CITY OF YORK COUNCIL

Cabinet

Report of the Cabinet Member for Corporate Services

Treasury Management Monitor 3 and Prudential Indicators 2012/13

Summary

1. This Council is required through regulations issued under the Local Government Act 2003 and the revised 2011 (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management (as revised) to provide members with an update on treasury management activities at least twice a year.

2. This report therefore ensures this council is implementing best practice in accordance with the Code. It updates on the Treasury Management activities for the period 1 April 2012 to 31 December 2013 and reviews:

   - Economic Background
   - Annual Investment Strategy
   - Investment portfolio
   - Borrowing portfolio
   - Compliance with Prudential Indicators

Background

3. The Council's Treasury Management function is responsible for the effective management of the Council's investments, cash flows, its banking, money market and capital transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

Economic Background and Analysis

4. The Council's treasury management activities have operated within the following economic background:
   a) Gross Domestic product (GDP) which measures the growth of the economy fell by 0.3% in quarter 4 of 2012. The

downgrade is mainly prompted by weakness in the Country's dominant service sector and the unwinding of the boost from the Olympic Games in the summer. This contraction is a concern as we move in 2013 as 2 consecutive quarters of negative growth results in a technical recession;

b) Retail sales weakened but spending off the high street held up;

c) Employment continued to rise, albeit at a slower pace. Annual growth of overall average earnings dropped from 1.8% in June to 1.3% in October. Given the rate of inflation over this period, real pay continued to fall on an annual basis;

d) Inflation remained stubbornly above the MPC's 2% target; October's jump in university tuition fees, hefty rises in utility prices at the end of the 2012 and a pick-up in food price inflation following poor harvests, mean that inflation is likely to hover between 2.5% and 3% for the best part of 2013. The announcement in November that Mark Carney, the current Governor of the Bank of Canada, and who will take on the Governorship of the Bank of England from June 2013, raised speculation that the MPC's current 2% inflation target may be reformulated;

e) The MPC paused its programme of asset purchases, with quantitative easing remaining at £375bn;

f) Equity prices in the UK and overseas largely continued to rise over the course of the fourth quarter, with the FTSE 100 picking up from 5,820 to 5,898. Over the period gilt prices fell, causing 10-year gilt yields to rise from about 1.55% to 1.80%

g) The US economy continued to recover at a modest pace and In the Eurozone, market sentiment continued to be steadied by the ECB's pledge to buy "unlimited" quantities of peripheral government's sovereign debt

5. From the economic overview described above the environment in which treasury management operates remains volatile. Sector – the Council's treasury management advisers – undertook a review of its interest rate forecasts following the issue of the latest Bank of England Inflation Report for November 2012. In the August Inflation Report, the Bank changed its position significantly in as much as it markedly downgraded its forecasts for the strength and speed of recovery in GDP growth whereas previously it had consistently been forecasting a strong recovery to over 3% p.a. In its November Report, the Bank has continued

this shift towards pessimism in the speed and strength of recovery; it is now only forecasting growth at around 1% in 2013 and 2% in 2014. These developments have pushed back Sector's expectations of the timing of the eventual start of increases in Bank Rate from Q4 2014 to Q1 2015, as well as the pace of rises in gilt yields. Table 1 is Sector's Interest Rate forecast:

	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%	0.75%
5yr PWLB rate	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%
10yr PWLB rate	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%
25yr PWLB rate	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%
50yr PWLB rate	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%

Table 1: Sector's – Treasury Management Advisers – Interest Rate Forecast

6. Economic forecasting remains difficult with so many external influences weighing on the UK. Equity prices staged a significant rise during the second half of 2012 and the start of January, accompanied by a fall in bond prices and a rise in bond yields. 2013 is likely to see a tug of war between bond and equity prices as ebbs and flows in investor confidence and fears cause recurring spikes and falls in their prices.

7. The overall balance of risks to economic recovery in the UK remains weighted to the downside. 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. Although the prospect of further QE is likely to keep gilt yields lower than they would otherwise be in the near term, this programme is not everlasting. At some stage, the expectation of a conclusion to QE will add to the upside pressure on gilt yields

8. Figure 1 below shows the actual and projection of the bank base rate, which has remained at historically low levels since April 2009. Sector latest bank base rate forecast is November 2012 and this is compared to the January 2012and January 2011 forecast. Other economists latest forecast are also shown for November 2012. The graph highlights the delay in the expectation of the increase in the Bank Base rate which is as a

result of the decision to expand quantitative easing and deterioration of growth prospects.

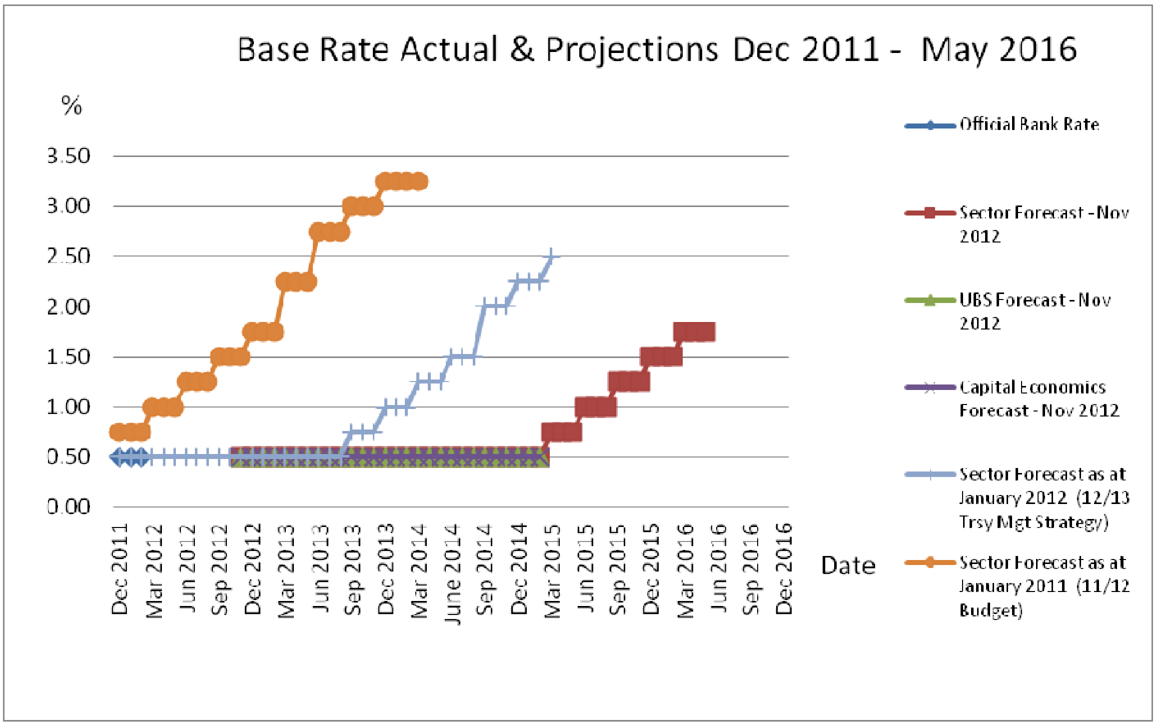

Figure 1: Base Rate 2012 to 2016 - latest forecast Nov 2012

Annual Investment Strategy

9. Treasury Management Strategy Statement for 2012/13 was approved by Council on 23 February 2012. The Council's Annual Investment Strategy, which is incorporated in the Strategy, outlines the Council's investment priorities as follows:
   - security of capital
   - liquidity
   - yield

   The Council will aim to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity.

10. Investments are placed with highly credit rated financial institutions using the creditworthiness matrices described in the Treasury Management Strategy, which includes sovereign credit ratings from the rating agencies and the credit default swap (CDS) overlay information provided by Sector.

11. During the period under review, the unsettled economic climate and heightened credit concerns made it appropriate to keep investments short term with a maximum duration of three months.

This limit applies to all entities in which the Council is considering investing, except for the following institutions:

(a) UK Government and related entities such as Local Authorities – suggested limit remains at 5 years.
(b) UK semi-nationalised institutions e.g. Lloyds / RBS – suggested limit remains at 1 year. UK ownership provides considerable conform to investors.
(c) Money market Funds – suggested limit remains at 1 year.

12. Investments held during the first nine months of 2012/13 in accordance with Sector's Creditworthiness matrices and changes to Fitch and Moody's credit ratings, remained within the Council's approved credit criteria limits contained in the Annual Investment Strategy.

Investment Portfolio

13. Investment rates available in the market have continued at historical low levels. The average level of funds available for investment purposes in the nine months of 2012/13 was £42.936m (£58.085m in 11/12). The level of funds available is largely dependent on the timing of the Council's cash flow as a result of precept payments, receipt of grants, borrowing and progress on the Capital Programme. These funds are therefore available on a temporary basis dependant on cash flow movement.

14. The average level of funds has fallen compared to a year ago due to using the Council's surplus funds to support capital expenditure rather than taking external borrowing. Investment rates are lower than borrowing rates, therefore it is beneficial to take less borrowing and reduce the investment portfolio.

15. There are no funds currently invested for periods of a year or more due to the limited institutions available for investment in the current market environment; in accordance with the credit criteria policy.

16. Investment activity during the first nine months of 2012/13 earned a rate of return of 1.50% (1.22% in 11/12). This is 1.09% (0.74% in 11/12) better than the average 7 day London Inter-Bank Deposit rate (LIBID) of 0.41% (0.48% in 11/12) and 1.00% (0.72% in 11/12) higher than the average base rate for the period of 0.50%.The interest earned to date in 2012/13 is in line with the treasury management budget.

17. The average rate of return is higher in 2012/13 than it was a year ago due to the Council being able to take advantage of higher interest rates offered by banks in the early part of 2012/13. These investment interest rates were available as banks needed to hold higher cash reserves on their balance sheets in accordance with Government regulations. To attract funds from institutions, they offered higher interest rates.

18. Figure 2 shows the interest rates available on the market between 7 days and 1 year and also the rate of return that the Council has achieved for the first nine months of 2012/13. It shows that favourable / competitive interest rates have been obtained for investments whilst ensuring the required liquidity and security of funds for the Council.

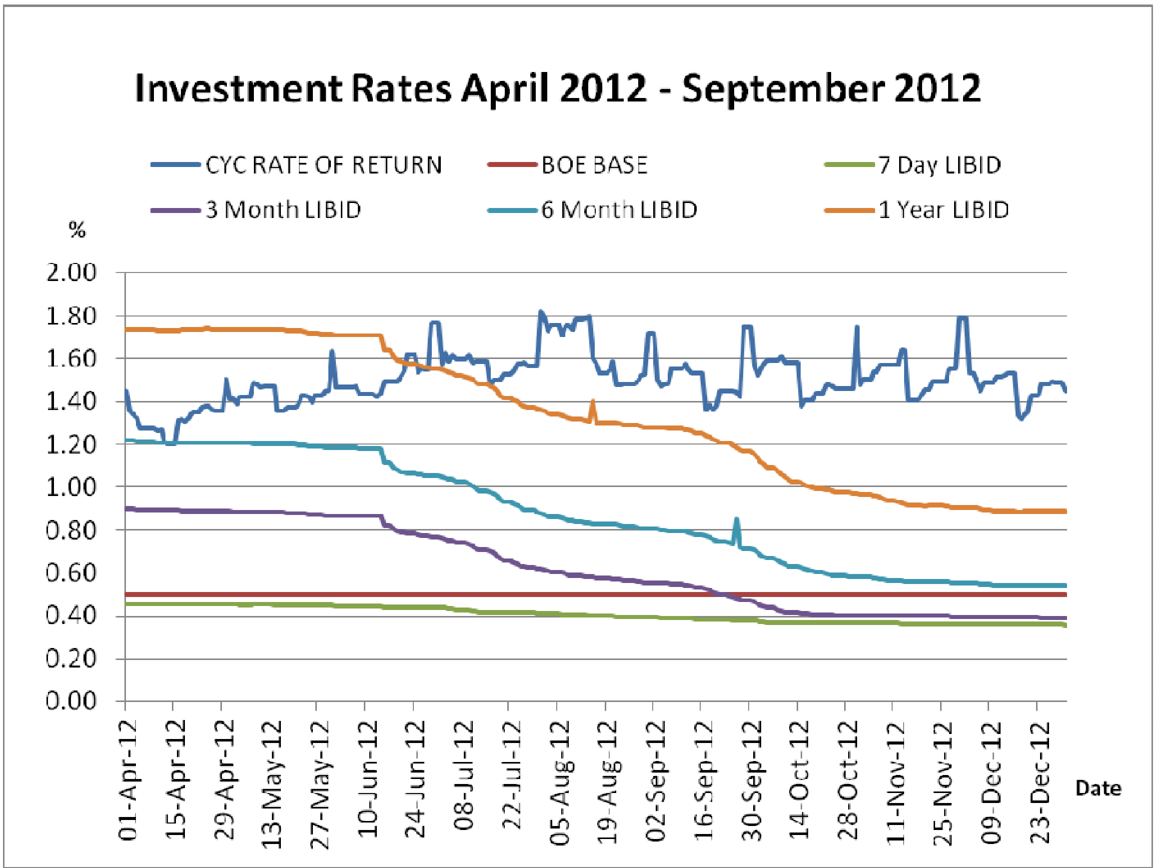

Figure 2 CYC Investments vs Money Market Rates

19. The higher rate of return on investment activity compared to the average LIBID rate and base rate for the period is due to the treasury team continuing to monitor the market and taking advantage of opportunities when they become available, whilst ensuring the security of the council's funds.

20. Figure 2 also shows the interest rates available for investment have markedly fallen in the last quarter of 2012. There are two major reasons for this. The main reason is the excess liquidity being provided to the market by Central Banks, such as the £80bn made available to UK Banks through the Funding for Lending Scheme at rates of around 0.5%. In return for the cheaper funding, banks must use this liquidity for onward lending for mortgages and loans to businesses in an aim to boost the availability of credit and potential for increased spending/growth in the wider economy. Banks therefore have access to cheaper funding which in turn has driven down market rates significantly in the last quarter.

21. The second important factor is a growing expectation that the economic recovery will be slow and prolonged and therefore bank rates and short-term rates will stay lower (i.e. at 0.5%), for longer. This has dragged down market rates as well to match future market expectations.

22. Figure 3 shows the investments in the portfolio are diversified and include deposits in short term call accounts, fixed term investments and money market funds.

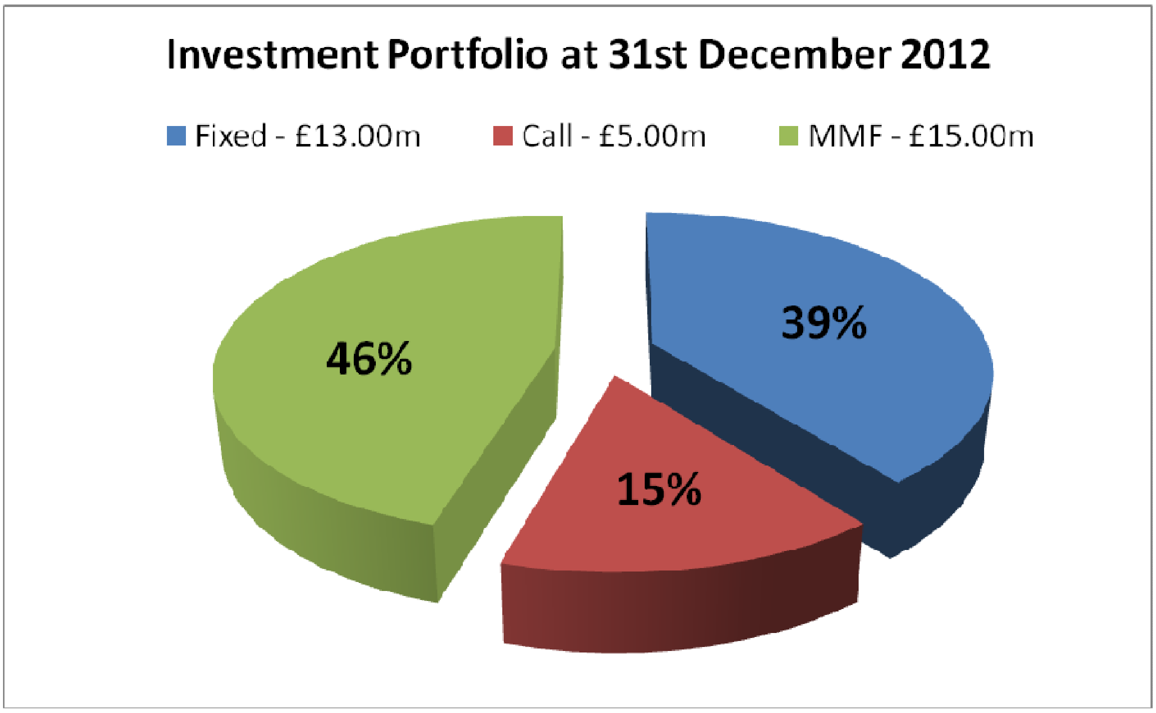

Figure 3 Diversified Investment Portfolio at 31 December 2012

Borrowing Portfolio

23. The Council undertakes long term borrowing in accordance with the investment requirements of the capital programme and all borrowing is therefore secured against its asset base.

24. The level of borrowing taken by the Council is determined by the Capital Finance Requirement (the Councils underlying need to borrow for capital expenditure purposes). Borrowing needs to be affordable, sustainable and prudent and the treasury management budget supports the borrowing finance costs in the longer term.

25. Under regulation, the Council can borrow in advance of need in line with its future borrowing requirements in accordance with the Capital Financing Requirement. The markets will continue to be closely monitored to ensure that advantage is taken of favourable rates in 2012/13 and the increased borrowing requirement is not as dependant on interest rates in any one year.

26. On the reverse side, the Council's level of borrowing can also be below the Capital Financing Requirement. This would mean that instead of increasing the Council's level of borrowing, surplus funds held for investment purposes would be utilised instead, decreasing the level of surplus funds being available for investment. In the current interest rate environment where investment rates are below borrowing rates consideration is given to the value of taking borrowing or whether it is better for the council to keep investment balances lower. This is referred to in paragraph 15 above.

27. Therefore, to minimise investment risk, no new borrowing has been taken during 2012/13 and it is anticipated that no further borrowing will be undertaken during this financial year. Rates continue to be monitored in this volatile opportunistic environment.

28. Sector – the Council's treasury management advisers - forecast that overall future Public Works Loans Board (PWLB) rates will rise, although there is still expected to be volatility in the market over the coming months.

29. At Monitor 2, it was explained that the Government has introduced a "certainty rate" from 1 November 2012 which enables local authorities to access cheaper borrowing rates from the PWLB - a reduction of 20 basis points. Therefore, Sector's 25 year PWLB target rate for new long term borrowing for the

quarter was lowered to 3.70% from 3.90% following the introduction of the “certainty rate”.

30. In general, gilt yields (on which PWLB rates are based) did rise during the quarter; however table 2 below shows that lower interest rates were available in November than in October. This is due to PWLB rates available to local authorities being reduced by 20 basis points from 1 November 2013 – the certainty rate.

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.96%	1.48%	2.46%	3.76%	3.91%
Date	05/11/12	09/11/12	09/11/12	09/11/12	30/11/12
High	1.21%	1.88%	2.90%	4.17%	4.34%
Date	17/10/12	25/10/12	25/10/12	22/10/12	22/10/12
Average	1.07%	1.68%	2.66%	3.93%	4.09%

Table 2 – PWLB Borrowing Rates - quarter ended 31.12.2012

31. The Councils long-term borrowing started the year at a level of £261.6m. A £3m loan was repaid in May 2012 in line with its maturity date. No new borrowing has been taken in the 1st nine months of 2012/13. The HRA amounts to 54% of the borrowing portfolio at £140.3m and the GF is 46% with borrowing at £118.3m, a total of £258.6m.

32. Figure 4 shows the fluctuation in PWLB rates since October 2010 when the Government’s Comprehensive Spending Review increased rates to 1% above gilt yields. It also shows that even, where PWLB rates available to local authorities fell by 20 basis points with the introduction of the “certainty rate” on 1 November 2012, that the general downward trend during2012/13, has seen rates beginning to rise slightly in quarter 4. The triangles highlight when new borrowing was taken in the previous financial year 2011/12.

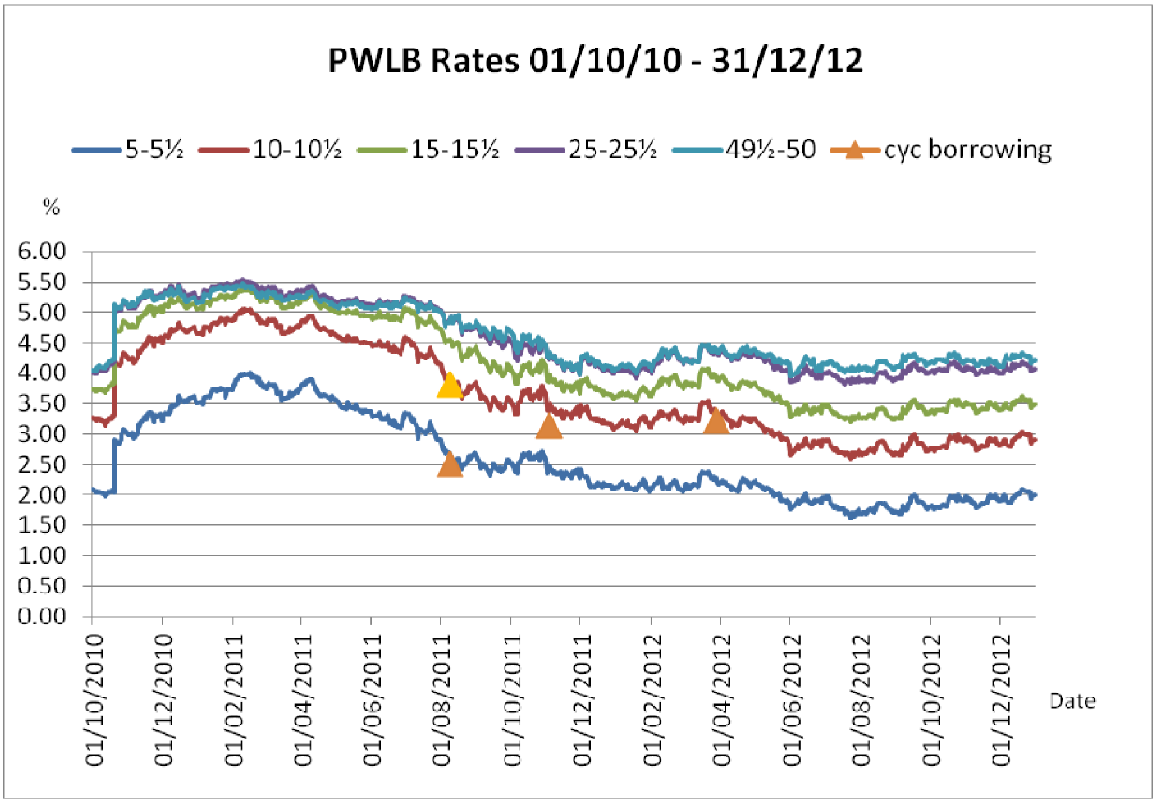

Figure 4 – PWLB rates vs CYC Borrowing Levels

33. Figure 5 illustrates the 2012/13 maturity profile of the Council's debt portfolio to 31 December 2012. The maturity profile shows that there is no large concentration of loan maturity in any one year, thereby spreading the interest rate risk dependency.

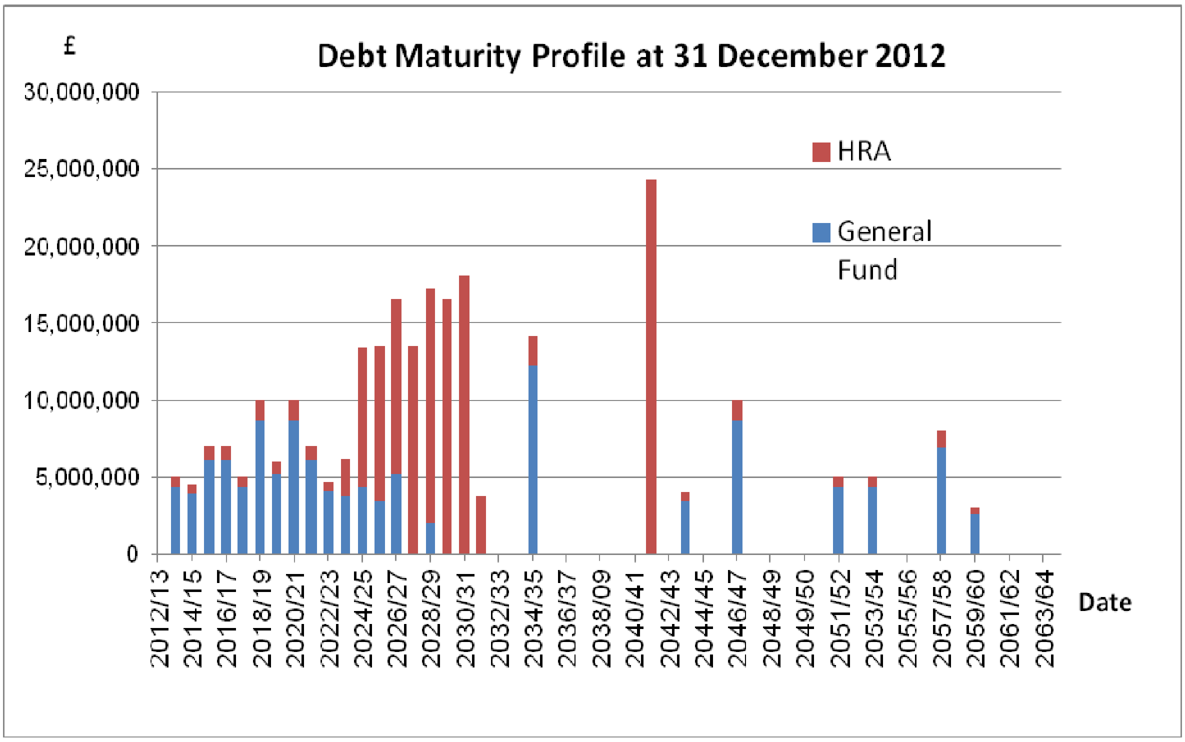

Figure 5 – Debt Maturity Profile 12/13

Compliance with Prudential Indicators

34. The Prudential Indicators for 2012/13, included in the Treasury Management Strategy Statement are based on the requirements of the Council's capital programme and approved at Council on 23 February 2012.

35. It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits" included in the Prudential Indicators. The monitoring of the Prudential Indicators is attached at Annex A, along with the revised limits for the HRA reform.

36. During the financial year 2012/13 to date the Council has operated within the treasury limits and Prudential Indicators set out.

Consultation and Options

37. The report shows the nine month position of the treasury management portfolio in 2012/13. The treasury management budget was set in light of the council's expenditure plans and the wider economic market conditions, based on advice from Sector - the Council's Treasury Management advisors. It is a statutory requirement to provide the information detailed in the report.

Analysis

38. The report is a statutory requirement and as such there are no specific options to analyse.

Council Plan

39. The Council Plan has five priorities which all require a budget to achieve. The treasury management function aims to achieve the optimum return on investments commensurate with the proper levels of security, and endeavours to minimise the interest payable by the Council on its debt structure. It thereby contributes to all Council Plan priorities.

Financial

40. The financial implications are in the body of the report.

Human Resources Implications

41. There are no HR implications as a result of this report.

Equalities

42. There are no equalities implications as a result of this report.

Legal Implications

43. Treasury Management activities have to conform to the Local Government Act 2003, the Local Authorities (Capital; Finance and Accounting) (England) Regulations 2003 (SI 2003/3146), which specifies that the Council is required to have regard to the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice and also the *Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008* (SI 2008/414), which clarifies the requirements of the Minimum Revenue Provision guidance.

Crime and Disorder Implications

44. There are no crime and disorder implications as a result of this report.

Information Technology Implications

45. There are no IT implications as a result of this report.

Property Implications

46. There are no property implications as a result of this report.

Risk Management

47. The Treasury Management function is a high-risk area because of the level of large money transactions that take place. As a result of this there are procedures set out for day to day treasury management operations that aim to reduce the risk associated with high volume high value transactions. These are detailed in the Treasury Management Strategy Statement at the start of each financial year.

Recommendations

48. Members are required, in accordance with the Local Government Act 2003 (revised), to:
    - Note the Treasury Management activities in 2011/12
    - Note the movements in the Prudential Indicators at Annex A

Reason – To ensure the continued performance of the Council's Treasury Management function.

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For further information please contact the author of the report

Background Papers

Cash-flow Model 12/13, Investment Register 12/13, PWLB Debt Register, Capital Financing Requirement 12/13, Venture Fund 12/13, Treasury Management budget 12/13, Statistics 12/13.

Annexes

Annex A – Prudential Indicators 2012/13