MEETING:	**AUDIT COMMITTEE**
DATE:	**22 NOVEMBER 2012**
TITLE:	**TREASURY MANAGEMENT 2012/13 – MID YEAR REVIEW**
PURPOSE:	**CIPFA's Code of Practice recommends that a report on the Council's actual Treasury Management during the current financial year is produced.**
RECOMMENDATION:	**RECEIVE THE REPORT FOR INFORMATION**
AUTHOR:	**DAFYDD L EDWARDS, HEAD OF FINANCE**

EXECUTIVE SUMMARY

During the six month period between 1 April and 30 September 2012, the Council's borrowing remained well within the limits originally set. There were no new defaults by banks in which the Council deposited money.

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1. BACKGROUND

The Council's Treasury Management Strategy has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

The Code also recommends that members are informed of Treasury Management activities at least twice a year. This report therefore ensures this authority is embracing Best Practice in accordance with CIPFA's recommendations.

Treasury management is defined as: "The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2. ECONOMIC BACKGROUND

The world economy faced yet another soft patch. The UK and the Eurozone (with the exception of Germany) struggled to show discernible growth whilst the US economy grew slowly. UK GDP contracted by 0.3% in the first calendar quarter of 2012 and by 0.4% in second, reflecting the difficult economic conditions faced by businesses and consumers domestically and globally. Businesses were more inclined to take defensive strategies involving cost cutting rather than increasing capital spending. Financial conditions facing households continued to be weak as wage growth remained subdued and was, for much of the period, outstripped by inflation. (Much of the fall in Q2 GDP could probably be attributed to the impact of the additional bank holiday for the Diamond Jubilee, and could be recovered in Q3.)

Inflation, which had remained stubbornly sticky throughout 2011, slowly began to fall. Annual CPI dipped below 3% for the first time in two and half years in May and fell to the lowest level since November 2009 in June, with a reading of 2.4%. It ticked up marginally to 2.5% by August. Although the recent rise in commodity prices has been worrying, the rise in oil and food prices – the latter mainly due to poor weather-related yields - are well below the spikes of 2010-11.

Some barometers of economic activity, however, provided a more buoyant and positive picture but tended to get overshadowed. Employment rose by 236,000 in the three months to July and the employment rate was at its highest since the three months to April 2009. The ILO unemployment rate fell 0.1% on the quarter to 8.1%. Whilst the effect of the Olympics undoubtedly played a part, despite its temporary nature, the underlying data pointed to a more resilient and optimistic outlook for the economy.

The lack of growth and the fall in inflation were persuasive enough for the Bank of England to sanction £50 billion asset purchases (QE) in July, taking total QE to £375 billion. The possibility of a rate cut from the current level of 0.5% was discussed at the Bank's Monetary Policy Committee meetings in June and July; however reference to it was subsequently dropped suggesting that this policy option had left the table for the immediate future. The government's Funding for Lending (FLS) initiative, intended to lower banks' funding costs, commenced in August. The Bank of England will assess its effects in easing the flow of credit before committing to further policy action.

Banks were embroiled in the scandal to manipulate LIBOR rates during the abnormal market conditions at the height of the 2007/2008 financial crisis. Barclays was fined a record £290 million, the FSA was also investigating HSBC, RBS, Citicorp and UBS; Lloyds was named in a lawsuit in the US. The big-four UK banks were also being investigated for mis-selling interest rate swaps to small businesses.

The US Federal Reserve extended quantitative easing through 'Operation Twist', in which it buys longer-dated bonds with the proceeds of shorter-dated US Treasuries. Poor employment data for August preceded the Fed further easing monetary policy at its September meeting; The Fed committed to purchasing $40 billion of agency mortgage-backed securities each month until the outlook for the labour market improves "substantially." The Fed also pledged to keep interest rates low until mid-2015. In Greece, the formation of an alliance of pro-euro parties after a second round of parliamentary elections prevented an immediate and disorderly exit from the Euro. The Euro region suffered a renewed bout of stress when Italian and Spanish government borrowing costs rose sharply and Spain was also forced to officially seek a bailout for its domestic banks. The European Central Bank responded with the announcement in September of its Outright Monetary Transactions (OMT) facility which allows the ECB to buy unlimited amounts of 1-3 year sovereign bonds provided the sovereign(s) first asks for such assistance and adheres to the strict conditionality attached to such purchases.

Gilt yields fell sharply raising the prospect that very short-dated yields could turn negative. 2-year yields fell to 0.06%, 5-year yields to 0.48% and 10-year yields to 1.45%. Despite the likelihood the DMO would revise up its gilt issuance for 2012/13, there were several gilt-supportive factors: the Bank of England's continued purchases of gilts under an extended QE programme; investors preferring the safer haven of UK government bonds to those of European sovereigns; the coalition's commitment to fiscal discipline by sticking to its "plan A" for deficit reduction; large scale purchases by banks to comply with the FSA's liquidity buffer requirements; and general risk aversion against a weak economic backdrop. PWLB borrowing rates fell commensurately (the Board maintained the +0.90% margin above the equivalent gilt yield for new borrowing).

Money market rates fell over the six month period by between 0.2% to 0.6% for 1-12 month maturities.

3. DEBT MANAGEMENT

	Balance on 01/04/2012 £000s	Debt Maturing £000s	Debt Repaid £000s	New Borrowing £000s	Balance on 30/09/2012 £000s	Increase/ Decrease in Borrowing
TOTAL BORROWING	113,865	860	124	NIL	112,811	-1054
Average Rate % / Life (yrs)	5.85% / 31.22 yrs	10.5%	9.71% / 1.16 yrs	__% / ___ yrs	5.86% / 31.00 yrs	------

The PWLB remains an attractive source of borrowing for the Council as it offers flexibility and control. The large downward move in gilt yields in the second quarter resulted in PWLB rates falling across all maturities.

In August HM Treasury announced details of the "Certainty Rate" which will enable "eligible authorities" to access cheaper PWLB funding, with a 20 basis point reduction on the standard PWLB borrowing rate. Initially announced in the March 2012 Budget, HM Treasury have introduced this initiative to incentivise local authorities to provide robust forecasts on borrowing plans. This rate is expected to be introduced in November 2012.

The Council has completed the pro-forma projecting the Council's likely borrowing requirement over a three year period and returned it to the Welsh Government by the deadline of 17th September 2012.

For the Council the use of internal resources in lieu of borrowing has continued to be the most cost effective means of funding £10.7m of capital expenditure in 2012/13. This has lowered overall treasury risk by reducing both external debt and temporary investments. However, this position will not be will not be sustainable over the medium term and the Council expects it will need to borrow £5m for capital purposes by 2013/14.

No debt rescheduling took place during the period.

4. INVESTMENT ACTIVITY

The Welsh Government Guidance on Local Government Investments gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

Investments

	Balance on 01/04/2012 £000s	Investments Made £000s	Investments Repaid £000s	Balance on 30/09/2012 £000s	Increase/ Decrease in Investments
Short Term Investments in Banks and Building Societies	47,630	221,865	(225,865)	43,630	(4,000)
Investments in Money Market Funds	0	35,000	(10,000)	25,000	25,000
Investments in other Local Authorities	5,000	5,000	(5,000)	5,000	0
TOTAL INVESTMENTS	52,630	233,865	(212,865)	73,630	21,000

Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2012/13. New investments were made with the following institutions:

- Other Local Authorities;
- AAA-rated Money Market Funds;
- Certificates of Deposit (CDs) and Term Deposits with UK Banks and Building Societies systemically important to the UK banking system and with select non-UK Banks;
- T-Bills, UK Government Gilts and DMADF (Debt Management Office);
- Bonds issued by Multilateral Development Banks, such as the European Investment Bank and World Bank;
- Pooled funds (collective investment schemes) meeting the criteria in SI 2004 No 534 and subsequent amendments.

Counterparty credit quality was assessed and monitored with reference to Credit Ratings (the Council's minimum long-term counterparty rating of A- (or equivalent) across rating agencies Fitch, S&P and Moody's); credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; sovereign support mechanisms /potential support from a well-resourced parent institution; share price.

Credit Risk

Counterparty Update

In June Moody's completed its review of banks with global capital market operations, downgrading the long-term ratings of all of them by between one to three notches. The banks on the Council's lending list which were affected by the ratings downgrades were Barclays, HSBC, Royal Bank of Scotland, as well as Royal Bank of Canada, JP Morgan Chase, BNP Paribas, Societe Générale, Credit Agricole/Credit Agricole CIB, Credit Suisse and Deutsche Bank. Separately, the agency also downgraded the ratings of Lloyds Bank, Bank of Scotland, National Westminster Bank and Santander UK plc. None of the long-term ratings of the banks on the Council's lending list were downgraded to below the Council's minimum A-/A3 credit rating threshold.

Counterparty credit quality is demonstrated by the Credit Score Analysis summarised below. The credit scores are based on the Council's quarter-end investment position.

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating
31/03/2012	4.98	A+	4.93	A+
30/06/2012	5.19	A+	3.00	AA
30/09/2012	3.74	AA-	3.48	AA

Scoring:
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-AAA = highest credit quality = 1
- D = lowest credit quality = 27
-Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

Following the decision to shorten deposit durations with investment counterparties back in May this year, the Council has since extended duration (decision made in late July). The move to extend duration was as a result of monitoring economic and political developments in the UK, Europe and globally. The various risk metrics used to assess the creditworthiness of financial institutions had shown continued signs of stabilisation, and in some cases, considerable improvement.

At this time of extending duration limits with UK, Australian, Canadian and American banks, the Council also reintroduced the strongest banks in the stronger European sovereigns onto its approved lending list.

The Council has not had any investments with non-uk banks during the period 1 April to 30 September 2012.

The Council's counterparty list as at 30 September 2012 is attached for information in Appendix A.

Safe Custody Arrangements

The Council set up a custody account with King and Shaxson in August 2012. By opening a custody account with King and Shaxson, the Council now has the ability to use a number of approved investment instruments as outlined in the 2012/13 Treasury Strategy and diversify the investment portfolio. Investment instruments requiring a custodian facility include Treasury Bills, Certificates of Deposit, Gilts, Corporate Bonds and Supranational Bonds.

By establishing custody arrangements, the Council is better-placed to consider the use of alternative investment instruments in response to evolving credit conditions.

The Council invested in a Certificate of Deposit with Standard Chartered Bank in August 2012.

Budgeted Income and Outturn

The Council's budgeted investment income for the year has been estimated at £0.7m. The average cash balances representing the Council's reserves, working balances and the Pension Fund's surplus cash were £76.3m during the period.

The UK Bank Rate has been maintained at 0.5% since March 2009 and is not expected to rise until 2015/2016. Short-term money market rates have remained at very low levels. New investments were made at an average rate of 0.95%. The Council anticipates an investment outturn of £729,030 for the whole year.

Icelandic Bank Investment Update

The following has now been resolved in relation to Icelandic deposits:

- ***Heritable*** – It is expected that 88p/£ will be recovered overall. 75% has been recovered to date, and a further 7% is expected in 2012/13 and the remaining 6% is expected in April 2013.

5. COMPLIANCE WITH PRUDENTIAL INDICATORS

The Council can confirm that it has complied with its Prudential Indicators for 2012/13, which were set in March 2012 as part of the Council's Treasury Management Strategy Statement which can be accessed through the following link:

http://www.gwynedd.gov.uk/ADNPwyllgorau/2012%20hyd%20at%20fis%20Mai/Cyngor%20Llawn/2012-03 01/english/08_04_(iii)%20Treasury%20Management.pdf. Details can be found in Appendix B.

6. OUTLOOK FOR QUARTER 3 – QUARTER 4

At the time of writing this activity report in November 2012, economic growth remains elusive. Tight credit conditions and weak earnings growth are constraining consumer and corporate spending. The outlook is for official interest rates to remain low for an extended period, as shown below.

	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
Official Bank Rate													
Upside risk				0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50
Central case	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**	**0.50**
Downside risk	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25

7. SUMMARY

In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during the first two quarters of 2012/13. As indicated in this report none of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

<u>APPENDIX A</u>

GWYNEDD COUNCIL'S LIST OF AUTHORISED COUNTERPARTIES (as updated 30/09/12)

Term Deposits / Call Accounts

Country	Counterparty	Maximum Limit of Investments £m	Maximum Length of Loans
UK	DMADF, DMO	No limit	No limit
UK	UK Local Authorities	£25m	1 year
UK	Santander UK Plc (Banco Santander Group)	£20m	~~Overnight~~ maximum 35 days
UK	Bank of Scotland (Lloyds Banking Group)	£20m	~~Overnight~~ maximum ~~35~~ 100 days
UK	Lloyds TSB (Lloyds Banking Group)	£20m	~~Overnight~~ maximum ~~35~~ 100 days
UK	Barclays Bank Plc	£20m	maximum 100 days
UK	**Clydesdale (National Australia Bank Group) **SUSPENDED 28/09/11****	~~£20m~~	~~2 years~~
UK	HSBC Bank Plc	£20m	~~maximum 6 months~~ 1 year
UK	Nationwide Building Society	£20m	maximum 100 days
UK	Nat West (RBS Group)	£20m	~~Overnight~~ maximum 35 days
UK	Royal Bank of Scotland (RBS Group)	£20m	~~Overnight~~ maximum 35 days
UK	Standard Chartered Bank	£20m	~~maximum 6 months~~ 1 year
Australia	Australia and NZ Banking Group	£5m	~~maximum 6 months~~ 1 year
Australia	Commonwealth Bank of Australia	£5m	~~maximum 6 months~~ 1 year
Australia	National Australia Bank Ltd (National Australia Bank Group)	£5m	~~maximum 6 months~~ 1 year
Australia	Westpac Banking Corp	£5m	~~maximum 6 months~~ 1 year
Canada	Bank of Montreal	£5m	~~maximum 6 months~~ 1 year
Canada	Bank of Nova Scotia	£5m	~~maximum 6 months~~ 1 year
Canada	Canadian Imperial Bank of Commerce	£5m	~~maximum 6 months~~ 1 year
Canada	Royal Bank of Canada	£5m	~~maximum 6 months~~ 1 year
Canada	Toronto-Dominion Bank	£5m	~~maximum 6 months~~ 1 year
Finland	Nordea Bank Finland	£5m	~~1 year~~ maximum 100 days
France	**BNP Paribas *SUSPENDED 13/09/11 ***	~~£5m~~	~~1 year~~
France	**Credit Agricole CIB (Credit Agricole Group) *SUSPENDED 13/09/11***	~~£5m~~	~~1 year~~
France	**Credit Agricole SA * SUSPENDED 13/09/11***	~~£5m~~	~~1 year~~
France	**Societe Generale *SUSPENDED 11/08/11***	~~£5m~~	~~1 year~~
Germany	Deutsche Bank AG	£5m	~~1 year~~ maximum 100 days
Netherlands	**ING Bank NV *SUSPENDED 01/12/11***	~~£5m~~	~~1 year~~
Netherlands	Rabobank	£5m	~~1 year~~ maximum 100 days
Netherlands	Bank Nederlandse Gemeenten	£5m	~~1 year~~ maximum 100 days
Sweden	Svenska Handelsbanken	£5m	~~1 year~~ maximum 100 days
Switzerland	**Credit Suisse *SUSPENDED 01/12/11***	~~£5m~~	~~1 year~~
US	JP Morgan	£5m	maximum 6 months

1) There is a limit of £20m on banks within the same banking group.
2) Investments in Non-UK banks will be restricted to a maximum limit of 40% of the portfolio, with a £10m country limit to a maximum of 30% of the portfolio per country.

Instrument	Country	Counterparty	Maximum Limit of Investments £m	Maximum Length of Loans
Gilts*	UK	DMO	No limit	6 years
AAA rated Money Market Funds	UK/Ireland/ Luxembourg	Money Market Funds	£5m per name	Daily Liquidity
Other MMFs and CIS	UK	Collective Investment schemes	£5m per name	Daily Liquidity
Treasury Bills*	UK	DMO	No Limit	1 year
Local Authority Bills*	UK	UK Local Authorities	£10m	1 year
Bonds issued by multilateral development banks*	Europe / America	EIB, Council of Europe, Inter American Investment Bank	£5m	6 years
Bonds issued by financial institutions guaranteed by the UK government*	UK	Guaranteed financial institutions	£5m	6 years
Sterling denominated bonds by non-UK sovereign governments*	Non-UK	Non-UK Sovereign Governments	£5m	3 years
Business loans to local companies**	UK	As agreed by the Local Loans Fund Scheme	£1m	10 years

* Investment in these instruments will be on advice from the Council's treasury advisor.
** Advancement of these loans will be approved by the procedure detailed in Appendix Ch, Paragraph 6. Evaluation of the Business Loans is not part of the advice or services from the Council's treasury advisor.

Capital Financing Requirement

Estimates of the Council's cumulative maximum external borrowing requirement for 2012/13 to 2014/15 are shown in the table below:

	31/03/2012 Actual £000	31/03/2013 Estimate £000	31/03/2014 Estimate £000	31/03/2015 Estimate £000
Capital Financing Requirement	152,241	155,904	160,361	166,915
Less: Existing Profile of Borrowing	(114,341)	(113,085)	(111,969)	(110,975)
Less: Other Long Term Liabilities	(29)	0	0	0
Cumulative Maximum External Borrowing Requirement	**37,871**	**42,819**	**48,392**	**55,940**

Usable Reserves

Estimates of the Council's level of Usable Reserves for 2012/13 to 2014/15 are as follows:

	31/03/2012 Actual £000	31/03/2013 Estimate £000	31/03/2014 Estimate £000	31/03/2015 Estimate £000
Usable Reserves	68,920	63,456	57,023	55,374

Prudential Indicator Compliance

(a) Authorised Limit and Operational Boundary for External Debt

The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of their indebted status. This is a statutory limit which should not be breached. The Council's Affordable Borrowing Limit was set at £190m for 2012/13.

The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit. The Operational Boundary for 2012/13 was set at £170m.

The Head of Finance confirms that there were no breaches to the Authorised Limit and the Operational Boundary during the year; borrowing at its peak was £115m.

(b) Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates.

The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of investments.

	Limits for 2012/13 %
Upper Limit for Fixed Rate Exposure	100%
Compliance with Limits:	Yes
Upper Limit for Variable Rate Exposure	50%
Compliance with Limits:	Yes

Interest Rate Exposures	Existing level at 31/03/12 %	2012/13 Approved %	Actual at 30/09/12 %
Fixed			
Upper Limit for Fixed Interest Rate Exposure on Debt	100	100	100
Upper Limit for Fixed Interest Rate Exposure on Investments	(100)	(100)	(66)
Net Fixed Exposure	0	**0**	34
Variable			
Upper Limit for Variable Interest Rate Exposure on Debt	0	50	0
Upper Limit for Variable Interest Rate Exposure on Investments	0	(50)	(34)
Net Variable Exposure	**0**	**0**	(34)

(c) Maturity Structure of Fixed Rate Borrowing

This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

Maturity Structure of Fixed Rate Borrowing	Upper Limit %	Lower Limit %	Actual Fixed Rate Borrowing as at 30/09/12	% Fixed Rate Borrowing as at 30/09/12	Compliance with Set Limits?
Under 12 months	25%	0%	938,562	0.97	Yes
12 months and within 24 months	25%	0%	1,373,452	1.42	Yes
24 months and within 5 years	50%	0%	4,108,953	4.25	Yes
5 years and within 10 years	75%	0%	4,581,868	4.75	Yes
10 years and above	100%	0%	85,608,589	88.61	Yes

(d) Gross and Net Debt

The purpose of this treasury indicator is to highlight a situation where the Authority is planning to borrow in advance of need.

Upper Limit on Net Debt compared to Gross Debt	2011/12 Actual £m	2012/13 Estimate £m	Compliance with Set Limits?
Outstanding Borrowing (at nominal value)	114	113	Yes
Other Long-term Liabilities (at nominal value)	0	0	Yes
Gross Debt	114	113	Yes
Less: Investments	47	36	Yes
Net Debt	**67**	**77**	Yes

(e) Net Debt and the Capital Financing Requirement

This is a key indicator of prudence. In order to ensure that over the medium term net borrowing will only be for a capital purpose, the Authority should ensure that the net external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional increases to the capital financing requirement for the current and next two financial years.

The Authority had no difficulty meeting this requirement so far in 2012/13, nor are there any difficulties envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the approved budget.

(f) Total principal sums invested for periods longer than 364 days

This indicator allows the Council to manage the risk inherent in investments longer than 364 days.

The limit for 2012/13 was set at £40m.

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

(g) Credit Risk

This indicator has been incorporated to review the Council's approach to credit risk. The Council confirms it considers security, liquidity and yield, in that order, when making investment decisions.

Credit ratings remain an important element of assessing credit risk, but they are not the sole feature in the Authority's assessment of counterparty credit risk. The authority considers the following tools to assess credit risk:

- Published credit ratings of the financial institution and its sovereign;
- Sovereign support mechanisms;
- Credit default swaps (where quoted);
- Share prices (where available);
- Economic fundamentals, such as a country's net debt as a percentage of its GDP);
- Corporate developments, news, articles, markets sentiment and momentum.

The Council can confirm that all investments were made in line with minimum credit rating criteria set in the 2012/13 Treasury Management Strategy Statement:

- long-term ratings of A- or equivalent;
- long-term ratings of AA+ or equivalent for non-UK sovereigns.