FLINTSHIRE COUNTY COUNCIL

TREASURY MANAGEMENT

MID YEAR REPORT 2012/13

1.00 PURPOSE OF REPORT

1.01 To provide members with a mid year update on matters relating to the Council's Treasury Management function.

2.00 BACKGROUND

2.01 Treasury management comprises the management of the Council's 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.

2.02 The Council's primary objectives for the investment of its surplus funds are to protect the principal sums invested from loss, and to ensure adequate liquidity so that funds are available for expenditure when needed. The generation of investment income to support the provision of local authority services is an important, but secondary, objective.

2.03 The Council's current policy is to appoint external consultants to advise on its treasury management function. The external adviser is Sterling Consultancy Services.

2.04 The Council has adopted the 2011 edition of the CIPFA Treasury Management in the Public Services: Code of Practice, which requires the Council to approve a treasury management strategy before the start of each financial year, a mid-year report, and an annual report after the end of each financial year.

2.05 In addition, the Welsh Government (WG) Guidance on Local Government Investments recommends that local authorities amend their investment strategies in light of changing internal or external circumstances. This report therefore meets the requirements of both sets of guidance.

3.00 TREASURY MANAGEMENT STRATEGY

3.01 The Council approved the 2012/13 Treasury Management Strategy at its meeting on 1st March 2012.

3.02 The Council's investment strategy as stated in the 2012/13 Treasury Management Strategy is to:

- Invest prudently and to have regard to security and liquidity of its investments before seeking the highest rate of return or yield.

- Have regard to guidance issued by the Welsh Government - Part 1 of the Local Government Act 2003, which introduced the Prudential Capital Finance System, gives a local authority power to invest for any purposes relevant to its functions under any enactment, or for the purposes of the prudent management of its financial affairs.

- Produce an Investment Strategy before the start of each financial year, which must be approved by the full council and be published.

3.03 The investment plan for 2012/13 which was outlined in the Policy Statement considered two scenarios. The first was the most risk-averse approach which only allowed for the following type of investments to be made:

- Money placed ‘on call’ with banks.
- Deposits with other local authorities.
- Use of AAA rated Money Market Funds.
- Use of Debt Management Office (DMO) as last resort.

The second scenario was the return to a more ‘normal’ approach where deposits are placed with banks with maturity periods for up to five years. Market conditions and credit risk would govern which approach would be followed.

During the period the credit risk marker remained at ‘amber status’ and market conditions stabilised somewhat (as described in the first paragraph of Sterling’s economic review in 4.01 below). Whilst the more risk-averse approach continues to be followed we have recommenced placing deposits with banks and building societies but with a self imposed restriction of a maximum 3 month maturity period.

3.04 The Council’s borrowing strategy as stated in the 2012/13 Treasury Management Strategy is for the Head of Finance to:

- Effect any borrowing required in 2012/13 at the cheapest cost commensurate with future risk based on interest rate forecasts outlined in the strategy statement.
- Manage the Council’s debt maturity profile, i.e. to leave no one future year with a high level of repayments that could cause problems in re-borrowing with the limits stated within the strategy statement.
- Monitor and review the level of variable interest rate loans in order to take greater advantage of interest rate movements, within the limits stated in the strategy statement.
- Regularly review the Council’s Capital Programme, including Prudential Borrowing, to consider the most financially advantageous method of financing future debt.
- Review opportunities which may arise for restructuring the Council’s debt in order to take advantage of potential savings as interest rates change and to enhance the balance of the long term portfolio (amend the maturity profile and/or the balance of volatility).

3.05 There has been no borrowing activity in the period to the end of August 2012:

- The debt maturity profile as at 31 August 2012 is shown in Appendix 1 on page 11. This shows a debt maturity profile in line with CIPFA recommendations of having no more than 10% of the debt portfolio maturing in any one future year. This has remained unchanged during 2012/13.
- £1.5m of existing debt will mature during the second half of 2012/13, and consideration will be given to the need to re-finance or repay the debt. Discussions with our Treasury Advisors and assessments of future capital expenditure plans, medium term cash flow forecasts, and future market conditions will all need to be considered.
- No debt restructuring opportunities have been identified during the early months of 2012/13 and no additional borrowing has been undertaken. This position will be reviewed again in the second half of 2012/13. It is unlikely that any debt restructuring will be undertaken as in the present market of low interest rates opportunities are limited as penalties to repay loans are prohibitive.
- Effective cash flow management has meant that no temporary borrowing was required during the reporting period.

4.00 ECONOMIC & INTEREST RATE REVIEW – APRIL TO AUGUST 2012

4.01 *Economic review and outlook (provided by Sterling Consultancy Services):*

The European Central Bank's (ECB) Long-Term Refinancing Operations, in which the central bank supplied cheap funding to the Eurozone banking system, initiated a calmer period of financial market activity in the first quarter of the year relative to recent times. The calm was not to last, however, as the ECB intervention did not address the root causes of the Eurozone sovereign debt crisis, i.e. unsustainable debt levels in uncompetitive countries.

A number of events pushed the crisis back to the fore: the two Greek general elections, the failure of Spanish bank Bankia and subsequent bailout speculation for the sector, and signs that the Eurozone economy was experiencing a deeper downturn in economic activity than previously expected. Throughout the quarter, Germany resisted pressure for regional debt mutualisation or a banking union, unprepared to risk the moral hazard of supporting profligate Mediterranean countries.

Meanwhile, yields on Spanish 10-year government bonds regularly exceeded seven percent, the danger level at which Ireland and Portugal approached the Eurozone/IMF for bailouts. Risk appetite plummeted; the FTSE 100 dropped 3.4% over the three months to June (it was down 8.8% at the end of May), while yields on safe haven bonds, including UK gilts and German bunds, regularly *dipped to new record lows.*

As the situation deteriorated, leaders made some progress towards a solution, prompted by the realisation that the link between sovereign and bank needed to be broken. At the EU summit at the end of June leaders agreed that the yet-to-be initiated bailout fund, the European Stability Mechanism (ESM), would have more flexibility, allowing it to buy the debt of struggling countries or directly recapitalise banks. However, these changes have yet to be approved by the parliaments of member nations, with a legal challenge in Germany threatening to derail the process. Pressure is currently growing for further direct ECB intervention in bond markets to reduce the pressure on struggling countries.

The reaction to the on-going sovereign crisis was exacerbated by the developing slowdown in global economic growth, as the Eurozone recession and uncertainty depressed confidence and business activity in other large economies. The US economy stuttered, with slower employment growth a particular concern, although the Federal Reserve resisted the temptation to engage in further monetary stimulus. A widely anticipated risk was the slowdown in Chinese growth, specifically whether the world's second largest economy would have a hard or soft landing. Signs of weakening domestic demand allied with a softer export outlook prompted multiple cuts in interest rates and the relaxation of commercial lending criteria by the People's Bank of China in an attempt to prop up economic activity. The deteriorating outlook for global growth had a significant impact on commodity prices, particularly oil prices. Over May and June the price of Brent crude fell around 30% from its April peak of $126 per barrel, although prices subsequently recovered part of these losses.

In the UK the recession continued into quarter two, with the loss of a working day to the Jubilee bank holiday the primary factor. However, as with the larger economies described above, the UK was not immune to the uncertainty emanating from the Eurozone, and data suggested that underlying business conditions had weakened. Trade data indicated that goods exports to the Eurozone were declining, a particular problem for a manufacturing sector struggling with weak domestic demand. The extreme wet weather in April caused a plunge in retail sales volumes, and on the positive side, a fall in inflation, while the construction sector output continued to decline amid both a weak housing market and a reduction in government capital spending.

The banking sector and credit bottleneck were perceived to be an important factor holding back economic recovery, prompting HM Treasury and the Bank of England to announce two schemes in June to reduce bank funding costs and increase the availability of cheaper finance for businesses. The Bank's intervention in the money markets placed downward pressure on Libor rates; 3-month LIBOR declined around 30 basis points during the half year to 0.70%. The deteriorating domestic and global economic conditions also boosted support for further monetary stimulus. The Monetary Policy Committee (MPC) duly increased the Asset Purchase Facility by £50bn to £375bn, the third tranche of *quantitative easing.*

4.02 As can be seen from the commentary above, the first quarter of 2012/13 saw some relatively 'calmer' times and consequently deposits were placed with banks, but with a restriction of a 3 month maximum maturity. However, the situation has not improved substantially since then and the 3 month restriction, with the exception of one longer term investment that we have made, remains in place (Please see paragraph 6.09 for further details regarding this investment).

4.03 The recent downward trend in the Consumer Price Index (CPI) inflation rate allied with the apparent synchronised global downturn led by the Eurozone has pushed market expectations for a rise in interest rate out to at least 2014.

4.04 The UK base rate has remained at 0.50% throughout the reporting period.

4.05 The latest central forecast from the Sterling is shown below and highlights how the current interest rate forecast has changed from that assumed in the Policy Statement and on which the current strategy was based. The risks to the forecast remain heavily to the downside, arising largely from the impact of the Eurozone sovereign debt crisis on UK business and household confidence.

	Policy Forecast	**Current Forecast**
Q1 2012	0.50%	0.50%
Q2 2012	0.50%	0.50%
Q3 2012	0.50%	0.50%
Q4 2012	0.75%	0.50%
H1 2013	1.00%	0.50%
H2 2013	1.50%	0.75%
H1 2014	2.00%	1.00%

4.06 Interest rates are now forecast to remain lower for longer than stated in the 2012/13 Policy Statement.

5.00 TREASURY MANAGEMENT GOVERNANCE: APRIL – AUGUST 2012

5.01 The Treasury Management Annual Report for 2011/12 and a quarterly update report, were presented to the Audit Committee on 25th June 2012.

5.02 The Council's cash flow was managed on a daily basis. The Authority acted both as a borrower and as a lender and was a net borrower over the period in question. The maximum long-term borrowing at any one time was £173.6m.

5.03 Internal Audit completed a review of the Treasury Management function in April 2012 and concluded that the service provides a substantial level of assurance.

5.04 The Treasury Management activity undertaken during this period complied with the approved Strategy, CIPFA Code of Practice and the relevant legislative provisions, with one exception. Treasury Management Practices state that we will not invest with any counterparty whose credit rating is subject to review by a rating agency. However, on the 1st May 2012 a 3 month investment was made with Close Brothers for £1.5m during a period when their credit rating was under review. This mistake was identified the very next day and although we received assurance from Sterling that the investment was not at risk, prompt action was taken to facilitate the early return of the money. The investment, along with interest accrued, was returned on 7th June 2012.

As a result of this, internal controls have been tightened to ensure that all future investments fully comply with our Treasury Management Practices.

5.05 As part of the Finance Function Review, responsibility for managing the Treasury Management function is being transferred to the Strategy and Technical Team within Corporate Finance. Arrangements have been put in place over a sufficient period of time to facilitate the smooth transition and to ensure that the function continues to be managed appropriately and risks mitigated.

6.00 INTERIM INVESTMENT AND PERFORMANCE REPORT

6.01 The maximum investments the Authority had on deposit at any one time totalled £79.2m. The average investment balance for the period was £67.4m and the average rate of return was 0.83%, generating investment income of £233k. The investment income received for the reporting period exceeded the budgeted figure of £153k by £80k.

6.02 Investments have been made with UK banks and building societies up to a maximum term of 3 months, as well as utilising investment opportunities afforded by money market funds, instant access accounts, Debt Management Office and other Local Authorities.

6.03 The average debt balance held was £173.6m and the average rate paid was 5.4%, generating interest payable of £410k in line with budget forecasts.

	Investments		Borrowing	
	Interest received £'000	Interest rate %	Interest paid £'000	Interest rate %
Actual	233	0.83	410	5.4
Budget	153	0.81	416	5.4
Difference	+80	+0.02	+6	-

6.04 Based on performance to date and forecasts that interest rates will remain flat for the remainder of 2012/13, the latest projected revenue outturn is for net interest received to be £86k above budget.

6.05 The weighted average temporary investment rate obtained for August of 0.81% is higher than the seven day LIBID rate of 0.40% which is a proxy of a return without effective cash flow management.

6.06 Effective short term cash flow management meant that no temporary borrowing was required during the reporting period.

6.07 The maturity of investments has been regularly reviewed with the aim of maximising returns whilst managing the risk of future interest rate movements. As at 31st August 2012, the maturity of investments is shown in the table below:

Maturity Due	**Percentage of Portfolio**		
	Policy %		**August 2012 %**
< 1month	35.0		64.0
1 – 12 months	55.0		32.5
> 12 months	10.0		0.0
Icelandic Investments	0		3.5

6.08 The maturity of investments is shorter than that in the Policy Statement. This is due to the risk-averse position adopted by the Council as detailed in paragraph 3.03.

6.09 Despite the self-imposed restriction of investing for no longer than 3 months maturity, the Bank of Scotland, which is partially owned by the taxpayer, were offering longer term deposits at a rate of 3.00%. After due consideration of balancing risk and return it was decided to deposit £4m for a period of 342 days at an interest rate of 3.00%.

6.10 A summary of investments as at 31st August 2012 is included in Appendix 2.

7.00 <u>TREASURY MANAGEMENT INDICATORS</u>

7.01 The Council measures its exposures to treasury management risks using the following indicators. Council is asked to note the following indicators as at 31st August 2012.

7.02 **Borrowing limits**

7.02.1 The Council approved these Prudential Indicators as part of the Capital Programme report.

	Limit £m	Actual £m	Met?
Operational boundary – borrowing	178.0	173.6	✓
Operational boundary – other long-term liabilities	9.6	6.0	
Operational boundary – TOTAL	187.6	179.6	
Authorised limit – borrowing	207.6	173.6	✓
Authorised limit – other long-term liabilities	0	6.0	
Authorised limit – TOTAL	207.6	179.6	

7.03 **Interest rate exposures**

7.03.1 This indicator is set to control the Council's exposure to interest rate risk. The exposures to fixed and variable rate interest rates, expressed as an amount of net principal borrowed were:

	Limit	Actual	Met?
Upper limit on fixed rate exposures	£200m	£143m	✓
Upper limit on variable rate exposures	£40m	-£33.6m *	✓

** The total invested at variable rate exceeds the total debt at variable rate.*

7.03.2 Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

7.04 **Maturity structure of borrowing**

7.04.1 This indicator is set to control the Council's exposure to refinancing risk. The maturity structure of fixed rate borrowing was:

Upper and Lower Limits for maturity structure of borrowing	Lower Limit	Upper Limit	Actual	Met?
Under 12 months	0%	15%	1%	✓
12 months and within 24 months	0%	10%	0%	✓
24 months and within five years	0%	30%	0%	✓
Five years and within 10 years	0%	50%	8%	✓
10 years and above	10%	100%	91%	✓

7.04.2 The maturity date of borrowing is the earliest date on which the lender can demand repayment.

7.05 **Principal sums invested for periods longer than 364 days**

7.05.1 The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its long-term investments. The total principal sums invested to final maturities beyond the period end were:

	2012/13	2013/14	2014/15
Limit on principal invested for longer than 364 days	£30m	£30m	£30m
Actual principal invested beyond year end for longer than 364 days	£0	£0	£0
Within limit?	✓	✓	✓

8.00 LANDSBANKI INVESTMENTS – UPDATE

8.01 In late 2011, it was confirmed that Priority status had been upheld by the Icelandic Supreme Court, with Local Authority Investors, including Flintshire County Council, being recognised as preferential creditors.

8.02 The Winding Up Board of Landsbanki made a distribution to priority creditors on 17th February 2012. Flintshire received £1.09m of the £3.70m original investment.

8.03 In March 2012, the Winding Up board announced that recoveries in the Landsbanki Administration would now likely be 100% of their deposits, subject to potential future exchange rate fluctuations. Although this is only a forecast and not guaranteed, it is marginally higher than the 95% previously forecast.

8.04 On 29th May 2012, a further distribution of £458k was received by the Council.

8.05 The pattern of future distributions is not yet known.

9.00 BENCHMARKING

9.01 Flintshire County Council is a member of the CIPFA Treasury Management Benchmarking Club. Half yearly data will be sent to CIPFA in early October and we expect to receive the Benchmarking Report at the end of October. The findings will be reported to Audit Committee on 12th December 2012.

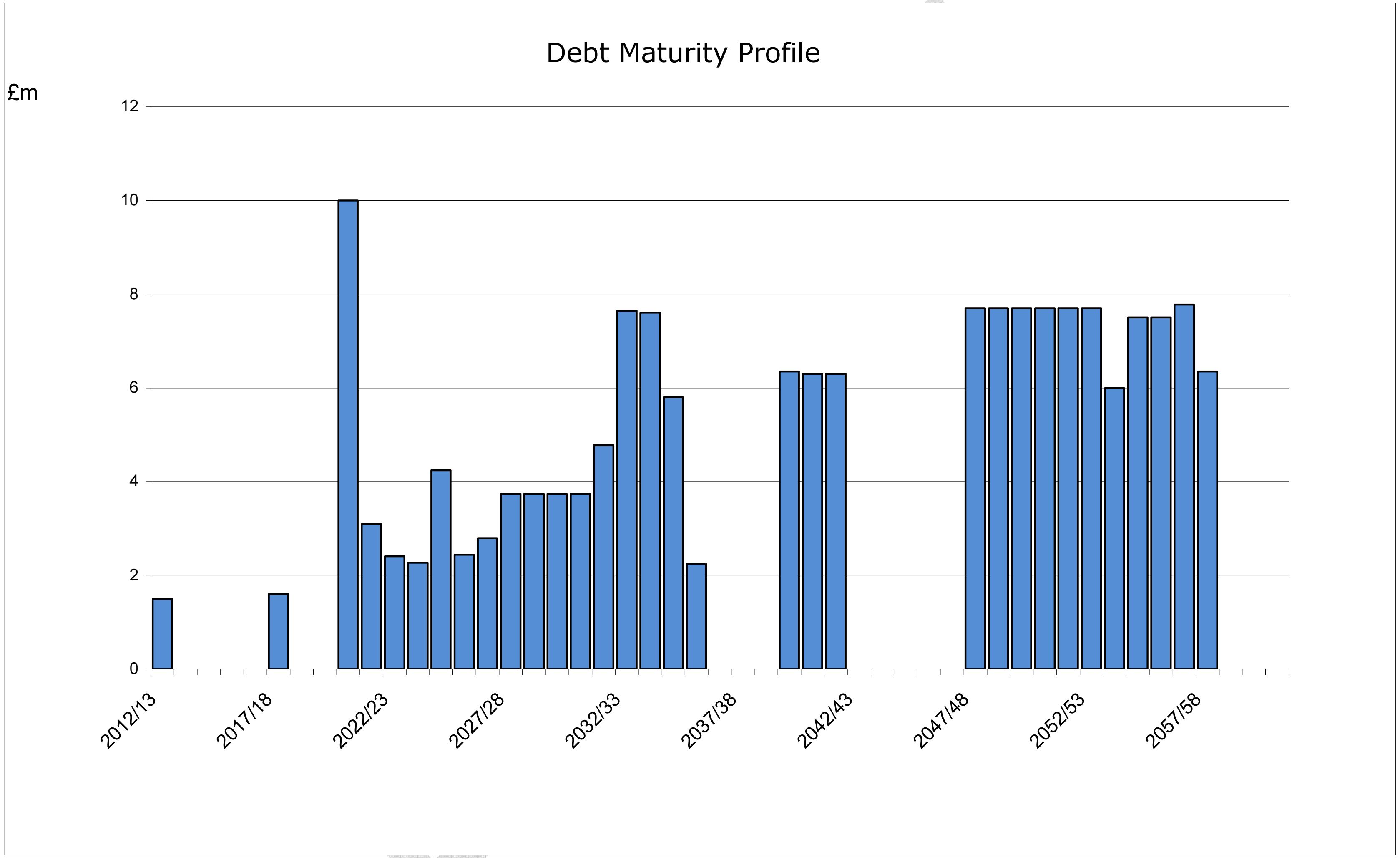
10.00 CONCLUSIONS

10.01 In summary, the key points of the report are:

- The continuation of our low risk strategy of investing for a maximum term of 3 months, with consideration given to suitable longer term investments as appropriate.
- We continue to utilise AAA rated Money Market Funds – as at 31st August 2012, £22.1m was invested across 4 separate funds.

- Internal Audit reviewed the Treasury Management function and concluded that in their opinion the operation provides a substantial level of assurance.
- Responsibility for the Council's Treasury Management Function is in the process of being transferred to the Strategy and Technical team in Corporate Finance.

Appendix 1:



Debt Maturity Profile
£m
12
10
8
6
4
2
0
2012/13
2017/18
2022/23
2027/28
2032/33
2037/38
2042/43
2047/48
2052/53
2057/58

Appendix 2

Flintshire County Council

Investments as at 31st August 2012 - by maturity date

Counterparty Name	Amount £m	Start Date	Maturity	Interest Rate	Interest Earned during investment period	Period to Maturity
LANDSBANKI ISLANDS	0.7	22-Jul-08	17-Oct-08	5.82%	16,646.79	Not Returned
LANDSBANKI ISLANDS	0.9	1-Sep-08	14-Nov-08	5.70%	17,334.25	Not Returned
LANDSBANKI ISLANDS	0.6	8-Sep-08	18-Nov-08	5.67%	11,029.32	Not Returned
BARCLAYS BANK	1.7	4-Jul-12	14-Sep-12	0.70%	2,347.40	1 month or less
NOTTINGHAM BUILDING SOCIETY	2.0	4-Jul-12	18-Sep-12	0.80%	3,331.51	1 month or less
SAFFRON BUILDING SOCIETY	1.7	4-Jul-12	18-Sep-12	0.75%	2,654.79	1 month or less
NOTTINGHAM BUILDING SOCIETY	1.0	4-Jul-12	18-Sep-12	0.85%	1,769.86	1 month or less
SAFFRON BUILDING SOCIETY	1.0	4-Jul-12	18-Sep-12	0.75%	1,561.64	1 month or less
BARCLAYS BANK	1.0	15-Jun-12	21-Sep-12	0.74%	1,997.59	1 month or less
COVENTRY BUILDING SOCIETY	1.9	4-Jul-12	21-Sep-12	0.71%	2,919.75	1 month or less
NATIONAL COUNTIES BUILDING SOCIETY	1.0	27-Jun-12	28-Sep-12	1.10%	2,802.74	1 month or less
SAFFRON BUILDING SOCIETY	1.0	29-Jun-12	28-Sep-12	1.05%	2,617.81	1 month or less
NOTTINGHAM BUILDING SOCIETY	1.6	2-Jul-12	28-Sep-12	0.95%	3,664.66	1 month or less
BANK OF SCOTLAND	3.0	31-Mar-12	30-Sep-12	0.75%	11,280.82	1 month or less
SVENSKA HANDELSBANKEN	1.0	30-Mar-12	30-Sep-12	0.75%	3,780.82	1 month or less
DEUTSCHE MANAGED STERLING FUND	5.7	2-Apr-12	30-Sep-12	0.49%	13,850.22	1 month or less
SSGA GBP LIQUIDITY FUND	4.5	2-Apr-12	30-Sep-12	0.51%	11,380.68	1 month or less
SWIP GLOBAL LIQUIDITY FUND	6.0	1-Jun-12	30-Sep-12	0.48%	9,547.40	1 month or less
BLACKROCK INST STERLING LIQUIDITY FUND	5.9	25-Jun-12	30-Sep-12	0.49%	7,682.93	1 month or less
NOTTINGHAM CITY COUNCIL	1.0	9-Jan-12	09-Oct-12	0.50%	3,753.42	1 - 3 months
PROGRESSIVE BUILDING SOCIETY	2.0	3-Aug-12	18-Oct-12	0.55%	2,290.41	1 - 3 months
NATIONWIDE BUILDING SOCIETY	1.3	3-Aug-12	18-Oct-12	0.53%	1,434.63	1 - 3 months
NATIONAL COUNTIES BUILDING SOCIETY	2.0	1-Aug-12	22-Oct-12	0.90%	4,043.84	1 - 3 months
NATIONWIDE BUILDING SOCIETY	2.0	3-Aug-12	22-Oct-12	0.54%	2,367.12	1 - 3 months
THE HIGHLAND COUNCIL	2.0	26-Oct-11	24-Oct-12	0.80%	15,956.16	1 - 3 months
COVENTRY BUILDING SOCIETY	2.0	1-Aug-12	26-Oct-12	0.59%	2,780.27	1 - 3 months
COVENTRY BUILDING SOCIETY	1.0	3-Aug-12	26-Oct-12	0.58%	1,334.79	1 - 3 months
LEEDS BUILDING SOCIETY	1.0	3-Aug-12	26-Oct-12	0.54%	1,242.74	1 - 3 months
DONCASTER COUNCIL	2.0	3-Oct-11	16-Apr-13	1.30%	39,961.64	3 months +
BANK OF SCOTLAND	4.0	27-Jul-12	04-Jul-13	3.00%	112,438.36	3 months +
	62.5				**315,804.36**	

Summary	Total		1 month or less	1 - 3 months	3 months +	12 months +
	£m	**%**	**£m**	**£m**	**£m**	**£m**
DEBT MANAGEMENT OFFICE (DMO)	0.0	0.0	0.0	0.0	0.0	0.0
UK	32.2	44.4	16.9	11.3	4.0	0.0
OVERSEAS	1.0	10.1	1.0	0.0	0.0	0.0
OTHER LOCAL AUTHORITIES	5.0	7.7	0.0	3.0	2.0	0.0
ICELAND (LANDSBANKI)	2.2	3.4	0.0	0.0	0.0	0.0
MONEY MARKET FUNDS	22.1	34.4	22.1	0.0	0.0	0.0
	62.5		**40.0**	**14.3**	**6.0**	**0.0**
		100.0%	64.0%	22.9%	9.6%	0.0%