CABINET
11 JANUARY 2011

ITEM NO. ....

MID YEAR PRUDENTIAL INDICATORS AND TREASURY MANAGEMENT MONITORING REPORT

Responsible Cabinet Member - Councillor Chris McEwan, Efficiency and Resources Portfolio

Responsible Director - Paul Wildsmith, Director of Resources

SUMMARY REPORT

Purpose of the Report

1. This report seeks approval of revised Prudential Indicators and provides a half-yearly review of the Council's borrowing and investment activities. Cabinet are requested to forward the revised indicators to Council for their approval and note changes to MTFP with regard to the Treasury Management Budget.

Summary

2. This report and the prudential indicators contained in it were examined by Audit Committee on 17th December 2010 and it was agreed at that meeting that the report be referred to Council via Cabinet to enable the updated indicators to be approved and that Cabinet be advised that Audit Committee is satisfied with the Councils borrowing and investment activities and the reported indicators.

3. The mandatory Prudential Code, which governs Council's borrowing, requires Council approvals of controls, called Prudential Indicators, relating to capital spending and borrowing. Prudential Indicators are set in three statutory annual reports. This mid year update follows Council's approval in February 2010 of the 2010/11 Prudential Indicators and Treasury Management Strategy.

4. The key objectives of the three annual reports are:

   (a) to ensure that governance of the large amounts of public money under the Council's Treasury Management activities,:
      (i) complies with legislation
      (ii) meets high standards set out in codes of practice
   (b) to ensure that borrowing is affordable,
   (c) to report performance of the key activities of borrowing and investments.

5. The key proposed revisions to Prudential Indicators relate to:

   (a) lower capital expenditure in 2010/11 mainly due to reduced government grants

(b) lower expected borrowing during 2010/11 due to increased reliance on internal borrowing i.e. use of cashflow, although additional borrowing of £10M may take place before the end of 2010/11.

Recommendation

6. It is recommended that :-

   (a) The Treasury Management half yearly review is noted.

   (b) That this report is forwarded to Council for approval of the updated prudential indicators within table 2 to 17

Reasons

7. The recommendations are supported by the following reasons :-

   (a) In order to comply with the Prudential Code for Capital Finance in Local Authorities.

   (b) To inform Members of the performance of the Treasury Management function.

   (c) To comply with the requirements of the Local Government Act 2003.

   (d) To enable further improvements to be made in the Council's Treasury Management Function.

Paul Wildsmith
Director of Resources

Background Papers

1. Capital Medium Term Financial Plan 2010/11
2. Accounting records
3. The Prudential Code for Capital Finance in Local Authorities

Elaine Hufford: Extension 2447

S17 Crime and Disorder	This report has no implications for S17 Crime and Disorder.
Health and Well Being	This report has no implications for the Council's Health and Well Being agenda.
Carbon Impact	This report has no impact on the Council's Carbon Emissions.
Diversity	This report has no implications for the Council's Sustainability agenda.
Wards Affected	All Wards.
Groups Affected	All Groups.
Budget and Policy Framework	This report must be considered by Council.
Key Decision	This is a key decision.
Urgent Decision	For the purposes of call in this report is not an urgent decision.
One Darlington: Perfectly Placed	This report has no particular implications for the Sustainable Community Strategy.
Efficiency	This report refers to actions taken to reduce costs and manage risks.

MAIN REPORT

Information and Analysis

8. Revisions to the regulatory framework of treasury management during 2009 introduced a requirement that the Council receive a mid-year review, in addition to the forward looking annual treasury management strategy and backward looking annual treasury management report previously required.

9. This report meets that requirement. It also incorporates the needs of the Prudential Code to ensure monitoring of the capital expenditure plans and the Council's prudential indicators (PIs). The treasury strategy and PIs were previously reported to Council on 25th February 2010.

10. This report concentrates on the revised positions for 2010/11. Future years' indicators will be revised when the impact of the MFTP for 2011/12 onwards is known.

11. A summary of the revised headline indicators for 2010/11 is presented in **Table 1** below. More detailed explanations of each indicator and any proposed changes are contained in the report. The revised indicators reflect the approved movement in the Capital MTFP since its inception in February 2010 and the means by which it is financed.

Table 1 Headline Indicators

	2010/11 Original Estimate	2010/11 Revised Estimate
	£M	£M
Capital Expenditure	70.278	42.962
Capital Financing Requirement	147.639	146.429
Operational Boundary for external debt	122.799	116.048
Authorised Limit for External debt	135.079	126.717
Ratio of Financing Costs to net revenue stream – General Fund	4.70%	4.76%
Ration of Financing costs to net revenue stream - HRA	12.47%	7.03%

12. The capital expenditure plans and prudential indicators for capital expenditure are set out initially, as these provide the framework for the subsequent treasury management activity. The actual treasury management activity follows the capital framework and the position against the treasury management indicators is shown at the end.

13. The underlying purpose of the report supports the objective in the revised CIPFA Code of Practice on Treasury Management and the Communities and Local Government Investment Guidance which state that Members receive and adequately scrutinise the treasury management service.

14. The underlying economic environment remains difficult for Councils, concerns over counterparty risk are improving but still challenging. This background encourages the Council to continue investing over the short term ie up to 1 year and with high quality UK counterparties. The downside of this policy is that investment returns remain low.

Key Prudential Indicators

15. This part of the report is structured to update

    (a) The Council's capital expenditure plans;
    (b) How these plans are being financed;
    (c) The impact of the changes in the capital expenditure plans on the PI's and the underlying need to borrow;
    (d) Compliance with the limits in place for borrowing activity; and
    (e) The revised financing costs budget for 2010/11.

Capital Expenditure PI

16. **Table 2** shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the budget.

Table 2

Capital Expenditure by Service	2010/11 Original Estimate	2010/11 Revised Estimate
	£M	£M
General Fund	56.089	28.873
HRA	14.189	14.089
Total	**70.278**	**42.962**

17. The changes to the 2010/11 capital expenditure estimates have been notified to Cabinet as part of the Capital Budget Monitoring process.

18. The main changes are

    (a) The original Prudential Indicators assumed that the majority of the capital funding secured for 2010/11would be expended in that year. It was expected that £25.598M would slip into future years however this increased to £43.975M as approved schemes included in 2009/10 were actually for future years.

    (b) The approved programme for 2010/11 has reduced due to cuts in grants.

    (c) It is expected that £12.100M of the approved Capital budget for 2010/11 will slip into future years.

    (d) A full reconciliation of the changes in capital expenditure for 2010/11 is attached at **Appendix 1**

Impact of Capital Expenditure Plans

Changes to the financing of the Capital Programme

19. **Table 3** below draws together the main strategy elements of the capital expenditure plans shown above, highlighting the original supported and unsupported elements of the capital

programme, and the expected financing arrangements of this capital expenditure. The borrowing element (Borrowing Need) 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.

Table 3

Capital Expenditure	2010/11 Original Estimate	2010/11 Revised Estimate
	£M	£M
Supported	58.820	30.603
Unsupported	11.458	12.359
Total Spend	70.278	42.962
Financed by		
Capital receipts	1.350	0.621
Capital grants	53.627	24.246
Capital contributions	0.702	2.134
Revenue	1.971	2.573
Total Financing	57.650	29.574
Borrowing Need	12.628	13.388

Changes to the Capital Financing Requirement (PI), External Debt (PI) and the operational Boundary (PI)

20. **Table 4** shows the Capital Financing Requirement (CFR), which is the underlying external need to borrow for capital purposes. It shows the expected debt position over the period. This is called the Operational Boundary

Prudential Indicator -External Debt / the Operational Boundary

Table 4

	2010/11 Original Estimate £M	2010/11 Revised Estimate £M
Prudential Indicator – Capital Financing Requirement		
CFR- General Fund	106.748	109.665
CFR - Housing	40.891	36.764
Total CFR	147.639	146.429
Net movement in CFR	7.094	10.399
Prudential Indicator – External Debt/ the Operational Boundary		
Borrowing	97.860	91.000
Other long term liabilities *	24.939	25.048
Total Debt 31 March	**122.799**	**116.048**

Prudential Indicator – Capital Financing Requirement

21. The CFR has increased for General Fund this is largely due to an increase finance leases (£2.500M) which will be brought on to the balance sheet under the new International

Financial Reporting Standards (IFRS)in the same way that the Private Finance Initiative (PFI) came on to the balance sheet during 2009/10.

22. The reduction in Housing CFR relates to the new profile of spend for the housing capital programme.

Limits to Borrowing activity

23. 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 capital purposes. Net borrowing should not, except in the short term exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2010/11 and the next two financial years. As shown in table 5 below. This allows some flexibility for early borrowing for future years.

Table 5

	2010/11 Original Estimate £M	2010/11 Revised Estimate £M	2011/12 Original Estimate £M	2012/13 Original Estimate £M
Gross borrowing	95.860	91.000		
Plus Other Long Term Liabilities*	24.939	24.198		
Less investments	-25.000	-15.000		
Net borrowing	95.799	100.198		
CFR* (year end position)	147.639	146.429	146.700	142.909

*Includes on balance sheet PFI schemes and finance leases

24. The Director of Corporate Services reports that no difficulties are envisaged for the current and future years in complying with this PI.

25. 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 desirable, could be afforded in the short term, but is not sustainable in the longer term. It is expected that maximum borrowing need (table 4 Total Debt 31 March) with a 10% headroom for unexpected movements. This is a statutory limit determined under section 3 (1) of the Local Government Act 2003.

26. It is proposed to move the Authorised Limit in **Table 6** in line with the movement in the Operational Boundary.

Table 6

Authorised limit for external debt	2010/11 Original Indicator £M	2010/11 Revised Indicator £M
Borrowing	110.140	100.100
Other Long Term Liabilities*	24.939	27.553
Total	135.079	127.653

Interest Rate Movements and Expectations (supplied by Butlers))

27. *UK short term interest rates moved 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 economic upturn, confidence that price pressures will abate and still fragile state of the financial sector supported the case for the maintenance of an accommodating interest rate policy.*

28. *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 would 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 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 reduced towards their 2009 lows as a result.*

29. *Short term rates are expected to remain on hold for a considerable time. The recovery in the economy is likely to remain slow. The danger of a double dip recession is fading but the crisis in the euro-zone, the prospect of tight economic policies at home and tenuous consumer confidence means the threat has not gone away completely*

30. *Long term interest rates will continue to benefit from these considerations and might be pressured lower in the event of a further programme of quantative easing. Nevertheless, without additional support, yields are probably close to their low point. Disappointment with the UK's inflation performance and the absence of quantative easing would return yields to a gradually rising trend before the end of the financial year.*

Table 7
Medium- Term Rate Estimates

Annual Average	***Bank rate***	***Money rates for investment purposes***		***PWLB rates for borrowing purposes***		
		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*

Treasury Strategy 2010/11 – 2012/13

Debt Activity during 2010/11

31. The expected borrowing need is set out below

Table8

	2010/11 Original Estimate £M	2010/11 Revised Estimate £M
CFR (year end position)	147.639	146.429
Less other long term liabilities PFI and finance leases	24.939	25.048
Net adjusted CFR (year end position)	122.700	121.381
Expected Total Borrowing	95.860	91.000
(Under)/over borrowing	26.840	30.381
Expected Net Movement in CFR	7.094	10.349
Expected Net Movement in CFR represented by		
Net financing need for the years from table 3	12.628	13.388
MRP/VRP	-3.994	-3.999
MRP relating to finance leases including PFI	-1.540	-1.540
Additional finance lease through IFRS		2.500
Movement in CFR	7.094	10.349

32. The Council is currently under- borrowed to address investment counterparty risk and the cost of carry on investments (investment return up to 1% and long term borrowing rates for the council are currently 3.22%). There is an interest rate risk, as longer term borrowing rates may rise, this position is being carefully monitored.

33. As yet this year no new borrowing has been undertaken, however during December/January 3 loans amounting to £13.750M are due to be repaid. A new loan has been arranged to replace those, this is a market loan (not with the PWLB) which has an interest rate of 2% for the first three years with a variable rate thereafter.

34. New borrowing of up to £10.00M may need to be taken later in the financial year as the expected borrowing need less any repayment of principal through the Minimum Revenue Provision is c£10.000M

Investment Strategy 2010/11-2012/13

35. The key objectives of the Council's investment strategy are safeguarding the repayment of the principal and interest of its investments on time- the investment yield 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.

Treasury Management Activity from 1st April 2010to 30th September 2010

36. Current investment position- The Council held £26.820M of investments at 30/09/2010 and this is made up of the following parts

Table 9

Sector	**Country**	**Up to 1 year**	**1 -2 years**	**2-3 years**
		£M	**£M**	**£M**
Banks	UK	**20.000**	**Nil**	**Nil**
Building Societies	UK	**3.000**	**Nil**	**Nil**
AAA Money Market Funds		**3.820**	**Nil**	**Nil**
Total		**26.820**	**Nil**	**Nil**

Short Term Cashflow Investments

37. Cash balances are invested on a daily basis to maximise the benefit of temporary surplus funds. A total of 150 investments were made in the period 1st April 2010 to 30th September 2010 totalling £220M these were for periods of between 1 and 364 days and earned interest of £80,770 for the period from April to September at an average rate of .0.97%

Longer Term Capital Investments

38. The Council's reserves and capital receipts are invested for varying periods up to the maximum permitted time of 3 years although in the present economic climate longer term investments are limited to between 6 months and 1 year. The investments have been at an average level of £9.00M. Some individual loans have matured and been renewed during this period. The longer term investments have earned interest of £101,596 for the first six months of 2009/10 at an average rate of 2.24%

Investment returns measured against the Service Performance Indicators

39. The target for our investment returns is to better or at least match a number of external comparators, this performance indicator is also known as yield benchmarking.

40. As can be seen from **Table 10,** the short term cashflow investments achievements are above market expectations. This is due to some of those investments being taken for 6 to 12 months where rates are higher. The long term capital investments are also above the long term indicators due to placing investments for longer periods of time when interest rates were higher. As these investments fall out during the rest of the year then our rates of return will fall to nearer the average of the external comparators, but it is expected that the returns will remain above the average indicators

Table 10

	Short Term Cashflow Investments %	**Long Term Capital Investments %**
Darlington Borough Council -Actual	**0.97**	**2.24**
External Comparators		
Local Authority- 2 day	0.35	
Local Authority - 7 day	0.35	
Local Authority - 6 months		0.87
Local Authority - 12 months		1.29
London Inter Bank Bid Rate – 7 day	0.42	0.42
Average of External Comparators	**0.37**	**0.86**

Treasury Management Budget

41. There are three main elements within the Treasury Management Budget:-

(a) Long term capital investments interest earned – a cash amount of c£9.000M which earns interest and represents the Council's revenue and capital balances, unused capital receipts, reserves and provisions.
(b) Cashflow interest earned – since becoming a unitary council in 1997, the authority has consistently had a positive cashflow. Unlike long term capital investments it does not represent any particular sum but it is the consequence of many different influences such as receipt of grants, the relationship between debtors and creditors, cashing of cheques and payments to suppliers.
(c) Debt servicing costs – This is the principal and interest costs on the Council's long term debt to finance the capital programme

Table 11 - Changes to Treasury Management Budget 2010-11

	£m	£m
Original Treasury Management Budget 2010-11		**3.795**
Less Reduced Repayment of Principal	-0.210	
Less Reduced Interest payments made on debt	-0.393	-0.603
Add Reduced interest from Investments	+0.039	+0.039
Revised Treasury Management Budget 2010/11		**3.231**

42. This statement concludes that the Treasury Management budget is forecast to achieve an improvement of £0.564M in 2010/11 savings in finance costs will be returned to Council balances.

Risk Benchmarking

43. A regulatory development is the consideration and approval of security and liquidity benchmarks. Yield benchmarks are currently widely used to assess investment performance and these are shown in Table 10. Discrete security and liquidity benchmarks are new requirements to the member reporting. These were first set in the Treasury Strategy report of the 25thFebruary 2010.

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

45. **Security –** The Council's maximum security risk benchmarks for the current portfolio of investments, when compared to historic default tables was set as follows:

0.03% historic risk of default when compared to the whole portfolio

46. The Director of Corporate Services can report that the investment portfolio was maintained within this overall benchmark during this year to date as shown in Table 12

Table 12

Maximum	**Benchmark 2010/11**	**Actual May**	**Actual August**	**Actual October**
Year 1	0.03%	0.00%	0.00%	0.01%
Year 2	0.00%	0.00%	0.00%	0.00%
Year 3	0.00%	0.00%	0.00%	0.00%

47. The counterparties that we use are all high rated therefore our actual risk of default based on the ratings attached to counterparties is virtually nil.

48. Since this benchmark was introduced default histories for the banking sector have now increased due to the banking crisis, had the benchmark been established now this would be set at a higher rate. However this would not indicate that the Council had changed its risk profile or would be looking at increasing its risk simply how it is benchmarking risk.

49. **Liquidity –** In respect of this area the Council set liquidity facilities/ benchmark to maintain

(a) Bank Overdraft -£0.500M
(b) Liquid short term deposits of at least £3.000M available within a weeks notice
(c) Weighted Average Life benchmark is expected to be 0.5 years with a maximum of 1.25years

50. The Director of Corporate Services can report that liquidity arrangements have been adequate for the year to date as shown in Table 13

Table 13

	Benchmark	Actual May	Actual August	Actual October
Weighted Average life	**0.5 to1.25years**	**0.2 years**	**0.3 years**	**0.36 years**

51. This is a new benchmark that may need to be adjusted over time and depending on the economic financial outlook. It was set expecting that some investments would be made for more than 1 year, but because of the current economic climate new investments are just being made up to 1 year as so the actual weighted average life is lower than expected.

52. The Council are at present holding some investments in Bank Call accounts, which allow withdrawal without notice, these are currently paying a better rate of interest than some medium term fixed investments so these increase our liquidity thereby reducing the weighted average life of our investments without sacrificing yield.

Treasury Management Indicators

53. **Actual and estimates of the ration 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.

Table 14

	2010/11 Original Indicator	2010/11 Revised Indicator
General Fund	**4.7%**	**4.76%**
HRA	**12.47%**	**7.03%**

54. The changes to the General Fund reflect the reduction in financing costs as shown in Table 11 but also include payments of interest and repayments of principal associated with finance leases that come on to the balance sheet under IFRS this new addition amounts to £0.650M that previously would have been included in departmental revenue costs not financing costs.

55. The reduced % from 12.47 to 7.03 for HRA reflects reduced interest and re-profiling of principal repayments due to the change in the profile of capital spend and reduction of departmental borrowing costs

Treasury Management Prudential Indicators

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

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

58. Historically for a number of years this Council has used these percentages; together they give flexibility to the treasury management strategy allowing the Council to take advantage of both fixed and variable rates in its portfolio whilst ensuring that its exposure to variable rates of interest is limited. The Council currently has 2 loans totalling £7.0M which have variable rates of interest; this represents 8.6% of the Council’s total debt portfolio.

Table 15

	2010/11 Original Indicator	2010/11 Revised Indicator
Limits on fixed interest rates	100%	100%
Limits on variable interest rates	40%	40%

59. **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. The higher limits for longer periods reflect the fact that longer maturity periods generally attract lower interest rates and give more stability to the debt portfolio.

Table 16 **Maturity Structures of Borrowing**

	2010/11 Original Indicator	2010/11 Actual to date	2010/11 Revised Indicator
Under 12 months	25%	17%	25%
12 months to 2 years	40%	8%	40%
2 years to 5 years	60%	11%	60%
5 years to 10 years	80%	0%	80%
10 years and above	100%	64%	100%

60. **Total Principal Funds Invested –**These limits are set having regard to the amount of reserves available for long term investment and show the limits to be placed on investments with final maturities beyond the year-end. This limit allows the authority to invest for longer periods if they give better rates of return than shorter periods. It also allows some stability in the interest returned to the Authority.

Table 17 **Total Principal Funds Invested**

	2010/11 Original Indicator	2010/11 Revised Indicator
Maximum principal sums invested greater than 1 year	£10M	£10M

Treasury Management Advisors

61. As Members will be aware the Council uses Butlers as its Treasury Management Advisors and this contract was extended for a 2 year period in July 2010 until July 2012.

62. In October Officers received communication from ICAP, Butlers parent company, that they had conducted a strategic review of the provision of treasury consultancy services and as a result of this review, they had agreed to transfer this part of their business to Sector Treasury Services Limited. On the 25th October 2010 the majority of Butlers staff moved across to Sector. Customer's contracts were to be assigned to Sector.

63. Sector are reviewing all of the services they currently provide i.e. those from Butlers and those from Sector with a view to providing the best services from each part of the business, this review may take a number of months to complete. Since this date Officers have found

no disruption to the level of service supplied and contact is through the same personnel as the Butlers contract.

Internal Audit of the Treasury Management Function.

64. An internal audit of the Treasury Management function was conducted in August 2010 and concluded that full assurance was achieved for all 14 of the risks that were assessed.

Conclusion

65. The prudential indicators have been produced to take account of the Council's borrowing position. The key borrowing indicator (the Operational Boundary) has been reduced to reflect the estimated debt position at the end of 2010/11. The Council's return on investments has been good, exceeding both of the targets set matching external comparators for the first six months of the current financial year. Based on the first six months of 2010/11 the Council's borrowing and investments is forecast to achieve an improvement of £0.564M on the 2010/11 approved budget.

Outcome of Consultation

66. No external consultation was undertaken in the production of this report, however this report was examined by Audit Committee at its meeting on 17th December 2010 and its recommendations are outlined in paragraph 2 of this report.