AUDIT COMMITTEE
14 DECEMBER 2012

ITEM NO. ....

MID YEAR PRUDENTIAL INDICATORS AND TREASURY MANAGEMENT MONITORING REPORT

SUMMARY REPORT

Purpose of the Report

1. This report seeks approval of the revised Treasury Management Strategy, Prudential Indicators and provides a half –yearly review of the Council's borrowing and investment activities. Audit Committee are requested to forward the revised Strategy and indicators to Cabinet and Council for their approval and note changes to the MTFP with regard to the Treasury Management Budget (Financing Costs).

Summary

2. The mandatory Prudential Code, which governs Council's borrowing, requires Council approval of controls, called Prudential Indicators, relating to capital spending and borrowing. Prudential Indicators are set in three statutory annual reports, a forward looking annual treasury management strategy, a backward looking annual treasury management report and this mid year update. The mid year update follows Council's approval in March 2012 of the 2012/13 Prudential Indicators and Treasury Management Strategy.

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

   (a) to ensure the 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

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

   (a) Higher capital expenditure in 2012/13 due to an increase in capital expenditure slippage from 2011/12,

   (b) The Operational Boundary and Authorised Limit remain unchanged at £134.900M and £148.390M respectively.

Recommendation

5. It is recommended that :

(a) The revised prudential indicators and limits within the report in Tables 1 to 6, 8 and 14 to 17 are examined.

(b) The changes to the Council's Investment Strategy outlined in paragraph 31 to 34 are agreed:

(i) To increase the counterparty limit for Banks 2 (UK part-nationalised) from £3.000M per bank to £5.000M per bank
(ii) To increase the maximum investment period for Banks 2(UK part-nationalised from 1 year to 2 years

(c) The reduction in the Treasury Management Budget (Financing Costs) of £30,000 shown in Table 11 is noted.

(d) That this report is forwarded to Council via Cabinet with comments from this committee, in order for the updated prudential indicators to be approved.

Reasons

6. 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 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 2012/13
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	There are no carbon impact implications in this report
Diversity	There are no specific implications for the Council's diversity agenda
Wards Affected	All Wards
Groups Affected	All Groups
Budget and Policy Framework	This report must be considered by Council
Key Decision	This is not an executive 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	The report refers to actions taken to reduce costs and manage risks.

MAIN REPORT

Information and Analysis

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

8. 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 the PIs were previously reported to Council on 1 March 2012

9. This report concentrates on the revised positions for 2012/13. Future year's indicators will be revised when the impact of the MTFP 2013/14 onwards is known.

10. A summary of the revised headline indicators for 2012/13 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 March 2012 and the means by which it is financed.

Table 1 Headline Indicators

	2012/13 Original Estimate	2012/13 Revised Estimate
	£M	£M
Capital Expenditure (Tables 2 and 3)	17.997	29.943
Capital Financing Requirement (Table 4)	172.375	171.739
Operational Boundary for External Debt (Table 4)	134.900	134.900
Authorised Limit for External Debt (Table 6)	148.390	148.390
Ratio of Financing Costs to net revenue stream- General Fund (Table 14)	7.61%	7.45%
Ratio of Financing Costs to net revenue stream- Housing Revenue Account (HRA) Table 14	23.28%	23.63%

11. 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.

12. 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 service.

13. The underlying economic environment remains difficult for Councils; concerns over counterparty risk are still around. This background encourages the Council to continue investing over the shorter term and with high quality UK counterparties, the downside is that investment returns remain low.

Key Prudential Indicators

14. This part of the report is structured to update:

    (a) The Council's capital expenditure plans
    (b) How these plans are financed
    (c) The impact of the changes in the capital expenditure plans on the PI's and the underlying need to borrow
    (d) Compliance and limits in place for borrowing activity
    (e) Changes to the annual Investment Strategy
    (f) The revised financing costs budget for 2012/1

Capital Expenditure PI

15. **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	2012/13 Original Estimate	2012/13 Revised Estimate
	£M	£M
General Fund	12.307	21.653
HRA	5.690	8.290
Total	17.997	29.943

16. The changes to the 2012/13 capital expenditure estimates have been notified to Cabinet as part of the Capital Budget Monitoring process.

17. The main changes are:

    (a) The original Prudential Indicators assumed that the majority of the capital funding secured for 2011/12 would be expended in that year. It was expected that £4.100M would slip into future years including 2012/13 however this increased to £14.259M as approved schemes included in 2011/12 were actually for future years.
    (b) A full reconciliation of the changes in capital expenditure 2012/13 is attached at **Appendix 1**

Impact of Capital Expenditure Plans

Changes to the financing of the Capital Programme

18. **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	2012/13 Original Estimate	2012/13 Revised Estimate
	£M	£M
Supported	16.107	19.772
Unsupported	1.890	10.171
Total Spend	17.997	29.943
Financed by		
Capital Receipts		0.140
Capital grants	15.607	19.564
Capital Contributions	0.500	0.182
Revenue	0.890	7.470
Total Financing	16.997	27.356
Borrowing Need	1.000	2.587

The Capital Financing Requirement (PI), External Debt (PI) and the Operational Boundary

19. **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/ Operational Boundary
Table 4

	2012/13 Original Estimate	2012/13 Revised Estimate
	£M	£M
Prudential Indicator- Capital Financing Requirement		
CFR General Fund	78.000	78.234
CFR General Fund PFI/Leasing IFRS	20.096	20.297
CFR - Housing	74.279	73.208
Total CFR	**172.375**	**171.739**
Net Movement in CFR	-4.933	-3.048
Prudential Indicator – External Debt/ Operational Boundary		
Borrowing	114.800	114.800
Other long Term Liabilities	20.100	20.100
Total Debt 31 March- Operational Boundary	**134.900**	**134.900**

Limits to Borrowing Activity

20. The first key control over the treasury activity is a PI to ensure that over the medium term, net borrowing (borrowing minus 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 2012/13 and the next two financial years. As shown in table 5 below.

Table 5

	2012/13 Original Estimate £M	2012/13 Revised Estimate £M	2013/14 Original Estimate £M	2014/15 Original Estimate £M
Gross borrowing	114.800	114.800	114.800	114.800
Plus Other Long Term Liabilities	20.100	20.100	18.900	17.600
Less Investments	-15.000	-15.000	-15.000	-15.000
Net borrowing	119.900	119.900	118.700	117.400
CFR* (year end position)	172.375	171.739	167.919	163.515

* includes on balance sheet PFI schemes and finance leases

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

22. 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. The Authorised Limit is set by increasing the Operational Boundary (Total Debt Table 4) by 10% to allow headroom for unexpected movements. This is a Statutory limit determined under section 3 (1) of the Local Government Act 2003.

23. 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	2012/13 Original Indicator £M	2012/13 Revised Indicator £M
Borrowing	126.280	126.280
Other Long Term Liabilities	22.110	22.110
Total	148.390	148.390

Economic Outlook for the coming months to March 2013 (Supplied by Sector)

24. The risks in economic forecasts continue unabated from the previous treasury strategy. Concern has been escalating that the Chinese economy is heading for a hard landing, rather than a gentle slowdown, while America is hamstrung by political deadlock which prevents a positive approach to countering weak growth. Whether the presidential election in November will remedy this deadlock is debatable but urgent action will be required early in 2013 to address the US debt position. However, on 13 September the Federal Bank announced an aggressive stimulus programme for the economy with a third round of quantitative easing focused on boosting the stubbornly weak growth in job creation, and this time with no time limit. They also announced that it was unlikely that there would be any increase in interest rates until at least mid 2015.

25. Eurozone growth will remain weak as austerity programmes in various countries curtail economic recovery. A crunch situation is rapidly developing in Greece as it has failed yet again to achieve deficit reduction targets and so may require yet another (third) bail out. There is the distinct possibility that some of the northern European countries could push for the ejection of Greece from the Eurozone unless its financial prospects improve, which does not seem likely at this juncture. A financial crisis was also rapidly escalating over the situation in Spain. However, in early September the ECB announced that it would purchase unlimited amounts of shorter term bonds of Eurozone countries which have formally agreed the terms for a bailout. Importantly, this support would be subject to conditions (which have yet to be set) and include supervision from the International Monetary Fund. This resulted in a surge in confidence that the Eurozone has at last put in place the framework for adequate defences to protect the Euro. However, it remains to be seen whether the politicians in charge of Spain and Italy will accept such loss of sovereignty in the light of the verdicts that voters have delivered to the politicians in other peripheral countries which have accepted such supervision and austerity programmes. The Eurozone crisis is therefore far from being resolved as yet. The immediate aftermath of this announcement was a rise in bond yields in safe haven countries, including the UK. Nevertheless, this could prove to be as short lived as previous “solutions” to the Eurozone crisis.

26. The Bank of England Quarterly Inflation Report in August pushed back the timing of the return to trend growth and also lowered its inflation expectations. Nevertheless, concern remains that the Bank’s forecasts of a weaker and delayed

robust recovery may still prove to be over optimistic given the world headwinds the UK economy faces. Weak export markets will remain a drag on the economy and consumer expenditure will continue to be depressed due to a focus on paying down debt, negative economic sentiment and job fears. The Coalition Government, meanwhile, is likely to be hampered in promoting growth by the requirement of maintaining austerity measures to tackle the budget deficit.

27. The overall balance of risks is, therefore, weighted to the downside:
    (a) We expect low growth in the UK to continue, with Bank Rate unlikely to rise in the next 24 months, coupled with a possible further extension of quantitative easing. This will keep investment returns depressed.
    (b) The expected longer run trend for PWLB borrowing rates is for them to eventually rise, primarily due to the need for a high volume of gilt issuance in the UK and the high volume of debt issuance in other major western countries. However, the current safe haven status of the UK may continue for some time, tempering any increases in yield.
    (c) This interest rate forecast is based on an assumption that growth starts to recover in the next three years to a near trend rate (2.5%). However, if the Eurozone debt crisis worsens as a result of one or more countries having to leave the Euro, or low growth in the UK continues longer, then Bank Rate is likely to be depressed for even longer than in this forecast.

Medium Term Interest Rate Estimates
Table 7

	Bank Rate	**Money rates for investment purposes**			**PWLB rates for borrowing purposes**			
		3 month	6 month	1 year	5 year	10 year	25 year	50 year
	%	%	%	%	%	%	%	%
2012/12								
Actual to date	0.50	0.50	0.70	0.90	1.60	2.50	3.80	3.90
Dec 2012	0.50	0.50	0.70	1.00	1.50	2.50	3.70	3.90
March 2013	0.50	0.50	0.70	1.00	1.50	2.50	3.80	4.00
2013/14								
June 2013	0.50	0.50	0.70	1.00	1.50	2.50	3.80	4.00
Sept 2013	0.50	0.50	0.70	1.00	1.60	2.60	3.80	4.00
Dec 2013	0.50	0.50	0.70	1.00	1.60	2.60	3.80	4.00
March 2014	0.50	0.50	0.70	1.10	1.70	2.70	3.90	4.10
2014/15								
June 2014	0.50	0.60	0.80	1.10	1.70	2.70	3.90	4.10
Sept 2014	0.50	0.60	0.90	1.20	1.80	2.80	4.00	4.20
Dec 2014	0.50	0.70	1.00	1.30	2.00	3.00	4.10	4.30
March 2015	0.75	0.80	1.10	1.30	2.20	3.20	4.30	4.50

Debt Activity during 2012/13

28. The expected borrowing need is set out below

Table 8

	2012/13 Original Estimate £M	**2012/13 Revised Estimate £M**
CFR (year end position)	172.375	171.739
Less other long term liabilities PFI and finance leases	20.096	20.297
Net adjusted CFR (net year end position)	152.279	151.442
Expected Total Borrowing	114.800	114.800
(Under)/ Over borrowing	(37.479)	(36.642)
Expected Net movement in CFR	-4.933	-3.048
Expected Net Movement in CFR represented by		
Net financing need for the year from table 3	1.000	2.587
MRP/VRP	-4.131	-4.068
MRP relating to finance leases including PFI	-1.802	-1.567
Movement in CFR	-4.933	-3.048

29. The Council is currently under-borrowed (total actual borrowing is less than the balance sheet requires CFR) to address counter party risk and the cost of carry on investments (investments return up to 1.5% and long term borrowing costs for the Council are currently 3.31%) There is an interest rate risk, as longer term borrowing rates may rise, this position is being carefully monitored

30. No new borrowing or replacement borrowing has taken place yet this year, although a £3.5M variable rate loan comes up for repayment in February 2013 and it is expected that this will be replaced with a similar loan.

Annual Investment Strategy 2012/13

31. The key objectives of the Council's investment strategy are safeguarding the repayment of principal and interest of its investments on time, the investment yield being a secondary objective.

32. It has become evident throughout the year that the monetary limits applied to our Banks 2 category which relates to the part nationalised banks have been insufficient for the amount of longer term money that the Council needs to invest, currently we have imposed a limit of £3million with each counterparty and there are 3 banks which fulfil this criteria allowing a maximum investment of £9million. It is proposed that this limit is increased £5million per counterparty to take advantage of the additional security offered by part nationalised banks and the better rates of interest also offered.

33. In addition there are occasionally good rates offered by these counterparties for investments over 1 year and up to 2 years, it is proposed that the time limit on Bank 2 category (which include the part nationalised uk banks only) be increased to a maximum of 2 years.

34. This increase in counterparty limits will still allow our investments to stay within our current security and liquidity benchmarks of 0.077% historic risk of default when comparing the whole portfolio for security purposes and whilst the Weighted Average Life of the whole portfolio would increase from the expected life of 0.4years but not to the maximum of 1 year.

Treasury Management Activity from 1st April 2012 to 30th September 2012

35. Current investment position – The Council held £20.051M of investments at 30/09/2012 and this is made up of the following parts

Table 9

Sector	Country	Up to 1 year
		£M
Banks	UK	9.000
Building Societies	UK	2.860
AAA Money Market Funds	Sterling Fund	8.191
Total		**20.051**

Short Term Cashflow Investments

36. Cash balances are invested on a daily basis to maximise the benefit of temporary surplus funds. A total of 69 investments were made in the period 1st April 2012 to 30th September 2012 totalling £76.824M these were for periods of between 1 and 364 days and earned interest of £33,446 on an average balance of £11.783M which equated to an average interest rate of 0.57%

Longer Term Capital Investments

37. The Council's reserves and capital receipts are invested for varying periods up to the maximum permitted time period which is currently 1 year for part Nationalised banks and 3 months for other counterparties. The investments have been at an average level of £8.000M. Some individual loans have matured and been renewed during this period The longer term investments have earned interest of £95,100 for the first six months of 2012/13 at an average rate of 2.37%.

Investment returns measured against the Service Performance Indicators

38. 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. As can be seen from Table 10, the short and long term investment achievements are above market expectations.

Table 10

	Short Term Cashflow Investments %	Long term Capital Investments %
Darlington Borough Council - Actual	**0.57**	**2.37**
External Comparators		
Local Authority – 2 Day	0.29	0.00
Local Authority – 7 Day	0.29	0.00
Local Authority -6 months	0.00	1.10
Local Authority – 12 months	0.00	1.58
London Inter Bank bid Rate - 7day	0.43	0.43
Average External Comparators	**0.34**	**1.04**

Treasury Management Budget

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

    (a) Long term capital investments interest earned – a cash amount of c£8.000M - £10.000M which earns interest and represents the Councils revenue balances, unused capital receipts, reserves and provisions.
    (b) Cash flow interest earned – since becoming a unitary council in 1997, the authority has consistently had a positive cash flow. 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 serving costs – this is the principal and interest costs on the Council's long term debt to finance the capital programme.

Table 11-Changes to the Treasury Management Budget (Financing Costs) 2012/13

	£M	£M
Original Treasury Management Budget 2012/13		**3.410**
Less Reduced Repayment of Principal	-0.042	
Add Increased Interest payments paid on debt	0.056	
Less increased interest earned on Investments	-0.044	-0.030
Revised Treasury Management Budget 2012/13		**3.380**

40. The repayment of principal is reduced because of the timing of capital expenditure is later than expected and the interest payable has increased due to an increase in the consolidated interest rate on the councils debt from 3.22% to 3.45%.

41. This statement concludes that the Treasury Management budget is forecast to achieve an improvement of £30,000 in 2012/13, these savings in finance costs will be returned to Council balances.

Risk Benchmarking

42. 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 also requirements of member reporting.

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

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

    0.077% historic risk of default when compared to the whole portfolio

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

Table12

Maximum	Benchmark 2012/13	Actual June	Actual August	Actual October
Year 1	0.077%	0.017%	0.011%	0.019%

46. The counterparties that we use are all high rated therefore our actual risk of default based on ratings attached to counterparties is very low.

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

    (a) Bank overdraft - £0.100M
    (b) Liquid short term deposits of a least £3.000M available within a weeks notice
    (c) Weighted Average Life benchmark is expected to be 0.4 years with a maximum of 1 year

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

Table 13

	Benchmark	Actual June	Actual August	Actual October
Weighted Average Life	0.4 to 1 year	0.23years	0.15years	0.25years

49. The figures are for the whole portfolio so include both longer term fixed investments currently up to one year as well as cash flow investments deposited with Money Market funds on a call basis (i.e. can be drawn on without notice).

Treasury Management Indicators

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

Table 14

	2012/13 Original Indicator	2012/13 Revised Indicator
General Fund	**7.61%**	**7.45%**
HRA	**23.28%**	**23.63%**

51. The changes to the General Fund reflect the reduction in financing costs shown in Table 11 but also include payments of interest and repayments of principal associated with finance leases and the PFI scheme. Whilst the changes to the HRA reflect the slightly higher interest costs charged to the HRA for the Self Financing Debt.

Treasury Management Prudential indicators

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

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

54. 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 is limited. At the end of 2012/13 the Council will have 3 variable rate loans amounting to £20.5M which represents 18.2% of the Councils debt portfolio.

Table 15

	2012/13 Original Indicator	2012/13 Revised Indicator
Limits on fixed interest rates	100%	100%
Limits on variable interest rates	40%	40%

55. **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 for the duration of the instrument) falling due for refinancing. The higher limits for longer periods reflect the fact that longer maturity periods give more stability to the debt portfolio.

Table 16
Maturity Structures of Borrowing

	2012/13 Original indicator	2012/13 Actual to Date	2012/13 Revised Indicator
Under 12 months	25%	3%	25%
12 months to 2 years	40%	3%	40%
2 years to 5 years	60%	0%	60%
5 years to 10 years	80%	6%	80%
10 years and above	100%	88%	100%

56. **Total Principal Funds Invested –** These limits are set having regard to the amount of reserves available for longer term investment and show the limits to be placed on investments with final maturities beyond 1 year. This limit allows the authority to invest for longer periods if they give better rates than shorter periods. It also allows some stability in the interest returned to the Authority. Although no investments have been made for longer periods to date this year the change in strategy proposed in paragraph 33 may lead to some longer term investments in the future.

Table 17
Principal Funds Invested

	2012/13 Original Indicator	2012/13 revised Indicator
Maximum principal sums invested greater than 1 year	£10M	£10M

Treasury Management Advisors

57. The Council continues to receive Treasury Management Advice from Sector; the contract has been extended to mid July 2013.

Conclusion

58. The prudential indicators have been produced to take account of the Council's borrowing position. The key borrowing indicator (the Operational Boundary) has not been changed and remains the same as the original estimate at £134.900M. The Councils return on investments has been good, exceeding both of the targets. Based on the first six months of 2012/12 the Council's borrowing and investments is forecast to achieve an improvement of £30,000 on the approved 2012/13 budget

59. The Council's treasury management activities comply with the required legislation and meet the high standards set out in the relevant codes of practice.

Outcome of Consultation

60. No consultation was undertaken in the production of this report.