Mid-Year Treasury Report 2011/12

1. Background

The Treasury Management Strategy for Epping Forest District Council 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

Growth: Global growth prospects deteriorated considerably over the six months to September, moving from an expectation of modest expansion to the risk of a double-dip recession. Q1 2011 GDP in the UK was 0.5% but was just 0.2% in Q2. Even economies like Germany's, which were hitherto seemingly strong, began to flounder with growth registering 0.1% in Q2.

Inflation: Inflation remained stubbornly high. Annual CPI for August was 4.5%; CPI had remained above MPC's 3% upper limit for 20 consecutive months and required the Bank of England's Governor to write his seventh open letter to the Chancellor. The Bank believed the elevated rate of inflation reflected the temporary impact of several factors: the increase in the VAT rate to 20%, past increases in global energy prices and import prices.

Employment / Consumer Confidence: Weakness persisted in the labour market. Job creation was unable to absorb the 90,000 quarterly growth in jobseekers, particularly those in the 16-20 age bracket. Unemployment on the ILO measure rose to 7.9%. High inflation trumping average earnings growth of only 2.9%, scarce availability of credit, stagnant house prices, all combined to lower disposable income, squeeze household spending power and leave consumer confidence fragile.

Central bankers' policies were driven by the feeble growth outlook rather than the upward trend in inflation. The Bank of England's August Inflation Report downgraded the growth forecast even as it acknowledged energy price rises could push CPI to 5% before inflation fell back to the 2% target over the medium-term. The UK's strategy of combining loose monetary policy (the Bank Rate had remained at 0.5% for 2½ years and Quantitative Easing at £200bn) with tight fiscal policy supported the rebalancing of the economy and also commanded support in the markets.

The protracted and unseemly political impasse to resolve the US debt ceiling issue turned a debate into a debacle. A lack of both political governance and measures to address the high debt burden (put off until after the 2012 presidential election), ultimately led Standard & Poor's to downgrade the US Sovereign from AAA to AA+. The country's weak economic and fiscal situation and an unemployment rate of 9.1% left the Federal Reserve little option but to commit to "exceptionally low" interest rates until mid 2013.

The European sovereign debt crisis deepened. The agreement in July to address Greece's fiscal problems and broaden the mandate for the European Financial Stability Facility (EFSF) only bought time for the Eurozone as market pressure increased on Italy and Spain, but did little to address the issue of overburdened sovereign balance sheets.

The European Banking Authority released the results of the second of its stress tests in July. 8 banks (two Greek, one Austrian and five small domestic Spanish banks) out of 91 banks failed the tests. All of the UK and non-UK banks tested by the EBA and which are on the Council's lending list met the 'stressed' Core Tier 1 Ratio of 5%, none were adjudged as 'near-failed' (i.e. having ratios between 5% and 6%).

Gilt yields and money market rates: The economic uncertainty resulted in analysts postponing the likelihood of an increase in the UK Bank Rate until mid 2012. Gilts were considered a safe haven and benefited from market turmoil. Gilt yields fell to their lowest levels in five years. 5-year gilt yields fell to 1.25%, 10-year yields to 2.2% and 20-year yields to 3.05%.

PWLB borrowing rates fell commensurately (the Board maintained the +0.90% margin above the equivalent gilt yield for new borrowing).

There was very little change to Libor and Libid rates as at 30/09/2011, the differential between 0.1% to 0.2% for maturities up to 12 months.

3. Debt Management

The use of internal resources in lieu of borrowing has continued to be the most cost effective means of financing £12.324m 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.

However, under the HRA Subsidy Reform the Council will take on debt of around £190m on 28 March 2012. More details are in Section 8 of this report.

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 01/04/2011 £000s	Investments Made £000s	Investments Repaid £000s	Balance on 30/09/2011 £000s	Increase/ Decrease in Investments
Short Term Investments					
▪ Deposits on call and Money Market Fund	7.733	67.132	69.509	5.356	-2,377,000
▪ Deposits on fixed term	43.803	44.000	43.258	44.545	+742,000
▪ Debt due from other Authority	0.481	0	0	0.481	0
Long Term Investments	0.439	0	0	0.439	0
TOTAL INVESTMENTS	**52.456**	**111.132**	**112.767**	**50.821**	**-1,635,000**

Mid-Year Treasury Report 2011/12

Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2011/12. New investments can be made with the following institutions/instruments:

- 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, Sweden, Switzerland and the USA);
- Deposits with the DMADF;
- Treasury Bills;
- Bonds issued by Multilateral Development Banks, such as the European Investment Bank

Counterparty credit quality is assessed and monitored with reference to: Credit Ratings (the Council's minimum long-term counterparty rating of A+ (or equivalent) across 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.

Credit Risk

Counterparty credit quality has been maintained 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
31/03/2011	3.83	AA-	3.93	AA-
30/06/2011	3.83	AA-	4.13	AA-
30/09/2011	3.88	AA-	4.03	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

Maturity Limits
The lack of real progress in resolving the sovereign debt crisis in Europe began to affect even the stronger Eurozone nations and their banking systems. Market volatility, as measured by the VIX index, spiked sharply in August, banks' share prices fell sharply. Having reviewed all credit indicators the Council, advised by Arlingclose, believed that there were no solvency issues with the banks on the recommended lending list. Nevertheless the share price moves were too sharp to ignore and a prudent response to the tensions and negativity in the markets was required.

The Council responded to the growing stress by scaling back maturities for new investments on the advice of the Council's treasury advisors. Limits for UK banks, Nationwide BS and Australian, Canadian and US banks have now been temporarily reduced to 6 months (Santander UK plc to is restricted to 3 months). Limits for European banks have been temporarily reduced to 1 month. French institutions have been suspended for new investments in response to concerns over funding and their sovereign exposure to peripheral European nations.

On 28th September Clydesdale Bank was suspended from the lending list following the bank's downgrade to A2 by Moody's, which falls below the Council's minimum criteria of A+ or equivalent.

During the first quarter Moody's placed the ratings of a number of UK institutions on review for possible downgrade. This is to align their ratings with evolving systemic support post credit crisis. The review is likely to be completed sometime in October and may lead to downgrades of some counterparties on the Council's lending list. The implications of any downgrades will be discussed with Arlingclose and could result in a review of the Council's minimum credit criteria, as set out in its Treasury Management Strategy Statement.

Until early September, where cash-flow permitted the Council followed a cautious investment strategy of a rolling programme of 6 month deposits with named counterparties for a proportion of its investments.

Budgeted Income and Outturn

The Council's budgeted investment income for the year has been estimated at £0.667m. The average cash balances representing the Council's reserves, working balances etc, were £54.587m during the period.

The UK Bank Rate has been maintained at 0.5% since March 2009 and not expected to rise until the end of 2012. Short-term money market rates have remained at very low levels (see Table 1 in Appendix 2). New deposits were made at an average rate of 1.20%. The Council anticipates an investment outturn of £0.667m for the whole year.

Icelandic Bank Investment Update
Following the latest guidance issued by CIPFA in September 2011 (LAAP Bulletin 82 Update 5), the following is now known:

- ***Heritable*** – It is expected that 86p-90p/£ will be recovered overall. At the time of the LAAP Bulletin 82 Update 5 was issued, interim payments totalling 60.42% of the claim had been made. 6.25% was received in April 2011 and 4.05% in July 2011. A further 4.50% is expected in October 2011.

5. Compliance with Prudential Indicators

The Council can confirm that it has complied with its Prudential Indicators for 2011/12, which were set in February 2011 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 2011, given the precarious outlook for growth it is believed the Bank of England would only raise rates after there was firm evidence that the economy had survived the fiscal consolidation. Therefore, the outlook is for official interest rates to remain low for an extended period, at least until late 2012.

	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14
Official Bank Rate													
Upside risk				0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.25	1.50	1.75	2.00	2.25
Downside risk						-0.25	-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50

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 2011/12. As indicated in this report none of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

8. Other Information

Reform of Council Housing Finance: In its publication *Implementing self-financing for council housing* issued in February 2011, the CLG set out the rationale, methodology and financial parameters for the initiative. Subject to the Localism Bill receiving Royal Assent and a commencement order being passed, final self-financing determinations are expected in January 2012 and the proposed transfer date is 28th March 2012.

Subsequent updates form CLG and CIPFA are being assessed by the Council, in conjunction with Arlingclose and its Housing Consultants.

Where the Council will be taking on debt

The self-financing model provides an indicative sustainable level of opening housing debt. As the Council's debt level generated by the model is higher than the Subsidy Capital Financing Requirement (SCFR), the Council will be required to pay the CLG the difference between the two, which is approximately £190m. This will require the Council to fund this amount in the medium term through internal resources and/or external borrowing. The Council has the option of borrowing from the PWLB or the market.

Whilst the CLG has encouraged authorities to consider now the options for financing the settlement, rather than wait for draft/final determinations, the CLG does not consider it prudent to borrow prior to Royal Assent. The 2011/12 Item 8 Determination will also be amended so that the HRA can be charged for interest costs arising from borrowing taken ahead of settlement date but after Royal Assent.

The treasury management implications of HRA reform and an appropriate strategy to manage the process are being actively reviewed with the Council's Treasury Advisor including the issues surrounding any early prefunding of the significant settlement payment (primarily the powers to borrow and the cost of carry).

Mid-Year Treasury Report 2011/12

On 20th September, following an announcement by HM Treasury, the PWLB confirmed that the interest rate offered to local authorities would be temporarily reduced to allow councils to borrow at lower levels for their one-off HRA reform settlement payment. This will enable the Council to borrow at around 13bps above the equivalent gilt yield (current borrowing rates are 1% above the gilt yield) to fund the HRA transaction. These lower rates will be available from the date of Royal Assent to 26th March 2012 only.

Appendix 1

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

Table 1: 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
01/04/2011		0.50		0.40	0.54	0.54	0.69	1.12	1.59
30/04/2011		0.50		0.50	0.40	0.49	0.69	1.05	1.52
31/05/2011		0.50		0.40	0.40	0.52	0.69	1.08	1.56
30/06/2011		0.50		0.50	0.40	0.50	0.77	1.06	1.54
30/07/2011		0.50		0.40	0.40	0.50	0.78	1.07	1.55
31/08/2011		0.50		0.40	0.40	0.56	0.86	1.15	1.63
30/09/2011		0.50		0.60	0.60	0.54	0.92	1.21	1.69
Average		**0.50**		0.41	0.43	0.53	0.77	1.10	1.58
Maximum		**0.50**		0.60	0.60	0.58	0.92	1.21	1.69
Minimum		**0.50**		0.40	0.35	0.49	0.68	1.01	1.40
Spread		**0.00**		0.20	0.25	0.09	0.24	0.20	0.29

Table 2: PWLB Borrowing Rates - Fixed Rate, Maturity Loans

Change Date	Notice No	1 year	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
01/04/2011	128/11	1.93	3.66	4.81	5.33	5.35	5.31	5.28
28/04/2011	162/11	1.73	3.45	4.61	5.18	5.21	5.17	5.14
31/05/2011	202/11	1.64	3.21	4.43	5.08	5.12	5.09	5.07
30/06/2011	246/11	1.61	3.09	4.42	5.17	5.21	5.20	5.18
29/07/2011	288/11	1.52	2.75	4.06	4.97	5.07	5.06	5.04
31/08/2011	332/11	1.48	2.50	3.71	4.66	4.84	4.87	4.85
30/09/2011	375/11	1.49	2.41	3.49	4.36	4.62	4.70	4.70
	Low	1.42	2.18	3.31	4.24	4.49	4.55	4.54
	Average	1.59	2.92	4.15	4.94	5.04	5.04	5.01
	High	1.97	3.73	4.89	5.41	5.42	5.39	5.35

Table 3: PWLB Borrowing Rates - Fixed Rate, Equal Instalment of Principal (EIP) Loans

Change Date	Notice No	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
01/04/2011	128/11	2.76	3.74	4.84	5.22	5.33	5.36
28/04/2011	162/11	2.55	3.53	4.64	5.05	5.18	5.22
31/05/2011	202/11	2.37	3.30	4.46	4.93	5.09	5.12
30/06/2011	246/11	2.25	3.17	4.46	4.99	5.17	5.22
29/07/2011	288/11	2.01	2.83	4.11	4.73	4.97	5.06
31/08/2011	332/11	1.88	2.57	3.75	4.38	4.67	4.80
30/09/2011	375/11	1.84	2.48	3.53	4.08	4.37	4.54

	Low	1.67	2.24	3.35	3.93	4.25	4.41
	Average	2.17	3.00	4.19	4.73	4.95	5.02
	High	2.82	3.82	4.92	5.30	5.41	5.44

Table 4: PWLB Variable Rates

	1-M Rate	**3-M Rate**	**6-M Rate**	**1-M Rate**	**3-M Rate**	**6-M Rate**
	Pre-CSR	**Pre-CSR**	**Pre-CSR**	**Post-CSR**	**Post-CSR**	**Post-CSR**
01/04/2011	0.67	0.77	0.89	1.57	1.67	1.79
28/04/2011	0.67	0.71	0.79	1.57	1.61	1.69
31/05/2011	0.66	0.70	0.76	1.56	1.60	1.66
30/06/2011	0.65	0.68	0.71	1.55	1.58	1.61
30/07/2011	0.65	0.67	0.69	1.55	1.57	1.59
31/08/2011	0.65	0.66	0.68	1.55	1.56	1.58
30/09/2011	0.65	0.65	0.66	1.55	1.55	1.56
Low	0.65	0.65	0.65	1.55	1.55	1.55
Average	0.66	0.69	0.72	1.56	1.59	1.62
High	0.69	0.79	0.91	1.59	1.69	1.81