CITY OF YORK COUNCIL

Appendix A

Cabinet **6 November 2012**
Report of the Cabinet Member for Corporate Services

Treasury Management Monitor 2 Mid Year review and Prudential Indicators 2012/13

Summary

1. This Council is required through regulations issued under the Local Government Act 2003 and the revised 2011 CIPFA (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 30 September 2012 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) Indicators suggest that economic growth returned after three quarters of recession, with GDP (Gross Domestic product) in September increasing by 1% on the previous quarter. Over the last year the economy has remained flat.
b) Retail sales held up well and spending off the high street strengthened;
c) The labour market continued to recover, with most of the rise in employment being driven by growing self and part-time employment, rather than full-time. Pay growth has remained modest. Annual growth of overall average earnings ticked up from 1.3% in June to 1.4% in July. Given the rate of inflation over this period, real pay continued to fall on an annual basis
d) Annual inflation CPI (Consumer Prices Index) stands at 2.2 per cent in September 2012, down from 2.5 per cent in August. This is the slowest rate of inflation since November 2009, when it was 1.9 per cent. Further falls in inflation over the next few months look unlikely as a result of the recent increase in commodity prices – oil and agriculture.
e) The MPC (Monetary Policy Committee) announced additional asset purchase of £50bn in July over the following four months. This would take the total amount of Quantitative Easing to £375bn. Therefore, interest rate markets are pricing in a decent chance of a cut in official interest rates within the next few months, but Mervyn King (the Governor of the bank of England) is opposed to this.
f) UK equity and government bond prices rose;
g) The US economy's recovery has remained fairly weak. In the Eurozone, market sentiment improved following the ECB's pledge to buy "unlimited" quantities of peripheral government's sovereign debt in early September, provided that those countries have formally requested a bail out The US economy continued to recover, but at a disappointingly slow pace.

5. From the economic uncertainty described above the environment in which treasury management operates remains volatile. Sector – the Council's treasury management advisers – have undertaken a review of its interest rate forecasts following the Bank of England Inflation Report for August 2012, which again pushed back the timing of growth and the rate at which inflation will fall back towards the target rate of 2%. Table 1 is Sector's Interest Rate forecast:

	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%	0.75%	1.00%
5yr PWLB rate	1.50%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.30%
10yr PWLB rate	2.50%	2.50%	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.20%	3.30%
25yr PWLB rate	3.70%	3.70%	3.70%	3.80%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%
50yr PWLB rate	3.90%	3.90%	3.90%	4.00%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%

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

6. The table highlights the first rise in Bank Rate is forecast to be in Q4 2014. For comparison purposes in January 2012, it was forecast that the Bank Rate would rise in Q1 2013. The current economic environment remains volatile with the uncertainty in the Euro zone and slow growth across the globe. PWLB (Public Works Loans Board) government rates for local authorities are forecast to remain low, rising in 2013 on a gradual upward trend.

7. Figure 1 below shows the actual and projection of the bank base rate, which has remained at historically low levels since April 2009. Sector forecast bank base rate in August 2012 is compared to their revised forecast in January 2012. Other economists latest forecast are also shown for August 2012. The graph highlights the continued delay in the expectation of the increase in the Bank Base rate which is as a result of the decision to expand quantitative easing (now at £375bn) and continued low growth prospects.

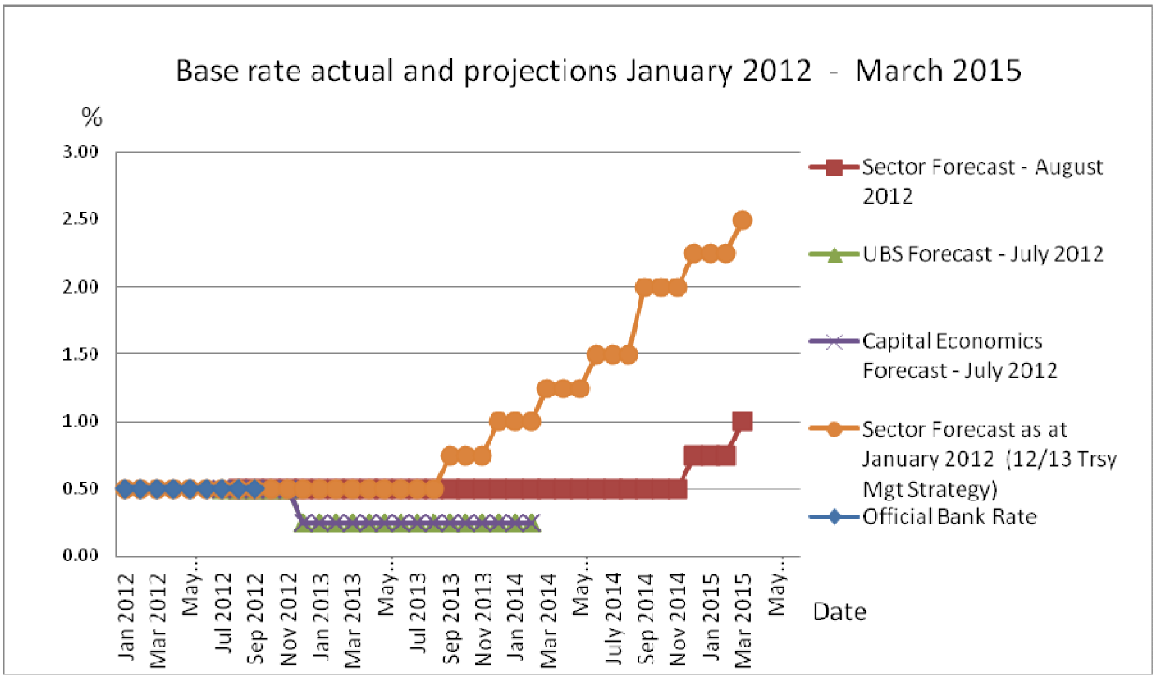

Figure 1: Base Rate 2012 to 2015 - latest forecast August 2012

Annual Investment Strategy

8. 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.

9. 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.

10. The current economic climate and the heightened credit concerns it is considered appropriate to keep investments short with a maximum duration of 3 months. This 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 of these entities provides comfort to investors.

(c) Money market Funds – suggested limit remains at 1 year.

11. Investments held during the first six 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

12. Investment rates available in the market have continued at historical low levels. The average level of funds available for investment purposes in the six months of 2012/13 was £43.418m. 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.

13. 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.

14. Investment activity during the first six months of 2012/13 earned a rate of return of 1.50% (compared to 1.50% 1st 6 months 11/12). This is 1.08% (compared to 1.03% 1st 6 months 11/12) better than the average 7 day London Inter-Bank Deposit rate (LIBID) of 0.43% (compared to 0.47% 1st 6 months 11/12) and 1.00% (compared to 1.00% 1st 6 months 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.

15. 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 six 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.

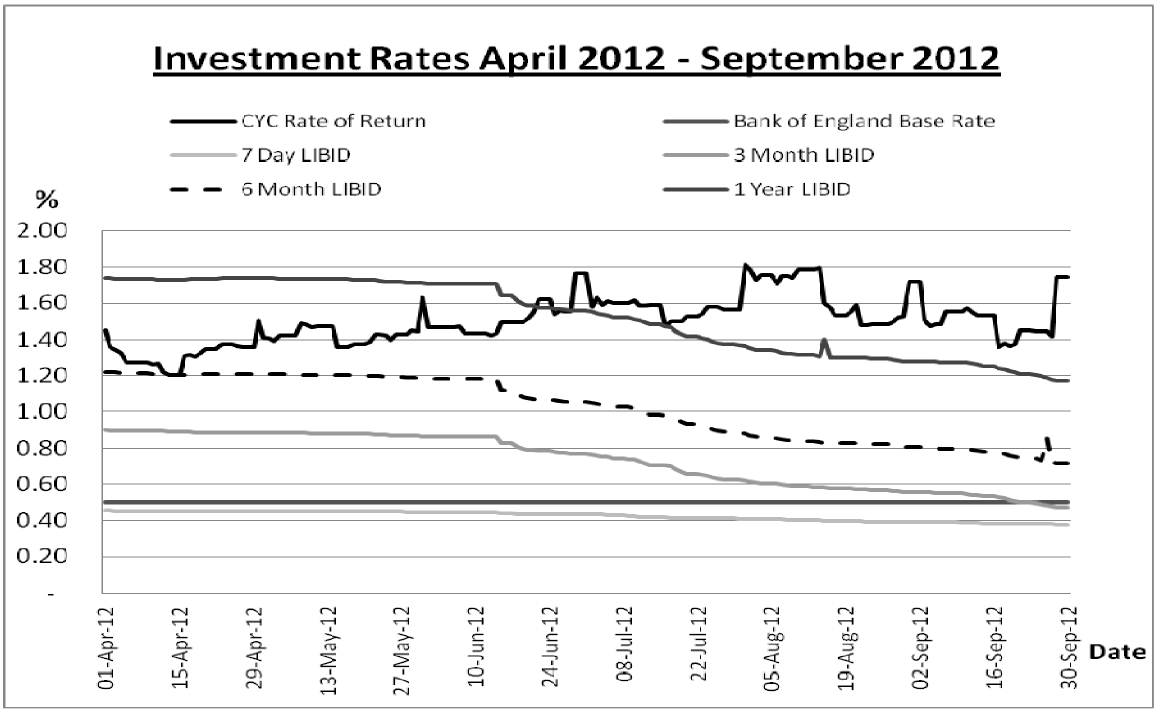

Figure 2: CYC rate of return on Investments vs Money Market Rates

16. 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. Investments in the portfolio are diversified and include fixed deposits in short term call accounts, fixed term investments and money market funds (MMF). This can be seen in Figure 3.

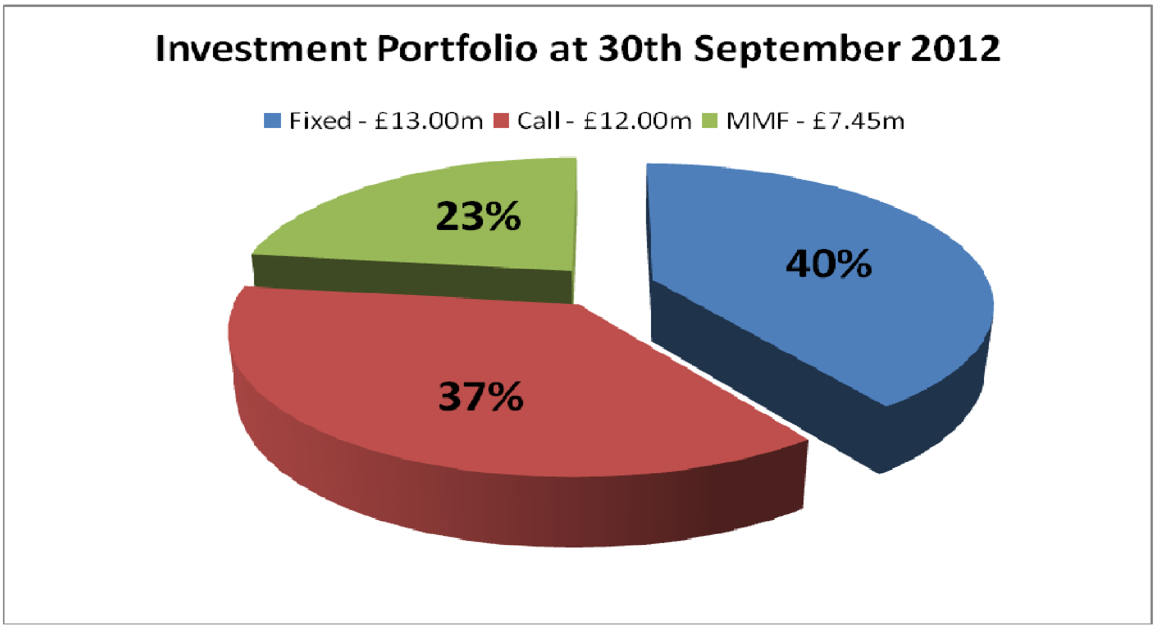

Figure 3 Diversified Investment Portfolio at 30 September 2012

Borrowing Portfolio

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.

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). Borrowing needs to be affordable, sustainable and prudent and the treasury management budget supports the borrowing finance costs in the longer term.

19. Under regulation, the Council can borrow in advance of need in line with its future borrowing requirements in accordance with the Capital Financing Requirement. This Council has not borrowed in advance of need during the quarter ended 30th September 2012 and has no intention to borrow in advance in 2012/13.

20. 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.

21. 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. To date no external borrowing has occurred in 2012/13.

22. The interest rate target level for borrowing in the Treasury Management Strategy for 2012/13, approved by Council 23 February 2012, was 4.5% to allow for external borrowing over different time periods. The revised interest rate forecast in table 1 above, shows that borrowing rates in the first six months of 2012/13 have fallen across the board. Table 2 shows Government Public Work Loans Board (PWLB) borrowing interest rates across the interest rate yield curve for the quarter to 30 September 2012.

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.00%	1.52%	2.52%	3.81%	4.02%
Date	02/08/12	23/07/12	23/07/12	18/07/12	18/07/12
High	1.21%	1.89%	2.91%	4.15%	4.32%
Date	02/07/12	17/09/12	17/09/12	17/09/12	17/09/12
Average	1.10%	1.68%	2.68%	3.94%	4.14%

Table 2 – PWLB Borrowing Rates - quarter ended 30 September 2012

23. Long-term rates (30 years and above) hit their lows for the current year on 1st June 2012 (3.96% for 50 year PWLB). Rates at the short/medium term fell even lower into July and reached their low point on 23rd July amidst growing expectations of UK bank rates remaining lower for longer and falling inflation expectations.

24. Overall, PWLB borrowing rates have risen since June/July and are currently 20-30 basis points above the earlier lows, but still historically low. This slight rise is due to a reduced level of perceived market risk leading to an outflow from UK gilts (selling gilts) into equities (buying equities). This results in a slight rise in interest rates.

25. There is further opportunity for lower borrowing rates to be achieved in Local Authorities, as in the March budget 2012 the government announced that they would introduce a 20 basis points discount on loans from the Public Work Loans Board. On

2 August 2012 the Treasury revealed details of the 'certainty rate' which will enable local authorities to access this cheaper borrowing. Authorities who wish to access this reduced rate were required by 17th September 2012 to complete a form detailing the amount of borrowing that authorities would require in accordance with their capital programme. On 12 October, the Government listed all those authorities that were eligible to receive the reduce rate of interest on borrowing. City of York Council have been included on this list.

26. 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 indicates that all interest rates have generally been on a downward trend during the 2012/13 and continue to remain at historical low levels. The yellow circles highlight when new borrowing was taken in 2011/12, no borrowing has occurred in 2012/13. In future, due to the 'certainty rate', PWLB interest rates available will be 20 basis points lower and will be illustrate on the graph in future reports.

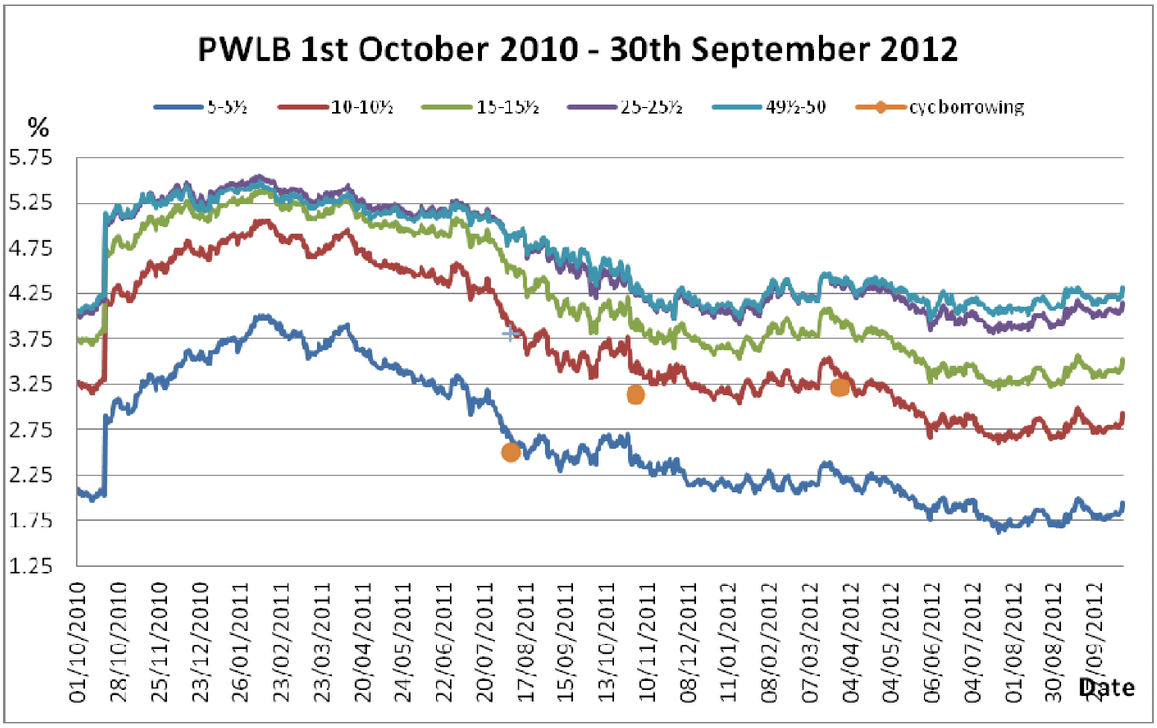

Figure 4 – PWLB rates vs CYC Borrowing Levels

27. The Councils long-term borrowing started the year at a level of £261.6m. This is split between the General Fund at £121.3m and the HRA at £140.3m. £3m loan was repaid in May 2012 in line with its maturity date, split between the General Fund and

HRA at £2.6m and £0.4m respectively. No new borrowing has been taken in the first six months of 12/13.

28. It is not anticipated that borrowing will be undertaken during this financial year as borrowing rates remain higher than investment rates, even with the PWLB 'certainty rate'. That said, borrowing rates are still at historically low levels and therefore rates will continue to be monitored in this volatile opportunistic environment. If rates forecast change and it is anticipated that borrowing rates are on the increase, then borrowing may occur to take advantage of favourable rates.

29. Figure 5 illustrates the 2012/13 maturity profile of the Council's debt portfolio as at 30 September 2012. This is split between the loans held by the General Fund and the loans held by the HRA, which is required under the Self Financing regulation. These regulations came in to force on 1 April 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.

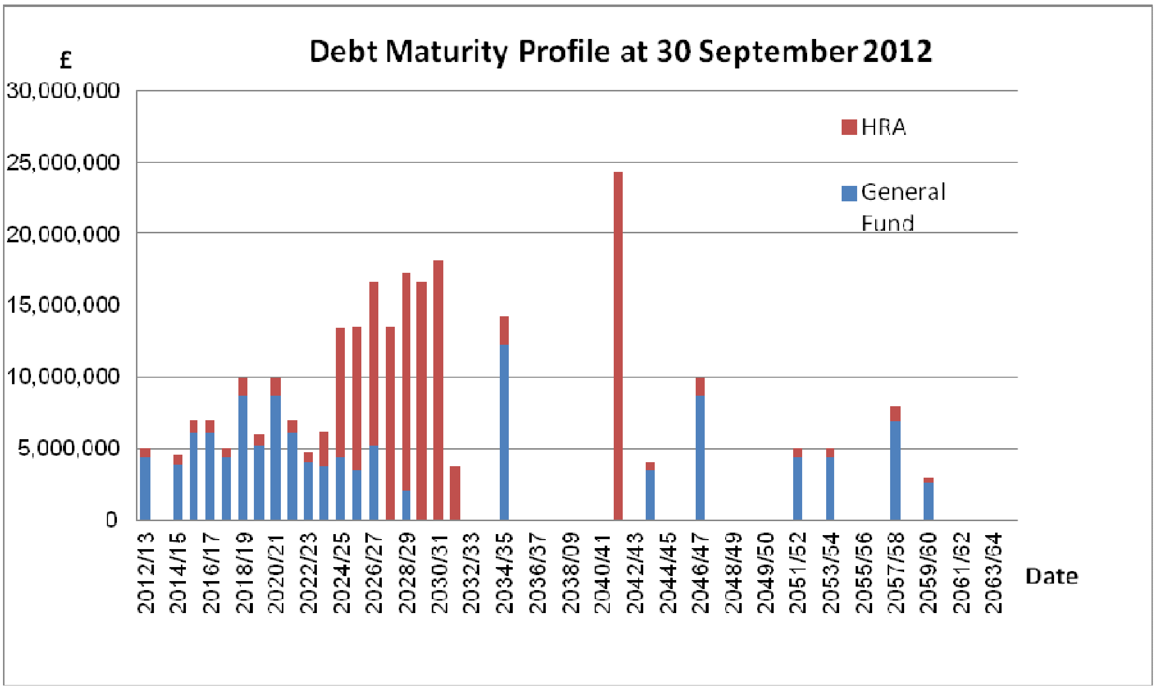

Figure 5 – Debt Maturity Profile 12/13

Compliance with Prudential Indicators

30. 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.

31. 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.

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

Consultation

33. The report shows the six 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 advisers.

Council Plan

34. 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.

Human Resources Implications

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

Equalities

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

Legal Implications

37. 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

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

Information Technology Implications

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

Property Implications

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

Risk Management

41. 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

42. Members are required, in accordance with the Local Government Act 2003, to:
- Note the treasury management activities in 2012/13
- Note the movements in the Prudential Indicators at Annex A

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

Contact Details

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	Report Approved	√	Date	06/11/12

Wards Affected: All
Specialist Implication Officers: None

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.

Annexes

Annex A – Prudential Indicators 2012/13