MID YEAR PRUDENTIAL INDICATORS AND TREASURY MANAGEMENT MONITORING REPORT

To:	**Governance and Audit Committee – 13th January 2011**
Main Portfolio Area:	**Finance and Corporate Services**
By:	**Treasury and Capital Accountant**
Classification:	**Unrestricted**

Summary: **To inform Governance and Audit Committee about the Treasury Management activity in the first half of 2010-11, and for the approval of any change to the prudential indicators.**

For Information

1.0 Introduction and Background to the Report

1.1 Revisions to the regulatory framework of treasury management during 2009 introduced a requirement that the Council receive a mid year treasury review, in addition to the forward looking annual treasury strategy and backward looking annual treasury report that were required previously.

This report meets that requirement and only discusses the Treasury Management activity for the first half of this financial year. It also incorporates the needs of the Prudential Code to ensure adequate monitoring of the capital expenditure plans and the Council's prudential indicators (PI's). The treasury strategy and PI's were previously reported to Council on 25th February 2010. Where changes to these indicators were approved by Council on 7th October 2010, the approved indicators have been incorporated into this report.

The capital expenditure plans and prudential indicators for capital expenditure are set out initially, as these provide the framework for the subsequent treasury management activity. The actual treasury management activity follows the capital framework (and the position against treasury management indicators shown at the end).

The underlying purpose of the report supports the objective in the revised CIPFA Code of Practice on Treasury Management and the CLG Investment Guidance. These state that Members receive and adequately scrutinise the treasury management service.

The underlying economic environment remains difficult for the Council, foremost being the improving, but still challenging, concerns over investment counterparty risk. This background encourages the Council to continue maintaining investments short term and with high quality counterparties. The downside of such a policy is that investment returns remain low.

The Deputy Chief Executive can report that the basis of the treasury management strategy, the investment strategy and the Prudential Indicators are not materially changed, except for the borrowing need in line with capital expenditure. This has reduced by £600,000 which is due to the authority no

longer being required to fund the construction of the pontoon as part of the London Array agreement.

1.2 This report is structured to highlight the key changes to the Council's capital activity (the prudential indicators {PI's}), the economic outlook and the actual and proposed treasury management activity (borrowing and investment).

The Key Prudential Indicators 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.

2.0 Key Prudential Indicators

2.1 Capital Expenditure (PI)

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

Capital Expenditure by Service £m	2010/11 Original Estimate	Current Position	2010/11 Revised Estimate
Customer Services and Business Transformation	0.087	0.087	0.087
Community Services	2.685	2.811	2.814
Environmental Services	0.140	0.140	0.260
Regeneration and Economic Development	8.605	11.092	10.731
Finance and Corporate Services	0.070	0.082	0.082
HRA	4.888	4.888	4.884
Total	16.475	19.100	18.858

The original estimate reflects the capital budgets that were approved by Council on 25th February 2010. The current position is the current capital budgets, as approved by Cabinet on 23rd September 2010 and the revised estimates reflects the capital expenditure that is expected by 31st March 2011. The material changes in relation to "Regeneration and Economic Development" are due to an increase in capital expenditure for the coastal defences and breakwater projects. The change in "Community Services" capital expenditure is due to an increased Disabled Facility Grant allocation to that which was expected. The capital budgets are approved by Cabinet every quarter, with full details of any changes in the capital programme being reported as part of those capital budget monitoring reports.

2.2 Impact of Capital Expenditure Plans - Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table

increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure £m	**2010/11 Original Estimate**	**Current Position**	**2010/11 Revised Estimate**
Supported	1.703	1.703	1.703
Unsupported	14.772	17.397	17.155
Total spend	16.475	19.100	18.858
Financed by:			
Capital receipts	1.826	1.826	1.826
Capital grants	8.021	10.893	10.893
Capital Reserves	2.605	2.605	2.605
Revenue	0.100	0.229	0.229
Total Financing	12.552	15.553	15.553
Borrowing Need	**3.923**	**3.547**	**3.305**

The reduction in the borrowing need is due to there no longer being a requirement for the authority to fund the construction of the pontoon as part of the London Array agreement, reducing the forecast capital expenditure by £600,000.

2.3 **Changes to the Capital Financing Requirement (PI), External Debt and the Operational Boundary (PI)**

The table in 2.5 below shows the CFR, which is the underlying external need to borrow for a capital purpose. It also shows the expected debt position over the period. This is termed the Operational Boundary.

2.4 **Prudential Indicator – Capital Financing Requirement**
We are on target to achieve the forecast Capital Financing Requirement.

2.5 **Prudential Indicator – External Debt / the Operational Boundary**

	2010/11 Original Estimate	**Current Position**	**2010/11 Revised Estimate**
Prudential Indicator – Capital Financing Requirement			
CFR – Non Housing	17.411	N/A	23.378
CFR – Housing	23.966	N/A	22.263
Total CFR	41.377	N/A	45.641
Net movement in CFR	2.252	N/A	4.264
Prudential Indicator – External Debt / the Operational Boundary			
Borrowing	26.646	26.646	26.646
Other long term liabilities*	0.000	3.418	3.418
Total Debt 31 March	26.646	30.064	30.064

* - On balance sheet PFI schemes and finance leases etc.

2.6 **Limits to Borrowing Activity**

The first key control over the treasury activity is a PI 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 2010/11 and next 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.

	2010/11 Original Estimate	Current Position	2010/11 Revised Estimate
Gross Borrowing	28.003	26.646	26.646
Plus Other Long Term liabilities*	0.000	3.418	3.418
Less Investments	7.000	7.000	7.000
Net Borrowing	21.003	23.064	23.064
CFR* (year end position)	41.380	45.641	45.641

* - Includes on balance sheet PFI schemes and finance leases etc.

The Deputy Chief Executive reports that no difficulties are envisaged for the current or future years in complying with this Prudential Indicator.

A further PI 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 Act 2003.

Authorised limit for external debt £m	2010/11 Original Indicator	Current Position	2010/11 Revised Indicator
Borrowing	44.000	44.000	44.000
Other long term liabilities*	0.000	3.418	3.418
Total	44.000	47.418	47.418

* - Includes on balance sheet PFI schemes and finance leases etc.

These limits were approved by Council on 7th October 2010 as a result in changes to the accounting treatment of the Spine Road and car park leases.

2.7 **Interest Rate Movements and Expectations**

UK short-term interest rates fluctuated in a very narrow range in the first half of the financial year. Bank Rate was held at its record low of 0.5% in spite of above target inflation and evidence of a recovery of activity in most industrialised economies. The tenuous nature of the economic upturn, confidence that price pressures will abate and the still fragile state of the financial sector supported the case for the maintenance of an accommodative monetary policy.

Long-term interest rates peaked in the early stages of the financial year. The rise was reversed in May. Confidence that the change of government will prompt a more aggressive approach to deficit reduction encouraged new investment in gilt-edged securities. More important, however, was the financial crisis in the euro-zone, triggered by the threat of a sovereign debt default by Greece. This, together with evidence of decelerating growth in the US, ensured continued demand for high quality government debt. Gilt yields and PWLB rates subsided towards their 2009 lows as a result.

Short-term rates are expected to remain on hold for a considerable time. The recovery in the economy is likely to remain insipid. The danger of a double-dip recession is fading but the crisis in the euro-zone, the prospects of tight economic policies at home and tenuous consumer confidence means the threat has not evaporated completely.

Long-term interest rates will continue to benefit from these considerations and might be pressured lower in the event of a fresh programme of Quantitative Easing. Nevertheless, without this additional support, yields are probably close to their low point. Disappointment with the UK's inflation performance and the absence of QE would return yields to a gradually rising trend before the year is out.

2.8 Medium-Term Rate Estimates

Annual Average %	Bank Rate	Money Rates		PWLB Rates*		
		3 month	1 year	5 year	20 year	50 year
2009/10	0.5	0.7	1.3	3.0	4.4	4.5
2010/11	0.5	0.7	1.5	2.4	4.2	4.3
2011/12	1.1	1.3	2.2	3.1	4.8	4.9
2012/13	2.3	2.5	3.3	4.0	5.0	5.1
2013/14	3.3	3.5	4.0	4.5	5.0	5.0
2014/15	4.0	4.2	4.5	4.8	5.0	5.0
2015/16	4.0	4.2	4.5	4.5	4.8	4.7

3.0 Treasury Strategy 2010/11 – 2012/13

3.1 Debt Activity during 2010/11

The expected borrowing need is set out below:

	2010/11 Original Estimate	Current Position	2010/11 Revised Estimate
CFR (year end position)	41.377	45.641	45.641
Less Other Long Term Liabilities*	0.000	3.418	3.418
Net Adjusted CFR (y/e position)	41.377	42.223	42.223
Borrowed at 30/09/10	26.646	26.646	26.646
Under/(over) borrowing	14.731	15.577	15.577
Expected need	2.059	0.000	0.000
Total Borrowing	28.705	26.646	26.646

* - Includes on balance sheet PFI schemes and finance leases etc.

The Council is currently under-borrowed to address investment counterparty risk and the cost of carry on investments (investments yield up to 1%, long term borrowing rates are approximately 4.5%). There is interest rate risk, as longer term borrowing rates may rise, this position is being carefully monitored.

During the first half of 2010/11 the Council has taken advantage of borrowing rates to repay maturing debt. The details are as follows:

Lender	Principal	Type	Interest Rate	Maturity
PWLB	£1m	Fixed interest rate	2.75%	5 years
PWLB	£1m	Fixed interest rate	3.84%	9.6 years

The revised budget position for debt charges is:

Debt charges	2010/11 Original Estimate	Current Position	2010/11 Revised Estimate
Borrowing	1.554	1.503	1.503
Other long term liabilities*	0.000	0.000	0.000
Total	1.554	1.503	1.503

4.0 Investment Strategy 2010/11 – 2012/13

4.1 Key Objectives

The objectives of the Council's investment strategy are the safeguarding the re-payment of the principal and interest of its investments on time – the investment return being a secondary objective. Following on from the economic background above, the current investment climate has one over-riding risk consideration, that of counterparty risk. As a result of these underlying concerns officers continue to implement an operational investment strategy which tightens the controls already in place in the approved investment strategy.

4.2 **Current Investment Position**

The Council held £24.152m of investments as at 30th September 2010, and the constituent parts of the investment position were as follows:

Sector	Country	Up to 1 year	1 - 2 years	2 – 3 years
Banks	UK	£5.952m	Nil	Nil
Money Market Funds	UK	£17.200m	Nil	Nil
Debt Management Office	UK	£1.000m	Nil	Nil
Total		**£24.152m**	**£0m**	**£0m**

The revised budget position for investment income is:

Interest Receivable	2010/11 Original Estimate	Current Position	2010/11 Revised Estimate
Income	0.195	0.085	0.128
Total	0.195	0.085	0.128

4.3 **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 new requirements to the Member reporting, although the application of these is more subjective in nature. These were first set in the Treasury Strategy Report 25th February 2010.

The current position against the benchmarks originally approved is discussed below.

4.4 **Security**

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

- 0.05% historic risk of default when compared to the whole portfolio.

The Deputy Chief Executive can report that the investment portfolio was maintained within this overall benchmark during this year to date.

4.5 **Liquidity**

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

- Bank overdraft - £0.5m

- Liquid short term deposits of at least £5m available with a week's notice.
- Weighted Average Life benchmark is expected to be 0.3 years, with a maximum of 1.0 year.

The Deputy Chief Executive can report that liquidity arrangements were adequate during the year to date.

Yield - Local measures of yield benchmarks are:

- Investments – Internal returns above the 7 day LIBID rate.

The Deputy Chief Executive can report that return to date averages 0.74%, against a 7 day LIBID to end June 2010 of 0.423%.

The security benchmarks for each individual year were set as:

Benchmarks	1 year	2 years	3 years	4 years	5 years
Maximum (current)	**0.05%**	**0%**	**0%**	**0%**	**0%**
Maximum (revised)	**0.05%**	**0%**	**0%**	**0%**	**0%**

The Deputy Chief Executive 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. The benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members. As this data is collated, trends and analysis will be collected and reported. Where counterparty is not credit rated a proxy rating will be applied.

5.0 Treasury Management Indicators

5.1 Actual and estimates of the ratio of financing costs to net revenue stream

This indicator identifies the trend in the cost of capital (financing costs net of interest and investment income) against the net revenue stream.

	2010/11 Original Indicator	2010/11 Revised Indicator
Non-HRA	4%	4%
HRA	10%	10%

We are on target to achieve the original forecast for ratio of financing costs to net revenue.

6.0 Treasury Management Prudential Indicators:

6.1 **Upper Limits on Variable Rate Exposure** – This indicator identifies a maximum limit for variable interest rates based upon the debt position net of investments.

Upper Limits on Fixed Rate Exposure – Similar to the previous indicator this covers a maximum limit on fixed interest rates.

Both of these are shown in the below table:

	2010/11 Original Indicator	Current Position	2010/11 Revised Indicator
Prudential indicator limits based on debt only			
Limits on fixed interest rates	31.000	41.418	41.418
Limits on variable interest rates	6.000	6.000	6.000
Prudential indicator limits based on investments only			
Limits on fixed interest rates	5.000	32.000	32.000
Limits on variable interest rates	32.000	32.000	32.000

The changes to these prudential indicators have already been amended and approved as part of the report sent to Council on 7th October 2010.

6.2 **Maturity Structures of Borrowing**

These gross limits are set to reduce the Council's exposure to large fixed rate loans (those instruments which carry a fixed interest rate for the duration of the instrument) falling due for refinancing.

	2010/11 Original Indicator	Current Position	2010/11 Revised Indicator
Maturity Structure of fixed borrowing			
Under 12 months	20%	0%	20%
12 months to 2 years	25%	13.55%	25%
2 years to 5 years	35%	16.36%	35%
5 years to 10 years	45%	22.58%	45%
10 years to 20 years	45%	20.32%	45%
20 years to 30 years	45%	18.16%	45%
30 years to 40 years	50%	9.03%	50%
40 years to 50 years	50%	0%	50%
50 years and above	50%	0%	50%

The original and revised indicators in the above table give the upper limit of fixed borrowing. The current position shows the actual percentage of fixed rate debt the authority has within each maturity span. None of the upper limits have been breached and no changes to the current indicators are required.

6.3 **Total Principal Funds Invested**

These limits are set to reduce the need for early sale of an investment, and show limits to be placed on investments with final maturities beyond each year-end.

	2010/11 Original Indicator	Current Position	2010/11 Revised Indicator
Maximum principal sums invested > 364 days[1]	£0	£0	£0

This authority does not currently place investments for more than one year due to the credit, security and counterparty risks of placing such investments. As such, this indicator was set to nil and does not require alteration.

7.0 Benchmarking

7.1 A benchmarking exercise was completed to compare the investment and debt profiles of Thanet District Council compared to other Kent authorities. Only 5 authorities responded to the request for information for the comparison exercise. These were Canterbury City Council, Dover District Council, Gravesham Borough Council, Medway Council and Kent Fire Authority. This exercise was based on debt and investments held on 19th October 2010 and so only shows the benchmarking for that one day as investments will be changing daily.

7.2 The findings from the investment comparison were that:

- TDC has the 3rd highest principal balance out of the 6 authorities.
- TDC has £8.7 million less than the average principal balance. This is largely distorted by Medway who have principal balances at least 4 times higher than the other 5 authorities.
- If Medway was excluded, TDC would actually be shown to have the 2nd highest principal balance and would have £2 million more principal balances than the average. (However, £1 million of this is the SFP security deposit which is a contractual obligation and is likely to have to be repaid). Also a large proportion of TDC balances are HRA reserves and so are ring-fenced.
- TDC appear to achieve the 2nd lowest average rate of investment at 0.86%, which is 0.39% less than the average investment rate achieved by all of the authorities together. However, this is being distorted by the SFP security deposit. 0.39% equates to £10.68 per daily, per £1 million.
- This is a contractual obligation and as part of that obligation we are required to place the money in the safest account possible. This is the DMO which in turns has the lowest rate of return. If this investment was excluded from the comparison, TDC would be seen to be achieving an average rate of interest of 1.01%. We would then be achieving the 4th highest rates of interest, of only 0.15% less than the average. This equates to £4.10 per day, per £1 million.
- The risk comparison shows that TDC have the 2nd most secure investments, with only 0.01% risk. Medway have 18 times more risk but only achieve an average investment rate of 1.08% - this is only 0.07% higher than TDC's when the SFP monies are excluded (i.e. £1.92 per £1 million). Canterbury and Dover achieve the highest interest rates but take on more risk than TDC.
- When looking at the counterparties that authorities are investing in, TDC has most of its investments with Money Market Funds, which will spread the risk over a greater number of counterparties than we would otherwise be able to access. However, other authorities concentrate their investments within a couple of counterparties.
- For example, Dover places nearly half of their total balances with Natwest. So should Natwest default, half of their investment balances

would be lost. They also place a third of their investments with Lloyds TSB, so again, if Lloyds were to default a third of their money could be lost with very little to fall back on.

- It appears that Medway, Gravesham and Thanet try to share equal risk across their counterparties.
- The only counterparties being used by other authorities that TDC do not currently use are Nationwide, Clydesdale, Svenska and Royal Bank of Scotland (RBS). RBS are the same banking group as Natwest and we have facilities already set up with Natwest, hence we would prefer to use Natwest in place of RBS. They offer the same rates and products at present. The others have call and notice accounts that have attractive rates that vary between 0.75%-0.85%, but the rates on their longer term deposits are much less attractive.

7.3 The findings from the debt comparison exercise were that:

- TDC has the third highest level of debt out of 6 authorities that responded.
- It follows that TDC also has the third highest average rate of borrowing, and annual interest payable too.
- Authorities appear to be starting to use EIP loans for new borrowing rather than maturity loans.
- The principal investment balances are only one day's balances. These will vary throughout the year so the interest received that has been calculated in the above table is likely to change. Likewise, the average rate of investment was only the average rate for that one particular day. Our current yearly average is less than that (0.75%).
- All authorities are paying more for debt than they are earning on investments as expected.
- TDC has more debt than investment balances as do Canterbury and Medway. All of the other authorities have higher levels of investment balances than debt.
- It appears that some of the authorities are still borrowing rather than using investment balances e.g. Medway, Canterbury.
- TDC now uses investment balances rather than borrowing, however, given that we are in the same position as Medway and Canterbury this suggests that in the past we have borrowed instead of using balances. (However, this is only an assumption based on the trends identified with Canterbury and Medway.)

8.0 Options

8.1 That Members note the content of this report and agree the prudential indicators that are shown.

9.0 Corporate Implications

9.1 Financial

9.1.1 There are no financial implications arising directly from this report.

9.2 Legal

9.2.1 The Council is legally obliged to have regard to the relevant CIPFA codes of practice and to any guidance issued by the Secretary of State.

9.3 Corporate

9.3.1 The Council would like to continue to improve on its score for Use of Resources, and improving its risk management processes will help towards this.

9.4 Equity and Equalities

9.4.1 There are no equity or equalities issues arising from this report.

9.5 Risks

9.5.1 Failure to undertake this process will impact on the Council's compliance with the Treasury Management Code of Practice.

10.0 Recommendation(s)

10.1 The Governance and Audit Committee is asked to recommend the following to Council:

"Note the report, the treasury activity and recommend approval of any changes to the prudential indicators. "

11.0 Decision Making Process

11.1 Under the treasury Management Code of Practice it is required that the Governance and Audit Committee note this report before it is sent to Council for approval.

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