Report to: **Cabinet**

Subject: **Prudential Code Indicator Monitoring Q1 2012/13 and Quarterly Treasury Activity Report Q1 (30 June 2012)**

Date: **6 September 2012**

Author: **Corporate Director (Chief Financial Officer)**

1. PURPOSE OF REPORT

To inform Members of the performance monitoring of the 2012/13 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 three months of 2012/13 (see paragraph 3)
- A review of interest rates (paragraph 4)
- A review of compliance with Prudential and Treasury Limits for 2012/13 (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 2012/13 (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 2012/13 to 2014/15 at its meeting on 12 January 2012. Following adjustment for the inclusion of the Local Authority Mortgage Scheme (LAMS), these were subsequently reconsidered by Cabinet on 16 February and referred for approval by Full Council on 5 March 2012. 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 1

Weakening business surveys since the start of Q1 suggest that the economy may not escape a third successive quarterly contraction. The weighted output balance of surveys in April and May was at a level consistent with quarterly expansion, albeit of only 0.2%. High street spending performed strongly in May on the official measure, following a weak performance in April. Evidence for early June suggests that the Jubilee holiday boosted spending, however, consumer confidence shows little sign of breaking out of its long-depressed state.

The labour market continued to perform relatively better. The Labour Force Survey measure of employment rose in the three months to April, whilst unemployment fell by 51,000 in the period February-April. The narrower claimant count measure of unemployment rose by 8,000 in May, the largest increase since September 2011.

Pay growth remained weak. Annual growth of overall average earnings rose from 0.8% to 1.9% in April. Given the rate of inflation over this period, real pay continued to fall on an annual basis, an underlying drag on the consumer and therefore growth.

House prices trended downwards. The Nationwide measure fell in two of the three months from April to June, and the less timely Halifax measure also saw an overall decline in prices over April and May.

Banks' funding costs eased over the quarter, reflecting actions by the Bank of England and Treasury to boost liquidity. Two initiatives were announced in June, a "funding for lending" scheme which would allow banks to temporarily "swap" their assets with the Bank of England in return for money they could lend to customers, and an emergency scheme that offered six-month low-cost liquidity to banks in tranches of £5bn a month. Costs, however, remained elevated and banks began to pass higher costs onto borrowers. Borrowing rates on most types of new mortgages rose in April and May.

Trade data showed a sharp deterioration in April. The UK posted its second largest monthly trade deficit on record, driven in large part by a widening of the gap between exports and imports with countries outside the EU. Exports to the Eurozone also fell, with weakness extending from the peripheral countries to what had previously been perceived as strong economies like Germany. The latest public finance figures were also disappointing. While April's budget surplus was the largest on record, this was boosted to the tune of £28bn by the transfer of a share of the assets of the Royal Mail's pension fund to the public sector. Once allowance was made for this, net borrowing for the first two months of the financial year was almost £4bn higher than the equivalent period in 2011/12.

Inflation fell further in the second quarter, with CPI falling from 3.5% in March to 2.8% in May, driven by declines in fuel and food prices. Core inflation fell from 2.5% to 2.2%. The most striking development in inflationary pressures was in the price of oil, which fell from $125 at the beginning of April to around $96 at the end of June, its lowest level since early 2011.

The MPC voted narrowly against pursuing more quantitative easing (QE) at its June meeting. The Governor of the Bank of England said in June that, as a consequence of the Eurozone crisis, he was already more pessimistic than suggested by the forecasts published in the Bank's Inflation Report only six weeks earlier. As a result of safe-haven flows from the Eurozone and the impact of QE, government bond yields fell during the quarter, with ten year yields at one point dropping below 1.5%, their lowest level ever.

4. INTEREST RATE FORECASTS

The Council's treasury adviser, Sector, periodically provides interest rate forecasts for its customers' use. The latest forecast was received on 14 August and is reproduced below. In the Budget of March 2012, it was announced that the Government would introduce a 20 basis point discount on PWLB loans for those authorities providing improved information and transparency on their long term borrowing and associated capital spending plans. The forecast below takes account of this discount, or "certainty rate", which will be effective from 1 November 2012.

	Now	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14	Mar 15
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00
3 month LIBID	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.70	0.90	1.10	1.40
6 month LIBID	0.85	0.85	0.85	0.85	0.85	0.85	0.85	1.00	1.10	1.30	1.50	1.80
12 month LIBID	1.30	1.30	1.30	1.30	1.30	1.40	1.50	1.70	1.90	2.10	2.30	2.60
5Yr PWLB	1.63	1.70	1.50	1.50	1.50	1.60	1.70	1.80	1.90	2.00	2.10	2.30
10Yr PWLB	2.65	2.70	2.50	2.50	2.50	2.60	2.70	2.80	2.90	3.00	3.20	3.30
25Yr PWLB	3.85	3.90	3.70	3.70	3.70	3.80	3.80	3.90	4.00	4.10	4.20	4.30
50Yr PWLB	4.05	4.10	3.90	3.90	3.90	4.00	4.00	4.10	4.20	4.30	4.40	4.50

The Sector central forecast is for the first increase in Bank Rate to be around December 2014, but there remains downside risk to this projection. With growth predictions for the UK continuing to be reduced on an almost monthly basis by both the Office for Budget Responsibility and economic commentators generally, and financial markets unconvinced that politicians have resolved the Eurozone sovereign debt crisis in the medium-term, high levels of volatility are expected to continue.

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 5 March 2012.

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 2012 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 2012/13, 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 the original estimate, due to the inclusion of approved carry-forward requests from 2011/12.

b) Ratio of Financing Costs to Net Revenue Stream

The projected outturn of 6.17% shows a reduction from the approved indicator of 6.46%. This is due to a reduction in MRP as a result of slippage on the capital programme in 2011/12.

c) Capital Financing Requirement (CFR)

The projected closing CFR for 2012/13 is slightly lower than the approved indicator. This is due to the reduced use of borrowing in 11/12 due to slippage, partially offset by the additional need for use borrowing in 12/13 to finance the sums brought forward.

d) Net Borrowing Requirement and CFR

This indicator seeks to ensure that borrowing over the medium term is only for capital purposes.

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 initially invested for periods over 364 days – one such investment was brought forward at 1 April 2012 and a further investment was made during quarter 1. Both these investments mature after 31 March 2013 but before 31 March 2014. They are classified as a “non specified investments” by way of their initial 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 5 March 2012.

f) Upper limits for the maturity structure of borrowing.

Appendix 1 shows the actual position as at 30 June 2012, and demonstrates that all activities are contained within the currently approved limits.

6. REVIEW OF THE INTEGRATED TREASURY MANAGEMENT STRATEGY STATEMENT, ANNUAL INVESTMENT STRATEGY AND MINIMUM REVENUE PROVISION POLICY STATEMENT 2012/13

The Integrated Treasury Management Strategy Statement (TMSS), Annual Investment Strategy and Minimum Revenue Provision Policy Statement for 2012/13 was approved by Council on 5 March 2012. 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 June 2012.

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 2012/13 is £3,250,700, however in view of the borrowing undertaken in advance of need during 2011/12, it is not currently anticipated that any new borrowing will be undertaken during the year. However, interest rates remain low, and as discussed above, the Budget 2012 introduced the PWLB “certainty rate”, whereby authorities providing transparency information regarding their borrowing and capital expenditure plans would be able to take advantage of a discount of 20 basis points. Advice will therefore be taken from Sector with regard to additional borrowing. 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 remain the security of capital and good 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 considered appropriate either to keep investments short–term, or to extend the period to one year or more with selected government-backed counterparties. Whilst call accounts are paying around 0.8%, rates of up to 3% can be achieved on fixed term deposits.

The Treasury Activity Report for the quarter ended 30 June 2012 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 1.87% has been achieved to 30 June, which outperforms both the 7 day and 3 month LIBID rates of 0.45% and 0.87% respectively. This has been achieved by mixing the use of call account investments with some longer term-deposits, with government supported institutions, at favourable rates, in accordance with the strategy discussed above.

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 three months to 30 June 2012.

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 2012/13
Position at 30 June 2012

Prudential Indicators

	2012/13 Original Estimate	2012/13 Position at 30 June 2012
	(Council 5 March 12)	
a) Capital Expenditure	£3,958,200	£4,909,900
b) Ratio of Financing Costs to Net Revenue Stream	6.46%	6.17%
c) Capital Financing Requirement (CFR)	£13,095,100	£12,961,009
d) Net Borrowing and CFR	£14,207,400	£1,811,577
e) Incremental impact of new 2012/13 capital investment decisions	£0.57	Not Applicable

Treasury Management Indicators

	2012/13 Original Estimate	2012/13 Position at 30 June 2012
	(Council 5 March 12)	
a) Authorised Limit for External Debt:		
Borrowing	£16,200,000	£10,811,577
Other Long Term Liabilities	£1,500,000	-
Total Authorised Limit	**£17,700,000**	**£10,811,577**
b) Operational Boundary for External Debt:		
Borrowing	£15,200,000	£10,811,577
Other Long Term Liabilities	£1,500,000	-
Total Operational Boundary	**£16,700,000**	**£10,811,577**
c) Upper limit for fixed interest exposure (Max o/s net Borrowing)	£14,200,000	£1,811,577
Local indicator-Investment only	100%	100.0%
Local indicator-Borrowing only	100%	100.0%
d) Upper limit for variable interest exposure (Max o/s net Borrowing)	£2,000,000	Nil
Local indicator-Investment only	100%	0.0%
Local indicator-Borrowing only	50%	0.0%
e) Upper limits for maturity structure of outstanding borrowing during 2012/13 (Lower limit 0% in all cases)		
Under 1 year	20%	0.0%
1-2 years	25%	0.0%
2-5 years	50%	37.0%
5-10 years	50%	0.0%
Over 10 years	100%	63.0%
f) Upper limits for principal sums initially invested for periods **over** 364 days		
Maturing beyond 31 March 2013	£5,000,000	£3,000,000
Maturing beyond 31 March 2014	£3,000,000	£0
Maturing beyond 31 March 2015	£1,000,000	£0

APPENDIX 2

Treasury Activity Report 2012/13 for the Quarter ended 30 June 2012

	Position at 1 April 12	Loans Made Quarter 1	Loans Repaid Quarter 1	Position at 30 June 12
	£	£	£	£
Long Term Borrowing				
PWLB	**10,811,577**	**0**	**0**	**10,811,577**
Temporary Borrowing				
Local Authorities	0	4,850,000	(4,850,000)	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**	**4,850,000**	**(4,850,000)**	**0**
TOTAL BORROWING	**10,811,577**	**4,850,000**	**(4,850,000)**	**10,811,577**
Temporary Investment				
Bank of Scotland	(6,000,000)	(3,000,000)	1,000,000	(8,000,000)
Barclays	(1,000,000)	0	0	(1,000,000)
HSBC Treasury	0	(920,000)	920,000	0
Royal Bank of Scotland	(500,000)	(18,160,000)	18,660,000	0
Santander-Abbey	(1,000,000)	(1,590,000)	2,590,000	0
Total Banks	**(8,5000,000)**	**(23,670,000)**	**23,170,000**	**(9,000,000)**
Building Societies	0	0	0	0
Debt Management Office	0	0	0	0
Local Authorities and Others	0	0	0	0
TOTAL INVESTMENT	**(8,500,000)**	**(23,670,000)**	**23,170,000**	**(9,000,000)**
NET BORROWING / (INVESTMENT)	**2,311,577**	**(18,820,000)**	**18,320,000**	**1,811,577**

Temporary Investment and Borrowing Statistics at 3 June 2012:

Investment

Fixed Rate	(8,000,000)	(3,920,000)	2,920,000	(9,000,000)
Variable Rate	(500,000)	(19,750,000)	20,250,000	0
TOTAL INVESTMENT	**(8,500,000)**	**(23,670,000)**	**23,170,000**	**(9,000,000)**

Proportion of Fixed Rate Investment	100.00%
Proportion of Variable Rate investment	0.00%
Temporary Investment Interest Receivable	£47,586
Equated Temporary Investment	£2,546,000
Weighted Average Interest Rate Received	1.87%
7 Day LIBID (Benchmark)	0.45%
3 Month LIBID	0.87%

Borrowing

Temporary Borrowing Interest Payable	£268
Equated Temporary Borrowing	£88,083
Weighted Average Interest Rate Paid	0.30%
7 Day LIBOR (Benchmark)	0.57%

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.