CITY OF YORK COUNCIL

Executive **7 September 2010**

Report of the Director of Customer and Business Support Services

Treasury Management Monitor 1 and Prudential Indicators 2010/11

Summary

1. This report updates the Executive on the Treasury Management performance for the period 1 April 10 to 31 July 2010 compared against the budget presented to Council on 25 February 2010.

2. The report highlights the economic environment for the first four months of the 2010/11 financial year and in relation to this reviews the council's treasury management performance covering:

   - Short-term investments,
   - Long-term borrowing,
   - Venture fund,
   - Treasury management budget.

Background

3. The Council's treasury management function is responsible for the effective management of the Council's 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.

4. The Council approved the Treasury Management Strategy, budget and Prudential Indicators on 25 February 2010. This report monitors the Treasury Management activity for the first four months of 2010/11 and shows the change in the Treasury Management budget to 31 July 2010 and the forecast outturn position for the year.

Economic Background and Analysis

5. The Council's short term investment and long term borrowing decisions have been affected by the following economic conditions:

   a. The first quarter of 2010/11 saw:

      i. the new coalition government enact a fiscal squeeze set to be the most severe since the end of the 1930's, through its Emergency Budget on the 22nd June;

ii. activity indicators suggest that the recovery picked up a little pace in the first quarter;
iii. high street spending recovered after a weak start to the year;
iv. the labour market showed some tentative signs of improvement;
v. the UK's trade position deteriorated, despite the weak pound;
vi. CPI inflation remained above target, however the measure of underlying inflation fell;
vii. the Monetary Policy Committee maintained Quantitative Easing and kept Bank Rate on hold at 0.5%;
viii. the equity rally went into reverse over concerns about the shape of the global recovery;
ix. the recovery in the US remains fairly strong, but remains weak in the euro-zone.

b. The key development of the first quarter was the Emergency Budget delivered on the 22nd June, which unveiled plans by the new Chancellor to severely tighten fiscal policy. The Budget directed the bulk of the fiscal tightening at households and the public sector instead of private companies. Key measures within the Budget included a rise in the standard rate of VAT from 17.5% to 20%, to take effect in January 2011. Plans for social security payments were scaled back however, the burden on lower income households was partly offset by an increase in the personal income tax allowance by £1,000 to £7,475 from April 2011. (High earners will not benefit.)

c. During the first quarter of 2010/11, activity surveys suggested that the recovery has gathered pace after the economy's 0.3% expansion. Encouragingly, the labour market has shown some tentative signs of improvement. The number of people claiming unemployment benefit fell by 32,000 in April and 31,000 in May, leaving the total at 1.48m. Employment also rose by 5,000 in the three months to April. However, the workforce increased at a faster rate, so that the total number of unemployed still rose by 23,000 in the three months to April.

d. The UK's trade position continued to deteriorate, despite the support provided by the lower pound.

e. Inflationary pressures have finally begun to ease. CPI inflation rose from 3.4% to a recent peak of 3.7% in April before falling back to 3.4% in May and 3.1% in August. Temporary factors, such as the rise in the rate of VAT to 17.5% in January and the rise in oil prices last year, continued to support above-target inflation. However, the forthcoming increase in the standard rate of VAT to 20% will also add to inflation throughout 2011.

f. According to the August inflation report, the economy will only be growing 3% in the second half of 2011 compared to the May inflation report at 3.5%. Mervyn King, the Bank's governor of the Bank of England, said Britain was facing a "choppy recovery". The overall outlook is weaker than that presented in the May Report, reflecting the softening in confidence, the persistence of tight credit conditions and the faster fiscal consolidation.

g. The Monetary Policy Committee (MPC) continued to keep Bank Rate on hold at 0.5% and to maintain its stock of asset purchases. The Bank of England's quarterly Inflation Report in August also projected inflation to be below the 2% target at the two year horizon, suggesting that rates will remain on hold (0.5%) for a considerable period; throughout the rest of this year into 2011.

h. Figure 1 shows the actual and projection of the base rate, which remains at historically low levels through much of 2010. The Council's treasury management advisers – Sector – forecast the position of the base rate in February 2010 and this is compared to their forecast along with other economists in July 2010. The base rate will slowly start to rise at the beginning of 2011/12 and continue gradually out to 2013. UBS forecast a rise in the base rate earlier than Sector, where as Capital Economics remain pessimistic about economic recovery to the end of 2011 and they forecast the base rate to remain at 0.5% for the near future.

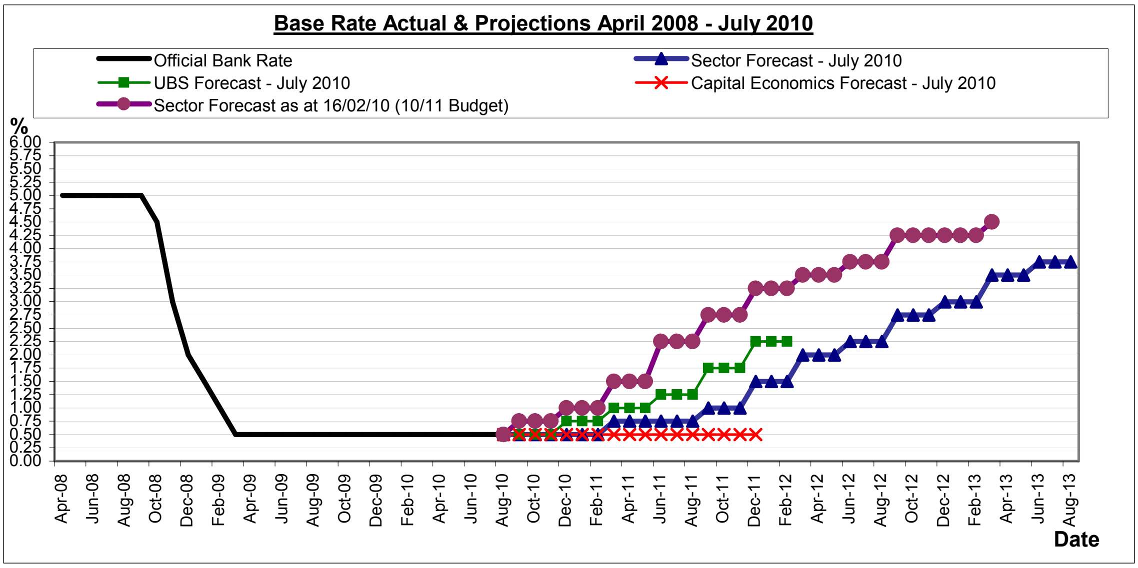

Figure 1: Base Rate 2008 to 2013 - latest forecast July 2010

i. Table 1 provides the Council's Treasury Advisers, Sector, forecast of the base rate and Public Works Loan Board (PWLB) rates as at 15 July 2010:

	Now	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
Bank rate	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.50%	2.00%	2.25%	2.75%	3.00%	3.50%
5yr PWLB rate	2.29%	2.50%	2.60%	2.80%	2.95%	3.20%	3.45%	3.80%	4.15%	4.40%	4.50%	4.65%
10yr PWLB rate	3.58%	3.80%	3.85%	4.00%	4.20%	4.40%	4.50%	4.70%	4.75%	4.90%	4.90%	5.05%
25yr PWLB rate	4.31%	4.45%	4.50%	4.55%	4.70%	4.80%	4.90%	5.05%	5.15%	5.20%	5.25%	5.25%
50yr PWLB rate	4.29%	4.45%	4.55%	4.60%	4.75%	4.85%	4.95%	5.05%	5.25%	5.25%	5.30%	5.30%

Table 1 – Sector's forecast interest rates as at 15 July 2010

j. With regard to long term borrowing, the Public Works Loan Board (PWLB) rates across all ranges are forecast to steadily increase, as seen in table 1. This is due to high gilt issuance, reversal of QE and investor concerns over inflation.

k. It should be noted that Sector have confirmed that there is a high level of uncertainties in all the above forecasts and markets are currently volatile. This is due to the difficulties of forecasting the timing and amounts of QE reversal, fiscal contraction following the general election in May 2010, speed of recovery of banks' profitability and balance sheet positions, changes in the consumer saving ratio and rebalancing of the UK economy towards exports.

l. The 1 year investment rate started the financial year at 1.19% and on 31 July 2010 had risen to 1.35%. Figure 2 shows the positions of market interest rates available for investments, which have all marginally risen in the first four months of 2010/11.

m. Due to the low rates available on the market for invest, a number of large UK banks keen to accept Local Authority investments continue to offer competitive rates on call accounts paying 0.25% to 0.3% above the Bank of England base rate as a minimum. In the first four months of 2010/11 call accounts still offer good value but higher rates can also now be achieved on fixed term market investments and also through Money Market Funds.

Investment Policy

6. The Treasury Management Strategy Statement for 2010/11 was approved by Council on 25 February 2010. The Council's Annual Investment Strategy, which is incorporated in the Strategy, outlines the Council's investment priorities as follows:
    - Security of Capital
    - Liquidity

7. The Council will also aim to achieve the optimum return on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term, and only invest with highly credit rated financial institutions using the Sector suggested creditworthiness matrices, including Credit Default Swap (CDS) overlay information provided by Sector, the Council's Treasury Management advisors.

8. Investments held at 31 July 2010 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.

Short Term Investments

9. Investment rates available in the market remain at an historical low point. The average level of funds available for investment purposes in the first four months of 2010/11 was £42.946m. 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 and progress on the Capital Programme. These funds are therefore available on a temporary basis dependant on cash flow movement. The authority holds some core cash balances for investment purposes, i.e. funds available for a year or more, however to date in 10/11 no funds have been invested for periods greater than one year due to the limited institutions available for investment in accordance with the credit criteria policy. This is a continuation of similar market conditions which prevailed through the majority of 2008/09 and through the whole of 2009/10.

10. Treasury Management investment activity during the first four months earned interest £221k, equivalent to a 1.24% rate of return. This is 0.82% better than the average 7 day London Inter-Bank Deposit rate (LIBID) of 0.42% and 0.74% higher than the average base rate for the period of 0.50%.

11. The high 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 longer term rates when they become available, using short term call deposit accounts where interest rates are higher and using Money Market Funds as a slightly alternate investment deposit.

12. The rate of return is approximately half of that seen in 2009/10 due to (a) interest rates remaining historically low on the market throughout 09/10 and into 10/11 and (b) no core balances having been invested for more than 1 year back in 2008/09 when rates were higher. The interest earned for the first four months of the year is in line with the treasury management budget but can be seen to be substantially lower than in previous years, thereby increases the requirement of the treasury management budget due to a less of an effect the investment earned netting off interest paid out on borrowing.

13. The Council has made 8 fixed term investments during the first four months of 2010/11, 2 directly with the Bank of Scotland and 6 via the money market brokers. This is the same as in 2009/10. Five of these investments have been made for periods of 6 months where value was shown and this allows the flexibility of funds becoming liquid if interest rates start to rise. This is shown in Figure 2 below. In accordance with the Treasury Management Strategy investments have been kept short due to the low levels of interest rates available and the limited number of institutions available in the market which the council can invest in complying with its credit rating policy.

14. A proportion of investments have been placed in call accounts where funds are secure and are able to be liquidated if more advantageous rates become available. The council operates 4 call accounts – Bank of Scotland

(0.75%), Alliance & Leicester (0.80%), Yorkshire bank 15 day (0.80%) and Yorkshire Bank call (0.50%) – but has found during the first four months of 2010/11 that better rates have been available on the market as described above in paragraph 13. Two money market funds are also being utilised – Prime rate MMF offering rates around 0.85% and Ignis offering rates around 0.60%. The MMF are needed to diversify the investment portfolio as the banks offering the most favourable fixed deposit rates are also the banks which offer the call accounts which the council uses.

15. Therefore in order to remain within the Councils lending limits, diversification of the council's portfolio is key. This ensures continued security of the council's funds, whilst operating within the bounds of the council's cash flow (liquidity) and giving consideration to the most favourable interest rates available.

16. Figure 2 shows the interest rates available on the market between 7 days and 1 year and the rate of return that the Council has achieved to 31 July 2010. It shows that favourable / competitive interest rates have been obtained for investment in line with the interest rates which are available when security of funds are of prime importance.

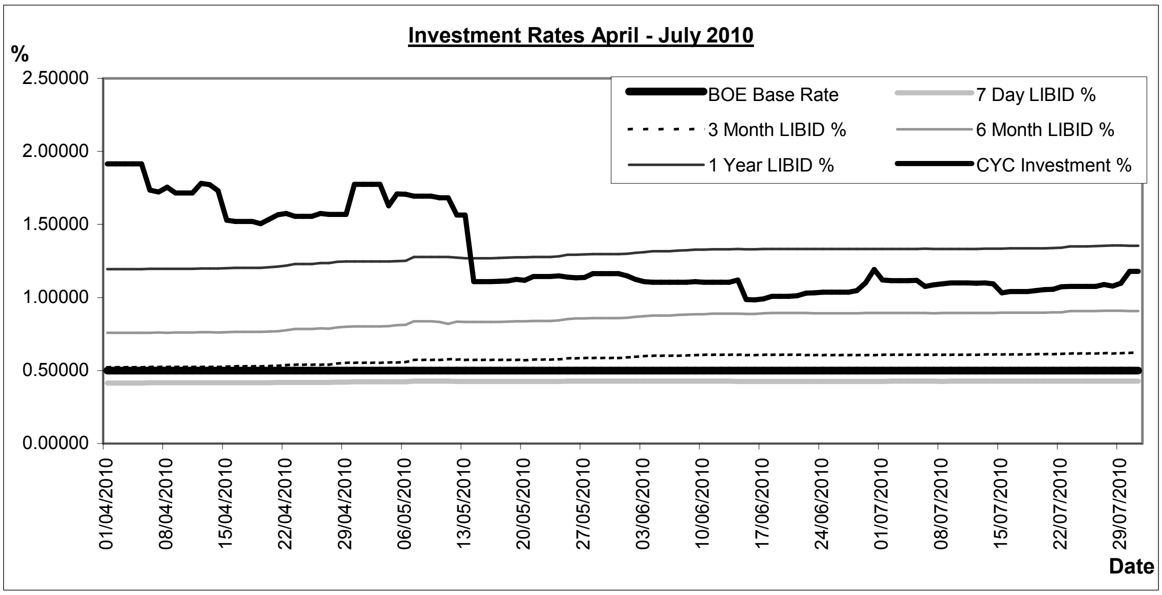

Figure 2 CYC Investments vs Money Market Rates

Long Term Borrowing

17. 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. The council's borrowing is funded by the Government through the Revenue Support Grant (RSG), which provides the Council with revenue funding to allow it to meet the interest and repayment costs of borrowing, this is known as supported borrowing. The introduction of the Prudential Code in April 2004 has also given the Council the flexibility to borrow without Government support. Under the Code Councils are free to borrow up to a level that is deemed prudent,

affordable and sustainable and within their prudential indicator limits. This is known as prudential borrowing.

18. 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). The Capital Financing Requirement for 2010/11 is £147.9m, which gives a total borrowing requirement during 2010/11 of £31.8m. This takes into account supported borrowing for capital schemes supported by RSG as explained in paragraph 18, also prudential borrowing for schemes under the prudential code that are funded from department budgets and corporate budgets– so are affordable, sustainable and prudent. In addition, due to the current economic and market environment capital receipts may not be realised when originally expected and therefore, in the short term borrowing is taken to cover this funding shortfall position of the capital programme.

19. In addition, the Council can borrow in advance of need in line with its future borrowing requirements in accordance with the Capital Financing Requirement. The Administrative Accommodation project is substantially increasing the Council's need to borrow over the next 3 years and therefore the markets will be closely monitored to ensure that advantage is taken of favourable rates in 10/11 and the increased borrowing requirement is not as dependant on interest rates in any one year over the 3 year period.

20. The Councils long-term borrowing started the year at a level of £116.1m. One loan of £4m was duly repaid in May 2010 in line with its maturity date. New Borrowing totalling £21m has been taken to mid August 10, as follows:
    - £5m market LOBO loan at 3.60% 50 years with options every 5 years on 12 May 10
    - £5m PWLB loan at 3.70% 10 years on 25 May 10
    - £5m market loan at 0.70% 1 year on 28 May 10
    - £3m PWLB loan at 2.95% 7 years on 12 August 10
    - £3m PWLB loan at 4.01% 14 years on 12 August 10

21. The loans taken in 2010/11 have been below the target of 4.5% set in the 2010/11 strategy. The loans are of fixed term duration, have targeted periods that offer the best rates available and also take into consideration the debt maturity portfolio. In the first four months, 45-50 year PWLB rates started 2010/11 at 4.65%, had a high of 4.75% and a minimum of 4.19% to July 2010. 9.5-10 year PWLB started at 4.14% and at the end of July 2010 fell to 3.52%. Long term interest rates are showing good value and borrowing has occurred to take advantage of these favourable rates.

22. During the first quarter there has been a lot of volatility in the financial markets and this has had an impact on the PWLB rates. Also the concern over the Euro zone debt crisis has led to an influx of investments into the UK as they are seen as a "safe haven". This in turn has had an impact on borrowing rates with rates coming down. This is seen in figure 3 below, where rates have continued to fall during August 2010.

23. The Council's borrowing strategy is to borrow at a target rate of 4.5% from the PWLB or the money market when rates are low and hold off from taking new borrowing when rates are high - following advice taken from the Councils contracted treasury management advisors (Sector Treasury Services) subject to cash flow constraints. Figure 3 shows the PWLB rates since April 2009 and details when new borrowing has taken place, taking into account the borrowing maturity profile.

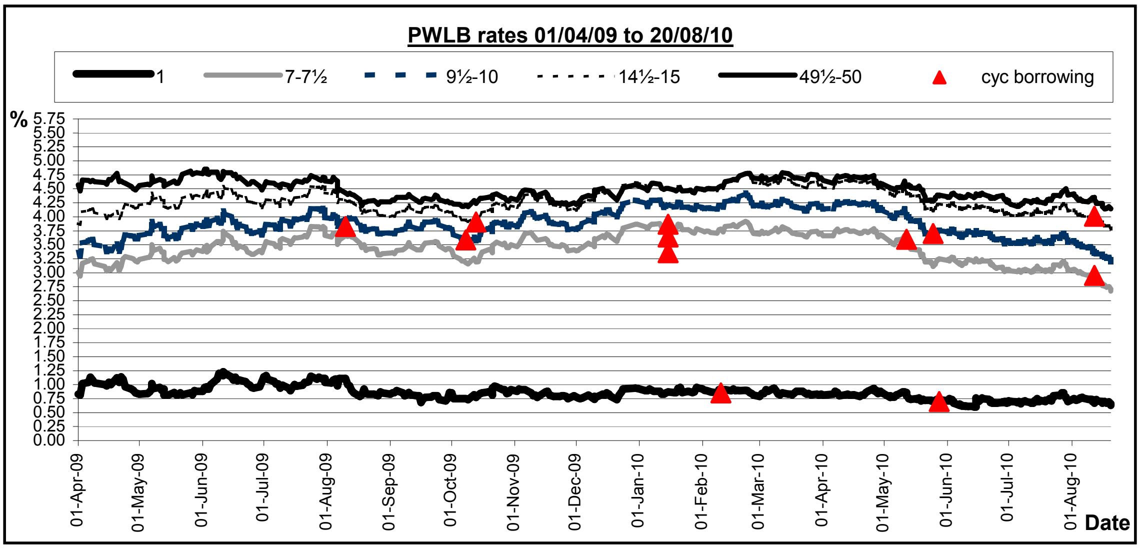

Figure 3 – PWLB rates vs CYC Borrowing Levels

24. Figure 4 illustrates the 2010/11 maturity profile of the Council's debt portfolio updated to reflect the borrowing this year. The borrowing portfolio totals £133.1m and the maturity profile shows that there is no large concentration of loan maturity, thereby spreading the interest rate risk dependency in any one year.

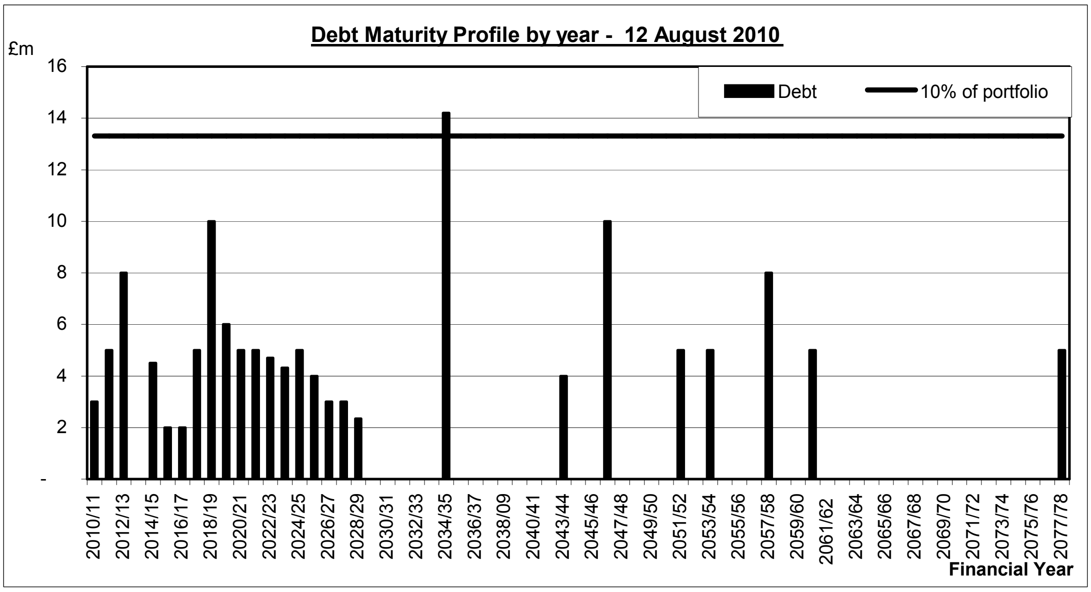

Figure 4 – Debt Maturity Profile 10/11

Venture Fund

25. The Venture Fund is used to provide short to medium term investment for internal projects which provide new revenue streams or generate budget savings and contribute to operational benefits of policy objectives. The projected movements on the Venture Fund for the year 2010/11 are shown in table 2 below.

	£'000
Balance at 1st April 2009	**2,219**
New Loan Advances	(1,551)
Loan Repayments	48
Net Interest Received	18
Balance at 31st March 2010	**734**

Table 2 – Projected Venture Fund Movement 2010/11

26. Table 2 indicates there are approvals for new loan advances in 2010/11 of £1,551k. This is for 4 schemes, for the easy programme £650k which reflects funding required for internal resources associated with the transformation programme – More for York – work, £200k for the street lighting capital scheme approved by Council on 21 February 2009, £500k contribution for the economic downturn approved by Council on 25 February 2010 and £201k for the early years deficit cost for the administrative accommodation project approved by Council on 15 July 2010. The easy programme loan is a prudent estimate of the amount which will potentially be required by year-end. 3 schemes contribute to loan repayments.

Treasury Management Budget

27. Treasury Management activity had a Corporate Budget approved at Council on 25 February 2010 of £11,131k. In August 2010, the current approved budget stands at £11,768k. The increase of £637k is transfer of budget from departments to cover the finance costs of approved capital programme schemes funded by prudential borrowing. This is explained further in paragraph 19 above. The projected outturn for 2010/11 is £11,618k, an estimated underspend of £150k. Table 3 details the individual components that make up this overspend.

	(Under)/Over Spend £000
Decrease in financing expenditure (interest paid)	(102)
Increase in interest receivable	(48)
Total Underspend	**(150)**

Table 3 – Treasury Management Budget 2010/11

28. The expected Treasury Management budget underspend is driven by the 2 factors in table 3 above. The reduction in finance expenditure is due to the reduced amount of interest to be paid on borrowing during 2010/11. The borrowing interest rates currently available on the market are more favourable than was expected when the budget was set. This change in

market conditions is explained in the economic background and analysis section at the beginning of the report.

29. The increase in interest receivable is due to slightly better interest rates received on investments and slightly higher cash balances. This is seen in figure 2 above where the market rates available for investment in the first four months of the year rise marginally. As reported during 2009/10, it is expected that growth will continue to be slow in 2010/11, resulting in continued lower market interest rates being available for investments.

Prudential Indicators Update

30. It is a statutory duty for the Council to determine and keep under review the “Affordable Borrowing Limits”. Council’s approved Prudential Indicators (affordability limits) are outlined in the approved Treasury Management Strategy. Prudential Indicators are attached at Annex A. Prudential Indicators were not breached during the first 4 months of 2010/11.

Consultation

31. This report is for information and reporting on the performance of the treasury management function. The budget was set in light of the prevailing expenditure plans and economic conditions, based on advice from the Council’s Treasury Management advisors.

Corporate Priorities

32. The Council has a priority to ensure value for money and efficiency of its services. Treasury Management 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.

Human Resources Implications

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

Equalities

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

Legal Implications

35. Treasury Management activities have to conform to the Local Government Act 2003 (SI 2003/3146), which specifies that the Council is required to adopt 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

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

Information Technology Implications

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

Property Implications

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

Risk Management

39. 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 as set out in the Treasury Management Practices statement that aim to reduce the risk associated with high volume high value transactions.

Recommendations

40. Members are requested to:
    - Note the performance of the treasury management activity;
    - Note the projected underspend of the treasury management budget of £150k.

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

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Report Approved   Date 07/09/10

Wards Affected: All
None

Specialist Implication Officers:

None

For further information please contact the author of the report

Background Papers

Cash-flow Model 09/10, Investment Register 09/10, PWLB Debt Register, Capital Financing Requirement 09/10, Venture Fund 09/10, Statistics 09/10.

Annexes

Annex A – Prudential Indicators