REPORT FOR:	**Governance, Audit and Risk Management Committee (GARM)**
Date:	**23 January 2013**
Subject:	**Half Year 2012/13 Treasury Management Activity**
Responsible Officer:	**Julie Alderson, Corporate Director of Resources**
Portfolio Holder:	**Sachin Shah (Portfolio Holder for Finance)**
Exempt:	**No**
Enclosures:	**Appendix 1 - Creditworthiness and Counterparty Policy** **Appendix 2 – Prudential Indicators** **Appendix 3 – Review of Counterparty Policy**

Section 1 – Summary and Recommendations

This report sets out a half year summary of Treasury Management activities for 2012/13. The report was referred by Cabinet to GARMC for review. An additional appendix 3 has been added discussing possible revisions to the counterparty policy.

Recommendation

(a) Review the half year treasury management activity for 2012/13.

(b) Consider the reasonableness of the proposed changes to the counterparty policy, as outlined in appendix 3.

Reason

To promote effective financial management and comply with the Local Authorities (Capital Finance and Accounting) Regulations 2003 requirement to 'have regard to' the CIPFA Prudential Code and Treasury Management Code of Practice.

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Section 2 – Report

Referral to GARM

1. The paper that follows was discussed by Cabinet on 13th December 2012. In line with GARMC's role to scrutinise treasury management activities, Cabinet has referred this report to GARMC.

2. An additional appendix 3 has been added to the Cabinet report discussing a change in counterparty policy that we propose to include in the strategy for 2013-14. The proposal is to enable the use of enhanced cash funds as an investment. This has been discussed with the Council's treasury advisor (Sector) and who will advise on fund selection.

3. Otherwise, the report is identical to that presented to Cabinet.

Introduction

4. The Council approved a Treasury Management Strategy for 2012/13 on 16th February 2012, which complies with the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management (November 2009) and Prudential Code for Capital Finance.

5. The revised code recommends that members should be updated on treasury management activities at least twice a year. This report therefore helps to ensure that best practice is being followed in accordance with the code.

6. The overall objective of treasury management is to manage the Council's cash flow, borrowing and investments, and to control the associated risks, so as to maintain security, liquidity, maximise the return on investments and to minimise interest charges on debt with minimal risk to the Council's assets.

7. This report is the half year summary of performance on treasury management activities to 30 September 2012 and covers:
   - the half year forecast outturn position;
   - the economy in the first half of 2012/13;
   - the Treasury Management activity for the period ended 30 September 2012; and
   - compliance with Prudential Indicators.

Forecast outturn Position

8. There is a forecast net surplus of £372,000 on the capital financing and investment income budget as detailed in the table below:

	Latest Budget	Forecast Outturn	Variation	
	£000	**£000**	**£000**	**%**
Cost of Borrowing	8,140	8.225	85	+1.0%
Investment Income	-678	-1,135	-457	-67.4%
Minimum Revenue Provision	12,726	12,726	0	0
Total	**20,188**	**19,816**	**-372**	**-1.8%**

9. The main reasons for the variations are :

- Borrowing cost – gross interest is in line with budget and the variance is due to a lower recharge to Housing reflecting below expected capital expenditure. HRA is allocated a share of borrowing costs based on the depreciated cost of its capital expenditure.

- Investment income – the additional income is due both to higher investment balances than was anticipated (capital expenditure so far this year is below forecast) and from the average interest rate (see paragraph 10 below) exceeding the budget of 1.5%; and

- MRP – Is estimated to be in line with budget.

10. The short term cash portfolio of £110 million is managed both to protect its value and support the overall Council budget by generating a favourable risk adjusted return. The headwinds faced have increased measurably this year. Not only are bank base rates at an all time low of 0.5% but to stimulate the economy the Government has offered funds to the banks at a cost of 0.25%. In this context, the average interest rate of 2.1% as at October 2012 places Harrow's return well into the top 10% of UK Local Authorities. The Council has recently approved increased flexibility to invest with the part nationalised banks, making a significant contribution to the income earned this year.

11. It will not be possible to improve on this performance using traditional bank and building society deposits and alternative investments are under consideration. These include investment in high quality bonds and project funding e.g. the West London waste incineration facility under construction. While extra returns are appreciated, the security of the Council's funds remains the priority.

The Economy and Interest Rates

12. The economic update is provided by the Council's treasury advisor, Sector.

UK & Global economy

13. 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 Eurozone, and that on-going negative sentiment in that area would inevitably permeate into the UK's economic performance.

14. With regard to the Eurozone, investor confidence remains weak because successive "rescue packages" have first raised, and then disappointed, market expectations. However, the uncertainty created by the continuing Eurozone 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.

15. 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 @

2.7% in October), UK GDP fell by 0.5% in the quarter to 30 June, the third quarterly fall in succession, before recording a 1% growth in the September quarter. 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. It is also the slowest recovery from a recession of any of the five UK recessions since 1930 and total GDP is still 3.5% below its peak in 2008.

16. 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.

17. 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 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.

<u>Outlook for the second half of 2012-13</u>

18. 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. Urgent action will be required early in 2013 to address the US debt position. However, 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.

19. Eurozone growth will remain weak as austerity programmes in various countries curtail economic recovery. However, in early September the ECB announced that it would purchase unlimited amounts of shorter term bonds of Eurozone countries which have formally agreed the terms for a bailout. This resulted in a surge in confidence that the Eurozone 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 Eurozone 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 Eurozone crisis.

20. The Bank of England Quarterly Inflation Report in August pushed back the timing of the return to trend growth. 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.

21. The overall balance of risks is, therefore, weighted to the downside:

- We expect 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 rates 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 Eurozone 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 the bank rate is likely to be depressed for even longer than in this forecast.

22. The Council's Treasury Advisers, Sector, provides the following forecast of bank base rate and PWLB borrowing rates:

	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
BANK RATE	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00
3m LIBID	0.60	0.60	0.60	0.60	0.60	0.60	0.70	0.90	1.10	1.40
6m LIBID	0.85	0.85	0.85	0.85	0.85	1.00	1.10	1.30	1.50	1.80
12m LIBID	1.30	1.30	1.30	1.40	1.50	1.70	1.90	2.10	2.30	2.60
5yr PWLB	1.50	1.50	1.50	1.60	1.70	1.80	1.90	2.00	2.10	2.30
10yr PWLB	2.50	2.50	2.50	2.60	2.70	2.80	2.90	3.00	3.20	3.30
25yr PWLB	3.70	3.70	3.70	3.80	3.80	3.90	4.00	4.10	4.20	4.30
50yr PWLB	3.90	3.90	3.90	4.00	4.00	4.10	4.20	4.30	4.40	4.50

23. Based on the above forecast, interest rate rises are again delayed for longer than was previously forecast. The first base rate increase is expected to be in Q4 of 2014 increasing thereafter by 0.25% a quarter. Long term PWLB rates are projected to steadily increase from the 2nd half of 2013 to reach 4.5% by Q1 of 2015.

Treasury Management Activity for the period ending 30 September 2012

24. The Council's debt and investment position as at 30 September 2012 were as follows:

	31st March 2012	Average Rate	Average Life yrs	30 Sept 2012	Average Rate	Average Life yrs
	£M	%	Yrs	£M	%	Yrs
Fixed Rate Funding						
- PWLB	218.5	4.09	39.1	218.5	4.09	38.7
- Market	131.8	4.65	35.4	131.8	4.65	34.9
Total Debt	**350.3**	**4.30**	**37.8**	**350.3**	**4.30**	**37.3**
Investments:						
- In-House	89.3	1.65	219 days	112.3	1.73	198 days
Total Investments	**89.3**			**112.3**		

Investments

25. The Council manages its investments in-house and invests with the institutions listed in the Council's approved lending list. The Council permits investments for a range of periods from overnight to three years, dependent on the Council's cash flows, its interest rate view and the interest rates on offer, although the average duration is less than a year.

26. A total of £112.3m (£118.3 million as at Sept 2011) investments were placed on deposit as at 30 September 2012.

27. The table below sets out the position as at 30 September 2012.

	2011/12 Sept 2011		2011/12 March 2012		2012/13 Sept 2012	
	£m	%	£m	%	£m	%
Specified Investments						
Banks	81.2	68.6	0.1	0.1	19.9	17.7
Building Societies	15.0	12.7	0.0		0.0	
Money Market Funds	4.1	3.5	5.7	6.4	24.6	21.9
Non –Specified Investments						
Banks	13.0	11.0	63.5	71.1	59.8	53.3
Building Societies	5.0	4.2	20.0	22.4	8.0	7.1
Total	118.3	100.0	89.3	100.0	112.3	100.0

28. A detailed analysis of the investment portfolio as at 31st October 2012 is shown on appendix 1. Balances as at the end of October rather than September (as above) has been used to highlight the impact of the change in counterparty limits discussed in paragraph 33 below.

29. The credit ratings of the main UK banks were lowered in Q4, 2011. Prior to that all the counterparties in use as at September 2011 achieved the credit quality to be classified as the more secure "specified investments" and only those investments with a maturity of over 12 months were classed as "non specified".

30. Following the changes to credit ratings at the end of 2011, only one bank in use meets the criteria for specified investments, Svenska Handelsbanken, with all the others being non specified.

31. Cabinet and Council (February 2012) (supported by GARMC) agreed to lower the long term and short term threshold for non specified investments. This enabled continued use of Lloyds, RBS, Barclays and Nationwide as counterparties. Although Santander continues to meet the same criteria, on the advice of Sector it has been suspended as a counterparty.

32. With the fall in UK base rates in 2008/09 from 5% to 0.5%, the yield on offer for short term investments plunged. Although base rates have not changed subsequently the interest rates being paid on investments have declined further in the last year as UK monetary policy has been to provide cheap funding to banks. Interest rates for money market and call accounts have fallen to as low as 0.4%. For much of 2012, Lloyds and RBS paid significantly higher rates than the other banks. Combined with the longer maturities permitted for these two banks, they attracted most new deposits in the year.

33. To take further advantage of the higher rates on offer from these two banks, an urgent Council decision was approved in October 2012 raising the limit on deposits with Lloyds and RBS from £30 million each, to 50% of total investments with each bank. The £30 million limit, in place since February 2012, was already higher than the £20 million for all other banks.

34. Following the revision to deposit limits, a further £25 million was invested with Lloyds in October and balances on call and money market accounts were switched to a higher returning RBS deposit account. By the end of November, only three counterparties will hold funds – Lloyds (including BoS), RBS and Nationwide. The latter received 2 and 3 year deposits in 2011. A listing of all new investments since April 2012 is attached (appendix 1).

35. The impact of the changes in credit ratings and counterparty limits has been a drastic reduction in the number of banks and buildings societies in the portfolio. At the start of 2008 the portfolio consisted of 18 building societies and one bank. Only one of these now qualifies as a possible counterparty. Reduced diversification of the portfolio is a concern and the increased limits for Lloyds and RBS will be kept under review in discussion with GARMC.

36. The Council remains a cautious investor placing security and liquidity considerations ahead of income generation. As mentioned above, many banks and buildings societies in which we safely invested for many years have been removed from the counterparty list and maximum maturities have been reduced from 5 years to 3 years (Lloyds and RBS) and 3 <u>months</u> for all other counterparties. These changes have restricted the opportunity to add value to the short term investment portfolio. A fresh look at the risks and rewards of investment opportunities is underway e.g. corporate bonds, reverting to 2008 counterparties and various other opportunities. It is hoped to make proposals in the next few weeks, which may help partly to address the 2013/14 budget gap

37. The performance of the investment portfolio is benchmarked on a quarterly basis by Sector both against their risk adjusted model and the returns from other local authorities. As at 30 September 2012, the average yield on the

portfolio of 1.74% exceeded the model return by 0.23%. The average for all 183 local authorities was 1.23%. These figures compares favourably with the average 3 month Libid rate of 0.67%.

38. Following the additional Lloyds deposit mentioned in paragraph 31 above, the average yield for Harrow is approximately 2.1%, This would place us around 10th (out of 183) in terms of income. The income returns across the local authorities range from circa 0.25% to 2.75%. Those with the lowest rating avoid banks and invest with Government entities. Those with the highest returns, such as Harrow, have a high allocation to the part nationalised banks, a greater proportion in funds in longer maturities and were fortunate enough to place deposits before recent interest rate declines.

Long Term Borrowing

39. Total long term debt of £350.3m at September 2012 is made up £131.8m Bank loans and £218.5m PWLB loans. The most recent borrowing (£88.5 million) was used to fund the HRA settlement payment in March 2012. The current borrowing strategy is to use investment balances to fund capital expenditure rather than take on new borrowing.

40. The table below analyses the maturity profile of borrowing. Two methods to record the maturity of lender option borrower option (LOBO) loans are shown. The lenders of LOBOs are permitted to reset interest rates five years after advancing the loan (and annually thereafter) such that the loans may have to be repaid sooner than the permitted life if rates are increased. In total there are LOBO loans outstanding of £83.8 million. The table shows LOBO's using both their final maturity (LHS) and also using the earliest date that the interest rate can be changed as the final maturity (RHS).

	upper limit	**lower limit**	**LOBO final maturity**		**LOBO interest reset date**	
Maturity structure of borrowing during 2012/13	**%**	**%**	**£m**	**%**	**£m**	**%**
under 12 months	20	0	0.0	0.0%	33.8	9.6%
12 months and within 24 months	20	0	16.0	4.6%	16.0	4.6%
24 months and within 5 years	30	0	10.0	2.9%	60.0	17.1%
5 years and within 10 years	40	10	27.0	7.7%	27.0	7.7%
10 years and above	90	30	297.3	84.9%	213.5	60.9%
Total			350.3	100.0%	350.3	100.0%

Prudential Indicators

41. Appendix 2 compares the expected outturn for the prudential indicators with prior year and that approved by February 2012 Council.

42. Capital expenditure is forecast to be £15 million below the current strategy due mainly to slippage on the schools expansion programme. It is likely that the expenditure will end the year lower, and receipts higher, impacting favourably on the prudential indicators.

43. Most of the indicators are in line or slightly better than projected at the start of the year. The one exception is the impact of the cost of debt and depreciation

(MRP) linked to new capital borrowing on council taxes and rents (table 5). The substantial increase for the General Fund is due to lower capital receipts to date, which is therefore not available to offset the cost of short life assets in the MRP calculation.

44. These variations are all discussed in more detail in individual budgetary reports.

FINANCIAL IMPLICATIONS

45. Financial matters are integral to the report.

PERFORMANCE ISSUES

46. The Council meets the requirement of the CIPFA Code of Practice for Treasury Management and therefore is able to demonstrate best practice for Treasury Management. The report above demonstrates how value for money has been achieved by maximising investment income and minimising borrowing costs, while complying with the Code and Council Policy.

ENVIRONMENTAL IMPACT

47. There is no environmental impact.

RISK MANAGEMENT IMPLICATIONS

48. Under the current economic climate there is a risk that the Council could lose its deposits due to failure of a counterparty.

Risk included on Directorate risk register? Yes
Separate risk register in place? No

Equalities implications

49. There is no direct equalities impact.

Corporate Priorities

50. This report deals with Treasury Management activity and the Prudential Code which underpin the delivery of the Council's corporate priorities.

Section 3 - Statutory Officer Clearance

Name: Julie Alderson Date: 10 January 2013	√	Chief Financial Officer
Name: Jessica Farmer Date: 11 January 2013	√	On Behalf of Monitoring Officer

Section 4: Contact details and background papers

Contact: George Bruce (Treasury & Pension Fund Manager) tel: 020-8424-1170)

Background Papers: Report to February 2012 Cabinet.