



<u>Committee and Date</u>	<u>Item</u>
Audit Committee 25 November 2010	9
CMT 29 November 2010	
Cabinet 08 December 2010	
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TREASURY STRATEGY 2010/11 – MID YEAR REVIEW

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Summary

This mid year Treasury Strategy report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management (revised November 2009) and covers the following:-

- An economic review for the first six months of 2010/11
- A review of the Treasury Strategy 2010/11 and Annual Investment Strategy
- A review of the Council's investment portfolio for 2010/11
- A review of the Council's borrowing strategy for 2010/11
- A review of any debt rescheduling undertaken
- A review of compliance with Treasury and Prudential limits for 2010/11

The key points to note are:-

- In the first six months all treasury management activities have been in accordance with the approved limits and prudential indicators set out in the Council's Treasury Strategy.
- The internal treasury team achieved a return of 0.70% on the Council's cash balances outperforming the benchmark by 0.35%. This amounts to additional income of £201,250 for the first six months of the year which is included within the Council's projected outturn position.
- Following the Chancellor's Spending Review announcement on 20 October 2010, HM Treasury instructed the Public Works Loan Board (PWLB) to increase the average rate on all new loans to an average of 1% above the Government's cost of borrowing which will take effect immediately. This means all the Council's future PWLB borrowing will be increased by up to 1% (at a cost of £10,000 per million borrowed).
- Latest information suggests that 95% of the £1 million deposit placed by Bridgnorth District Council with the Icelandic Bank, Landsbanki will be repaid. However, non priority creditors have objected to the criteria for priority creditors meaning all cases have been referred to the Icelandic District Court to resolve. Non priority creditors are currently expected to be repaid 38% of their deposits.

Recommendations

Members are asked to note the report.

REPORT

Introduction

1. The Council defines its treasury management activities as “the management of the authority’s investments and cash flows, its banking, money market and capital market transactions, the effective control of the risks associated with the activities, and the pursuit of optimum performance consistent with those risks”. The report informs Members of the treasury activities of the Council for the first six months of the financial year.
2. The revised CIPFA Code of Practice on Treasury Management was adopted by Council in February 2010. 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 Strategy - 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 has now changed from the Strategic Overview and Scrutiny Committee to the Audit Committee.

Economic update

3. **Global Economy** - The sovereign debt crisis peaked in May 2010 prompted, in the first place, by major concerns over the size of the Greek government’s total budget and annual deficit. However, any default or write down of Greek debt would have substantial impact on other countries, in particular, Portugal, Spain and Ireland. This crisis culminated in the EU and the International Monetary Fund putting together a 750 million euro support package in mid May.
4. Growth in the US, UK and the Euro zone in the second quarter of 2010 was particularly driven by strong growth in the construction sector. General expectations are for much more subdued figures for the remainder of 2010.

5. **UK Economy** – Following the general election in May 2010, the coalition government has put in place an austerity plan to carry out correction of the public sector deficit over the next five years. The inevitable result of fiscal contraction will be a rise in unemployment in particular in public sector services. This may have a knock on effect on consumer and business confidence. House prices have started a negative trend during the summer and mortgage approvals are at very weak levels and also declining.
6. The Monetary Policy Committee (MPC) voted to keep official interest rates on hold at 0.5% since March 2009 and to not increase its programme of asset purchases under the Bank’s quantitative easing (QE) programme since November 2009. The Bank of England’s quarterly inflation report in August once again projected inflation to fall below the 2% target at the two year horizon, suggesting that rates will remain on hold for a considerable period.
7. Inflationary pressures have remained high so far during 2010. Consumer Price Inflation (CPI) peaked at 3.7% in April and has fallen back to 3.1% in August, RPI remains high at 4.7% in August.
8. Prior to the general election, credit rating agencies had been issuing repeated warnings that unless there was a major fiscal contraction, then the AAA UK sovereign rating was at significant risk of being downgraded. However, after the Chancellor’s budget on 22 June confidence has returned that the UK will retain its AAA rating.

Economic Forecast

9. The Council receives its treasury advice from Sector Treasury Services. Their latest interest rate forecasts are shown below:

	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13
BankRate	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.50%	3.00%	3.25%	3.25%
5yrPW IBRate	3.05%	3.05%	3.25%	3.45%	3.65%	3.85%	4.15%	4.45%	4.65%	4.95%	5.25%	5.25%
10yrPW IBRate	4.15%	4.15%	4.25%	4.55%	4.75%	4.85%	5.15%	5.25%	5.45%	5.45%	5.75%	5.75%
25yrPW IBRate	5.05%	5.15%	5.15%	5.25%	5.35%	5.55%	5.55%	5.65%	5.85%	5.85%	5.85%	5.85%
50yrPW IBRate	4.95%	5.05%	5.05%	5.15%	5.25%	5.45%	5.45%	5.55%	5.75%	5.75%	5.75%	5.75%

10. Sector believes the Bank Rate will remain at its current low level of 0.50% before rising to 0.75% in September 2011. The Bank Rate is then expected to gradually increase to reach 3.25% by the end of June 2013.
11. Long term PWLB rates are expected to steadily increase over time to reach 5.75% by December 2012 due to high gilt issuance in the UK and the high volume of debt issuance in other major western countries.
12. There is considerable uncertainty in all forecasts due to the speed of economic recovery in the US and EU, the degree to which government austerity programmes will dampen economic growth, the potential for more quantitative easing and the timing of this in both the UK and US, the potential for a major EU sovereign debt

crisis and the speed of recovery of banks profitability and balance sheet position. There is also still some risk of a “double dip” recession.

Treasury Strategy 2010/11

13. The Treasury Management Strategy (TMS) for 2010/11 was approved by Full Council in February 2010. The Council’s Annual Investment Strategy, which is incorporated in the TMS, outlines the Council’s investment priorities as the security and liquidity of its capital. As outlined above there is still considerable uncertainty and volatility in the financial and banking market, both globally and in the UK. In this context it is considered that the Treasury Strategy approved in February 2010 is still fit for purpose in the current economic climate.
14. The Council aims to achieve the optimum return on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term (up to 1 year), and only invest with highly credit rated financial institutions using the Sector’s suggested creditworthiness approach, including sovereign credit rating and Credit Default Swap (CDS) overlay information provided by Sector. The Treasury Team continue to take a prudent approach keeping investments short term and with the most highly credit rated organisations.
15. In the first six months of 2010/11 the internal treasury team outperformed its benchmark by 0.35%. The investment return was 0.70% compared to the benchmark of 0.35%. This amounts to additional income of £201,250 during the first six months which is included within the Council’s projected outturn position.
16. A full list of investments held as at 30 September 2010, compared to Sector’s counterparty list, and changes to Fitch, Moody’s and Standard & Poor’s credit ratings are shown in **Appendix A**. None of the approved limits within the Annual Investment Strategy were breached during the first six months of 2010/11. Officers continue to monitor the credit ratings of institutions on a daily basis. Delegated authority has been put in place to make any amendments to the approved lending list.
17. As illustrated in the economic background section above, investment rates available in the market are at an historical low point. The average level of funds available for investment purposes in the first six months of 2010/11 was £115 million.
18. The Council’s budgeted investment income for 2010/11 is £1.09 million. The current interest receivable/payable budgets are projecting an under spend of £1 million due to additional MRP savings in 2010/11 and deferring some Prudential borrowing to 2011/12. This position assumes that the Council will undertake all borrowing required for the capital programme during the year. The expenditure on the capital programme continues to be monitored closely and any borrowing required will be taken as late as possible to reduce interest costs further.

Borrowing

19. It is a statutory duty for the Council to determine and keep under review the “Affordable Borrowing Limits”. Council’s approved Prudential Indicators (affordability limits) are outlined in the TMS. A list of the approved limits is shown in **Appendix B**. The schedule at **Appendix C** details the Prudential Borrowing approved and utilised to date.
20. Officers can confirm that the Prudential Indicators were not breached during the first six months of 2010/11. Although net borrowing was slightly higher than anticipated it

was still well below the Capital Financing Requirement and within the Authorised borrowing limit of the Council.

21. Sector's target rate for new long term borrowing (25 years) for the second quarter of 2010/11 started at 4.65% and ended at 4.20%. Due to the overall financial position and the underlying need to borrow for capital purposes (the Capital Financing Requirement - CFR), new external borrowing of £25.7 million is required in 2010/11. This figure is as at 30th September 2010. An under achievement of capital spend in 2010/11 would effect the above borrowing figure of £25.7 million and this will be reported in the next quarterly Treasury Management update report. No borrowing has currently been undertaken to date. As outlined below, the general trend has been a reduction in interest rates during the six months, across all bands, with the low points occurring in the middle of August. The high points were in early to mid April.

PWLB BORROWING RATES 2010/11 for 1 to 50 years

	1	2	3	4	5	10	25	50
1. 4.2010	0.81%	1.37%	1.91%	2.40%	2.84%	4.14%	4.62%	4.65%
30.9.2010	0.64%	0.91%	1.22%	1.55%	1.88%	3.14%	3.95%	4.01%
HIGH	0.93%	1.52%	2.07%	2.56%	2.99%	4.27%	4.73%	4.74%
LOW	0.60%	0.89%	1.20%	1.52%	1.84%	3.06%	3.92%	3.93%
spread	0.33%	0.63%	0.87%	1.04%	1.15%	1.21%	0.81%	0.81%
average	0.73%	1.15%	1.58%	1.99%	2.37%	3.65%	4.35%	4.35%
high date	26/04/2010	26/04/2010	26/04/2010	26/04/2010	26/04/2010	12/04/2010	12/04/2010	26/04/2010
low date	15/06/2010	24/08/2010	25/08/2010	31/08/2010	31/08/2010	31/08/2010	31/08/2010	31/08/2010

22. During the first six months of the financial year there has been a lot of volatility in the financial markets and this has had an impact on the PWLB rates. The coalition government's emergency budget to accelerate the speed of reduction in the public sector deficit has meant that UK gilts have taken a safe haven status for international investors which have caused a major fall in bond yields which, in turn, have dragged down PWLB rates.
23. However, following the Chancellor's announcement on the Spending Review on 20 October 2010, the HM Treasury instructed the PWLB to increase the average interest rate on all new loans to an average of 1% above the Government's cost of borrowing which will take effect immediately. This means all the Council's future PWLB borrowing will be increased by up to 1%.

Debt Rescheduling

24. 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

Landsbanki Deposit Update

25. The claim for the £1 million deposit placed by Bridgnorth District Council with the Icelandic Bank, Landsbanki has been accepted as a priority claim by the Landsbanki Winding up Board. It has previously been reported that the Council expected 88% of the deposit to be repaid in four equal instalments of 22% starting in March 2011, with the final payment being made in December 2013. Latest information now suggests that 95% of the deposit may be repaid but the profile of repayments has been amended. The first payment of 22% is now not expected until October 2011, with

annual payments of 9% in October each year until 2017, with the final payment of 19% being made in October 2018. The loss on this investment is being allowed for in the Shropshire Council accounts.

26. However, an objection has been filed in respect of the decision by non-priority creditors such as bond holders and banks. Challenges to the decision will follow Icelandic legal processes. First of all the courts require that the parties go through a process of mediation, as no agreement was reached during this stage of the process all cases are now being heard by the Icelandic District Court. If unsuccessful parties wish to appeal the decision of the Icelandic District Court then this appeal is heard in the Icelandic Supreme Court which could delay the timing of any repayments further. It is expected that the decision will be upheld but if the claims are classified as unsecured claims the expected recovery rate is around 38%.

List of Background Papers (This MUST be completed for all reports, but does not include items containing exempt or confidential information)

Council, 27 February 2009, Treasury Strategy 2009/10.

Council, 25 February 2010, Treasury Strategy 2010/11

Strategic Overview & Scrutiny, 9 September 2009, Treasury Management Update Quarter 1 2009/10.

Cabinet, 23 September 2009, Treasury Management Update Quarter 1 2009/10.

Strategic Overview & Scrutiny, 21 October 2009, Treasury Management Update Quarter 2 2009/10.

Cabinet, 21 October 2009, Treasury Management Update Quarter 2 2009/10.

Strategic Overview & Scrutiny, 24 February 2010, Treasury Management Update Quarter 3 2009/10.

Cabinet, 24 February 2010, Treasury Management Update Quarter 3 2009/10.

Cabinet, 12 May 2010, Treasury Management Update Quarter 4 2009/10.

Strategic Overview & Scrutiny, 12 May 2010, Treasury Management Update Quarter 4 2009/10.

Strategic Overview & Scrutiny, 8th September 2010, Treasury Management Update Quarter 1 2010/11.

Cabinet, 15th September 2010, Treasury Management Update Quarter 1 2010/11.

Cabinet, 10th November 2010, Treasury Management Update Quarter 2 2010/11.

Human Rights Act Appraisal

The recommendations contained in this report are compatible with the provisions of the Human Rights Act 1998.

Environmental Appraisal

N/A

Community / Consultations Appraisal

N/A

Risk Management Appraisal

Compliance with the CIPFA Code of Practice on Treasury Management, the Council's Treasury Policy Statement and Treasury Management Practices and the Prudential Code for Capital Finance together with comprehensive and rigorous internal controls will enable the Council to manage the risk associated with Treasury Management activities and the potentials for financial loss.

Cabinet Member:

Keith Barrow, Leader of the Council

Local Member

N/A

Appendices

A. Investment Report as at 30th September 2010

B. Prudential Limits

C. Prudential Borrowing Schedule