

**Mid-Year Treasury Report 2010/2011**

**1. Background**

The Treasury Management Strategy for 2010/11 has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year. The Code also recommends that members are informed of Treasury Management activities at least twice a year. This report therefore ensures this authority is embracing Best Practice in accordance with CIPFA's recommendations.

Treasury management is defined as: "The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

**2. Economic Background**

- The UK continued to emerge from recession but the level of activity remained well below pre-crisis levels. GDP registered 0.3% growth in the first calendar quarter of 2010 and the 1.2% in the second.
- The Bank of England's Monetary Policy Committee (MPC) maintained the Bank Rate at 0.5% and Quantitative Easing at £200bn. However, the minutes of Bank of England's September meeting contained the possibility of further Quantitative Easing to keep the economy and inflation on track in the medium term.
- Inflation continued to decline although the annual CPI to August 2010 still stood at 3.1%. This has resulted in two open explanatory letters from the Bank of England's Governor to the Chancellor. In the coming months higher food and fuel prices raise the risk that we may not see inflation come down much more until 2011, and then it will rise back again in January with the signalled hike in VAT to 20%.
- The Bank of England's August Quarterly Inflation Report showed inflation remaining above the 2% target for longer than previously projected. Although the recovery in economic activity was expected to continue, the overall outlook for growth was weaker than presented in the May report.
- The successful formation of a coalition government dispelled uncertainty surrounding a hung parliament result in May's General Election. The new government's Emergency Budget laid out tough action to address the UK's budget deficit, aiming to eliminate the structural deficit by 2014/15. This is to be achieved through austerity measures – £32bn of spending cuts and £8bn of net tax increases. Gilts have benefitted from this decisive plan as well as expected reductions in supply for each year of the forecast. The expected level of spending cuts and tax rises looks to be enough to extinguish the recent concern about inflation expectations.
- The US Federal Reserve (the Fed) kept rates on hold at 0.25% following signs of a slowdown in American growth. At its meeting in September the Fed sent a strong signal that it is prepared to do more and moving closer to a second wave of

unconventional monetary easing. The European Central Bank maintained rates at 1%. The major ongoing worries in Europe extended from sovereign weakness in the 'PIIGS' nations (Portugal, Italy, Ireland, Greece and Spain), the exposure of the continent's banking sector to the sovereign and corporate debt of these nations and the risk of contagion extending to other countries. The sovereign ratings of Greece, Ireland, Portugal and Spain were downgraded by the rating agencies.

- The results from the EU Bank Stress Tests, co-ordinated by the Committee of European Banking Supervisors, highlighted that only 7 (2 Greek, 1 German and 4 Spanish "caja" banks) of the 91 institutions that made up the scope of the analysis were classed to have failed the adverse scenario tests. The tests are a helpful step forward, but there were doubts if they were far-reaching or demanding enough. The main UK Banks' (Barclays, HSBC, Lloyds and RBS) Tier 1 ratios all remained above 9% under both the 'benchmark scenario' and the 'adverse scenario' stress tests.
- Gilts rallied as the growth momentum faded and the UK seemed to offer a safe harbour from Euroland's turbulence. 5- and 10-year gilt yields fell to lows of 1.57% and 2.83% respectively.

### 3. Debt Management

The use of internal resources in lieu of borrowing has been the most cost effective means of financing £11.934m of capital expenditure. This has lowered overall treasury risk by not taking on external debt and reducing temporary investments. This position will be continued over the medium term and the Council does not expect it will need to borrow for capital purposes.

### 4. Investment Activity

The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

#### Investments

	Balance on 01/04/2010 £000s	Investments Made £000s	Investments Repaid £000s	Balance on 30/09/2010 £000s	Increase/ Decrease in Investments
Short Term Investments					
▪ Deposits on call and Money Market Fund	10.396	69.583	67.102	12.877	+2,481,000
▪ Deposits on fixed term	32.949	63.000	60.158	35.791	+2,842,000
▪ Debt due from other Authorities	0.508	0.0	0.0	0.508	0.0
Long Term Investments	0.673	0.0	0.0	0.673	0.0
<b>TOTAL INVESTMENTS</b>	44.526	132.583	127.260	49.849	+5,323,000

Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2010/11. This restricted new investments to the following:

- the Debt Management Office
- Other Local Authorities
- AAA-rated Stable Net Asset Value Money Market Funds
- Deposits with UK Banks and Building Societies systemically important to the UK banking system and deposits with select non-UK Banks (Australia, Canada, Finland, France, Germany, Netherlands, Spain, Switzerland and the US). Counterparty credit quality is assessed and monitored with reference to: Credit Ratings (Council's minimum long-term counterparty rating of A+ across all three rating agencies, Fitch, S&P and Moody's); Credit Default Swaps; GDP of the country in which the institution operates; the country's net debt as a Percentage of GDP; Sovereign Support Mechanisms /potential support from a well-resourced parent institution; Share Price.
- Bonds issued by Multilateral Development Banks, such as the European Investment Bank

### Credit Risk

Counterparty credit quality has been progressively strengthened through the first half of the year, as can be demonstrated by the Credit Score Analysis summarised below:

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating
31/03/2010	4.30	AA-	4.40	AA-
30/06/2010	4.23	AA-	4.37	AA-
30/09/2010	4.01	AA-	3.89	AA-

#### Scoring:

-Value weighted average reflects the credit quality of investments according to the size of the deposit

-Time weighted average reflects the credit quality of investments according to the maturity of the deposit

-AAA = highest credit quality = 1

-D = lowest credit quality = 15

-Aim = A+ or higher credit rating, with a score of 5 or lower, to reflect current investment approach with main focus on security

### Counterparty Update

- Following the challenging economic conditions facing Spain, the fiscal challenges ahead for the country, concerns over the effect of rising debt funding costs, and the downgrade of Spain's sovereign rating to AA by Standard and Poor's, the Council has suspended deposits with Spanish banks in Q1 2010 (BBVA and Banco Santander).
- Deposits with Santander UK Plc (a wholly owned subsidiary of Banco Santander) were initially restricted to one month during Q1. Within Q2 investor nervousness following the 'PIIGS' sovereign crisis in Q1 abated. There was an improvement in Banco Santander's creditworthiness indicators (share price and CDS) and therefore a prudent increase in the maturity limit for Santander UK plc to six months was warranted.

The Council's budgeted investment income for the year has been estimated at £0.897m. The average cash balances representing the Council's reserves, working balances, were £50.776m during the period.

The UK Bank Rate has been maintained at 0.5% since March 2009. Short-term money market rates have remained at very low levels. New deposits for periods up to one year have been made at an average rate of 1.03%. The Council anticipates an investment outturn of £0.524m for the whole year.

### **Icelandic Investments Update**

Following guidance from CIPFA, issued in September 2010, the following is now known:

- **Heritable** – It is now expected that 85p/£ will be recovered overall. 6.27% was repaid in July 2010, and a further dividend is due in October 2010.

### **5. Compliance with Prudential Indicators**

The Council can confirm that it has complied with its Prudential Indicators for 2010/11, which were set in February 2010 as part of the Council's Treasury Management Strategy Statement. Details can be found in the committee report attached.

### **6. Outlook for Q3-Q4**

At the time of writing this activity report in September 2010, the outlook for interest rates was as follows:

	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
<b>Official Bank Rate</b>										
<b>Upside risk</b>	-	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50
<b>Central case</b>	0.50	0.50	0.50	0.75	1.00	1.25	1.50	2.00	2.50	2.75
<b>Downside risk</b>	-	-	-	- 0.25	- 0.50	- 0.50	- 0.50	- 0.50	- 0.50	- 0.50

- The recovery in growth is likely to be slow, uneven and more "Square root" than "V" shaped.
- The path of base rates reflects the fragility of the recovery and the significantly greater fiscal tightening of the emergency budget. With growth and underlying inflation likely to remain subdued, the Bank will stick to its lower for longer stance on policy rates.
- Gilts will remain volatile as the growth versus headline inflation debate escalates.
- The negative outlook (S&P) for the UK will remain until the plans to cut the deficit have been formulated in the CSR.

### **7. Summary**

In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during the first quarter of 2010/11. As indicated in this report none of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

## 8. Other Information

- CLG Investment Guidance** – The revised guidance came into effect on 1<sup>st</sup> April 2010. The guidance reiterated the need to focus on security and liquidity, rather than yield. It also recommended that strategies include details of assessing credit risk, reasons for borrowing in advance of need and the use of treasury advisers. *The Council has incorporated the changes into its Treasury Strategy, Practices and Procedures.*

- Money Market Data and PWLB Rates**

*The average, low and high rates correspond to the rates during the financial year and rather than those in the tables below*

### Bank Rate, Money Market Rates

Date	Bank Rate	O/N LIBID	7-day LIBID	1-month LIBID	3-month LIBID	6-month LIBID	12-month LIBID
01/04/2010	0.50	0.35	0.35	0.42	0.51	0.81	1.26
30/04/2010	0.50	0.30	0.30	0.43	0.53	0.83	1.29
31/05/2010	0.50	0.45	0.50	0.61	0.60	0.85	1.35
30/06/2010	0.50	0.35	0.35	0.45	0.61	0.94	1.38
31/07/2010	0.50	0.40	0.40	0.50	0.71	1.01	1.46
31/08/2010	0.50	0.40	0.55	0.50	0.71	1.00	1.45
30/09/2009	0.50	0.30	0.25	0.51	0.72	1.01	1.46
Minimum	0.50	0.30	0.25	0.42	0.51	0.81	1.26
<b>Average</b>	<b>0.50</b>	<b>0.37</b>	<b>0.42</b>	<b>0.49</b>	<b>0.63</b>	<b>0.93</b>	<b>1.38</b>
Maximum	0.50	0.50	0.55	0.61	0.75	1.01	1.46
Spread		0.20	0.30	0.19	0.24	0.20	0.20