Appendix A

Treasury Management Report to 30 September 2010

1. Background

The Treasury Management Strategy for 2010-2011 has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009, 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.

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."

2. Economic Background

The UK continued to emerge from recession but the level of activity remained well below pre-crisis levels. GDP registered 1.2% growth in the in the second calendar quarter of 2010 and 0.8% in the third, taking the annual growth rate to 2.8%. This is the fastest recorded annual growth increase for three years.

The Bank of England's Monetary Policy Committee (MPC) maintained the Bank Rate at 0.5% and Quantitative Easing (QE) at £200bn. The recent GDP data does not take account of the fiscal tightening that is yet to come and growth is expected to slow as the austerity measures bite. The MPC has the option to return to QE in 2011 should circumstances warrant but it isn't a foregone conclusion.

Inflation continued to decline although the annual CPI to September 2010 still stood at 3.1%. This has resulted in two open explanatory letters from the Bank of England's Governor to the Chancellor. In the coming months higher food and fuel prices raise the risk that we may not see inflation come down much more until 2011, and then it will rise back again in January with the increase in VAT to 20%.

The Bank of England's August Quarterly Inflation Report showed inflation remaining above the 2% target for longer than previously projected. Although the recovery in economic activity was expected to continue, the overall outlook for growth was weaker than presented in the May report.

The formation of a coalition government dispelled uncertainty surrounding a hung parliament result in May's General Election. The new government's Emergency Budget laid out tough action to address the UK's budget deficit, aiming to eliminate the structural deficit by 2014/15. This is to be achieved through austerity measures – £32bn of spending cuts and £8bn of net tax increases. Gilts have benefitted from this decisive plan as well as expected reductions in supply for each year of the forecast. The expected level of spending cuts and tax rises looks to be enough to extinguish the recent concern about inflation expectations.

The Comprehensive Spending Review did not directly constitute big fiscal news – the framework and target remain the same as announced in the June Emergency Budget, the CSR was largely about the distribution of the retrenchment in spending. The commitment to achieve cyclically-adjusted current balance and a declining debt-to-GDP ratio by 2015-16 was reaffirmed. Following the CSR Fitch reaffirmed the UK's AAA rating and Standard & Poor's, which had a 'negative' outlook for the long-term rating, changed its outlook back to 'Stable', citing the coalition government's policy objective and political resolve to close the fiscal gap and the administrative capacity to achieve the expenditure control and revenue enhancement. The next big fiscal milestone will be the Office of Budget Responsibility's statement and the Chancellor's response on November 29, which will contain a revised set of macro-economic and fiscal projections, taking into account the Spending Review decision.

The US Federal Reserve (the Fed) kept rates on hold at 0.25% following signs of a slowdown in American growth. At its meeting in September the Fed sent a strong signal that it is prepared to do more and moving closer to a second wave of unconventional monetary easing. The European Central Bank maintained rates at 1%. The major ongoing worries in Europe extended from sovereign weakness in the 'PIIGS' nations (Portugal, Italy, Ireland, Greece and Spain), the exposure of the continent's banking sector to the sovereign and corporate debt of these nations and the risk of contagion extending to other countries. The sovereign ratings of Greece, Ireland, Portugal and Spain were downgraded by the rating agencies.

The results from the EU Bank Stress Tests, co-ordinated by the Committee of European Banking Supervisors, highlighted that only 7 (2 Greek, 1 German and 4 Spanish "caja" banks) of the 91 institutions that made up the scope of the analysis were classed to have failed the adverse scenario tests. The tests are a helpful step forward, but there were doubts if they were far-reaching or demanding enough. The main UK Banks' (Barclays, HSBC, Lloyds and RBS) Tier 1 ratios all remained above 9% under both the 'benchmark scenario' and the 'adverse scenario' stress tests.

Gilts rallied as the growth momentum faded and the UK seemed to offer a safe harbour from Euroland's turbulence. 5- and 10-year gilt yields fells to lows of 1.57% and 2.83% respectively.

3. Debt Management

	Balance on 01/04/2010 £000s	**Debt Repaid £000s**	**New Borrowing £000s**	**Balance on 30/09/2010 £000s**	**Increase/ Decrease in Borrowing**
Short Term Borrowing	5,006	25,500	20,500	6	(5,000)
Long Term Borrowing	156,253	0	0	156,253	0
Total Borrowing	161,259	25,500	20,500	156,253	(5,000)

The Council's Capital Financing Requirement (CFR) represents the authority's underlying need to borrow for capital purposes. At the beginning of this financial year, the Council's CFR as at 31/3/2011 was estimated at £192.5m. The Council has not borrowed up to the level of the CFR. The use of internal resources in lieu of borrowing has been the most cost effective means of financing of capital expenditure. This has lowered overall treasury risk by reducing both external debt and temporary investments. However, this position will not be sustainable over the medium term and the Council expects it will need to borrow to support its capital commitments that are due to be agreed in November when Executive consider the Capital Programme Review.

The PWLB remains the Council's preferred source of borrowing given the transparency and control that its facilities continue to provide.

£35.6m of PWLB fixed rate loans at an average rate of 4.73% was rescheduled last year into variable rate loans at an average rate of 0.7% which mitigate the impact of changes in variable rates on the Council's overall treasury portfolio (the Council's investments are deemed to be variable rate investments due to their short-term nature). Variable rate borrowing is expected to remain attractive for some time as the Bank of England maintains the base rate at historically low levels. This strategic exposure to variable interest rates will be regularly reviewed and, if appropriate, reduced by switching into fixed rate loans.

The Debt rescheduling concentrated on repaying longer term loans at over 4% to take advantage of the significant fall in shorter term interest rates. This has generated revenue savings of £721k (£671k after premium write off) in the current year to the end of September.

Rescheduling activity complies with the accounting requirements of the Local Authority Accounting Code of Practice and regulatory requirements of the Capital Finance and Accounting Regulations (SI 2007 No 573 as amended by SI 2008/414).

4. Investment Activity

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.

Investments

	Balance on 01/04/2010 £000s (a)	Investments Made £000s (b)	Investments Repaid £000s (c)	Balance on 30/09/2010 £000s (a+b-c)=d	Increase/ Decrease in Investments (b-a)
Short Term Investments	59,350	291,320	289,970	60,700	1,350
Long Term Investments	0	0	0	0	0

Investments in Pooled Funds-Lime fund	4,530	0	0	4,567	37*
Funds Managed Externally on segregated basis:- Investec	5,749	0	0	5,777	28**
Total Investments	69,629	291,320	289,970	71,044	1,415

* Units valued at market value
** valued at Total market value plus any interest rec'd – reinvested

The investments in the table above include day-to-day balances which arise from cashflow timing differences between receipts and payments.

The UK Bank Rate has been maintained at 0.5% since March 2009. Short-term money market rates have remained at very low levels. Despite this new deposits for periods up to one year have been made between 0.96% -2.1%.

For internally managed funds the council has been able to able to obtain a rate of return over its set benchmark of 3 month LIBID (currently 0.63%), the Council's average rate of return being 1.55%

<u>Externally Managed Funds:</u>

The Council's Investment Property Fund, the Lime fund has increase in value in the first half of the year by £37k in capital Currently it is valued at £4,567k and the first quarterly return generated a return of 5.5% before fees and 4.8% after fees.

Our externally managed funds with Investec have not performed as well, currently they are achieving a return of 1.22% before fees and 1.01% after fees. The Council is currently exploring ways in which the fund can be restructured with its advisers, Arlingclose.

Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2010/11. This restricted new investments to the following:

- the Debt Management Office
- Other Local Authorities
- AAA-rated Stable Net Asset Value Money Market Funds
- Deposits with UK Banks and Building Societies systemically important to the UK banking system and deposits with select non-UK Banks (Australia, Canada,

Finland, France, Germany, Netherlands, Spain, Switzerland and the US). Counterparty credit quality is assessed and monitored with reference to: Credit Ratings (Council's minimum long-term counterparty rating of A+ across all three 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.

- Bonds issued by Multilateral Development Banks, such as the European Investment Bank

- Pooled funds (collective investment schemes) meeting the criteria in SI 2004 No 534 and subsequent amendments.

Counterparty Update

Following the challenging economic conditions facing Spain, the fiscal challenges ahead for the country, concerns over the effect of rising debt funding costs, and the downgrade of Spain's sovereign rating to AA by Standard and Poor's, the Council has suspended deposits with Spanish banks in Q1 2010 (BBVA and Banco Santander).

5. Compliance with Prudential Indicators

The Council can confirm that it has complied with its Prudential Indicators for 2010/11, which were set in 25th February 2010 as part of the Council's Treasury Management Strategy Statement. These are outlined in the Annex A to the report.

6. Outlook for Q3-Q4

At the time of writing this activity report in September 2010, the outlook for interest rates was as follows:

	Dec 200	Mar 2011	Jun 2011	Sep 2011	Dec 2011	Mar 2012	Jun 2012	Sep 2012	Dec 2012	Mar 2013
Official Bank Rate										
Upside risk	0	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	0.75	1.00	1.25	1.50	2.00	2.50	2.75
Downside risk	0	0	0	-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50

- The recovery in growth is likely to be slow, uneven and more "Square root" than "V" shaped.
- The path of base rates reflects the fragility of the recovery and the significantly greater fiscal tightening of the emergency budget. With growth and underlying

inflation likely to remain subdued, the Bank will stick to its lower for longer stance on policy rates.

- Gilts will remain volatile as the growth versus headline inflation debate escalates.
- The negative outlook (S&P) for the UK will remain until the plans to cut the deficit have been formulated in the CSR.

7. Summary

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 second quarter of 2010/11. As indicated in this report none of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

8. Other Information

CLG Investment Guidance – The revised guidance came into effect on 1st April 2010. The guidance reiterated the need to focus on security and liquidity, rather than yield. It also recommended that strategies include details of assessing credit risk, reasons for borrowing in advance of need and the use of treasury advisers.

Reform of Council Housing Finance –The consultation deadline was 6th July 2010. It has been confirmed that the reforms will go ahead as they have received cross-party support. Although most of the detail around this hasn't been finalised the consultation proposes the removal of the subsidy system by offering a one-off reallocation of debt, with a compulsory uptake by 2012/13.

In the Consultation the PwC self-financing model provides an indicative sustainable level of opening housing debt, which took into account Rental Income, Management and Maintenance cost and MRA (major repair allowance). As the Council's debt level generated by the model is higher than the Subsidy Capital Financing Requirement (SCFR), the Council will be required to pay the CLG the difference between the two, which is an one off payment of approximately £152m, all future payment to the CLG for HRA subsidy will then cease

The Council will fund this amount in the medium term through internal resources and/or external borrowing. The Council has the option of borrowing from the PWLB or the market. The type of loans taken will be decided on in discussions with the Housing department and the councils' Treasury Advisors.

PWLB Intraday Rate Setting – On 26th April 2010 the PWLB introduced twice daily rate settings at 9:30 and 12:30. It is intended that the intra-daily re-sets should result in a reduction in the differential between the borrowing premature redemption rates. This was set out in Circular 143. It was also announced that the DMO/PWLB plans to increase the number of regular intra-daily re-sets to three times a day in the near future. A further announcement on this is expected in due course.

Annex A

Prudential Indicator Compliance

(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.

- The Council's Affordable Borrowing Limit was set at £221m for 2010/11.

- 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.

- The Operational Boundary for 2010/11 was set at £211m.

- There were no breaches to the Authorised Limit and the Operational Boundary during the period to 30/09/10; borrowing at its peak was £169.3m.

(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 2010/11 %
Upper Limit for Fixed Rate Exposure	100%
Compliance with Limits:	Yes
Upper Limit for Variable Rate Exposure	35%
Compliance with Limits:	Yes

(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. The maturity of the Councils borrowing is profiled in order that no more than 20% matures in any one Financial year.

Maturity Structure of Fixed Rate Borrowing	Actual £000's Fixed Rate Borrowing as at 30/09/10	% Fixed Rate Borrowing as at 30/09/10	Compliance with Set Limits?
under 12 months	6	0.00	Yes
12 months and within 24 months	651	0.42	Yes
24 months and within 5 years	28,973	18.54	Yes
5 years and within 10 years	16,060	10.28	Yes
10 years and within 15 years	12,734	8.15	Yes
15 years and within 20 years	19,398	12.41	Yes
20 years and within 25 years	2,522	1.61	Yes
25 years and within 30 years	0	0.00	Yes
30 years and above	75,916	48.58	Yes

(d) 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 2010/11 was set at £20m.

- The Council's policy response since the onset of the credit crunch in 2007 was to keep investment maturities to a maximum of 12 months. No investments were made for a period greater than 364 days during this period.

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

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	5-yr SWAP Bid
01/04/10	0.50	0.35	0.35	0.42	0.51	0.81	1.26	2.82
30/04/10	0.50	0.30	0.30	0.43	0.53	0.83	1.29	2.95
31/05/10	0.50	0.45	0.50	0.61	0.60	0.85	1.35	2.58
30/06/10	0.50	0.35	0.35	0.45	0.61	0.94	1.38	2.42
31/07/10	0.50	0.40	0.40	0.50	0.71	1.01	1.46	2.39
31/08/10	0.50	0.40	0.55	0.50	0.71	1.00	1.45	2.02
30/09/09	0.50	0.30	0.25	0.51	0.72	1.01	1.46	2.05
Minimum	0.50	0.30	0.25	0.42	0.51	0.81	1.26	2.02
Average	**0.50**	**0.36**	**0.39**	**0.49**	**0.63**	**0.92**	**1.38**	**2.46**
Maximum	0.50	0.45	0.55	0.61	0.72	1.01	1.46	2.95
Spread		0.15	0.30	0.19	0.21	0.20	0.20	0.94

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
01/04/10	064/10	0.81	2.84	4.14	4.21	4.60	4.61	4.63
30/04/10 09:15	088/10	0.85	2.86	4.13	4.20	4.60	4.60	4.59
30/04/10 12:15	089/10	0.85	2.86	4.13	4.20	4.61	4.61	4.60
28/05/10 09:16	126/10	0.72	2.45	3.75	3.82	4.35	4.36	4.36
28/05/10 12:15	127/10	0.73	2.46	3.76	3.83	4.36	4.38	4.38
30/06/10 09:17	170/10	0.70	2.3	3.57	3.65	4.26	4.32	4.32
30/06/10 12:16	171/10	0.67	2.27	3.54	3.62	4.22	4.28	4.27
30/07/10 09:15	216/10	0.71	2.32	3.58	3.65	4.35	4.43	4.43
30/07/10 12:16	217/10	0.70	2.29	3.55	3.62	4.32	4.41	4.40
31/08/10 09:16	258/10	0.64	1.84	3.06	3.14	3.83	3.94	3.95
31/08/10 12:15	259/10	0.63	1.84	3.05	3.13	3.82	3.93	3.93
30/09/10 09:15	302/10	0.64	1.88	3.14	3.22	3.86	3.99	4.02
	Low	0.63	1.84	3.05	3.13	3.82	3.93	3.93
	Average	**0.72**	**2.35**	**3.62**	**3.69**	**4.27**	**4.32**	**4.32**
	High	0.85	2.86	4.14	4.21	4.61	4.61	4.63

PWLB Repayment 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
01/04/10	064/10	0.56	2.38	3.82	4.35	4.36	4.26	4.19
30/04/10 09:15	088/10	0.62	2.43	3.83	4.37	4.37	4.32	4.29
30/04/10 12:15	089/10	0.62	2.43	3.83	4.37	4.38	4.33	4.30
28/05/10 09:16	126/10	0.49	2.02	3.43	4.11	4.13	4.09	4.08
28/05/10 12:15	127/10	0.50	2.04	3.44	4.12	4.15	4.11	4.10
30/06/10 09:17	170/10	0.47	1.89	3.26	4.02	4.09	4.05	4.02
30/06/10 12:16	171/10	0.44	1.86	3.23	3.98	4.05	4.00	3.97
30/07/10 09:15	216/10	0.48	1.91	3.26	4.11	4.20	4.15	4.12
30/07/2010 12:16	217/10	0.47	1.88	3.23	4.08	4.18	4.13	4.10
31/08/10 09:16	258/10	0.41	1.46	2.74	3.58	3.71	3.67	3.63
31/08/10 12:15	259/10	0.40	1.45	2.73	3.57	3.70	3.66	3.62
30/09/10 09:15	302/10	0.41	1.48	2.82	3.62	3.76	3.75	3.72
	Low	0.40	1.45	2.73	3.57	3.70	3.66	3.62
	Average	**0.49**	**1.94**	**3.30**	**4.02**	**4.09**	**4.04**	**4.01**
	High	0.62	2.43	3.83	4.37	4.38	4.33	4.30

PWLB Variable Rates

	1-M Rate	3-M Rate	6-M Rate
01-04-2010	0.6500	0.6500	0.7000
30-04-2010	0.6500	0.6500	0.7000
31-05-2010	0.6500	0.6500	0.7000
30-06-2010	0.6500	0.7000	0.7000
31-07-2010	0.6500	0.7000	0.7000
31-08-2010	0.6500	0.6500	0.7000
30-09-2010	0.6500	0.7000	0.7000
Minimum	0.6500	0.6500	0.7000
Average	**0.6500**	**0.6714**	**0.7000**
Maximum	0.6500	0.7000	0.7000