CANNOCK CHASE COUNCIL

AUDIT AND GOVERNANCE

25TH SEPTEMBER 2012

REPORT OF HEAD OF FINANCE

ANNUAL TREASURY MANAGEMENT REVIEW REPORT FOR 2011-12 AND QUARTER 1 OF 2012-13

1. Purpose of Report

1.1 To advise Members of the Council's Treasury activities during 2011-12 and during the first quarter of 2012-13

2. Recommendation

2.1 That the contents of this report be noted and be recommended for agreement by Council on 26th September.

3. Conclusions and Reasons for the Recommendations

3.1 The CIPFA Code of Practice on Treasury Management in the Public Services 2009 (updated in 2011) requires that reports be submitted as follows:-

(a) Annual Strategy and Plan in advance of the year.

(b) Annual review Report after the year end close.

(c) Mid year review report

4. Key Issues

4.1 The Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management in the Public Services 2009 (updated in 2011) was adopted by this Council on 24 February 2010 and this Council fully complies with its requirements. The primary requirements of the Code are the:-

(a) creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities;

(b) creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives;

(c) receipt by the Council of an annual treasury management strategy report (including the annual investment strategy report) for the year ahead, a mid year review report (as a minimum) and an annual review report of the previous year;

(d) delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

(e) delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body which in this Council is the Audit and Governance Committee.

Treasury management in this context 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".

4.2 This annual treasury report covers:

- the Council's treasury position as at 31 March 2012;
- the Council's capital expenditure and Financing 2011-12
- the Council's overall borrowing need
- the strategy for 2011-12
- the economy and interest rates in 2011-12;
- borrowing rates in 2011-12;
- the borrowing outturn for 2011-12;
- investment outturn for 2011-12;
- investment rates for 2011-12;
- debt rescheduling;
- other issues

4.3 This report also covers the Council's treasury activity for the first quarter of 2012-13.

4.4 During 2011-12 the Council did increase its Long Term Borrowing Portfolio by £3 million for Housing Capital purposes and refinanced a maturing loan for £3 million and took out borrowing of £59.245 million as part of the housing finance reform. The Council has also taken out additional borrowing of £4.7 million during the first quarter of 2012 to cover part of the borrowing required for the refurbishment of Chase Leisure Centre.

4.5 Although the investment return again exceeded the accepted benchmark of the uncompounded LIBID 7 day rate, investments were of necessity kept in small amounts and on the whole, short term (i.e. 3 months or less). This inevitably decreases the return available, but based upon market conditions in the year actually increases the amount of interest earned by the Council.

4.6 None of the prudential indicators set at the beginning of the year were exceeded and all investments were carried out with institutions listed in the Council's approved lending list.

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Section 1

Background

Purpose

This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2011-12. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code). This report also covers the Council's treasury activities for the first quarter of 2012-13.

During 2011-12 the minimum reporting requirements were that the Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 2nd March 2011)
- a mid year treasury update report (Council 2nd November 2011)
- an annual review following the end of the year describing the activity compared to the strategy (this report).

Recent changes in the regulatory environment place a much greater onus on members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Audit and Governance Committee before they were reported to the full Council.

Executive Summary

During 2011-12, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Prudential and treasury indicators	2010-11 Actual £,000	2011-12 Original £,000	2011-12 Actual £,000
Capital Expenditure	9,547	13,353	13,548
Capital Financing Requirement:			
Non-HRA	8,764	12,414	8,660
HRA	19,762	22,762	22,762
HRA due to the housing finance reform		59,267	59,245
Total	28,526	94,443	90,667
Net Borrowing	15,372	80,641	76,686
External Debt	21,486	83,568	83,546
Investments under 1 year	6,114	2,927	6,860

Other prudential and treasury indicators are to be found in the main body of this report. The Head of Finance also confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit (the authorised limit) was not breached.

The financial year 2011-12 continued the challenging investment environment of previous years, namely low investment returns and continuing heightened levels of counterparty risk.

Housing Finance Reform

The implementation of housing finance reform at the end of 2011-12 abolished the housing subsidy system financed by Central Government and, consequently, all housing debt has been reallocated nationally between housing authorities. The result of this reallocation is that this Council made a capital payment to the Department of Communities and Local Government of £59.245 million. This resulted in an increase in the CFR and total borrowing of £59.245 million at the end of the year. There has been no impact on HRA revenue finances in 2011-12 due to compensation adjustments being made in the HRA determination.

During the first quarter of 2012-13, the Council has complied with its legislative and regulatory requirements.

Section 2

Details of Matters to be Considered

This report summarises:

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- Reporting of the required prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to the indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed debt activity; and
- Detailed Investment activity.
- The treasury management activity for the first quarter of 2012-13.

The Council's Capital Expenditure and Financing 2011-12

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed

£m	**2010-11 Actual**	**2011-12 Estimate**	**2011-12 Actual**
Non-HRA capital expenditure	4,465	7,354	7,748
HRA capital expenditure	5,080	5,999	5,800
Total Capital Expenditure	**9,545**	**13,353**	**13,548**
Resourced by:			
- Capital receipts	1,027	858	974

- Capital grants	1,699	2,773	2,608
- Capital reserves	819		189
- Revenue	1,402	4,065	2,362
- Major Repairs Reserve	3,221	255	283
Unfinanced capital expenditure	**1,377**	**5,402**	**7,132**

The Council's overall borrowing need

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's debt position. The CFR results from the capital activity of the Council and what resources have been used to pay for the capital spend. It represents the 2011-12 unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

Reducing the CFR – the Council's (non HRA) underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to reduce the CFR. This is effectively a repayment of the non-Housing Revenue Account (HRA) borrowing need (there is no statutory requirement to reduce the HRA CFR). This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- The application of additional capital financing resources (such as unapplied capital receipts); or
- Charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP)

The Council's 2011-12 MRP Policy was approved as part of the Treasury Management Strategy Report for 2011-12 on 2nd March 2011.

The Council's CFR for the year is shown below, and represents a key prudential indicator. It includes PFI and leasing schemes on the balance sheet, which increase the Council's borrowing need. No borrowing is actually required against these schemes as a borrowing facility is included in the contract.

Housing finance reform has abolished the housing subsidy system financed by central government and consequently, all housing debt has been reallocated nationally between housing authorities. The result of this reallocation is that this Council has made a capital payment to the Department of Communities and Local Government of £59.245 million. This has resulted in an increase in the CFR and total borrowing of £59.245 million at the end of the year. There has been no impact on HRA revenue finances in 2011-12 due to compensating adjustments being made in the HRA determination.

CFR (£m)	31 March 2011 Actual	31 March 2012 Original Indicator	31 March 2012 Actual
Opening Balance	28,067	30,026	29,138
Add unfinanced capital expenditure	1,377	5,402	7,132
Add Adjustment for HRA Reform		59,267	59,245
Less MRP	306	252	252
Less borrowing adjustments			4,132
Less Provision & Lease adjustments			464
Closing Balance	29,138	94,443	90,667

Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

Net borrowing and the CFR – in order to ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. This essentially means that the Council is not borrowing to support revenue expenditure. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2011-12 plus the expected changes to the CFR over 2012-13 and 2013-14 from financing the capital programme. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2011-12. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2011 Actual £,000	31 March 2012 Budget £,000	31 March 2012 Actual £,000
Net Borrowing Position	15,372	80,641	76,686
CFR	28,526	94,443	90,667

The authorised limit – the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. The table below demonstrates that during 2011-12 the Council has maintained gross borrowing within its authorised limit.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or above the boundary is acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream – this indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	2011-12 £m
Authorised Limit	94.443
Maximum gross borrowing position	83.546
Operational boundary	87.600
Average gross borrowing position	27.612
Financing costs as a proportion of net revenue stream	8.9%

Treasury Position at 31 March 2012

The Council's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the beginning and the end of 2011-12 the Councils' treasury position was as follows:-

	31 March 2012 Principal	Rate/Return	31 March 2011 Principal	Rate/Return
Fixed Rate Funding:				
- PWLB	£83.5m		£21.4m	
- Market	£- m £83.5m	4.08%	£- m	6.36%
Variable Rate Funding:				
- PWLB	£- m		£- m	
- Market	£0.0m	0.00%	£0.0m	0.00%
Total Debt	**£83.5m**	**4.08%**	**£21.4m**	**6.36%**
Investments:				
- In-house	£6.8m	0.79%	£6.2m	0.74%
- With Managers	£- m	-%	£- m	-%
Total Investments	**£6.8m**	**0.79%**	**£6.2m**	**0.74%**

The maturity structure of the debt portfolio was as follows:

	£,000
Under 12 months	204
12 - 24 months	0
2 years to 5 years	3,800
5 years to 10 years	2,605
10 years and above	76,937

The Strategy for 2011-12

The expectation of interest rates within the strategy for 2011-12 anticipated low but rising bank rate (starting in quarter 4 of 2011) with similar gradual rises in medium and longer term fixed borrowing rates over 2011-12. Variable or short-term rates were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and reduce counterparty risk.

The actual movement in gilt yields meant that PWLB rates fell sharply during the year and to historically very low levels. This was caused by a flight to quality into UK gilts from EU sovereign debt and from shares as investors became concerned about the potential for a Lehmans type crisis of financial markets if the Greek debt crisis were to develop into a precipitous default and exit from the Euro.

The Economy and Interest Rates 2011-12

Sovereign debt crisis. 2011-12 was the year when financial markets were apprehensive, fearful of the potential of another Lehman's type financial crisis, prompted by a precipitous Greek Government debt default. At almost the last hour, the European Central Bank (ECB) calmed market concerns of a liquidity crisis among European Union (EU) banks by making available two huge three year credit lines, totalling close to €1 trillion at 1%. This also provided a major incentive for those same banks to then use this new liquidity to buy EU sovereign debt yielding considerably more than 1%.

A secondary benefit of this initiative was the bringing down of sovereign debt yields, for the likes of Italy and Spain, below unsustainable levels. The final aspects in the calming of the EU sovereign debt crisis were two eleventh hour agreements: one by the Greek Government of another major austerity package and the second, by private creditors, of a "haircut" (discount) on the value of Greek debt that they held, resulting in a major reduction in the total outstanding level of Greek debt. These agreements were a prerequisite for a second EU / IMF bailout package for Greece which was signed off in March.

Despite this second bailout, major concerns remain that these measures were merely a postponement of the debt crisis, rather than a solution, as they did not address the problem of low growth and loss of competitiveness in not only Greece, but also in other EU countries with major debt imbalances. These problems will, in turn, also affect the financial strength of many already weakened EU banks during the expected economic downturn in the EU. There are also major questions as to whether the Greek Government will be able to deliver on its promises of cuts in expenditure and increasing tax collection rates, given the hostility of much of the population. In addition, an impending general election in May 2012 will deliver a democratic verdict in the way that Greece is being governed under intense austerity pressure from the northern EU states.

The UK coalition Government maintained its tight fiscal policy stance against a background of warnings from two credit rating agencies that the UK could lose it's AAA credit rating. Key to retaining this rating will be a return to strong economic growth in order to reduce the national debt burden to a sustainable level, within the austerity plan timeframe. The USA and France lost their AAA ratings from one rating agency during the year.

UK growth proved mixed over the year. In quarter 2, GDP growth was zero, but then quarter 3 surprised with a return to robust growth of 0.6% q/q before moving back into negative territory (-0.3%) in quarter 4. The year finished with prospects for the UK economy being decidedly downbeat due to a return to negative growth in the EU in quarter 4, our largest trading partner, and a sharp increase in world oil prices caused by Middle East concerns. However, there was also a return of some economic optimism for growth outside the EU and dovish comments from the major western central banks: the Fed in America may even be considering a third dose of quantitative easing to boost growth.

UK CPI inflation started the year at 4.5% and peaked at 5.2% in September. The fall out of the January 2011 Vat increase from the annual CPI figure in January 2012 helped to bring inflation down to 3.6%, finishing at 3.5% in March. Inflation is forecast to be on a downward trend to below 2% over the next year.

The Monetary Policy Committee agreed an increase in quantitative easing (QE) of £75bn in October on concerns of a downturn in growth and a forecast for inflation to fall below the 2% target. QE was targeted at further gilt purchases. The MPC then agreed another round of £50bn of QE in February 2012 to counter the negative impact of the EU debt and growth crisis on the UK.

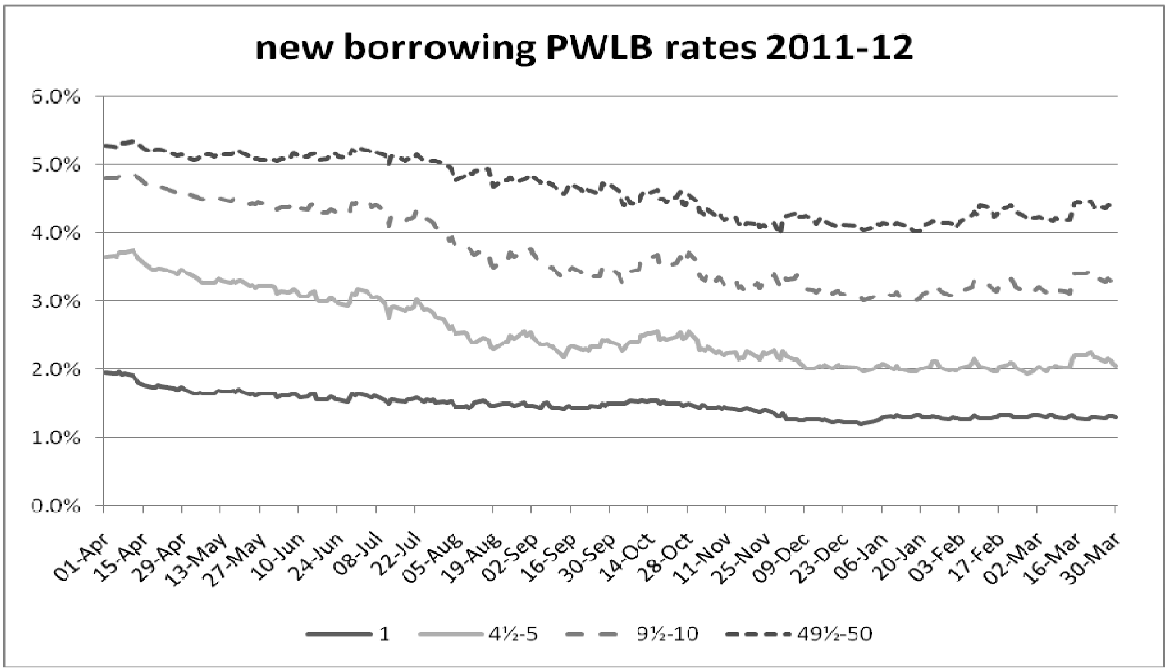
Gilt yields fell for much of the year, until February, as concerns continued building over the EU debt crisis. This resulted in safe haven flows into UK gilts which, together with the two UK packages of QE during the year, combined to depress PWLB rates to historically low levels.

Bank Rate was unchanged at 0.5% throughout the year while expectations of when the first increase would occur were steadily pushed back until the second half of 2013 at the earliest. **Deposit Rates** picked up in the second half of the year as competition for cash increased among banks.

Risk premiums were also a constant factor in raising money market deposit rates for periods longer than 1 month. Widespread and multiple downgrades of the credit ratings of many banks and sovereigns, continued Euro zone concerns, and the significant funding issues still faced by many financial institutions, meant that investors remained cautious of longer-term commitment.

Borrowing Rates in 2011-12

PWLB borrowing rates: the graph and table for PWLB maturity rates below show, for a selection of maturity periods, the high and low points in rates, the average rates, spreads and individual rates at the start and end of the financial year.



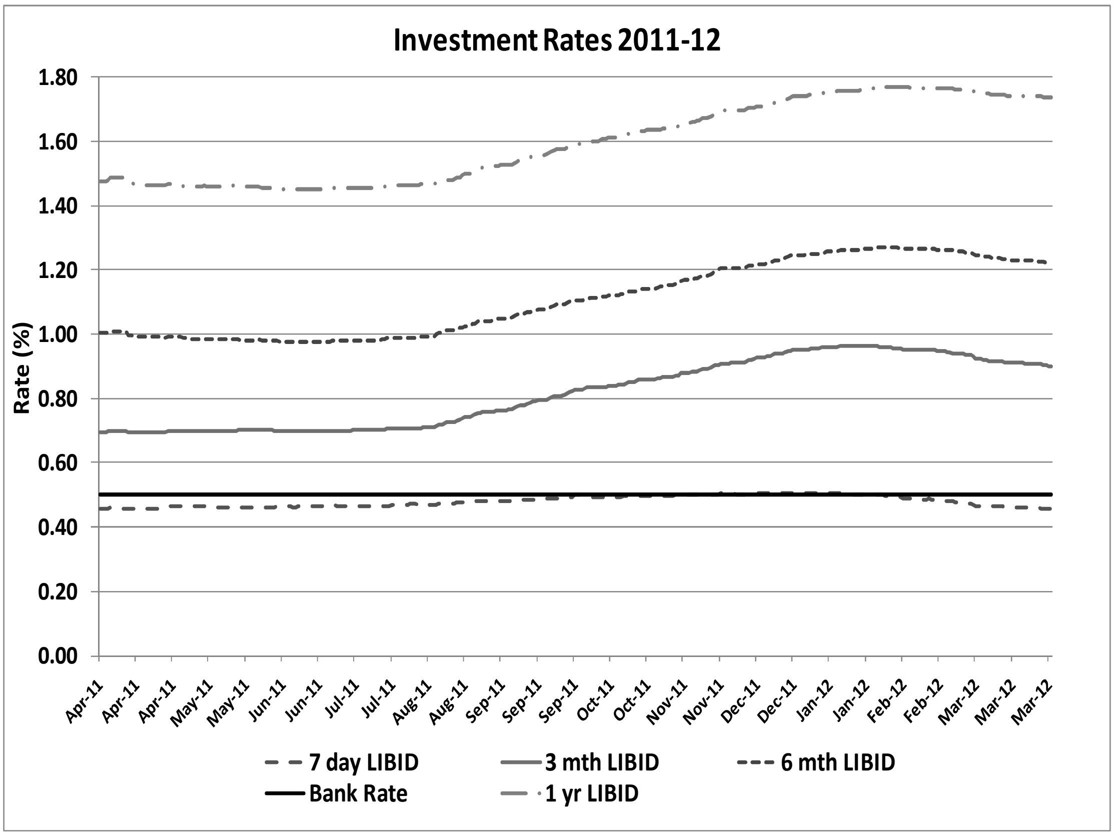
Borrowing Outturn for 2011-12

New Borrowing was taken out in November 2011 for £3,000,000 for a period of 20 years at 4.01% and in March 2012 for £3,000,000 for a period of 3 years at a rate of 1.57%. Also PWLB borrowing was taken out in March for the HRA self financing debt settlement of £59,245,000 for 50 years at a rate of 3.48%.

Investment Rates in 2011-12

The tight monetary conditions following the 2008 financial crisis continued through 2011-12 with little material movement in the shorter term deposit rates. However, one month and longer rates rose significantly in the second half of the year as the Eurozone crisis grew. The ECB's actions to provide nearly €1 trn of 1% 3 year finance to EU banks eased liquidity pressures in the EU and investment rates eased back somewhat in the first quarter of 2012. This action has also given EU banks time to strengthen their balance sheets and liquidity positions on a more permanent basis. Bank Rate remained at its historic low of 0.5% throughout the year while market expectations of the imminence of the start of monetary tightening was gradually pushed further and further back during the year to the second half of 2013 at the earliest.

Overlaying the relatively poor investment returns was the continued counterparty concerns, most evident in the Euro zone sovereign debt crisis which resulted in a second rescue package for Greece, in quarter 1 2012. Concerns extended to potential fallout on the European banking industry if the crisis could have ended with Greece leaving the Euro and defaulting.



Investment Outturn for 2011-12

Investment Policy – the Council's investment policy is governed by CLG guidance, which has been implemented in the annual investment strategy approved by the Council on 2nd March 2011. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

Resources The Council's cash balances comprise revenue and capital resources and cash flow monies. The Council's core cash resources comprised as follows:

Balance Sheet Resources (£m)	31 March 2011 £,000	31 March 2012 £,000
Balances	3,601	3,314
Earmarked Reserves	6,817	7,010
Provisions	1,330	1,041
Usable Capital Receipts	1,787	1,683
Total	13,535	13,048

Investments held by the Council – the Council maintained an average balance of £11m of internally managed funds. The internally managed funds earned an average rate of return of 0.79 %. The comparable performance indicator is the average 7-day LIBID rate which was 0.48%.

Other Issues

There were no other issues of note for Treasury to deal with in 2011-12

Quarter 1 2012-13

Economic Background

- The economic outlook has generally weakened;
- Demand on the high street was volatile, as a result of temporary distortions;
- Employment rose and unemployment fell, but earnings growth remained weak;
- Inflation continued to fall;
- The Bank and the HM Treasury announced measures to help the UK banking sector;
- The MPC indicated another tranche of quantitative easing (QE);
- Gilt yields fell on the back of deteriorating economic data and safe-haven flows from the euro-zone;
- Sentiment towards the Eurozone alternately rose on the announcement of measures to address the crisis, but then fell back as measures disappointed.

The weakening business surveys since the start of Q1 suggests that the economy will be lucky to escape a third successive quarterly contraction (output shrank by 0.4% in Q3 11/12 and 0.3% in Q4 11/12). Admittedly, the weighted output balance of the CIPS/Markit surveys in April and May was at a level consistent with quarterly expansion, albeit of only 0.2%. However it is not clear that the CIPS surveys have improved on the detrimental impact on output of the extra bank holiday for the Queen's Jubilee at the start of June.

The CIPS Surveys does exclude the retail sector and high street spending, which performed strongly in May on the official measure, following a weak, poor-weather driven performance in April. Evidence for early June from the CBI's Distributive Trades Survey suggests that the Jubilee holiday may have boosted spending. Nevertheless, consumer confidence showed no signs of breaking out of its long-depressed state.

The labour market continued to perform relatively better. The Labour Force Survey measure of employment rose by 166,000 in the three months to April, whilst unemployment fell by 51,000 in the period February – April. The scale of the decline was more modest than the rise in employment, with the number of people looking for work outpacing jobs growth. The narrower claimant count measure of unemployment did rise by 8,000 in May, the largest increase since September 2011.

Pay growth remained weak. Annual growth of overall average earnings rose from 0.8% to 1.9% in April as the poor bonus season ended. Excluding bonuses, growth was only 1.8%. Given the rate of inflation over this period, real pay continued to fall on an annual basis, an underlying drag on the consumer and therefore growth.

House prices trended downwards. The Nationwide measure fell in two of the three months from April to June, with the annual rate of house price inflation declining from -0.7% in May to -1.5% in June. The less timely Halifax measure also saw an overall decline in prices over April and May.

Banks' funding costs eased over the quarter, reflecting actions by the Bank of England and Treasury to boost liquidity. Two initiatives were announced in June – a 'funding for lending' scheme which would allow banks to temporarily "swap" their assets with the Bank of England in return for money they could lens to customers, and an emergency scheme that offered six-month liquidity to banks in tranches of £5bn a month.

Costs, however, remained elevated and banks began to pass higher costs onto borrowers. Borrowing rates on most types of new mortgages picked up in April and May.

Trade data showed a sharp deterioration in April. The UK posted its second largest monthly trade deficit on record, driven in large part by a widening of the gap between exports and imports with countries outside the EU. Exports to the Eurozone also fell, with weakness extending from the peripheral countries to what had previously been perceived as strong economies like Germany.

The latest public finance figures also disappointed. While April's budget surplus was the largest on record, this was flattered to the tune of £28bn by the transfer of a share of the assets of the Royal Mail's pension fund to the public sector. Once allowance was made for this, net borrowing for the first two months of the financial year was almost £4bn higher than the equivalent period in 2011/12.

Inflation fell further in the second quarter. CPI inflation fell from 3.5% in March to 2.8% in May, driven by declines in fuel and food prices. Core inflation fell from 2.5% to 2.2%.

The most striking development in inflationary pressures was in the price of oil, which fell from $125 at the beginning of April to around $96 at the end of June, its lowest level since early 2011.

Consistent with the decline in inflation, medium-term indicators of inflation suggested that underlying price pressures remained weak. Household respondents to June's YouGov/Citigroup inflation expectations survey predicted the annual rate of inflation in a year's time would be 2.4%, the lowest year-ahead expectation since April 2010.

The MPC voted narrowly against pursuing more quantitative easing (QE) at its June meeting. The consensus view was that the MPC would decide on further purchases in July. The Governor of the Bank of England said in June that, as a consequence of the Eurozone crisis, he was already more pessimistic than suggested by the forecasts published in the Bank's Inflation Report only six weeks earlier.

As a result of, safe-haven flows from the Eurozone and the impact of the QE, government bond yields fell during the quarter, with ten year yields at one point dropping below 1.5%, their lowest level ever.

After signs of acceleration in Q4 11/12, the US economy's recovery lost momentum. Total non-farm payroll employment was up only 69,000 in May, following a similarly weak rise in April of 77,000. US retail sales values fell in April and May.

Market sentiment towards the Eurozone remained volatile as successive 'rescue packages' first raised, and then disappointed, expectations. The economic news suggested that the Eurozone economy contracted sharply in the second quarter, while Eurozone unemployment rose to 11.1% in May, the highest rate since the creation of the euro in 1999.

Interest Rate Forecast

The Council's treasury advisor, Sector, provides the following forecast:

	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.25%	1.50%
5yr PWLB rate	2.10%	2.20%	2.20%	2.30%	2.40%	2.50%	2.60%	2.80%	3.00%	3.20%	3.40%
10yr PWLB rate	3.00%	3.20%	3.30%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%
25yr PWLB rate	4.20%	4.30%	4.30%	4.40%	4.50%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%
50yr PWLB rate	4.30%	4.40%	4.40%	4.50%	4.60%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%

The Sector central forecast is for the first increase in bank rate to be in the first quarter of 2014 but there is a downside risk to this projection. With growth predictions for the UK continuing to be reduced on an almost monthly basis by both the Office for Budget Responsibility and economic commentators generally, and financial markets unconvinced that politicians have resolved the Eurozone sovereign debt crisis in the medium-term, we are likely to continue to experience high levels of volatility.

Summary Outlook

The outlook for the global economy remains clouded with uncertainty. The UK economy has struggled to generate a sustained recovery so this offers little hope for a strong recovery in 2012, and possibly even into 2013. Consumer and business confidence levels are generally low and it is not easy to see potential for a significant increase in the growth rate in the short term.

Eurozone

- Regular Eurozone summits have yet to put in place the building blocks for a long-term recovery.
- The outcome of French and Greek elections have emphasised the desire of the southern nation states and France to see more of a growth agenda than has been prevalent of late and also a potential move towards fiscal union;
- Cash outflows from banks have generally been from the southern nation states to Germany, Holland, Denmark and Finland.
- The Germans remain reticent about fiscal union of any sort;
- In the first week of July, the ECB cut the base lending rate to 0.75% from 1% whilst the deposit rate was reduced to zero.

US

- Economic prospects have disappointed in recent weeks with the key non-farm payroll monthly figures tending to dip below 100,000 new jobs. For a proper, robust recovery, something in the order of 200,000 new jobs needs to be created each month.

- Operation twist remains in place, ensuring that long term funding costs are forced down as well as the loose monetary policy at the short end of the curve;

- However, in a typically fraught election year, the US still has to address reducing the huge total of public debt and annual deficits but that will have to wait until 2013 at the earliest;

- Presidential elections are due in November 2012.

China

- Falling inflation has opened the way for relaxing credit restrictions to boost growth, which has been flagging;

- Current expectations are that it will maintain a reasonable rate of growth, though less than in previous years.

UK

- Austerity measures, aimed at getting the public sector deficit into order over the next four years, may start losing support unless the economy starts to revive soon;

- Some £80bn is going to be made available by the Government to the banks to parcel through to business but it is not clear that all of this will be taken up;

- The housing market, a gauge of consumer confidence, remains subdued although house prices are supported by the weak £ relative to some of the other main currencies;

- Economic forecasts for 2012 and beyond have been revised lower on a near quarterly basis;

- The bank of England embarked on a £50bn third round of Quantitative Easing (QE) at the start of July to stimulate economic activity. It is unlikely to be the last tranche of QE and the total now stands at £375bn;

- Inflation has eased from its peak of 5.2% (CPI) in September 2011, now standing at 2.8% with the outlook brighter given commodity and oil prices seem to be in decline, at least for the moment.

- “Safe Haven” status has underpinned demand for gilts and kept yields at historic lows. Unlikely to see material change in the near term.

Sectors Forward View

Economic forecasting remains difficult with so many external influences weighing on the UK. Key areas of uncertainty include:

- The impact of the Eurozone crisis on financial markets and the banking sector;

- The impact of the UK Government's austerity plan on confidence and growth;
- Monetary policy action failing to stimulate growth in western economies;
- The potential for weak growth or recession in the UK's main trading partners – the EU and US.

The overall balance of risks remains weighted to the downside. Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. However, near-term, QE is likely to depress yields and further QE thereafter may lead to a reassessment of Sector's central forecast.

Given the weak outlook for economic growth, Sector sees the prospects for any interest rate changes before early 2014 as very limited indeed. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2012/13, which includes the Annual Investment Strategy, was approved by Council on 29th February 2012. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield

The Council wall also aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity. In the current economic climate and the heightened credit concerns it is considered appropriate to keep investments short term with a maximum duration of 3 months.

This limit will apply to all entities on the suggested Sector Credit List with the following exceptions:

1. UK Government and related entities such as Local Authorities. Their suggested duration limit will remain at 5 years.
2. UK semi-nationalised institutions (Lloyds/ RBS). We continue to view the current significant UK ownership of these entities as providing significant comfort to investors.
3. Money Market Funds.

A full list of investments held at 30th June 2012, compared to Sector's counterparty list are shown below:

	Borrower	Principal	Interest Rate	Type
5 Yrs	Deutsche MMF	£3,957,000	0.61%	Money Market
5 Yrs	Ignis MMF	£4,490,000	0.69%	Money Market

1 Yr	Bank of Scotland PLC	£3,048,000	0.50%	Call Account
1 Yr	National Westminster Bank PLC	£3,845,000	0.80%	Call Account
	Total Investments	£15,340,000	0.66%	

Investment rates available in the market have continued at historically low levels. The average funds available for investment purposes during the quarter was £11m. These funds were available on a temporary basis, and the level of fund available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme.

The benchmark return for the first quarter was 0.45% and as show above the Council has outperformed the benchmark by 0.21 bps. The Council's budgeted investment return for 2012-13 is £122,260 and performance for the year is in line with the budget.

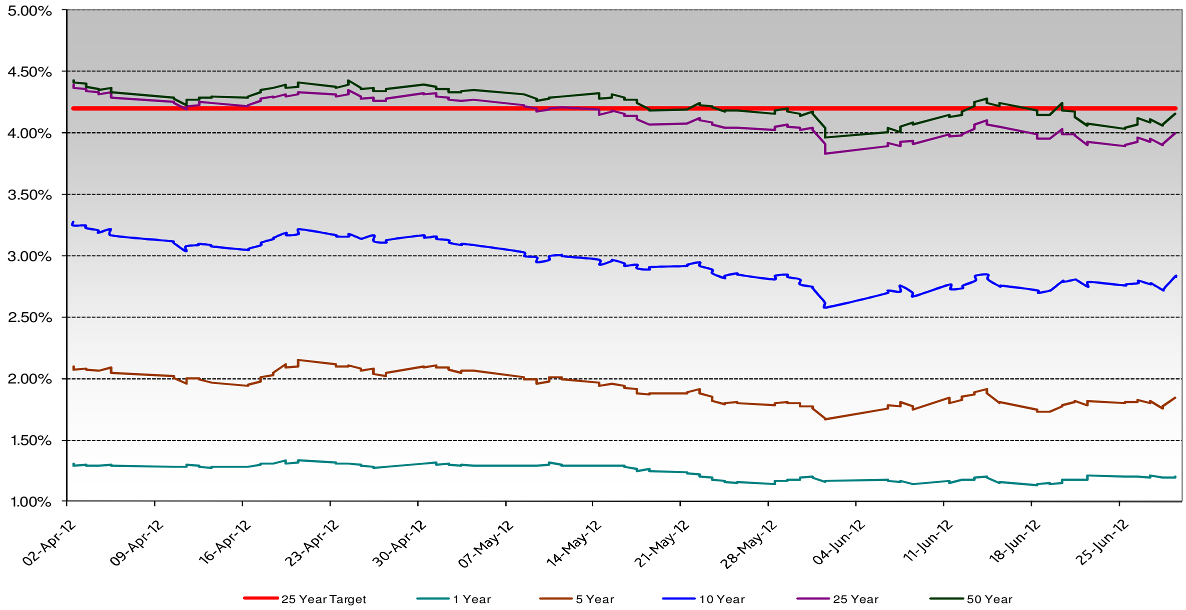
New Borrowing

Sector's 25 year PWLB target rate for new borrowing for the quarter remained at 4.20%. Due to the overall financial position and the underlying need to borrow for capital purposes (the Capital Financing Requirement – CFR), new external borrowing of £4.7 million was undertaken in May 2012 from the PWLB at a market rate of 4.05% over a 25 year period.

As shown below, interest rates across the interest rate yield curve generally fell during the quarter. The low points during the quarter were generally seen during June.

PWLB rates quarter ended 30.6.2012

	1 Year	**5 Year**	**10 Year**	**25 Year**	**50 Year**
Low	1.13%	1.67%	2.58%	3.83%	3.96%
Date	18/06/12	01/06/12	01/06/12	01/06/12	01/06/12
High	1.33%	2.15%	3.28%	4.39%	4.43%
Date	19/04/12	20/04/12	02/04/12	02/04/12	02/04/12
Average	1.24%	1.92%	2.95%	4.13%	4.24%



This council has not borrowed in advance of need during the quarter ended 30th June 2012 and has no intention to borrow in advance in 2012-13.

Compliance with Treasury and Prudential Limits

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. The Council's approved Treasury and Prudential Indicators are included in the approved TMSS. During the financial year to date the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices. The prudential and treasury indicators are shown in Annex 2.

Section 3

Contribution to Council Priorities

As a major contributor to attaining the Budget requirements Treasury Management enables the Council to fulfil all aspects of its priorities.

Section 4

Financial Implications

The financial implications have been addressed throughout this report.

Section 5

Human Resource Implications

There are no Human Resource Implications arising from this report.

Section 6

Legal Implications

The legal implications are set out throughout the report.

Section 7

Section 17 (Crime Prevention) Implications

There are no Section 17 implications arising from this report.

Section 8

Human Rights Act Implications

There are no identified implications in respect of the Human Rights Act 1998 arising from this report.

Section 9

Data Protection Act Implications

There are no implications arising from this report.

Section 10

Risk Management Implications

Treasury Management is a high risk area due to the large amounts of money dealt with on a daily basis. However, the Council has a Treasury Policy and Strategy in place which is approved each year for the following 12 months. The Council also has advice on investment and lending from the leading company in the field and has instituted a strict control and delegation of duties regime which reduces all risks to a minimum.

Section 11

Equality and Diversity Implications

There are no identified implications arising from this report.

Section 12

Other Options Considered

There are no other options to be considered.

Section 13

List of Background Papers

Statement by the Leader of the Council 2011-12

Report Author Details

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Annex 1

Prudential Indicators

	2011-12 Projected	2011-12 Actual	2012-13 Estimated	2013-14 Estimated	2014-15 Estimated
Affordability					
Ratio Financing Costs to Net Revenue Stream					
General Fund	0.81%	0.72%	4.65%	4.27%	5.41%
HRA	9.14%	9.63%	20.12%	19.62%	21.36%
Incremental impact of capital investment decisions on Council Tax					
Incremental impact of capital investment decisions on average weekly housing rents			-0.45%	1.17%	-1.55%
Capital Expenditure	£m	£m	£m	£m	£m
Total Capital Expenditure (including external funding)					
General Fund	7.354	7.748	5.928	0.992	1.291
HRA	5.999	5.800	7.164	9.369	9.742
Capital Financing Requirement as at 31March					
General Fund	12.414	9.575	15.547	15.072	14.306
HRA	82.029	82.007	82.007	82.007	85.007
Net Borrowing Requirement					
Brought Forward at 1 April	15.372	15.292	83.546	88.206	88.206
Net Existing Borrowing (ie less Investments) as at 31 March	80.641	76.684	83.546	88.206	88.206
New Borrowing	66.147	66.147	3.628		3.000
In Year Borrowing Requirement	-0.878	-4.755	-3.628	0.000	-3.000

Prudence

Net Borrowing and the Capital Finance: Net Borrowing is not expected to exceed the total of the Capital Financing Requirement (except in the short term)

Treasury Indicators

	2011-12 Projected	2011-12 Actual	2012-13 Estimated	2013-14 Estimated	2014-15 Estimated
External Debt					
Authorised Limit	94.443	94.443	97.554	97.079	99.313
Operational Boundary	87.600	87.600	91.228	91.228	94.228
External Debt as at 31 March if no new borrowing undertaken	21.301	21.301	21.097	21.093	21.090

Prudence

Net Borrowing and the Capital Finance Requirement: Net Borrowing is not expected to exceed the total of the Capital Financing Requirement (except in the short term)

	2011-12 Projected	2011-12 Actual	2012-13 Estimated	2013-14 Estimated	2014-15 Estimated
Interest Rate Exposure					
Upper Limit Fixed					
Borrowing	100%	100%	100%	100%	100%
Investment	50%	50%	50%	50%	50%
Upper Limit Variable					
Borrowing	10%	10%	10%	10%	10%
Investment	100%	100%	100%	100%	100%
Maturity Structure Of Borrowing					
Under 12 months	4%	0%	0%	0%	0%
12 months to 24 months	0%	0%	0%	0%	0%
24 months to 5 years	1%	5%	5%	5%	5%
5 years to 10 years	0%	3%	3%	3%	3%
10 years and above	95%	92%	92%	92%	92%

Annex 2

Prudential Indicator	**2012-13 Budget** **£,000**	**Quarter 1 Actual** **£,000**
Capital Expenditure – General Fund	5,928	0.796
Capital Expenditure – HRA	7,164	0.667
In Year Borrowing Requirement	3,628	3,628
Authorised Limit for External Debt	97,554	97,554
Operational boundary for External Debt	91,228	91,228
Gross Borrowing	83,546	88,245
Investments	0	15,340
Net Borrowing	83,546	72,905
Capital Financing Requirement – General Fund	15,547	15,547
Capital Financing Requirement – HRA	82,007	82,007
Ratio of Financing Costs to Net Revenue Stream - GF	4.65%	4.65%
Ratio of Financing Costs to Net Revenue Stream - HRA	20.12%	20.12%
Maturity Structure of Borrowing		
- Under 12 Months	0%	0%
- 12 months to 24 months	0%	0%
- 24 months to 5 years	5%	4%
- 5 years to 10 years	3%	3%
- 10 years and above	92%	93%