Mid Year Monitoring Report 2010/11
Treasury Management and Prudential Indicators - 1 April 2010 to 30 September 2010

1 Introduction

1.1 The Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance:

- The Local Government in Scotland Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity;

- The Act permits the Scottish Ministers to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (although no restrictions have been made as yet during 2010/11);

- Statutory Instrument (SSI) 29 2004, requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities, and therefore to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services; and the treasury activity with regard to the CIPFA Code of Practice for Treasury Management in Local Authorities.

1.2 Revisions to the regulatory framework of treasury management during 2009 introduced a requirement that the Council receive a mid year treasury review, in addition to the forward looking annual treasury strategy and backward looking annual treasury report required previously. This report meets that requirement and also incorporates the needs of the Prudential Code to ensure adequate monitoring of the capital expenditure plans and the Council's prudential indicators (PIs). The treasury strategy and PIs were previously reported to Council on 24 March 2010. The current position is shown (where appropriate) and revisions to the 2010/11 estimate are provided where required.

1.3 This report sets out:

- Key changes to the Council's capital activity (the prudential indicators);

- The economic outlook;

- The actual and proposed treasury management activity (borrowing and investment).

- The risk approach to treasury management (the treasury management indicators)

2 Key Prudential Indicators

2.1 This part of the report is structured to update:

- The Council's capital expenditure plans and how these plans are being financed;
- The impact of the changes in the capital expenditure plans on the PIs and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

2.2 **Capital Expenditure** – Table A shows the current position and revised estimates for capital expenditure. The revised estimate for capital expenditure during 2010/11 has increased by £9.590m from the original estimate due to the following:

- 2009/10 income and slippage which was identified to be carried into 2010/11.
- Consent to borrow for equal pay which was granted by the Scottish Government in February 2010 and approved by Council on 28 April 2010.

Table A:

£000	2010/11 Original Estimate	Current Position	2010/11 Revised Estimate
Capital Expenditure	**47,607**	**24,356**	**57,197**
Capital receipts	8,845	1,331	11,873
Capital grants	5,654	2,963	7,573
Govt supported borrowing	5,070	2,535	5,070
Revenue	0	0	0
Net financing need for the year	**28,038**	**17,527**	**32,681**

2.3 **Impact of changes in Capital Expenditure Plans** – Table B shows the CFR, which is the underlying external need to borrow for a capital purpose while Table C shows the expected debt position over the period.

2.3.1 The reduction in the level of debt at 1 April between original estimate and revised estimate (as detailed in Table C) is due to the fact that no new borrowing was undertaken during 2009/10.

2.3.2 The CFR is calculated on a year end position based on the Council's balance sheet and therefore the current position is not shown. The Executive Director of Corporate Services can report however that the Council is on target to meet the 2010/11 revised estimates for both indicators.

Table B:

£000	2010/11 Original Estimate	2010/11 Revised Estimate
CFR – Non Housing	221,421	222,052
CFR – Housing	101,154	102,290
Total CFR	**322,575**	**324,342**
Movement in CFR	15,927	1,767

Table C:

£000	**2010/11 Original Estimate**	**Current Position**	**2010/11 Revised Estimate**
Debt at 1 April	308,448	300,890	300,890
Maturing Debt	(20,079)	(20,062)	(20,079)
New Borrowing : Maturing Debt	20,045	20,045	20,045
New Borrowing : CFR	16,017	13,043	21,133
Debt at 31 March	**324,431**	**313,916**	**321,989**
Operational Boundary	**356,874**	**345,307**	**354,188**
Investments at 31 March	5,221	13,427	4,764

2.4 **Compliance with the limits in place for borrowing activity** – The first key control over the treasury activity is a PI to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Net external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2010/11 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent. As discussed in section 2.3 above the current position is not shown since the CFR is calculated on a year end position. The revised indicator is detailed in Table D and the Executive Director of Corporate Services reports that no difficulties are envisaged for the current year in complying with this PI.

Table D:

£000	**2010/11 Original Estimate**	**2010/11 Revised Estimate**
Gross Debt	324,431	321,989
Investments	5,221	4,764
Net Debt	319,210	317,225
CFR	322,575	324,342

2.4.1 A further PI controls the overall level of borrowing. This is the Authorised Limit which is detailed in Table E and represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Table E:

(£000)	**2010/11 Original Estimate**	**Current Position**	**2010/11 Revised Estimate**
Authorised Limit for External Debt	389,317	376,699	386,387

3 Economic Outlook

3.1 Interest Rate Movements and Expectations are detailed in Table F. UK short-term interest rates fluctuated in a very narrow range in the first half of the financial year. Bank Rate was held at its record low of 0.5% in spite of above target inflation and evidence of a recovery in activity in most industrialised economies. The tenuous nature of the economic upturn, confidence that price pressures will abate and the still fragile state of the financial sector supported the case for the maintenance of an accommodative monetary policy.

3.2 Long-term interest rates peaked in the early stages of the financial year. The rise was reversed in May. Confidence that the change of government will prompt a more aggressive approach to deficit reduction encouraged new investment in gilt-edged securities. More important, however, was the financial crisis in the euro-zone, triggered by the threat of a sovereign debt default by Greece. This, together with evidence of decelerating growth in the US, ensured continued demand for high quality government debt. Gilt yields and PWLB rates subsided towards their 2009 lows as a result.

3.3 Short-term rates are expected to remain on hold for a considerable time. The recovery in the economy is likely to remain insipid. The danger of a double-dip recession is fading but the crisis in the euro-zone, the prospects of tight economic policies at home and tenuous consumer confidence means the threat has not evaporated completely.

3.4 Long-term interest rates will continue to benefit from these considerations and might be pressured lower in the event of a fresh programme of Quantitative Easing. Nevertheless, without this additional support, yields are probably close to their low point. Disappointment with the UK's inflation performance and the absence of QE would return yields to a gradually rising trend before the year is out.

Table F:

Annual Average %	Bank Rate	Money Rates 3 Month	1 Year	PWLB Rates 5 Year	20 Year	50 Year
2009/10	0.5	0.7	1.3	3.0	4.4	4.5
2010/11	0.5	0.7	1.5	2.4	4.2	4.3
2011/12	1.1	1.3	2.2	3.1	4.8	4.9
2012/13	2.3	2.5	3.3	4.0	5.0	5.1
2013/14	3.3	3.5	4.0	4.5	5.0	5.0
2014/15	4.0	4.2	4.5	4.8	5.0	5.0
2015/16	4.0	4.2	4.5	4.5	4.8	4.7

4 Treasury Management Activity

4.1 This part of the report is structured to update:

- The Council's expected borrowing need and details of under/(over) borrowing;
- Debt rescheduling and new borrowing; and
- Debt charges.
- Investments

4.2 The Expected Borrowing Need – This is set out in Table G and demonstrates that the Council is currently under-borrowed to address investment counterparty risk and the cost of carry on investments (investments yield up to 1%, long term borrowing rates are approximately 4.5%). This introduces an element of interest rate risk, as longer term borrowing rates may rise, however, this position is being carefully monitored.

Table G:

£000	2010/11 Original Estimate	2010/11 Revised Estimate
CFR	322,575	324,342
Less Other Long Term Liabilities	93,514	94,853
Net Adjusted CFR	229,061	229,489
Actual/Estimated Borrowing at 31 March	214,944	227,136
Under/(Over) Borrowing	14,117	2,353

4.3 Debt rescheduling and new borrowing – During the first half of 2010/11 no debt rescheduling exercises have been undertaken, however, the Council has taken advantage of longer term borrowing rates with the following borrowings (as noted in Table H) taken out to replace naturally maturing debt:

Table H:

Lender	Principal	Type	Interest Rate	Maturity
PWLB	£10.045m	Fixed	2.680%	4.5 Years
PWLB	£10.000m	Fixed	3.980%	8.5 Years

4.4 Debt Charges – The revised estimate for debt charges for both the General Fund and the HRA is shown in Table I.

Table I:

£000	2010/11 Original Estimate	Current Position	2010/11 Revised Estimate
Borrowing	27,978	12,901	27,787
Other Long Term Liabilities	7,577	3,705	7,577
Total	35,555	16,706	35,396

4.5 Investments – The objectives of the Council's investment strategy are the safeguarding of the re-payment of the principal and interest of its investments on time with the investment return being a secondary objective. Following on from the economic background above, the current investment climate has one over-riding risk consideration, that of counterparty risk. As a result of these underlying concerns, officers continue to implement an operational investment strategy which tightens the controls already in place in the approved investment strategy.

4.5.1 The Council held £13.427m of investments at 30/09/2010, and the constituent parts of the investment position are detailed in Table J:

Table J:

Sector	Country	< 1 Year	1 – 2 Years	2 – 3 Years
Banks	UK	£13.427m	Nil	Nil
Local Authorities	UK	Nil	Nil	Nil
Total		£13.427m	Nil	Nil

4.5.2 Table K details the revised budget position for investment income:

Table K:

£000	2010/11 Original Estimate	Current Position	2010/11 Revised Estimate
Investment Income	168	58	75

4.5.3 A regulatory development to address risk is the consideration and approval of security and liquidity benchmarks. Yield benchmarks are currently widely used to assess investment performance. Discrete security and liquidity benchmarks are new requirements to the Member reporting, although the application of these is more subjective in nature. These were first set in the Treasury Strategy Report which was presented to Council on 24 March 2010.

- **Security** - The Council's maximum security risk benchmark for the current portfolio in relation to investment periods of up to one year (when compared to historic default tables) was set at 0.03% and the Executive Director of Corporate Services can report that the investment portfolio was maintained within this overall benchmark during this year to date.

  - Since this benchmark was introduced we have received more up to date default information (on which these benchmarks are based), which reflects increased counterparty defaults during the banking crisis. The basis of the previous benchmark has, therefore, moved and the new proposed benchmarks are noted in Table L. This does not indicate the Council has changed its risk profile, or is looking to increase risk, simply how it is benchmarking risk.

  - The benchmarks are an average risk of default measure, and would not constitute an expectation of loss against a particular investment. The benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members. As this data is collated, trends and analysis will be collected and reported. Where counterparty is not credit rated a proxy rating will be applied.

Table L:

Long term rating	1 year	2 years	3 years	4 years	5 years
AAA	0.00%	0.01%	0.05%	0.10%	0.17%
AA	0.03%	0.06%	0.08%	0.14%	0.20%
A	0.08%	0.22%	0.37%	0.52%	0.70%
BBB	0.24%	0.68%	1.19%	1.79%	2.42%

- **Liquidity** – The Executive Director of Corporate Services can report that liquidity arrangements were adequate during the year to date and that the liquidity facilities and benchmarks set by the Council as noted below were maintained.

  - Bank overdraft - £1.000m
  - Liquid short term deposits of at least £5.000m available on an overnight basis.

- **Yield** – The Executive Director of Corporate Services can report that investment return to date average 0.65%. Table M illustrates how this average return compares with the local measures of yield investment benchmarks approved in March 2010.

Table M:

Benchmark	Benchmark Return	Average Return
Internal returns above the 7 day LIBID rate	0.42%	0.65%
Internal returns above the 1 month LIBID rate	0.44%	0.65%
Internal returns above the Council investment account	0.50%	0.65%

4.5.4 The current counterparty criteria is kept under regular review and a proposed revision to the Investment Strategy is attached for approval. The key change to the criteria is:

- Reliance has previously been placed upon inclusion of some institutions that are an Eligible Institution for the HM Treasury Credit Guarantee Scheme initially announced on 13 October 2008. These institutions were subject to suitability checks before inclusion, and had access to liquidity from the Bank of England as well as UK sovereign guaranteed funding if needed. The criteria allowed the Council access to investment counterparties such as Royal Bank of Scotland and Lloyds, which are part Government owned, but would otherwise have been removed due to poor Individual/Financial strength rating.

- The benefits of this scheme were mainly focussed at the height of the credit crisis in late 2008, early 2009. Although the ability of entities to issue new guaranteed debt has now closed, the benefits of medium term funding provided under the scheme will remain until the debt finally matures.

- If “Eligible Institution” status is formally withdrawn before credit ratings improve, it would potentially see a reduced capacity for the Council to deal within the money markets as these organisations would automatically be deleted from the authorised dealing list. Whilst this Scheme is still operational, additional complementary measures have been introduced to the markets. New liquidity and capital arrangements are being introduced and the organisations are FSA registered and subject to a more onerous regime (such as stress testing), such that comfort can still be taken from the original Scheme.

- Whilst any change in the original Credit Guarantee Scheme may prompt concerns over credit quality, these would be addressed by maintaining the short and long criteria embodied in the main credit rating criteria, limiting deposits up to one year in duration, and increased officer monitoring of supplementary indicators.

- It is proposed to adjust the investment counterparty criteria to show:

  - The investment criteria will temporarily allow institutions originally deemed Eligible Institutions, included under the terms of the HM Treasury Credit Guarantee Scheme (initially announced on 13 October 2008), even though the ability of Eligible Institutions to issue new guaranteed debt has ceased. Counterparty quality will be monitored through the application of the Council's minimum short and long credit ratings based on the Lowest Common Denominator approach. These institutions will be limited to a maximum of 364 days deposits and be subject to monitoring by officers through supplementary credit information.

5 Key Treasury Management Indicators

5.1 This part of the report is structured to update:

- Actual and estimates of the ratio of financing costs to net revenue stream;
- Upper limits on interest rate exposure:
- The maturity structure of borrowing; and
- Total principal sums invested.

5.2 **Actual and estimates of the ratio of financing costs to net revenue stream** – This indicator (as shown below in Table N) identifies the trend in the cost of capital (financing costs net of interest and investment income) against the net revenue stream. The reduction in the estimated Non HRA financing costs percentage for 2010/11 is due to a reduction in estimated loan charges.

Table N:

	2010/11 Original Estimate	2010/11 Revised Estimate
Non HRA	6.36%	5.99%
HRA	40.98%	40.73%

5.3 **Upper Limits On Fixed and Variable Rate Exposure** – These indicators identify a maximum limit for fixed and variable interest rates based upon the debt position and were set at 100% and 30% respectively for 2010/11. The Executive Director of Corporate Services can report that no limits were breached in the year to date.

5.4 **Maturity Structures Of Borrowing** – These maximum limits are set to reduce the Council's exposure to large fixed rate loans (those instruments which carry a fixed interest rate for the duration of the instrument) which are due to naturally mature in any given period as detailed in Table O.

Table O:

Maturity Structure of Fixed Interest Rate Borrowing	2010/11 Original Estimate	Current Position	2010/11 Revised Estimate
Under 12 months	15%	0%	15%
12 months to 2 years	15%	0%	15%
2 years to 5 years	30%	22%	30%
5 years to 10 years	50%	18%	50%
10 years to 20 years	50%	4%	50%
20 years to 30 years	50%	1%	50%
30 years to 40 years	50%	14%	50%
40 years to 50 years	100%	11%	100%
50 years to 60 years	100%	16%	100%
60 years to 70 years	100%	14%	100%

5.5 **Total Principal Funds Invested** – These limits are set to reduce the need for early sale of an investment, and show limits to be placed on investments with final maturities beyond each year-end. The Council does not invest sums for periods greater than 364 days and therefore this indicator is not applicable.