Report to: **Cabinet**

Subject: **Prudential Code Indicator Monitoring 2011/12 and Quarterly Treasury Activity Report – Quarter 1 to 30 June 2011**

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1. PURPOSE OF REPORT

To inform Members of the performance monitoring of the 2011/12 Prudential Code Indicators, and to advise Members of the quarterly treasury activity as required by the Treasury Management Strategy. CIPFA's revised Code of Practice for Treasury Management recommends 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 revised 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 Prudential Indicators for 2011/12 to 2013/14 at its meeting on 13 January 2011, and these were subsequently approved by Full Council on 23 February 2011. 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 1

The first quarter of 2011/12 saw:

- The economic recovery struggle to regain momentum;
- Conditions on the high street deteriorate;
- Mixed signals on the strength of the labour market recovery;
- Public sector borrowing come out disappointingly high;
- The near-term outlook for CPI inflation deteriorate further;
- The Monetary Policy Committee move away from raising interest rates;
- UK equities stay broadly flat over the quarter and gilt yields fall;
- Economic growth slow in the US and euro-zone.

The economic recovery has been struggling to regain momentum after underlying activity more or less stagnated between October and March. The additional bank holiday for the Royal Wedding pulled down both industrial and services output in April. But the CIPS/Markit business surveys have failed to pick up by much since. An average of the surveys over the last three months point to quarterly GDP growth in Q1 of just 0.3% - less than half its trend rate.

The industrial recovery appears to have lost momentum quite quickly. The CIPS/Markit manufacturing survey has fallen to a level consistent with falls in manufacturing output. The output expectations balance of the CBI industrial trends survey has fallen more modestly, but has nonetheless dropped for the past three months in a row.

Meanwhile, the consumer outlook has darkened. The pick-up in the consumer sector seen during the spring appears to have been only temporary, reflecting the good weather and extra bank holiday. Retail sales volumes fell in May, more than reversing April's increase. The CBI's distributive trades survey fell in June. And a number of well-known retailers have recently fallen into administration.

Consumers appear to be reacting to the squeeze on their real incomes. Household real disposable incomes fell by 0.8% in Q1. Inflation is outpacing average earnings by about 2.5%. Consumer confidence also fell back in June and remains consistent with further falls in consumer spending.

Meanwhile, the news on the labour market has been mixed. The Workforce Jobs measure of employment rose strongly in Q1. But the timelier Labour Force Survey measure flattened off in April and May. And the number of job vacancies continued to fall throughout the quarter. The claimant count measure of unemployment also continued to rise over the last three months. This only partly reflected a rise in the number of lone parents claiming Jobseeker's Allowance due to recent benefit changes.

The housing market has continued to tread water. The number of mortgage approvals for new house purchase was broadly unchanged over the quarter at a very low level of just 46,000 or so. House prices have also remained broadly flat,

and the Nationwide index ended the quarter at about the same level as it ended 2010/11.

To stimulate local demand, the council is currently exploring an opportunity to introduce a Gedling Borough based Local Authority Mortgage Scheme, aimed at supporting first-time home-buyers to fund the increased deposits required by mortgage lenders. A further detailed report on this subject will follow in due course.

Meanwhile, net trade looks unlikely to provide as big a contribution to GDP growth in Q1 as it did in the final quarter of 2010/11. Net trade boosted quarterly GDP growth by some 1.4% in Q1. However, the trade deficit was unchanged in April compared to March.

The weakness of the economy appears to be having some adverse effect on the public finances. Borrowing in the first two months of the fiscal year totalled £27.4bn, compared to last year's £25.9bn. It is early days but, at this rate, borrowing will overshoot the OBR's Budget full-year forecast of £122bn.

Oil prices rose but then fell back during the quarter, and so ended Q1at $113 per barrel, close to the level seen at the end of 2010/11. Agricultural prices fell sharply over the past quarter.

The near-term outlook for inflation has deteriorated further. Although CPI inflation held steady at 4.5% in May, it now looks likely to rise to 5.5% or even higher within the next few months. Food price inflation is likely to rise further. And Scottish Power announced in June a 19% rise in gas prices and 10% rise in electricity prices to take effect in August. Other utility suppliers are likely to follow suit.

Households' inflation expectations rose sharply in June. But so far, there are no signs of any pick-up in pay growth. The median pay settlement was unchanged at 2.5% in May.

Most Monetary Policy Committee members still think that the rise in inflation will be only temporary and that inflation will fall back sharply next year. So despite the worsening of the near-term inflation outlook, the weakness of the activity data has pushed most members further away from an interest rate rise.

Some members have even started to discuss the prospect of giving the economy more support. Admittedly, the hurdle for more quantitative easing will be quite high. However, it is certainly possible if the economy remains as weak as we expect.

In financial markets, the FTSE 100 finished the quarter at around 5,950 – about the same level as at the end of 2010/11. This was broadly in line with international stock markets – the S&P500 was also little changed over the period. Ten year gilt yields fell from 3.69% to 3.38% on the back of a drop in interest rate expectations. At the end of March, markets were expecting interest rates to have risen by this July. But now they expect rates to stay on hold until July next year. Meanwhile, sterling was broadly unchanged against the dollar at about $1.60, and fell only a little against the euro.

In the US, the recovery also appears to have lost a significant amount of momentum. The ISM manufacturing index fell sharply in May and reversed only a fraction of this drop in June. Payrolls employment rose by a disappointing 54,000 in

May. Meanwhile, the euro-zone economy expanded at a healthy pace in Q1, but recent falls in most leading indicators suggest that growth is slowing there too. Germany has continued to outperform the rest of the region. The risk of an imminent Greek disaster eased temporarily after an initial draft agreement on a second Greek bailout package but European policymakers' inability to deal with the crisis quickly and effectively created further uncertainty and volatility.

4. INTEREST RATE FORECASTS AT 30 JUNE 2011 AS AT 30 JUNE 2011

The Council's treasury adviser, Sector, has provided the following forecast:

Sector's Interest Rate View	NOW	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14
Sector's Bank Rate View	**0.50%**	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.00%	2.25%	2.50%	2.75%	3.00%
5yr PWLB Rate	**3.12%**	3.55%	3.65%	3.75%	3.90%	4.00%	4.15%	4.25%	4.45%	4.60%	4.65%	4.75%
10yr PWLB View	**4.45%**	4.75%	4.75%	4.80%	4.95%	4.95%	5.00%	5.05%	5.15%	5.20%	5.25%	5.25%
25yr PWLB View	**5.24%**	5.40%	5.40%	5.40%	5.40%	5.40%	5.45%	5.50%	5.50%	5.50%	5.60%	5.65%
50yr PWLB Rate	**5.20%**	5.40%	5.40%	5.40%	5.40%	5.40%	5.45%	5.50%	5.50%	5.50%	5.60%	5.65%

- The Sector central forecast is for a November 2011 first increase in Bank Rate but with reservations that it could well slip back in time, unless there is some good news on the UK economic recovery before then.
- Sector has undertaken its normal quarterly review of interest rate forecasts after the issue of the Bank of England's quarterly Inflation Report. The key Bank of England comments are shown below:
  - Mervyn King said after the May Inflation Report was published that 'Bank Rate cannot stay down indefinitely' but this does not equate to saying 'there will be a first increase in Bank Rate in November 2011'. Financial markets have over-reacted to this statement.
  - Continuing wage freezes / low pay settlements
  - BoE forecasts for the speed of recovery and of increases in GDP growth rate have consistently been over optimistic since the recession started in 2009
  - CPI will blip up in 2011 due to temporary supply side shock factors but these will drop out within 12 months - as will VAT increases
  - Unless the output gap is closed (unlikely for some considerable time) inflation will eventually fall below target
  - CPIY (CPI less the effects of increase in indirect taxation) has been at or below 2% during 2010 and under 2.9% in 2011

Upside risks to the central forecast:

- Bank Rate cuts do finally succeed in feeding through to stimulate a strong economic recovery.
- A major increase in UK exports due to the circa 20% depreciation of Sterling over the last two years and import substitution by UK produced goods and services - assuming a reasonably strong economic recovery in US, EU and emerging markets.

- Corporate profitability has improved considerably since the recession due to cost cutting; many larger corporate balance sheets are now awash with cash. This could fuel an increase in investment expenditure and also M&A (merger and acquisitions) activity i.e. drive share prices higher and give investors a feel good factor to spend more.

Downside risks to the central forecast:

- Chinese and Indian economies are now over-heating, with Chinese authorities spooked by inflation over 5%. The Chinese central bank has raised the central rate four times and increased bank reserve requirements six times since October 2010 to curtail bank credit creation capacity. This could lead to increased volatility or an outright fall in commodity prices.
- UK emerging market funds are finding it difficult to place the huge investment cash flows they are receiving; Chinese investors with surplus cash are investing it in property and shares as if it is a one way bet! Ideally, there needs to be a rebalancing of Chinese spending on retail sales as opposed to the creation of asset price bubbles in property and shares.
- US economy has disappointed in Q1 2011 limping along at 1.8% annual growth rate after a strong Q4 2010 at 3.1%
- US (and UK) have exhausted their capacity for any further fiscal stimulus for their economies
- US is still not even on the starting line for dealing with cutting back a massive annual fiscal deficit; cut backs to come are likely to dampen the economy further
- US: banks have major risk exposure to a fraught housing market where house prices have gone down 8.2% in the 12 months to April 2011, have fallen 29.5% since the peak in June 2006, where 29.5% of mortgages are now in negative equity and there is no imminent turn around in sight for the housing market
- Peripheral European economies' crisis requires the European Central Bank to adopt a more pragmatic stance to debt restructuring: the longer the delay, the bigger the potential fallout.
- UK consumer confidence at very low levels whilst major cuts in Government expenditure and public sector jobs still to feed through fully into the economy and to dampen growth over the next few years.
- Despite the private sector creating more jobs than the public sector is cutting, the high current total level of unemployment of around 2.5m means that it will take several years to reduce total unemployment down to pre recession levels.
- No significant growth in personal disposable income likely for a couple of years due to:
    - Continuing wage freezes / low pay settlements
    - Inflation exceeding wage increases so disposable income is being eroded
    - Increases in taxation
    - Mortgagors coming off cheap fixed rate mortgage deals onto standard variable rates.

- House prices have fallen to their lowest level since July 2009 and no turn around is in sight in the current economic climate.
- Consumers are focused on reducing over-borrowing by repaying debt rather than spending and are fearful of eventual increases in Bank Rate sending mortgage standard variable rates (SVRs) up in parallel; rebuilding of consumer balance sheets will increase the savings ratio and depress consumer expenditure.
- Banks are still heavily focused on rebuilding their balance sheets – RBS and Lloyds still have massive maturing wholesale borrowing to refinance; the Bank of England Special Liquidity Scheme (SLS) ends in Jan 2012; the BoE has lent £185bn to banks and building societies which must be repaid. The BoE has indicated there will be no extension of this timeframe for the SLS.
- Eventual reversal of Quantitative Easing by selling gilts etc. will take cash out of the economy and restrict credit growth; gilt sales will need to be sensitively timed considering the huge level of gilt sales already planned just to fund each year's deficit.

5. COMPLIANCE WITH TREASURY AND PRUDENTIAL INDICATORS

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limit. The Council's approved Treasury and Prudential Indicators (affordability limits) are included in the Treasury Management Strategy Statement (TMSS) approved by Council on 2 March 2011. Following the decision not to progress with the new leisure centre scheme, several of the indicators have been recalculated to exclude the potential borrowing in advance of need that had been allowed for.

During the financial year to date the Council has operated within the treasury limits and Prudential Indicators set out in the council's TMSS, and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators as at 30 June are shown at Appendix 1.

Prudential Indicators

These are based on estimates of expected outcomes, and are key indicators of "affordability". They are monitored on a quarterly basis, and Appendix 1 compares the approved indicators against the projected outturn for 2011/12, and shows variances on some of the indicators, as described below:

a) Capital Expenditure

This has been recalculated following the decision not to proceed with the leisure centre project.

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 2010/11.

b) Ratio of Financing Costs to Net Revenue Stream

The revised estimate and projected outturn show a small increase, from 5.65% to 5.75%, against the approved indicator. This is due to further changes made to the net budget requirement after the submission of the Prudential Indicators to Cabinet on 13 January 2011.

c) Capital Financing Requirement (CFR)

This has been recalculated following the decision not to proceed with the leisure centre project.

The estimated closing CFR for 2011/12 is higher than originally anticipated, due to the inclusion of the carry forwards from 2010/11, and the associated need for increased usage of borrowing.

d) Net Borrowing Requirement and CFR

This indicator seeks to ensure that borrowing over the medium term is only for capital purposes. It has been recalculated following the decision not to proceed with the leisure centre project.

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. This has been recalculated following the decision not to proceed with the ne leisure centre, since provision had been allowed for borrowing in advance of need, should this have been advantageous.

b) Operational Boundary for External Debt. This too has been recalculated.

“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.

This indicator has been recalculated following the decision not to proceed with the leisure centre project.

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 – one such investment was brought forward at 1 April 2011 and a further investment was made during the period. Both these investments matures before 31 March 2012, and are classified as a "non specified investments" by way of their terms, however they are within both the Treasury Indicator discussed here, and the limits set out for non specified investments in the Annual Investment Strategy approved by Members on 2 March 2011.

f) Upper limits for the maturity structure of borrowing.

Appendix 1 shows the actual position as at 30 June 2011 and demonstrates that all activities are contained within the currently approved, and revised, limits.

6. INVESTMENT STRATEGY

The Treasury Activity Report for the quarter ended 30 June 2011 is attached at Appendix 2, in accordance with the Treasury Management Strategy. For reference, definitions of LIBOR and LIBID are given at Appendix 3.

7. NEW BORROWING

No new borrowing was undertaken during the quarter to 30 June 2011.

8. DEBT RESCHEDULING

No debt rescheduling was undertaken during the quarter to 30 June 2011. Advice in this regard will continue to be taken from Sector.

9. RECOMMENDATION

Members are asked to note the Prudential Indicator Monitoring at Appendix 1, and the Treasury Activity Report at Appendix 2, and to refer the report to Full Council for approval of the revisions to the indicators as follows:

Indicator	Original	Revised
Capital expenditure	£2,676,900	£2,501,900
Ratio of financing costs	5.65%	5.75%
Capital Financing Requirement (CFR)	£11,303,162	£11,128,162
Net borrowing and CFR	£20,484,329	£12,981,529
Authorised limit for external debt	£24,000,000	£16,500,000
Operational boundary for external debt	£23,500,000	£15,500,000
Upper limit for fixed interest exposure	£20,500,000	£13,000,000

APPENDIX 1

Prudential and Treasury Indicators for 2011/12
Quarter 1 ended 30 June 2011

Prudential Indicators	**2011/12 Original Estimate**	**2011/12 Revised Estimate**	**2011/12 Position at 30 June 2011**
a) Capital Expenditure	£2,676,900	£2,501,900	3,455,700
b) Ratio of Financing Costs to Net Revenue Stream	5.65%	5.75%	5.75%
c) Capital Financing Requirement (CFR)	£11,303,162	£11,128,162	£11,550,362
d) Net Borrowing and CFR	£20,484,329	£12,981,529	£1,606,577
e) Incremental impact of new 2010/11 capital investment decisions	£0.41	£.0.41	

Treasury Management Indicators	**2011/12 Original Estimate**	**2011/12 Revised Estimate**	**2011/12 Position at 30 June 2011**
a) Authorised Limit for External Debt:			
Borrowing	£22,500,000	£15,000,000	£9,811,577
Other Long Term Liabilities	£1,500,000	£1,500,000	-
Total Authorised Limit	**£24,000,000**	**£16,500,000**	**£9,811,577**
b) Operational Boundary for External Debt:			
Borrowing	£21,500,000	£14,000,000	£9,811,577
Other Long Term Liabilities	£1,500,000	£1,500,000	-
Total Operational Boundary	**£23,500,000**	**£15,500,000**	**£9,811,577**
c) Upper limit for fixed interest exposure (Max o/s net Borrowing)	£20,500,000	£13,000,000	£3,811,577
Local indicator-Investment only	100%		73.13%
Local indicator-Borrowing only	100%		100%
d) Upper limit for variable interest exposure (Max o/s net Borrowing)	£2,000,000		-£2,205,000
Local indicator-Investment only	100%		26.87%
Local indicator-Borrowing only	50%		0%
e) Upper limits for maturity structure of outstanding borrowing during 2011/12 (Lower limit 0% in all cases)			
Under 1 year	20%		0%
1-2 years	20%		0%
2-5 years	35%		30.6%
5-10 years	50%		0%
Over 10 years	100%		69.4%
f) Upper limits for principal sums invested for periods **over** 364 days			
Maturing beyond 31 March 2012	£5,000,000		£3,000,000
Maturing beyond 31 March 2013	£3,000,000		£0
Maturing beyond 31 March 2014	£0		£0

APPENDIX 2

Treasury Activity Report 2011/12 for the Quarter ended 30 June 2011

	Position at 1 April 11	Loans Made Quarter 1	Loans Repaid Quarter 1	Position at 30 June 11
	£	£	£	£
Long Term Borrowing				
PWLB	**9,811,577**	**0**	**0**	**9,811,577**
Temporary Borrowing				
Local Authorities	0	0	0	0
Public Corporations	0	0	0	0
Central Government	0	0	0	0
Banks and other Institutions	0	0	0	0
Total Temporary Borrowing	**0**	**0**	**0**	**0**
TOTAL BORROWING	**9,811,577**	**0**	**0**	**9,811,577**
Temporary Investment				
Bank of Scotland	5,000,000	3,800,000	-4,800,000	4,000,000
Barclays	0	0	0	0
HSBC Treasury	0	1,260,000	-1,260,000	0
Royal Bank of Scotland	2,010,000	14,725,000	-14,530,000	2,205,000
Santander-Abbey	0	11,115,000	-9,115,000	2,000000
Total Banks	**7,010,000**	**30,900,000**	**-29,705,000**	**8,205,000**
Building Societies	0	0	0	0
Debt Management Office	0	0	0	0
Local Authorities and Others	0	0	0	0
TOTAL INVESTMENT	**7,010,000**	**30,900,000**	**-29,705,000**	**8,205,000**
NET BORROWING / (INVESTMENT)	**2,801,577**	**(30,900,000)**	**29,705,000**	**1,606,577**

Temporary Investment and Borrowing Statistics at 30 June 2011:

Investment

Fixed Rate	5,000,000	7,260,000	-6,260,000	6,000,000
Variable Rate	2,010,000	23,640,000	-23,445,000	2,205,000
TOTAL INVESTMENT	**7,010,000**	**30,900,000**	**-29,705,000**	**8,205,000**

Proportion of Fixed Rate Investment	73.13%
Proportion of Variable Rate investment	26.87%
Temporary Investment Interest Receivable	£32,783
Equated Temporary Investment	£2,369,246
Weighted Average Interest Rate Received	1.38%
7 Day LIBID (Benchmark)	0.46%
3 Month LIBID	0.70%

Borrowing

Temporary Borrowing Interest Payable	-
Equated Temporary Borrowing	-
Weighted Average Interest Rate Paid	-
7 Day LIBOR (Benchmark)	0.59%

APPENDIX 3

LIBOR - 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. *e. 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 - 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.