Report to: **Cabinet**

Subject: **Prudential Code Indicator Monitoring Q3 2011/12 and Quarterly Treasury Activity Report Q3 (31 December 2011)**

Date: **2 February 2012**

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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 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 nine 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 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 3

Activity indicators suggest that the economic recovery ground to a halt in the third quarter, and output may even have contracted. The weighted output balance of the Chartered Institute of Purchasing and Supply (CIPS)/Markit surveys in October fell to a level that has previously been consistent with a contraction in GDP, but the output balance then broadly held at that level in November.

The CIPS surveys exclude the retail sector, and the latest news from the high street has been poor, reflecting the pressures on households' finances. Official figures indicate that retail sales (excluding petrol) rose by 0.9% in October but fell by 0.7% in November, despite deep discounting. Anecdotal evidence suggests that spending was generally weaker than is usual in December.

Conditions in the labour market have also continued to deteriorate, albeit at a slower pace. The Labour Force Survey measure of employment fell by 63,000 in the three months to October. The number of employees plummeted by 252,000, but this was partly offset by a 166,000 rise in self-employment. Rises in the claimant count measure of unemployment also moderated, increasing by 2,500 in October and 3,000 in November.

The housing market has continued its slow recovery. Mortgage approvals for new house purchase rose from 51,200 in September to 52,900 in November, and according to Nationwide, house prices were 0.6% higher in December than they were in September. Nonetheless, banks began passing on the rise in their wholesale funding costs, reflecting the adverse effects of the euro-zone debt crisis, to consumers during the quarter.

Latest data suggests that net trade was likely to make a positive contribution to GDP growth in the third quarter. Despite weaker than expected GDP growth, the latest public finance figures indicate that borrowing is well below last year's totals. Spending growth has slowed, while growth in tax receipts is being maintained. If the trend is sustained, borrowing will total around £122bn in 2011/12.

CPI inflation fell during the quarter, from its recent peak of 5.2% in September to 5.0% in October and 4.8% in November. It was expected to fall further in December as past rises in energy prices a year ago dropped out of the annual comparison. Inflation remained on track to fall further in the coming months. The MPC restarted quantitative easing (QE) in October and announced a further £75bn gilt purchases to be completed by February. The MPC may yet sanction further purchases in Q4.

Reflecting this dovish stance, market expectations for official interest rates continued to fall during Q3. While bond markets felt that the default risk on UK government bonds had grown during the quarter, they viewed that risk to be lower than in many other major economies, including Germany.

In contrast to the UK, economic data in the US improved during Q3. Manufacturing strengthened during November and December to a level consistent in the past with annual GDP growth of 2.5% to 3.0%. Non-farm payrolls increased by 112,000 in October, and 100,000 in November.

In the euro-zone, policymakers made little progress to deal with the region's debt crisis. The economic data in the euro-zone also continued to weaken, and a deep recession in the euro-zone remains a key risk to the outlook for the UK economy.

4. INTEREST RATE FORECASTS AT 31 DECEMBER 2011

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

Sector's Interest Rate View	NOW	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%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%
5yr PWLB Rate	**2.06%**	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 View	**3.11%**	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 View	**4.06%**	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	**4.13%**	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, however PWLB rates and bond yields remain unpredictable. Exceptional levels of volatility are being experienced, and these are closely correlated to political developments (or the lack of them) in the Eurozone sovereign debt crisis.

Sector undertook a review of interest rate forecasts as a result of two major events:

- The decision by the MPC to expand quantitative easing by a further £75bn

  This decision had an immediate effect of depressing gilt yields at the long end of the curve. It also clearly underlined how concerned the MPC is about the prospects for UK growth and that recession is now a much greater concern than inflation. This tranche is due to be completed in February 2012.

- The marked deterioration of growth prospects in the US, EU and UK

  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 "safe haven" flows into UK gilts, which have depressed gilt yields and pushed 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 31 December 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 lower than the revised estimate, due to slippage on the current year programme to 2012/13.

b) Ratio of Financing Costs to Net Revenue Stream

The projected outturn of 4.81% shows a reduction from the revised indicator of 5.75%. This is due to the inclusion of revised estimates for interest receivable and adjustments to MRP.

c) Capital Financing Requirement (CFR)

The projected closing CFR for 2011/12 is lower than the revised indicator, due to slippage on the capital programme.

d) Net Borrowing Requirement and CFR

This indicator seeks to ensure that borrowing over the medium term is only for capital purposes. At 31 December 2011, 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 31 December 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 31 December 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.

The latest projection of the requirement for borrowing in 2011/12 is £1,368,600, however in view of the borrowing undertaken in advance of need during 2010/11, it is not currently anticipated that any new borrowing will be undertaken during the year.

However, interest rates remain low therefore advice will be taken from Sector, and should conditions be advantageous, some further borrowing in advance of need will be considered by the Chief Financial Officer.

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 31 December 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 1.33% has been achieved, which outperforms both the 7 day and 3 month LIBID rates of 0.48% and 0.78% 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 Chief Financial Officer under the approved scheme of delegation.

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 nine months to 31 December 2011.

8. RECOMMENDATIONS

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

APPENDIX 1

Prudential and Treasury Indicators for 2011/12
Position at 31 December 2011

Prudential Indicators

	2011/12 Original Estimate	2011/12 Revised Estimate	2011/12 Position at 31 Dec 2011
	(Cabinet 3/1/11)	(Cabinet 4/8/11)	
a) Capital Expenditure	£2,676,900	£3,455,700	£3,027,200
b) Ratio of Financing Costs to Net Revenue Stream	5.65%	5.75%	4.81%
c) Capital Financing Requirement (CFR)	£11,303,162	£11,550,362	£10,731,694
d) Net Borrowing and CFR	£20,484,329	£12,981,529	-£2,238,423
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 31 Dec 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	£1,611,577
Local indicator-Investment only	100%	100%	68.05%
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	-£3,850,000
Local indicator-Investment only	100%	100%	31.95%
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 31 December 2011

	Position at 1 Oct 11	Loans Made Quarter 3	Loans Repaid Quarter 3	Position at 31 Dec 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	4,350,000	-3,350,000	5,000,000
Barclays	0	1,000,000	0	1,000,000
HSBC Treasury	0	3,200,000	-3,200,000	0
Royal Bank of Scotland	4,790,000	11,130,000	-12,070,000	3,850,000
Santander-Abbey	5,000,000	1,500,000	-5,500,000	1,000,000
Total Banks	**13,790,000**	**21,180,000**	**-24,120,000**	**10,850,000**
Building Societies	0	1,200,000	0	1,200,000
Debt Management Office	0	0	0	0
Local Authorities and Others	0	0	0	0
TOTAL INVESTMENT	**13,790,000**	**22,380,000**	**-24,120,000**	**12,050,000**
NET BORROWING / (INVESTMENT)	**-3,978,423**	**-22,380,000**	**24,120,000**	**-2,238,423**

Temporary Investment and Borrowing Statistics at 31 December 2011:

Investment

Fixed Rate	9,000,000	7,400,000	-8,200,000	8,200,000
Variable Rate	4,790,000	14,980,000	-15,920,000	3,850,000
TOTAL INVESTMENT	**13,790,000**	**22,380,000**	**-24,120,000**	**12,050,000**

Proportion of Fixed Rate Investment	68.05%
Proportion of Variable Rate investment	31.95%
Temporary Investment Interest Receivable	£123,758
Equated Temporary Investment	£9,294,132
Weighted Average Interest Rate Received	1.33%
7 Day LIBID (Benchmark)	0.48%
3 Month LIBID	0.78%

Borrowing

Temporary Borrowing Interest Payable	-
Equated Temporary Borrowing	-
Weighted Average Interest Rate Paid	-
7 Day LIBOR (Benchmark)	0.60%

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.