REPORT TO:	Audit & Governance Committee
DATE:	15 December 2010
SUBJECT:	Treasury Management 2010/11 – Mid Year Review
WARDS AFFECTED:	All
REPORT OF:	John Farrell Interim Head of Corporate Finance and ICT Strategy
CONTACT OFFICER:	Jeff Kenah Corporate Finance Manager 0151 934 4104
EXEMPT/CONFIDENTIAL:	No

PURPOSE/SUMMARY: To review Treasury Management Activities undertaken in the first half of 2010/11 against the Treasury Management Policy and Strategy document 2010/11.
REASON WHY DECISION REQUIRED: To comply with the requirements of the Council's Treasury Management Policy Statement.
RECOMMENDATION(S): Audit & Governance Committee is requested to note the Treasury Management Mid-year Review for 2010/11.

KEY DECISION:	No
FORWARD PLAN:	Not appropriate
IMPLEMENTATION DATE:	Immediate

ALTERNATIVE OPTIONS:
This report is put before Audit & Governance in order to comply with the Treasury Management Policy and Strategy document 2010/11 that was approved by Cabinet in March 2010.

IMPLICATIONS:

Budget/Policy Framework: Compliance with the Policy and Strategy Documents, incorporating appropriate reporting, will enable the Council to secure the most favourable terms for raising funds, maximise returns on investments whilst at all time minimising the level of risk to which it is exposed.

Financial: There are no additional financial implications as a result of the report.

CAPITAL EXPENDITURE	**2010/ 2011 £**	**2011/ 2012 £**	**2012/ 2013 £**	**2013/ 2014 £**
Gross Increase in Capital Expenditure	---	---	---	---
Funded by:	---	---	---	---
Sefton Capital Resources	---	---	---	---
Specific Capital Resources	---	---	---	---
REVENUE IMPLICATIONS				
Gross Increase in Revenue Expenditure	---	---	---	---
Funded by:				
Sefton funded Resources	---	---	---	---
Funded from External Resources	---	---	---	---
Does the External Funding have an expiry date? Y/N		When?		
How will the service be funded post expiry?				

Legal: None.

Risk Assessment: Compliance with the Policy and Strategy Documents minimise the level of risk to which the Council is exposed.

Asset Management: None.

CONSULTATION UNDERTAKEN/VIEWS

Discussion with the Council's Treasury Management Advisor – Sector Treasury Services.

CORPORATE OBJECTIVE MONITORING:

Corporate Objective		Positive Impact	Neutral Impact	Negative Impact
1	Creating a Learning Community		√	
2	Creating Safe Communities		√	
3	Jobs and Prosperity		√	
4	Improving Health and Well-Being		√	
5	Environmental Sustainability		√	
6	Creating Inclusive Communities		√	
7	Improving the Quality of Council Services and Strengthening local Democracy	√		
8	Children and Young People		√	

LIST OF BACKGROUND PAPERS RELIED UPON IN THE PREPARATION OF THIS REPORT

None.

1. BACKGROUND

1.1 The Treasury Management Policy and Strategy document for 2010/11 (approved by Council on 4 March 2010) included a requirement for a mid-year review of treasury management activities in 2010/11. This report is the first of such documents and presents relevant treasury management information for the period ending 30 September 2010. The strategy document also requires a quarterly update on treasury management activity. The quarterly report will be included as part of this mid-year review and no separate quarterly report will be issued for the second quarter to September 2010.

1.2 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by this Council on 4 March 2010.

The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy for the year ahead, a Mid-year Review Report and an Annual Report covering activities during the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is Audit & Governance Committee.

This mid-year report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- An economic update for the first six months of 2010/11
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- A review of the Council's investment portfolio for 2010/11
- A review of interest earned
- A review of the Council's borrowing strategy for 2010/11
- A review of any debt rescheduling undertaken during 2010/11
- A review of compliance with Treasury and Prudential Limits for 2010/11

2 ECONOMIC UPDATE

2.1 Global economy

The sovereign debt crisis peaked in May 2010 prompted, in the first place, by major concerns over the size of the Greek government's total debt and annual deficit. However, any default or write down of Greek debt would have substantial impact on other countries, in particular, Portugal, Spain and Ireland. This crisis culminated in the EU and IMF putting together a €750bn support package in mid - May.

Growth in the US, UK and the Euro zone in quarter 2 of 2010 was particularly driven by strong growth in the construction sector catching up from inclement weather earlier in the year and is unlikely to be repeated; general expectations are for much more subdued figures for the remainder of 2010. Market expectations for all three sectors of the economy is that these have all peaked and are pointing downwards, though not necessarily in to negative territory.

2.2 UK economy

Following the general election in May 2010, the coalition government has put in place a plan to carry out a reduction of the public sector deficit over the next five years. The inevitable result of fiscal contraction will be major job losses during this period as has been highlighted in the press. This will have a knock on effect on consumer and business confidence. House prices have started a negative trend during the summer and mortgage approvals are at very weak levels and also declining.

Economic Growth – GDP growth is likely to have peaked at 1.2% in quarter 2 of 2010.

Unemployment – the trend of falling unemployment (on the benefit claimant count) has now been replaced since July with small increases which are likely to be the start of a new trend of rising unemployment.

Inflation and Bank Rate – the Consumer Price Index (CPI) has remained high so far during 2010. It peaked at 3.7% in April and has fallen back to 3.1% in September. The Retail Price Index (RPI) remains high, at 4.6% in September. Although inflation has remained stubbornly above the MPC's 2% target, the MPC is confident that inflation will fall back under the target over the next two years. The last quarterly Inflation Report in August showed a significant undershoot after the end of 2011.

The Bank of England finished its programme of quantitative easing with a total of £200bn in November 2009 (although there is currently some increase in expectations that there might be a second round of quantitative easing).

The view of our treasury consultants, Sector, is that there is unlikely to be any increase in Bank Rate until the middle of 2011.

AAA rating – prior to the general election, credit rating agencies had been issuing repeated warnings that unless there was a major fiscal contraction, then the AAA sovereign rating was at significant risk of being downgraded. Sterling was also under major pressure during the first half of the year. However, after the Chancellor's budget on 22 June, Sterling has strengthened against the US dollar and confidence has returned that the UK will retain its AAA rating. In addition, international investors now view UK government gilts as being a safe haven from EU government debt. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and PWLB rates.

2.3 Our Treasury Consultants, Sector, project bank base interest rates and PWLB borrowing rates to be as follows:

	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
Bank rate	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.50%	3.00%	3.25%
5yr PWLB rate	2.20%	2.20%	2.20%	2.40%	2.60%	2.80%	3.00%	3.30%	3.60%	3.80%	4.10%	4.40%
10yr PWLB rate	3.30%	3.30%	3.30%	3.40%	3.70%	3.90%	4.00%	4.30%	4.40%	4.60%	4.60%	4.90%
25yr PWLB rate	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.70%	4.70%	4.80%	5.00%	5.00%	5.00%
50yr PWLB rate	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.70%	4.70%	4.80%	5.00%	5.00%	5.00%

3 TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY UPDATE

The Treasury Management Strategy Statement (TMSS) for 2010/11 was approved by this Council on 4 March 2010. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as follows:

- Security of capital
- Liquidity

The Council will also 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 (maximum investment period of 12 months), and only invest with highly credit rated financial institutions, using Sector's suggested creditworthiness approach, including sovereign credit rating and credit default swap (CDS) overlay information.

A breakdown of the Council's investment portfolio is shown in Section 4 of this report.

Borrowing rates have been at historically low rates during the first six months of the 2010/11 financial year. Any new external borrowing undertaken has been identified in Section 6 of this report.

Investments and borrowing during the first six months of the year have been in line with the strategy.

As outlined in Section 2 above, there is still considerable uncertainty and volatility in the financial and banking market, both globally and in the UK. Against this background it is considered that the strategy approved on 4 March 2010 is still applicable in the current economic climate.

4 INVESTMENTS HELD

4.1 Investments held at the end of September 2010 comprise the following:

Immediate access deposits

Institution	Deposit £m	Rate %	Maturity date	On current counterparty list?
Santander Group	5.000	0.80	N/A	Yes
Natwest	5.000	0.80	N/A	Yes
Blackrock MMF	6.890	0.56	N/A	Yes
Total	16.890			

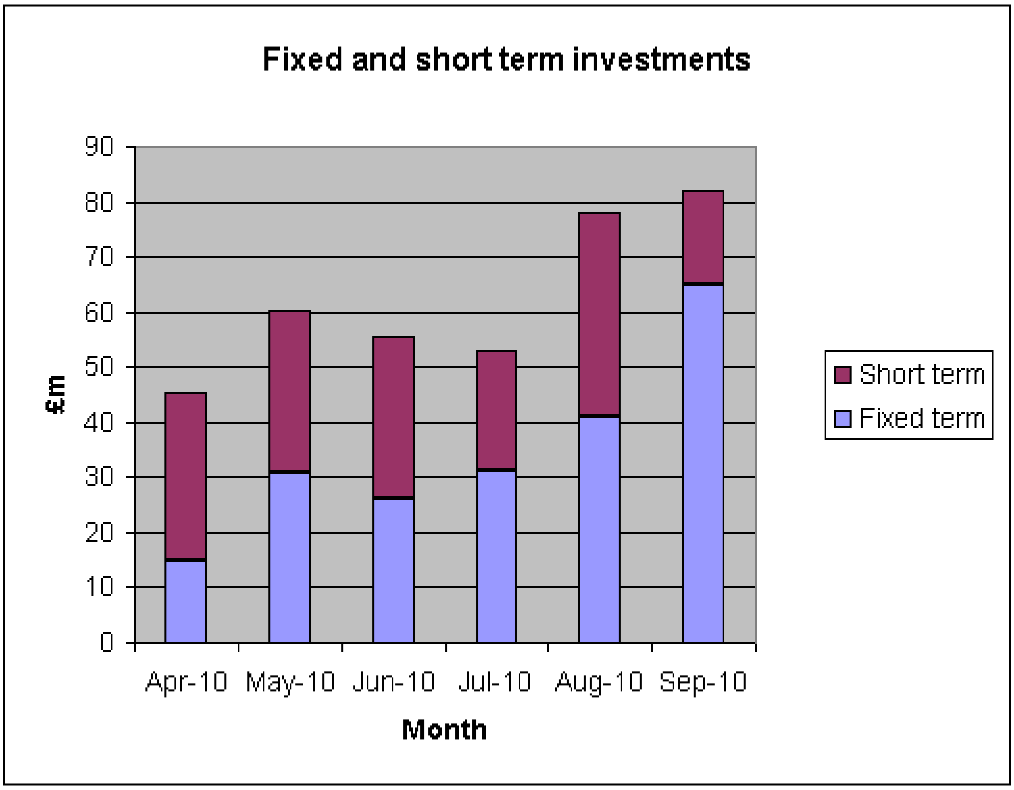
Fixed term deposits

Clydesdale	15.000	0.75	14/10/2010	Yes
Barclays	6.000	0.92	18/11/2010	Yes
Barclays	5.000	0.90	17/11/2010	Yes
Barclays	4.000	0.90	01/03/2011	Yes
Lloyds	5.000	1.82	30/11/2010	Yes
Natwest	10.000	1.32	30/11/2010	Yes
Santander	10.000	1.32	14/04/2011	Yes
Llloyds	10.000	1.70	22/09/2011	Yes
Total	65.000			
TOTAL	81.890			

4.2 All of the organisations are on the current counterparty list. The maximum level of investment permitted in any one institution, or banking group, is currently £25m. Whilst the maximum should be retained, in case conditions change, a day to day operational maximum of £15m is currently being imposed. This will spread the risk of investments for the Council, but will have a small detrimental impact on the returns the Council will receive in the future.

4.3 It should be noted that the deposit with Clydesdale is a 15 day notice account, which until recently had been an immediate access account. An immediate access account is available with Clydesdale but at a much lower rate of interest. This move away from immediate access accounts paying above the Bank of England base rate will continue as banks are required to hold larger capital balances, and hence wish to move away from immediate access accounts which pay above the base rate. This move may cause us to use our money market fund accounts more regularly as they still pay a rate of interest above the base rate.

4.4 The ratio of overnight deposits (i.e. short term) to fixed term investments is illustrated below:



The standard lending list is contained within Appendix A.

5 INTEREST EARNED

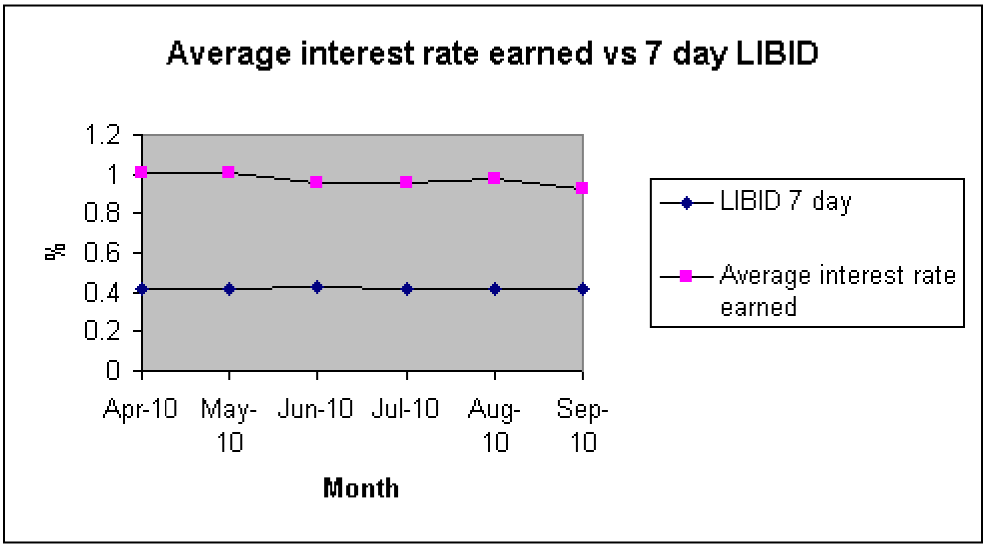
5.1 The actual performance of investments against the profiled budget for the period to 30 September is shown below:

	Budget £'000s	Actual £'000s	Variance £'000s
To 30 September	**96**	**264**	**168**

5.2 The original budget of investment income for 2010/11 was £0.228m (which equated to an average interest rate of 0.515%), was based on investments in place at 1st April 2010.

5.3 The investment income achieved during the first half year is £0.264m, which equates to an average interest rate of 0.97%.

We have outperformed the 7 day LIBID average (standard measure of performance for local authorities) as follows:



6 NEW BORROWING

The Council's capital financing requirement (CFR) for 2010/11 is £200m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Due to the high cost of borrowing as against the low level of interest rates earned on investments, the Council had taken the decision to internally borrow.

Due to a fall in PWLB interest rates on short term loans in recent months, new external borrowing of £20m was undertaken from the PWLB on 31/08/2010 and this has had the impact of reducing our level of internal borrowing. Two loans were taken out, one for £10m over five years at a rate of 1.86%, and one at £10m over six years at a rate of 2.17%. The Council's current level of PWLB borrowing at September 2010 is £131.65m.

As outlined below, the general trend has been a reduction in interest rates during the six months, across all bands, with the low points occurring in the middle to end of August. The high points were in early to mid April. However, following the Comprehensive Spending Review, an additional 1% has been added to the cost of borrowing rates for new borrowings from PWLB with effect from 20 October 2010. By taking the £20m additional borrowing in August the Council has fortuitously the 1% levy. However, future borrowings will be affected; this will impact on our revenue position compared to budget.

It is not anticipated that further borrowing will be undertaken during this financial year.

7 DEBT RESCHEDULING

Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. During the first six months of the year, no debt rescheduling was undertaken.

8 PRUDENTIAL INDICATOR MONITORING

8.1 Prudential indicators are an integral component of measuring how prudently a Council is acting with regard to its finances. They were introduced into all local authorities (by CIPFA) following the Local Government Act 2003. A number of measures/limits/parameters including capital financing, external debt, impact on council tax, and treasury management are set prior to the start of the year and are monitored on a monthly basis.

8.2 It should be noted that two of the prudential indicators have been breached.

(i) The Capital Financing Requirement (CFR) limit has been breached by £0.85m. This is because when the indicator was calculated an assumed asset value of £6m was used in respect of the Crosby Leisure Centre PFI scheme, the valuation being supplied by Sector, our Treasury Management Consultants. The actual value of the asset at 31 March 2010 as valued by Capita Symonds was £7.525m, which has caused the breach. This issue was reported in the Prudential Indicators Outturn report 2009/10 as presented to Cabinet on 8 July 2010. This indicator will be monitored over the coming months and a revision of the indicator may be put forward; and

(ii) The Interest Rate Exposure Indicators has been exceeded:

- The limits for fixed rate interest rate exposure expressed as a percentage of net outstanding debt were set to remain between 200% and 120%.
- The limits for variable rate interest rate exposure expressed as a percentage of net outstanding debt were set to remain between -20% and -100%.

8.3 The above indicators are there to prevent either too much investment in fixed or variable interest rate arrangements. This is to ensure a reasonable balance between fixed rate investments where cash is locked away, and variable rate investments that earn a lower rate of interest but give more immediate access to funds.

8.4 The variance in both of these indicators is due to the higher level of overnight deposits being held than originally envisaged. As noted in paragraph 2.3, the problem of identifying institutions with which to invest has meant higher levels of investments in liquid funds, including Money Market Funds. Although these deposits do not earn as much income as fixed term deposits, they are felt to be safer in current economic conditions due the immediate access to funds that they allow. Hence, this breaching of these indicators may continue over coming months, and no corrective action is considered necessary. If monitoring does suggest that these indicators will continue to be breached, a revision of the indicators may be put forward.

8.5 The breaching of these indicators has been caused by specific reasons which are not considered to be an indication of any inherent problems.

9 RECOMMENDATION

Audit & Governance Committee is asked to note the Treasury Management Mid-year Review Report 2010/11.

APPENDIX A

SEFTON COUNCIL
STANDARD LENDING LIST

UK and International Banks (including Nationwide Building Society	RATING	Negative rating watch?	Individual rating	Support rating	CDS	Deposit £000s
United Kingdom AAA						
Santander UK)	F1+ / AA-	Yes	B	1	Monitoring	
Barclays	F1+ / AA-	Yes	B	1	In range	
Clydesdale Bank	F1+ / AA-	Yes	C	1	N/A	
HSBC	F1+ / AA	Yes	B	1	In range	
Lloyds TSB/HBOS - nationalised	F1+ / AA-		C	1	N/A	
RBS Group – nationalised	F1+ / AA-	Yes	C/D	1	N/A	
Nationwide	F1+ / AA-	Yes	B	1	Monitoring	
Canada AAA						
Bank of Montreal	F1+ / AA-		B	1	N/A	
Bank of Nova Scotia	F1+ / AA-		B	1	N/A	
Canadian Imperial Bank of Commerce	F1+ / AA-	Yes	B	1	N/A	
Royal Bank of Canada	F1+ / AA	Yes	A/B	1	N/A	
Toronto Dominion Bank	F1+ / AA-	Yes	B	1	N/A	
Finland AAA						
Nordea Bank	F1+ / AA-		B	1	N/A	
France AAA						
BNP Paribas	F1+ / AA	Yes	B	1	In range	
CNCE Calyon Corporate & Investment	F1+ / AA-	Yes	C	1	Monitoring	
Credit Industriel et Commercial	F1+ / AA-		B/C	1	N/A	
Germany AAA						
Deutsche Bank	F1+ / AA-	Yes	B/C	1	In range	
Landwirtschaftliche retenbamk	F1+/AAA		W/D	1	N/A	
Netherlands AAA						
Bank Nederlandse Gemeenten	F1+ / AAA		A	1	N/A	

UK and International Banks (including Nationwide Building Society	**RATING**	**Negative rating watch?**	**Individual rating**	**Support rating**	**CDS**	**Deposit £000s**
Coop Centrale Raiffeisen – Boerenleenbank BA	F1+ / AA+	Yes	A/B	1	In range	
Singapore AAA						
DBS	F1+ / AA-		B	1	In range	
Overseas Chinese Banking Corporation	F1+ / AA-		B	1	In range	
United Overseas Bank	F1+ / AA-		B	1	In range	
Sweden AAA						
Nordea Bank	F1+ / AA-	Yes	B	1	N/A	
Svenska Handelsbanken	F1+ / AA-	Yes	B	1	In range	
Switzerland AAA						
Credit Suisse	F1+ / AA-	Yes	B/C	1	In range	
USA AAA						
Bank of New York Mellon	F1+ / AA-		A/B	2	N/A	
Deutsche Bank Trust Company Americas	F1+ / AA-	Yes	N/R	1	N/A	
HSBC Bank USA	F1+ / AA	Yes	B/C	1	N/A	
JP Morgan Chase Bank	F1+ / AA-	Yes	B	1	In range	
Wells Fargo	F1+ / AA-	Yes	B	1	In range	

The recent economic situation has provided challenges for the Council with regard to its investment strategy. The report presented to Cabinet on 11 June 2009 explained the difficulties in identifying banking institutions to invest in (which provided reasonable investment returns), whilst remaining within the deposit limit of £15m. Consequently, Cabinet agreed to increase the deposit limit from £15m to £25m. As noted in 4.2 above, the Council has remained within an operational boundary of £15m. At present, it is not expected that there will be any need to review this limit.