Mole Valley District Council

Agenda Item 8(i)

Report considered by the Audit Committee on 29th November 2012

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Subject	Treasury Management – Mid Year Monitoring Report – 2012/13.

RECOMMENDATIONS

The Committee is asked to:

1) Receive and note the Treasury Management Mid Year Monitoring Report for the period ended 30th September 2012.
2) Recommend to Council that the Authorised Limit be increased to £5.5m and that the Operational Boundary is increased to £4m. Paragraphs 4.7 and 4.8 give more detail behind these amended treasury prudential indicators.
3) Commend the report to Council, making any relevant recommendations and observations as Members see fit.

SUMMARY

This report outlines the performance of the Treasury Management function of the Council for the six months ending 30th September 2012. It provides an update on the current economic conditions affecting Treasury Management decision making and looks ahead to future reporting requirements.

The key points to note are:

- All treasury related transactions were undertaken by authorised officers and within the limits approved by the Council
- All investments were to counterparties on the approved lending list
- The Council operated within the Prudential Indicators for Treasury Management
- Changes to the Treasury Management Strategy are shown in the body of the report.

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011 has been adopted by the Council. The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management

function.

- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by Council of an annual Treasury Management Strategy Statement – including the Annual Investment Strategy and Minimum Revenue Provision Policy – for the year ahead, a **Mid-year Review Report** and an Annual Report covering activities during the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Audit Committee.

This report meets that requirement. It also incorporates the needs of the Prudential Code to ensure adequate monitoring of the capital expenditure plans and the Council's prudential indicators (PIs). The Treasury Management Strategy and PIs were previously reported to Audit Committee on 24th January 2012 and Council on 21st February 2012.

1. **Background**

1.1 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operation ensures that this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering maximising investment return.

1.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

1.3 As a consequence treasury management is defined as:
"The management of the local authority's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

1.4 The report updates members on treasury management activities in the period to 30th September 2012 and covers:

- The general economic background
- Update on amendments to the Treasury Management Strategy
- Compliance with approved policies, practices and regulatory requirements

2. Economic Background

2.1 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.

2.2 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.

2.3 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 at 2.2% in September), UK GDP fell by 0.4% 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% below its peak in 2008.

2.4 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.

2.5 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.

Sector's outlook for the next six months of 2012/13

2.6 Sector is the Council's treasury management advisors.

- 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 presidential election in November will remedy this deadlock is debatable but urgent action will be required early in 2013 to address the US debt position. However, on 13th 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 (currently 0.25%).

- Eurozone 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 yet another (third) bail out. There is the distinct possibility that some of the northern European countries could push for the ejection of Greece from the Eurozone 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 European Central Bank (ECB) announced that it would purchase unlimited amounts of shorter term bonds of Eurozone 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 (IMF). 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.

- 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 is likely to be hampered in promoting growth by the requirement of maintaining austerity measures to tackle the budget deficit.

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

- Sector expects low growth in the UK to continue, with the 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 Public Works Loans Board (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 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.

2.7 Sector has provided the following forecast of interest rates:

	17.09.12 actual	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	0.50	0.75	1.00
3m LIBID	0.55	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	0.85	1.00	1.10	1.30	1.50	1.80
12m LIBID	1.30	1.30	1.30	1.30	1.40	1.50	1.70	1.90	2.10	2.30	2.60
5yr PWLB	1.89	1.50	1.50	1.50	1.60	1.70	1.80	1.90	2.00	2.10	2.30
10yr PWLB	2.91	2.50	2.50	2.50	2.60	2.70	2.80	2.90	3.00	3.20	3.30
25yr PWLB	4.15	3.70	3.70	3.70	3.80	3.80	3.90	4.00	4.10	4.20	4.30
50yr PWLB	4.32	3.90	3.90	3.90	4.00	4.00	4.10	4.20	4.30	4.40	4.50

LIBID – London Interbank Bid rate (investment rates)

PWLB – Public Works Loans Board rate (borrowing rates)

The above Sector forecasts for PWLB rates incorporate the introduction of the **PWLB certainty rate** in November 2012 which will reduce PWLB borrowing rates by 0.20% for most local authorities. The actual PWLB rates on 17.9.12 ought therefore to be reduced by 20bps to provide a true comparison to the forecasts.
(Gilt yields have also risen significantly after the recent ECB bond buying policy announcement but Sector feel that yields are likely to fall back after this initial bounce.)

3. Amendments to the Treasury Management Strategy

3.1 The report is structured to highlight the key changes to the Council's capital activity (the prudential indicators (PIs)), the economic outlook and the actual and proposed treasury management activity (borrowing and investment).

3.2 The original Treasury Management Strategy for 2012/13 was approved by the Council on 21st February 2012. This was subject to revision during the year due to Moody's (credit rating agency) on 22nd June downgrading fifteen banks. UK banks RBS, Barclays and HSBC were among the names downgraded (Lloyds were also affected but dealt with separately).

3.3 The agency said that “All of the banks affected by today's actions have significant exposure to the volatility and risk of outsized losses inherent to capital markets activities". Whilst recognising "the clear intent of governments around the world to reduce support for creditors" the framework was not in place by which they would allow a bank to fail. The move will make raising funds less easy to access through the markets and may offer a further explanation for the actions taken by the Bank of England and Government. The cheap availability of funds should reduce the pressure on UK banks in the market.

3.4 The downgrading has not adversely affected Mole Valley’s ability to invest funds, with one exception. The downgrading of Royal Bank of Scotland’s (RBS) short-term rating from P-1 to P-2 has meant that this bank was removed from the investment counterparty list. This effectively left the Authority in a state of technical breach with the current Treasury Management Strategy. One of the parameters in the Strategy states that counterparties must have a short-term rating of ‘P-1’.

3.5 A view was taken that the downgradings had little to do with a worsening of the long term viability of these banks but rather acknowledges central government's policy of diminished financial support. It was concluded that RBS be retained on the counterparty list, recognising that if we were to remove them, it would mean that we would not have enough counterparties to effectively manage our investment portfolio. This could result in lower interest returns for the Council.

3.6 For information Moody’s short-term ratings are defined as follows;
Prime-1 (P-1) – Best ability to repay short-term debt.
Prime-1/Prime-2 (P-1/P-2) – Best ability or high ability to repay short term debt.
Prime-2 – (P-2) – High ability to repay short term debt.

3.7 Such issues have arisen in the past and it was agreed by Council (21/02/12) ‘That if any urgent and immediate changes to the Treasury Management (TM) Strategy are required they will be delegated to the Strategic Director (Section 151 Officer) in consultation with the Portfolio Holder for Finance and Chairman of Audit Committee. If all are in agreement the TM Strategy and Treasury Management Practices (TMP’s) will be modified to reflect this change. Ultimately any change will be ratified at the next available Council meeting after having been considered at the first available meeting of the Audit Committee’.

3.8 The appropriate agreement has been given as identified in paragraph 8.9 above. Agreement to amending the Treasury Management Strategy to reflect the change in short-term rating for counterparties from P-1 to P-2 was given at Audit Committee on 27th September and this was recommended to Council (04/12/12).

3.9 Amendment to the Authority’s Authorised Limit and Operational Boundary is required. This is covered in more detail in paragraphs 4.7 and 4.8.

4. Compliance with Approved Policies, Practices and Regulatory Requirements

Key Prudential Indicators

4.1 This part of the report is structured to update:

- The Council's capital expenditure plans
- How these plans are being financed
- The impact of the changes in the capital expenditure plans on the PIs and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity

4.2 Prudential Indicators for 2012/13 were set in accordance with the Prudential Code and the Treasury Management Code of Practice and were approved by Council on 21st February 2012. These Prudential Indicators and the actual performance against them are set out below:

Capital Expenditure and the Financing of the Capital Programme

4.3 The table below draws together the main strategy elements of the capital expenditure plans and the expected financing arrangements of this capital expenditure.

Capital Expenditure	**2012/13 Original £m**	**2012/13 Updated £m**	**2013/14 Estimate £m**	**2014/15 Estimate £m**	**2015/16 Estimate £m**
Capital Expenditure	4.668	5.735	3.890	2.825	2.590
Financed by:					
Capital receipts	3.872	4.667	3.370	2.305	2.070
Government grants	0.270	0.442	0.270	0.270	0.270
Other grants and conts.	0.526	0.626	0.250	0.250	0.250
Revenue	0	0	0	0	0
Net financing need for the year	0	0	0	0	0

Capital Financing Requirement (CFR) and Minimum Revenue Provision (MRP)

4.4 The CFR reflects the underlying need to finance capital expenditure by borrowing or other long-term liability arrangements. Other long-term liabilities include credit arrangements associated with finance leases. The CFR will increase whenever capital expenditure is incurred. If this expenditure is resourced immediately then there is a zero net increase in the CFR. If this expenditure is not immediately resourced then the CFR of the authority will increase. A positive CFR indicates a borrowing requirement which will incur a MRP or statutory repayment of principal and interest from the general fund.

4.5 The latest CFR projections are:

	2012/13 Original £m	2012/13 Revised £m	2013/14 Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m
Capital Financing Requirement (CFR)	3.343	3.512	3.262	3.012	2.512

Borrowing

4.6 There is no requirement to borrow to fund the capital programme in 2012/13 and as such any borrowing during the year would be on a short-term basis and for the purposes of cash flow management only. There has been no requirement for any short-term borrowing during the first half of the year.

Prudential Indicators for Borrowing:

Borrowing Limits

4.7 The Authorised Limit is the 'Affordable Borrowing Limit' required by Section 3 of the Local Government Act 2003 irrespective of its indebted status. The introduction of International Financial Reporting Standards (IFRS) required finance leases to be included under other long-term liabilities on the balance sheet. The Treasury Management Strategy agreed by Council on 21st February 2012 included for an Authorised Limit of £2,000,000. In light of the requirement to include finance lease within this figure a revised Authorised Limit for external debt of £5,500,000 is proposed. The cost of finance leases in 2011/12 amounted to £3.8m.

4.8 The Operational Boundary is the expected borrowing position of the Council during the year and periods where the actual position is either below or over the Operational Boundary is acceptable subject to the Authorised Limit not being exceeded. The Treasury Management Strategy agreed by Council on 21st February 2012 included for an Operational Boundary of £500,000. In light of the requirement to include finance lease within this figure a revised Operational Boundary for external debt of £4,000,000 is proposed. The cost of finance leases in 2011/12 amounted to £3.8m.

4.9 Actual borrowing 1st April – 30th September 2012

Maximum external borrowings at any one time	0
Total borrowings during period	0
Debt repaid during period	0

4.10 Actual External Debt

Actual borrowing as at 30th September 2012	0
Actual other long term liabilities at 30th September 2012	0
Actual external debt as at 30th September 2012	0

4.11 NB – borrowing limits set out how much the Council is able to borrow at any one time. The Authorised Limit is the maximum amount of borrowing allowed whereas the Operational Boundary is the most likely requirement. It is permissible for the Council to exceed the Operational Boundary on occasion but not to exceed the Authorised Limit without approval from Council.

4.12 Interest Rate Exposure on Borrowing

Upper limit for fixed interest rate exposure	0%
Upper limit for variable interest rate exposure	0%

4.13 Actual Performance

Proportion of interest paid at fixed rates	0%
Proportion of interest paid at variable rates	0%

4.14 Maturity Structure of Borrowings

Upper limit (under 12 months)	0%
Lower limit (under 12 months)	0%

4.15 Actual Performance

Upper limit (under 12 months)	0%
Lower limit (under 12 months)	0%

4.16 The table below shows the impact of debt and investments on the revenue budget.

	2011/12 Actual £000	**2012/13 Estimate £000**	**2012/13 Estimate 30/09/11 £000**	**2013/14 Estimate £000**	**2014/15 Estimate £000**
Interest on borrowing	0	0	0	0	0
Interest on investments	378	307	360	339	517

Investment Strategy

4.17 The objectives of the Council's investment strategy are safeguarding the re-payment of the principal and interest of its investments on time, the liquidity of those sums, with the investment return being the final objective.

4.18 The Council's in-house investment team manages an investment portfolio of between £20 and £35 million. The opening and closing balances on the Council's investment portfolio for the first half of 2012/13 are as follows:

	Investments at 01/04/2012 £	Investments at 30/09/2012 £
Temporary investments	16,655,000	25,000,000
Long-term investments	4,000,000	4,000,000
Total investments outstanding	20,655,000	29,000,000

4.19 The constituent parts of the investment position as at 30th September 2012 are:

Sector	Country	Up to 1 year £	1 - 2 years £	2 – 3 years £	3 - 5 years £
Banks	UK	20,000,000	2,000,000	2,000,000	0
Building Societies	UK	5,000,000	0	0	0
Total		**25,000,000**	**2,000,000**	**2,000,000**	**0**

Prudential Indictors for Investments

4.20 Maximum principal sums limit for investments for periods longer than 364 days maturing in:

2012/13	5,000,000
2013/14	5,000,000
2014/15	5,000,000
2015/16	5,000,000

4.21 Actual Performance (as at 30/09/12)

Matured or maturing within 2012/13	0
Maturing in 12 to 24 months (2013/14)	2,000,000
Maturing in 24 to 36 months (2014/15)	0
Maturing in 36 to 48 months (2015/16)	2,000,000

4.22 Interest Rate Exposure on Investments

Upper limit for fixed interest rate exposure	100%
Upper limit for variable interest rate exposure	17%

4.23 Actual Performance

Proportion of interest paid at fixed rates (April – September 2012)	100%
Proportion of interest paid at variable rates (April – September 2012)	7%

4.24 All of the Council's investments were placed with organisations approved in the Annual Treasury Management Strategy for 2012/13 and in accordance with the Prudential Indicators set out in that Strategy and with the Treasury Management Code of Practice.

4.25 Risk Benchmarking

A regulatory development is the consideration and approval of security and liquidity benchmarks. Yield benchmarks are currently widely used to assess investment performance. Discrete security and liquidity benchmarks are fairly new requirements to Member reporting, although the application of these is more subjective in nature. These were first set in the Treasury Strategy Report 26th January 2010 (Scrutiny and Audit Committee).

The following reports the current position against the benchmarks originally approved.

4.26 Security

The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, was set as follows:

0.08% historic risk of default when compared to the whole portfolio.

The Strategic Director (Section 151 Officer) can report that the investment portfolio was maintained within this overall benchmark during this year to date.

4.27 Liquidity

In respect of this area the Council set liquidity facilities/benchmarks to maintain:

- Bank overdraft - £500,000
- Liquid short term deposits of at least £2m available immediately.

The Strategic Director (Section 151 Officer) can report that liquidity arrangements were satisfactory during the year to date.

Yield - Local measures of yield benchmarks are:

- Investments – Internal returns above the 7 day LIBID rate

Based on the Authority's minimum long-term credit rating of A the security benchmarks for each individual year were set as:

Benchmarks	1 year	2 years	3 years	4 years	5 years
Maximum (01/04/12)	0.08%	0.22%	0.37%	0.52%	0.70%
Maximum (30/09/12)	0.08%	0.22%	0.37%	0.52%	0.70%

Since the benchmarks were first included in the Strategy our advisors have received more up to date default information, which reflects increased counterparty defaults during the banking crisis. The table shows how the Council is benchmarking risk.

The Strategic Director (Section 151 Officer) can report that these benchmarks were not breached during the year to date.

Note: The benchmarks are an average risk of default measure, and would not constitute an expectation of loss against a particular investment. Where a counterparty is not credit rated a proxy rating will be applied.

5. Corporate Implications

5.1 Legal Implications

The Council's treasury management activities are regulated by a variety of professional codes, statutes and guidance:

- The Local Government Act 2003 (the 2003 Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity.
- The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing

which may be undertaken (no restrictions were made in the first six months of 2012/13).

- Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act.
- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA *Prudential Code for Capital Finance in Local Authorities.*
- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services.
- Under the Act the DCLG has issued *Guidance on Local Government Investments* to structure and regulate the Council's investment activities. Updated guidance became available on 1st April 2010.

The Council has complied with all of the above relevant statutory and regulatory requirements that limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

5.2 **Financial and Risk Implications**

Too high a reliance on investment income can place the Council at significant risk of budget variation as interest rates rise and fall which has a knock-on impact upon future Council Tax levels. The Council's Medium Term Financial Strategy addresses this risk and seeks to reduce this reliance over time.

Security of capital is cited in the Financial Services risk register (FIN 13) and this is mitigated by use of counterparty credit security ratings. The lowering of these ratings increases risk. It is felt that a credit rating of A is acceptable for the Council's risk profile (being 'top six' out of a possible 28 ratings) and represents upper quartile performance. Officers will also use supplementary credit information to monitor investment counterparties.

5.3 **Equalities Implications**
None within the report

5.4 **Employment Issues**
None within the report

5.5 **Sustainability Issues**
None within the report

5.6 **Consultation**
The Council is in regular contact with Sector, the Council's appointed Treasury Management advisor. Meetings have been convened during the first half-year involving Sector, Officers and Members.

6. **BACKGROUND PAPERS :** Performance management information from Sector.

Appendix A – Hierarchy of Counterparty Security Ratings

Short Term		
Fitch	**Moody's**	**S&P**
F1+	P-1	A-1+
F1		A-1
F2	P-2	A-2
F3	P-3	A-3
B		B
C		C
D		D

Long Term			Description
Fitch	**Moody's**	**S&P**	(AAA = highest, D = lowest)
AAA	Aaa	AAA	Highest security
AA+	Aa1	AA+	
AA	Aa2	AA	
AA-	Aa3	AA-	
A+	A1	A+	
A	A2	A	
A-	A3	A-	
BBB+	Baa1	BBB+	
BBB	Baa2	BBB	
BBB-	Baa3	BBB-	
BB+	Ba1	BB+	
BB	Ba2	BB	
BB-	Ba3	BB-	
B+	B1	B+	
B	B2	B	
B-	B3	B-	
CCC+	Caa1	CCC+	
CCC	Caa2	CCC	
CCC-	Caa3	CCC-	
CC+	Ca	CC+	
CC	Ca	CC	
CC-	Ca	CC-	
C+	C	C+	
C	C	C	
C-	C	C-	
DDD	D	DDD	
DD	D	DD	
D	D	D	Lowest Security