Report to: **Cabinet**

Subject: **Prudential Code Indicator Monitoring 2010/11 and Quarterly Treasury Activity Report**

Date: **4 November 2010**

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1. PURPOSE OF REPORT

To inform Members of the performance monitoring of the 2010/11 Prudential Code Indicators, and to advise Members of the quarterly treasury activity as required by the Treasury Management Strategy. CIPFA issued a revised Code of Practice for Treasury Management in November 2009, following consultation with local authorities during the year. The revised Code suggests that members should be informed of Treasury Management activities at least twice a year, and preferably quarterly. The Council have long adopted this “best practice”, and are fully compliant with the new Code.

2. BACKGROUND

The Local Government Act 2003 introduced the Prudential Framework for Local Authority Capital Investment, the key objectives being:

1. That capital investment plans are affordable, prudent and sustainable

2. That treasury management decisions are taken in accordance with good professional practice

3. That local strategic planning, asset management and proper option appraisal are supported

To demonstrate that these objectives have been fulfilled, the Prudential Code details the Prudential and Treasury Management indicators that must be set and monitored. These indicators are designed to support and record local decision-making, and not to be comparative performance indicators.

Consideration was given by Cabinet to the indicators for 2010/11 to 2012/13 at its meeting on 18 February 2010, and these were subsequently approved

by Full Council on 3 March 2010. The Prudential Code requires the Chief Financial Officer (ie. the Head of Corporate Services) to establish procedures to monitor performance against all forward-looking prudential indicators, and to report any significant deviations from expectations.

3. ECONOMIC BACKGROUND AT QUARTER 2

The sovereign debt crisis peaked in May 2010, prompted initially by major concerns over the size of the Greek government's total debt and annual deficit. However, any default or write down of Greek debt would also have a substantial impact on other countries, in particular, Portugal, Spain and Ireland. The crisis culminated in the EU and IMF putting together a €750bn support package in mid May.

Growth in the US, UK and the Euro zone in quarter 2 of 2010 was particularly driven by strong growth in the construction sector catching up from inclement weather earlier in the year and is unlikely to be repeated. General expectations are for much more subdued figures for the remainder of 2010. Market expectations for all three sectors of the economy are that these have all peaked and are pointing downwards, though not necessarily into negative territory.

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 major job losses during this period, in particular in public sector services. This will 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. GDP growth is likely to have peaked at 1.2% in quarter 2 of 2010.

CPI has remained high during 2010. It peaked at 3.7% in April and has fallen back to 3.1% in August. RPI remains high, at 4.7% in August. Although inflation has remained stubbornly above the MPC's 2% target, the MPC is confident that inflation will fall back under the target over the next two years. The last quarterly Inflation Report in August showed a significant under-shoot after the end of 2011.

The Bank of England finished its programme of quantitative easing with a total of £200bn in November 2009 (although there is currently some increase in expectations that there might be a second round of quantitative easing). Sector's view is that there is unlikely to be any increase in Bank Rate until the middle of 2011.

Prior to the general election, credit rating agencies had been issuing repeated warnings that unless there was a major fiscal contraction, then the UK's AAA sovereign rating was at significant risk of being downgraded. Sterling was also under major pressure during the first half of the year. However, after the Chancellor's budget on 22 June, Sterling has strengthened against the US dollar and confidence has returned that the UK

will retain its AAA rating. In addition, international investors now view UK government gilts as being a safe haven from EU government debt. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and PWLB rates.

It is currently difficult to have confidence as to how strong the UK economic recovery is likely to be, and there are a range of views in the market. Sector has adopted a moderate view. There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas:

- the speed of economic recovery in the US and EU
- the degree to which government austerity programmes will dampen economic growth
- the speed of rebalancing of the UK economy towards exporting and substituting imports
- changes in the consumer savings ratio
- the potential for more quantitative easing, and the timing of this in both the UK and US
- the speed of recovery of banks' profitability and balance sheet imbalances
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economy

The overall balance of risks is weighted to the downside and there is some risk of a double dip recession and deleveraging, creating a downward spiral of falling demand, falling jobs and falling prices, although this is currently viewed as being a small risk.

Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries.

Sector's current interest rate forecast (*prior to Comprehensive Spending Review*):

	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
Bank rate	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.50%	3.00%	3.25%
5yr PWLB rate	2.20%	2.20%	2.20%	2.40%	2.60%	2.80%	3.00%	3.30%	3.60%	3.80%	4.10%	4.40%
10yr PWLB rate	3.30%	3.30%	3.30%	3.40%	3.70%	3.90%	4.00%	4.30%	4.40%	4.60%	4.60%	4.90%
25yr PWLB rate	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.70%	4.70%	4.80%	5.00%	5.00%	5.00%
50yr PWLB rate	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.70%	4.70%	4.80%	5.00%	5.00%	5.00%

Following the Chancellor's announcement on the Spending Review on 20 October 2010, HM Treasury instructed the Public Works Loans Board to increase the average interest rate on all new loans to an average of 1%

above the Government's cost of borrowing, to take effect immediately. The projected rates in the above table will need to be reviewed in to reflect the impact of this decision. The increased rates will be factored into the affordability calculations required under the Prudential Code for the Council's future capital programme borrowing requirements.

4. PRUDENTIAL CODE INDICATOR MONITORING

Appendix 1 details the Prudential and Treasury Management indicators for 2010/11, together with the monitoring position at 30 September 2010.

1. Prudential Indicators

These are based on estimates of expected outcomes, these are four key indicators of "affordability". They are monitored on a quarterly basis, and Appendix 1 compares the approved indicators against the projected outturn for 2010/11, and shows variances on some of the indicators, as described below:

a) Capital Expenditure

The latest projected outturn shows that capital expenditure is expected to be higher than originally anticipated, due to the inclusion of approved carry-forward requests from 2009/10 and amendments to the programme requested during the quarterly monitoring process.

b) Ratio of Financing Costs to Net Revenue Stream

The projected outturn shows a reduction against the approved indicator, due largely to the decision to no longer provide for a voluntary MRP in respect of serviced debt. Offsetting this, £2m of PWLB borrowing was undertaken in May 2010 and a further £1m in August 2010. These sums have all been invested in the short term, pending their use. As previously reported, investment of the £2m resulted in a "cost to carry" of approximately £20,000, however extremely favourable PWLB rates made this a prudent decision. In the case of the additional £1m there is no cost to carry, since the investment return achieved will match the rate paid for the loan. As always, advice was taken from the Council's Treasury Advisers with regard to the timing of borrowing, and this will continue to be the case.

c) Capital Financing Requirement (CFR)

As discussed at b) above, £3m of new external borrowing had been undertaken as at the end of September 2010, and further borrowing in advance of need for future years may be undertaken before the year-end if interest rates continue to be beneficial. Advice regarding the timing of borrowing will continue to be taken from Sector Treasury Services. The estimated closing CFR for 2010/11 is lower than originally anticipated, due

to slippage in the capital programme and a reduced need for the use of borrowing in 2009/10.

2. Treasury Management Indicators

These are based on limits, beyond which activities should not pass without management action. They include two key indicators of "affordability" and four key indicators of prudence.

"Affordability"

a) Authorised Limit for External Debt

b) Operational Boundary for External Debt

"Prudence"

c) Upper Limit for Fixed Interest Exposure – represented by the maximum permitted net outstanding principal sum borrowed at fixed rates. Please note that a negative indicator represents net investment.

d) Upper Limit for Variable Interest Rate Exposure – represented by the maximum permitted net outstanding principal sum borrowed at variable rates. Please note that a negative indicator represents net investment.

e) Upper limits for principal sums invested for periods over 364 days

f) Upper limits for the maturity structure of borrowing

Appendix 1 shows the actual position as at 30 September 2010 and demonstrates that all activities are contained within the currently approved limits.

5. QUARTERLY TREASURY ACTIVITY REPORT

The Treasury Activity Report for the quarter ended 30 September 2010 is attached at Appendix 2, in accordance with the Treasury Management Strategy. For reference, definitions of LIBOR and LIBID are given below.

LIBOR is the London Interbank Offered Rate

LIBOR is the interest rate at which the London banks are willing to offer funds in the inter-bank market. It is the average of rates which five major London banks are willing to lend $10 million for a period of three or six months, and is the benchmark rate for setting interest rates for adjustable-rate loans and financial instruments.

Ie. the London banks are LENDING to each other, which affects the rate at which the banks will lend to other parties eg. local authorities, ie. Gedling are

BORROWING money

LIBID is the Interbank BID (LIBID) rate

LIBID is the interest rate at which London banks are willing to borrow from one another in the inter-bank market. It is the average of rates which five major London banks willing to bid for a $10 million deposit for a period of three or six months.

Ie. the London banks are BORROWING from each other, which affects the rates at which they will borrow from other parties eg. local authorities, ie. Gedling are LENDING money.

6. RECOMMENDATION

Members are asked to note the Prudential Indicator Monitoring at Appendix 1, and the Treasury Activity Report at Appendix 2.