TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY – MID YEAR REVIEW REPORT 2012/13

To:	**Governance & Audit Committee – 11th December 2012**
Main Portfolio Area:	**Finance**
By:	**Capital & Treasury Finance Officer**
Classification:	**Unrestricted**

Summary: **This report summarises treasury management activity and prudential/treasury indicators for the first half of 2012/13.**

For Information

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 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.

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 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

2.1 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management has been adopted by this Council.

2.2 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 activities.

- 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 the full 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 (stewardship 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 Governance and Audit Committee.

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

- An economic update for the first six months of 2012/13;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure (prudential indicators);
- A review of the Council's investment portfolio for 2012/13;
- A review of the Council's borrowing strategy for 2012/13;
- A review of any debt rescheduling undertaken during 2012/13;
- A review of compliance with Treasury and Prudential Limits for 2012/13.

2.4 There have not been any key changes to the Treasury and Capital Strategies during the first half of 2012/13.

3 Sector's Economic Update (issued by Sector on 17 September 2012)

3.1 Economic performance to date (issued by Sector on 17 September 2012)

3.1.1 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.

3.1.2 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.

3.1.3 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 @ 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.

3.1.4 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.

3.1.5 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 and gilt yields, prior to the European Central Bank (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 (issued by Sector on 17 September 2012)

3.2.1 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.

3.2.2 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.

3.2.3 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.

3.2.4 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 forecast (issued by Sector on 17 September 2012)

	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 and Annual Investment Strategy update

4.1 The Treasury Management Strategy Statement (TMSS) for 2012/13 was approved by this Council on 19 January 2012.

4.2 The underlying TMSS approved previously requires revision in the light of economic and operational movements during the year. The proposed changes are set out below:

4.2.1 A negative rating watch applying to a counterparty at the minimum Council criteria may be, rather than will be, removed from the list. The decision on whether to remove the counterparty will be in line with advice from the Council's external treasury consultancy (Sector).

4.2.2 Clarification that any reference to a sovereign AAA rating requirement does not apply to the UK.

4.2.3 Add a new counterparty category of 'part nationalised UK banks' (Lloyds Banking Group and Royal Bank of Scotland Group) which can be included on the counterparty list if they continue to be part nationalised or meet the other criteria required for inclusion on the list. The category of 'part nationalised UK banks' to have a money limit of £7m, time limit of 1 year and no ratings criteria.

4.2.4 Increase the minimum level of short term deposits (available with a week's notice) from £5m to £10m.

4.2.5 Increase the limit on 'fixed interest rate' investments from £35m to £45m, and increase the limit on 'variable interest rate' investments from £35m to £45m.

4.2.6 Increase the maturity limits for fixed rate borrowing as shown in the table below:

Maturity structure	**Upper limit (current)**	**Upper limit (proposed)**
Under 1 year	25%	50%
12 months to under 2 years	30%	50%
2 years to under 5 years	40%	50%
5 years to under 10 years	50%	55%
10 years to under 20 years	45%	50%
20 years to under 30 years	45%	50%
30 years to under 40 years	50%	50%
40 years to under 50 years	50%	50%
50 years and above	50%	50%

4.2.7 Remove Eligible Institution as an investment classification (in line with Sector advice) but allow the use of UK Banks / Building Societies (and/or those that are non-UK and domiciled in a country which has a minimum sovereign long term rating of AAA) which have, as a minimum, the ratings below (where rated), each with a money limit of £4m and time limit of 1 year:

- Short term credit rating from Fitch, Moody's and S&P : F1 (or equivalent)

- Long term credit rating from Fitch, Moody's and S&P : A (or equivalent)
- Viability (Fitch) / Financial Strength (Moody's): bb- (Fitch), C- (Moody's)

5 The Council's Capital Position (Prudential Indicators)

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

5.2 Prudential Indicator for Capital Expenditure

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	2012/13 Original Estimate £m	Current Position - Actual at 30/09/12 £m	2012/13 Revised Estimate £m
General Fund	8.045	1.704	15.194
HRA	2.740	0.597	5.258
Total	10.785	2.301	20.452

Revised estimate includes £8m General Fund carry-forward from the previous year.

5.3 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	2012/13 Original Estimate £m	Current Position - Actual at 30/09/12 £m	2012/13 Revised Estimate £m
Unsupported	10.785	2.301	20.452
Total spend			
Financed by:			
Capital receipts	1.675		2.379
Capital grants	2.809		8.773
Capital reserves	2.140		3.575
Revenue	0.600		2.748
Total financing	**7.224**		**17.475**
Borrowing need	**3.561**		**2.977**

Revised estimate includes £8m General Fund carry-forward from the previous year.

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

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

Prudential Indicator – Capital Financing Requirement

We are on target to achieve the forecast Capital Financing Requirement.

Prudential Indicator – External Debt / the Operational Boundary

	2012/13 Original Estimate £m	Current Position – Actual at 30/09/12 £m	2012/13 Revised Estimate £m
Prudential Indicator – Capital Financing Requirement			
CFR – non housing	22.111		21.529
CFR – housing	23.388		23.041
Total CFR	45.499		44.570
Net movement in CFR	**3.248**		**2.319**
Prudential Indicator – External Debt / the Operational Boundary			
Borrowing		26.720	
Other long term liabilities*		3.266	
Total debt	**43.000**	**29.986**	**43.000**

** On balance sheet PFI schemes and finance leases etc. Actual balance as at 31/03/12.*

5.5 Limits to Borrowing Activity

The first key control over 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 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.

	2012/13 Original Estimate £m	Current Position – Actual at 30/09/12 £m	2012/13 Revised Estimate £m
Gross borrowing	30.625	26.720	29.097
Plus other long term liabilities*	3.185	3.266	3.185
Less investments	8.000	28.506	20.000
Net borrowing	25.810	1.480	12.282
CFR* (year end position)	45.499		44.570

** Includes on balance sheet PFI schemes and finance leases etc. Actual balance as at 31/03/12.*

The Chief Executive 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 Act 2003.

Authorised limit for external debt	2012/13 Original Indicator	Current Position – Actual at 30/09/12	2012/13 Revised Indicator
Borrowing	36.000	26.720	36.000
Other long term liabilities*	14.000	3.266	14.000
Total	50.000	29.986	50.000

** Includes on balance sheet PFI schemes and finance leases etc. Actual balance as at 31/03/12.*

6 Investment Portfolio 2012/13

6.1 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.

6.2 The Council held £28.506m of investments as at 30 September 2012 (£19.276m at 31 March 2012). The yield on deposits for the first six months of the year is 0.81% against a benchmark (average 7-day LIBID rate) of 0.43%. The constituent investments are:

Sector	Country	Up to 1 year	1-2 years	2-3 years
Banks	UK	£10.146m	£0m	£0m
Money Market Funds	UK	£18.360m	£0m	£0m
Total		**£28.506m**	**£0m**	**£0m**

6.3 The Chief Financial Officer confirms that, apart from the proposed change in section 4.2.1, the approved limits within the Annual Investment Strategy were not breached during the first six months of 2012/13.

6.4 The Council's budgeted deposit return for 2012/13 is £0.179m, and performance for the first half of the financial year is above budget at £0.116m.

6.5 Risk Benchmarking

A development in the revised Codes and the CLG Investment Guidance 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 Member reporting, although the application of these is more subjective in nature. These were set in the Treasury Management Strategy Report in January 2012.

The mid-year position against these benchmarks is given below.

6.6 Security

The Council's maximum security risk benchmark for the current portfolio, when compared to historic default tables, is:

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

The security benchmark for each individual year is:

	1 year	2 years	3 years	4 years	5 years
Maximum	**0.05%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**

Note: This benchmark is an average risk of default measure, and would not constitute an expectation of loss against a particular investment.

The Chief Executive can report that the investment portfolio was maintained within this overall benchmark for the first half of this financial year.

6.7 Liquidity

In respect of this area the Council seeks 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 0.5 years, with a maximum of 1.0 years.

The Chief Executive can report that liquidity arrangements were adequate for the first half of this financial year.

This authority does not currently place investments for more than one year due to the credit, security and counterparty risks of placing such investments.

6.8 Yield

Local measures of yield benchmarks are:

- Investments – Internal returns above the 7 day LIBID rate

The Chief Executive can report that the yield on deposits for the first half of the financial year is 0.81% against a benchmark (average 7-day LIBID rate) of 0.43%.

6.9 Investment Counterparty criteria

Proposed changes to the current investment counterparty criteria selection approved in the TMSS are shown in section 4 of this report.

7 Borrowing

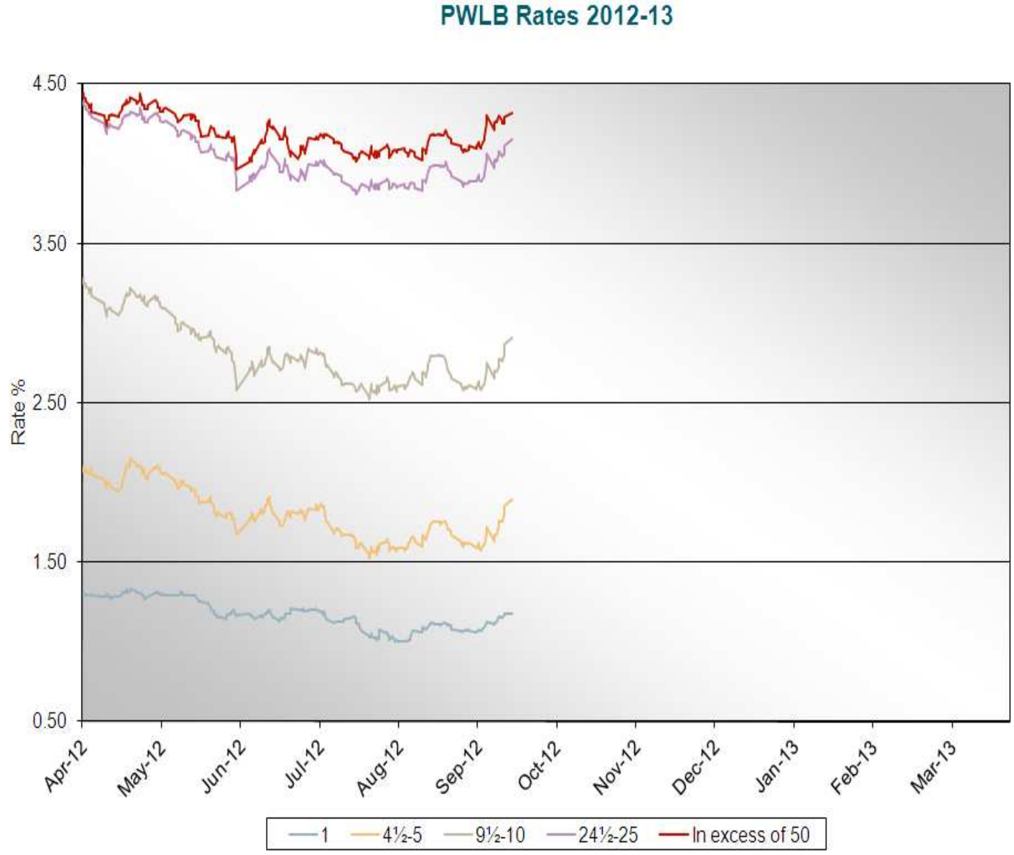
7.1 The Council's capital financing requirement (CFR) original estimate for 2012/13 is £45.499m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Table 5.5 shows the Council has borrowings of £26.720m and has utilised £28.506m of cash flow funds in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate.

7.2 No new external borrowing was undertaken from the PWLB / market in the first half of this financial year.

7.3 As outlined below, the general trend has been a reduction in interest rates during the six months, across all maturity bands.

7.4 It is anticipated that further borrowing will be undertaken during this financial year.

7.5 The graph and table below show the movement in PWLB rates for the first six months of the year (to 10.9.12):



7.6 Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. During the first six months of the year, no debt rescheduling was undertaken. The Council is currently under-borrowed to address investment counterparty risk and the differential between borrowing and investment interest rates. This position is carefully monitored.

7.7 A portion of the council's PWLB debt matures at the end of 2012. It is intended to repay this debt although options will be reviewed in due course in line with market conditions.

7.8 The Council's budgeted debt interest payable for 2012/13 is £1.396m and performance for the first half of the financial year is £0.086m below budget.

7.9 Treasury Management Indicators

7.9.1 Ratio of financing costs to net revenue stream

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream (the amount to be met from local taxpayers and central government grant, and rent income for the HRA).

%	2012/13 Original Indicator	2012/13 Revised Indicator
Non-HRA	4.0%	3.8%
HRA	11.5%	8.3%

7.9.2 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:

	2012/13 Original Indicator £m	Current Position – Actual at 30/09/12 £m	2012/13 Revised Indicator £m
Prudential indicator limits based on debt only			
Limits on fixed interest rates	50.000	22.220	50.000
Limits on variable interest rates	50.000	4.500	50.000
Prudential indicator limits based on investments only			
Limits on variable interest rates	35.000	25.301	35.000

7.9.3 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.

	2012/13 Original Indicator	Current Position – Actual at 30/09/12	2012/13 Revised Indicator
Maturity Structure of fixed borrowing			
Under 12 months	25%	19.08%	25%
12 months to 2 years	30%	7.18%	30%
2 years to 5 years	40%	3.59%	40%
5 years to 10 years	50%	32.34%	50%
10 years to 20 years	45%	16.17%	45%
20 years to 30 years	45%	14.45%	45%
30 years to 40 years	50%	7.19%	50%
40 years to 50 years	50%	0.00%	50%
50 years and above	50%	0.00%	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.

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 and VAT

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

9.2 Legal

9.2.1 This report is required to be brought before the Governance and Audit Committee, Cabinet and Council for approval, under the CIPFA Treasury Management Code of Practice.

9.3 Corporate

9.3.1 This report evidences that the Council continues to carefully manage the risk associated with its treasury management activities.

9.4 Equity and Equalities

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

10.0 Recommendation(s)

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

- Note the report, the treasury activity and recommend approval of any changes to the prudential indicators.
- Recommend approval of any changes to the investment criteria.
- Recommend approval of any other changes of treasury management policy.

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.

12.0 Disclaimer

12.1 Neither Thanet District Council nor any of its officers or employees makes any representation or warranty, express or implied, as to the accuracy or completeness of the information contained herein (such information being subject to change without notice) and shall not be in any way responsible or liable for the contents hereof and no reliance should be placed on the accuracy, fairness or completeness of the information contained in this document. Any opinions, forecasts or estimates herein constitute a judgement and there can be no assurance that they will be consistent with future results or events. No person accepts any liability whatsoever for any loss howsoever arising from any use of this document or its contents or otherwise in connection therewith.