REPORT FOR: CABINET

Date:	15 December 2011
Subject:	Half Year 2011/12 Treasury Management Activity
Key Decision:	Yes
Responsible Officer:	Julie Alderson, Interim Director Finance
Portfolio Holder:	Councillor Bill Stephenson, Leader and Portfolio Holder for Finance and Business Transformation
Exempt:	No
Decision subject to Call-in:	Yes, except for the Recommendation to Council
Enclosures:	Appendix 1 - Creditworthiness and Counterparty Policy

Section 1 – Summary and Recommendations

This report sets out a half year summary of Treasury Management activities for 2011/12. Changes are proposed to the external debt limits and counterparty policy.

Recommendation

(a) Note the half year treasury management activity for 2011/12.
(b) Recommend the Council approve the revised counterparty policy for investments shown in appendix 1.
(c) Recommend the Council approve the increase in authorised limit (£378m) and operational boundary (£366m) for external debt
(d) Recommend that the Governance, Audit and Risk Management Committee review the report.

Reason

(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 2011/12 on 10 February 2011, 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.

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 2011 and covers:
   - the half year forecast outturn position;
   - the economy in first half of 2011/12;
   - the Treasury Management activity for the period ending 30 September 2011; and
   - compliance with Prudential Indicators.

Forecast outturn Position

5. There is a forecast net surplus of £441,000 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	8,906	9,238	332	3.7%
Investment Income	-498	-1,153	-655	-132%
Minimum Revenue Provision	11,847	11,729	-118	-1.0%
Total	**20,255**	**19,814**	**-441**	**-2.2%**

6. 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 their share of 'internal' borrowings;

   - Investment income – the additional income is due to slightly higher investment balances than was anticipated and from the average interest rate of 1.65% exceeding the budget of 0.75%; and

   - MRP – Is 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

8. 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. At the time of writing, EU Governments together with the ECB and IMF were negotiating a solution involving Greek debt write downs, bank recapitalisation and further support to the European financial stability facility.

9. Euro concerns coupled with political difficulties in the US over the size and control of 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.

10. 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, and despite recent partial recovery are well below 2011 highs.

UK economy

11. Following zero growth in the final half of 2010/11 the UK economy grew by a weaker than expected 1.1% in the first nine months of 2011. 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.

12. The announcement by the MPC on 6 October of a second round of quantitative easing 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.

13. 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.

Looking forward

14. There remain huge uncertainties in economic forecasts due to the following major difficulties:

- the increase in risk that the UK, US and 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, and
- the speed of recovery of banks' profitability and balance sheet imbalances and the risk of substantial losses being incurred on EU sovereign debt.

15. The overall balance of risks is weighted to the downside. 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, but more positively also keep new borrowing costs low.

16. 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.

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

	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**
BANK RATE	0.50	0.50	**0.50**	0.50	0.50	0.50	**0.50**	0.50	0.75	1.00	**1.25**	1.50	2.00	2.25	**2.50**
3 month LIBID	0.75	0.70	**0.70**	0.70	0.70	0.70	**0.75**	0.80	0.90	1.20	**1.40**	1.60	2.10	2.40	**2.60**
6 month LIBID	1.00	1.00	**1.00**	1.00	1.00	1.00	**1.10**	1.20	1.40	1.60	**1.80**	2.00	2.50	2.70	**2.90**
12 month LIBID	1.50	1.50	**1.50**	1.50	1.50	1.60	**1.70**	1.80	1.90	2.20	**2.40**	2.60	3.10	3.20	**3.30**
5 yr PWLB	2.30	2.30	**2.30**	2.30	2.30	2.40	**2.50**	2.60	2.70	2.80	**2.90**	3.10	3.30	3.50	**3.70**
10 yr PWLB	3.30	3.30	**3.30**	3.30	3.40	3.40	**3.50**	3.60	3.70	3.80	**4.00**	4.20	4.40	4.60	**4.80**
25 yr PWLB	4.20	4.20	**4.20**	4.20	4.30	4.30	**4.40**	4.50	4.60	4.70	**4.80**	4.90	5.00	5.10	**5.20**
50 yr PWLB	4.30	4.30	**4.30**	4.30	4.40	4.40	**4.50**	4.60	4.70	4.80	**4.90**	5.00	5.10	5.20	**5.30**

18. Based on the above forecast, interest rate rises are again slower than was previously forecast. The first base rate increase is expected to be in Q3 of 2013 increasing thereafter to 2.50% in Q1 of 2015. Long term PWLB rates are projected to steadily increase to reach 5.30% by Q1 of 2015 due to high gilt issuance and the reversal of QE.

Treasury Management Activity for the period ending 30 September 2011

19. The Council's debt and investment position as at 30 September 2011 were: as follows:

	31st March 2011	Average Rate	Average Life yrs	30 Sept 2011	Average Rate	Average Life yrs
	£M	%	Yrs	£M	%	Yrs
Fixed Rate Funding						
- PWLB	130.0	4.50	32.8	130.0	4.50	32.3
- Market	131.8	4.65	36.4	131.8	4.65	35.9
Total Debt	**261.8**	**4.57**	**34.6**	**261.8**	**4.57**	**34.1**
Investments:						
- In-House	112.8	1.30	219 days	118.3	1.69	224 days
Total Investments	**112.8**			**118.3**		

Investments

20. 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 less than a year.

21. A total of £118.3m investments were placed on deposit as at 30 September 2011. The average interest rate being earned on balances as at 30 September 2011 was 1.69%. This figure compares favourably with the average 3 month Libid rate of 0.72%.

22. The table below sets out the position as at 30 September 2011.

	2010/11				2011/12	
	Sept 2010		March 2011		Sept 2011	
	£m	%	£m	%	£m	%
Specified Investments						
Banks	68.1	57.0	77.1	68.4	81.2	68.6
Building Societies	19.0	15.9	10.0	8.9	15.0	12.7
Money Market Funds	32.3	27.1	7.7	6.8	4.1	3.5
Non –Specified Investments						
Banks			13.0	11.5	13.0	11.0
Building Societies			5.0	4.4	5.0	4.2
Total	119.4	100.0	112.8	100.0	118.3	100.0

23. 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.

24. Compared with 2010, there has been a reduction in use of low yielding but highly liquid money market funds in favour of term deposits with UK high street banks in order to capture the higher yields for longer dated maturities. With a

limit of £25 million on deposits with maturities over 12 months, most deposits are placed for twelve months in such a way as to ensure regular redemptions. Five counterparties – Lloyds Group, RBS, Barclays, Santander UK and Nationwide account for 91% of deposits at 30th September 2011. New investments in the last six months were valued at £44 million (£5 million for 6 months, £34 million for 12 months, £2 million for 24 months and £3 million for 36 months).

25. The average interest rate of 1.69% as at 30 September 2011 compares favourably with the average rate of 1.30% at March 2011 and 1.20% at 30 September 2010, reflecting the longer average maturity of the portfolio as shown in paragraph 19. A year ago the average maturity was 45 days as little in the way of longer dated deposits had been completed. Interest income remains considerably below the 5.3% earned in 2009 reflecting the decline in interest rates, which dropped from 6.05% at 30 September 2008 to 0.58% at 30 September 2010 and are currently 0.69% (all 1 month libor).

Creditworthiness and Counterparty Policy

26. The creditworthiness and counterparty policy is approved annually by Council. The currency policy is attached (appendix 1). The current counterparties in use are:

- Royal Bank of Scotland [The Council's bankers]
- Lloyds / HBOS
- Santander UK
- Nationwide Buildings Society
- Barclays
- Svenska Handelsbanken
- Money Market Funds [all AAA rated]

27. The first four listed above were down graded in October 2011 and no longer meet the required credit quality. No new deposits are being placed with these banks and maturing deposits are being recalled and invested mainly in money market funds. These banks are the most active in the UK for sterling deposits, particularly long term, and offer significantly higher rates than the DMO or Local Authorities.

28. The Council's treasury advisor, Sector, provides recommended maximum maturities for major UK and overseas banks. These are based on current credit ratings adjusted for impending reviews and for UK banks range from 0 months (no deposits) to 24 months. Sector further refines the maximum maturities by factoring in the implied ratings from credit default spreads. The adjusted maximum maturity recommendation for Harrow's current counterparties are:

12 months – RBS & Lloyds/HBOS
3 months – Barclays, Santander UK, Nationwide & Svenska

29. Sector have advised that they would be content for the maximum maturities of the part nationalised banks (Lloyds/BoS & RBS) to be extended for 2-3 years and for up to 30% of the deposits to be invested with each bank. Sector sees these banks as UK Government risk rather than pure banking risks.

30. The Counterparty Policy was discussed with GARMC on 1st December 2011 who agreed that the policy should be amended in line with the Sector guidance. The revised counterparty policy is attached at appendix 1. Maximum maturities for the Council's banks will be limited to 36 months for the nationalised banks and three months for all other counterparties and only extended with the approval of Cabinet.

31. A weakening of the required long and short term ratings has been balanced by shorter maximum maturities and higher support ratings. The revised policy maintains an appropriate balance between security, liquidity and yield, with an emphasis on the first two. An overly cautious approach would significantly impact on the investment income earned. For example, the difference in annual income between a money market account and a 2 year deposit with RBS is 2.65% i.e. £265,000 of annual interest on £10 million invested.

Long Term Borrowing

32. Total long term debt of £261.8m at September 2010 is made up £131.8m Bank loans and £130.0m PWLB loans. There has been no new borrowing since May 2010 in accordance with the borrowing strategy, which is to reduce temporary investment balances rather than take on new borrowing.

33. As part of the Housing finance reforms, Harrow Council is required to pay the Government £89 million on 28 March 2012. The current expectation is that the full value of the payment to the Government will be funded by new fixed rate long term borrowing from the PWLB. Currently, 50 year PWLB debt for HRA settlement purposes is anticipated to cost 3.6% compared with the average rate on existing debt of 4.6%. Initially, consideration was given to partially using investment cash balances to fund part of the HRA settlement. However, given the attractiveness of PWLB rates for settlement purposes, the optimum long term financial position of the Council will benefit from fully funding the payment from the PWLB.

34. Modelling the options for sharing the cost of debt servicing between the General Fund and HRA indicate that retaining a single debt pool is the optimum arrangement for the Council.

35. The Authorised Limit and Operational Boundary for External Debt are £289m and £277m respectively as approved at February 2011 Council. In the table below, both of these have been increased by £89 million to reflect the additional HRA borrowing as discussed in paragraph 33. Approval for the increased debt limits is requested.

36. 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 one to five 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 2011	
	%	%	£m	%
Under 12 Months	20	0	0.0	0.0
12 Months and under 24 Months	20	0	0.0	0.0
24 Months and within 5 years	30	0	16.0	6.1
5 years and within 10 years	40	10	32.0	12.2
10 years and above	95	30	213.8	81.7
Total			261.8	100.00

Prudential Indicators

37. The table on the following page compares the expected out-turn for the prudential indicators with prior year and that approved by February 2011 Council. The Out-turn indicators will be updated prior to Council submission in light of the impact of the ongoing review of capital expenditure plans.

38. Capital expenditure is forecast to be £4.9 million in excess of the agreed strategy, mainly due to additional housing related expenditure of £4 million. A shortfall in capital receipts has been offset by higher anticipated grants. The projected out-turn as detailed in the Revenue and Capital Monitoring Report for Quarter 2 elsewhere on the Agenda probably overestimates capital expenditure as gross to date is under £20 million.

39. The ratios of financing costs to revenue stream are projected to be marginally below budget due to higher investment income.

40. Net debt is projected to increase by a modest £4.1 million despite the significant net borrowing of £27 million in the year. The annual change in CFR (£16.6 million) represents capital expenditure after deduction of grants and receipts (£27.2 million) less MRP charged in year (£10.6 million).

41. The increase in the incremental impact of capital expenditure on Council tax is due to increases in MRP compared with both budget and prior year. For Housing, both higher capital expenditure and increased MRA is responsible for the increased impact.

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

PRUDENTIAL INDICATOR	2010/11	2011/12	2011/12
	Actual	Approved	Forecast Out-turn
	£'000	£'000	£'000
Capital Expenditure			
Non - HRA	52,645	45,175	46,065
HRA	5,302	6,360	10,322
Total Expenditure	**57,947**	**51,535**	**56,387**
Funding:-			
Grants	26,101	10,550	17,682
Capital Receipts	5,462	12,789	7,311
Revenue Financing	290	0	0
Major Repairs Allowance	3,932	4,148	4,148
Borrowing	22,162	24,048	27,246
	57,947	**51,535**	**56,387**
Ratio of financing costs to net revenue stream			
Non - HRA	12.95%	11.67%	11.29%
HRA	24.82%	24.76%	23.75%
Net borrowing requirement			
brought forward 1 April	182,054	203,192	195,898
carried forward 31 March	195,898	218,531	200,046
in year borrowing requirement	**13,844**	**15,339**	**4,148**
Capital Financing Requirement (CFR) as at 31 March			
Non – HRA	251,470	254,866	262,467
HRA	55,197	58,589	60,805
Total	**306,667**	**313,455**	**323,272**
Annual Change in CFR - General Fund	13,037	2,117	10,997
Annual Change in CFR - HRA	710	1,012	5,608
Total Annual Change in CFR	**13,747**	**3,129**	**16,605**
Incremental impact of capital investment decisions	**£ p**	**£ p**	**£ p**
Increase in council tax (band D) per annum	31.64	53.65	65.54
Increase in average housing rent per week	0.70	1.02	1.70
Authorised Limit for external debt			
Borrowing	262	378	351
Other long term liabilities	26	20	26
Total	**288**	**398**	**377**
Operational Boundary for external debt			
Borrowing	262	366	351
Other long term liabilities	26	20	26
Total	**288**	**386**	**377**
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing	262	386	351
Upper limit for variable rate exposure			
Net principal re variable rate borrowing	0	100	0
Upper limit for principal sums invested over 364 days	18	25	25

FINANCIAL IMPLICATIONS

43. Financial matters are integral to the report.

PERFORMANCE ISSUES

44. 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

45. There is no environmental impact.

RISK MANAGEMENT IMPLICATIONS

46. 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

47. There is no direct equalities impact.

Corporate Priorities

48. 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: 28 November 2011	√	Chief Financial Officer
Name: Jessica Farmer Date: 28 November 2011	√	On Behalf of Monitoring Officer

Section 4 – Performance Officer Clearance

Name: David Harrington Date: 28 November 2011	√	on behalf of Divisional Director, Partnerships, Development & Performance

Section 5 – Environmental Impact Officer Clearance

Name: John Edwards Date: 28 November 2011	√	Divisional Director (Environmental Services)

Section 6: Contact details and background papers

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

Background Papers: Report to February 2011 Cabinet.

Call-In Waived by the Chairman of Overview and Scrutiny Committee	**NOT APPLICABLE** *[Call-in applies except to the Recommendation to Council and where the decision is for noting only]*

Creditworthiness and Counterparty Policy
(Approved Cabinet February 2011)

23. Investment instruments identified for use in the financial year are listed below under the 'Specified' and 'Non-Specified' Investments categories.

24. Counterparty limits are approved by the Section 151 Officer in accordance with the Council's Treasury Management Practices. At present, each approved counterparty has a £20 million limit, which is further restricted to a group limit of £30 million e.g. Lloyds / HBOS.

25. Specified investments are considered low risk and relate to funds invested for up to one year. Non-Specified investments sometimes offer the prospect of higher returns but carry a higher risk and may have a maturity beyond one year. All investments and borrowing are sterling denominated.

<u>Specified Investments</u>

26. All such investments will have maturities up to maximum of 1 year, meeting the minimum rating criteria where applicable. The instruments and credit criteria to be used are set out in the table below.

Instrument	**Minimum Credit Criteria**	**Use**
Debt Management Agency Deposit Facility	Government backed	In-house
Term deposits – other LAs	Local Authority issue	In-house
Term deposits – banks and building societies	AA- Long Term F1+Short-term 2 Support B Individual AAA Sovereign	In-house
UK Nationalised banks	F1+ Short-term 1 Support	In-house
Money Market Funds	AAA	In-house

<u>Non-Specified Investments</u>

	Minimum Credit Criteria	**Use**	**Max % of total investments**	**Max. maturity period**
Term deposits – banks and building societies	AA- Long Term F1+ Short-term 2 Support B Individual AAA Sovereign	In-house	50%	5 yrs
Callable Deposits	F1+ Short term A Long Term	In-house	20%	5 yrs

27. All credit ratings will be monitored in house with the help of Sector who alert the Council to changes in Fitch ratings through its creditworthiness service. Opportunities to use credit default swap costs and other financial information to anticipate changes in credit quality are being considered.

28. If a downgrade results in the counterparty no longer meeting the Council's minimum criteria, its further use as an investment will be withdrawn immediately.

Proposed Revised Counterparty Policy

Specified Investments

29. All such investments will have maturities up to maximum of 1 year, meeting the minimum rating criteria where applicable. The instruments and credit criteria to be used are set out in the table below.

Instrument	**Minimum Credit Criteria**	**Use**
Debt Management Agency Deposit Facility	Government backed	In-house
Term deposits – other LAs	Local Authority issue	In-house
Term deposits – banks and building societies	AA- Long Term F1+Short-term 2 Support B Individual AAA Sovereign	In-house
Money Market Funds	AAA	In-house

Non – specified Investments

	Minimum Credit Criteria	**Use**	**Max % of total investments**	**Max. maturity period**
Term deposits – banks and building societies	**A** Long Term **[AA-]** **F1** Short-term **[F1+]** **1** Support **[2]** B Individual **UK** or AAA Sovereign	In-house	50%	3 months [5 years]
UK nationalised Banks [RBS & Lloyds / HBOS]	**F1** Short-term **[F1+]** **1** Support **[2]**	In-house	30% for each of the two Groups	36 months
Callable Deposits	**F1** Short term **[F1+]** A Long Term **1 Support**	In-house	20%	3 months [5 years]

Ratings in bold have been altered. Those in [ ] are the current approved policy.