WARDS AFFECTED: All
Item No

AUDIT COMMITTEE
26 NOVEMBER 2011

REPORT OF DEPUTY CHIEF EXECUTIVE & CORPORATE DIRECTOR OF RESOURCES

TREASURY MANAGEMENT STRATEGY 2010/11 – HALF YEARLY UPDATE

1. PURPOSE OF REPORT

This report provides details of treasury management actions taken in 2010/11 to date, proposes an amendment to the existing investment counterparty list and changes to the Prudential Indicators.

2. RECOMMENDATIONS

It is recommended that the Committee note:

- the treasury management actions taken in 2010/11 to date (**Annexe 1, section 3**)
- the proposed change to the approved investment counterparty list (**Annexe 1**, **Appendix 1**)
- and the proposed amendments to the 2010/11 Prudential Indicators (**Annexe 1 Appendix 2**)

3. REASONS FOR CONSIDERATION

The City Council's treasury management function operates in accordance with the Code of Practice for Treasury Management in the Public Services (the Code), issued by the Chartered Institute of Public Finance and Accountancy (CIPFA). Under this Code, the annual Treasury Management Strategy is considered by a designated scrutiny body (Audit Committee) and approved by a full meeting of Nottingham City Council before the beginning of the financial year to which it applies. A half-yearly report is also a requirement of the Code, with any changes to the strategy required to be approved by a full Council meeting.

4. BACKGROUND

Treasury management is the management of a local authority's cash flows, borrowings and investments, together with the management of the associated risks and the pursuit of the optimum performance or return consistent with those risks. Since 1 April 2004 councils have been required to have regard to the Prudential Code. The Code requires treasury management to be carried out in accordance with good professional practice. The City Council retains external advisors to assist with this activity.

Annexe 1 (the Executive Report on this subject of 16 November) provides details of treasury management activity to 30 September 2010, the proposed inclusion of the European Investment bank in the list of approved investment counterparties and proposed changes to the Prudential Indicators for 2010/11.

5. BACKGROUND PAPERS OTHER THAN PUBLISHED WORKS OR THOSE DISCLOSING EXEMPT OR CONFIDENTIAL INFORMATION

PWLB records, working papers

6. PUBLISHED DOCUMENTS REFERRED TO IN COMPILING THIS REPORT

- Treasury Management in the Public Services, Code of Practice 2009 - CIPFA
- The Prudential Code for Capital Finance in Local Authorities 2009 – CIPFA
- Guidance on Local Government Investments 2009 – Communities & Local Government

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Deputy Chief Executive & Corporate Director for Resources

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ANNEXE 1

EXECUTIVE BOARD – 16 NOVEMBER 2010

Title of paper:	**TREASURY MANAGEMENT 2010/11 – HALF YEARLY UPDATE**	
Director(s)/ Corporate Director(s):	Carole Mills-Evans Deputy Chief Executive & Corporate Director, Resources	**Wards affected:** All
Portfolio Holder(s):	Councillor Graham Chapman, Portfolio Holder for Resources, Economic Development and Reputation	**Date of consultation with Portfolio Holder(s):** 20 October 2010
Report author and contact details:	Jeff Abbott, Head of Corporate and Strategic Finance Tel: 0115 8763648 E-mail: jeff.abbott@nottinghamcity.gov.uk	
Other colleagues who have provided input:	Pete Guest, Treasury Management Officer Tel: 0115 8764163 E-mail: pete.guest@nottinghamcity.gov.uk	
Key Decision:	No	

Reasons for Key Decision:	
Expenditure of £500,000 or more in a single year	
Revenue income of £500,000 or more in a single year	
Savings of £500,000 or more in a single year	
Capital expenditure of £1,000,000 or more	
Capital income of £1,000,000 or more	
Significant effects on communities living or working in an area comprising two or more wards in the City	
Relevant Council Plan Strategic Priority:	
World Class Nottingham	✓
Work in Nottingham	✓
Safer Nottingham	✓
Neighbourhood Nottingham	✓
Family Nottingham	✓
Healthy Nottingham	✓
Serving Nottingham Better	✓

Summary of issues (including benefits to citizens/service users):

This report sets out treasury management actions and performance from 1 April 2010 to 30 September 2010 and seeks endorsement of a change to the investment counterparty list and amendment of the 2010/11 Prudential Indicators.

Recommendation(s):

1 To note the treasury management actions taken in 2010/11 to date, specifically that:

- £20m of new borrowing has been raised
- No rescheduling of debt has been undertaken
- The average return on investments to 30 September 2010 was 0.99%
- Between 1 April and 30 September, daily cash flow performance was above target at 98.3%

2	To endorse and recommend for approval by the City Council at its meeting on 13 December 2010: • The new proposals in respect of investment counterparties to include the European Investment Bank as a non-specified investment within the approved list **(section 3.6)** • The amended Prudential Indicators for 2010/11 **(Appendix 2)**

1 BACKGROUND

1.1 Treasury management is the management of a local authority's cash flows, borrowings and investments, together with the management of the associated risks and the pursuit of the optimum performance or return consistent with those risks. Since 1 April 2004 councils have been required to have regard to the Prudential Code. The Code requires treasury management to be carried out in accordance with good professional practice. The City Council retains external advisors to assist with this activity.

1.2 In respect of external investments, the City Council is required to ensure that CLG guidance is followed, with priorities being:

- Security of the invested capital
- Liquidity of the invested capital
- And, commensurate with security and liquidity, an optimum return on those investments

1.3 The City Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Treasury management risks are identified in the Council's approved Treasury Management Practices. The main risks to the Council's treasury activities are:

- liquidity risk (inadequate cash resources)
- market or interest rate risk (fluctuations in interest rate levels and thereby in the value of investments).
- inflation risks (exposure to inflation)
- credit and counterparty risk (security of investments)
- refinancing risks (impact of debt maturing in future years)
- legal and regulatory risk (i.e. non-compliance with statutory and regulatory requirements, risk of fraud)

2 REASONS FOR RECOMMENDATIONS (INCLUDING OUTCOMES OF CONSULTATION)

2.1 To ensure that councillors are kept informed of the actions taken by the Chief Finance Officer (CFO) under delegated authority. The current Treasury Management Code of Practice, adopted by the City Council, requires the CFO to submit three reports on treasury management each year; a policy and strategy statement for the ensuing financial year, a 6-monthly progress report and an outturn report. It is also a requirement of the Code that the reports be considered by the main City Council meeting, as well as any scrutiny or executive committees.

3 TREASURY MANAGEMENT ACTIVITY TO 30 SEPTEMBER 2010

3.1 2010/11 strategy

The overall Treasury Management Strategy for 2010/11 was approved by the City Council on 8 March 2010. **Table 1** shows the actions taken as at 30 September against each of the main four elements of the strategy:

TABLE 1: TREASURY MANAGEMENT ACTIONS	
Strategy 2010/11	**Actions to 30 September 2010**
New borrowing – to raise up to £53.1m to finance new capital expenditure in the year and replace maturing long-term debt.	To date, £20m of new debt has been raised. (*see 3.3*)
Debt rescheduling – to give consideration to any debt rescheduling or repayment opportunities which enable revenue savings to be generated in the year.	To date no debt rescheduling has taken place (*see 3.4*)
Investments – to ensure the security of funds invested through the application of a restricted counterparty list and a maximum period of investment. Within those confines, to maximise the return on investments.	The average return on investments from 1 April to 30 September 2010 has been 0.99%. The average 7-day LIBID rate (the benchmark) for the same period was 0.42%. The 2010/11 budget assumed an average return of 1.35% for the period. (*see 3.5)*
Daily cash management – to maintain an overnight cash balance between £0.3m overdrawn and £0.15m in-hand every day. The 2010/11 target is to exceed 97.8% (2009/10 performance)	Between 1 April and 30 September 2010 performance was above target at 98.3%.

3.2 Interest rates during 2010/11

The Bank of England Base Rate has been unchanged in 2010/11, having been set at the level of 0.50% by the Monetary Policy Committee in March 2009. The previous strategy report anticipated that rates would increase, by March 2011, to 1.50% as the UK economy recovered. However, the current forecast is for the 0.50% rate to remain in place until at the summer of 2011, with growth recovery in the UK expected to be limited by the impact of the Comprehensive Spending Review.

Short-term interest rates have also risen more slowly than anticipated, as a consequence of the continuance of the 0.50% base rate, with all rates out to 12 months being lower than previously assumed, at 30 September. Long-term borrowing costs have been more volatile, as anticipated, with rates moving in response to market sentiment at various points during the year.

Table 2 shows a range of interest rates over the period and, for comparison purposes, the anticipated rates at 1 October 2010 included in the original strategy report:

TABLE 2: INTEREST RATES 2010/11								
Date	**Base Rate**	**1 month**	**3 month**	**6 month**	**1 year**	**5 years**	**20 years**	**50 years**
	%	**%**	**%**	**%**	**%**	**%**	**%**	**%**
1 Apr	0.50	0.42	0.51	0.81	1.26	2.82	4.60	4.65
1 May	0.50	0.43	0.53	0.83	1.29	2.95	4.61	4.60
1 Jun	0.50	0.45	0.60	0.91	1.35	2.60	4.34	4.37
1 Jul	0.50	0.45	0.61	0.94	1.38	2.45	4.24	4.30
1 Aug	0.50	0.50	0.71	1.01	1.46	2.39	4.35	4.42
1 Sep	0.50	0.50	0.71	1.00	1.45	2.06	3.85	3.96
1 Oct	0.50	0.51	0.72	1.01	1.46	2.06	3.92	4.07
1 Oct *	***0.50***	***0.75***	***1.00***	***1.25***	***1.50***	***2.90***	***4.75***	***4.50***

estimated

3.3 Long-term borrowing

The continuing low return on short-term investments, coupled with a more benign forecast for long-term rates, has led to a deferral in the raising of long-term borrowing, with internal cash balances being used as a source of temporary borrowing. To date, of the £53m of required borrowing in 2010/11, only £20m of new debt has been raised, with a 20-year PWLB loan being taken in August at 1.92%, when rates fell to their lowest point of the year.

3.4 Debt rescheduling

The opportunities for debt rescheduling during 2010/11 have been limited, with lower interest rates mitigating against the repayment of existing long-term debt. Anticipated changes in the yield curve may provide some opportunities for switching into variable rate debt in the second half of the year.

3.5 Investments

The City Council's cash investments represent reserves and provisions held within the balance sheet plus surplus working capital. As at 30 September all investments were managed in-house. The 2010/11 budget assumed an average cash surplus of £108m during the year. The actual average cash balance to 30 September was £118.4m.

The 2010/11 approved investment strategy limits investments with counterparties to the Government's Debt Management Office, other local authorities, those UK banks included in the Government's permanent capital investment and liquidity support scheme, and Money Market Funds (pooled, short maturity, high quality investment vehicles offering instant access). In addition, a number of overseas banks are included on the list, with selection based on a range of criteria, including credit ratings, credit default swap rates, government support mechanisms and parent bank support.

During the first half of the year, the majority of the City Council's surplus cash has been held in major UK bank call accounts which provide an acceptable rate of return, linked to the base interest rate, whilst offering liquidity with instant access to deposits available. At 30 September, 30% of deposits were in longer-period deposits providing additional return, but at the expense of liquidity. To date, no new deposits have been made with overseas banks in 2010/11.

The average rate of interest earned on all investments to 30 September was 0.99%. The original budget assumed a return of 1.35% for the same period.

The fall in return reflects the slower than anticipated increase in the base interest rate. (For comparison purposes, the benchmark 7-day LIBID interest rate for the same period was 0.41%).

3.6 Investment strategy changes

Consideration of alternative investment opportunities, to enhance returns on deposits whilst maintaining high levels of security and liquidity, is an active part of the treasury management strategy. Our external advisors have identified bonds issued by the European Investment Bank (EIB) as a means of protecting investments against prolonged periods of low interest rates. The EIB, which has an AAA credit rating from all 3 rating agencies, is owned by the 27 member states of the EU and provides development funding through the issuance of bonds. Our advisors' current view on this investment option is:

"*The joint and individual pan-European government guarantees in place on these bonds provide security of the principal invested. Even at the lower yields likely to be in force, the return on these bonds will provide certainty of income against an outlook of low official interest rates*"

EIB bonds are for a minimum period of one year and are therefore classified as non-specified investments and require a custodial account to be set up with a third-party bank. Limits of 1 year and £20m will be imposed on any deposits in this instrument. **Appendix 1** provides details of the amended list of total approved counterparties for external investment.

3.7 Prudential Indicators

Prudential indicators are a series of financial indicators relating to treasury management issues, including affordability, prudence and borrowing levels and cover a rolling 3-year period. The current indicators were approved by Council on 8 March 2010. They are regularly monitored and the Prudential Code requires any changes to indicators to be reported to and approved by a meeting of the City Council.

The current indicators are shown in **Appendix 2.** The proposed changes to the 2010/11 indicators are also shown and are in respect of indicators 5 to 13. The changes in indicators 5 to 11 provide updated figures for capital expenditure, the Capital Financing Requirement (the Council's underlying need to borrow) and external debt, and reflect the latest forecasts to the Capital Programme, reported elsewhere on this agenda.

The changes to indicators 12 and 13 reflect the need to increase the limits of variable debt, as a percentage of total external borrowing. Any immediate debt rescheduling opportunities, to generate revenue savings, are expected to involve repaying long-term fixed rate loans and replacing them with cheaper variable rate debt. An increase in the variable rate debt limit from 30% to 50% is therefore proposed to accommodate any such rescheduling activity.

The 2011/12 Treasury Management Strategy, which will be submitted as part of the budget process, will include a full review of all prudential indicators for the next three years.

3.8 Icelandic Bank deposits - update

The City Council had a total of £41.6m invested with three Icelandic banks which collapsed in October 2008. These banks are currently going through an administration process to determine the level of payments to be made to the banks' creditors. The latest position in respect of deposits with each bank is:

a) Heritable Bank (original deposit £15.6m) – the administrators continue to realise the assets of the bank and make stage payments to creditors. To date, repayments of principal and interest totalling £7.234m have been received back; representing over 45% of the original investment. It is currently estimated that the final sum recovered will be c 85% of the original deposit.

b) Landsbanki Bank (£15m) – following submissions from all creditors, the Winding Up Board of the bank recognised claims from UK local authorities as priority creditors within its administration process. This would enable an estimated 95% repayment of sums deposited, plus interest, to be repaid to the City Council. The Icelandic District Court will have to ratify the decision of the Board, following legal submissions from other Landsbanki creditors. That court case is now expected to be early in 2011. If, following this legal action, local authorities are reclassified as ordinary creditors, the level of recovery would fall to c38%. Local authorities will have legal representation at that hearing through the auspices of the Local Government Association.

c) Glitnir Bank (£11m) – the Winding Up Board for Glitnir Bank classified UK local authority claims as ordinary creditors, rather than priority. This decision is also dependant on the outcome of a court hearing in the Icelandic District Court. The level of projected recovery varies between 29% and 100%, dependent upon the outcome of that hearing. Again, there will be legal representation for UK authorities.

Regulations issued by the DCLG to enable the deferment of any impairment (write-off) of Icelandic Bank deposits cease on 31 March 2011. Once the outcome of the court hearings are known a better assessment of the final level of impairment required will be possible along with the appropriate measures to finance that impairment.

4 OTHER OPTIONS CONSIDERED IN MAKING RECOMMENDATIONS

Options for management of the City Council's debt and investment portfolio are continually reviewed. The overall aim is to minimise the net revenue costs of our debt whilst maintaining an even debt profile in future years, and to maximise investment returns within stated security and liquidity guidelines.

5 FINANCIAL IMPLICATIONS (INCLUDING VALUE FOR MONEY)

Total treasury management payments comprise interest charges and receipts and provision for repayment of debt. A proportion of the City Council's debt relates to capital expenditure on council housing and this is recharged to the HRA (and funded through the Housing Subsidy system). The remaining costs are included within the treasury management section of the General Fund budget. **Table 3** sets out the budget for 2010/11 and the projected outturn (the actual for 2009/10 is also shown for comparison).

TABLE 3: REVENUE BUDGET POSITION			
DESCRIPTION	**Actual 2009/10** **£m**	**Budget 2010/11** **£m**	**Projected Outturn** **£m**
External interest	23.489	27.739	23.312
Debt repayment provision	12.199	13.940	13.239
Less: HRA recharge	(11.928)	(14.224)	(11.890)
General Fund expenditure	**23.760**	**27.455**	**24.661**
Investment and other interest	(2.600)	(2.157)	(1.376)
Prudential borrowing recharge	(1.502)	(1.607)	(1.584)
Transfer to/from TM reserve	(0.719)	-	-
Net General Fund position	**18.739**	**23.691**	**21.701**

The projected outturn anticipates a saving of £1.990m in 2010/11. These savings have arisen through the active management of the debt and investment portfolios:

- Reduction in external interest costs (net of investment interest), through the use of internal cash for temporary borrowing and repayment of existing debt
- Reduction in the provision for debt repayment through the use of other capital resources and slippage in Capital Programme expenditure.

These savings will be reflected in the revised Medium Term Financial Plan. Opportunities for further savings, through the rescheduling of debt and the improvement of investment returns, will continue to be considered.

6 RISK MANAGEMENT ISSUES (INCLUDING LEGAL IMPLICATIONS, CRIME AND DISORDER ACT IMPLICATIONS AND EQUALITY AND DIVERSITY IMPLICATIONS)

Risk management plays a fundamental role in treasury activities, due to the value and nature of transactions involved. The management of specific treasury management risks is set out in the Manual of Treasury Management Practices and Procedures and a risk register is prepared for the treasury function.

7 EQUALITY IMPACT ASSESSMENT

This report does not include proposals for new or changing policies, services or functions.

8 LIST OF BACKGROUND PAPERS OTHER THAN PUBLISHED WORKS OR THOSE DISCLOSING CONFIDENTIAL OR EXEMPT INFORMATION

PWLB records, working papers

9 PUBLISHED DOCUMENTS REFERRED TO IN COMPILING THIS REPORT

Treasury Management in the Public Services, Code of Practice 2009 – CIPFA
The Prudential Code for Capital Finance in Local Authorities – CIPFA

Appendix 1

ELIGIBLE COUNTERPARTIES FOR INVESTMENT 2010/11				
INSTRUMENT	**COUNTRY**	**COUNTERPARTY**	**MAX. SUM**	**MAX. PERIOD DAYS**
Term deposit / Call account	U.K.	Debt Management Office	No limit	364
		UK local authorities	No limit	364
		Bank of Scotland / Lloyds TSB Bank	£20m	364
		Barclays Bank	£20m	364
		Co-operative Bank (the Council's bank)	No limit	5
		Clydesdale Bank	£20m	31
		HSBC Bank	£20m	364
		Nationwide Building Society	£20m	364
		Royal Bank of Scotland	£20m	364
		Santander UK (Abbey National)	£20m	364
	Australia	Australia & NZ Banking Group	£5m	183
		Commonwealth Bank of Australia	£5m	183
		National Australia Bank Ltd	£5m	183
		Westpac Banking Corporation	£5m	183
	Canada	Bank of Montreal	£5m	183
		Bank of Nova Scotia	£5m	183
		Canadian Imp. Bank of Commerce	£5m	183
		Royal Bank of Canada	£5m	183
		Toronto-Dominion Bank	£5m	183
	Finland	Nordea Bank Finland	£5m	183
	France	BNP Paribas	£5m	183
		Calyon	£5m	183
		Credit Agricole SA	£5m	183
	Germany	Deutsche Bank AG	£5m	183
	Netherlands	Rabobank	£5m	183
SUSPENDED	Spain	Banco Bilbao Vizcaya Argentaria	£5m	183
		Banco Santander SA	£5m	183
	Switzerland	Credit Suisse	£5m	183
	USA	JP Morgan	£5m	183
Money Market Funds		AAA-rated funds (Constant Net Asset Value)	£10m per fund	N/A
Supranational Bonds (>364 days)		European Investment Bank	£20m	1 year

IMPORTANT NOTES:

<u>Credit Rating Definitions</u>

Short Term Ratings

Fitch F1
Highest credit quality, indicating the strongest capacity or timely payment of commitments.

Standard & Poor's A-1
Strong capacity to meet its financial commitments.

Moody's P-1
Offers superior credit quality and a very strong capacity for timely payment of short-term deposit obligations.

Long Term Ratings

Fitch A+
High credit quality. 'A' ratings denote expectations of low credit risk. They indicate strong capacity for payment of financial commitments. The '+' denotes the relative status within the category.

Standard & Poor's A+
An obligor rated 'A' has strong capacity to meet its financial commitments. The '+' denotes the relative status within the category.

Moody's A1
Banks rated A are considered upper-medium grade and are subject to low credit risk. The modifier 1 indicates that the rating is in the higher end of its generic rating category.

<u>Limiting Factors</u>

Co-operative Bank – *the City Council's own bank does not meet the City Council's applied criteria. They are included on the counterparty list, with a maximum period of investment of 5 days, for cash flow purposes.*

Groups *- where more than one institution is included within a banking group, the individual limit will apply to the total investment in that group*

Countries *- a maximum of 10% of the investment portfolio to be invested in any one country (excluding the UK) at the time of investment, with a maximum of 25% of the portfolio, at the time of investment, in non-UK banks in total.*

Money Market Funds *– a limit of £40m in all MMFs is to be applied at all times.*

European Investment Bank bonds– *a maximum period of 1 year*

APPENDIX 2

PRUDENTIAL INDICATORS				
PI	**Statutory Indicators**	**Actual 2009/10**	**2010/11 Approved March 2010**	**2010/11 Revised Approval *(i)***
Prudential indicators of affordability				
P1	Ratio of financing costs to net revenue stream - GF	6.08%	7.88%	**7.88%**
P2	Ratio of financing costs to net revenue stream - HRA	14.52%	15.93%	**15.93%**
P3	Estimates of the incremental impact of new capital investment decisions on Council Tax	+£0.04	+£1.26	**+£1.26**
P4	Estimates of the incremental impact of new capital investment decisions on rents	-	+£0.01	**£+0.01**
P5	Authorised limit for external debt *(ii)*	£552.8m	£748.5m	**£752.3m**
P6	Operational Boundary for external debt *(ii)*	£552.8m	£738.5m	**£742.3m**
Prudential indicators for prudence				
P7	Capital Expenditure - GF	£165.2m	£125.1m	**£144.2m**
P8	Capital Expenditure - HRA	£51.4m	£59.3m	**£61.9m**
P9	Capital Financing Requirement – GF *(ii)*	£316.0m	£405.9m	**£398.9m**
P10	Capital Financing Requirement – HRA *(ii)*	£284.8m	£322.2m	**£323.4m**
P11	External Debt – borrowing & other debt *(ii)*	£539.3m	£718.5m	**£722.3m**

PRUDENTIAL INDICATORS (continued)				
PI	**Statistory Indicators**	**Actual 2009/10**	**2010/11**	
Prudential Indicators for Treasury Management				
P12	Limit on variable interest rates	16.63%	0 – 30%	**0 – 50%**
P13	Limit on fixed interest rates	83.37%	30 – 70%	**50 – 100%**
P14	Fixed debt maturity structure			
	• Under 12 months	7.46%	0 – 20%	**0 – 20%**
	• 12 months to 2 years	5.72%	0 – 20%	**0 – 20%**
	• 2 to 5 years	13.56%	0 – 25%	**0 – 25%**
	• 5 to 10 years	12.97%	0 – 25%	**0 – 25%**
	• 10 to 25 years		0 – 50%	**0 – 50%**
	• 25 to 40 years		0 – 25%	**0 – 25%**
	• 40 years and above		0 – 75%	**0 – 75%**
P15	Sums invested for > 364 days – in house limit	£15m	£40m	**£40m**

i) Only those shaded items are seeking approval for change
ii) Includes notional debt in respect of PFI schemes