CITY OF YORK COUNCIL

Executive **15 February 2011**

Report of the Director of Customer and Business Support Services

Treasury Management Monitor 3 and Prudential Indicators 10/11

Summary

1. This report updates the Executive on the Treasury Management performance for the period 1 April 2010 to 31 December 2011 compared against the budget presented to Council on 25 February 2010.

2. The report highlights the economic environment for the first nine months of the 2010/11 financial year and 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. CIPFA (the Chartered Institute of Public Finance and Accountancy) issued the revised Code of Practice for Treasury Management in November 2009. It recommended that at a minimum, a mid year review of Treasury Management strategy and performance should be undertaken which highlights any areas of concern that have arisen since the original strategy was approved. These quarterly reports therefore ensure this council is implementing best practice in accordance with the Code.

5. 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 nine months of 2010/11 and shows the change in the Treasury Management budget to 31 December 2010 and the forecast outturn position for the year.

Economic Background and Analysis

6. The Council's short term investment and long term borrowing decisions have been affected by the following economic conditions described in the paragraphs below.

7. The quarter ended 31st December 2010 saw the following
   i. Activity indicators strengthening again, suggesting that the recovery still has a reasonable amount of momentum;
   ii. Spending on the high street continuing to recover;
   iii. Conditions in the labour market deteriorating further;
   iv. House prices continuing to fall with some regional exceptional;
   v. The public finances deteriorating, tentatively questioning whether the government can meet its fiscal forecasts;
   vi. The UK's trade deficit widens further, pouring cold water on hopes of an export-led recovery;
   vii. CPI inflation rise and pipeline price pressures continuing to build;
   viii. The Monetary Policy Committee shying away from doing more quantitative easing;
   ix. UK equities surging and gilt yields rising;
   x. Economic growth picking up strongly in the US and maintaining pace in the euro-zone

8. Activity indicators suggested that the recovery still has a reasonable amount of momentum with modest growth, having briefly pointed to a double-dip in prior months. The recovery weakened in the construction sector, but strengthened in the larger manufacturing sector. GDP (Gross Domestic Product) expanded by 0.7% q/q in the third quarter of 2010 to 2.7%

9. There were signs that consumer spending improved during the quarter. Survey evidence has suggested that December's heavy snowfall has not had too much of a negative effect on retail spending over the festive period as a whole, with consumers making up for weaker spending in early December during the post-Christmas "sales" period.

10. The resilience of consumer spending during the quarter was in sharp contrast to the renewed deterioration of conditions in the labour market with unemployment rising over the last quarter. House prices have also continued to fall during the quarter.

11. Public finances appear to have deteriorated during the quarter. Borrowing on the PSNB ex. measure (Public sector net borrowing excluding temporary effects from financial interventions) was in line with 2009/10's figure in October but was £6bn higher than a year before in November. The figures therefore cast doubt on whether the Government will be able to meet its borrowing forecast of £149bn this year, some £7bn lower than last year's total. Elsewhere, there are still few signs that the external sector has begun to support the overall recovery.

12. The CPI (consumer price inflation) edged up from 3.1% to 3.2% in October and then to 3.3% in November. Part of the rise may have reflected retailers pushing up their prices ahead of the VAT rise in January 2011. The rise also seems to have reflected the surge in commodity prices (eg food, grains, metals) during the quarter and earlier in the year. If these commodities hold onto their recent price gains, then their inflationary effects will build over the next few months.

13. Encouraging activity data and strong inflation data prevented the Monetary Policy Committee (MPC) from following the Fed in sanctioning more quantitative easing (QE) at its November meeting. The majority of members on the MPC have continued to vote for official interest rates to remain on hold at 0.5%; the minutes to their meetings suggested that most members thought that the risks that CPI inflation would overshoot the 2% target in two years time had grown. Some members also expressed concern about the recent rise in households' inflation expectations.

14. From the economic analysis, figure 1 below shows the actual and projection of the base rate, which has remained 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 revised forecast along with other economists in January 2011. The graph highlights the shift in the position of the base rate which is aligned with the slower growth forecast. The base rate will now slowly start to rise in the last quarter of 2011/12, 0.75% in December 2011 and continue gradually out to 2013, where in December 2013 it is forecast to be 3.25%. 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.

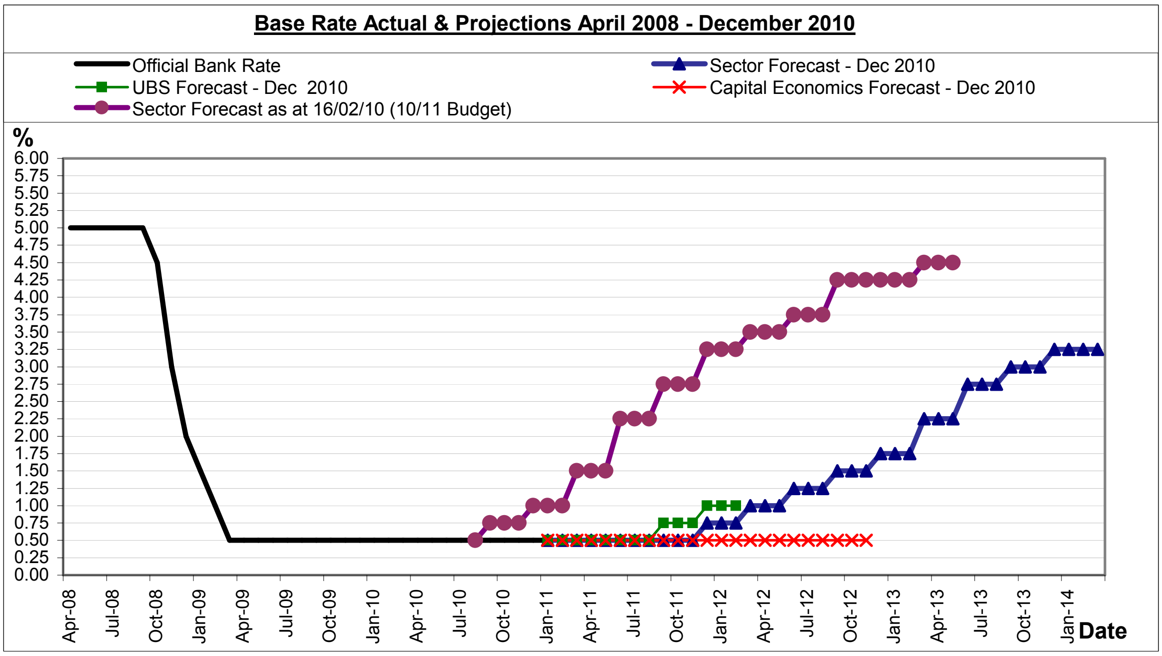

Figure 1: Base Rate 2008 to 2013 - latest forecast Dec 2010

15. Table 1 below provides the Council's Treasury Advisers', Sector, forecast of the base rate and Public Works Loan Board (PWLB) rates as at 5 January 2011. This forecast has not changed their view on base rate or the outlook for the UK economy to that reported in the previous monitor, however this revised update is particularly for the sell off in the bond markets in November and December and is mainly focused on revisions to the 5 and 10 year rates:

Sector's Interest Rate View	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13
Sector's Bank Rate View	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.25%	2.75%	3.00%	3.25%
5yr PWLB Rate	3.30%	3.30%	3.40%	3.50%	3.60%	3.80%	3.90%	4.10%	4.30%	4.60%	4.80%	4.90%
10yr PWLB View	4.40%	4.40%	4.40%	4.50%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%	5.40%
25yr PWLB View	5.20%	5.20%	5.20%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%	5.60%	5.70%
50yr PWLB Rate	5.20%	5.20%	5.20%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%	5.60%	5.70%

Table 1 – Sector's forecast interest rates as at 5 January 2011

16. The Treasury Management 2010/11 monitor 1 and 2 reports saw overall rates across all ranges forecast to steadily increase. During August and, September however there was a fall in yields and the lowest rates were seen in this period. Long term borrowing for the Council was taken during this time as detailed later in the report.

17. This interest rate forecast for monitor 3 shows that PWLB rates are still forecast to steadily rise. The change in the forecast sees rates in the first half of 2011 being higher than previously estimated and then continuing to rise but at a slightly slower rate. All rates across the board increased at monitor 2 due to the comprehensive spending review and PWLB rates being set at 1% above the governments gilt level. This is approximately 0.85% increase across the board on all PWLB rates.

18. There is a risk in the forecast that the Monetary Policy Committee (MPC) will increase the base rate in Q3 of 2011 rather than Q4 as detailed in the above table. This is due to concerns that inflation has been so much above its 2% target for such a long time. The bank of England's growth forecast has been downgraded in 2011 to 2.3% but upgraded in 2012 to 3% due to the continuation of strong monetary policy stimulus through an exceptionally low Bank Rate and the current level of QE.

19. Sector still maintains that the general trend beyond the next twelve months is of rising gilt yields and PWLB rates. However, as there are significant potential downside risks to these forecasts and to the pace of both UK /

world recovery, the Council should err on the side of caution when forecasting investment rates.

20. The 1 year investment rate started the financial year at 1.19%, on 30 September 2010 had risen to 1.36% and on 31 December 2010 had fallen back slightly to 1.33%. Advantage was taken of favourable1 years rates with a nationalised bank in the their quarter of 2010/11 when 1.9% was achieved. Any forecasts beyond a one year time horizon will be increasingly subject to being significantly amended as and when world events and financial markets change. Figure 2 below shows the positions of market interest rates available for investments during 2010/11, which have all marginally risen in the first nine months.

Investment Policy

21. 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
    - yield

22. The Council will aim to achieve the optimum return (yield) 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 seek to invest where value is available in significantly higher rates in periods up to 12 months; particular to nationalised and semi nationalised UK banks. Investments are with highly credit rated financial institutions using the creditworthiness matrices described in the Treasury Managment Strategy, including sovereign credit ratings and credit default swap (CDS) overlay information provided by Sector.

23. Investments held at 31 December 2010, which were 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

24. Investment rates available in the market continue to remain at a historical low point. The average level of funds available for investment purposes in the first nine months of 2010/11 was £65.535m. 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.

25. 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, due to the credit crunch.

26. Treasury Management investment activity during the first nine months of 2010/11 earned interest £562k, equivalent to a 1.14% rate of return. This is 0.72% better than the average 7 day London Inter-Bank Deposit rate (LIBID) of 0.42% and 0.64% higher than the average base rate for the period of 0.50%.

27. 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 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.

28. The interest earned for the first nine months of the year is slightly higher than the Treasury Management budget estimated but is substantially lower than in previous years. This thereby increases the requirement of the Treasury Management budget, as detailed below in the report, due to a reduced affect the investment earned has in netting off interest paid out on borrowing.

29. The Council has made 21 fixed term investments during the first nine months of 2010/11, 5 directly with the Bank of Scotland and Santander and 16 via the money market brokers. Six of these investments have been made for periods of 6 months where value was shown at between 1.15% and 1.35% and 3 made for a year at between 1.50% and 1.90%. The money market rates available for investment are shown in Figure 2 below. Investing for 6 months allows favourable rates to be taken and also allows the flexibility of funds becoming liquid when interest rates are predicted to start to rise in the future. 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.

30. 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 6 call accounts – Bank of Scotland (0.75%), Alliance & Leicester (0.80%), Yorkshire bank 15 day (0.80%) and Yorkshire Bank call (0.50%), and opened a 30 day (1.0%) and instant access (0.80%) with Natwest in October 2010 – but has found during 2010/11 that better rates have been available on the market for fixed term deposits and also in money market funds (MMF). Therefore, funds held in the call accounts have been reduced with the average balance for the first 9 months in 2010/11 being £10.914m compared to £14.870m in 2009/10. The two money market funds being utilised are Prime rate MMF offering rates around 0.85% and Ignis offering rates around 0.70%. The MMF's 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. In 2010/11 the average balance in the money market funds is £22.808m.

31. In order for investments 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.

32. 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 to 31 December 2010. It shows that favourable / competitive interest rates have been obtained for investments whilst ensuring the required liquidity and security of funds for the Council.

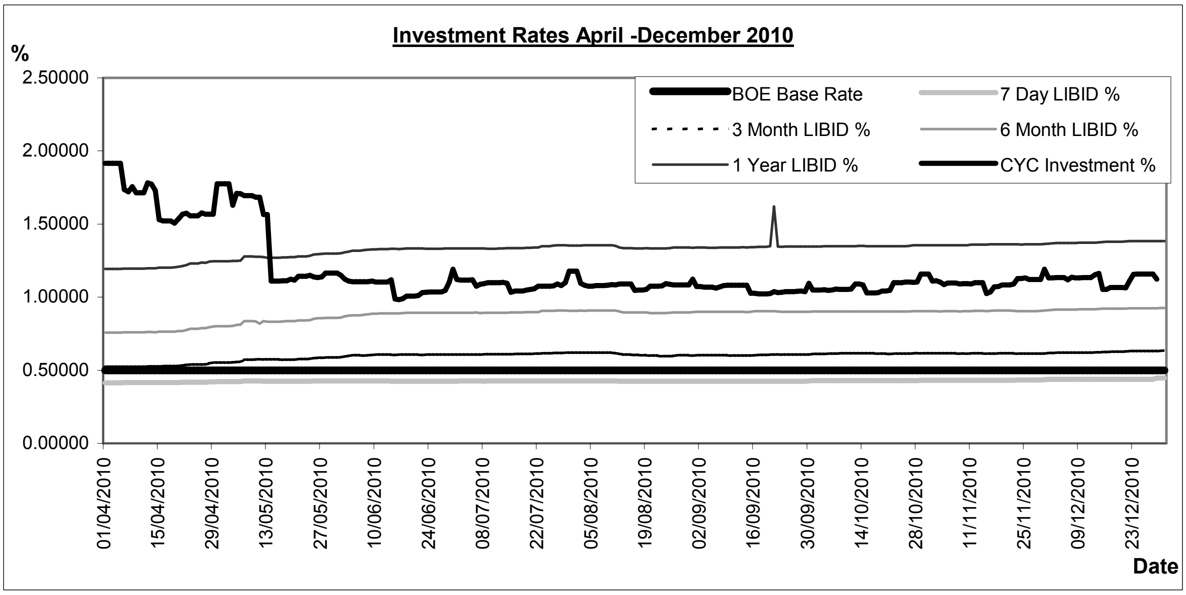

Figure 2 CYC Investments vs Money Market Rates

Long Term Borrowing

33. 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.

34. 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). This takes into account supported borrowing for capital schemes supported by RSG as explained in the paragraph above, 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.

35. 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 continue to be closely monitored to ensure that advantage is taken of favourable rates in 2010/11 and the increased borrowing requirement is not as dependant on interest rates in any one year over the 3 year period.

36. 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.

37. Prior to the Comprehensive Spending Review loans have been taken as borrowing rates were seen to be good value for the longer term, as explained in paragraph 16 above. Locking into historically low borrowing rates enables some stability on the costs incurred in the Treasury Management revenue budget going forwards.

38. Equally since the Comprehensive Spending Review, borrowing rates are being closely monitored for volatility in the market for when rates are deemed to be favourable, market loans are being considered in addition to PWLB loans and a balance is being taken between increasing borrowing and the lower levels of interest being earned on investments. The Sector Treasury Management advisors forecast that future PWLB rates will also rise - in addition to the increase from the Comprehensive Spending Review - which is also being taken into account.

39. 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 £24m has been taken to date in 2010/11:
    - £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
- £3m PWLB loan at 3.92% 50 years on 31 August 10

40. The loans taken in 2010/11 have been below the original target of 4.5% set in the Council approved 2010/11 strategy. In the Treasury Management Monitor 2 report the target level was raised to 5.5% due to the change in PWLB rates in the Comprehensive Spending Review, paragraph 17 refers. (It is not intended that borrowing rates will be taken at this level as it is forecast that the market is still volatile and there will remain opportunities for rates below 4.5%, every attempt will be made to keep rates at the lowest levels possible.)

41. The loans taken are of fixed term duration, have targeted periods that offer the best rates available and also take into consideration the debt maturity portfolio. In 2010/11, from 1 April 2010 to 31 December 2010, 45-50 year PWLB rates started at 4.65%, rose to a high of 5.45% during December 2010 and were at a minimum of 3.92% on 31 August 2010. 9.5-10 year PWLB started at 4.14%, at the end of August fell to a minimum of 3.05% and have seen a high of 4.75% in December 2010.

42. Figure 3 shows the fluctuation in PWLB rates since April 2009 and details when new borrowing has taken place.

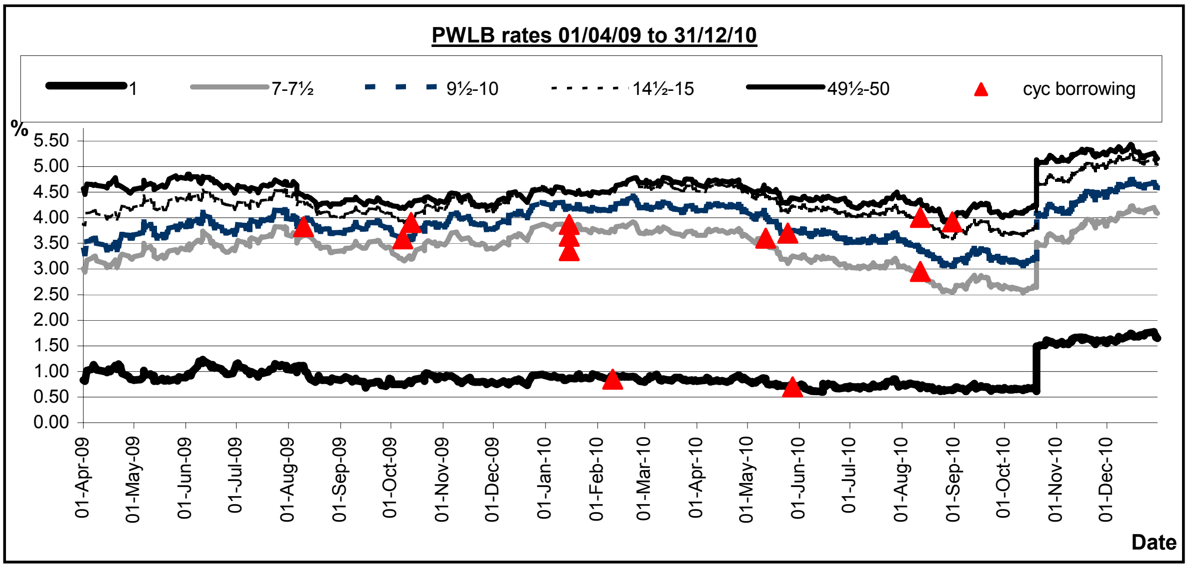

Figure 3 – PWLB rates vs CYC Borrowing Levels

43. Figure 4 illustrates the 2010/11 maturity profile of the Council's debt portfolio updated to reflect the borrowing this year to 31 December 2010. The borrowing portfolio totals £136.1m 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.

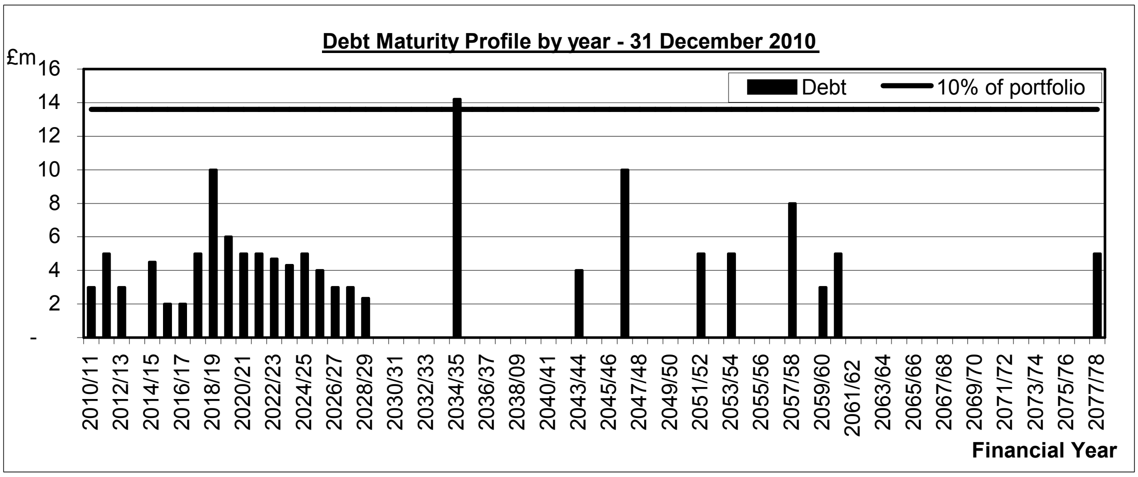

Figure 4 – Debt Maturity Profile 10/11

Venture Fund

44. 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

45. 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 to the Treasury Management budget 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.

46. The position of the venture fund reported at monitor 3 is no change from that reported to Members on 16 November 2010 at monitor 2.

Treasury Management Budget

47. Treasury Management activity had a Corporate Budget approved at Council on 25 February 2010 of £11,131k. In August 2010, the current approved

budget stood 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. In January 2011, the current approved budget stood at £11,736k. The reduction of £32k was approved by the Director of Customer & Business Support Services in line with the financial regulations. It was a transfer to Property Services for the loss of revenue from the property 1 Newgate Street being sold as a capital receipt and used to fund the capital programme in 09/10.

48. The projected outturn for 2010/11 is £11,536k, an estimated underspend of £200k. Table 3 details the individual components that make up this overspend.

	(Under)/Over Spend £000
Decrease in financing expenditure (interest paid)	(114)
Reduction in Minimum revenue provision charge to repay debt	(61)
Increase in interest receivable	(25)
Total Underspend	**(200)**

Table 3 – Treasury Management Budget 2010/11

49. The Treasury Management budget under spend at monitor 3 is driven by the 3 factors in table 3. The reduction in finance expenditure is due to the reduced amount of interest to be paid on borrowing during 2010/11. Until the Chancellor's Comprehensive Spending Review (CSR) on 20 October 2010, the borrowing interest rates available on the market were more favourable than were expected when the budget was set. There has been a delay in taking further borrowing due to the CSR, this has resulted in lower interest being paid in 10/11. In addition there is still volatility to lock into lower rates.

50. There is a slight increase in interest receivable compared to the budget. The cash balances to invest are slightly higher than anticipated and the use of various investment products - longer term deposits, short term call accounts and money market funds – are resulting in slightly better interest rates being received on investments. Of prime importance is always the security of the Council's funds.

51. It is expected that growth will continue to be slow in 2010/11, resulting in continued lower market interest rates being available for investments. It is interesting to note that in the 2010/11 strategy in February 2010 our Sector Treasury Management advisers were forecasting the base rate to rise in September 2010 to 0.75% and in March 2011 to 1.50%. On 29 October 2010, this had been revised to 0.75% in September 2011 and 1.50% in June 2012. Now the forecast on 5 January 2011 has been revised to 0.75% in December 2011 and 1.50% in September 2012. This highlights that investment interest earned will continue to be at low levels for the foreseeable future.

52. A technical review of the council's capital financing requirement and minimum revenue provision is ongoing and more detail on the financial impact of this will be provided in a future report. In accordance with the guidance the minimum revenue provision is at a level that is prudent. Further details are contained in the capital programme Budget Strategy 2010/11 to 2014/15.

.

Compliance with Treasury and Prudential Limits

53. It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits". Council's approved treasury limits and prudential indicators (affordability limits) for 2010/11 are outlined in the approved Treasury Management Strategy Statement (TMSS) at Council on 25 February 2010. During the financial year to date the Council has operated within the treasury limits and Prudential Indicators set out in the Council's TMSS. The monitoring of the Prudential Indicators is attached at Annex A. Prudential Indicators were not breached during the first 9 months of 2010/11.

Consultation

54. 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

55. The Council's corporate strategy has the 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

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

Equalities

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

Legal Implications

58. 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

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

Information Technology Implications

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

Property Implications

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

Risk Management

62. 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

63. Members are requested to:
    - Note the performance of the Treasury Management activity;
    - Note the projected underspend of the Treasury Management budget of £200k.

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

Contact Details

Author:	**Chief Officer Responsible for the report:**
Louise Branford-White Technical Finance Manager Corporate Finance Tel No. 551187	Ian Floyd Director of CBSS
	Keith Best Assistant Director of CBSS (Finance)
Ross Brown Principal Accountant Corporate Finance Tel No. 551207	Report Approved √ Date 15/02/11

Wards Affected: All None

Specialist Implication Officers:

None

For further information please contact the author of the report

Background Papers

Cash-flow Model 10/11, Investment Register 10/11, PWLB Debt Register, Capital Financing Requirement 10/11, Venture Fund 10/11, Treasury Management budget 101/11, Statistics 09/10.

Annexes

Annex A – Prudential Indicators