Committee and Date	Item
SMB 31 October 2011 Audit Committee 10 November 2011 Cabinet 16 November 2011 Council 24 November 2011	**5** Public

TREASURY STRATEGY 2011/12 – MID YEAR REVIEW

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1. Summary

1.1 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 update for the first six months of 2011/12
- A review of the Treasury Strategy 2011/12 and Annual Investment Strategy
- A review of the Council's investment portfolio for 2011/12
- A review of the Council's borrowing strategy for 2011/12
- A review of any debt rescheduling undertaken
- A review of compliance with Treasury and Prudential limits for 2011/12

1.2 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 0.98% on the Council's cash balances outperforming the benchmark by 0.59%. This amounts to additional income of £272,415 for the first six months of the year which is included within the Council's projected outturn position.

- The proposed reform of the Housing Revenue Account (HRA) subsidy arrangements are expected to take place on 28 March 2012. This will involve the Council paying funds to the government which will remove the Council from the HRA subsidy system. The overall impact will be beneficial to the Council as it will no longer have to make future annual housing subsidy payments to the government from 1 April 2012.

- Latest information suggests that 95% of the £1 million deposit placed by Bridgnorth District Council with the Icelandic Bank, Landsbanki will be repaid. The claim is currently going through the Icelandic Supreme Court due to a further objection from non priority creditors. Payments are likely to be delayed until December 2011 with annual payments thereafter and the final payment being made in December 2018.

2. Recommendations

2.1 Cabinet recommend that Council approve the prudential indicators in paragraph 9.2 of this report which require revision due to the HRA reform.

2.2 Members are asked to accept the position as set out in the report.

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3. Risk Assessment and Opportunities Appraisal

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

3.2 There are no direct environmental, equalities or climate change consequences arising from this report.

3.3 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 the rigorous internal controls will enable the Council to manage the risk associated with Treasury Management activities and the potential for financial loss.

4. Financial Implications

4.1 There are no direct financial implications arising from this report. The revenue implications of funding the HRA payment will be met from the savings achieved within the HRA from not making future annual housing subsidy payments. These payments are due to be abolished from 1 April 2012.

5. Background

5.1 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.

5.2 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 is the Audit Committee.

6. Economic update

6.1 **Global Economy** - The Eurozone 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 Eurozone response, left commentators concerned over the potential impact of sovereign default and resulting effect on the Eurozone banking sector. The approval by various countries of the £440 billion bail out fund in September 2011 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.

6.2 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 Poors, has led to a much more difficult and uncertain outlook for the world economy. Growth prospects in the US, UK and the Eurozone 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.

6.3 **UK Economy** – Following zero growth in the final half of 2010/11 the UK economy grew by weaker than expected 0.2% in the first quarter of 2011/12, providing a knock on effect to future growth prospects. Growth prospects will be governed by UK consumer sentiment, which is currently subdued due to falling disposable income. Higher VAT, overhanging debt, high inflation and concerns over employment are likely to weigh heavily on consumers into the future.

6.4 Inflation remains stubbornly high, although the expectation of future falls, the external nature of the price increases (energy, oil, food etc.), and the negative impact a rate rise would have on the UK economy, is likely to stop the Monetary Policy Committee (MPC) from raising the Bank Rate, currently at an historically low level of 0.50%, for some considerable time to come. An indicator of the worsening position arose from the MPC minutes recently signalling a greater willingness to expand the quantitative easing programme which they have now done by increasing it by a further £75 billion, this clearly underlines how concerned the MPC now is about the prospects for growth of the UK economy.

6.5 International investors continue to view UK government gilts as being a safe haven from the EU sovereign debt crisis. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and sent Public Works Loan Board (PWLB) borrowing rates to low levels.

7 Economic Forecast

7.1 The Council receives its treasury advice from Sector Treasury Services. Sector has recently undertaken a review of their interest rate forecasts as a result of two major events. The decision by the MPC to expand quantitative easing over the next four months by a further £75 billion had an immediate effect of reducing long term borrowing rates and the marked deterioration of growth prospects in the US, EU and UK, especially as concerns have further increased over Greece and the potential fall out from their debt situation also depressed PWLB rates to even lower levels. Their latest interest rate forecasts are shown below:

Sector's Interest Rate View

	Now	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Sector's Bank Rate View	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%
5yr PWLB Rate	**2.41%**	2.30%	2.30%	2.30%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.10%	3.30%	3.50%	3.70%
10yr PWLB Rate	**3.46%**	3.30%	3.30%	3.30%	3.40%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%	4.60%	4.80%
25yr PWLB Rate	**4.31%**	4.20%	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%
50yr PWLB Rate	**4.42%**	4.30%	4.30%	4.30%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%

7.2 Sector believes the Bank Rate will remain at its current low level of 0.50% before rising to 0.75% in September 2013. This means investment returns will continue to be at historically low levels during this period. The Bank Rate is then expected to gradually increase to reach 1.25% by 31 March 2014 and 2.50% by 31 March 2015.

7.3 Long term PWLB rates are expected to fall slightly to 4.30% in December 2011 before steadily increasing over time to reach 5.30% by 31 March 2015 due to high 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, postponing any increases until 2012.

7.4 There is considerable uncertainty in all forecasts due to the speed of economic recovery in the UK, 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 which could have a significant impact on financial markets and the global and UK economy and the speed of recovery of banks profitability and balance sheet position. There is also still some risk of a “double dip “recession.

8. Housing Revenue Account (HRA) Reform

8.1 The proposed reform of the HRA subsidy arrangements are expected to take place on 28 March 2012 once the necessary legislation has been passed later on this year. This will involve the Council paying funds to the Communities for Local Government (CLG) which will remove the Council from the HRA subsidy system. The expected payment is currently around £87.6 million as previously reported to Members. This will impact on both the capital structure of the Council (as the HRA Capital Financing Requirement will rise by the size of the payment), and the treasury management service will need to consider the funding implications for the borrowing.

8.2 Members will recall being advised previously that following the Chancellor's spending review announcement on 20 October 2010, HM treasury instructed the PWLB to increase the average rate on all new loans to an average of 1% above the Government's cost of borrowing. This led authorities to examine possible financing from the markets at cheaper rates instead of the PWLB to finance the HRA payment. However, in September 2011 the Government announced that it would reduce the borrowing rates offered to local authorities from the PWLB by up to 1% to finance the payment to leave the HRA subsidy system. This means the PWLB will offer the cheapest form of funding to finance this transaction.

8.3 The funding of the payment for the HRA reform will take place between 1 January 2012 and 31 March 2012 once the necessary legislation has been passed. The reduced borrowing rates are for a specific purpose i.e. to finance the payment to leave the HRA subsidy system and will only be available during this period. Borrowing rates offered by the PWLB for other purposes will continue to be an average of 1% above the Government's cost of borrowing. Members will be updated on the latest position in the quarterly treasury update reports.

9. Treasury Strategy update

9.1 The Treasury Management Strategy (TMS) for 2011/12 was approved by Full Council on 24 February 2011. The Treasury Strategy approved previously needs to be amended as revised prudential indicators need to be approved to accommodate the impact of the HRA reform changes outlined above. Whilst this will formally allow the borrowing to take place, no action can take place until the necessary legislation is in place.

9.2 Subject to statutory powers, the Council will be required to make a one off payment to the CLG to remove the HRA from the current housing subsidy system. This one off payment will ensure the Council no longer has to make annual payments to the CLG and it is expected that the overall impact will be beneficial to the Council. Whilst the legislative framework is not yet in place, by agreeing to these revised prudential indicators the Council is ensuring the necessary local requirements are in place well before the payment is required on the 28 March 2012. The Council are therefore requested to approve the changes to the 2011/12 prudential indicators outlined below. All the other prudential indicators previously approved by Council remain the same.

Prudential Indicator 2011/12	**Original Estimate £m**	**Impact of HRA Reform £m**	**Revised Prudential Indicator £m**
Authorised Limit	£453	£88	£541
Operational Boundary	£383	£88	£471
Gross Borrowing	£298	£88	£386
Capital Financing Requirement (HRA only)	£1.2	£88	£89.2

10. Annual Investment Strategy update

10.1 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 in paragraph 6 & 7 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 Annual Investment Strategy approved on 24 February 2011 is still fit for purpose in the current economic climate.

10.2 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. This approach has been endorsed by our external advisors, Sector.

10.3 In the first six months of 2011/12 the internal treasury team outperformed its benchmark by 0.59%. The investment return was 0.98% compared to the benchmark of 0.39%. This amounts to additional income of £272,415 during the first six months which is included within the Council's projected outturn position.

10.4 A full list of investments held as at 30 September 2011, 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 2011/12 and have not been previously breached. 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.

10.5 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 2011/12 was £94 million.

10.6 The Council's interest receivable/payable budgets are currently projecting a surplus of £163,000 due to no long term borrowing being undertaken to date.

11. Borrowing

11.1 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.

11.2 Officers can confirm that the Prudential Indicators were not breached during the first six months of 2011/12 and have not been previously breached.

11.3 Due to the overall financial position and the underlying need to borrow for capital purposes (the Capital Financing Requirement - CFR), new non-HRA external borrowing of £8 million is required in 2011/12. This figure is as at 30 September 2011. 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 and towards the end of September. The high points were in early to mid April.

PWLB Borrowing rates 1 April - 30 Sept 2011

Date	1yr	5yr	10yr	25yr	50yr
High	1.97%	3.73%	4.89%	5.43%	5.34%
Date	06/04/2011	11/04/2011	11/04/2011	11/04/2011	11/04/2011
Low	1.42%	2.18%	3.31%	4.44%	4.57%
Date	13/09/2011	13/09/2011	13/09/2011	26/09/2011	13/09/2011
Average	1.59%	2.92%	4.15%	5.02%	5.02%
Spread betweeen High and Low	0.55%	1.55%	1.58%	0.99%	0.77%
01-Apr-11	1.95%	3.65%	4.80%	5.36%	5.28%
30-Sep-11	1.49%	2.41%	3.49%	4.53%	4.70%
Spread between 01/04/11 and 30/09/11	0.46%	1.24%	1.31%	0.83%	0.58%

11.4 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 aim to accelerate the speed of reduction in the public sector deficit, the MPC announcement to increase quantitative easing and the marked deterioration of growth prospects in the US, EU and UK 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.

12. Debt Rescheduling

12.1 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

13. Landsbanki Deposit Update

13.1 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 and the Icelandic District Court. Local Authority claims are currently going through the Icelandic Supreme Court due to a further objection from non priority creditors. Latest information suggests that 95% of the deposit may be repaid, the first payment of 22% is now not expected until December 2011, with annual payments of 9% in December each year until 2017, with the final payment of 19% being made in December 2018.

13.2 Failure to secure preferential creditor status would have a significant impact upon the amount of the deposit that is recoverable. If preferential creditor status is not achieved the recoverable amount may only be 33%. On the basis of legal advice obtained by local authorities and advice provided by the Local Government Association, it remains the most likely outcome that the claims will enjoy priority status.

List of Background Papers (This MUST be completed for all reports, but does not include items containing exempt or confidential information) Council, 24 February 2011, Treasury Strategy 2011/12 Cabinet, 03 August 2011, Treasury Management Update Quarter 1 2011/12.
Cabinet Member: Keith Barrow, Leader of the Council
Local Member N/A
Appendices A. Investment Report as at 30th September 2011 B. Prudential Limits C. Prudential Borrowing Schedule