

**Cabinet**

**16 January 2013**

**Mid-Year Report for the period to  
30 September 2012 on Treasury  
Management Service**



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**Report of Corporate Management Team  
Don McLure, Corporate Director Resources  
Councillor Alan Napier, Cabinet Portfolio Holder for Resources**

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### **Purpose of the Report**

- 1 The regulatory framework of treasury management requires the Council to receive a mid year treasury review, in addition to the forward looking annual treasury strategy and backward looking performance against the previous annual treasury strategy.
- 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 2012/13 – 2015/16 on 22 February 2012.
- 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**

#### **Economic Update and Forecast Outlook**

- 4 Economic sentiment, in respect of the prospects for the UK economy to recover swiftly from recession, suffered a major blow in August when the Bank of England substantially lowered its expectations for the speed of recovery and rate of growth over the coming months and materially amended its forecasts for 2012 and 2013. It was noted that the UK economy is heavily influenced by worldwide economic developments, particularly in the Euro zone, and that on-going negative sentiment in that area would inevitably permeate into the UK's economic performance.
- 5 With regard to the Euro zone now, investor confidence remains weak because successive "rescue packages" have first raised, and then repeatedly disappointed, market expectations. However, the uncertainty created by the continuing Euro zone debt crisis is having a major effect in undermining

business and consumer confidence not only in Europe and the UK, but also in America and the Far East/China.

- 6 In the UK, consumer confidence remains very depressed with unemployment concerns, indebtedness and a squeeze on real incomes from high inflation and low pay rises, all taking a toll. Whilst inflation has fallen considerably (CPI @ 2.6% in July), UK GDP fell by 0.5% in the quarter to 30 June, the third quarterly fall in succession. This means that the UK's recovery from the initial 2008 recession has been the worst and slowest of any G7 country apart from Italy (G7 = US, Japan, Germany, France, Canada, Italy and UK). It is also the slowest recovery from a recession of any of the five UK recessions since 1930 and total GDP is still 4.5% below its peak in 2008.
- 7 This weak recovery has caused social security payments to remain elevated and tax receipts to be depressed. Consequently, the Chancellor's plan to eliminate the annual public sector borrowing deficit has been pushed back further into the future. The Monetary Policy Committee has kept Bank Rate at 0.5% throughout the period while quantitative easing was increased by £50bn to £375bn in July. In addition, in June, the Bank of England and the Government announced schemes to free up banking funds for business and consumers.
- 8 On a positive note, despite all the bad news on the economic front, the UK's sovereign debt remains one of the first ports of call for surplus cash to be invested in and gilt yields, prior to the European Central Bank (ECB) bond buying announcement in early September, were close to zero for periods out to five years and not that much higher out to ten years.

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

- 9 Sector's view is that the risks in economic forecasts continue unabated from the previous treasury strategy. Concern has been escalating that the Chinese economy is heading for a 'hard landing', rather than a gentle slowdown, while America is hamstrung by political deadlock which prevents a positive approach to countering weak growth. Whether the re-election of President Obama in November will remedy this deadlock is debatable but urgent action will be required early in 2013 to address the US debt position. On 13 September the Federal Reserve announced an aggressive stimulus programme for the economy with a third round of quantitative easing focused on boosting the stubbornly weak growth in job creation, and this time with no time limit. They also announced that it was unlikely that there would be any increase in interest rates until at least mid 2015.
- 10 Euro zone growth will remain weak as austerity programmes in various countries curtail economic recovery. A crunch situation is rapidly developing in Greece as it has failed yet again to achieve deficit reduction targets and so may require a third bail out. There is the distinct possibility that some of the northern European countries could push for the ejection of Greece from the Euro zone unless its financial prospects improve, which does not seem likely at this juncture. A financial crisis was also rapidly escalating over the situation in Spain. However, in early September the ECB announced that it would purchase unlimited amounts of shorter term bonds of Euro zone countries which have formally agreed the terms for a bailout. Importantly, this support

would be subject to conditions (which have yet to be set) and include supervision from the International Monetary Fund. This resulted in a surge in confidence that the Euro zone has at last put in place the framework for adequate defences to protect the Euro. However, it remains to be seen whether the politicians in charge of Spain and Italy will accept such loss of sovereignty in the light of the verdicts that voters have delivered to the politicians in other peripheral countries which have accepted such supervision and austerity programmes. The Euro zone crisis is therefore far from being resolved as yet. The immediate aftermath of this announcement was a rise in bond yields in safe haven countries, including the UK. Nevertheless, this could prove to be as short lived as previous “solutions” to the Euro zone crisis.

- 11 The Bank of England Quarterly Inflation Report in August pushed back the timing of the return to trend growth and also lowered its inflation expectations. Nevertheless, concern remains that the Bank’s forecasts of a weaker and delayed robust recovery may still prove to be over optimistic given the world headwinds the UK economy faces. Weak export markets will remain a drag on the economy and consumer expenditure will continue to be depressed due to a focus on paying down debt, negative economic sentiment and job fears. The Coalition Government, meanwhile, is likely to be hampered in promoting growth by the requirement of maintaining austerity measures to tackle the budget deficit.
- 12 The overall balance of risks is, therefore, weighted to the downside:
  - Sector expects low growth in the UK to continue, with Bank Rate unlikely to rise in the next 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 eventually 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, tempering any increases in yield.
  - This interest rate forecast is based on an assumption that growth starts to recover in the next three years to a near trend rate (2.5%). However, if the Euro zone debt crisis worsens as a result of one or more countries having to leave the Euro, or low growth in the UK continues longer, then Bank Rate is likely to be depressed for even longer than in this forecast.

## Sector's Interest Rate Forecast

|                | 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 | Mar-16 |
|----------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| BANK RATE      | 0.50   | 0.50   | 0.50   | 0.50   | 0.50   | 0.50   | 0.50   | 0.50   | 0.50   | 0.75   | 1.00   | 1.25   | 1.50   | 1.75   |
| 3 month LIBID  | 0.50   | 0.50   | 0.50   | 0.50   | 0.50   | 0.50   | 0.60   | 0.60   | 0.70   | 0.80   | 1.10   | 1.40   | 1.70   | 1.90   |
| 6 month LIBID  | 0.70   | 0.70   | 0.70   | 0.70   | 0.70   | 0.70   | 0.80   | 0.90   | 1.00   | 1.10   | 1.30   | 1.60   | 1.90   | 2.20   |
| 12 month LIBID | 1.00   | 1.00   | 1.00   | 1.00   | 1.00   | 1.10   | 1.10   | 1.20   | 1.30   | 1.30   | 1.50   | 1.80   | 2.10   | 2.40   |
| 5yr PWLB       | 1.50   | 1.50   | 1.50   | 1.60   | 1.60   | 1.70   | 1.70   | 1.80   | 2.00   | 2.20   | 2.30   | 2.50   | 2.70   | 2.90   |
| 10 yr PWLB     | 2.50   | 2.50   | 2.50   | 2.60   | 2.60   | 2.70   | 2.70   | 2.80   | 3.00   | 3.20   | 3.30   | 3.50   | 3.70   | 3.90   |
| 25yr PWLB      | 3.70   | 3.80   | 3.80   | 3.80   | 3.80   | 3.90   | 3.90   | 4.00   | 4.10   | 4.30   | 4.40   | 4.60   | 4.80   | 5.00   |
| 50yr PWLB      | 3.90   | 4.00   | 4.00   | 4.00   | 4.00   | 4.10   | 4.10   | 4.20   | 4.30   | 4.50   | 4.60   | 4.80   | 5.00   | 5.20   |

- 13 The above Sector forecasts for PWLB rates incorporate the introduction of the PWLB certainty rate in November 2012 which has reduced PWLB borrowing rates by 0.20% for most local authorities, including Durham.

## Treasury Management Strategy Statement and Investment Strategy Update

- 14 The Treasury Management Strategy Statement (TMSS) for 2012/13 was approved by the Council on 22 February 2012.
- 15 The underlying previously approved TMSS required revision in the light of economic and operational movements during the year. The revisions were reported and agreed by Council on 19 September 2012. The first revision increased the monetary limit for the 'Banks 2' category (part-nationalised) from £50m to £60m. The only other amendment agreed by Council was to give delegated power to the Corporate Director Resources in consultation with the Cabinet Portfolio Holder for Resources to amend counterparty monetary and time limits.
- 16 The amended table of approved time and monetary limits that we have been operating within following the above revision is shown at Appendix 2.

## 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           | 2012/13<br>Original<br>Estimate<br>(£m) | 2012/13<br>Approved<br>Revisions<br>(£m) | 2012/13<br>Revised<br>Estimate<br>(£m) |
|--|---|--|--|
| Assistant Chief Executive                | 3.703                                   | -1.270                                   | 2.433                                  |
| Children and Adults Services             | 98.639                                  | -2.330                                   | 96.309                                 |
| Neighbourhoods                           | 29.867                                  | 2.396                                    | 32.263                                 |
| Regeneration and Economic<br>Development | 43.079                                  | 12.126                                   | 55.205                                 |
| Resources                                | 22.148                                  | -18.190                                  | 3.958                                  |
| Other                                    | 0                                       | 0.153                                    | 0.153                                  |
| Total General Fund                       | 197.436                                 | -7.115                                   | 190.321                                |
| HRA                                      | 44.854                                  | 0.890                                    | 45.744                                 |
| Total GF and HRA                         | 242.290                                 | -6.225                                   | 236.065                                |

- 18 Taking into account slippage from the 2011/12 capital programme, additional approved grant funded expenditure and reprofiling into future years, the revised capital expenditure budget for the General Fund is £190.321m and for HRA is £45.744m.
- 19 Details of the individual capital projects and scheme funding can be found in the Quarter 2 Forecast of Revenue and Capital Outturn 2012/13 for General Fund and Housing Revenue Account – Period to 30 September 2012 report presented to Cabinet on 14 November 2012.

### Impact of Capital Expenditure Plans

- 20 The table below draws together the main strategy elements of the capital expenditure plans, 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 £0.375m.

| Capital Expenditure | 2012/13<br>Original<br>Estimate (£m) | 2012/13<br>Revised<br>Estimate (£m) |
|---------------------|--------------------------------------|-------------------------------------|
| General Fund        | 197.436                              | 190.321                             |
| Financed by:        |                                      |                                     |
| Capital receipts    | 21.608                               | 21.604                              |
| Capital grants      | 85.490                               | 80.188                              |
| Capital Reserves    | 1.230                                | 0.535                               |
| Revenue             | 4.196                                | 3.457                               |
| Total Financing     | 112.524                              | 105.784                             |
| Borrowing Need      | 84.912                               | 84.537                              |

- 22 On the HRA has the underlying borrowing requirement has been revised down by £0.110m.

| Capital Expenditure | 2012/13<br>Original<br>Estimate (£m) | 2012/13<br>Revised<br>Estimate (£m) |
|---------------------|--------------------------------------|-------------------------------------|
| HRA                 | 44.854                               | 45.744                              |
| Financed by:        |                                      |                                     |
| Capital receipts    | 0.525                                | 0.525                               |
| Capital grants      | 30.158                               | 30.158                              |
| Capital Reserves    | 0                                    | 0                                   |
| Revenue             | 4.922                                | 5.922                               |
| Total Financing     | 35.605                               | 36.605                              |
| Borrowing Need      | 9.249                                | 9.139                               |

## Capital Financing Requirement

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

|                   | 2011/12<br>Outturn Position<br>(£m) | 2012/13<br>Original<br>Estimate (£m) | 2012/13<br>Revised<br>Estimate (£m) |
|-------------------|-------------------------------------|--------------------------------------|-------------------------------------|
| CFR – Non Housing | 353.472                             | 449.447                              | 423.016                             |
| CFR – Housing     | 225.663                             | 240.314                              | 234.802                             |
| Total CFR         | 579.136                             | 689.761                              | 657.818                             |

## 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.
- 26 Due to the overall financial position and the underlying need to borrow, additional external loans of £20m were arranged from the PWLB during the period as follows:

| Ref.        | Value | Interest Rate | Date of Loan | Maturity date    |
|-------------|-------|---------------|--------------|------------------|
| PWLB 501272 | £10m  | 3.01%         | 21 May 2012  | 15 November 2022 |
| PWLB 501346 | £10m  | 2.89%         | 12 June 2012 | 7 December 2023  |

- 27 The overall borrowing position at 30 September 2012 was £435m, of which £212m relates to the General Fund and £223m to the Housing Revenue Account.
- 28 It is anticipated that further loans could be arranged during 2012/13 financial year, should market conditions prove advantageous.

## Limits to Borrowing Activity

- 29 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 2012/13 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.

- 30 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.
- 31 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 | 2012/13<br>Original<br>Indicator (£m) | 2013/14<br>Original<br>Indicator (£m) | 2014/15<br>Original<br>Indicator (£m) |
|------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|
| Borrowing                          | 722.710                               | 737.658                               | 743.558                               |
| Other long term liabilities        | 50.000                                | 50.000                                | 50.000                                |
| Total                              | 772.710                               | 787.658                               | 793.558                               |

### Investment Portfolio

- 32 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 Paragraphs 4 to 8, 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.
- 33 The Council held £142m of investments at 30 September 2012, and the constituent parts of the investment position are:

| Sector             | Country | 0-3 months | 3-6 months | 6-12 months |
|--------------------|---------|------------|------------|-------------|
| Banks              | UK      | 51         | 9          | 69          |
| Building Societies | UK      | 9          | 4          | 0           |
| Local Authorities  | UK      | 0          | 0          | 0           |
| Total              | £142m   | 60         | 13         | 69          |

- 34 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.
- 35 The investment portfolio yield for the first six months of the year is 1.57% against a benchmark 7 day London Inter Bank Bid Rate (the rate at which banks take deposits from each other) yield of 0.43%.
- 36 The original budgeted investment return for 2012/13 was £0.577m, however it is now expected that this will be exceeded by around £0.848m.

### **Icelandic Deposits**

- 37 The County Council had £7m deposited across the Icelandic banks Glitnir Bank hf (£4m), Landsbanki (£2m) and Kaupthing Singer and Friedlander Ltd (£1m), which all effectively collapsed financially in October 2008.
- 38 The Council's recovery position at 30 September 2012 is as follows:
- Glitnir: a full distribution was made in March 2012, however an element of the distribution is in the Icelandic Kroner currency, which has been placed in an escrow account in Iceland due to currency controls currently operating in the country. As a result this element is subject to exchange rate risk, over which the Council has no control. The Council has made an impairment of 4% to allow for currency fluctuations.
  - Landsbanki: 43% of an anticipated 100% recovery has been repaid. Again, a small element of the distribution is in Icelandic Kroner which has been placed in an escrow account in Iceland due to currency controls and is subject to exchange rate risk.
  - Kaupthing Singer and Friedlander: 73% of the outstanding balance has been repaid. 83.5% recovery is anticipated in the long run.
- 39 A full update regarding the recovery position was provided to County Council on 19 September 2012 in the Treasury Management Outturn 2011/12 report.

### **Recommendations**

- 40 It is recommended that Members:
- i. Note the contents of the mid-year review report
  - ii. Approve the time and monetary limits for investments shown in the table at Appendix 2

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## **Appendix 1: Implications**

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### **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

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

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|                                    | Long Term Rating | Money Limit        | Time Limit |
|------------------------------------|------------------|--------------------|------------|
| Banks 1 category high quality      | AA               | £50m               | 1yr        |
| Banks 1 category medium quality    | A                | £25m               | 3 months   |
| Banks 2 category part nationalised | N/A              | £60m               | 1yr        |
| Banks 3 category Council's banker  | A-               | £25m               | 3 months   |
| DMADF/Treasury Bills               | AAA              | unlimited          | 6 months   |
| Other Local Authorities            | N/A              | £10m per authority | 1yr        |
| Money Market Funds                 | AAA              | £10m               | 1 year     |