CITY OF PLYMOUTH

Subject:	Treasury Management Strategy 2012/13– Mid-year Review.
Committee:	Audit Committee Full Council
Date:	13 December 2012 28 January 2013
Cabinet Member:	Councillor Lowry
CMT Member:	Director for Corporate Services
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Ref:	Acct/AL
Key Decision	No
Part:	I

Purpose of the report:

The Local Government Act 2003 requires the Council to set out its Treasury Strategy for borrowing and to prepare an Annual Investment Strategy. The Council's strategy for 2012/13 was approved by full Council at its budget meeting on 27 February 2012. This report provides an update on the progress and outcomes against the Treasury Management Strategy for the six month period ended 30 September 2012. It is a requirement of the CIPFA Code of Practice on Treasury Management that a full mid year report, as a minimum, should be presented to Full Council.

Corporate Plan 2012-2015:

Effective financial management is fundamental to the delivery of corporate improvement priorities. Treasury Management activity has a significant impact on the Council's activity both in revenue budget terms and capital investment and is a key factor in facilitating the delivery against a number of corporate priorities.

Implications for Medium Term Financial Plan and Resource Implications: Including finance, human, IT and land

Treasury Management affects the Council's budget in terms of borrowing costs and investment returns.

Other Implications: e.g. Child Poverty, Community Safety, Health and Safety, Risk Management and Equality, Diversity and Community Cohesion:

The current volatility and uncertainty within the global financial markets has had a substantial effect on Treasury Management activities. The risk in the Council's investments and loans will be constantly monitored and acted upon through the Treasury Management Board which meets on a regular basis.

Recommendations & Reasons for recommended action:

1. The report be noted and presented to full Council in accordance with TMP 6

Alternative options considered and reasons for recommended action:

It is statutory requirement under the Local Government Act 2003 and supporting regulations to set an annual treasury strategy for borrowing and prepare an annual investment strategy. The Council has adopted the Cipfa Code of Practice for Treasury Management which requires a mid-year report to be submitted to the Audit Committee and Full Council covering the performance against this approved strategy.

Background papers:

- Treasury Management Strategy Report 2012/13 to Council 27 February 2012
- Treasury Management Practices update for 2012-13 approved by Audit committee 21 June 2012
- Treasury management budget working papers

Sign off:

Finance	djn1213.020	Legal		HR	n/a	Corp Prop	n/a	IT	n/a	Strat Proc	n/a
Originating SMT Member Malcolm Coe											

Treasury Management Strategy Mid-Year Review

1. Introduction

1.1 The Treasury Management Strategy for 2012/13 was approved by full Council at its meeting of the 27th February 2012. The Treasury Management Strategy has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, 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.

1.2 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. "

1.3 The responsibility for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions is delegated by the Council to its Section 151 Officer – the Director for Corporate Services, and is overseen by a Treasury Management Board consisting of senior officers of the Council.

1.4 The day to day operation of the treasury management activity is carried out in accordance with detailed Treasury Management Practices (TMP's). Updates to these practices for 2012-13 were approved by the Audit Committee on 21st June 2012.

1.5 The Council works closely with its treasury management advisors, Arlingclose, who assist the Council in formulating views on interest rates, regular updates on economic conditions and interest rate expectations, and advice on specific borrowing and investment decisions.

1.6 This report therefore provides an update on the Council's treasury management activity for the period ended 30th September 2012 together with performance against approved Treasury Management Prudential Indicators. In accordance with Treasury Management Practice (TMP) note 6, the report is required to be presented to full Council.

2. Economic Background

2.1 Before reviewing the Council's performance to date it is appropriate to outline the national and economic background within which Council Officers have operated during the first part of the year. The key financial issues are outlined below.

Growth: The world economy faced yet another soft patch. The UK and the Eurozone (with the exception of Germany) struggled to show discernible growth whilst the US economy grew slowly. UK GDP contracted by 0.3% in the first calendar quarter of 2012 and by 0.4% in second, reflecting the difficult economic conditions faced by businesses and consumers domestically and globally. Businesses were more inclined to take defensive strategies involving cost cutting rather than increasing capital spending. Financial conditions facing households continued to be weak as wage growth remained subdued and was, for much of the period, outstripped by inflation. (Much of the fall in Q2 GDP could probably be attributed to the impact of the additional bank holiday for the Diamond Jubilee, and could be recovered in Q3.)

Inflation: Inflation, which had remained stubbornly sticky throughout 2011, slowly began to fall. Annual CPI dipped below 3% for the first time in two and half years in May and fell to the lowest level since November 2009 in June, with a reading of 2.4%. It ticked up marginally to 2.5% by August. Although the recent rise in commodity prices has been worrying, the rise in oil and food prices – the latter mainly due to poor weather-related yields - are well below the spikes of 2010/11.

Some barometers of economic activity, however, provided a more buoyant and positive picture but tended to get overshadowed. Employment rose by 236,000 in the three months to July and the employment rate was at its highest since the three months to April 2009. The ILO unemployment rate fell 0.1% on the quarter to 8.1%. Whilst the effect of the Olympics undoubtedly played a part, despite its temporary nature, the underlying data pointed to a more resilient and optimistic outlook for the economy.

The lack of growth and the fall in inflation were persuasive enough for the Bank of England to sanction £50 billion asset purchases (Quantitative Easing - QE) in July, taking total QE to £375 billion. The possibility of a rate cut from the current level of 0.5% was discussed at the Bank's Monetary Policy Committee meetings in June and July; however reference to it was subsequently dropped suggesting that this policy option had left the table for the immediate future. The government's Funding for Lending (FLS) initiative, intended to lower banks' funding costs, commenced in August. The Bank of England will assess its effects in easing the flow of credit before committing to further policy action.

Banks were embroiled in the scandal to manipulate LIBOR rates during the abnormal market conditions at the height of the 2007/08 financial crisis. Barclays was fined a record £290 million, the FSA was also investigating HSBC, RBS, Citicorp and UBS; Lloyds was named in a lawsuit in the US. The big-four UK banks were also being investigated for mis-selling interest rate swaps to small businesses.

The US Federal Reserve extended quantitative easing through 'Operation Twist', in which it buys longer-dated bonds with the proceeds of shorter-dated US Treasuries. Poor employment data for August preceded the Fed further easing monetary policy at its September meeting; The Fed committed to purchasing $40 billion of agency mortgage-backed securities each month until the outlook for the labour market improves "substantially." The Fed also pledged to keep interest rates low until mid-2015. In Greece, the formation of an alliance of pro-euro parties after a second round of parliamentary elections prevented an immediate and disorderly exit from the Euro. The Euro region suffered a renewed bout of stress when Italian and Spanish government borrowing costs rose sharply and Spain was also forced to officially seek a bailout for its domestic banks. The European Central Bank (ECB) responded with the announcement in September of its Outright Monetary Transactions (OMT) facility which allows the ECB to buy unlimited amounts of 1-3 year sovereign bonds provided the sovereign(s) first asks for such assistance and adheres to the strict conditionality attached to such purchases.

Gilt Yields and Money Market Rates: Gilt yields fell sharply raising the prospect that very short-dated yields could turn negative. 2-year yields fell to 0.06%, 5-year yields to 0.48% and 10-year yields to 1.45%. Despite the likelihood the DMO would revise up its gilt issuance for 2012/13, there were several gilt-supportive factors: the Bank of England's continued purchases of gilts under an extended QE programme; investors preferring the safer haven of UK government bonds to those of European sovereigns; the coalition's commitment to fiscal discipline by sticking to its "plan A" for deficit reduction; large scale purchases by banks to comply with the FSA's liquidity buffer requirements; and general risk aversion against a weak economic backdrop. PWLB borrowing rates fell commensurately (the Board maintained the +0.90% margin above the equivalent gilt yield for new borrowing).

Money market rates fell over the six month period by between 0.2% to 0.6% for 1-12 month maturities.

Money market data and PWLB rate movements over the first half of 2011/12 are attached as Appendix 1 to this report.

3 The Council's Strategy for 2012/13

3.1 The Council's treasury management strategy was approved by full Council on 27th February 2012. As an overriding principle, the strategy proposed that the Council would continue to minimise risk contained within its current debt and investment portfolios by establishing an integrated debt management and investment policy which balanced certainty and security, with liquidity and yield. The Council would continue to make use of short term variable rate borrowing, whilst at the same time seeking to balance its investments across a range of investment instruments.

3.2 The borrowing strategy was to be based on affordability and subject to credit conditions throughout the year. In adverse credit conditions the strategy was to use internal balances to cover any borrowing requirement enabling the Authority to minimise borrowing costs and reduce overall treasury risk by reducing the level of external investment balances. In improved credit conditions the Director for Corporate Services would consider externalising borrowing using short-term or long-term loans as part of a balanced maturity profile within the approved Prudential Indicators.

4. Review of the Council's Performance April – September 2012

4.1 Table 1 shows the Council's overall treasury portfolio at 30th September 2012 compared to the position at the start of the year.

Table 1

01/04/2012 £m	Average Interest rate %		30/9/2012 £m	Average Interest rate %
		External Borrowing Long-term:		
61.315	5.4001	PWLB	61.315	5.4001
130.000	4.4202	Market	130.000	4.4202
0.083	1.1668	Bonds	0.088	1.1668
15.000	0.2900	Temporary Borrowing	19.000	0.2658
206.398	**4.4098**	**Total PCC Borrowing**	**210.402**	**4.3293**
		Long-term liabilities		
31.017	8.7300	PFI Schemes	31.017	8.7300
2.585	n/a	Finance Leases	2.585	n/a
9.510	n/a	Cornwall County Council (TBTF)	9.510	n/a
249.510		**Total External Debt**	**253.514**	
(83.975)	1.0564	**Total Investments**	**(90.216)**	0.8853
165.535		**Net Borrowing/(Net Investment) Position**	**163.298**	

Borrowing

4.2 Under Section 3 of the Local Government Act 2003 and supporting regulations the Council must determine and keep under review how much it can afford to borrow. The Council is required to set two limits:

- The Authorised Limit
- The Operational Boundary

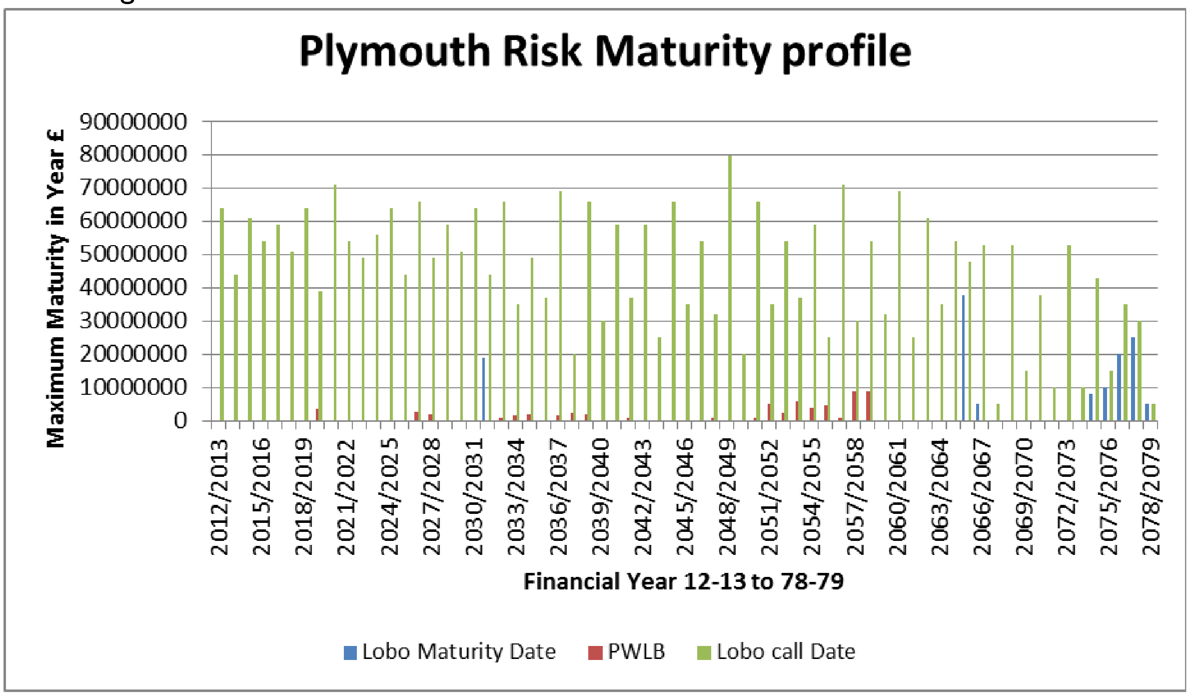
4.3 The external debt limits for 2012/13, as approved by Council in February 2012, are as follows:

- Authorised limits £309m
- Operational Boundary £279m

4.4 The maximum external debt outstanding during the period was £273.7m on 4th May 2012 (including £43m for the PFI scheme, finance leases and Tamar bridge debt administered by Cornwall County Council). This was within both the authorised limit and the operational boundary. By 31st August debt had fallen to £234.4m due to the strategy to reduce short-term borrowing and call account deposits to reduce credit risk due to increased uncertainty in the Eurozone. At 30th September 2012 total external debt increased to £253.514m with external borrowing excluding PFI, Finance leases and Tamar Bridge debt at £210.402m including £19m of short-term loans taken as credit conditions improved during September. This left a balance of £30.9m internally borrowed using available balances to cover the funding of the capital programme. Officers will monitor credit conditions and increase/reduce external borrowing when appropriate.

4.5 The following graph shows the maturity profile of the Council's long-term borrowing at 30th September 2012:

Figure 1



4.6 The debt portfolio currently includes £130m of LOBO loans. These loans have various option call dates where the banks have the ability to amend the loan terms and at which point the Council could choose to repay the loan if the terms are changed. This is reflected within the maturity profile shown above (in green) to enable officers to risk manage the Council's cashflows. To 30th September 2012 £10m of loans had reached their call option dates. No options were exercised and these loans will continue at fixed rates until the next option dates in 2 to 4 years time.

4.7 Table 2 shows the movement in the borrowing portfolio during the year.

Table 2

	Balance on 01/04/2012 £000s	Debt Maturing £000s	Debt Repaid £000s	New Borrowing £000s	Balance on 30/09/2012 £000s	Increase/ (Decrease) in Borrowing
Short Term Borrowing	15,000	(87,790)	0	91,790	19,000	4,000
Long Term Borrowing	191,398	0	0	4	191,402	4
TOTAL BORROWING	**206,398**	**(87,790)**	**0**	**91,794**	**210.402**	**4,004**

4.8 New borrowing in year

The use of short-term borrowing has continued to be the most cost effective means of financing capital expenditure and cashflow requirements. During the first half of the year when credit conditions fluctuated the strategy moved in and out of using internal balances to using short-term borrowing. By matching any short-term borrowing with the available liquid deposits held in bank call accounts, this has lowered overall treasury risk by allowing flexibility of reducing debt and investment levels at short notice when credit conditions deteriorated.

The Council started the year with £15m of short–term loans with £91.794m of new loans taken and £87.790m of loans maturing in 2012/13. The average period of new loans taken in the period 1st April 2012 to 30th September 2012 was 39.32 days at an average rate of 0.2738%. Short-term fixed/variable rate borrowing is expected to remain attractive for some time as the Bank of England maintains the base rate at historically low levels. Subject to credit conditions the borrowing strategy for the remainder of the year will be to take short-term loans up to the limit of the Council's Capital Financing Requirement (CFR).

4.9 Debt Rescheduling

There has been no debt rescheduling in the period due to falling interest rates making the repayment of any PWLB loans more expensive. Officers along with our advisers Arlingclose will monitor PWLB interest rates looking for opportunities to repay any debt, maximising the savings achieved whilst maintaining a balanced maturity profile.

4.10 Overall Debt performance for the first part of the year

All new debt taken in 2012-13 has been in short-term borrowing to meet cashflow/capital financing requirements. Over the period total loan debt has increased by £4.004m as a result of an increase in short-term borrowing due to the improvement in credit conditions. The increase in short-term borrowing has resulted in a reduction in the average rate on external borrowing from 4.4098% on 1st April 2012 to 4.3293% on 30th September 2012.

4.11 PWLB borrowing

The PWLB remains an attractive source of borrowing for the Council in considering any long-term loans as it offers flexibility and control. The large downward move in gilt yields in the second quarter resulted in PWLB rates falling across all maturities (tables 2 and 3 in Appendix 1).

In August HM Treasury announced details of a "Certainty Rate" which will enable "eligible authorities" to access cheaper PWLB funding, with a 20 basis point reduction on the standard PWLB borrowing rate. Initially announced in the March 2012 Budget, HM Treasury have introduced this initiative to incentivise local authorities to provide robust forecasts on borrowing plans. The Council has completed the pro-forma projecting the Council's likely borrowing requirement over a three year period and returned it to CLG by the deadline of 17th September 2012 and are now eligible for this discounted rate for new loans starting on or after 1st November 2012.

Due to affordability and credit risk the current borrowing strategy is to take short-term borrowing at very low rates. However the Director for Corporate Services will continue to monitor interest rates and credit conditions and consider long-term borrowing in line with the approved 2012/13 Treasury Management Strategy.

Investments

4.12 Managing Investment Risk

4.12.1 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.

4.12.2 Security of capital 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 2012/13. This restricted new investments to the following:

- The Debt Management Agency Deposit Facility (DMO)
- Treasury Bills (T-Bills) issued by the UK Government
- Term Deposits or business reserve accounts with UK banks or building societies systemically important to the UK economy
- UK nationalised/part nationalised banks
- Deposits with other local authorities
- Deposits with highly credit rated foreign banks
- Certificate of deposits with banks and building societies
- Bonds issued by Multilateral Development Banks, such as the European Investment Bank
- Gilts (Bonds issued by the UK government)
- AAA-rated Money Market Funds with a Constant Stable Net Asset Value investing in instruments issued predominantly in government securities
- AAA-rated Money Market Funds with a Constant Stable Net Asset Value investing in instruments issued primarily by financial institutions

- AAA-rated Money Market Funds with a Variable Net Asset Value
- Other Money Market Funds and Collective Investment Schemes which meet the definition of a collective investment scheme as defined in SI 2004 No 534 and SI 2007 No 573.
- Commercial Paper
- Corporate Bonds

4.12.3 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.

4.13 <u>Counterparty Update</u>

4.13.1 The Council started the year with the following maturity limits with financial institutions on the Council's list:

UK institutions:

- Santander UK for a maximum period of 35 days;
- Barclays Bank , Lloyds TSB, Bank of Scotland, Royal Bank of Scotland, National Westminster and Nationwide Building Society for a maximum period of 100 days;
- HSBC Bank and Standard Chartered for a maximum period of 6 months.

Non-UK Institutions

- Approved Australian, Canadian and USA banks for a maximum period of 6 months

In May as a result of political and economic developments in Europe and the UK and their likely consequences for the banking sector, together with a pending review of a number of global banks by the rating agency Moody's, the maturity limit for RBS/NatWest and Lloyds/Bank of Scotland was reduced to a maximum of 35 days. Later in the month resulting from the rapid developments in relation to the Greek and Eurozone debt crisis and the downgrade of the credit rating for Santander UK the maturity limit for this bank was reduced to overnight/call.
During the month as credit concerns increased Santander UK was suspended from the council's lending list and a minimum of £15m deposited with the DMO to cover month end salary and creditors payments.

In June as a result of growing concerns over Europe and the exposure of some banks to Eurozone debt the maximum duration limits for new deposits with RBS/NatWest and Lloyds/Bank of Scotland was reduced further to overnight/call. Also in June Moody's completed its review of banks with global capital market operations, downgrading the long-term ratings of all of them by between one to three notches. The banks on the Council's lending list which were affected by the ratings downgrades were Barclays, HSBC, Royal Bank of Scotland, as well as Royal Bank of Canada, JP Morgan Chase, BNP Paribas, Societe Generale, Credit Agricole, Credit Suisse and Deutsche Bank. Separately, the agency also downgraded the ratings of Lloyds Bank, Bank of Scotland, National Westminster Bank and Santander UK plc. None of the long-term ratings of the banks on the Council's lending list were downgraded to below the Council's minimum A-/A3 credit rating threshold.

In July with credit conditions improving maturity limits were increased, with RBS/NatWest and Santander UK increased to a maximum period of 35 Days, Lloyds/Bank of Scotland to 100 days and HSBC, Standard Chartered and approved Australian & Canadian Banks to 12 months.
With credit conditions improving throughout the summer, added to by good banking results from Santander UK, it was decided in August to reintroduce deposit in our Santander UK call account and no longer use the DMO. At the end of September the maturity limits in use for financial institutions were.

UK Institutions:

- Santander UK, Royal Bank of Scotland and National Westminster for a maximum period of 35 days;
- Barclays Bank , Lloyds TSB, Bank of Scotland and Nationwide Building Society for a maximum period of 100 days;
- HSBC Bank and Standard Chartered for a maximum period of 12 months.

Non-UK Institutions

- Approved European Banks for a maximum period of 100 days
- Approved USA banks for a maximum period of 6 months
- Approved Australian and Canadian banks for a maximum period of 12 months

4.14 Investment Activity

4.14.1 Investments are made short term to cover cash flow and liquidity requirements and longer term to maximise and guarantee future income. With maximum maturity limits reduced during the first 6 months of the year there has been limited opportunity to lock in higher rates for longer periods with the maximum maturity of deposits taken in the period limited to 3 months. In line with the Council's approved investment strategy for 2012/13 the following deposits in 3 month maturities have been taken in the period 1st April 2012 to 30th September 2012.

Amount	Start Date	End Date	Term (days)	Rate %
£5.0m	24/04/12	24/07/12	91	1.40
£5.0m	20/08/12	20/11/12	92	1.35
£5.0m	17/09/12	17/12/12	91	1.35

4.14.2 The above deposits have been taken above target rates and increased the forecast return on investments in 2012/13. This together with higher rates negotiated on call accounts have achieved returns above the budget target rate of 0.8%.

4.14.3 Figure 2 below shows the split of deposits over country/sector as at 30th September 2012. In terms of risk management, the majority of the investment portfolio is now held in UK institutions. These institutions are of systemic importance to the UK economy and as such would in probability receive state support should they have difficulty in operating due to adverse credit conditions. Table 3 provides more detail of the actual deposits by counterparty group.

Figure 2

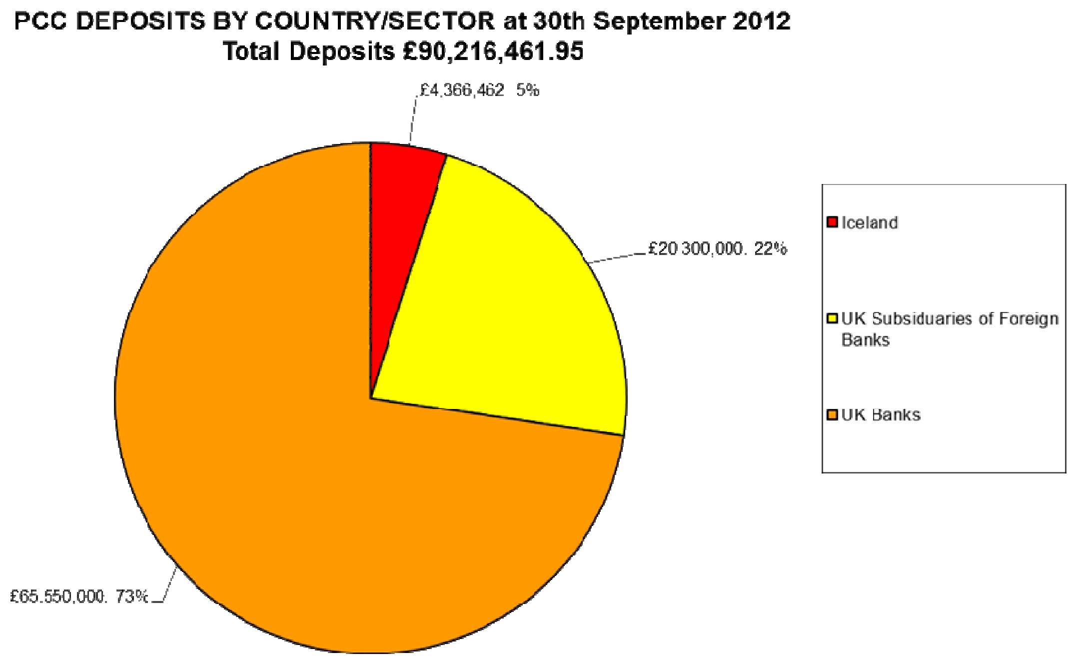
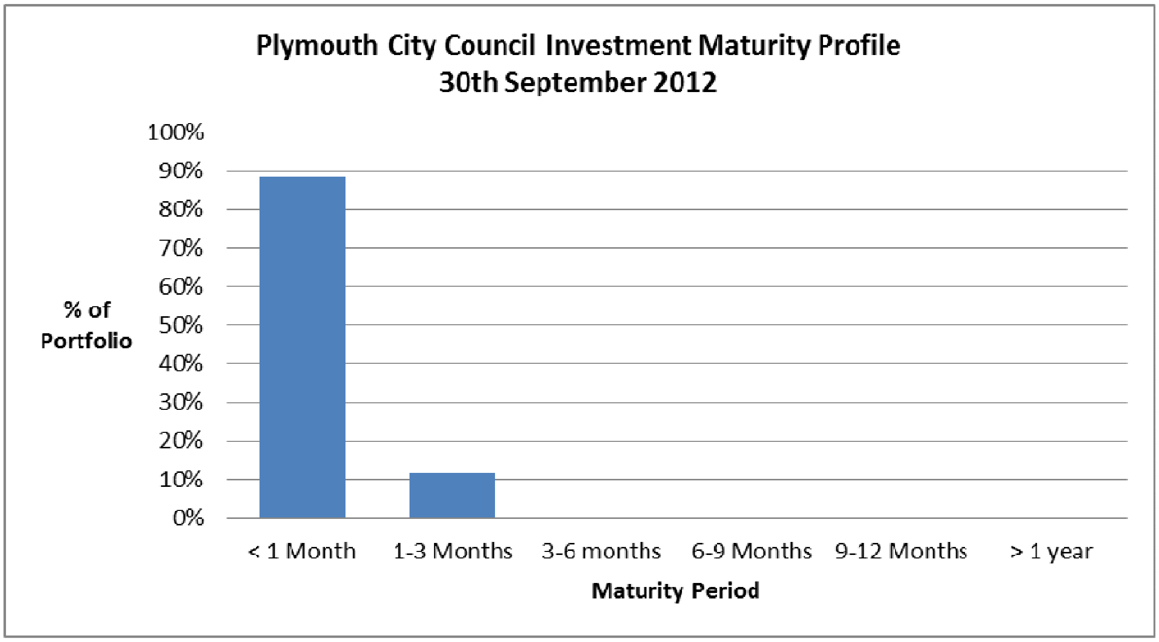


Table 3

Counterparty	Total
	£m
Iceland	4.366
Banco Santander	
Santander UK (was Abbey National)	20.3000
Lloyds Banking Group	
Bank of Scotland	15.100
Lloyds TSB	5.000
Barclays	24.300
Royal Bank of Scotland (RBS)	
RBS	21.150
Total	**90.216**

4.14.4 The maturity profile of the Council's deposits is represented in figure 3. This shows a large proportion of deposits maturing in less than one month, reflecting the deposits in call accounts, giving the liquidity requirement to meet cashflow and the ability to react to further adverse changes in market conditions. In the period covered by this report the Treasury Management officer has negotiated increased rates on the Council's call accounts which in most cases pay higher than available fixed term deposits out to the maturity limits in place. The deposits beyond 1 month are 3 month deposits with Lloyds Banking Group where rates are higher than those available on call accounts.

Figure 3



4.15 <u>Credit Risk</u>

4.15.1 The Treasury Management Strategy report to Audit Committee in February 2010 outlined a recommendation that officers work to develop a set of benchmarking criteria against which the Council's investment risk could be measured. The Council's treasury advisors, Arlingclose, as a result developed the following matrix to score the credit risk of an authority's investment portfolio. This continues to be used in 2012-13:

<u>Scoring:</u>
-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 = 27
-Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

4.15.2 Table 3 shows the rating currently attached to the Council's portfolio and its movement during the year.

Table 3

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating
31/03/2012	5.48	A+	5.42	A+
30/06/2012	5.10	A+	5.65	A
30/09/2012	5.99	A	6.06	A

Note: These scores exclude any deposits with Icelandic banks.

Based on the scoring methodology, the Council's counterparty credit quality has fluctuated during the year as a result of credit rating downgrades and the temporary use of the DMADF deposit facility with the DMO. Throughout the first half of the year the council's credit score was maintained well within the target level of 7 as set in the approved 2012/13 strategy.

4.15.3 Arlingclose have used the scoring matrix to compare Plymouth's investment risk against other unitary authorities who use Arlingclose as their advisors. The results are shown in section 5.

5. Benchmarking

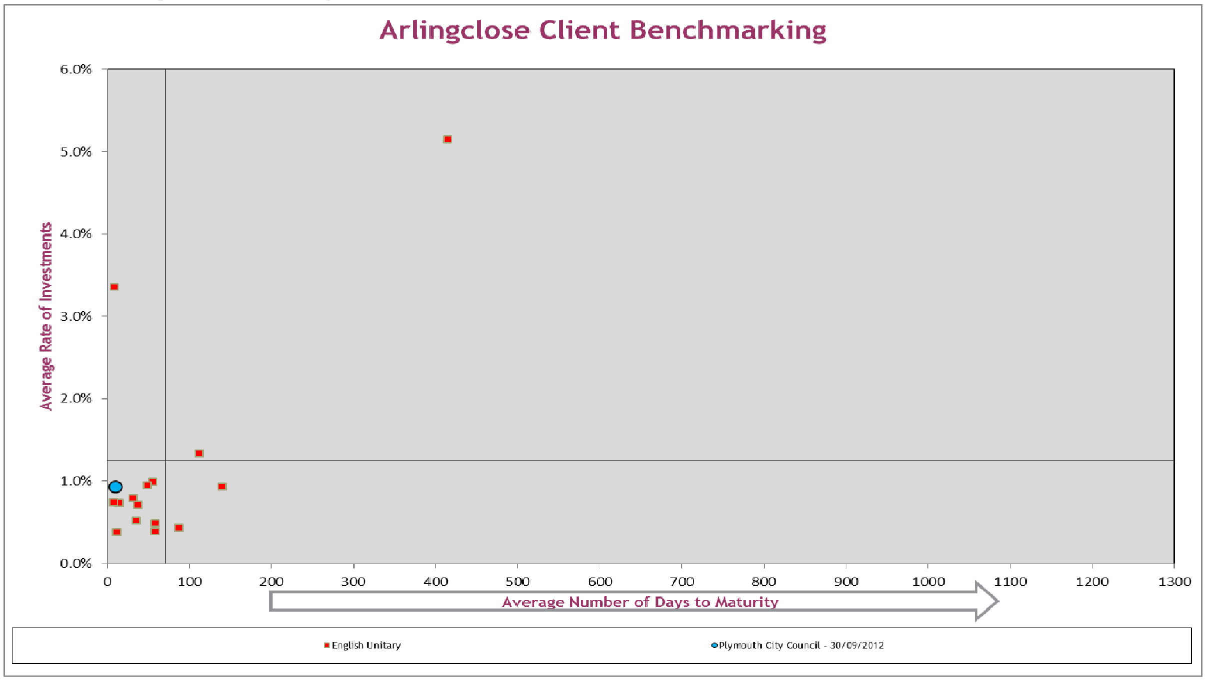
5.1 The Council's performance on investments is measured against a benchmark of the 7 day libid rate. For the period to 30th September 2012 the return on investments made in 2012/13 was 0.856% against the average 7 day Libid for the period of 0.54%. Including investment made in previous years at higher rates the average return on all deposits taken to 30th September 2012 was 0.9729%.

5.2 As outlined above, Arlingclose have developed a set of benchmarking criteria to enable comparisons on performance to be made on data provided by all their clients. To compare like with like the following graphs compare our performance with other unitary authorities. This is based on data provided to 30th September 2012.

The 3 graphs used for comparison are:

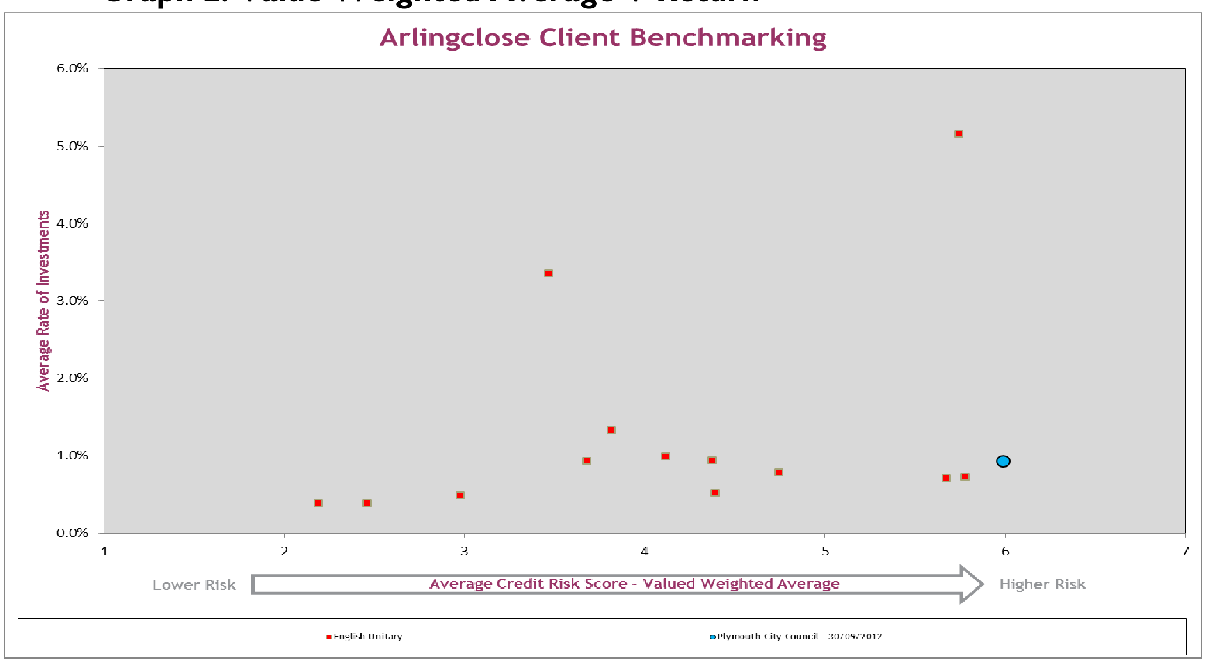
1. Average rate of investment against average maturity period
2. Average rate of investment against value weighted average credit risk score
3. Average rate of investment against time weighted average credit risk score

Graph 1 Average Number of days to Maturity V Return



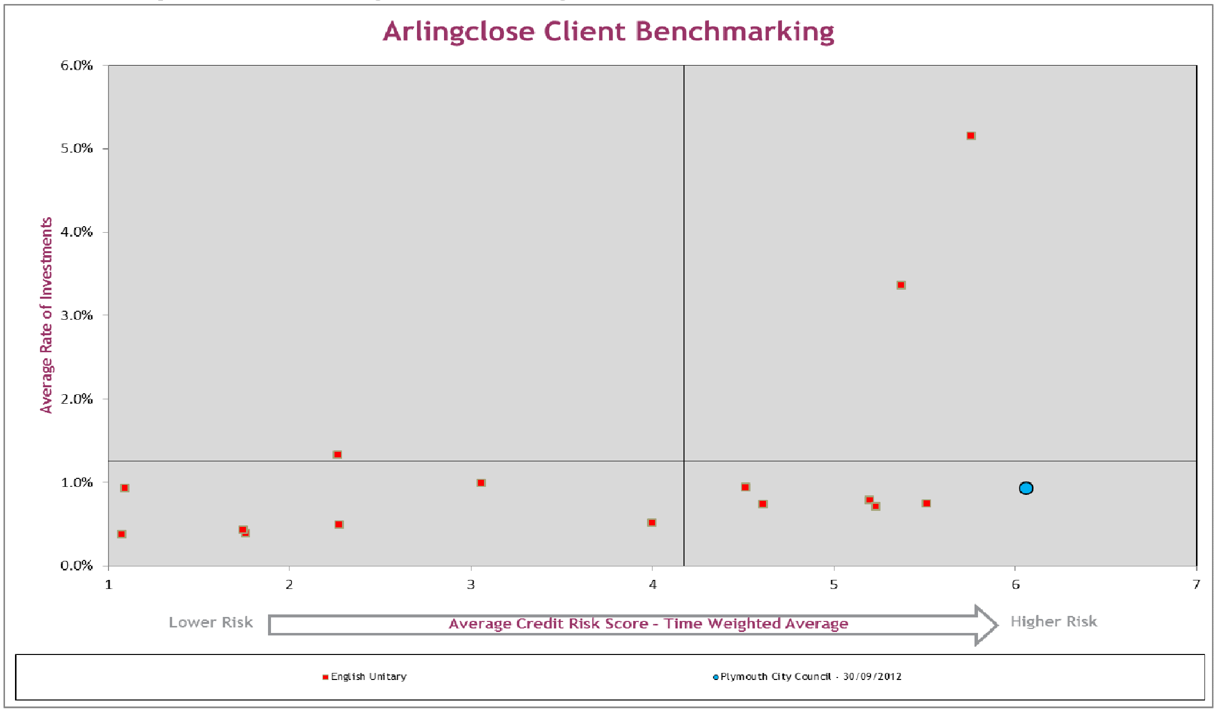
This graph shows the duration of investments against return. It shows the Council's investments have performed well against the majority of other unitary authorities reflecting the higher rates negotiated on call accounts

Graph 2. Value Weighted Average V Return



As a general rule the aim should be to convert a greater average length of portfolio duration into a greater than average return. There should be a positive correlation between duration and return. However this chart should not be viewed in isolation from other measured parameters and it should be noted that a high average number of days to maturity does not necessarily mean a higher risk, in fact the reverse may be considered true in some cases. The majority of the Council's investments are in call accounts with UK banks. These banks have been downgraded increasing the credit risk score but are still of systemic importance to the UK economy and as such are considered secure investments.

Graph 3 Time weighted Average V Return



Longer-term investments with banks are inherently more risky. Ideally authorities should move towards the top left hand corner of the above graph. Therefore it is preferable to see risk taken converted into return at a greater than average rate. All the Council's investments are in short-term deposits or instant access call accounts so there are no longer-term deposits impacting on our credit risk score. The lower risk scores of other unitary authorities are due to the use of Money Market Funds (MMF) which are AAA rated giving the lowest credit risk score. It has been the policy of the Council to use call accounts with UK banks in the first half of the year as opposed to the alternative of liquid MMF's. Although MMF's are rated AAA the instruments within these funds have far lower ratings. Arlingclose are reviewing their credit risk scores to reflect this. This will bring the scores of other authorities closer to that of this Authority.

6. Revenue Implications of Treasury Management

6.1 The expenditure and income arising from the Council's borrowing and investments accrues to the revenue accounts. This includes interest payable and receivable, the minimum revenue provision (for debt repayment), and premiums and discounts written out to revenue from previous debt rescheduling. Some of the interest receivable is passed on to specific accounts where this interest has accrued from the investment of surplus balances for these services. The balance (net cost) is met by the General Fund. The table below shows the monitoring positions against budget arising from these transactions in 2012/13 to 30th September 2012.

Summary of Capital Financing Costs 2012/13

	2012/13 Budget £000	Forecast 2012/13 Outturn £000	Variance £000
External Interest payments	9,660	9,091	(569)
External Interest received	(503)	(595)	(92)
Interest transferred to other accounts	115	115	0
Premiums / Discounts written out to Revenue	(189)	(189)	0
Debt Management Expenses	143	143	0
Treasury Management Cost	**9,226**	**8,595**	**(661)**
Minimum Revenue Provision	7,897	7,807	(90)
Recharges for unsupported borrowing	(3,775)	(3.510)	265
Recovered from trading Accounts	(3,662)	(3,662)	0
Net Cost to General Fund	**9,686**	**9,200**	**(486)**

7 Icelandic Bank Update

7.1 The latest position on the recoveries of monies invested in the Icelandic banks is as follows:

Glitnir - received £5,033,247.31 (principal £4,742,018.12 and interest £291,229.19) amounting to 79.03% of our agreed claim leaving a balance yet to be recovered of £1,335,240.36.

Landsbanki – received £1,993,537.27(principal £1,887,758.90 and interest £105,778.37) amounting to 47.19% of our agreed claim. The amount received includes £246,162.37 received in 2012/13 (October) leaving a balance yet to be recovered of £2,230,598.07.

Heritable – received £2,350,910.81 (principal £2,236,861.87 and interest £114,048.94) amounting to 74.56% of our claim. This includes £209,365.25 received in 2012-13 (April and July) made up of principal of £199,208.37 and interest of £10,156.88 leaving a balance of £802,047.56 yet to be recovered.

8 Compliance with Prudential Indicators

8.1 Under the arrangements set out in the Prudential Code for Capital Finance in Local Authorities, individual authorities are responsible for deciding the level of their affordable borrowing, having regard to the Code, and for establishing a range of prudential indicators covering borrowing limits and other treasury management measures. The Prudential Indicators for 2012/13 were approved by Council on 27th February 2012.

The performance to 30th September 2012 against these limits are set out below:

(a) Authorised Limit and Operational Boundary for External Debt

- The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of their indebted status. This is a statutory limit which should not be breached. It is measured on a daily basis against all external borrowing items on the balance sheet (i.e. long and short term borrowing, overdrawn bank balances and long term liabilities). It is consistent with the Council's existing commitments, its proposal for capital expenditure and its approved treasury management policy/strategy.

- The Council's Affordable (Authorised) Borrowing Limit was set at £309m for 2012/13 including a limit for other long term liabilities of £34m to cover PFI and Finance Leases.

- The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit. It is a focus for the day to day treasury management and a means by which the authority manages its external debt within the self-imposed Authorised Limit. The Operational Boundary may be breached at certain times during the year due to short-term cashflow requirements.

- The Operational Boundary for 2012/13 was set at £279m.

- There were no breaches to the Authorised Limit or Operational Boundary to 30th September 2012 with the total external debt (including PFI and finance leases) reaching its maximum level of £273.712m on 4th May 2012.

(b) Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

- These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates.
- The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of investments.

	Limits for 2012/13 %
Upper Limit for Fixed Rate Exposure	200
Maximum exposure in 2012-13	115.4
Compliance with Limits:	Yes
Upper Limit for Variable Rate Exposure	50
Maximum exposure in 2012-13	25.42
Compliance with Limits:	Yes

The Council's exposure to both fixed and variable rates was managed well within the limits set during the first half of the year.

(c) Maturity Structure of Fixed Rate Borrowing

- This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates, and is designed to protect against excessive exposure to interest rate changes.

- It is calculated as the amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate. The maturity of borrowing is determined by reference to the earliest date on which the lender can require payment. The repayment of the majority of PWLB loans over the last 2 years has resulted in a high proportion of Lobo (Lenders Option, Borrowers Option) loans which may be subject to rate change or repayment at specified intervals. On specified dates the Lender has the option to vary the rate. If the option is taken the Council (Borrower) has the option to repay the loan. Therefore the loan may be subject to repayment on a number of occasions throughout the life of the loan. These repayment possibilities are included in the limits set for the maturity of fixed rate borrowing and the monitoring of actuals against these limits. The following table shows the performance against limits during the year.

Maturity Structure of Fixed Rate Borrowing	**Upper Limit %**	**Lower Limit %**	**Highest % of Actual Fixed Rate Borrowing during 12-13**	**Lowest % of Actual Fixed Rate Borrowing during 12-13**	**Compliance with Set Limits?**
under 12 months	50	0	48.63	33.48	Yes
12 months and within 24 months	60	0	22.99	7.84	Yes
24 months and within 5 years	40	0	14.11	8.88	Yes
5 years and within 10 years	25	0	1.94	1.94	Yes
10 years and within 20 years	30	0	2.50	2.50	Yes
20 years and with 30 years	30	0	5.73	5.73	Yes
30 years and within 40 years	25	0	3.41	2.33	Yes
40 years and within 50 years	40	0	19.52	18.45	Yes
50 years and above	25	0	0.00	0.00	Yes

(d) Gross and Net Debt

- The purpose of this indicator is to highlight a situation where the Authority is planning to borrow in advance of need.

Net Debt as a % of Gross Debt	**Approved Limit %**	**Actual to 30th September 2012 %**	**Compliance with Set Limits**
Upper Limit	80	71.65	Yes
Lower Limit	35	52.56	Yes

During the period from 1st April to 30th September 2012 borrowing has been limited to within the Council's Capital Financing Requirement for the year and no borrowing has been taken in advance of need for future year's capital expenditure funding requirement.

(e) Net Debt and the Capital Financing Requirement

- This is a key indicator of prudence. In order to ensure that over the medium term net borrowing will only be for capital purposes, the Authority should ensure that the net external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional increases to the capital financing requirement for the current and next two financial years.
- The Authority had no difficulty meeting this requirement so far in 2012/13, nor are there any difficulties envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the approved budget.

(f) Total principal sums invested for periods longer than 364 days

- This indicator allows the Council to manage the risk inherent in investments longer than 364 days.
- The limit for 2012/13 was set at £20m.
- The Council's strategy for 2012-13 started with maximum deposit maturity limits out to 1 year. However due to adverse changes in credit conditions, and reductions in maturity limits during the year to date, the maximum deposits made were in up to 3 month maturities. Having not taken any deposits over 364 days in the first half of the year the Council still has space for up to £20m of longer-term deposits should this be viewed as appropriate in light of credit conditions, available counterparties and the risk/reward of these investments.

(g) Credit Risk

- This indicator has been incorporated to review the Council's approach to credit risk.
- The Council confirms it considers security, liquidity and yield, in that order, when making investment decisions.
- Credit ratings remain an important element in assessing credit risk, but they are not the sole feature of the Authority's assessment of counterparty risk. The authority considers the following tools to assess credit risk.
    - Published credit ratings of the financial institution and its sovereign;
    - Sovereign support mechanism;
    - Credit default swaps (where quoted);
    - Share prices (where quoted);
    - Economic fundamentals, such as country's net debt as a percentage of its GDP;
    - Corporate developments, news, articles, market sentiment and momentum.

- The Council can confirm that all investments were made in line with minimum credit rating criteria set in the 2012/13 Treasury Management Strategy.
    - Long-term ratings of A- or equivalent;
    - Long-term sovereign ratings of AA+ or equivalent for non-UK sovereigns.

9. Outlook for Q3-Q4

9.1 At the time of writing this activity report in October 2012, economic growth remains elusive. Tight credit conditions and weak earnings are constraining consumer and corporate spending. The outlook is for official rates to remain low for an extended period, as shown below.

	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
Official Bank Rate													
Upside risk				0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50
Central case	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**
Downside risk	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25

10 Summary

10.1 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 half of 2012/13. 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 given to security and liquidity over yield.

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	2-yr SWAP Bid	3-yr SWAP Bid	5-yr SWAP Bid
01/04/2012		0.50		0.55	0.55	0.61	1.00	1.33	1.84	1.22	1.30	1.59
30/04/2012		0.50		0.50	0.65	0.60	0.99	1.32	1.84	1.35	1.43	1.68
31/05/2012		0.50		0.48	0.65	0.57	0.97	1.30	1.82	1.20	1.20	1.34
30/06/2012		0.50		0.50	0.50	0.55	0.83	1.13	1.65	0.96	0.99	1.25
31/07/2012		0.50		0.50	0.65	0.45	0.63	0.92	1.43	0.76	0.77	1.02
31/08/2012		0.50		0.50	0.52	0.40	0.57	0.81	1.23	0.75	0.78	1.03
30/09/2012		0.50		0.25	0.52	0.40	0.47	0.66	0.95	0.70	0.76	1.00
Average		**0.50**		0.46	0.54	0.51	0.79	1.08	1.57	1.01	1.05	1.28
Maximum		**0.50**		0.55	0.65	0.61	1.00	1.33	1.84	1.38	1.45	1.72
Minimum		**0.50**		0.25	0.30	0.40	0.47	0.66	0.95	0.70	0.76	1.00
Spread		**0.00**		0.30	0.35	0.21	0.53	0.67	0.89	0.68	0.69	0.72

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
02/04/2012	130/12	1.29	2.07	3.25	4.22	4.43	4.46	4.41
30/04/2012	166/12	1.31	2.09	3.15	4.13	4.38	4.42	4.39
31/05/2012	210/12	1.19	1.76	2.74	3.79	4.13	4.19	4.16
29/06/2012	248/12	1.20	1.84	2.83	3.79	4.11	4.19	4.16
31/07/2012	292/12	1.01	1.57	2.58	3.60	3.97	4.07	4.05
31/08/2012	336/12	1.07	1.62	2.61	3.62	4.05	4.14	4.11
28//09/2012	376/12	1.15	1.67	2.64	3.71	4.12	4.20	4.14
	Low	1.17	1.52	2.52	3.16	3.57	3.81	3.94
	Average	1.41	1.80	2.81	3.43	3.81	4.03	4.15
	High	1.69	2.15	3.28	3.92	4.23	4.39	4.45

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
02/04/2012	130/12	1.56	2.14	3.29	3.91	4.23	4.38
30/04/2012	166/12	1.60	2.15	3.19	3.81	4.14	4.31
31/05/2012	210/12	1.37	1.81	2.78	3.41	3.81	4.03
29/06/2012	248/12	1.41	1.89	2.87	3.45	3.80	4.01
31/07/2012	292/12	1.17	1.63	2.62	3.32	3.61	3.85
31/08/2012	336/12	1.22	1.67	2.65	3.25	3.64	3.90
28//09/2012	376/12	1.29	1.72	2.68	3.31	3.73	3.99
	Low	1.14	1.57	2.56	3.18	3.58	3.81
	Average	1.37	1.85	2.85	3.45	3.82	4.04
	High	1.64	2.21	3.32	3.94	4.24	4.39

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**
02/04/2012	0.59	0.60	0.62	1.49	1.50	1.52
30/04/2012	0.58	0.60	0.62	1.48	1.50	1.52
31/05/2012	0.58	0.58	0.58	1.48	1.48	1.48
29/06/2012	0.58	0.57	0.56	1.48	1.47	1.46
31/07/2012	0.56	0.54	0.49	1.46	1.44	1.39
31/08/2012	0.55	0.54	0.52	1.45	1.44	1.42
28//09/2012	0.57	0.56	0.54	1.47	1.46	1.44
Low	0.55	0.53	0.48	1.45	1.43	1.38
Average	0.578	0.5743	0.5668	1.478	1.4743	1.4668
High	0.60	0.60	0.62	1.50	1.50	1.52