Meeting	Cabinet Resources Committee
Date	18 October 2012
Subject	**Treasury Management Outturn for Quarter Ended 30 June 2012**
Report of	Cabinet Member for Resources and Performance
Summary	To report on Treasury Management activity for quarter ended 30 June 2012.

Officer Contributors	John Hooton – Assistant Director of Strategic Finance Iain Millar – Head of Treasury and Pensions
Status (public or exempt)	Public
Wards Affected	N/A
Key Decision	No
Reason for urgency / exemption from call-in	Cabinet Resources Committee
Function of	Executive
Enclosures	Appendix A – Money Market and PWLB Rates Appendix B – Deposits as at 30 June 2012 with Credit Ratings Appendix C – Compliance with Prudential Indicators
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1 RECOMMENDATIONS

1.1 That the Treasury Management activity and position for the first quarter ended 30 June 2012 be noted.

1.2 That the Committee notes the Council's response to continuing market uncertainty which is set out in sections 9.1.4 and 9.5.

2. RELEVANT PREVIOUS DECISIONS

2.1 Cabinet Resources Committee 28 February 2012 (Decision item 10) Treasury Management Outturn for the quarter ended 30 June 2012.

2.2 Council 6 March 2012, (Decision item 10) – Treasury Management Strategy 2012/13.

2.3 Cabinet Resources Committee 20 June 2012 (Decision item 10) Treasury Management Outturn for the year ended 31 March 2012.

3. CORPORATE PRIORITIES AND POLICY CONSIDERATIONS

3.1 The Treasury Management Strategy (TMS) ensures effective treasury management supports the achievement of the Council's corporate priority for 2012-2013, 'Better services with less money', through the strategic objective "manage resources and assets effectively and sustainably across the public sector in Barnet". The TMS is committed to the principles of achieving value for money in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

4. RISK MANAGEMENT ISSUES

4.1 Borrowing and deposit rates are determined by the market and can be volatile at times. Officers mitigate this volatility by monitoring the interest rate market in conjunction with treasury advisors and brokers, and by actively managing the debt and deposit portfolios.

5. EQUALITIES AND DIVERSITY ISSUES

5.1 Under the Equality Act 2010, the council must have due regard to the need to: a) eliminate discrimination, harassment, victimisation and any other conduct that is prohibited by or under the Act; b) advance equality of opportunity between those with a protected characteristic and those without; c) promote good relations between those with a protected characteristic and those without. The 'protected characteristics' referred to are: age; disability; gender reassignment;

pregnancy and maternity, race, religion or belief; sex; sexual orientation. It also covers marriage and civil partnership with regard to eliminating discrimination.

5.2 The management of the Council's cash flow ensures the availability of adequate monies to pay for the delivery of the authority's public duties.

6. USE OF RESOURCES IMPLICATIONS (Finance, Procurement, Performance and Value for Money, Staffing, IT, Property, Sustainability)

6.1 The purpose of the treasury function is to maximise the Council's budget for investment return and minimise interest costs in accordance with the risk strategy set out in the TMS.

6.2 The total value of long term loans as at 30 June 2012 was £304.08m. The average cost of borrowing was 3.89%. New borrowing of £102.58m was taken on 28th March 2012 to finance the Council Housing reform settlement at an average cost of 3.36%. No new borrowing was taken during the first quarter.

6.3 At 30 June 2012, deposits outstanding amounted to £209.0m (including £3.144m of Icelandic impairments), achieving an average rate of return of 0.74% (adjusted for Icelandic deposits) against a benchmark of 0.59%. A list of deposits outstanding and counterparty credit ratings as at quarter end 30 June 2012 is attached as Appendix B.

6.4 In response to market uncertainty the Council has further restricted its investment criteria which impacted on investment performance as short term money market rates remained at low levels through out the year.

6.5 The wider financial implications for the Council are dealt with in section 9 of this report.

7. LEGAL ISSUES

7.1 The Council is under a fiduciary duty to the taxpayer, to ensure that public funds and assets are managed in a prudent manner. The monitoring of treasury management activity would ensure that the Council meets its fiduciary duty to the taxpayer as far as the management of funds is concerned. Other legal issues are addressed in the body of this report.

8. CONSTITUTIONAL POWERS

8.1 Financial Regulations (Part 1, Section 7) within the Council Constitution state:

(1) This organisation adopts the key recommendations of CIPFA's Treasury Management in the Public Services Code of Practice (the Code), as described in Section 4 of that Code.

(2) Cabinet Resources Committee will create and maintain a Treasury Management Policy Statement, stating the policies and objectives of its treasury management activities.

(3) The Chief Finance Officer will create and maintain suitable Treasury Management Practices (TMP's) setting out the manner in which the Authority will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

(4) The content of the policy statement and TMP's will predominantly follow the recommendations contained in Section 6 and 7 of the Code, subject only to amendment where necessary to reflect the particular circumstances of the organisation. Such amendments will not result in the authority materially deviating from the Code's key recommendations.

(5) Cabinet Resources Committee will receive reports on its treasury management policies, practices and activities, including an annual strategy and plan in advance of the year, and an annual report after its close in the form prescribed in the TMP's. These reports will incorporate the prudential borrowing limits and performance indicators.

8.2 Constitution - Responsibilities for Functions, Section 3.6 states that a function of the Cabinet Resources Committee is to "consider reports on Treasury Management Strategy and activity, including creating and maintaining a Treasury Management Policy Statement."

9. BACKGROUND INFORMATION

9.1 Treasury Management Strategy

9.1.1 The Council's timeframes and credit criteria for placing cash deposits and the parameters for undertaking any further borrowing are set out in the Treasury Management Strategy (TMS).

9.1.2 The TMS 2012/13 was approved by Cabinet on 20 February 2012 and by Council on 6 March 2012.

9.1.3 The TMS is under constant review to reflect market conditions and the financing requirements of the Council. The Council's treasury advisers, Arlingclose, have recommended reducing maximum duration for new investments from 365 days to 3 months for approved UK, Australian, Canadian and US banks and no new investment In European banks. The following points relate to the operational overlay being applied to the Council's strategy:

i) Given current market uncertainty, officers have followed an even more cautious strategy than has been recommended by Arlingclose for new investments. The Council's investments are temporarily restricted to 14 days duration. Any investment proposed beyond 14 days must be approved by the Deputy Chief Executive.;

ii) Tightening counterparty criteria. Treasury Officers are restricted to investing only with UK, Canadian and Australian institutions who meet the required minimum credit rating in accordance with the treasury management strategy;

iii) Since October 2011, Money Market Funds(MMF) have been used cash investments in highly liquid financial instruments with the highest credit rating Arlingclose have recommended that MMF investments are restricted to 10% of the Council's total cash (previously 15%), in any one MMF. Investments must be diversified between a minimum of two funds and exposure limited to 0.5% of each MMF's total funds under management. These deposits have high credit ratings and are highly liquid, but due to general concerns within markets, the Council has reduced its overall exposure to this class of deposit to £17 million in total split between two funds; and

iv) The Debt Management Office will be used when other permitted counterparties reach their group investment limits.

9.1.4 The 2012-2013 TMS counterparty criteria was amended to allow investment with UK banks which have systemic importance to the global banking system. This allows new investment with the main UK clearing banks which had previously been removed from the counterparty list because of their credit rating downgrading. Investment continues to be subject to an operational overlay to manage credit risk. There are limits on investment duration and the counterparty list is restricted to the key banks and subject to regular review.

9.1.5 Restrictions on duration of investment and exclusions from the counterparty list are expected to be a temporary measure. This report therefore asks the Committee to note the continued cautious approach to the current investment strategy.

9.2 Icelandic Bank Deposits

9.2.1 On 28 October 2011, the Supreme Court of Iceland upheld the District Court judgment for the test cases that local authorities' claims are deposits that qualify in full for priority in the bank administrations. Securing priority creditor status means that authorities with deposits in Glitnir are set to recover 100 per cent of their money, whilst those with deposits in Landisbanki are estimated to recover 94.8 per cent. These decisions are now final and there is no further right of appeal.

9.2.2. The Council has impaired £3.133 million in its accounts against Icelandic Bank losses. The latest indications are that the Council will recover an amount in excess of the principal deposited in Iceland. Most of the recoverable deposits and interest due will be paid from escrow accounts in Icelandic and Norwegian Kroner, Euros, and US Dollars. Fluctuations in currency rates against sterling since 2009 is likely to result in a potential shortfall on the deposits and interest expected to be returned to the Council. The potential shortfall can be met from within the existing risk reserve. To date the Council has received £10.97 from the Glitnir Winding- up Board with a further £2.5 million held in escrow. For Landsbanki, the partial distribution is £6.8 million .A further £9.3 million is due to the Council with further partial distributions expected each year until 2018 as and when the administrators realise assets.

9.3 Economic Background

9.3.1 **Growth:** UK GDP contracted by 0.3% in the first calendar quarter of 2012 and by 0.4% in the second quarter though much of second quarter fall could be attributed to the additional bank holiday for the Diamond Jubilee and the US economy grew slowly, 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.

9.3.2 **Inflation:** Inflation 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.

9.3.3 **Employment / Consumer Confidence:** 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.

9.3.4 **Monetary Policy:** The lack of growth and the fall in inflation were persuasive enough for the Bank of England to sanction £50 billion asset purchases (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 will not be considered 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.

9.3.5 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

9.3.6 The European Central Bank lowered its deposit rate to 0% from 0.25% to encourage banks to provide credit into the Euro economy rather than keeping balances in the central bank's overnight deposit facility. Bank's funding costs remained high not least due to the capital requirements imposed by regulators. Banks were embroiled in the scandal to manipulate LIBOR rates during the abnormal trading conditions at the height of the 2007-2008 crises.

9.3.7 In Greece the formation of a pro euro alliance after a second election, avoided an exit from the Euro. The Region suffered further stress when Italian and Spanish government borrowing costs rose sharply and Spain was also forced to seek a bailout for its domestic banks. The European Central Bank 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.

9.3.8 **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).

9.3.9 Money market rates fell over the period by between 0.2% to 0.6% for 1-12 month maturities. Continued low gilt yields during the quarter means that Public Works Loan Board (PWLB) borrowing rates remain at close to historically low rates PWLB remained an attractive source of borrowing though the use of internal resources in lieu of borrowing continues to be the most effective means of funding capital expenditure for the Council. The TMS will be kept under review specifically in terms of market conditions, benchmarks and yield.

9.4 Debt Management

9.4.1 The total value of long term loans as at 30 June 2012 was £304.08m. There has been no external borrowing in the financial year to date. The average total cost of borrowing for the quarter ending 30 June 2012 was 3.89%.

9.4.2 Given the significant cuts to local government funding putting pressure on Council finances, the decision was taken to minimise debt interest payments without compromising the longer-term stability of the portfolio. The differential between the cost of new longer-term debt and the return generated on the Council's temporary investment returns was significant (just over 3%). The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding capital expenditure. This has, for the time being, lowered overall treasury risk by reducing both external debt and temporary investments. The latest advice from Arlingclose is that there is no benefit from taking new long term debt while borrowing costs are forecast to remain at current levels.

9.4.3 The Council's long term debt position to the end of the quarter ended 30 June 2012 was as follows:

	31 March 2012		30 June 2012	
	Principal	Principal	Principal	Average Rate
PWLB Market	£139.00m £ 62.50m	£139.00m £ 62.50m	£139.00m £ 62.50m	4.19% 3.91%
Total	£201.50m	£201.50m	£201.50m	4.10%
PWLB HRA self-financing	£102.58m	£102.58m	£102.58m	3.36%
Total	£304.08m	£304.08m	£304.08m	3.89%

9.4.4 The Council's long-term debt portfolio is a mixture of PWLB and market loans in the form of Lender's Option Borrower's Option, (LOBO's) loans that are at a fixed interest rate for an initial period, following which the lender can change the interest rate but the borrower has the option to repay the loan if the rate is changed and not considered value for money.

9.4.5 In order to comply with accounting standards for financial instruments, some of the market loans in the debt portfolio have been recalculated on an effective interest rate basis as opposed to being calculated on an amortised cost basis. The total value of loans in question before remeasurement was £9.5m; an additional charge of £0.36m was added to the carrying value of these loans.

9.4.6 Money Market data and PWLB rates are attached at Appendix A.

9.4.7 PWLB Borrowing: Despite the issue of Circular 147 in October 2010, where new borrowing rates for fixed loans increased by approximately 0.87% across all maturities, the PWLB remains the preferred source of borrowing for the Council as it offers flexibility and control.

9.4.8 Alternative Sources: The decision to offer a reduced PWLB rate is cheaper than the forecast costs of borrowing from capital markets.

9.5 Investment Performance

9.5.1 The DCLG's revised Investment Guidance came into effect on 1 April 2010 and reiterated the need to focus on security and liquidity, rather than yield. Security of capital remained the Authority's main investment objective. This was maintained by following and complying with the counterparty policy as out in the TMS 2012/13.

9.5.2 Counterparty credit quality was 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; Gross Domestic Product (GDP) of the country in which the institution operates; the country's net debt as a percentage of GDP; any potential support mechanisms and share price.

9.5.3 Deposits are managed internally. At 30 June 2012, deposits outstanding amounted to £209m, (£3.144m being Icelandic impairments)), achieving an average rate of return of 0.74% (adjusted for Icelandic deposits) against a benchmark of 0.59%. Four Icelandic deposits totalling £27.4m (but partially repaid) are outside the TMS as approved on 6 March 2012. A list of deposits outstanding and counterparty credit ratings as at quarter end 31 December 2011 is attached as Appendix B.

9.5.4 The benchmark is the average 7-day LIBID rate is provided by the authority's treasury advisors Arlingclose. The LIBID rate or London Interbank Bid Rate is the rate that a Euromarket bank is willing to pay to attract a deposit from another Euromarket bank in London.

9.6 Prudential Indicators

9.6.1 The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of its indebted status. This is a statutory limit which should not be breached. The Council's Authorised Limit (also known as the Affordable Borrowing Limit) was set and approved at £465.248 million.

9.6.2 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 with the Authorised Limit. The Council's Operational Boundary for 2012/2013 was set and approved at £450.218million

9.6.3 During the quarter end to 30 June 2012 there were no breaches of the Authorised Limit and the Operational Boundary.

9.6.4 Further details of compliance with prudential indicators are contained in Appendix C.

9.7 Compliance

9.7.1 The current 2012/2013 TMS was approved by Council on 6 March 2012. The TMS demands regular compliance reporting to this Committee to include an analysis of deposits made during the review period. This also reflects good practice and will serve to reassure this Committee that all current deposits for investment are in line with agreed principles as contained within the corporate TMS.

9.7.3 All Deposits placed during the quarter ended 30 June 2012 were compliant with the TMS as approved on 6 March 2012.

9.7.4 Treasury management procedures are monitored and reviewed in light of CIFPA guidance and current market conditions.

9.8. Outlook for Q3 2012

9.9.1 Financial markets continue to remain extremely nervous and are suffering from extreme changes in sentiment. economic growth remains elusive. Tight credit conditions and weak earnings growth are constraining consumer and corporate spending. The outlook is for official interest 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

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 quarter of the financial year 2011/12. As indicated earlier 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 being given to security and liquidity over yield.

The proposed changes to counterparty credit criteria are set out in the 2012-2013 Treasury Management Strategy.

11. LIST OF BACKGROUND PAPERS

11.1 None.

Cleared by Finance (Officer's initials)	**MC**
Cleared by Legal (Officer's initials)	**TE**