ITEM NO	

REPORT TO THE EXECUTIVE

DATE	**23rd August 2011**
PORTFOLIO	**Resources**
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TREASURY MANAGEMENT UPDATE QUARTER ENDED 30TH JUNE 2011

PURPOSE

1. To report to Members on Treasury Management dealings during the period 1st April 2011 to 30th June 2011, in compliance with the CIPFA codes of practice on Treasury Management in the Public Services, and the Prudential Code for Capital Finance in Local Authorities.

RECOMMENDATION

2.
- That the Executive note the treasury management activities undertaken during the period 1st April 2011 to 30th June 2011.
- That the Executive recommend to Full Council the approval a revised List of Investment Counterparties, as outlined within Appendix 1

REASONS FOR RECOMMENDATION

3.
- CIPFA (the Chartered Institute of Public Finance and Accountancy) issued the revised Code of Practice for Treasury Management in November 2009; it recommends that Members should be updated on treasury management activities at least twice a year, but preferably quarterly. This report therefore ensures this Council is implementing best practice in accordance with the Code.
- To ensure that the Council's funds are invested prudently to generate investment income whilst maximising the security of the funds invested.

SUMMARY OF KEY POINTS

4. **INTRODUCTION**

Treasury Management entails the management of the Council's cash flows, its borrowings and its investments, the management of the associated risks and the pursuit of the optimum performance or return consistent with those risks.

The monitoring requirements for treasury were set out in both the Treasury Management Strategy Statement for 2011/2012 and the Prudential and Treasury Indicators for 2011/2012 – 2013/2014, approved by Full Council on the 24th February 2011.

5. **ECONOMIC BACKGROUND**

(provided by the Council's external service providers, Sector Treasury Services):

UK Economy:

The industrial recovery appears to have lost momentum quite quickly. The CIPS/Markit manufacturing survey has fallen to a level consistent with falls in manufacturing output. The output expectations balance of the CBI industrial trends survey has fallen more modestly, but has nonetheless dropped for the past three months in a row.

Meanwhile, the consumer outlook has darkened. The pick-up in the consumer sector seen during the spring appears to have been only temporary, reflecting the good weather and extra bank holiday. Retail sales volumes fell in May, more than reversing April's increase. The CBI's distributive trade's survey fell in June. And a number of well-known retailers have recently fallen into administration.

Consumers appear to be reacting to the squeeze on their real incomes. Household real disposable incomes fell by 0.8% in Q1. Inflation is outpacing average earnings by about 2.5%. Consumer confidence also fell back in June and remains consistent with further falls in consumer spending. The news on the labour market has been mixed. The Workforce Jobs measure of employment rose strongly in Q1. But the timelier Labour Force Survey measure flattened off in April and May. And the number of job vacancies continued to fall throughout the quarter. The claimant count measure of unemployment also continued to rise over the last three months. This only partly reflected a rise in the number of lone parents claiming Jobseeker's Allowance due to recent benefit changes.

The housing market has continued to tread water. The number of mortgage approvals for new house purchase was broadly unchanged over the quarter at a very low level of just 46,000 or so. House prices have also remained broadly flat.

The weakness of the economy appears to be having some adverse effect on the public finances. Borrowing in the first two months of the fiscal year totalled £27.4bn, compared to last year's £25.9bn. It is early days but, at this rate, borrowing will overshoot the OBR's Budget full-year forecast of £122bn.

But the near-term outlook for inflation has deteriorated further. Although CPI inflation held steady at 4.5% in May, it now looks likely to rise to 5.5% or even higher within the next few months. Food price inflation is likely to rise further. And Scottish Power announced in June a 19% rise in gas prices and 10% rise in electricity prices to take effect in August. Other utility suppliers are likely to follow suit.

Households' inflation expectations rose sharply in June. But so far, there are no signs of any pick-up in pay growth. The median pay settlement was unchanged at 2.5% in May. Most Monetary Policy Committee members still think that the rise in inflation will be only temporary and that inflation will fall back sharply next year. So despite the worsening of the near-term inflation outlook, the weakness of the activity data has pushed most members further away from an interest rate rise.

Some members have even started to discuss the prospect of giving the economy more support. Admittedly, the hurdle for more quantitative easing will be quite high. However, it is certainly possible if the economy remains as weak as we expect.

Global Economy:

In financial markets, the FTSE 100 finished the quarter at around 5,950 – about the same level as at the end of the first quarter. This was broadly in line with international stock markets – the S&P500 was also little changed over the period. Ten year gilt yields fell from 3.69% to 3.38% on the back of a drop in interest rate expectations. At the end of March, markets were expecting interest rates to have risen by this July. But now they expect rates to stay on hold until July next year. Meanwhile, sterling was broadly unchanged against the dollar at about $1.60, and fell only a touch against the euro.

In the US, the recovery also appears to have lost a significant amount of momentum. The ISM manufacturing index fell sharply in May and reversed only a fraction of this drop in June. Payrolls employment rose by a disappointing 54,000 in May. Meanwhile, the euro-zone economy expanded at a healthy pace in Q1, but recent falls in most leading indicators suggest that growth is slowing there too. Germany has continued to outperform the rest of the region. The risk of an imminent Greek disaster eased temporarily after an initial draft agreement on a second Greek bailout package but European policymakers' inability to deal with the crisis quickly and effectively created further uncertainty and volatility.

To summarise Sector Treasury Services commentary, the quarter ended 30th June 2011 saw;

- The economic recovery struggle to regain momentum;
- Conditions on the high street deteriorate;
- Mixed signals on the strength of the labour market recovery;
- Public sector borrowing come out disappointingly high;
- The near-term outlook for CPI inflation deteriorate further;
- The Monetary Policy Committee move away from raising interest rates;
- UK equities stay broadly flat over the quarter and gilt yields fall;
- Economic growth slow in the US and euro-zone.

6. **HISTORICAL INTEREST RATE FORECAST**

The Council's treasury adviser, Sector, provided Finance staff with the following interest rate forecast as at the end of June 2011:

Sector's Interest Rate View	Now	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13	Mar 14
Sector's Bank Rate View	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.00%	2.25%	2.50%	2.75%	3.00%
5yr PWLB Rate	3.12%	3.55%	3.65%	3.75%	3.90%	4.00%	4.15%	4.25%	4.45%	4.60%	4.65%	4.75%
10yr PWLB View	4.45%	4.75%	4.75%	4.80%	4.95%	4.95%	5.00%	5.05%	5.15%	5.20%	5.25%	5.25%
25yr PWLB View	5.24%	5.40%	5.40%	5.40%	5.40%	5.40%	5.45%	5.50%	5.50%	5.50%	5.60%	5.65%
50yr PWLB Rate	5.20%	5.40%	5.40%	5.40%	5.40%	5.40%	5.45%	5.50%	5.50%	5.50%	5.60%	5.65%

The Sector central forecast is for a November 2011 first increase in Bank Rate but with reservations that it could well slip back in time, unless there is some good news on the UK economic recovery before then.

Outlook

The key question is how quickly, and strongly, will the UK economy respond to the positive stimulus from low Bank Rate, quantitative easing and the devaluation of sterling?

Negative growth of -0.5% in Q4 2010 was a huge shock; +0.5% (quarter on quarter) in Q1 2011 meant that growth had been flat for six months. A marginal upgrading of Q1 growth figures will have only a marginal effect on the big picture for the UK but there is considerable uncertainty as to how the UK economy will evolve in the coming months.

US Q1 growth of only 1.8% (on an annualised basis) was also a disappointment despite non-farm payroll data showing improvement.

China and India have embarked on a major thrust to cool their over-heating economies and so may depress the rate of world economic growth.

There has been a significant erosion of the confidence of financial markets in the EU handling of the peripheral debt crisis. There is now a major and escalating risk that the Greek, Irish, Portuguese debt crisis may not be contained and could lead to debt restructurings that could do significant damage to banks which already have weakened balance sheets. It is worth noting that many western governments have already exhausted their capacity to increase government debt to again bail out banks further damaged by any such future events and to counter the dampening of economic growth that would follow.

US economy has disappointed in Q1 2011 limping along at 1.8% annual growth rate after a strong Q4 2010 at 3.1%

US (and UK) have exhausted their capacity for any further fiscal stimulus for their economies

US is still not even on the starting line for dealing with cutting back a massive annual fiscal deficit; cut backs to come are likely to dampen the economy further

US: banks have major risk exposure to a fraught housing market where house prices have gone down 8.2% in the 12 months to April 2011, have fallen 29.5% since the peak in June 2006, where 29.5% of mortgages are now in negative equity and there is no imminent turn around in sight for the housing market

Peripheral European economies' crisis requires the European Central Bank to adopt a more pragmatic stance to debt restructuring: the longer the delay, the bigger the potential fallout.

UK consumer confidence at very low levels whilst major cuts in Government expenditure and public sector jobs still to feed through fully into the economy and to dampen growth over the next few years.

Despite the private sector creating more jobs than the public sector is cutting, the high current total level of unemployment of around 2.5m means that it will take several years to reduce total unemployment down to pre recession levels.

No significant growth in personal disposable income likely for a couple of years due to:

- Continuing wage freezes / low pay settlements
- Inflation exceeding wage increases so disposable income is being eroded
- Increases in taxation
- Mortgagors coming off cheap fixed rate mortgage deals onto standard variable rates.

House prices have fallen to their lowest level since July 2009 and no turnaround is in sight in the current economic climate.

Consumers are focused on reducing over-borrowing by repaying debt rather than spending and are fearful of eventual increases in Bank Rate sending mortgage standard variable rates (SVRs) up in parallel; rebuilding of consumer balance sheets will increase the savings ratio and depress consumer expenditure.

Banks are still heavily focused on rebuilding their balance sheets – RBS and Lloyds still have massive maturing wholesale borrowing to refinance; the Bank of England Special

Liquidity Scheme (SLS) ends in Jan 2012; the BoE has lent £185bn to banks and building societies which must be repaid. The BoE has indicated there will be no extension of this timeframe for the SLS.

Eventual reversal of Quantitative Easing by selling gilts etc. will take cash out of the economy and restrict credit growth; gilt sales will need to be sensitively timed considering the huge level of gilt sales already planned just to fund each year's deficit.

7. THE COUNCIL'S INVESTMENT DEPOSITS

The Council aims to achieve the optimum return on investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover short term cash flow needs but also to seek out value available in significantly higher rates in periods up to 12 months with highly credit rated financial institutions.

Quarter 1 Activity:

Investment rates available in the market have continued at historically low levels. The average level of funds available for investment purposes during the quarter was £1.2m**.** These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme.

There have been a total of 38 market investments made during the period 1st April 2011 to 30th June 11 totalling £44.95 million. Comprising of 33 with HSBC Sterling Line totalling £34.95m, 2 with individual counter parties [Nationwide Building Society] through the brokerage facility, 2 with our Call Accounts [Santander UK & Royal Bank of Scotland], and 1 with our Lloyds Fixed Deposit Account.

Appendix 1 shows the maximum amount invested with any of the counter parties and at any one time during the period 1st April 2011 to 30th June 2011. The maximum limit per counterparty is shown in brackets.

Appendix 2 provides Members with an analysis of the Council's short-term investments during the period 1st April to 30th June 2011, as well as comparing this to the deposits placed throughout the 2010/2011 financial year.

8. MOVEMENTS IN THE COUNCIL'S EXTERNAL DEBT

Below is a summary of the Council's external indebtedness, as at 1st April, and as at 30th June.

	As At 01 April '11	As At 30 June '11	Change +/(-) During this period
	£	£	£
Public Works Loan Board	22,916,365	22,915,647	(718)
Temporary Market Loans	54,240	54,240	NIL
Total level of Indebtedness	**22,970,605**	**22,969,887**	**(718)**

On the 30th June 2011, an Equal Instalment of Principal (EIP) loan was partly repaid as scheduled, totalling £718. There has been **no new** borrowing undertaken during the quarter ended 30th June 2011.

PWLB rates quarter ended 30.06.2011 [Provided by Sector Treasury Services]

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.53%	2.93%	4.25%	5.09%	5.05%
Date	27/06/11	27/06/11	27/06/11	02/06/11	02/06/11
High	1.97%	3.73%	4.89%	5.44%	5.35%
Date	06/04/11	11/04/11	11/04/11	11/04/11	11/04/11
Average	1.69%	3.29%	4.51%	5.22%	5.16%

9. **COMPLIANCE WITH TREASURY AND PRUDENTIAL LIMITS**

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. The Council's approved Treasury and Prudential Indicators (affordability limits) are included in the approved Treasury Management Strategy Statement.

Quarter 1 Activity:

During the first quarter ended 30th June 2011, the Council's treasury management activities operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices.

The Prudential and Treasury Indicators are shown in Appendix 3. Members are asked to note that all these prudential indicators are not comparative performance indicators however, were applicable the actual position for the quarter end has been listed to provide Members with an update on performance.

10. **ICELANDIC BANK DEFAULTS**

Members were provided with an update on the current position regarding the £1m deposit outstanding since October 2008 as part of the Treasury Management Review of Activity for 2010/2011 presented to Committee back in July.

The current position remains unchanged, in that it is estimated that 95% of the £1m deposit and interest due [after accounting for inflation] will ultimately be recovered as the legal position is that the Council's claim will enjoy priority status. It is however not expected that the final payment will be made until 2018.

11. **LIST OF INVESTMENT COUNTERPARTIES**

The Council has an approved list of counterparties as part of the Treasury Policy Statement [TPS] which governs treasury management activity. This list is a restricted list taking into consideration the credit rating of the institution concerned and there are also limits on the amount which can be invested with any particular institution from a particular sector e.g. building society, bank etc. and also any group of institutions within overall banking group.

The TPS outlines that the list be reviewed as a minimum annually and the current list, shown in Appendix 4 was approved by Full Council on the 16th December 2010.

As part of the daily operations of the treasury management dealings, in consultation with guidance from Sector and the money market brokers, decisions are taken within Finance temporarily suspending/revising operations within individual counterparties.

Members will notice that under paragraph 7 to this report, "Investment Deposits" activity during quarter 1 resulted in the Council breaching the £5m limit set for deposits with HSBC. The limit was exceeded on one occasion, by £400k on the 30th June. The limit was further breached on the 1st July by a further £900k. The breach covered a total of 7 days duration.

The initial breach on the 30th June was due to a deposit of £1m being placed with our bank HSBC, with whom we had £4.4m already deposited, against a maximum limit of £5m.

HSBC was the only available institution where we could deposit up to £600k [interest rate being 0.4%] however leaving funds on the Council's current account [HSBC are the Council's banking providers] would still have breached the £5m limit with no interest accruing. Within the counterparties list finance staff had already deposited a total of £6m with other institutions [£2m with Santander, £2m with RBS and £2m Lloyds fixed term deposit] resulting in there being no other options available.

For this reason it is recommended that the HSBC limit be increased to £10m.

Proposed limits:

The Executive are asked to endorse a revised list of counterparties as shown in Appendix 5 detailing the proposed new list and limits set for each institution and Members are asked to recommend to Full Council that this list be approved. The revised list has been produced using the 4 way credit rating approach and indicates the recommended length of borrowing period in accordance with credit quality, after taking into account Sector's recommendations

FINANCIAL IMPLICATIONS AND BUDGET PROVISION

12. None arising as a direct result of this report.

POLICY IMPLICATIONS

13. All transactions are in accordance with the Council's approved Treasury Policy Statement.

DETAILS OF CONSULTATION

14. No external consultation required.

BACKGROUND PAPERS

15. Treasury Management Strategy Report & Prudential Indicators Report for 2011/2012. External Borrowing & Investment Files. PWLB Transactions & Interest Files. Guidance from Sector Treasury Services.

FURTHER INFORMATION	
PLEASE CONTACT:	**Lindsey Cowburn, Capital and Treasury Accountant**