2011/12 Original Estimate (£m) | 2011/12 Approved Revisions (£m) | 2011/12 Revised Estimate (£m) |
|---------------------------------------|--------------------------------|---------------------------------|-------------------------------|
| Assistant Chief Executive             | 3.598                          | -1.595                          | 2.003                         |
| Adults Wellbeing and Health           | 4.912                          | -3.716                          | 1.196                         |
| Children and Young People             | 82.454                         | 8.134                           | 90.589                        |
| Neighbourhoods                        | 36.630                         | -0.072                          | 36.558                        |
| Regeneration and Economic Development | 46.741                         | 20.886                          | 67.626                        |
| Resources                             | 19.820                         | -3.748                          | 16.072                        |
| <b>Total General Fund</b>             | <b>194.156</b>                 | <b>19.889</b>                   | <b>214.045</b>                |
| HRA                                   | 25.245                         | 17.547                          | 42.792                        |
| <b>Total GF and HRA</b>               | <b>219.401</b>                 | <b>37.436</b>                   | <b>256.837</b>                |

- 18 Taking into account slippage from the 2010/11 capital programme, additional approved grant funded expenditure and reprofiling into future years, the revised capital expenditure budget for the General Fund is £214.045m and for HRA is £42.792m.
- 19 Details of the individual capital projects and scheme funding can be found in the Quarter 2 Forecast of Outturn report also on this Cabinet agenda.

### Impact of Capital Expenditure Plans

- 20 The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported 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). This will be reduced in part by revenue

charges for the repayment of debt which is known as the Minimum Revenue Provision.

- 21 On the General Fund the underlying borrowing requirement has been revised down by £16.302m due in the main to reprofiling of schemes to future years.

| Capital Expenditure | 2011/12<br>Original<br>Estimate (£m) | 2011/12<br>Revised<br>Estimate (£m) |
|---------------------|--------------------------------------|-------------------------------------|
| General Fund        | 194.156                              | 214.045                             |
| Financed by:        |                                      |                                     |
| Capital receipts    | 15.600                               | 16.146                              |
| Capital grants      | 92.521                               | 115.373                             |
| Capital Reserves    | 1.850                                | 0.380                               |
| Revenue             | 8.723                                | 22.986                              |
| Total Financing     | 118.694                              | 154.885                             |
| Borrowing Need      | 75.462                               | 59.160                              |

- 22 The HRA has an increased requirement to borrow of £17.174m, however this is supported by additional revenue funding provided by government.

| Capital Expenditure | 2011/12<br>Original<br>Estimate (£m) | 2011/12<br>Revised<br>Estimate (£m) |
|---------------------|--------------------------------------|-------------------------------------|
| HRA                 | 25.245                               | 42.792                              |
| Financed by:        |                                      |                                     |
| Capital receipts    | 0.666                                | 0.264                               |
| Capital grants      | 13.421                               | 13.221                              |
| Capital Reserves    | 2.400                                | 2.400                               |
| Revenue             | 4.660                                | 5.635                               |
| Total Financing     | 21.147                               | 21.520                              |
| Borrowing Need      | 4.098                                | 21.272                              |

### Capital Financing Requirement

- 23 The table shows the CFR, which is the underlying external need to borrow for a capital purpose.

|                   | 2010/11<br>Outturn Position<br>(£m) | 2011/12<br>Original<br>Estimate (£m) | 2011/12<br>Revised<br>Estimate (£m) |
|-------------------|-------------------------------------|--------------------------------------|-------------------------------------|
| CFR – Non Housing | 332.412                             | 383.492                              | 367.190                             |
| CFR – Housing     | 152.235                             | 157.540                              | 174.714                             |
| Total CFR         | 484.647                             | 541.032                              | 541.364                             |

### Borrowing Strategy

- 24 The CFR shown above indicates the requirement for the Council to borrow to support its capital activities. This borrowing can be in the form of external

sources (e.g. PWLB) or internal resources (e.g. use of reserves, working capital).

- 25 The Corporate Director Resources, under delegated powers, will adopt the most appropriate form of borrowing depending on the prevailing interest rates at the time. Research indicates it is likely that shorter term fixed rates may provide lower cost opportunities in the short/medium term.
- 26 Due to the overall financial position and the underlying need to borrow, additional external loans of £20m were arranged on 6 October 2011 from the PWLB as follows:

| Ref.        | Value | Interest Rate | Maturity date    |
|-------------|-------|---------------|------------------|
| PWLB 499060 | £10m  | 2.61%         | 2 March 2018     |
| PWLB 499061 | £10m  | 2.72%         | 2 September 2018 |

- 27 It is anticipated that further loans could be arranged during this financial year, should market conditions prove advantageous.
- 28 The treasury service is currently analysing the options for the implications of the HRA reform impact. As the CLG will require an estimated payment on the 28 March 2012 of £28m, it is anticipated that an additional loan from PWLB will be used to pay this amount and ensure the overall position of the Council is safeguarded and both the HRA and non-HRA funds are not disadvantaged.
- 29 On 21 September 2011 the government announced that rates on loans from the PWLB for this specific purpose would be temporarily reduced. The interest rate will be approximately 0.85% lower than that previously available.

### Limits to Borrowing Activity

- 30 The first key control over the treasury activity is a Performance Indicator (PI) 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 2010/11 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has an approved policy for borrowing in advance of need, and this will be used if it is considered prudent.
- 31 The Corporate Director Resources reports that no difficulties are envisaged for the current or future years in complying with this PI. The table below summarises the position.

|                         | 2011/12<br>Original<br>Estimate (£m) | 2011/12<br>Revised<br>Estimate (£m) |
|-------------------------|--------------------------------------|-------------------------------------|
| Gross Borrowing         | 354.789                              | 374.789                             |
| Less Investments        | 50.000                               | 100.000                             |
| Net Borrowing           | 304.789                              | 274.789                             |
| CFR (year end position) | 541.032                              | 541.364                             |

- 32 A further PI 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<br>Original<br>Indicator (£m) | 2011/12<br>Revised<br>Indicator (£m) | 2012/13<br>Revised<br>Indicator (£m) |
|------------------------------------|---------------------------------------|--------------------------------------|--------------------------------------|
| Borrowing                          | 591.000                               | 619.000                              | 619.000                              |
| Other long term liabilities        | 0.500                                 | 0.500                                | 1.000                                |
| <b>Total</b>                       | <b>591.500</b>                        | <b>619.500</b>                       | <b>620.000</b>                       |

### Investment Portfolio

- 33 The primary objectives of the Council's investment strategy are to safeguard the re-payment of principal and interest from its investments on time (security) and to ensure adequate availability of funds (liquidity). Investment return is a secondary objective.
- 34 Following on from the economic background earlier in the report, the current investment climate has one over-riding risk consideration, that of counterparty risk. As a result of these underlying concerns officers continue to implement an operational investment strategy which tightens the controls already in place in the approved investment strategy.
- 35 The Council held £117m of investments at 30 September 2011, and the constituent parts of the investment position are:

| Sector             | Country      | 0-3 months  | 3-6 months | 6-12 months |
|--------------------|--------------|-------------|------------|-------------|
| Banks              | UK           | £87m        | £8m        | £8m         |
| Building Societies | UK           | £9m         | -          | -           |
| Local Authorities  | UK           | £2m         | -          | £3m         |
| <b>Total</b>       | <b>£117m</b> | <b>£98m</b> | <b>£8m</b> | <b>£11m</b> |

- 36 As set out earlier in the report, 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.
- 37 The investment portfolio yield for the first six months of the year is 0.93% against a benchmark 7 day London Inter Bank Bid Rate (the rate at which banks take deposits from each other) yield of 0.47%.

- 38 The original budgeted investment return for 2011/12 was £0.577m, however it is now expected that this will be exceeded by around £0.685m.

### **Icelandic Deposits**

- 39 The County Council inherited £7m of deposits from the former Derwentside District Council that were invested across the Icelandic banks Glitnir (£4m), Landsbanki (£2m) and Kaupthing (£1m), which all effectively collapsed financially in October 2008.
- 40 For Kaupthing a total repayment of £0.580m (58%) has been received at October 2011 and it is anticipated that a further 24% will be recovered by the end of 2012/13, taking total dividends expected to be paid to 82%.
- 41 In the cases of Landsbanki and Glitnir, the Icelandic Supreme Court announced its decision on 28 October 2011 and found in favour of UK local authorities and other UK wholesale depositors retaining priority creditor status.
- 42 This judgement means the council will be paid first when it comes to receiving funds back and will recover almost all of the money initially invested and interest owed. Our current estimate is 100% recovery for Glitnir deposits and 98% for Landsbanki.
- 43 The way in which the LGA and our legal advisors have coordinated the legal action with other local authorities has minimised legal costs whilst enabling us to advance the strongest possible arguments to secure this result. The cost of the litigation to date amounts to less than 1 per cent of the amount expected to be recovered.

### **Member Training**

- 44 The increased Member consideration of treasury management matters is complex and therefore requires a suitable training process. It is proposed therefore to undertake training for members at a suitable time in early spring 2012.

### **Recommendations**

- 45 It is recommended that Members:
- i. Note the contents of the mid-year review report
  - ii. Approve the key changes to the 2011/12 prudential indicators in light of the impact of Housing Subsidy changes
  - iii. Approve the time and monetary limits for investments shown in the table at Appendix 2

---

|                 |                       |             |                     |
|-----------------|-----------------------|-------------|---------------------|
| <b>Contact:</b> | <b>David Watchman</b> | <b>Tel:</b> | <b>0191 3833940</b> |
|-----------------|-----------------------|-------------|---------------------|

---



---

## **Appendix 1: Implications**

---

### **Finance**

Details of the overall financing of the Council's anticipated capital expenditure, along with forecast borrowing and investment income returns are provided in the report.

### **Staffing**

None

### **Risk**

None

### **Equality and Diversity / Public Sector Equality Duty**

None

### **Accommodation**

None

### **Crime and Disorder**

None

### **Human Rights**

None

### **Consultation**

None

### **Procurement**

None

### **Disability issues**

None

### **Legal Implications**

None

---

**Appendix 2: Revised Time and Monetary Limits Table**


---

|                         | Fitch(or equivalent)     | Money Limit          | Time Limit |
|-------------------------|--------------------------|----------------------|------------|
| Limit 1 Category        | AAA                      | £50m                 | 1yr        |
| Money Market Funds      | AAA                      | £50m (£10m per fund) | None       |
| Limit 2 Category        | A<br>(Amended from 'AA') | £50m                 | 1yr        |
| Eligible Institutions   | A                        | £50m                 | 1yr        |
| Limit 3 Category        | A                        | £25m                 | 3 months   |
| Eligible Institutions   | A                        | £25m                 | 3 months   |
| UK Government – DMO     |                          | Unlimited            | 6 months   |
| Other Local Authorities |                          | £10m per authority   | 1yr        |