Midlothian

Audit Committee
Tuesday 30 October 2012
Item No 10

Treasury Management Mid-Year Review Report 2012/13

Report by Gary Fairley, Head of Finance & Human Resources

1 Purpose of Report

The purpose of this report is to inform members of the Treasury Management activity undertaken during the first half of 2012/13.

2 Background

The Council on 23 March 2010 adopted the Code of Practice for Treasury Management in Local Authorities, and the Prudential Code for Capital Finance in Local Authorities, both published by the Chartered Institute of Public Finance and Accountancy and complies with its requirements which include a mid-year update report.

A detailed report on the activity during 2012/13 is enclosed as Appendix A. The main points arising from treasury activity during the first half of 2012/13 were:

- The opening of three Money Market Funds (MMFs), as a result of the impact of the economic climate on the Council's list of approved counterparties for investment;
- The average interest rate earned on external investments was 2.11%, more than double the benchmark rate of 1.02%. The comparator figure for the half-year in 2011/12 was 1.25% (and full year equivalent 1.49%);
- Total long term borrowing in the half year was £10 million;
- No debt rescheduling has been undertaken during the period;
- The strategy for borrowing to fund Capital Expenditure in the second half of 2012/13 is expected to conform to the Treasury Management and Investment Strategy 2012/13 reported to Council on 28 February 2012.

3 Report Implications

3.1 Resource

Expenditure on loan charges is reported in quarterly financial positions to Council, with Quarter 1 monitoring reported in September 2012.

3.2 Risk

As the Council follows the requirements of the CIPFA Code of Practice for Treasury Management, and the Prudential Code, there is a reduced level of risks involved in Treasury Management activities. Those risks that do exist are further controlled through written Treasury

Management Practices which define the responsibilities of all staff involved and these have recently been reviewed and updated.

3.3 Policy

Strategy
The strategies adopted are an integral part of the Corporate aim to achieve Best Value as they seek to minimise the cost of borrowing by exercising prudent debt management and investment. This in turn helps to ensure that the Council's capital expenditure is sustainable in revenue terms.

Consultation
Although no external consultation has taken place cognisance has been taken of professional advice obtained from Sector, the Council's appointed Treasury Consultants.

Equalities
There are no equality issues arising from this report.

Sustainability
There are no sustainability issues arising from this report.

4 Summary

Treasury Management activity during the half year has followed the strategy for 2012/13 for borrowing to finance capital expenditure, and has been effective in maximising investment income within the parameters set by the strategy for the year. It is expected that Treasury Management activity will continue to follow the strategy in the second half of 2012/13.

5 Recommendations

It is recommended that Council

a) Note that the Financial Services team has achieved a better than benchmark return on investments for the half year;
b) Note the report and the treasury activity undertaken in the half-year.

23 October 2012

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Appendix A

Treasury Management
Mid-year Review Report 2012/13

1 Background

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

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 finance its capital spending. 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.

As a consequence treasury management is defined as:

"*The management of the local authority's investments and 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*."

2 Introduction

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management was adopted by the Council on 23 March 2010, with a revised 2011 edition noted by Council in the Treasury Management and Investment Strategy 2012/13 report on 28 February 2012.

The primary requirements of the revised Code are as follows:

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

2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

3. Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy - for the year ahead; and a **Mid-year Review Report** and an Annual Report (stewardship report) covering activities during the current/ previous year.

4. 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.

5. 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 Audit Committee.

This mid year report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- An economic update for the first six months of 2012/13 (Section 3);
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy (Section 4);
- The Council's capital expenditure indicators (prudential indicators) (Section 5);
- A review of the Council's investment portfolio for 2012/13 (Section 6);
- A review of the Council's borrowing strategy for 2012/13 (Section 7);
- A review of any debt rescheduling undertaken during 2012/13 (Section 8).

3 Economic update

3.1 Economic performance to date

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.

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.

In the UK, consumer confidence remains very depressed with unemployment concerns, indebtedness and a squeeze on real incomes from high inflation and low pay rises, all taking a toll. Whilst inflation has fallen considerably (CPI @ 2.6% in July), UK GDP fell by 0.5% in the quarter to 30 June, the third quarterly fall in succession. This means that the UK's recovery from the initial 2008 recession has been the worst and slowest of any G7 country apart from Italy (G7 = US, Japan, Germany, France, Canada, Italy and UK). It is also the slowest recovery from a recession of any of the five UK recessions since 1930 and total GDP is still 4.5% below its peak in 2008.

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.

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.

3.2 Outlook for the next six months of 2012/13

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 13 September the Fed. 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.

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 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. 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, meanwhile, 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:

- 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 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 Bank Rate is likely to be depressed for even longer than in this forecast.

3.3 Sector's Interest Rate Forecasts

	17.9.12 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

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.)

4 Treasury Management Strategy Statement update

The Treasury Management Strategy Statement (TMSS) for 2012/13 was approved by Council on 28 February 2012.

There are no policy changes to the TMSS; the details in this report update the position in light of the updated economic position and budgetary changes already approved.

A breakdown of the Council's investment portfolio is shown in Section 6 of this report.

Borrowing rates have been at historically low rates during the first six months of the 2012/13 financial year. New external borrowing undertaken has been identified in Section 7 of this report.

Investments and borrowing during the first six months of the year have been in line with the TMSS; and the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

5 The Council's Capital Position (Prudential Indicators)

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 prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

5.1 Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure for financial year 2012/13 since the original Treasury Strategy was reported to Council on 28 February 2012.

Capital Expenditure by Service	2012/13 Original Estimate £000's	2012/13 Revised Estimate £000's
Corporate Resources	4,337	7,346
Education & Children's Services	28,535	29,447
Communities & Wellbeing	2,034	2,589
Business Transformation	995	637
HRA.	23,075	21,467
Total	**58,976**	**61,486**

5.2 Changes to the Financing of the Capital Programme

The table below details how the Capital Expenditure in Section 5.1 is to be financed:-

Capital Expenditure	2012/13 Original Estimate £000's	2012/13 Revised Estimate £000's
Total spend	**58,976**	**61,486**
Financed by:		
Capital receipts	2,199	1,580
Capital grants	27,151	24,584
Developer/Other Contributions	1,414	2,711
Total financing	**30,764**	**28,875**
Borrowing required to finance Capital Plans	**28,212**	**32,611**

The borrowing element of the table above increases the underlying indebtedness of the Council by way of an increase in the Capital Financing Requirement (CFR), although both (i) the required borrowing, and (ii) the CFR, will be reduced by the in-year revenue charges for the repayment of debt (the Principal Debt Repayments).

The total borrowing required for the year will also be further adjusted to account for any refinancing of maturing debt, other treasury requirements, and any borrowing undertaken in advance (i.e. to finance future year's capital programmes).

5.3 Changes to the Prudential Indicators for the Capital Financing Requirement, External Debt and the Operational Boundary

The table below shows the CFR, which is the Council's underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period.

	2012/13 Original Estimate £000's	**2012/13 Revised Estimate £000's**
Prudential Indicator – Capital Financing Requirement		
CFR – General Services	115,760	112,340
CFR – HRA	143,691	139,845
Total CFR	**259,451**	**252,185**
Net movement in CFR	**21,278**	**25,889**
Prudential Indicator – External Debt		
Total Debt 31 March 2013	**238,028**	**247,820**

Prudential Indicator – Capital Financing Requirement

The 12/13 CFR outturn is therefore expected to reduce by £7.3 million from the original forecast in the Treasury Strategy reported to Council on 28 February 2012. Whilst the expected increase in the CFR in 12/13 itself is expected to be £4.6 million more than originally forecast (due to an increase in Capital Expenditure of £2.5 million and a decrease in funding of £2.1 million), the outturn CFR for 11/12 was £11.9m lower than the original forecast in the Treasury Strategy reported to Council on 28 February 2012, as a result of capital expenditure underspend.

Prudential Indicator – External Debt

Conversely, the expected total level of external debt at 31 March 2013 is expected to be £9.8 million higher than the original forecast made at the start of the year.

This is due to the Council continuing to cash-back its balance sheet reserves by locking into historically low PWLB rates and placing these monies on deposit with the Bank of Scotland group (2 deposits originally in 2011/12, with one of these refinanced in June 2012). This approach has allowed the Council to reduce its internal borrowing position, lock into PWLB rates at their historically low level, offset any cost of carry, and partly cash-back the Council's balance sheet reserves, whilst ensuring the security of funds through the use of a UK government backed counterparty.

5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Net external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2012/13 and the following two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2012/13 Original Estimate £000's	**2012/13 Revised Estimate £000's**
Gross borrowing	£238,028	£247,820
Less investments	£(10,732)	£(38,456)
Net borrowing	**£227,296**	**£209,364**
CFR	**£259,451**	**£252,185**

The Head of Finance & HR reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government in Scotland Act 2003.

Authorised limit for external debt	**2012/13 Original Indicator £000's**	**2012/13 Revised Indicator £000's**
Borrowing	£267,000*	£289,100*

** Authorised Limit equal to maximum CFR over 3 year life of General Services and HRA Capital Plans.*

6 Investment Portfolio 2012/13

In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As set out in Section 3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. The continuing Euro zone sovereign debt crisis, and its potential impact on banks, prompts a low risk and short term strategy. Given this risk adverse environment, investment returns are likely to remain low.

The Council held £41.6 million of investments as at 30 September 2012 (£42.7 million at 31 March 2012), summarised in the table below:-

Loan Type	31 March 12		30 September 12	
	Principal Outstanding	Weighted Average Rate	Principal Outstanding	Weighted Average Rate
	£000's	%	£000's	%
Money Market Funds	£ -	n/a	£ 8,185	0.66%
Bank Call/Notice Accounts	£ 17,798	0.88%	£ 4,525	1.09%
Bank Fixed Deposits	£ 24,900	2.78%	£ 28,900	3.06%
Total Loans	**£ 42,698**	**1.99%**	**£ 41,610**	**2.37%**

These investments represent the available General Fund and HRA reserves, Capital Fund and Provisions held for future expenditure, elements of which are currently utilised to finance cashflow and the existing Capital Financing requirement.

The Council's budgeted investment return for 2012/13 (revised in year) is £912k (representing a 2.31% return on an expected average investment level of £39.5 million). Investment returns for the half year amount to £475k (a return of 2.11% against an average investment level of £45.0 million), against a benchmark of 6-month LIBID un-compounded rate of 1.02%.

The Head of Finance & Human Resources confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2012/13.

Investment Counterparty criteria

The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function. This uses the Sector credit scoring methodology which is a sophisticated methodology incorporating credit ratings from the three main credit rating agencies, credit watches and credit outlooks, CDS spreads and Country sovereign ratings to provide a list of only the most creditworthy counterparties, and for these counterparties, a maximum suggested duration for any one investment. In this challenging economic climate whereby counterparty lists are becoming smaller in nature, Santander have fallen from the Council's approved list, necessitating the opening of three AAA-rated Money Market Funds (MMFs) to manage the Council's short-term cash-flow.

7 Borrowing

Borrowing in the half-year to date

Due to the overall financial position and the underlying need to borrow for capital purposes, new long-term external borrowing of £10 million was undertaken from the PWLB in July 2012 with a term of 18.5 years at an interest rate of 3.63%.

The Council held £225.0 million of external borrowing as at 30 September 2012 (£224.8 million at 31 March 2012), summarised in the table below:-

Loan Type	31 March 12			30 September 12		
	Principal Outstanding		Weighted Average Rate	Principal Outstanding		Weighted Average Rate
	£000's		%	£000's		%
PWLB Annuity	£	868	8.92%	£	855	8.91%
PWLB Maturity	£	147,175	3.97%	£	147,175	3.94%
LOBO	£	20,000	4.51%	£	20,000	4.51%
Temporary Market	£	56,750	0.42%	£	57,000	0.31%
EIB	£	8	8.75%	£	6	8.75%
Total Loans	**£**	**224,801**	**3.14%**	**£**	**225,036**	**3.09%**

Borrowing for the second half of the year

The Council's revised Capital Financing Requirement (CFR) for 2012/13 is £252.2 million (see table 5.3). The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is typically driven by market conditions.

The Council's gross borrowing at 31 March 2013 is projected to be £247.8 million. Against the CFR of £252.2 million, this means that the Council has utilised £4.4 million of cash-flow funds in lieu of borrowing (i.e. is internally borrowed by £4.4 million). This is a prudent and cost effective approach in the current economic climate.

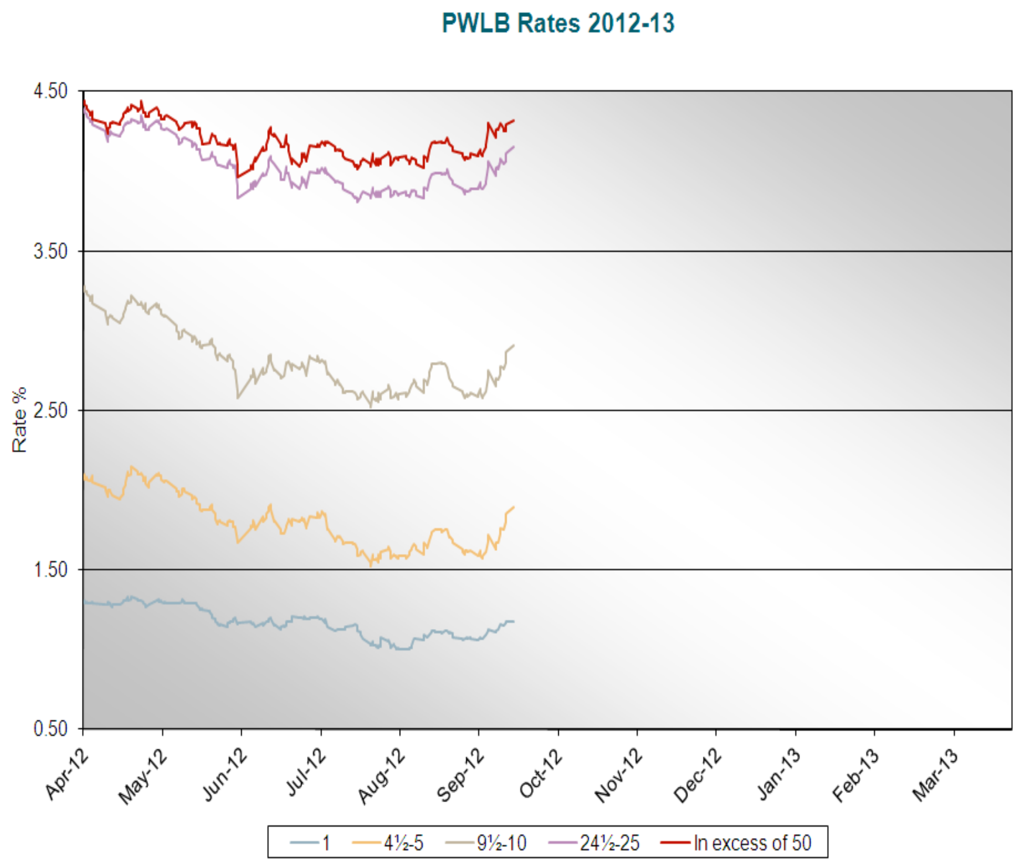
The introduction of the certainty rate from the UK Government on 1st November 2012 provides qualifying Councils with a 20bps reduction in any loans drawn from the PWLB. This Council, through the submission of borrowing forecasts in the first half of 2012/13, has qualified for this discount and the expectation is that long-term borrowing to support the Council's Capital Plans will be primarily drawn from PWLB in the 2nd half of 2012/13.

Borrowing in advance of need

The Council has not borrowed in advance of need during the first half of 2012/13 and will only borrow in advance in the second half if market conditions dictate that it is prudent to do so.

Borrowing Rate forecast

As outlined below, the general trend has been a reduction in interest rates during the six months, across all maturity bands. A summary of the outlook for PWLB borrowing rates over the short-medium term is reported in table 3.3.



8 Debt Rescheduling

Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates and therefore no debt rescheduling was undertaken during the first six months of 2012/13.