MID YEAR PRUDENTIAL INDICATORS AND TREASURY MANAGEMENT MONITORING REPORT

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

Summary: **To inform Governance & Audit about the Treasury Management activity in the first half of 2011-12, and for the approval of any change to the prudential indicators.**

<u>For Information</u>

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 24th February 2011.

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 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.

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	2011/12 Original Estimate	Current Position	2011/12 Revised Estimate
General Fund	10.065	6.375	6.375
HRA	3.266	3.534	3.534
Total	13.331	9.909	9.909

The original estimate reflects the capital budgets that were approved by Council on 24th February 2011. The current position is the current capital budget, as approved by Cabinet on 17th November 2011 and the revised estimates reflects the capital expenditure that is expected by 31st March 2012. The capital expenditure budget has been significantly reduced due mainly to the re-profiling of the Dreamland project and slippage of the Yacht Valley, Waste transfer station and business services projects and savings brought about by the reduced estimate of capital receipts during the year.

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	2011/12 Original Estimate	Current Position	2011/12 Revised Estimate
Supported	0	0	0
Unsupported	13.331	9.909	9.909
Total spend	13.331	9.909	9.909
Financed by:			
Capital receipts	0.760	0.050	0.076
Capital grants	4.452	5.233	5.233
Capital Reserves	3.116	3.459	3.459
Revenue	1.000	1.141	1.141
Total Financing	9.328	9.883	9.909
Borrowing Need	**4.003**	**0.026**	**0.000**

The reduction in the borrowing need is due to the re-profiling of the Dreamland and slippage of the Yacht Valley, Waste transfer station and business services projects and savings brought about by the reduced estimate of capital receipts during the year.

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**

	2011/12 Original Estimate	Current Position	2011/12 Revised Estimate
Prudential Indicator – Capital Financing Requirement			
CFR – Non Housing	23.502	N/A	19.202
CFR – Housing	23.966	N/A	23.966
Total CFR	47.468	N/A	43,168
Net movement in CFR	3.306	N/A	(0.697)
Prudential Indicator – External Debt / the Operational Boundary			
Borrowing	26.646	30.646	27.646
Other long term liabilities*	0.000	3.418	3.418
Total Debt 31 March	26.646	34.064	31.064

* - 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 2011/12 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.

	2011/12 Original Estimate	Current Position	2011/12 Revised Estimate
Gross Borrowing	30.646	30.646	27.646
Plus Other Long Term liabilities*	3.418	3.418	3.418
Less Investments	6.000	12.000	12.000
Net Borrowing	28.064	22.064	19.064
CFR* (year end position)	47.468	43.168	43.168

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

The Chief Executive (S151) 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	2011/12 Original Indicator	Current Position	2011/12 Revised Indicator
Borrowing	36.000	36.000	36.000
Other long term liabilities*	15.000	15.000	15.000
Total	51.000	51.000	51.000

* - 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**

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. The approval by various countries of the €440bn bail out fund in September has brought temporary relief to financial markets but this does not provide a credible remedy to the scale of the Greek debt problem or the sheer magnitude of the potential needs of other countries for support.

This, coupled with political difficulties in the US over their plans to address the budget deficit, the size and control over 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.

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.

As set out above, 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.

Short-term rates are expected to remain low due to slow growth in the UK, with a low Bank Rate to continue for at least 24 months, coupled with a further extension of quantitive easing. This will keep investment returns depressed.

2.8 **Medium-Term Rate Estimates**

Annual Average %	Bank Rate	Money Rates		PWLB Rates*		
		3 month	1 year	5 year	25year	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	0.5	0.7	1.5	2.3	4.2	4.3
2012/13	0.5	0.75	1.7	2.5	4.4	4.5
2013/14	1.25	1.40	2.4	2.9	4.8	4.9
2014/15	2.5	2.6	3.3	3.7	5.2	5.3

3.0 Treasury Strategy 2011/12 – 2013/14

3.1 Debt Activity during 2011/12

The expected borrowing need is set out below:

	2011/12 Original Estimate	Current Position	2011/12 Revised Estimate
CFR (year end position)	47.468	43.168	43.168
Less Other Long Term Liabilities*	3.418	3.418	3.418
Net Adjusted CFR (y/e position)	44.050	39.750	39.750
Borrowed at 30/09/11	30.646	30.646	27.646
Under/(over) borrowing	13.404	9.104	12.104
Expected need	0.000	0.000	0.000
Total Borrowing	30.646	30.646	27.646

* - 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 1.05%, long term borrowing rates are approximately 3.4%). There is interest rate risk, as longer term borrowing rates may rise. This position is being carefully monitored.

During the first half of 2011/12 the Council has taken advantage of borrowing rates to repay maturing debt. The details are as follows:

Lender	Principal	Type	Interest Rate	Maturity
PWLB	£4m	Fixed interest rate	3.31%	10 years

The revised budget position for debt charges is:

Debt charges	2011/12 Original Estimate	Current Position	2011/12 Revised Estimate
Borrowing	1.554	1.449	1.449
Other long term liabilities*	0.000	0.000	0.000
Total	1.554	1.449	1.449

Debt charges are due to reduce over coming years as the Council re-borrows to finance maturing debts which are currently at significantly higher interest rates than currently.

4.0 Investment Strategy 2011/12 – 2013/14

4.1 Key Objectives

The objectives of the Council's investment strategy are 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 £25.954m of investments as at 30th September 2011, 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	£12.964m	Nil	Nil
Money Market Funds	UK	£12.990m	Nil	Nil
Total		**£25.954m**	**£0m**	**£0m**

The revised budget position for investment income is:

Interest Receivable	2011/12 Original Estimate	Current Position	2011/12 Revised Estimate
Income	0.145	0.089	0.145
Total	0.145	0.089	0.145

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 on 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 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 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 Chief Executive can report that return to date averages 0.89%, against a 7 day LIBID to end August 2011 of 0.4825%.

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 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.

	2011/12 Original Indicator	2011/12 Revised Indicator
Non-HRA	3%	5.5%
HRA	9%	10.5%

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:

	2011/12 Original Indicator	Current Position	2011/12 Revised Indicator
Prudential indicator limits based on debt only			
Limits on fixed interest rates	51.000	51.000	51.000
Limits on variable interest rates	51.000	51.000	51.000
Prudential indicator limits based on investments only			
Limits on fixed interest rates	35.000	35.000	35.000
Limits on variable interest rates	35.000	35.000	35.000

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.

	2011/12 Original Indicator	Current Position	2011/12 Revised Indicator
Maturity Structure of fixed borrowing			
Under 12 months	25%	9.79%	20%
12 months to 2 years	30%	2.03%	25%
2 years to 5 years	40%	9.79%	35%
5 years to 10 years	50%	16.32%	45%
10 years to 20 years	45%	27.74%	45%
20 years to 30 years	45%	13.13%	45%
30 years to 40 years	50%	6.53%	50%
40 years to 50 years	50%	0%	50%
50 years and above	50%	14.67%	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.

	2011/12 Original Indicator	Current Position	2011/12 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.

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 continues to ensure it has strong risk management processes with regard to its treasury activities to protect the Council's limited financial resources.

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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Reporting to:	Sarah Martin, Financial Services Manager DDI 01843 577617

12.0 Corporate Consultation Undertaken

12.1

Finance	Sarah Martin and Nicola Walker
Legal	Peter Reilly