

**Manchester City Council
Report for Information**

Report to: Audit Committee – 9 December 2010
Subject: Treasury Management Interim Report 2010-11
Report of: City Treasurer

Purpose

To report the Treasury Management activities of the Council during the first six months of 2010-11.

Recommendations

The Audit Committee is asked to note the contents of the report.

Wards Affected:

Not Applicable

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Background documents (available for public inspection):

Treasury Management Strategy Statement and Borrowing Limits and Annual Investment Strategy Report 2009/10 (Executive Committee 10 February 2010)

1 Introduction and Background

- 1.1 Treasury Management in Local Government is regulated by the CIPFA Code of Practice on Treasury Management in Local Authorities. The City Council has adopted the Code and complies with its requirements. A primary requirement of the Code is the formulation and agreement by full Council of a Treasury Policy Statement which sets out Council, Committee and Chief Financial Officer responsibilities, and delegation and reporting arrangements. This was approved by the Council on the 8th of October 2003, and updated and approved by the Executive on the 10th of February 2010.
- 1.2 CIPFA amended the CIPFA Treasury Management in the Public Services Code of Practice in late 2009, and the revised Code recommended that local authorities include, as part of their Treasury Management Strategy Statement, the requirement to report to members at least twice a year on the activities of the Treasury Management function. The recommendation was included within the Treasury Management Strategy Statement approved by the Executive on the 10th of February 2010, and by Council on the 3rd of March 2010. This report therefore ensures that the Council meets the requirements of the Strategy, and therefore the Code.
- 1.3 Treasury Management in this context is defined as:
- “The management of the organisation’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”.
- 1.4 This interim report covers:
- The Council’s portfolio position as at 30th Sept 2010
 - A review of economic conditions
 - External borrowing
 - Compliance with treasury limits and prudential Indicators
 - Temporary borrowing & investment outturn

2 Current Portfolio Position

- 2.1 The last year has seen an interest rate differential between the cost of long term debt (4% to 4.5%) and the return available from short term investments (under 1%) which led to the council following a strategy of borrowing internally (using cash backed reserves). As well as the cost of carry (paying out more interest on long term borrowing than can be earned from short term investing), there is also a difficulty in finding suitable organisations to lend surplus cash to as fewer of them meet our criteria since the banking crisis.
- 2.2 As outlined in the approved Treasury Management Strategy for 2010/11 there was a need to undertake some permanent borrowing in 2010/11 to fund the capital programme and to replace some of the internal funds. Most of this borrowing has now been taken however the policy remains to keep cash low and minimise temporary investments.

2.3 The Council's debt position at the beginning and middle of year was as follows:

Loan Type	31 March 2010		30 Sept 2010	
	Principal	Average Rate	Principal	Average Rate
	£m	%	£m	%
PWLB	131.3	3.96	200.7	4.00
Temporary Borrowing	0.7	0.49	0.1	0.44
Market Loans	549.6	4.89	499.6	4.95
Stock	8.2	3.36	8.2	3.37
Gross Total	689.8	4.69	708.6	4.66
Temporary Deposits	(17.2)	0.75	(102.7)	0.49
Net Total	672.6	4.79	605.9	5.37

2.4 When reviewing the table above it is important to note that the temporary borrowing and deposit figures fluctuate daily to meet the daily cash flow requirements of the council. The temporary figures in the table above are therefore only a snapshot at a particular point in time. In the two weeks up to the 30th of September the Council received several grants which had to be deposited for short periods of time, including Partnerships for Schools funding (£24.9m) and Housing Market Renewal Fund (£35.3m). By the 1st of November the level of temporary deposits had fallen to £61.5m

2.5 The authority has taken on £70m of new PWLB in this financial year, the details of which are outlined below, in paragraphs 4.2 and 4.3. This borrowing was taken in advance of need to take advantage of the historically low interest rates being offered by the PWLB, thereby reducing the overall cost of the loans to the authority. Current cash flow projections suggest that by year end the total level of investments will be around £25m.

2.6 At the instigation of Royal Bank of Scotland as part of a restructure exercise by the lender, a £50m market loan was repaid by the authority temporarily on the 27th of September, to be retaken 3 months later on the 29th of December. The interest rate on the loan is 4.28%, so this break provided a significant saving of £535,000 to the authority as no interest is incurred on the loan during this period.

3 Review of Economic Conditions April to September 2010

3.1 In September the bank of England left the key lending rate at a record low of 0.5% for the 19th successive month. There has been no increase in the level of quantitative easing beyond the £200bn already committed, but a minority of the members of the Monetary Policy Committee have begun to suggest that a further round of quantitative easing is required to improve liquidity in the financial markets. The concerns expressed in our report of 12 months ago about many banks being reluctant to lend, thereby limiting opportunities for the council to borrow from the market, continue to exist.

3.2 The new bank liquidity regime being pursued by the FSA may further impact the ability of the Council to achieve interest rates above the base rate on short term deposits. The Treasury Management function is actively researching alternative options which may protect the average rate achieved on deposits, should the regime be implemented as planned.

3.3 Appendix 1 provides a more detailed review of the recent economic situation.

4 External Borrowing in the first half of 2010-11

4.1 PWLB interest rates have fluctuated across the first 6 months of the year, gradually decreasing during the second quarter across all bands as illustrated in the table below and the graph at Appendix 2.

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.60%	1.84%	3.06%	3.92%	3.93%
Date	15/06/2010	31/08/2010	31/08/2010	31/08/2010	31/08/2010
High	0.93%	2.99%	4.27%	4.73%	4.74%
Date	26/04/2010	26/04/2010	12/04/2010	12/04/2010	26/04/2010
Average	0.73%	2.37%	3.65%	4.35%	4.35%

4.2 Due to the overall financial position as outlined in paragraph 2.1 and the underlying need to borrow for capital purposes, new external borrowing of £70m was undertaken during the first half of the current financial year. In May £20m was taken, with a further £50m being taken in September, both with durations of 50 years.

4.3 The rates at which the borrowing took place are shown in the table below and marked on the graph at Appendix 2. The rates achieved are significantly below the highest rates offered for loans of their duration, with the £50m loan being taken only 1 basis point away from the lowest rate achievable during the first half of the current financial year. The £20m loan was taken to avoid any potential post-election clampdown on local authority borrowing. Current equivalent rates as at the 30th of September 2010 were 4.02%.

	Start Date	Maturity (Years)	Amount (£M)	Interest Rate
A	10/05/2010	50	20	4.48%
B	01/09/2010	50	50	3.94%

4.4 The Comprehensive Spending Review announced an increase in PWLB interest rates, to 'reflect the availability of capital funding', effective immediately on the 20th of October 2010. The interest rates have been increased to 1 per cent above UK government gilts, which has had the effect of increasing the PWLB rates by 0.8 to 0.9 per cent. For example, the interest rate for a 50 year PWLB loan, similar to those already taken by the authority this year, stood at 5.11% on

the 1st of November. In the medium term this may have the effect of making market loans more competitive for the authority.

5 Compliance with Treasury Limits

5.1 During the first half of the financial year, the Council operated within the treasury limits and Prudential Indicators set out in the Treasury Management Strategy Statement. Performance against these targets is shown in Appendix 3.

6 Investment Strategy for 2010-11

6.1 The Treasury Management Strategy Statement (TMSS) for 2010-11 was approved by Executive on 10th February 2010. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as (a) the security of capital and (b) liquidity of investments.

6.2 In order to achieve a higher level of security the City Treasurer introduced the following measures:

- Investments to be restricted to UK banks, building societies, local authorities and government institutions.
- Diversify the investment portfolio into more secure UK government and government backed institutions.
- Although the investment strategy allows investments up to 364 days, restrict deposits to as short a time period as feasible.

6.3 The City Council's temporary cash balances are managed by the City Treasurer in-house and invested with those institutions listed in the City's Approved Lending List. Officers can confirm these institutions meet the security criteria set out in the Annual Investment Strategy and the approved limits were not breached in the first half of 2010-11.

7 Temporary Borrowing and Investment Outturn for the first half of 2010-11

7.1 As illustrated in the economic background section (Appendix 1), investment rates available in the market are at an historic low point. The average level of funds available for investment purposes in the first half of 2010-11 was just under £77m. These funds were available on a temporary basis and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants, progress on the capital programme and dates at which external borrowing was taken.

7.2 Detailed below is the result of the temporary investment and borrowing undertaken by the Council. As illustrated, the authority outperformed the benchmark by 9 basis points on investments and 6 basis points on borrowing.

	Average temporary Investment/borrowing	Net Return/Cost	Benchmark Return / Cost *
Temporary Investments	£76.93m	0.51%	0.42%
Temporary Borrowing	£0.951m	0.49%	0.55%

* Average 7-day LIBID / LIBOR rate sourced from Sector

7.3 None of the institutions in which investments were made show any difficulty in repaying investments and interest in full during the year. The list of institutions in which the Council invests is kept under continuous review. It remains the Council's policy not to invest with institutions based outside the UK, including those in Ireland.

8 Conclusion

8.1 The current borrowing position reflects the strong balance sheet of the council. It enables net interest costs to be minimised and reduces credit risk by making temporary use of internal borrowing (reserves, provisions, positive cash flows etc). Although some new borrowing has been taken to take advantage of low interest rates, the policy remains to keep cash as low as possible and not to borrow in advance of need for capital purposes.

8.2 Proactive treasury management during the year has enabled us to achieve an average net return on our investments of 0.51%, which is significantly better than the Benchmark Average 7-day LIBID rate of 0.42% and an average net cost of temporary borrowing of 0.49% which is better than the benchmark of 0.55%.

8.3 In addition, the average rate of interest on the Council's gross debt has reduced by 3 basis points from 4.69% to 4.66%. This has occurred mainly due to new PWLB borrowing being taken when interest rates have been at their lowest point so far this year, coupled with the temporary pay back of the RBS loan which was at a higher rate than the PWLB loan. The average interest rate on net debt, which includes temporary investments, has risen. This is a reflection on both the historic low level of interest rates available in the market for deposits and the cash position of the authority at the end of September.

8.4 Consideration will be given to further borrowing during this financial year depending on the interest rates available and the need to borrow to meet the council's cash needs. Whilst the council has in the past made substantial use of market funds there is less availability in the market since the 'credit crunch' and PWLB loans are seen as providing more certainly and better value. However all alternatives available will be considered.

8.5 Given the cash position of the council and the possible effects of the new bank liquidity regime, consideration will also be given to alternative forms of investment, such as treasury bills. However, these instruments will only be considered if they provide a level of security and liquidity that is acceptable to the authority, in line with the Treasury Management strategy.

APPENDIX 1

Review of Economic Conditions April to September 2010

1 Global economy

- 1.1 The sovereign debt crisis peaked in May 2010 prompted, in the first place, by major concerns over the size of the Greek government's total debt and annual deficit. However, any default or write down of Greek debt would have substantial impact on other countries, in particular, Portugal, Spain and Ireland. This crisis culminated in the EU and IMF putting together a €750bn support package in mid May.
- 1.2 Growth in the US, UK and the Euro zone in quarter 2 of 2010 was particularly driven by strong growth in the construction sector catching up from inclement weather earlier in the year and is unlikely to be repeated; general expectations are for much more subdued figures for the remainder of 2010. Market expectations for all three sectors of the economy is that these have all peaked and are pointing downwards, though not necessarily in to negative territory.

2 UK economy

- 2.1 Following the general election in May 2010, the coalition government has put in place an austerity plan to carry out correction of the public sector deficit over the next five years. The inevitable result of fiscal contraction will be major job losses during this period, in particular in public sector services. This will have a knock on effect on consumer and business confidence. House prices have started a negative trend during the summer and mortgage approvals are at very weak levels and also declining.
- 2.2 **Economic Growth** – GDP growth is likely to have peaked at 1.2% in quarter 2 of 2010.
- 2.3 **Unemployment** – the trend of falling unemployment (on the benefit claimant count) has now been replaced since July with small increases which are likely to be the start of a new trend of rising unemployment.
- 2.4 **Inflation and Bank Rate** – CPI has remained high so far during 2010. It peaked at 3.7% in April and has fallen back to 3.1% in August. RPI remains high, at 4.7% in August. Although inflation has remained stubbornly above the MPC's 2% target, the MPC is confident that inflation will fall back under the target over the next two years. The last quarterly Inflation Report in August showed a significant undershoot after the end of 2011.
- 2.5 The Bank of England finished its programme of quantitative easing with a total of £200bn in November 2009 (although there is currently some increase in expectations that there might be a second round of quantitative easing).
- 2.6 **AAA rating** – prior to the general election, credit rating agencies had been issuing repeated warnings that unless there was a major fiscal contraction, then the AAA sovereign rating was at significant risk of being downgraded. Sterling

was also under major pressure during the first half of the year. However, after the Chancellor’s budget on 22 June, Sterling has strengthened against the US dollar and confidence has returned that the UK will retain its AAA rating. In addition, international investors now view UK government gilts as being a safe haven from EU government debt. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and PWLB rates.

3 Economic Forecast

3.1 The Council’s Treasury Advisers, Sector, have provided us with the following forecast:

3.2 Sector’s forecast on interest rates is below:

	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
Bank rate	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.50%	3.00%	3.25%
5yr PWLB rate	2.20%	2.20%	2.20%	2.40%	2.60%	2.80%	3.00%	3.30%	3.60%	3.80%	4.10%	4.40%
10yr PWLB rate	3.30%	3.30%	3.30%	3.40%	3.70%	3.90%	4.00%	4.30%	4.40%	4.60%	4.60%	4.90%
25yr PWLB rate	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.70%	4.70%	4.80%	5.00%	5.00%	5.00%
50yr PWLB rate	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.70%	4.70%	4.80%	5.00%	5.00%	5.00%

3.3 They stress that it is currently difficult to have confidence as to exactly how strong the UK economic recovery is likely to be, and there are a range of views in the market. Sector has adopted a moderate view. There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas:

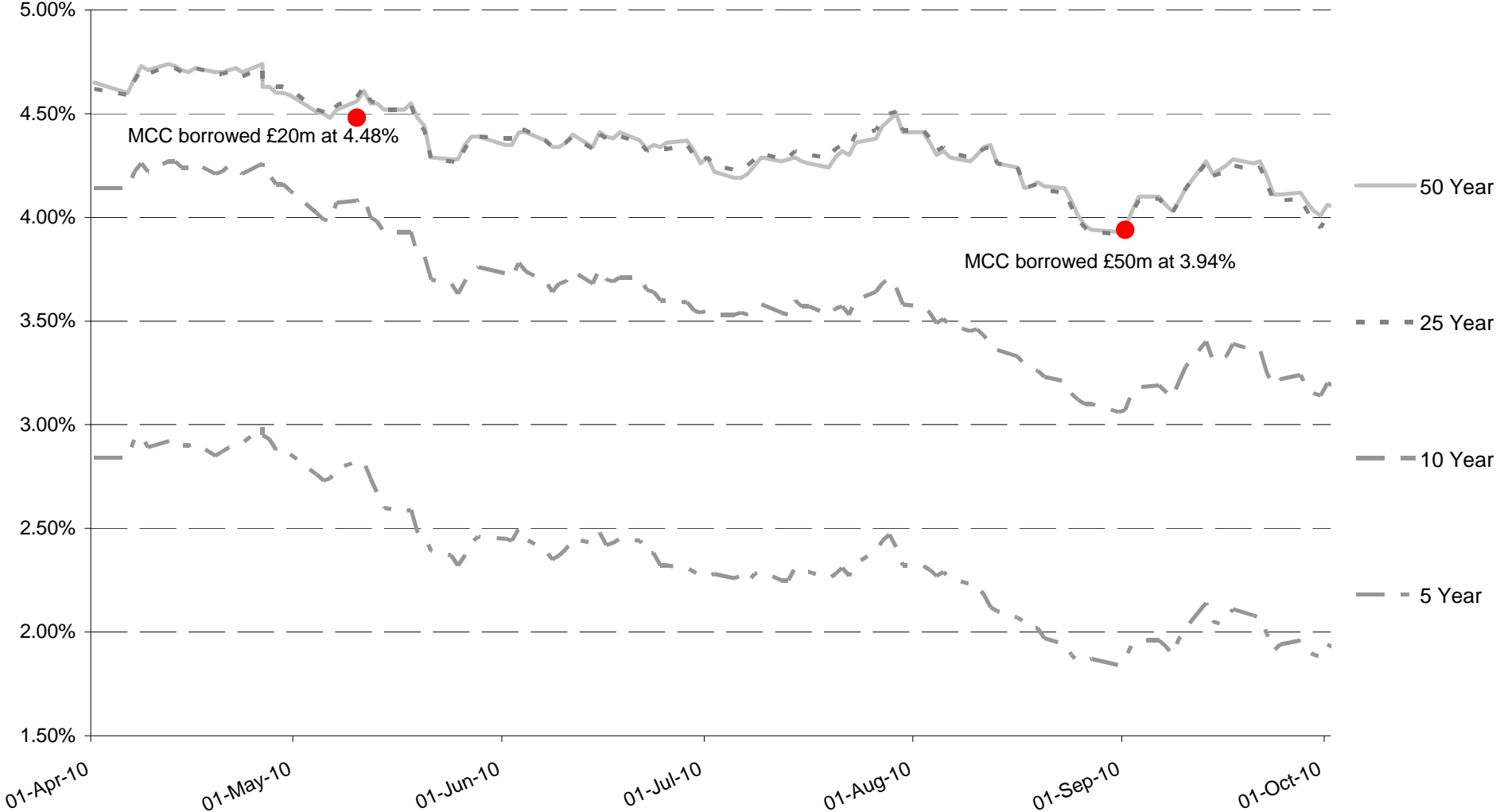
- the speed of economic recovery in the US and EU;
- the degree to which government austerity programmes will dampen economic growth;
- the speed of rebalancing of the UK economy towards exporting and substituting imports;
- changes in the consumer savings ratio;
- the potential for more quantitative easing, and the timing of this in both the UK and US;
- the speed of recovery of banks’ profitability and balance sheet imbalances ; and
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economy.

3.4 The overall balance of risks is weighted to the downside and there is some risk of a double dip recession and deleveraging, creating a downward spiral of falling demand, falling jobs and falling prices, although this is currently viewed as being a small risk.

- 3.5 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.

APPENDIX 2

PWLB RATES 2010-11



**APPENDIX 3
TREASURY MANAGEMENT PRUDENTIAL INDICATORS: 2010-11**

Performance to 30 September 2010

	Original	Minimum In Year to 30 Sept 2010	Maximum In Year to 30 Sept 2010
	£000	£000	£000
Operational Boundary for External Debt - Borrowing	£1,040,000	£689,615	£769,963
Other Long Term Liabilities	£0	£0	£0
Authorised Limit for External Debt - Borrowing	£1,187,000	£689,615	£769,963
Other Long Term Liabilities	£0	£0	£0
		Actual as at 30 Sept 2010	
Authority has adopted CIPFA's Code of Practice for Treasury Management in the Public Services	Yes	Yes	
Upper Limit for Fixed Interest Rate Exposure			
Net Borrowing at Fixed Rate as a percentage of Total Net Borrowing	83%	72%	
Upper Limit for Variable Interest Rate exposure			
Net Borrowing at Variable Rate as a percentage of Total Net Borrowing	56%	28%	
Upper Limit for Principal Sums Invested for over 364 days	£0	£0	

Maturity structure of Fixed Rate Borrowing	Lower Limit	Upper Limit	Actual as at 30 Sept 2010
	2010-11 Original	2010-11 Original	
under 12 months	0%	50%	0%
12 months and within 24 months	0%	60%	18%
24 months and within 5 years	30%	80%	35%
5 years and within 10 years	0%	60%	10%
10 years and above	10%	60%	37%

Appendix 4

Glossary of Terms

Authorised Limit - This represents the limit beyond which borrowing is prohibited, and needs to be set and revised by the Council. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable. It is the expected maximum borrowing need, with some headroom for unexpected movements.

Bank Rate – the rate at which the Bank of England offers loans to the wholesale banks, thereby controlling general interest rates in the economy.

Counterparty – the other party involved in a borrowing or investment transaction.

Credit Rating – A qualified assessment and formal evaluation of an institution's (bank or building society) credit history and capability of repaying obligations. It measures the probability of the borrower defaulting on its financial obligations, and its ability to repay these fully and on time.

Discount – Where the prevailing interest rate is higher than the fixed rate of a long-term loan, which is being repaid early, the lender can refund the borrower a discount. This is calculated on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender is able to offer the discount, as their investment will now earn more than when the original loan was taken out.

Fixed Rate Funding - A fixed rate of interest throughout the time of the loan. The rate is fixed at the start of the loan and therefore does not affect the volatility of the portfolio, until the debt matures and requires replacing at the interest rates relevant at that time.

Liquidity – The ability of an asset to be converted into cash quickly and without any price discount. The more liquid a business is, the better able it is to meet short-term financial obligations.

LIBOR – (London Interbank Offer Rate). The interest rate at which banks offer to take short-term borrowing from other banks in the London interbank market.

LOBO – Lender Option Borrower Option. Long-term borrowing deals structured in a such a way that a low rate of interest is usually offered for a short, initial period (anything from 1 year to 7 years), followed by a “step up” to a higher rate of interest (the “back end” interest rate), which is to be charged for the remainder of the loan period. The overall length of LOBOs is usually 50 or 60 years, but can be for shorter or longer periods. After the “step up” date, and at set intervals thereafter, the lender (the bank) has the option of increasing the “back end” interest rate. Whenever this option is exercised, if the proposed new interest rate is unacceptable, the borrower (the City Council) can redeem the loan without penalty. The City Treasurer has, more recently, looked at Vanilla LOBO loans, which have an interest rate which remains constant throughout the life of the loan, although still potentially subject to change at the lender's option.

Market - The private sector institutions - Banks, Building Societies etc.

Maturity Profile/Structure - an illustration of when debts are due to mature, and either have to be renewed or money found to pay off the debt. A high concentration in one year will make the Council vulnerable to current interest rates in that year.

Operational Boundary – This indicator is based on the probable external debt during the course of the year; it is not a limit and actual borrowing could vary around this boundary for short times during the year. It should act as an early warning indicator to ensure the Authorised Limit is not breached.

Premium – Where the prevailing current interest rate is lower than the fixed rate of a long-term loan, which is being repaid early, the lender can charge the borrower a premium. This is calculated on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender may charge the premium, as their investment will now earn less than when the original loan was taken out.

Prudential Code - The Local Government Act 2003 requires the Council to ‘have regard to’ the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council’s capital investment plans are affordable, prudent and sustainable.

PWLB - Public Works Loan Board. An institution managed by the Government to provide loans to public bodies at rates which reflect the rates at which the government is able to sell Gilts.

Volatility - The degree to which the debt portfolio is affected by current interest rate movements. The more debt that matures in the year and needs replacing, and the more debt subject to variable interest rates, the greater the volatility.

Yield Curve - A graph of the relationship of interest rates to the length of the loan. A normal yield curve will show interest rates relatively low for short term loans compared to long term loans. An inverted Yield Curve is the opposite of this.