Appendix A

TREASURY MANAGEMENT

AND

PRUDENTIAL INDICATORS

MID YEAR REPORT

2010/11

MID YEAR REPORT 2010-11

1.0 INTRODUCTION AND BACKGROUND

1.1 This part of the report is structured to update:

- The Council's capital expenditure plans;
- 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.

2.0 CAPITAL EXPENDITURE (PI)

This table shows the revised estimates for capital expenditure and reflects the changes since the capital programme was agreed as part of the 2010/11 budget setting process.

Capital Expenditure by Service	2010/11 Original Estimate £000	Current Position £000	2010/11 Revised Estimate £000
Council Housing	1,325	375	1,325
Private Housing	386	260	494
Council Property	5,517	307	4,794
Vehicle, Plant & Equipment	17	17	17
Information Technology	0	9	39
Town Centre Improvements	64	9	243
Community Initiatives	20	20	20
Recreation, Leisure & Tourism	0	97	141
Planning and Conservation	15	7	28
Total	7,344	1,101	7,101

2.1 Impact of Capital Expenditure Plans

2.1.1 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	2010/11 Original Estimate £000	2010/11 Revised Estimate £000
Supported Expenditure	5,690	6,494
Unsupported Expenditure (borrowing)	1,654	607
Total spend	7,344	7,101
Financed by:		
Capital receipts	83	213
Capital grants	281	373
Capital Reserves	3,866	4,457
Revenue	1,160	1,151
Total Financing	5,390	6,194
Borrowing Need	**1,954**	**907**

The level of borrowing need has reduced from the original estimate due to a change in the financing arrangements associated with the new build project offset by carry forwards from prior years.

2.2 **Changes to the Capital Financing Requirement (PI), External Debt and the Operational Boundary (PI)**
The table below shows the CFR, which is the underlying external need to borrow for a capital purpose. It also shows the expected debt position over the period. This is termed the Operational Boundary.

2.2.1 **Prudential Indicator – Capital Financing Requirement**
The capital financing requirement has been revised from the original prediction to take accounts of changes in the financing arrangements for the new build project and also schemes carried forward from 2009/10.

2.2.2 **Prudential Indicator – External Debt / the Operational Boundary**

	2010/11 Original Estimate £000	Current Position £000	2010/11 Revised Estimate £000
Prudential Indicator – Capital Financing Requirement			
CFR – Non Housing	7,037	[redacted]	5,620
CFR – Housing	4,296		4,296
Total CFR	11,333		9,916
Net movement in CFR	1,682		635
Prudential Indicator – External Debt / the Operational Boundary			
Borrowing	12,015	11,000	11,000
Other long term liabilities	245	200	200
Total Debt 31 March	12,260	11,200	11,200

3.0 **LIMITS TO BORROWING ACTIVITY**

3.1 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. The current position shows a predicted under-borrowed position against the original prediction due to the use of internal cash flow balances.

	2010/11 Original Estimate £000	Current Position £000	2010/11 Revised Estimate £000
Gross Borrowing	10,515	8,588	9,488
Plus Other Long Term liabilities	250	200	200
Less Investments	-872	-4,150	-859
Net Borrowing	9,893	4,238	8,829
CFR (year end position)	11,333	9,916	9,916

No difficulties are envisaged for the current or future years in complying with this PI.

3.2 A further PI controls the overall level of borrowing. This is the Authorised Limit which 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.

Authorised limit for external debt	2010/11 Original Indicator £	Current Position £	2010/11 Revised Indicator £
Borrowing	**18,750**	18,750	**17,800**
Other long term liabilities	250	250	200
Total	19,000	19,000	18,000

The change in the authorised limit has occurred due to the change in the borrowing need in the current year,

4.0 INTEREST RATE MOVEMENTS AND EXPECTATIONS

4.1 The Council's treasury management advisers have provided the following view of the economy for the first half of the year:

4.2 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.

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.

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.

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.

Medium-Term Rate Estimates

Annual Average %	Bank Rate	Money Rates		PWLB Rates*		
		3 month	1 year	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

5.0 TREASURY STRATEGY 2010/11 – 2012/13

5.1 Debt Activity during 2010/11

The expected borrowing need is set out below:

	2010/11 Original Estimate £000	Current Position £000	2010/11 Revised Estimate £000
CFR (year end position)	11,333	9,916	9,916
Less Other Long Term Liabilities	-250	-200	-200
Net Adjusted CFR (y/e position)	11,083	9,716	9,716
Borrowed at 30/09/10	8,588	8,588	8,588
Under/over borrowing	-2,495	-1,128	-1,128
Expected need	1,954	900	900
Total Borrowing	10,542	9,488	9,488

The Council is currently under-borrowed to address investment counterparty risk and the cost of carry on investments (investments yield under 1%, long term borrowing rates are approximately 5.2%). There is interest rate risk, as longer term borrowing rates may rise, this position is being carefully monitored. Also, as a result of the Spending Review HM Treasury has instructed PWLB to increase the average interest rate on all new loans to an average of 1.00% above Government's cost of borrowing .This was brought in to effect on 20 October 2010. This will effect any new borrowing later in the year and the variable rate loan maturing on 10 March 2011 (see para 5.2 below).

5.2 No new borrowing(s) have been undertaken during the year , however, a variable rate PWLB loan (£1.6m) was extended from 10 Sept 2010 for six months at an interest rate of 0.70%.This is likely to produce a gross saving of approximately £47,800 as a result of interest rates being maintained at a low level over the past 18 months.

Lender	Principal	Type	Interest Rate	Maturity
	£m		%	
PWLB	1.6	Variable interest rate	0.70	To 10/3/2011

5.3 The revised budget position for debt charges is:

Debt charges	2010/11 Original Estimate £000	Current Position £000	2010/11 Revised Estimate £000
Borrowing	415	167	346
Other long term liabilities*	0	0	0
Total	415	167	346

6.0 **INVESTMENT STRATEGY 2010/11 – 2012/13**

6.1 **Key Objectives** - The objectives of the Council's investment strategy are safeguarding the repayment of the principal and interest of its investments on time – 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.

6.2 **Current Investment Position** - The Council held £4.15m of investments at 30/09/2010, and the constituent parts of the investment position are:

Sector	Country	Up to 1 year £000	1 - 2 years £000	2 – 3 years £000
Banks	UK	1,400	0	0
Building Societies	UK	1,000	0	0
Debt Management Office	UK	1,750	0	0
Total		4,150	0	0

6.3 The revised budget position for investment income is:

Interest Receivable	2010/11 Original Estimate £000	Current Position £000	2010/11 Latest Forecast £000
Income	16	8	13
Total	16	8	13

6.4 **Risk Benchmarking** – A regulatory development 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 on 3 February 2010.

The following reports the current position against the benchmarks originally approved.

6.5 **Security** - The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, was set as follows:

0.12% historic risk of default when compared to the whole portfolio.

The investment portfolio was maintained within this overall benchmark during the year to date with the average risk, at 30 September, being 0.001% or £50 on the total sum invested (£4.15M)—it is not an expectation of default.

The security benchmarks for each individual year were set as:

Benchmarks	1 year	2 years	3 years	4 years	5 years
Maximum (current)	**0.03%**	**0.12%**	**0.10%**	**0.08%**	**0.06%**
Maximum (revised)	**0.06%**	**0.06%**	**0.08%**	**N/A**	**N/A**

These benchmarks were not breached during the year to date. However since this benchmark was introduced we have received more up to date default information, which reflects increased counterparty defaults during the banking crisis. The basis of the previous benchmark has therefore moved and the new benchmark is proposed as shown in the table above at 0.08%. Again this does not indicate the Council has changed its risk profile, or is looking to increase risk, simply how it is benchmarking risk.

Note: 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.

6.6 **Liquidity** – In respect of this area the Council set liquidity facilities/benchmarks to maintain:

- Bank overdraft - £1.0m
- Liquid short term deposits of at least £0.25m available with a week's notice.
- Weighted Average Life benchmark is expected to be 1.5 years, with a maximum of 3.0 years.

The actual against the benchmark as at 30 September 2010 was 10.66 days which is well within the prescribed limit approved. This is because the current portfolio has been kept relatively short.

Liquidity arrangements should be adequate during the remainder of the year.

Yield - Local measures of yield benchmarks are:

- The investment return to date is 0.34% against the seven day money market rate of 0.35% (-£176)

The security of the investments is paramount and as such a large proportion of the surplus monies has been placed with the Debt Management Office resulting in a lower rate of return against the benchmark.

6.7 **Revisions to the Investment Strategy** – The current counterparty criteria is under regular review and a proposed revision to the Investment Strategy is recommended for approval. The present 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, long and support criteria embodied in the main credit rating criteria, limiting deposits up to a maximum of 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, Long and Support credit ratings based on the Lowest Common Denominator approach. These institutions will be limited to a time limit of less than one month and an investment limit of £1m and be subject to monitoring by officers through supplementary credit information (e.g. CDS prices).

6.8 **Treasury Management Indicators**

6.9 **Actual and estimates of the ratio of financing costs to net revenue stream** – This indicator identifies the trend in the cost of capital (financing costs net of interest and investment income) against the net revenue stream.

	2010/11 Original Indicator	**2010/11 Revised Indicator**
	%	%
Non-HRA	6.66	6.14
HRA	2.97	2.59

We are on target to achieve the original forecast for ratio of financing costs to net revenue.

7.0 TREASURY MANAGEMENT PRUDENTIAL INDICATORS

7.1 **Upper Limits On Variable Rate Exposure** – This indicator identifies a maximum limit for variable interest rates based upon the debt position net of investments.

7.2 **Upper Limits On Fixed Rate Exposure** – Similar to the previous indicator this covers a maximum limit on fixed interest rates.

	2010/11 Original Indicator £m	Current Position £m	2010/11 Revised Indicator £m
Prudential indicator limits based on debt net of investments			
Limits on fixed interest rates	15	7.0	15
Limits on variable interest rates	4	1.6	4

7.3 **Maturity Structures Of Borrowing** – These gross 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) falling due for refinancing.

	2010/11 Original Indicator	Current Position	2010/11 Revised Indicator
Maturity Structure of fixed borrowing			
Under 12 months	0-100%	[redacted]	0-100%
12 months to 2 years	0-100%	[redacted]	0-100%
2 years to 5 years	0-100%	[redacted]	0-100%
5 years to 10 years	0-100%	[redacted]	0-100%
10 years and above	0-100%	[redacted]	0-100%

7.4 **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.

	2010/11 Original Indicator £m	Current Position £m	2010/11 Revised Indicator £m
Maximum principal sums invested > 364 days[1]			
Cash deposits	1	0	1

[1] Maximum limit of 100% applies to each period. The principal / percentage amount given is the limit for investments that have maturities of longer than one year at year end.

7.5 Butlers Treasury Management Consultants have entered into an agreement with Sector Treasury Services to transfer the business of Butlers with effect from the 25th October 2010. Customers of Butlers will have their contracts assigned to Sector from that date. It is too early to say whether this will have any significant effect on the overall Treasury Management Service.