REPORT FOR: CABINET

Date:	15 December 2010
Subject:	Half Year 2010/11 Treasury Management Activity
Key Decision:	No
Responsible Officer:	Myfanwy Barrett, Corporate Director Finance
Portfolio Holder:	Bill Stephenson(Leader and Portfolio Holder for Finance and Business Transformation)
Exempt:	No
Decision subject to Call-in:	Yes
Enclosures:	Nil

Section 1 – Summary and Recommendations

This report sets out a half year summary of Treasury Management activities for 2010/11.

Recommendations:

(a) Note the half year treasury management activity for 2010/11.
(b) Recommend that the Governance, Audit and Risk Management Committee review the report.

Reason: (For recommendation)

(a) To promote effective financial management and comply with the Local Authorities (Capital Finance and Accounting) Regulations 2003 and other relevant guidance.
(b) To keep Cabinet Members informed of Treasury Management activities and performance.

Section 2 – Report

Introduction

1. The Cabinet approved a Treasury Management Strategy for 2010/11 on 11 February 2010, which complies with the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management (revised November 2009) and Prudential Code for Capital Finance.

2. 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.

3. 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 charges on loan debt with minimal risk to the Council's assets.

4. This report is the half year summary of performance on treasury management activities to 30 September 2010 and covers:
    - the half year forecast outturn position;
    - the economy in first half of 2010/11;
    - the Treasury Management activity for the period ending 30 September 2010; and
    - compliance with Prudential Indicators.

Forecast outturn Position

5. There is a forecast net surplus of £819,000 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	9,232	8,854	-378	-4.1%
Investment Income	-690	-878	-188	-27.2%
Minimum Revenue Provision	11,382	11,129	-253	-2.2%
Total	**19,924**	**19,105**	**-819**	**-4.1%**

6. The main reasons for the variations are :

    - Borrowing cost – new borrowings are lower than estimated (£20m v budget £24m and cheaper 3.5% v budget 4.75%);

    - Investment income – the additional income is due to slightly higher average balances than was anticipated; and

    - MRP – broadly in line with budget.

The Economy and Interest Rates

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

Global economy

The credit crunch storm of August 2007 eventually fed through to the near collapse of the world banking system in September 2008. This then pushed most of the major economies of the world into a very sharp recession in 2009. Many governments were forced to recapitalise and rescue their major banks and central banks precipitately cut their central bank rates to 0.10% – 1.00% in order to counter the recession. Most major economies resorted to a huge expansion of fiscal stimulus packages in 2008 and 2009 plus various measures of quantitative easing in order to promote a faster exit from recession. This, together with expenditure on direct support provided to ailing banks, has led to a rapid expansion in government debt and the total level to which such debt has risen has caused major concern in some countries. The banking crisis has therefore now mutated into a sovereign debt crisis.

This sovereign debt crisis initially peaked in May 2010, prompted in the first place by major concerns over the size of the Greek government's total debt and annual deficit. This crisis culminated in the EU and IMF putting together a huge €750bn support package in mid May in order to stem this fear of contagion. The crisis of confidence spread to Ireland and its beleaguered banks which have been crippled by a property boom turned to bust, with a further €85 billion aid package agreed in late November. Concerns have shifted to Portugal who look likely to require support, with Spain and Italy also seen as weak by financial markets and suffering ever increasing yield spreads on their debt.

So far global growth in 2010 has been robust with the outlook improving, particularly in emerging economies. Inflation, other than in the UK, is under control although further out inflation rather than deflation is seen as more likely to give rise to concern.

UK economy

Economic growth in Q2 & 3 has been higher than forecast, although expectations are for a much more anaemic growth in 2011/12. The coalition government has now put in place a quicker than expected plan to reduce the fiscal deficit within five years. The inevitable result of fiscal contraction will be major job losses during this period in the public sector. The housing sector is expected to remain weak and unemployment levels to rise.

Inflation has remained stubbornly high in 2010 with CPI at 3.2% in October but expected to fall back to and under its 2% target over the next three years. There is unlikely to be any increase in Bank Rate in 2010/11. At the present time further quantitative easing to boost growth in the economy remains a possibility if growth slows in 2011.

Markets have reacted well to the Government's fiscal reduction plans and the UK's AAA sovereign rating remains safe while sterling has stabilised against the Euro and US dollar. In fact, in recent weeks, the UK has been seen as a safe haven from the euro zone. The ten year gilt yield after reaching a peak of 4.35% on 19 February, has steadily fell to a close of day low of 2.83% on 1 September.

Looking forward

The overall balance of risks in the UK is weighted to the downside i.e. the pace of economic growth disappoints and bank rate increases are delayed and / or lower. There is an identifiable risk of a double dip recession and deleveraging creating a downward spiral of falling demand, falling jobs and falling prices and wages leading to deflation but this is considered to be a small risk. Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in this country and the high volume of debt issuance in other major western countries.

Longer term there are major uncertainties around the potential sovereign debt risks in the EU that could plunge the EU and many other western countries back into recession. Some commentators are already forecasting that the EU risks a major fracture in three to five years time between the internationally competitive countries and the uncompetitive peripheral countries which will struggle to escape a stranglehold of huge indebtedness without restructuring their debt.

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

	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14
Bank rate	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.25%	2.75%	3.00%	3.25%	3.25%
5yr PWLB rate	3.00%	3.00%	3.10%	3.20%	3.30%	3.50%	3.80%	4.10%	4.30%	4.40%	4.50%	4.70%	4.90%	5.00%
10yr PWLB rate	4.10%	4.10%	4.10%	4.20%	4.30%	4.40%	4.60%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%	5.40%
25yr PWLB rate	5.00%	5.10%	5.20%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%	5.50%	5.60%	5.70%	5.70%
50yr PWLB rate	5.10%	5.20%	5.30%	5.40%	5.40%	5.50%	5.50%	5.50%	5.60%	5.60%	5.60%	5.60%	5.70%	5.70%

9. Based on the above forecast, interest rate rises are slower than was previously forecast. The first base rate increase is expected to be in Q4 of 2011 increasing to 3.25% in Q4 of 2013. Long term PWLB rates to steadily increase to reach 5.70% by the end of 2014 due to high gilt issuance, reversal of QE and investor concerns over inflation.

Treasury Management Activity for the period ending 30 September 2010

10. The Council's debt and investment position as at 30 September 2010 was as follows:

	31st March 2010	Average Rate	Average Life yrs	30 Sept 2010	Average Rate	Average Life yrs
	£M	**%**	**Yrs**	**£M**	**%**	**Yrs**
Fixed Rate Funding						
- PWLB	130.3	4.49	33.72	130.3	4.50	33.25
- Market	111.8	4.85	36.89	131.8	4.65	36.45
Total Debt	**242.1**	**4.66**		**262.1**	**4.57**	**34.86**
Investments:						
- In-House	95.3	2.25		119.4	1.20	45 days
Total Investments	**95.3**			**119.4**		

Investments

11. 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 five years, dependent on the Council's cash flows, its interest rate view and the interest rates on offer, although the average duration is rarely more than a few months.

12. A total of £119.4m investments were placed on deposit as at 30 September 2010. The average forecast return is expected to be approximately 1.20%. This figure compares favourably with the average 7 day LIBOR rate for the first half of the year at 0.58%.

13. The table below sets out the position as at 30 September 2010.

	2009/10				**2010/11**	
	Sept 2009		**March 2010**		**Sept 2010**	
	£m	**%**	**£m**	**%**	**£m**	**%**
Specified Investments						
Banks	50.7	49.3	75.4	79.1	78.1	65.4
Money Market Funds	14.1	13.7	14.9	15.7	32.3	27.1
Non –Specified Investments						
Building Societies	38.0	37.0	5.0	5.2	9.0	7.5
Total	102.8	100.0	95.3	100.0	119.4	100.0

14. The Council also aims to achieve the optimum return on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term, and only invest with highly credit rated financial institutions.

15. Compared with 2008 and 2009, there has been a switch from loans to building societies to lending to banks and money market funds reflecting concerns with

counterparty exposures and the governments willingness to support individual financial institutions. These concerns have also been reflected in the preference for short term maturities with less than 20% of the portfolio maturing beyond 2010. During the period £23m of deposits were placed for three months, £26m for 6 months and £5m for one year to take advantage of the higher rates on offer for longer maturities.

16. There have been no changes in names on the counterparty list in the period. Following the repayment of a time deposit with Coventry Building Society. The only remaining approved building society is Nationwide, which uniquely retains top tier short term credit ratings.

17. The average interest rate of 1.20% at 30 September 2010 compares with 5.26% at 31 March 2009 and 2.25% at 31 March 2010. The fall in income reflects the decline in libor rates, which dropped from 6.05% at 30 September 2008 to 0.53% at 30 September 2009 and are currently 0.58% (all 1 month libor).

Long Term Borrowing

18. The Authorised Limit and Operational Boundary for External Debt are £296m and £274m respectively.

19. In order to fund the capital programme and to take advantage of the lower interests rates, the Treasury Management Group decided, based on the advice received from Sector, to borrow £20m Lender Option Borrower Option (LOBOs) from RBS for a period of 40 years from May 2010 at 3.5%.

20. Total long term debt of £262.1m at September 2010 is made up £131.8m Bank loans and £130.3m PWLB loans.

21. In total there are LOBO loans outstanding of £83.8 million that are shown in the table below as having maturities of between 40 and 68 years. The lenders are permitted to reset interest rates in approximately 2 to 5 years time (and annually thereafter) such that the loans may have to be repaid sooner than the permitted life.

	Upper Limit	**Lower Limit**	**Actual 30 Sept 2010**	
	%	**%**	**£m**	**%**
Under 12 Months	20	0	0.0	0.0
12 Months and under 24 Months	20	0	0.1	0.1
24 Months and within 5 years	30	0	16.1	6.1
5 years and within 10 years	40	10	32.0	12.2
10 years and above	95	30	213.9	81.6
Total			262.1	100.00

Prudential Indicators

22. The table in the following page compares the expected out-turn for the prudential indicators with prior year and that approved by February 2010 Cabinet.

23. Capital expenditure is forecast to be £32.6 million in excess of the agreed strategy of which £19.4 million is carry forward agreed at the June Cabinet. Additional expenditure of £13.2 includes £7.8 million relating to Children's services. The additional expenditure is financed from grants (£19.4 million), capital receipts (£8.7 million) and additional borrowing (£4.7 million).

24. Ratios of financing costs to revenue stream are projected to be within budget. The annual change in CFR (£43.1 million) is partly the capitalisation of leases (£19.3 million) and new external borrowing (£20 million). The remainder is internal borrowing offset by MRP charges. The impact of using longer asset lives in MPR calculations is to lower the impact of non-housing capital expenditure on council tax. The capital expenditure impact on rents in 2010/11 is due to part financing (£500,000) from revenue.

PRUDENTIAL INDICATOR	2009/10	2010/11	2010/11
	Actual	Approved	Forecast Out-turn
	£'000	£'000	£'000
Capital Expenditure			
Non - HRA	84,822	38,028	67,874
HRA	11,163	7,610	10,380
Total Expenditure	**95,985**	**45,638**	**78,254**
Funding:-			
Grants	57,638	11,329	30,761
Capital Receipts	1,314	250	8,687
Revenue Financing	0	500	500
Major Repairs Allowance	3,778	3,932	3,932
Borrowing to Fund the Capital Programme	33,255	29,627	34,374
	95,985	**45,638**	**78,254**
Ratio of financing costs to net revenue stream			
Non - HRA	8.79%	11.74%	10.99%
HRA	25.03%	29.11%	27.95%
Net borrowing requirement			
brought forward 1 April	144,667	186,999	182,054
carried forward 31 March	182,054	171,328	176,400
in year borrowing requirement	**37,387**	**-15,671**	**-5,654**
Capital Financing Requirement (CFR) as at 31 March			
Non – HRA	213,894	225,997	252,231
HRA	54,474	59,186	59,239
Total	**268,368**	**285,183**	**311,470**
Annual Change in CFR - General Fund	17,358	8,135	38,337
Annual Change in CFR - HRA	6,894	3,536	4,765
Total Annual Change in CFR	**24,252**	**11,671**	**43,102**
Incremental impact of capital investment decisions	**£ p**	**£ p**	**£ p**
Increase in council tax (band D) per annum	42.35	24.12	28.20
Increase in average housing rent per week	2.07	3.41	3.31
Authorised Limit for external debt			
Borrowing	269	296	262
Other long term liabilities	19	0	19
Total	**288**	**296**	**281**
Operational Boundary for external debt			
Borrowing	269	274	262
Other long term liabilities	19	0	19
Total	**288**	**274**	**281**
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing / investments	269	274	268
Upper limit for variable rate exposure			
Net principal re variable rate borrowing/Investments	0	115	13
Upper limit for total principal sums invested for over 364 days	7	25	8

FINANCIAL IMPLICATIONS

25. Financial matters are integral to the report.

PERFORMANCE ISSUES

26. 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

27. There is no environmental impact.

RISK MANAGEMENT IMPLICATIONS

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

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

Equalities implications

29. There is no direct equalities impact.

Corporate Priorities

30. 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: Jennifer Hydari Date: 24 November 2010	√	On Behalf of Chief Financial Officer
Name: Jessica Farmer Date: 24 November 2010	√	On Behalf of Monitoring Officer

Section 4 – Performance Officer Clearance

Name: David Harrington Date: 19 November 2010	√	On behalf of the Divisional Director, Partnership Development and Performance

Section 5 – Environmental Impact Officer Clearance

Name: John Edwards Date: 24 November 2010	√	Divisional Director (Environmental Services)

Section 6: Contact details and background papers

Contact: Jennifer Hydari, Divisional Director Finance and Procurement
Tel: 020-8424-1393

Background Papers:
Report to February 2010 Cabinet.
http://www.harrow.gov.uk/www2/mgConvert2PDF.aspx?ID=4534&T=10

Call-In Waived by the Chairman of Overview and Scrutiny Committee	**NOT APPLICABLE**