1. Introduction

1.1 The council's Treasury Management Strategy has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA's) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

1.2 The Code also recommends that members are informed of Treasury Management activities at least twice a year by providing a mid-year report and an annual outturn report. This report therefore ensures the council is meeting Best Practice in accordance with CIPFA's recommendations.

1.3 The following provides background information as well as performance to date.

2. Economic Background

2.1 Growth
Global economic growth continues to remain subdued. The UK and the Eurozone (with the exception of Germany) struggled to show growth whilst the US economy grew slowly. The UK economy contracted by 0.30% in the first calendar quarter of 2012 and by 0.40% in the second.

2.2 Inflation
Inflation has started to fall in contract to 2011 when it remained high. In May annual CPI was below 3% for the first time in two and a half years; in June it fell to 2.40% which was the lowest level since November 2009.

2.3 Employment
Employment was more positive with employment increasing by 236,000 in the three months to July; the employment rate reaching its highest level since the three months to April 2009.

2.4 Measures taken by the Bank of England
The lack of growth and the fall in inflation resulted in the Bank of England agreeing a further £50 billion of asset purchases in July, taking total Quantitative Easing to £375 billion. The possibility of a cut in the Bank Base Rate from 0.50% 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 initiative (intended to lower banks funding costs) commenced in August. The Bank of England will assess its effectiveness in easing the flow of credit before committing to further action.

2.5 Interest Rates: With no change in the Bank Base Rate (and debate over whether the rate could fall further) together with the impact of additional funding provided to banks through the Funding for Lending Scheme, the interest rate obtained on the council's investments has remained low and available interest rates have tended to fall.

2.6 Gilt yields have also fallen making the interest rates on loans from the Public Works Loan Board cheaper.

3. The Council's Investments

3.1 At 30th September 2012 the council held the following investments:

Investment	Term	Maturity Date	Interest Rate	Amount invested £m	£m
Instant Access Bank Accounts:					
National Westminster	N/A	N/A	1.10%	4.45	
Santander	N/A	N/A	0.80%	2.00	6.45
Instant access Money Market Funds:					
Prime Rate	N/A	N/A	0.61%	2.90	
Ignis	N/A	N/A	0.65%	4.07	6.97
Fixed Term Deposits:					
Lloyds	91 days	30/10/12	1.35%	2.00	
Barclays	100 days	01/11/12	0.73%	2.00	
Bank of Scotland	99 days	06/11/12	1.40%	2.00	
Bank of Scotland	100 days	09/11/12	1.40%	2.00	
Bank of Scotland	102 days	20/11/12	1.40%	1.00	
Lloyds	99 days	30/11/12	1.38%	0.50	
Lancashire C C	364 days	06/03/13	0.85%	2.00	
Gateshead Council	549 days	18/11/13	1.10%	2.00	13.50
Total			**0.99%**		**26.92**

3.2 In June the credit rating agency Moody's completed its review of global banks. As a result of this review the long-term ratings of many of the banks were downgraded including Barclays, HSBC and the Royal Bank of Scotland. Separately the agency also downgraded the ratings of Lloyds Bank, Bank of Scotland, Nat West and Santander. None of the long-term ratings of the banks on the council's lending list were downgraded below the minimum credit rating stipulated in the council's Treasury Management Strategy for 2012-13. However, the short-term ratings for the Royal Bank of Scotland and Nat West were downgraded to just below the council's minimum criteria.

3.3 As a result of the downgrade in the short-term rating the council withdrew funds from the Royal Bank of Scotland and is now only using an instant access deposit account with Nat West, as permitted in the Strategy.

3.4 Our treasury advisor (Arlingclose) has the view that in the capital markets, the perceived credit standing of an institution is assessed by reference to its long-term credit rating which represents an agency's view of an institution's capacity to honour its financial obligations and its vulnerability to foreseeable events over the medium-term. The long-term rating is the principal driver of a bank's funding costs and perceived creditworthiness internationally, and hence market sentiment towards that institution. It is for this reason that although a number of ratings are considered (long-term, short-term, support, viability), the long-term rating should take precedence over other ratings.

3.5 For this reason Arlingclose recommend revising the 2012-13 Treasury Management Strategy to remove reference to a minimum short-term credit rating. Whilst the council will continue to take account of the short-term rating as part of the available information when assessing investment counterparties, the short-term rating would not be specified in the minimum criteria.

3.6 It should be noted that the Council does not place over-reliance on credit ratings alone and takes additional factors into account when assessing an institution's overall creditworthiness such as credit default swaps, share prices, sovereign support mechanisms and economic fundamentals (a country's net debt/GDP) as well as on corporate developments and/or news of market sentiment towards counterparties.

3.7 Since the beginning of the year the council's eligible UK counterparties, together with the maximum maturity periods (as recommended by the council's treasury advisers Arlingclose), have been as follows:

	Date revised				
	1st April	**3rd May**	**18th May**	**1st June**	**30th July**
Santander UK	35 days	35 days	overnight	overnight	35 days
Nat West and RBS	100 days	35 days	35 days	overnight	35 days
Bank of Scotland and Lloyds TSB	100 days	35 days	35 days	overnight	100 days
Nationwide	100 days	100 days	100 days	100 days	100 days
Barclays	100 days	100 days	100 days	100 days	100 days
HSBC and Standard Chartered Bank	6 months	6 months	6 months	6 months	12 months

3.8 The rate of interest received on the council's investments has generally been falling since the start of the new financial year. For example, interest rates on the following investments have been as follows:

Investment		**2nd Apr**	**2nd Jul**	**28th Sep**
Prime Rate Money Market Fund (instant access)		0.87%	0.69%	0.61%
Ignis Money Market Fund (instant access)		0.82%	0.72%	0.65%
Nationwide	E.g. 3 month term deposit	0.98%	0.60%	0.51%
Barclays	E.g. 3 month term deposit	0.91%	0.83%	0.53%

3.9 The prime policy objective of investment management is the security and liquidity of funds, however, once the safest of the counterparties have been identified (with the assistance of the council's treasury adviser Arlingclose) the council does then consider the return available from alternative investments.

3.10 In recent weeks the council has not invested with Nationwide or Barclays because the interest rates offered on term deposits for up to 100 days has fallen short of the interest rates earned on alternative instant access investments.

3.11 It is hoped that further stabilisation in financial markets within the next few months will see a lengthening in the recommended maturity periods to compensate for the lower rates.

3.12 Although the council can invest with HSBC for twelve months no funds have been placed on term deposit because the interest rates offered by HSBC are relatively low. The interest rate offered on a one year term deposit with HSBC is currently 0.60%.

3.13 The one year deposit rate offered by Standard Chartered Bank is higher at around 0.90% however the council is unable to invest with this bank directly. On the recommendation of Arlingclose, the council is in the process of opening a custody account with investment firm King and Shaxson. A custody account will enable the council to use a number of alternative approved investment instruments and diversify the investment portfolio. Such instruments include Treasury Bills, Certificates of Deposit (including deposits with Standard Chartered) and Gilts.

3.14 Arlingclose has issued the following forecast of the Bank Base Rate (issued 28th September 2012). Arlingclose believe that it could be 2016 before the first increase in the Bank Base Rate.

Bank Rate	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Upside risk				+0.25	+0.25	+0.25	+0.25	+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**
Downside risk	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25

3.15 The council has earned interest on its investments as follows:

Month	**Amount invested**		**Average rate of interest earned**		**Amount of interest earned**	**Budget**	**Under/ (Over) Spend**
	Actual £m	**Budget £m**	**Actual %**	**Budget %**	**£**	**£**	
Apr-12	22.11	30	1.15	0.90%	20,643	22,500	(1,857)
May-12	31.94	40	1.09	0.90%	29,247	30,000	(753)
Jun-12	32.57	45	1.07	0.90%	28,657	33,750	(5,093)
Jul-12	32.34	50	0.93	0.90%	25,676	37,500	(11,824)
Aug-12	31.33	45	0.98	0.90%	26,116	33,750	(7,634)
Sep-12	28.82	45	0.99	0.90%	23,472	33,750	(10,278)
Total to 30 September 2012					**153,811**	**191,250**	**(37,439)**
Oct-12		45		0.90%		33,750	
Nov-12		40		0.90%		30,000	
Dec-12		35		0.90%		26,250	
Jan-13		35		0.90%		26,250	
Feb-13		30		0.90%		22,500	
Mar-13		30		0.90%		22,500	
Total						**352,500**	

3.16 The interest received in the first half of the year has fallen short of the amounts budgeted by £37,439. Whilst the average rates achieved each month have been higher than the budgeted rate of 0.90% the average amounts invested have been lower.

3.17 The investment budget was set on a consistent basis with the borrowing budget assuming that the council may take out further borrowing totalling £11.5 million at the end of 2011/12 and/or at the beginning of 2012/13. The postponement of this borrowing has caused investment income to fall but the reduction in income is outweighed by savings made on the borrowing side.

3.18 If financial markets do not improve, with interest rates remaining low and the council only able to invest for short periods, actual investment income may fall short of the amount budgeted by around £75,000. However, continuing improvement in financial markets and an easing of financial constraints would reduce this shortfall.

4. The Council's Borrowing

Short-term borrowing

4.1 During the first six months of the year the council has taken out short-term loans from other local authorities as follows:

Date Borrowed	Council	£m	Period (days)	Date Repayable	Interest Rate*	Interest Paid
01/05/12	Worcestershire	3.00	7	08/05/12	0.29%	£166.85
02/05/12	Rhondda	3.97	8	10/05/12	0.29%	£252.34
08/05/12	Worcestershire	3.50	7	15/05/12	0.29%	£194.66
10/05/12	Coventry	3.50	21	31/05/12	0.28%	£563.84
28/05/12	Caerphilly	3.00	10	07/06/12	0.28%	£230.14
24/08/12	Leicester	2.00	83	15/11/12	0.26%	£1,182.47
24/08/12	London Borough of Hammersmith & Fulham	2.00	52	15/10/12	0.27%	£769.32
12/09/12	East Renfrewshire	2.00	50	01/11/12	0.27%	£739.73
Total interest paid to 30 September 2012						**£4,099.35**
Loan repaid						
*In addition to interest the council also pays broker commission at 0.10% per annum.						

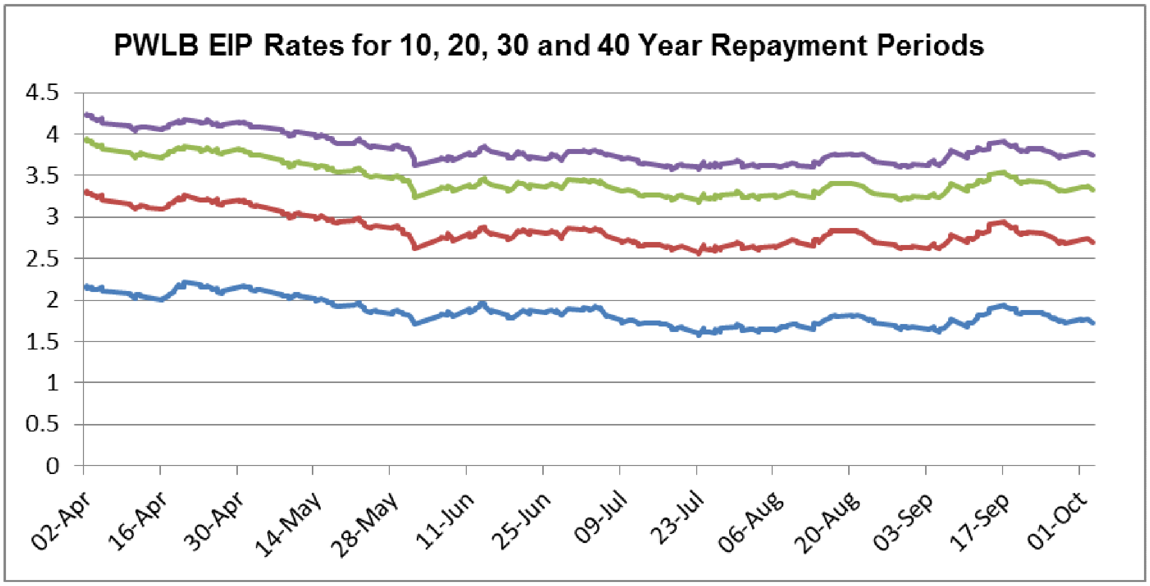
4.2 Short-term loans taken out in May were to provide additional liquidity at a time when balances were relatively low. More recent borrowing was to fund capital expenditure (including the Rockfield purchase). It is intended that short-term borrowing will continue to be renewed so long as there are good quality investment opportunities available and until such time as the funding is replaced by longer term borrowing from the Public Works Loan Board.

Long-term borrowing

4.3 No long-term loans have been taken out in the year to date.

4.4 The Public Works Loan Board (PWLB) remains an attractive source of borrowing for the council as it offers flexibility and control. The large downward movement in gilt yields in the second quarter resulted in PWLB rates falling across all maturities.

4.5 The graph below shows the interest rates available on new loans from 1st April 2012 to date. The interest rates shown are those relating to "Equal Instalments of Principal" (EIP) loans which are repaid in equal instalments over the period of the loan. As can be seen below, since falling in April and May 2012, interest rates have remained relatively low.



4.6 There are currently good reasons to postpone further borrowing from the Public Works Loan Board, including:

- The expectation that PWLB rates will remain low for some months to come;
- The 0.20% cut in PWLB rates which will take effect from 1st November 2012;
- The large differential between PWLB rates and the amount currently earned on the council's investments;
- The availability of cheap short-term loans from other local authorities, and
- The flexibility offered by short-term borrowing in terms of repaying loans and reducing investments should financial conditions deteriorate.

4.7 Regarding the second point above, the 20 points reduction was initially announced in the March 2012 Budget with the discounted rate being available to local authorities who provide additional information regarding their borrowing plans. Further clarification was provided in August with the announcement that the rate would apply from 1st November 2012. The council has already submitted information concerning its likely borrowing requirements over the next three years so that it may benefit from the new lower rates.

4.8 The council's borrowing budget was based on taking out new loans of £11.50 million. The longer the council can postpone taking out these loans the greater will be the underspend for 2012/13. The current underspend, which is based on postponing taking out any new PWLB loans until 2013 (and so recognising nine months of savings), can be estimated as follows:

Summary of Borrowing Budget	**Budget**	**Forecast**	**Surplus**
	£m	**£m**	**£m**
Minimum Revenue Provision	9.95	9.81	0.14
Interest on existing loans (January 2012 position)	5.76	5.76	-
Provision for borrowing of £5.50m to be taken out before the end of 2011/12 at 4.00%	0.22	0.06	0.16

Borrowing requirement for 2012/13 of £6m, included at an interest rate of 4.00%	0.24	0.06	0.18
Interest payable on short-term borrowing in lieu of longer-term loans		0.02	(0.02)
Additional budget towards property disposal costs	0.05	0.05	-
Original budget	**16.22**	**15.76**	**0.46**
Budget adjustment relating to a reduction in capital financing contributions from directorates	**(0.15)**	**-**	**(0.15)**
Forecast budget surplus as at 31 March 2013	**16.07**	**15.76**	**0.31**

5. Summary of Outturn Position

5.1 The outturn position will depend upon the timing of any new long-term borrowing and any improvement in the financial markets. However, the forecast at the end of September is for an underspend of £235,000. This forecast assumes postponement of PWLB borrowing until 2013 and that difficulties in the financial markets will persist on the investment side. The underspend comprises a borrowing underspend of £310,000, as detailed above, but a shortfall on interest earned of around £75,000.

5.2 The council is able to capitalise interest costs relating to interest paid on borrowing used to fund large capital schemes that take substantial periods of time to get to the point at which the assets may be utilised. Such interest, incurred at the construction or installation phase, may be added to the cost of the associated asset. It is difficult to provide an estimate at this stage, however, any interest that the council is able to capitalise will increase the underspend noted above.