Report to: **Cabinet**

Subject: **Prudential Code Indicator Monitoring Q2 2011/12 and Quarterly Treasury Activity Report Q2 (30 September 2011)**

Date: **3 November 2011**

Author: **Head of Corporate Services**

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 is fully compliant with the revised Code.

This report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- An economic update for the first six months of 2011/12 (see paragraph 3)
- A review of interest rates (paragraph 4)
- A review of compliance with Prudential and Treasury Limits for 2011/12 (paragraph 5)
- A review of the Integrated Treasury Management Strategy Statement and Annual Investment Strategy and Minimum Revenue Provision Policy Statement (paragraph 6)
- A review of any debt rescheduling undertaken during 2011/12 (paragraph 7)

2. BACKGROUND

It is a statutory duty under the Local Government Act 2003 (the Act) and its supporting regulations for the Council to determine and review how much it can afford to borrow. The Act introduced the Prudential Framework for Local Authority Capital Investment, the key objectives being:

- That capital investment plans are affordable, prudent and sustainable.
- That treasury management decisions are taken in accordance with good professional practice.

- 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 2

Indicators suggest that the economic recovery has stalled. The weighted output balance fell in August to a level consistent with contraction in the past. The surveys also exclude retail activity, and the latest news from the high street suggests that the sector is in a similar position. While sales volumes rose by 0.2% in July, they fell by the same amount in August.

The slow economic recovery has impacted on the job market. The Labour Force Survey measure of employment fell by 70,000 in the three months to July, the first fall this year.

The public finances are expected to miss this year's fiscal forecasts. If the trend in borrowing seen over the first five months of the fiscal year continues, it will be around £5bn higher than the OBR expects. The full impact of some tax changes has yet to be felt, but lags between developments in the economy and the public finances suggest that the recent slowdown is unlikely to have had its full effect on receipts.

Conditions in the housing market have continued to deteriorate. Whilst the number of mortgage approvals for new house purchase rose from 48,800 in June to 52,400 in August, this has not prevented renewed falls in house prices.

The trade in goods and services deficit was £4.5bn in July, compared to an average monthly deficit of £3.8bn in Q1. The survey measures of export orders also point to falls in exports ahead.

Inflation continued to rise in the second quarter. CPI inflation rose from 4.2% in June to 4.4% in July and 4.5% in August. A series of rises in electricity and gas prices also took effect in late August and September which, together with a rise in food inflation reflecting past rises in agricultural commodity prices, could push inflation higher still in September. Inflation is expected to rise a little higher in the third quarter – but recent developments suggest that it should fall quite sharply next year.

Measures of inflation “expectations” have also risen. The Bank of England’s measure of households’ inflation expectations in the year ahead rose from 3.9% to 4.2% in Q2. However with conditions in the labour market continuing to deteriorate, these expectations seem unlikely to become ingrained. The annual rate of average earnings growth including bonuses fell from 3.1% to 2.9% in July (the rate excluding bonuses fell from 2.2% to 1.7%). Real pay growth has thus remained negative.

The MPC became more “dovish” during Q2. Two members abandoned their votes for a rate rise at the meeting in August, and the minutes of September’s meeting also suggested that further quantitative easing (QE) was possible. Most members accepted that the case for policy stimulus has significantly strengthened, and QE was subsequently expanded by £75bn in October.

Financial market sentiment deteriorated sharply in the second quarter, reflecting declining prospects for economic growth and renewed risk aversion as a result of the intensification of the euro-zone sovereign debt crisis. The FTSE 100 finished the quarter some 14% lower than at the end of the first quarter. Meanwhile, a global shift away from risk saw the dollar strengthen, and sterling weaken against the dollar but strengthened slightly against the euro.

4. INTEREST RATE FORECASTS AT 30 SEPTEMBER 2011

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

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%

The Sector central forecast is for the first increase in bank rate to be in September 2013. The markets are experiencing exceptional levels of volatility, closely correlated to political developments in the sovereign debt crisis. The interest rate review has taken place as a result of:

- The decision by the MPC to expand quantitative easing over the next four months by a further £75bn, which had an immediate effect of depressing gilt yields at the long end of the curve. It also clearly underlines how concerned the MPC is about the prospects for growth of the UK economy and that recession is now a much greater concern than inflation.

- 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. This has led in turn to a further increase in flows into UK gilts since Sector’s last interest rate forecast in August, which has depressed gilt yields and PWLB rates to even lower levels.

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, the effect of which was built in to the original TMSS, several of the indicators were amended at Cabinet on 4 August 2011.

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 September 2011 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

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. Slippage on the current year programme has also been incorporated.

b) Ratio of Financing Costs to Net Revenue Stream

The projected outturn shows a small decrease when compared with the revised indicator, from 5.75% to 5.32%. This is due to the inclusion of revised estimates for interest receivable and interest payable on serviced debt.

c) Capital Financing Requirement (CFR)

The projected closing CFR for 2011/12 is higher than originally anticipated, due to the inclusion of the carry forwards from 2010/11, and the recently approved investment in a scheme to provide photovoltaic panels, both of which increase the need for the use of borrowing.

d) Net Borrowing Requirement and CFR

This indicator seeks to ensure that borrowing over the medium term is only for capital purposes. At 30 September the council's net position is one of net investment.

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 – one such investment was brought forward at 1 April 2011 and a further investment was made during quarter 1. Both these investments mature 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 September 2011 and demonstrates that all activities are contained within the currently approved, and revised, limits.

6. REVIEW OF THE INTEGRATED TREASURY MANAGEMENT STRATEGY STATEMENT, ANNUAL INVESTMENT STRATEGY AND MINIMUM REVENUE PROVISION POLICY STATEMENT 2011/12

The Integrated Treasury Management Strategy Statement (TMSS), Annual Investment Strategy and Minimum Revenue Provision Policy Statement for 2011/12 was approved by Council on 2 March 2011. This document covered both the borrowing and investment strategies for the year, together with the council's intentions with regard to MRP.

Borrowing Strategy

No new borrowing was undertaken during the quarter ended 30 September 2011.

The council's Capital Financing Requirement (CFR) represents its underlying need to borrow to finance capital investment. Due to favourable interest rates, borrowing in advance of need is sometimes desirable, with the result that the CFR can differ to the actual borrowing planned in the year.

Following the recent Council decision to fund investment in photovoltaic panels from Prudential borrowing, the latest projection of the requirement for borrowing in 2011/12 is £1,574,800, however in view of the borrowing undertaken in advance of need in 2010/11, it is not currently anticipated that any new borrowing will be undertaken during 2011/12. However, interest rates have generally been on a downward trend during the quarter, with the low-point being during September, therefore advice will be taken from Sector and should conditions be advantageous, some further borrowing in advance of need will be considered by the Head of Corporate Services.

Investment Strategy

The council's investment priorities are the security of capital and liquidity. The council will always seek to obtain the optimum return (yield) on its investments, but only that commensurate with proper levels of security and liquidity. In the current economic climate and the heightened credit concerns, it is generally considered appropriate to keep investments short–term, with a maximum duration of 3 months.

The Treasury Activity Report for the quarter ended 30 September 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. Members will note that an equated rate of 1.28% has been achieved, which outperforms both the 7 day and 3 month LIBID rates of 0.47% and 0.72% respectively. This has been achieved by keeping the majority of investments short-term, but mixing these with the occasional longer term deposit, always with high quality institutions, at particularly favourable rates.

Credit ratings advice continues to be taken from Sector, however the ultimate decision on what is prudent and manageable for this council is taken by the Head of Corporate Services under the approved scheme of delegation.

Following notification of the downgrade by Fitch of most of the UK banking institutions on 13 October 2011, the council's minimum lending criteria became unworkable. The Head of Corporate Services accordingly agreed a change in the minimum criteria as follows:

Criterion	**Original**	**Amended**
Long Term	AA- or better	A or better
Short Term	F1+	F1 or better
Individual Support	A, B or C	A, B or C (no change)
Support (Govt etc)	1, 2 or 3	1, 2 or 3 (no change)

This change inevitably introduces some additional counterparties to the lending list. Close attention will be paid to these, given that such institutions were previously not deemed acceptable. Rather than the usual lending limit of £5m per counterparty, the Head of Corporate Services will operate a lower level for any new counterparty used a result of the general downgrade. Initially this will be set at a maximum of £1.5m per new counterparty to be approved by the Principal Accountant, and at £3m to be approved by the Financial Services Manager. Above £3m will require the express approval of the Head of Corporate Services. This arrangement will be subject to ongoing review.

7. DEBT RESCHEDULING

Debt rescheduling opportunities have been limited in the current economic climate, and due to the structure of interest rates following the increases in PWLB rates in October 2010. Advice in this regard will continue to be taken from Sector.

No debt rescheduling was undertaken during the quarter to 30 September 2011.

8. RECOMMENDATIONS

Members are asked to:

1. Note the report, together with the Prudential Indicator Monitoring at Appendix 1, and the Treasury Activity Report at Appendix 2.

2. Confirm the action taken by the Head of Corporate Services with regard to the change in minimum lending criteria made necessary by the Fitch downgrade of the UK banks, as detailed at paragraph 6 above.

APPENDIX 1

Prudential and Treasury Indicators for 2011/12
Quarter 2 ended 30 September 2011

Prudential Indicators	**2011/12 Original Estimate**	**2011/12 Revised Estimate**	**2011/12 Position at 30 Sept 2011**
	(Cabinet 3/1/11)	(Cabinet 4/8/11)	
a) Capital Expenditure	£2,676,900	£2,501,900	£3,783,600
b) Ratio of Financing Costs to Net Revenue Stream	5.65%	5.75%	5.32%
c) Capital Financing Requirement (CFR)	£11,303,162	£11,128,162	£11,869,062
d) Net Borrowing and CFR	£20,484,329	£12,981,529	-£3,978,423
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 Sept 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	£811,577
Local indicator-Investment only	100%	100%	65.26%
Local indicator-Borrowing only	100%	100%	100%
d) Upper limit for variable interest exposure (Max o/s net Borrowing)	£2,000,000	£2,000,000	-£4,790,000
Local indicator-Investment only	100%	100%	34.74%
Local indicator-Borrowing only	50%	50%	0%
e) Upper limits for maturity structure of outstanding borrowing during 2011/12 (Lower limit 0% in all cases)			
Under 1 year	20%	20%	0%
1-2 years	20%	20%	0%
2-5 years	35%	35%	30.6%
5-10 years	50%	50%	0%
Over 10 years	100%	100%	69.4%
f) Upper limits for principal sums invested for periods **over** 364 days			
Maturing beyond 31 March 2012	£5,000,000	£5,000,000	£3,000,000
Maturing beyond 31 March 2013	£3,000,000	£3,000,000	£0
Maturing beyond 31 March 2014	£0	£0	£0

APPENDIX 2

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

	Position at 1 July 11	Loans Made Quarter 2	Loans Repaid Quarter 2	Position at 30 Sept 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	4,000,000	1,700,000	-1,700,000	4,000,000
Barclays	0	0	0	0
HSBC Treasury	0	2,750,000	-2,750,000	0
Royal Bank of Scotland	2,205,000	12,920,000	-10,335,000	4,790,000
Santander-Abbey	2,000,000	9,850,000	-6,850,000	5,000,000
Total Banks	**8,205,000**	**27,220,000**	**-21,635,000**	**13,790,000**
Building Societies	0	0	0	0
Debt Management Office	0	0	0	0
Local Authorities and Others	0	0	0	0
TOTAL INVESTMENT	**8,205,000**	**27,220,000**	**-21,635,000**	**13,790,000**
NET BORROWING / (INVESTMENT)	**1,606,577**	**-27,220,000**	**21,635,000**	**-3,978,423**

Temporary Investment and Borrowing Statistics at 30 September 2011:

Investment

Fixed Rate	6,000,000	11,750,000	-8,750,000	9,000,000
Variable Rate	2,205,000	15,470,000	-12,885,000	4,790,000
TOTAL INVESTMENT	**8,205,000**	**27,220,000**	**-21,635,000**	**13,790,000**

Proportion of Fixed Rate Investment	65.26%
Proportion of Variable Rate investment	34.74%
Temporary Investment Interest Receivable	£73,909
Equated Temporary Investment	£5,754,506
Weighted Average Interest Rate Received	1.28%
7 Day LIBID (Benchmark)	0.47%
3 Month LIBID	0.72%

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.