Humberside Police Authority

Agenda Item 10

22 November 2011

Joint Report of the Chief Constable and the Deputy Chief Executive and Treasurer

TREASURY MANAGEMENT MID-TERM REVIEW REPORT 2011/12

PURPOSE OF THE REPORT

1. The purpose of this report is to introduce the Treasury Management Mid-Term Review Report for 2011/12 providing details of Treasury Management activity during the period 1 April to 30 September 2011. The report is submitted to the Authority in compliance with the arrangements set out within the Treasury Management Strategy Statement (TMSS) approved on 22 March 2011.

BACKGROUND

2. The Prudential Code for Capital Finance in Local Authorities (the Prudential Code) underpins the system of capital finance. Local authorities, including police authorities, determine their own programmes for capital investment and the Prudential Code has been developed as a professional code of practice to support authorities, when making decisions on strategic planning, asset management and capital investment.

3. It seeks to ensure that authorities operate within a clear framework to satisfy themselves that investment plans are considered affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good professional practice. These are designed to support and record local decision making in a manner that is publicly accountable.

4. Authorities are required by Regulation to have regard to the Prudential Code when carrying out their duties in accordance with the Local Government Act 2003.

5. A primary requirement of the Code is the formulation and agreement by full Authority of a Treasury Management Strategy Statement (TMSS) and Treasury Management Practices (TMPS). These set out the responsibilities, delegation and reporting arrangements with regard to treasury management and are designed to support and record local decision making in a manner that is publicly accountable.

6. The TMSS for 2011/12 was approved in March 2011, after the budget for 2011/12 and Medium Term Financial Strategy (MTFS) had been agreed in February 2011.

7. The TMSS requires members to receive a minimum of a mid-year review and an annual report on treasury management activities. This report ensures that the Authority meets the requirements of the Strategy, and therefore the Code.

8. Treasury Management 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”.

9. The Mid-Term Review Report has been prepared in conjunction with Sector, the Authority’s treasury management advisers.

INFORMATION

10. The Treasury Management Mid-Term Review Report for 2011/12 is attached at Appendix 1. This formal report supplements the monthly investment reports provided to Members via the Authority’s website.

11. Details of performance and information on relevant agreed Treasury and Prudential Indicators are included within the Report.

OPTIONS, RISKS AND OPPORTUNITIES

12. The TMSS sets out detailed information in relation to risks associated with treasury management activity and proposed mitigating actions whilst acknowledging that the risk cannot be entirely eliminated. The TMSS and the TMPs and the procedures detailed within them are intended to limit the Authority’s exposure to unforeseen and unbudgeted financial consequences of treasury management activity.

13. The reporting requirements are intended to ensure that treasury management activity has been conducted in accordance with the policy and strategy agreed by the Police Authority and that treasury management operations have been performed within agreed limits.

14. Sector has provided officers of the Authority and the Force with additional information in relation to treasury management activity. However it must be recognised that the responsibility for all decisions with regard to policies, strategy and transactions remain with the Authority.

POLICING PLAN AND PERFORMANCE

15. Effective treasury management arrangements are an important factor in ensuring that the Force and the Authority operate efficiently. It also contributes towards delivering value for money and the strategic aim of seeking to deliver improved performance through the best use of resources.

FINANCIAL IMPLICATIONS

16. The Treasury Management Mid-Term Review Report sets out details of the treasury management activity undertaken in the period 1 April to 30 September 2011. The financial implications of this activity have been factored

into the Authority's budget monitoring reports and into updates of the MTFS which continues to be revised to reflect the forecast of future interest rates along with other factors, including cash flow.

LEGAL IMPLICATIONS

17. The Authority is required to comply with the requirements of the Local Government Act 2003 and to have regard to guidance from the Department for Communities and Local Government and the CIPFA Code when determining its treasury management policy and strategies together with detailed practices.

18. The TMSS requires the Police Authority to consider a mid-term review of treasury management activity.

EQUALITIES AND DIVERSITY AND HUMAN RIGHTS

19. There is no direct impact on equality and diversity as a result of this report.

CONCLUSIONS

20. The Mid-term Review Report sets out information on treasury management activity undertaken during the period 1 April – 30 September 2011. It provides a commentary on recent events affecting the money markets during the period, information on loans drawn down from the PWLB and action taken to utilise counterparties with the highest credit quality.

21. The report indicates that the Authority has operated in compliance with agreed treasury management practices and within the Treasury and Prudential Indicators set out in the TMSS agreed prior to the start of the financial year in March 2011.

RECOMMENDATION

22. It is recommended that Members consider and note the report and the treasury management activity that has been undertaken during the period 1 April to 30 September 2011.

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Background Documents:	File Ref:- JB/TM/MTRR/2011/12

APPENDIX 1

Humberside Police Authority

Treasury Management Strategy Statement and Annual Investment Strategy

Mid-Term Review Report 2011/12

1 Background

The Authority operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering maximising investment return.

The second main function of the treasury management service is the funding of the Authority's capital plans. These capital plans provide a guide to the borrowing need of the Authority, essentially the longer term cash flow planning to ensure the Authority can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Authority risk or cost objectives.

As a consequence treasury management 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. "

2 Introduction

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by this Authority on 22 March 2011.

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Strategy Statement which sets out the policies and objectives of the Authority's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Authority will seek to achieve those policies and objectives.
3. Receipt by the full Authority of an annual Treasury Management Strategy Statement - including an Minimum Revenue Provision Policy and Annual Investment Strategy - for the year ahead, a **Mid-year Review Report** and an Annual Report covering activities during the previous year.
4. Delegation by the Authority of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
5. Delegation by the Authority of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Authority the delegated body is the Resources Committee:

This mid-term Review Report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- An economic update for the first six months of 2011/12;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Authority's capital expenditure (prudential indicators);
- A review of the Authority's investment portfolio for 2011/12;
- A review of the Authority's borrowing strategy for 2011/12;
- A review of any debt rescheduling undertaken during 2011/12;
- A review of compliance with Treasury and Prudential Limits for 2011/12

Recommendation:-

It is recommended that Members consider and note the report and the treasury management activity that has been undertaken during the period 1 April to 30 September 2011.

3 Economic update

3.1 Global economy

The Euro zone sovereign debt crisis continued with Spain, and particularly Italy, being the focus of renewed market concerns that they may soon join with Greece, Ireland and Portugal in needing assistance. This uncertainty and the lack of a co-ordinated or credible Euro zone response, left commentators concerned over the potential impact of sovereign default and resulting effect on the Euro zone banking sector. The approval by various countries of the €440bn bail out fund in September brought temporary relief to financial markets but this did not provide a credible remedy to the scale of the Greek debt problem or the sheer magnitude of the potential needs of other countries for support.

This, coupled with political difficulties in the US over their plans to address the budget deficit, the size and control over the US sovereign debt, and the subsequent loss of the AAA credit rating from Standard and Poor's, led to a much more difficult and uncertain outlook for the world economy.
Growth prospects in the US, UK and the euro zone have been lower than expected, with future prospects similarly cut. Whilst not a central view, concerns of a double dip recession in some Western countries have increased. World stock markets fell in the second quarter of 2011/12 as a consequence.

3.2 UK economy

Following zero growth in the final half of 2010/11 the UK economy grew by a weaker than expected 0.1% in the first quarter of 2011/12, providing a knock on effect to future growth prospects. Growth prospects are governed by UK consumer sentiment, which is currently subdued due to falling disposable income. Higher VAT, overhanging debt, high inflation and concerns over employment continued to weigh heavily on consumers into the future.

The announcement by the MPC on 6 October of a second round of quantitative easing of £75bn emphasised how seriously the MPC now views recession as being a much bigger concern than inflation. Although inflation remains stubbornly high, the MPC's expectation of future falls resulting in an under shoot of its 2% target opened the way for this new round of QE.

International investors continue to view UK government gilts as being a safe haven from the EU sovereign debt crisis. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and sent PWLB borrowing rates to low levels.

3.3 Outlook for the next six months of 2011/12

There remain huge uncertainties in economic forecasts due to the following major difficulties:

- the increase in risk that the UK, US and EU could fall into recession
- the likely political gridlock in the US preventing significant government fiscal action to boost growth ahead of the Presidential elections in November 2012
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economies
- the degree to which government austerity programmes will dampen economic growth;
- the potential for further 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 risk of substantial losses being incurred on EU sovereign debt

The overall balance of risks is weighted to the downside:

- Low growth in the UK is expected to continue, with a low Bank Rate to continue for at least 24 months, coupled with a possible further extension of quantitative easing. This will keep investment returns depressed.
- The expected longer run trend for PWLB borrowing rates is for them to rise, primarily due to the need for a high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. However the current safe haven status of the UK may continue for some time, postponing any increases until 2012.

3.4 Sector's interest rate forecast

Sector's interest rate forecast was revised on 7 October 2011 as a result of two major events:-

- The decision by the MPC to expand quantitative easing by a further £75bn, which had an immediate effect of depressing gilt yields at the long end of the curve. This clearly underlined how concerned the MPC is about the prospects for growth of the UK economy and that recession is now decisively a much greater concern than inflation and
- The marked deterioration of growth prospects in the US, EU and UK, especially as concerns had further increased over Greece and the potential fall out from their debt situation. This led in turn to a further increase in safe haven flows into UK gilts which depressed gilt yields and PWLB rates to even lower levels.

These developments had left Sector's short term forecasts for PWLB rates which where last revised on 16 August 2011 markedly out of line with actual rates and substantially pushed back their expectations of the timing of the eventual start of increases in Bank Rate and the expected eventual rise in gilt yields and PWLB rates.

The revised forecast is as detailed below:-

	NOW	Dec-11	**Mar-12**	Jun-12	Sep-12	Dec-12	**Mar-13**	Jun-13	Sep-13	Dec-13	**Mar-14**	Jun-14	Sep-14	Dec-14	**Mar-15**
BANK RATE	0.50	0.50	**0.50**	0.50	0.50	0.50	**0.50**	0.50	0.75	1.00	**1.25**	1.50	2.00	2.25	**2.50**
3 month LIBID	0.75	0.70	**0.70**	0.70	0.70	0.70	**0.75**	0.80	0.90	1.20	**1.40**	1.60	2.10	2.40	**2.60**
6 month LIBID	1.00	1.00	**1.00**	1.00	1.00	1.00	**1.10**	1.20	1.40	1.60	**1.80**	2.00	2.50	2.70	**2.90**
12 month LIBID	1.50	1.50	**1.50**	1.50	1.50	1.60	**1.70**	1.80	1.90	2.20	**2.40**	2.60	3.10	3.20	**3.30**
5 yr PWLB	2.30	2.30	**2.30**	2.30	2.30	2.40	**2.50**	2.60	2.70	2.80	**2.90**	3.10	3.30	3.50	**3.70**
10 yr PWLB	3.30	3.30	**3.30**	3.30	3.40	3.40	**3.50**	3.60	3.70	3.80	**4.00**	4.20	4.40	4.60	**4.80**
25 yr PWLB	4.20	4.20	**4.20**	4.20	4.30	4.30	**4.40**	4.50	4.60	4.70	**4.80**	4.90	5.00	5.10	**5.20**
50 yr PWLB	4.30	4.30	**4.30**	4.30	4.40	4.40	**4.50**	4.60	4.70	4.80	**4.90**	5.00	5.10	5.20	**5.30**

4 Treasury Management Strategy Statement and Annual Investment Strategy update

The Treasury Management Strategy Statement (TMSS) for 2011/12 was approved by this Authority on 22 March 2011. No policy changes to the TMSS are proposed at this time although temporary measures have been put in place to increase the approved counterparty limits for Santander (UK), Bank of Scotland and the Nationwide so that credit quality was not compromised in treasury management activity.

5 The Authority's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The Authority's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

5.1 Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed in March 2011.

Capital Expenditure by Service	2011/12 Original Estimate £m	Current Position (spend at 30/9/11) £m	2011/12 Revised Estimate £m
Total	22.570	4.162	22.066

5.2 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Authority by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	2011/12 Original Estimate £m	2011/12 Revised Estimate £m
Total spend	**22.570**	**22.066**
Financed by:		
Capital Receipts	0	0
Capital grants	1.619	1.300
Revenue	0	0
Total financing	**1.619**	**1.300**
Borrowing need	**20.951**	**20.766**

5.3 The Prudential Indicators for the Capital Financing Requirement, External Debt and the Operational Boundary

The table shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period. This is termed the Operational Boundary.

Prudential Indicator – Capital Financing Requirement

The Authority's capital financing requirement is marginally higher than originally forecast, in part due to the reclassification of the lease on the helicopter as a finance lease.

Capital Financing Requirement	2011/12 Original Estimate £m	2011/12 Revised Estimate £m
Capital Financing Requirement as 31 March 2012	**48.936**	**49.035**

Prudential Indicator – External Debt / the Operational Boundary/ Authorised Limit

	2011/12 Original Estimate £m	**2011/12 Revised Estimate £m**
Prudential Indicator – Capital Financing Requirement/Operational Boundary		
Total CFR	79.783	79.968
Net movement in CFR	**19.559**	**19.553**
Prudential Indicator –External debt/Operational Boundary		
Authorised Limit	**81.783**	**81.968**
Borrowing	21.203	17.294
Other long term liabilities*	0	1.242
Total debt	**21.203**	**18.536**

As reported in the Annual Treasury Management Report for 2010/11 the lease in connection with the helicopter has been reclassified as a finance lease to comply with the requirements of the International Financial Reporting Standards (IFRS) which now requires it to be included under the heading of long term liability and to be scored against the Authority's borrowing limits.

5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Net external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2011/12 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Authority has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2011/12 Original Estimate £m	**2011/12 Revised Estimate £m**
Gross borrowing	19.924	17.294
Plus other long term liabilities	0	1.242
Less investments	10.092	10.000
Net borrowing	**9.832**	**8.536**

The Deputy Chief Executive and Treasurer reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

The Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

6 Investment Portfolio 2011/12

In accordance with the Code, it is the Authority's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Authority's risk appetite. As set out in Section 3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and broadly in line with the 0.5% Bank Rate. The continuing Euro zone sovereign debt crisis, and its potential impact on banks, prompts a low risk and short term strategy. Given this risk adverse environment, investment returns are likely to remain low.

The Authority held £38.922m of investments as at 30 September 2011 (£15.702m at 31 March 2011) and the investment portfolio yield for the first six months of the year is 0.81% against a benchmark average 7-day rate of 0.37%.

Full details of the investments held on 30 September 2011 (excluding Icelandic Bank investments) are shown in the September monthly investment report posted on the Members' website,

The Deputy Chief Executive and Treasurer confirms that the approved counterparty limits previously approved within the Annual Investment Strategy were temporarily increased by Chair's decision records and the revised limits were not breached during the first six months of 2011/12.

The Authority's budgeted investment return for 2011/12 was £80k however this is now estimated to be £180k as a result of a combination of factors including cashflow balances, which drive the forecast generally being higher than originally anticipated, and the impact of taking PWLB loans earlier than originally forecast.

Investment Counterparty criteria

The current investment counterparty criteria selection approved in the TMSS has been temporarily extended by urgent matters decision records as reported to the Police Authority on 27 September 2011. This has allowed the treasury management function to ensure that investments are only made with counterparties with the highest credit quality.

7 Borrowing

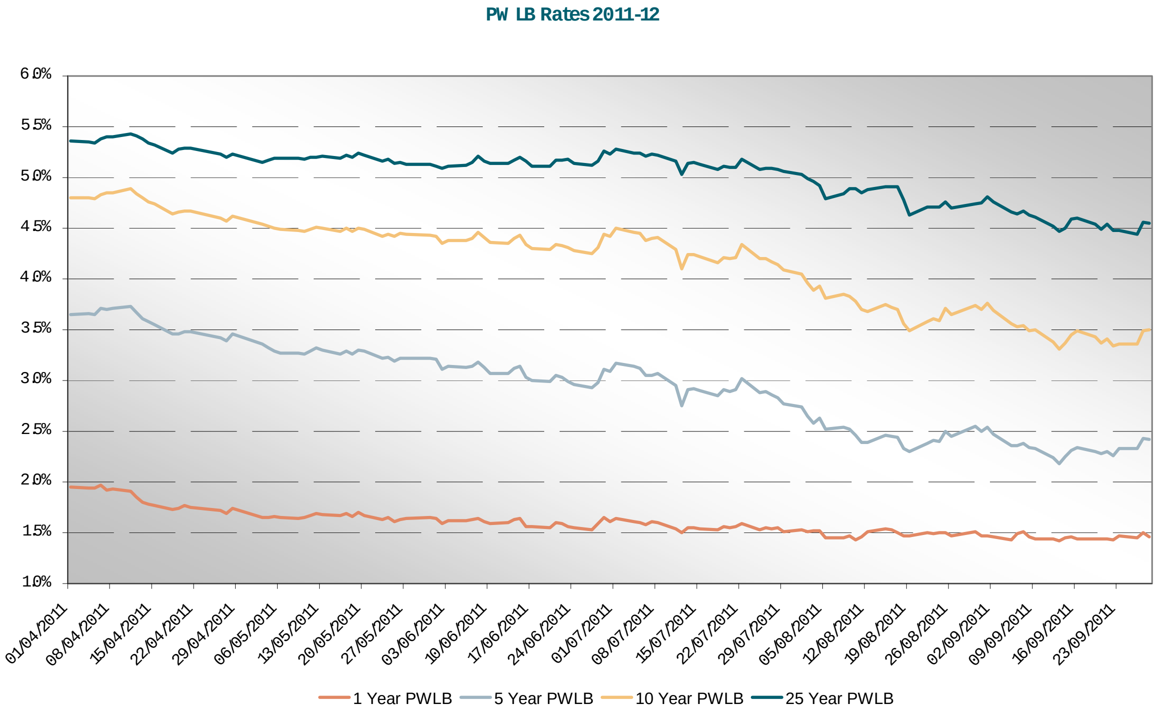
The Authority's capital financing requirement (CFR) for 2011/12 is £49m. The CFR denotes the Authority's underlying need to borrow for capital purposes. If the CFR is positive the Authority may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Table 5.4 shows the Authority has borrowings of £18.536m and has utilised cash flow funds in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate.

Due to the overall financial position and the underlying need to borrow for capital purposes (the capital financing requirement - CFR), new external borrowing of £10m was taken from the PWLB in August and September. Details of loans are set out below:-

Period (years)	**Type**	**Amount**	**Rate at 1/4/11**	**Borrowing Rate**	**Variation From 1/4/11**	**Date of Borrowing**
4 -4.5	Maturity	£1m	3.47%	2.19%	1.28%	15/09/2011
4.5 -5	EIP	£3m	2.76%	1.89%	0.87%	25/08/2011
5- 5.5	Maturity	£1m	3.81%	2.64%	1.17%	25/08/2011
6 -6.5	Maturity	£1m	4.11%	2.92%	1.19%	25/08/2011
6.5 -7	Maturity	£1m	4.24%	2.82%	1.42%	15/09/2011
7-7.5	Maturity	£1m	4.35%	3.17%	1.18%	25/08/2011
7.5-8	Maturity	£1m	4.46%	2.97%	1.49%	22/09/2011
8.5-9	Maturity	£1m	4.65%	3.16%	1.49%	22/09/2011

As outlined below, the general trend has been a reduction in interest rates during the six months, across all maturity bands.

The graph below shows the movement in PWLB rates for the first six months of the year:-



8 Debt Rescheduling

No debt rescheduling was undertaken during the first six months of 2011/12.

9 Icelandic Banks

Up to 30 September 2011, the Authority received the following dividends in connection with the investments held in the UK subsidiaries of the Icelandic Banks that failed in 2008, Kaupthing Singer and Friedlander (KSF) and Heritable:-

Dividend Date	KSF Amount p/£	Dividend Date	Heritable Amount p/£
22 July 2009	20	28 July 2009	16.1
9 December 2009	10	16 December 2009	12.7
30 March 2010	5	26 March 2010	6.2
28 July 2010	10	16 July 2010	6.3
8 December 2010	8	14 October 2010	4.1
25 May 2011	5	14 January 2011	4.7
		15 April 2011	6.2
		13 July 2011	4.1
TOTAL	**58**	**TOTAL**	**60.4**

KSF declared a 7th dividend of 5p/£ on 5 October 2011 with Heritable declaring a 9th dividend of 4.2p/£ on 18 October 2011.

The last forecast information from the administrators of the two banks is for dividends of 86p—90p/£ for Heritable and 79 -86p/£ for KSF.

Since the annual accounts were completed the Authority has received LAAP82 update no 5 which will be used to update calculations of impairments.