

COPY

CABINET – 16 NOVEMBER 2010

TREASURY MANAGEMENT MID TERM REVIEW 2010/11

Report by Assistant Chief Executive & Chief Finance Officer

Introduction

1. The Chartered Institute of Public Finance and Accountancy's (CIPFA's) 'Code of Practice on Treasury Management (Revised) 2009' requires that Council receives an updated report on Treasury Management activities at least twice per year. This is the first report to fulfil the requirement for 2010/11 and sets out the position as at 30 September 2010.
2. The following annexes are attached
 - Annex 1 Lending List Changes
 - Annex 2 Debt Financing 2010/11
 - Annex 3 PWLB interest rate graph
 - Annex 4 PWLB debt Raised and Maturing
 - Annex 5 Prudential Indicator Update.

Strategy 2010/11

3. The approved Treasury Management Strategy for 2010/11 was based on an average base rate forecast of 0.63% (0.50% for April to December rising to 1.00% in January 2011).
4. The Strategy for Long Term Borrowing was to use a combination of external borrowing and internal balances.
5. The Strategy included the continued use of the services of external fund managers, Scottish Widows Investment Partnership (SWIP) and Investec.

Market Background

6. The UK continued to emerge from recession in the first two quarters of the financial year, but the level of activity remained below pre-crisis levels. GDP registered 0.3% growth in the first calendar quarter of 2010 and 1.2% in the second.
7. The Bank of England's Monetary Policy Committee (MPC) has maintained the Bank Rate at 0.5% and Quantitative Easing at £200bn. However, the minutes of Bank of England's September meeting contained the possibility of further Quantitative Easing to keep the economy and inflation on track in the medium term.
8. Inflation continued to decline although the annual CPI to August 2010 remained at 3.1% (above the Government's target of 2%). This has resulted in two open explanatory letters from the Bank of England's Governor to the

Chancellor. In the coming months higher food and fuel prices raise the risk that inflation may not fall before 2011, at which point it is likely to rise again when VAT is increased to 20%.

9. The Bank of England's August Quarterly Inflation Report showed inflation remaining above the 2% target for longer than previously projected. Although the recovery in economic activity was expected to continue, the overall outlook for growth was weaker than presented in the May report.
10. The successful formation of a coalition government dispelled uncertainty surrounding a hung parliament result in May's General Election. The new government's Emergency Budget in June 2010 laid out action to address the UK's budget deficit, aiming to eliminate the structural deficit by 2014/15. This is to be achieved through austerity measures – £32bn of spending cuts and £8bn of net tax increases. Market perception of the deficit reduction plan resulted in a drop in Gilt yields. The expected level of spending cuts and tax rises appears to have extinguished the recent concern about inflation expectations.
11. The US Federal Reserve (the Fed) kept rates on hold at 0.25% following signs of a slowdown in American growth. At its meeting in September the Fed sent a strong signal that it is prepared to do more, and is moving closer to a second wave of unconventional monetary easing. The European Central Bank maintained rates at 1%. The major ongoing worries in Europe extended from sovereign weakness in Portugal, Italy, Ireland, Greece and Spain, the exposure of the continent's banking sector to the sovereign and corporate debt of these nations and the risk of spreading to other countries. The sovereign ratings of Greece, Ireland, Portugal and Spain were downgraded by the rating agencies.
12. The results from the EU Bank Stress Tests, co-ordinated by the Committee of European Banking Supervisors, highlighted that only 7 (2 Greek, 1 German and 4 Spanish "caja" banks) of the 91 institutions that made up the scope of the analysis were classed to have failed the adverse scenario tests. The tests are a helpful step forward, but there were doubts if they were far-reaching or demanding enough. The main UK Banks' (Barclays, HSBC, Lloyds and RBS) Tier 1 ratios all remained above the levels deemed as safe under both the 'benchmark scenario' and the 'adverse scenario' stress tests.
13. Gilts rallied as the growth momentum faded and the UK seemed to offer a safe harbour from Euroland's turbulence. 5- and 10-year gilt yields fell to lows of 1.57% and 2.83% respectively, which in turn reduced new borrowing rates available to Local Authorities.

Treasury Management Activity

Debt Financing

14. Oxfordshire County Council's (the Council) debt financing to date for 2010/11 is analysed in Annex 2.

15. The original 2010/11 borrowing strategy was to use a combination of external borrowing and internal balances. This was intended to reduce the cost of carry (the difference between borrowing rates and investment returns), and also partly retain the ability to borrow internally in the future if borrowing rates were prohibitively expensive.
16. In July 2010 in light of uncertainty over the cost of financing, and the future ability of Local Authorities to finance, capital expenditure through borrowing, the Treasury Management Strategy Team (TMST) took the view that retaining the ability to borrow internally in future years was necessary. Therefore borrowing was arranged for the Capital Financing Requirement for the year.
17. The Council's cumulative total external debt has increased from £412.09m on 1 April 2010 to £441.75m by 30 September 2010, a net increase of £29.66m. The purpose of the increase in borrowing was to finance capital expenditure. Gross 'new' borrowing amounted to £30m all of which was borrowed from the PWLB¹. No new money market debt has been arranged during the year. The total forecast external debt for 31 March, after repayment of loans maturing during the year is £434.41m. The forecast debt financing position for 31 March 2011, is shown in Annex 2.
18. Following the Spending Review (SR) in October 2010, borrowing rates from the PWLB included an increased premium of 0.87% across all loans. Therefore, officers concerns over the cost of borrowing were warranted and the decision to borrow £30m before the SR has avoided additional interest payments of £0.261m per annum.
19. At 30 September 2010, the authority had 78 PWLB loans totalling £391.75m and 10 LOBO² loans totalling £50m. The combined weighted average interest rate for debt as at 30th September 2010 was 4.63%. Details of new loans arranged during 2010/11 are shown in Annex 3.

Maturing Debt

20. The Council repaid £0.338m of maturing PWLB loans during the first half of the year. The weighted average interest rate payable on the matured loans was 1.12%. The details are set out in Annex 4. This relates to Prudential Borrowing relating the early repayment of a lease relating to SAP and its associated licences.

Debt Restructuring

21. There has been no restructuring of Long Term Debt during the year.

¹ The Public Works Loan Board is a Government agency operating within the United Kingdom Debt Management Office and is responsible for lending money to Local Authorities.

² LOBO (Lender's Option/Borrower's Option) Loans are long-term loans which include a re-pricing option for the bank at predetermined intervals.

Investment Strategy

22. Security and liquidity of cash was prioritised above the requirement to maximise returns. The Council continued to adopt a cautious approach to lending to financial institutions and continuously monitored credit quality information relating to counterparties.
23. The majority of deposits were limited to 3 months in duration throughout the first half of the financial year. A programme of 6 month deposits has been tailored with 4 counterparties deemed to be of higher credit quality. This has had the effect of increasing the yield whilst maintaining relatively low average maturity profile. The weighted average maturity of all deposits during the first half of 2010/11 was 97.17 days. This compared to an average of 94 days during 2009/10.
24. The Council used fixed and structured deposits, as well as call accounts to deposit its in-house temporary cash surpluses during the first half of 2010/11.

The Council's Lending List

25. The Council's in-house cash balances were deposited with institutions that meet the Council's approved credit rating criteria. The approved Lending List was regularly updated during the period to reflect changes in bank and building society credit ratings. Changes were reported to Cabinet each month. Annex 1 shows the amendments incorporated into the Lending List during the first half of 2010/11, in accordance with the approved credit rating criteria and additional temporary restrictions.
26. In April 2010 a 4 day maturity loan was arranged with Rabobank taking the total deposits with Rabobank to £22.25m. The absolute lending limit with Rabobank was £30m, subject to a maximum of 10% of the total investment portfolio. At the time of the deposit 10% of the investment portfolio was £20.08m. The 10% single counterparty limit was therefore breached by £2.17m for 4 days. There was no financial loss to the Council as a result of this breach, and further measures have been put in place to minimise the risk of further breaches of the 10% limit.

Investment Outturn

27. The average daily balance of temporary surplus cash invested in-house in the six months to 30th September was £208m. The Council achieved an average in-house return for that period of 0.80%, producing gross interest receivable of £0.833million (excluding interest accrued on Landsbanki deposits). Temporary surplus cash includes; developer contributions; school balances; council reserves and balances; trust fund balances; and various other funds to which the Council pays interest at each financial year end, based on the average earned on all balances.
28. The Council uses the seven-day inter-bank sterling rate as its benchmark to measure its own in-house investment performance. During the first half of 2010/11 the average seven-day interbank sterling rate was 0.42%. The

Council's average in-house return (0.80%) thus exceeded the benchmark by 0.38%. The Council operates a number of call accounts and instant access (call) Money Market Funds to deposit short-term cash surpluses. The average balance held on call in the 6 months to 30 September was £61.5million.

External Fund Managers

29. The Council has continued to use the services of two external fund managers: Investec Asset Management Limited and Scottish Widows Investment Partnership Limited (SWIP). Each fund manager manages £10m of the Council's cash, plus their accumulated returns. Investec began managing the fund on 13 April 2006 and SWIP on 13 July 2006. The fund managers were given slightly different investment targets and performance is measured against different benchmarks.
30. SWIP's annualised return for the first 6 months of the year was 0.92% (net of management charges) compared to their annualised benchmark of 0.50%. Investec's return for the year (net of management charges) was 0.84%, compared with a benchmark of 2.00%.
31. In September 2010 the Council agreed changes to the Treasury Management Strategy to allow a change in the investment mandate of Investec in response to changes in the economic environment.

Prudential Indicators for Treasury Management

32. During the financial year the Council operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Strategy Report. The outturn for the Prudential Indicators is shown in Annex 5.

External Performance Indicators and Statistics

33. The County Council has taken part in the inaugural CIPFA Treasury Management Risk Benchmarking study, the results of the risk management benchmarking exercise are not yet available. The County Council is also a member of the CIPFA Treasury and Debt Management benchmarking club and receives annual reports comparing returns and interest payable against other authorities. The benchmarking results for 2009/10 showed that Oxfordshire County Council had achieved an average return of 1.4% compared with an average of 1.5% for their comparative group of County Councils and an average of 1.9% for all 136 members. The lower average interest received was mainly due to higher than average balances in short-term deposits and lower balances in longer-term and structured products. Oxfordshire County Council also had higher than average balances placed with the Debt Management Deposit Account Facility during May - July 2009, due to the strategy to minimise credit risk. This resulted in a lower than average rate of interest received.
34. The average interest rate paid for all debt during 2009/10 was 4.7% in line with the comparative group of 19 County Councils and compared favourably with the all member average of 5.2%. Oxfordshire County Council had a

higher than average proportion of its debt portfolio in PWLB loans. Oxfordshire County council had 12% of its debt in LOBO loans at 31/3/2010 compared with an all member average of 20% and a comparative group average of 19%.

35. Arlingclose will also benchmark the Council's investment performance against its other clients. The results of this benchmarking is not yet available.

Training

36. As stated in the Treasury Management Strategy, key Treasury Management officers will be encouraged to study towards the new CIPFA and ACT³ joint Certificate on International Treasury Management – Public Finance. In April 2010, two members of the Treasury Management Team successfully completed and passed the Certificate.

Financial and Legal Implications

37. Interest payable and receivable in relation to Treasury Management activities are only two parts of the overall Strategic Measures budget.
38. The 2010/11 budget for interest receivable is £1.624m. The forecast outturn for interest receivable is £1.688m giving net forecast excess income of £0.064m. The increase is mainly due to higher cash balances due in part to the moratorium on the capital programme.
39. The 2010/11 budget for interest payable is £19.973m. The forecast outturn for interest payable is £20.194m giving a net forecast overspend of £0.221m. The increase is due to the change in borrowing strategy as detailed in paragraphs 14 – 18.

RECOMMENDATION

40. **The Cabinet is RECOMMENDED to note the report, and to RECOMMEND Council to note the Council's Mid Term Treasury Management Review 2010/11.**

SUE SCANE
Assistant Chief Executive & Chief Finance Officer

Background papers: Nil

Contact officer: Tim Chapple, Financial Manager – Treasury & Pension
Fund Investments – Corporate Core Tel: (01865) 323978

October 2010

³ Association of Corporate Treasurers

Lending List Changes during 2010/11**Counterparties added/reinstated**

Goldman Sachs Sterling Liquid Reserves Fund
Hendersons Liquid Asset Fund
Santander UK Plc
Ignis Sterling Liquidity Fund

Counterparties removed/suspended

Santander UK Plc
Alliance & Leicester Plc
Bilbao Bizkaia Kutxa

Lending limits & Maturity limits decreased

	New Lending limit	Maximum Maturity
Lloyds TSB Bank Plc	£10m	6 months
Bank of Scotland Plc	£10m	6 months

ANNEX 2

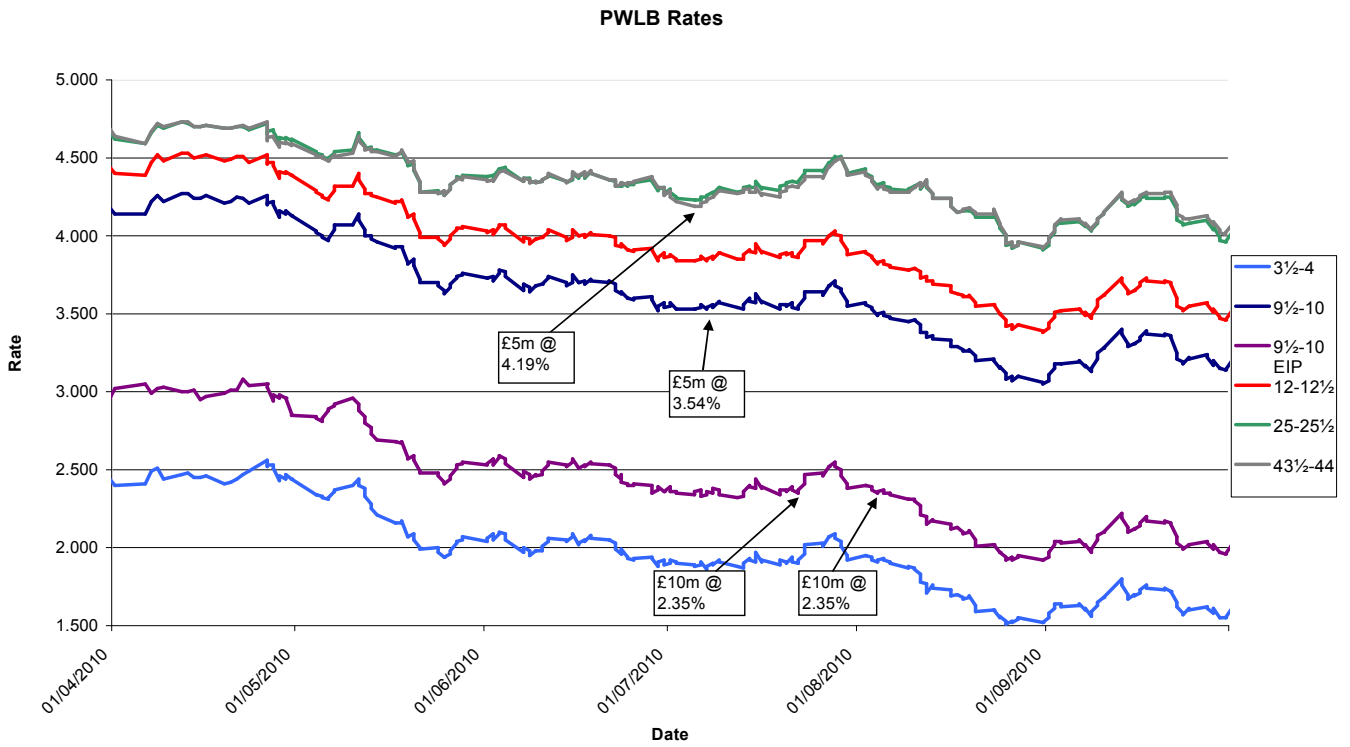
OXFORDSHIRE COUNTY COUNCIL DEBT FINANCING 2010/11

<u>Debt Profile</u>		£m
1. PWLB	85%	362.09
2. Money Market LOBO loans	12%	<u>50.00</u>
3. Sub-total External Debt		412.09
4. Internal Balances	3%	<u>14.17</u>
5. Actual Debt at 31 March 2010	100%	426.26
6. Government Supported Borrowing		26.06
7. Unsupported Borrowing		12.65
8. Borrowing in Advance		0.00
9. Minimum Revenue Provision		<u>-17.05</u>
10. Forecast Debt at 31 March 2011		447.92
<u>Maturing Debt</u>		
11. PWLB loans maturing during the year		7.68
12. PWLB loans repaid prematurely in the course of debt restructuring		<u>0.00</u>
13. Total Maturing Debt		7.68
<u>New External Borrowing</u>		
14. PWLB Normal		30.00
15. PWLB loans raised in the course of debt restructuring		0.00
16. Money Market LOBO loans		<u>0.00</u>
17. Total New External Borrowing		30.00
<u>Debt Profile Year End</u>		
18. PWLB	86%	384.41
19. Money Market LOBO loans	11%	<u>50.00</u>
20. Sub-total External Debt		434.41
21. Internal Balances	3%	<u>13.51</u>
22. Forecast Debt at 31 March 2011	100%	447.92

Line

- 1 – 5 This is a breakdown of the Council's debt at the beginning of the financial year (1 April 2010). The PWLB is a government agency operating within the Debt Management Office. LOBO (Lender's Option/ Borrower's Option) loans are long-term loans, with a maturity of up to 60 years, which includes a re-pricing option for the bank at predetermined time intervals. Internal balances include provisions, reserves, revenue balances, capital receipts unapplied, and excess of creditors over debtors.
- 6 'Government Supported Borrowing' is the amount that the Council can borrow in any one year to finance the capital programme. This is determined by Central Government, and in theory supported through the Revenue Support Grant (RSG) system.
- 7 'Unsupported Borrowing' reflects Prudential Borrowing taken by the authority whereby the associated borrowing costs are met by savings in the revenue budget.
- 8 'Borrowing in Advance' is the amount the Council borrowed in advance during 2010/11 to fund future capital finance costs.
- 9 The amount of debt to be repaid from revenue. The sum to be repaid annually is laid down in the Local Government and Housing Act 1989, which stipulates that the repayments must equate to at least 4% of the debt outstanding at 1 April each year.
- 10 The Council's forecast total debt by the end of the financial year at 31 March 2011, after taking into account new borrowing, debt repayment and movement in funding by internal balances.
- 11 The Council's normal maturing PWLB debt.
- 12 PWLB debt repaid early during the year.
- 13 Total debt repayable during the year.
- 14 The normal PWLB borrowing undertaken by the Council during 2010/11.
- 15 New PWLB loans to replace debt repaid early.
- 16 The Money Market borrowing undertaken by the Council during 2010/11.
- 17 The total external borrowing undertaken.
- 18-22 The Council's forecast debt profile at the end of the year.

PWLB Interest Rates 2010/11



New borrowing undertaken during 2010/11

Long-term debt Raised and Maturing 2010/11**Normal Debt Financing PWLB: Loans Raised**

Date	Amount £m	Interest Rate%	Termination Date
08/07/2010	5	4.19	14/06/2054
09/07/2010	5	3.54	01/06/2020
26/07/2010	10	2.35	13/07/2020
06/08/2010	10	2.35	31/07/2020
Total	30		

Public Works Loan Board: Loans Matured during first half of 2010/11

Date	Amount £m	Rate %
31/08/2010	0.338	1.120
Total	0.338	

Public Works Loan Board: Loans Due to Mature during second half of 2010/11

Date	Amount £m	Rate %
21/12/2010	1	6.375
13/01/2011	4	4.750
13/01/2011	0.500	2.350
31/01/2011	1	6.375
31/03/2011	0.500	2.350
28/02/2011	0.340	1.120
Total	7.340	

