CITY OF YORK COUNCIL

Appendix A

Cabinet

Report of the Cabinet Member for Corporate Services

Treasury Management Monitor 2 Mid Year Review and Prudential Indicators 2011/12

Summary

1. This Council is required through regulations issued under the Local Government Act 2003 and the revised 2009 (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management to provide Members with an update on treasury management activities at least twice a year.

2. This report recommends changes to the 2011/12 Treasury Management Strategy Statement and Prudential Indicators in light of the HRA reform changes. It also updates on the Treasury Management activities for the period 1 April 2011 to 30 September 2011.

3. This mid year report highlights the economic environment for the first six months of the 2011/12 financial year and reviews the Council's Treasury Management activities covering:

   - Treasury Management Strategy Statement
   - HRA reform
   - Compliance with Prudential Indicators
   - Annual Investment Strategy
   - Investment portfolio
   - Borrowing portfolio

Background

4. 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

5. The Council's treasury management activities have operated within the following economic background over the last 6 months to 30 September 2011:
   (a) Indicators suggest that the economy has at best stagnated;
   (b) Conditions on the high street have deteriorated further;
   (c) Employment has fallen again;
   (d) The public finances are expected to miss this year's fiscal forecasts;
   (e) CPI inflation rising, heading for a peak of around 5% in Q4;
   (f) The MPC signal a move towards increasing QE further;
   (g) Equities prices plummet and gilt yields fall to historic lows;
   (h) The economic recoveries falter in the US and Europe

6. There remains huge uncertainties in economic forecasts due to:
   (a) The decision by the MPC to expand quantitative easing over the next four months by a further £75bn which had an immediate effect of depressing gilt yields at the long end of the curve. This clearly underlines how concerned the MPC is about the prospects for growth of the UK economy and that recession is now a greater concern than inflation.
   (b) The marked deterioration of growth prospects in the US, EU and UK, especially with increased concerns over Greece and the potential fall out from their debt situation. This has led in turn to a further increase in safe haven flows into UK gilts, which have depressed gilt yields and PWLB rates to lower levels.

7. From the economic uncertainty described above, it is expected that low growth in the UK will continue, with a low Bank rate for at least 24 months.

8. Figure 1 below shows the actual and projection of the bank base rate, which has remained at historically low levels since April 2009. The Council's treasury management advisers – Sector – forecast the position of the base rate in January 2011 for the 2011/12 Treasury Management Strategy this is compared to their revised forecast in August 2011. Other economists latest forecast are shown in May 2011. 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.

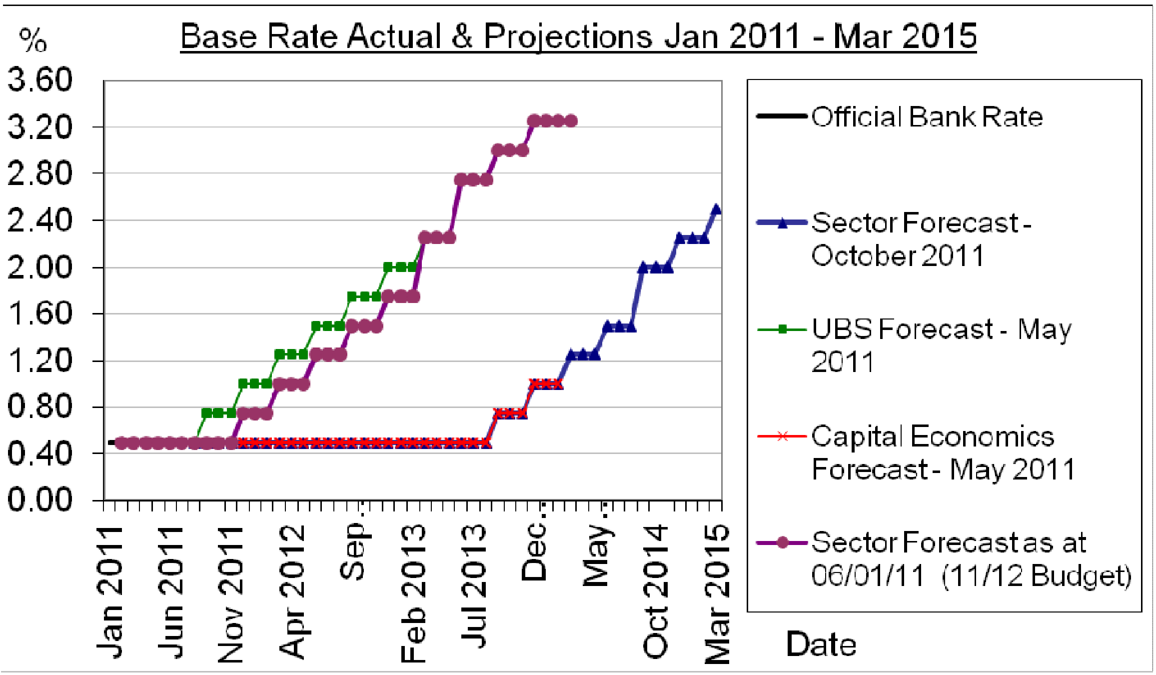

Figure 1: Base Rate 2011 to 2015 - latest forecast August 2011

Treasury Management Strategy Statement (TMSS)

9. The Treasury Management Strategy Statement (TMSS) for 2011/12 was approved by this Council on 24 February 2011. Included in the TMSS are Prudential Indicators which determine and keep under review how much the Council can afford to borrow. This is a statutory requirement under Section 3 of the Local Government Act 2003 and supporting regulations.

10. If these Prudential Indicators change along with the TMSS, it is a legal requirement to seek Council approval for these changes.

11. The TMSS approved previously, currently requires revision in light of the proposed changes to the current HRA subsidy arrangements. The following paragraphs explain the proposed HRA reform, the resultant required changes to the TMSS and prudential and treasury limits.

HRA Reform

12. The proposed reform of the HRA subsidy arrangements are expected to take place on 28 March 2012. This will involve the Council paying £112m to the Department of Communities and Local Government (CLG) which will remove the Council from the current HRA subsidy system. It should be noted that this figure will change slight between now and the 28 March 2012 due to the impact of inflation.

13. This one off payment of £112m will ensure that the HRA will no longer make future annual payments to the CLG through the housing subsidy system. It is expected that the overall impact will be beneficial to the Council.

14. The HRA capital expenditure payment will be financed by a form of borrowing. This could be a money market loan or a bond but is more likely to be a Public Works Loan Board (PWLB) Loan as the Government announced on the 18th September that Local Authorities will be able to borrow from the PWLB at lower rates than currently offered by the PWLB. The level of rates will be approximately 0.15% above the level of the gilt, rather than the current PWLB rate of 1% above the gilt. These rates apply solely for the purpose to borrow for the HRA reform and are at the level which all PWLB rates were at prior to the Comprehensive Spending Review in October 2010. The HRA PWLB rates will be available from January 2012.

15. The legislative framework to enable the HRA reform to take place is yet to be agreed by Government in the White Paper in November 2011. The inclusion of the HRA reform in this treasury management report enables members to recommend to Council the approval for the change in the Prudential Indicators. This will allow the Council to borrow and take advantage of favourable PWLB rates when they become available in January 2012.

16. The original Prudential Indicators approved at Council on 24 February 2011 are attached at Annex A and are compared with the revised limits to incorporate the HRA reform requirement. Further explanation of the Prudential Indicators are detailed in the paragraphs below.

17. Further information on the HRA Reform will be reported to Members in the coming months, this will include further detail on

the required HRA borrowing portfolio in conjunction with housing services.

Compliance with Prudential Indicators

18. The Prudential Indicators included in the TMSS are based on the requirements of the Council's Capital programme. The Capital programme is an amount of capital expenditure which is funded from various external resources e.g. grants, revenue contributions etc and also borrowing. The level of borrowing required to support the capital programme over time is known as the Capital Financing Requirement. .

19. The one off payment to the DCLG to remove the HRA from the current housing subsidy system is expected to be £112m. The £112m is capital expenditure which forms part of the capital programme and will increase the level of borrowing of the Council. The Council has to ensure that total capital investment (capital expenditure) remains within sustainable limits which are affordable and prudent.

20. 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) for 2011/12 are outlined in the approved Treasury Management Strategy Statement (TMSS) at Council on 24 February 2011. During the financial year to date the Council has operated within the Prudential Indicators set out in the Council's TMSS. The monitoring of the Prudential Indicators is attached at Annex A, along with the revised limits for the HRA reform. Prudential Indicators were not breached during the first 6 months of 2011/12.

21. Affordability - how much the council can afford to borrow – is determined by the "Authorised Borrowing Limit" and the "Operational Boundary". The "Authorised Limit" represents the legislative limit specified in the Act and the "operational boundary" is the maximum level of debt allowed for on going operational purposes. If the Authorised Borrowing limit is to be breached, a revised limit needs to be approved by full Council.

22. The key indicators which have changed in relation to the HRA reform are the Authorised Borrowing Limit which was £22m and

has been revised for approval to £347m, the Operational Boundary is now set at £327m, it was £202m and the Capital Financing Requirement has risen to £292.8m from £180.8m

23. Members are therefore requested to approve the changes to the Council's Prudential Indicators for 2011/12 shown in Annex A.

Annual Investment Strategy

24. Treasury Management Strategy Statement for 2011/12 was approved by Council on 24 February 2011. 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

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

26. The current economic climate with the continuing Euro zone sovereign debt crisis and its potential impact on banks prompts a low risk and short term strategy. 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 provides considerable conform to investors.
    (c) Money market Funds – suggested limit remains at 1 year.

27. Investments held during the first six months of 2011/12, 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

28. 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 six months of 2011/12 was £57.5m. 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.

29. The authority holds some core cash balances for investment purposes, i.e. funds available for a year or more, however to date in 2011/12 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 and 2010/11.

30. Treasury Management investment activity during the first six months of 2011/12 earned an interest rate of return of 1.5%. This is 1.03% better than the average 7 day London Inter-Bank Deposit rate (LIBID) of 0.47% and 1% higher than the average base rate for the period of 0.50%. The interest earned to date in 2011/12 is in line with the treasury management budget.

31. 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 deposits of short term call accounts, fixed term and money market funds.

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 for the first six months of 201/12. It shows that favourable / competitive interest rates have been obtained for investments whilst ensuring the required liquidity and security of funds for the Council.

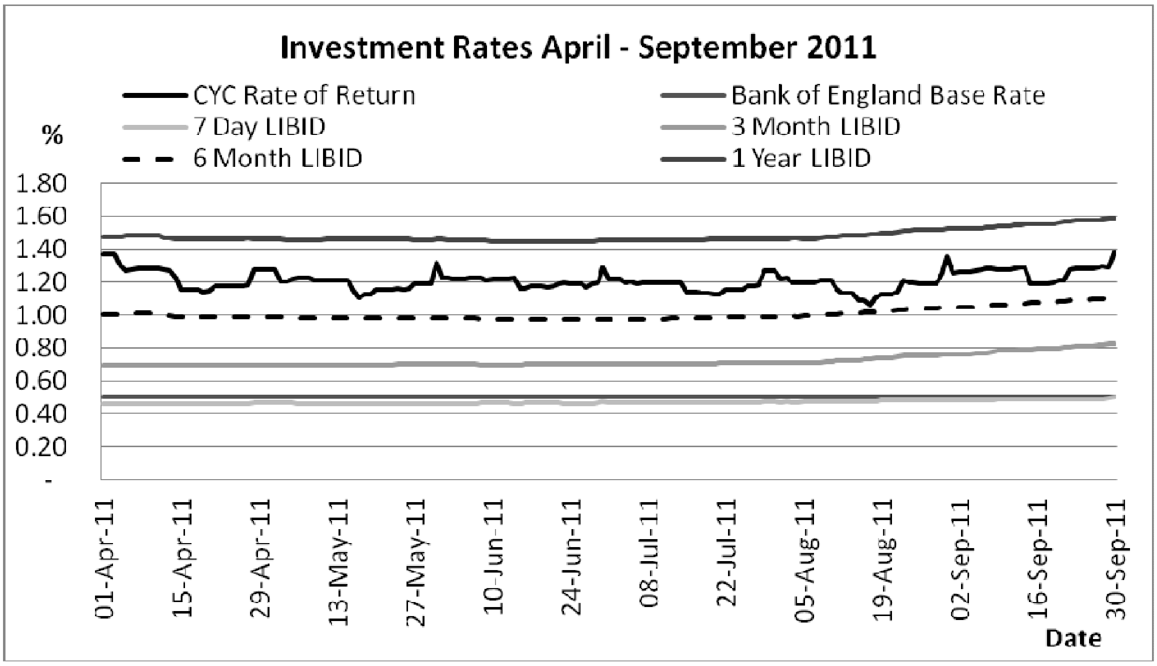

Figure 2 CYC Investments vs Money Market Rates

Borrowing Portfolio

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.

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

35. 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 Administrative Accommodation project increases the Council's need to borrow over the next year and therefore the markets will continue to be closely monitored to ensure that advantage is taken of favourable rates in 2011/12 and the increased borrowing requirement is not as dependant on interest rates in any one year.

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. Sector - treasury management advisers - forecast that future PWLB rates will also rise. The market is expected to remain volatile over the coming months but from 2012 rates are expected to be on a rising trend. Therefore, rates are being monitored to take advantage of long term low attractive borrowing rates, whilst being mindful that investment rates are to remain low for the foreseeable future.

38. The Councils long-term borrowing started the year at a level of £133.1m. A £5m loan was repaid in May 2011 in line with its maturity date. New borrowing of £7m was taken in August 2011.

39. The loans taken in 2011/12 are below the original target of 5% set in the Council approved 2011/12 strategy, the £5m 10 year loan was at 3.81% and the £2m 5 year loan at 2.54%. At this Treasury Management Monitor 2 report the target level for loans for the remainder of 2011/12 is 4.3%.

40. Figure 3 shows the fluctuation in PWLB rates since October 2010 when the Comprehensive Spending Review increased rates to 1% above gilt yields. It highlights when the new borrowing in 2011/12 has taken place, compared to rates available.

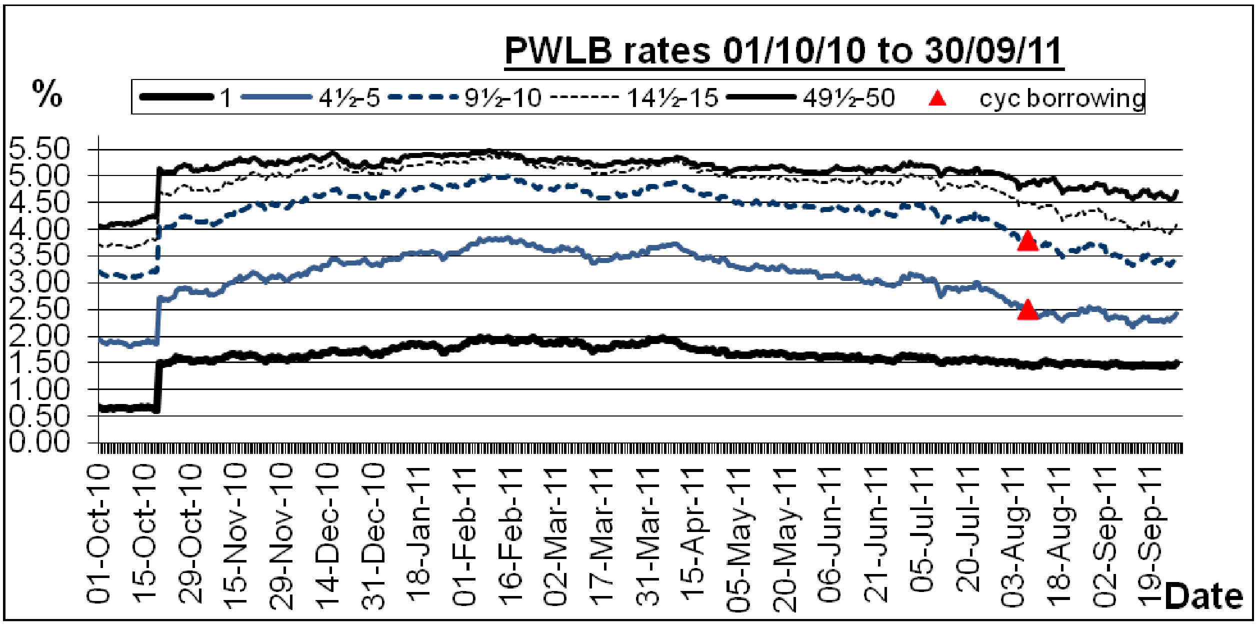

Figure 3 – PWLB rates vs CYC Borrowing Levels

41. Figure 4 illustrates the 2011/12 maturity profile of the Council's debt portfolio updated to reflect the borrowing this year to 30 September 2011. The maturity profile shows that there is no large concentration of loan maturity, thereby spreading the interest rate risk dependency in any one year.

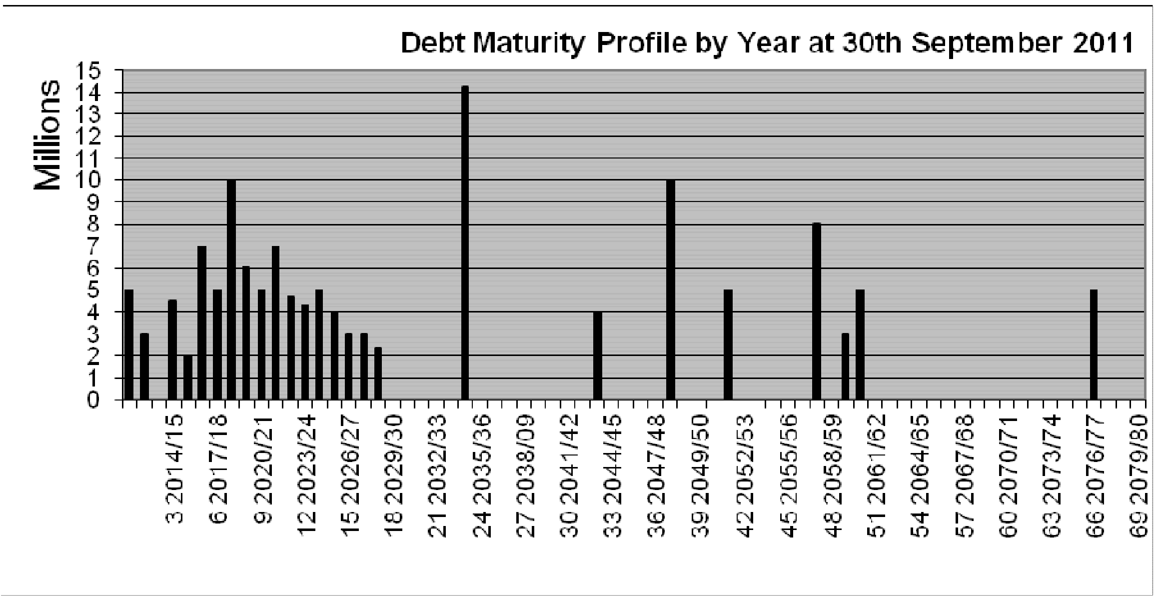

Figure 4 – Debt Maturity Profile 11/12

Consultation

42. The report shows the position of the treasury management portfolio in 2011/12 and provides initial information regarding the future HRA reforms. A further report will be provided to Members

on the HRA reforms in the coming months. 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.

Corporate Priorities

43. 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

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

Equalities

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

Legal Implications

46. 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

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

Information Technology Implications

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

Property Implications

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

Risk Management

50. 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

51. Members are requested to recommend to full Council to:
    - Approve the changes to the Prudential Indicators in light of the HRA reform, specifically the Authorised Borrowing Limit at £347m
    - Note the HRA reform is to be approved by the Government White paper in November 2011 and payment of £112m to the CLG on 28 March 2011
    - Note the expected impact on the capital and treasury activities of the HRA reform
    - Note the Treasury Management activities in 2011/12

Reason – to ensure the continued performance of the Council's Treasury Management function and the inclusion of the affects of the HRA reform on treasury management activities.

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Wards Affected: All

Specialist Implication Officers: None

For further information please contact the author of the report

Background Papers

Cash-flow Model 11/12, Investment Register 11/12, PWLB Debt Register, Capital Financing Requirement 11/12, Venture Fund 11/12, Treasury Management budget 11/12, Statistics 11/112.

Annexes

Annex A – Prudential Indicators 2011/12