Epping Forest District Council
Mid-Year Treasury Report 2012/13

1. Background

The Council's Treasury Management Strategy has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

The Code also recommends that members are informed of Treasury Management activities at least twice a year. This report therefore ensures this authority is embracing Best Practice in accordance with CIPFA's recommendations.

Treasury management is defined as: "The management of the local authority'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. Economic Background

Growth: The world economy faced yet another soft patch. The UK and the Eurozone (with the exception of Germany) struggled to show discernible growth whilst the US economy grew slowly. UK GDP contracted by 0.3% in the first calendar quarter of 2012 and by 0.4% in second, reflecting the difficult economic conditions faced by businesses and consumers domestically and globally. Businesses were more inclined to take defensive strategies involving cost cutting rather than increasing capital spending. Financial conditions facing households continued to be weak as wage growth remained subdued and was, for much of the period, outstripped by inflation. (Much of the fall in Q2 GDP could probably be attributed to the impact of the additional bank holiday for the Diamond Jubilee, and could be recovered in Q3.)

Inflation: Inflation, which had remained stubbornly sticky throughout 2011, slowly began to fall. Annual CPI dipped below 3% for the first time in two and half years in May and fell to the lowest level since November 2009 in June, with a reading of 2.4%. It ticked up marginally to 2.5% by August. Although the recent rise in commodity prices has been worrying, the rise in oil and food prices – the latter mainly due to poor weather-related yields - are well below the spikes of 2010-11.

Some barometers of economic activity, however, provided a more buoyant and positive picture but tended to get overshadowed. Employment rose by 236,000 in the three months to July and the employment rate was at its highest since the three months to April 2009. The ILO unemployment rate fell 0.1% on the quarter to 8.1%. Whilst the effect of the Olympics undoubtedly played a part, despite its temporary nature, the underlying data pointed to a more resilient and optimistic outlook for the economy.

The lack of growth and the fall in inflation were persuasive enough for the Bank of England to sanction £50 billion asset purchases (QE) in July, taking total QE to £375 billion. The possibility of a rate cut from the current level of 0.5% 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 (FLS) initiative, intended to lower banks' funding costs, commenced in August. The Bank of England will assess its effects in easing the flow of credit before committing to further policy action.

Banks were embroiled in the scandal to manipulate LIBOR rates during the abnormal market conditions at the height of the 2007/2008 financial crisis. Barclays was fined a record £290 million, the FSA was also investigating HSBC, RBS, Citicorp and UBS; Lloyds was named in a lawsuit in the US. The big-four UK banks were also being investigated for mis-selling interest rate swaps to small businesses.

The US Federal Reserve extended quantitative easing through 'Operation Twist', in which it buys longer-dated bonds with the proceeds of shorter-dated US Treasuries. Poor employment data for August preceded the Fed further easing monetary policy at its September meeting; The Fed committed to purchasing $40 billion of agency mortgage-backed securities each month until the outlook for the labour market improves "substantially." The Fed also pledged to keep interest rates low until mid-2015. In Greece, the formation of an alliance of pro-euro parties after a second round of parliamentary elections prevented an immediate and disorderly exit from the Euro. The Euro region suffered a renewed bout of stress when Italian and Spanish government borrowing costs rose sharply and Spain was also forced to officially seek a bailout for its domestic banks. The European Central Bank responded with the announcement in September of its Outright Monetary Transactions (OMT) facility which allows the ECB to buy unlimited amounts of 1-3 year sovereign bonds provided the sovereign(s) first asks for such assistance and adheres to the strict conditionality attached to such purchases.

Gilt Yields and Money Market Rates: Gilt yields fell sharply raising the prospect that very short-dated yields could turn negative. 2-year yields fell to 0.06%, 5-year yields to 0.48% and 10-year yields to 1.45%. Despite the likelihood the DMO would revise up its gilt issuance for 2012/13, there were several gilt-supportive factors: the Bank of England's continued purchases of gilts under an extended QE programme; investors preferring the safer haven of UK government bonds to those of European sovereigns; the coalition's commitment to fiscal discipline by sticking to its "plan A" for deficit reduction; large scale purchases by banks to comply with the FSA's liquidity buffer requirements; and general risk aversion against a weak economic backdrop. PWLB borrowing rates fell commensurately (the Board maintained the +0.90% margin above the equivalent gilt yield for new borrowing).

Money market rates fell over the six month period by between 0.2% to 0.6% for 1-12 month maturities.

3. Debt Management

	Balance on 01/04/2012 £m	Debt Maturing £m	Debt Repaid £m	New Borrowing £m	Balance on 30/09/2012 £m	Increase/ Decrease in Borrowing
Short Term Borrowing	0.000	0.000	0.000	0.000	0.000	-
Long Term Borrowing*	185.456	0.000	0.000	0.000	185.456	-
TOTAL BORROWING	**185.456**	**0.000**	**0.000**	**0.000**	**185.456**	**-**
Average Rate % / Life (yrs)	3% / 25 yrs	NA	NA	NA	3% / 25 yrs	-

(*this relates to £185.456m borrowed in March 2012 for HRA self-financing settlement).

PWLB Borrowing: The PWLB remains an attractive source of borrowing for the Council as it offers flexibility and control. The large downward move in gilt yields in the second quarter resulted in PWLB rates falling across all maturities (tables 2 and 3 in Appendix 2).

Alternative borrowing sources: Whilst there are several claims that a competitive, comparable equivalent to long-dated PWLB borrowing is readily available, the Council will continue to adopt a cautious and considered approach to funding from the capital markets.

For the Council the use of internal resources in lieu of borrowing has continued to be the most cost effective means of funding £15m of capital expenditure. This has lowered overall treasury risk by reducing temporary investments. The medium term capital programme can be fully financed by internal resources.

4. Investment Activity

The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

Investments

	Balance on 01/04/2012 £m	Investments Made £m	Investments Repaid £m	Balance on 30/09/2012 £m	Increase/ Decrease in Investments
Short Term Investments	42.349	88.000	82.167	48.182	+£5.833m
Long Term Investments	0.137	0.000	0.000	0.137	-
TOTAL INVESTMENTS	**42.486**	**88.000**	**82.167**	**48.319**	**+£5.833m**

Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2012/13. New investments were made with the following institutions:

- Other Local Authorities;
- AAA-rated Money Market Funds;
- Term Deposits with UK Banks and Building Societies systemically important to the UK banking system.

Counterparty credit quality was assessed and monitored with reference to Credit Ratings (the Council's minimum long-term counterparty rating of A- (or equivalent) across rating agencies Fitch, S&P and Moody's); credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; sovereign support mechanisms /potential support from a well-resourced parent institution; share price.

Credit Risk

Counterparty Update
In June Moody's completed its review of banks with global capital market operations, downgrading the long-term ratings of all of them by between one to three notches. The banks on the Council's lending list which were affected by the ratings downgrades were Barclays, HSBC, Royal Bank of Scotland. Separately, the agency also downgraded the ratings of Lloyds Bank, Bank of Scotland, National Westminster Bank and Santander UK plc. None of the long-term ratings of the banks on the Council's lending list were downgraded to below the Council's minimum A-/A3 credit rating threshold.

Counterparty credit quality is demonstrated by the Credit Score Analysis summarised below. The credit scores are based on the Council's quarter-end in-house investment position.

Date	Value Weighted Average - Credit Risk Score	Value Weighted Average - Credit Rating	Time Weighted Average - Credit Risk Score	Time Weighted Average - Credit Rating
31/03/2012	4.35	AA-	5.36	A+
30/06/2012	4.12	AA-	5.56	A
30/09/2012	4.56	A+	2.42	AA+

Scoring:
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-AAA = highest credit quality = 1
- D = lowest credit quality = 27
-Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

Following the decision to shorten deposit durations with investment counterparties back in May this year, the Council has since extended duration (decision made in late July). The move to extend duration was as a result of monitoring economic and political developments in the UK, Europe and globally. The various risk metrics used to assess the creditworthiness of financial institutions had shown continued signs of stabilisation, and in some cases, considerable improvement.

Maturities for new investments with financial institutions on the Council's list are currently as follows:

UK Institutions
- Santander UK for a maximum period of 100 days;
- Royal Bank of Scotland, National Westminster, Lloyds TSB, and Bank of Scotland for a maximum period of 6 months;
- HSBC Bank, Standard Chartered, Barclays Bank, and Nationwide Building Society for a maximum period of 12 months.

Budgeted Income and Outturn

The Council's budgeted investment income for the year has been estimated at £0.561m. The average cash balances representing the Council's reserves, were £53.6m during the period.

The UK Bank Rate has been maintained at 0.5% since March 2009 and is not expected to rise until 2015/2016. Short-term money market rates have remained at very low levels (see Table 1 in Appendix 2). New investments were made at an average rate of 0.98%. The Council anticipates an investment outturn of £0.514m for the whole year.

Icelandic Bank Investment Update
The following has now been resolved in relation to Icelandic deposits:

- ***Heritable*** – It is expected that 88p/£ will be recovered overall. 75% has been recovered to date, and a further 7% is expected in 2012/13.

5. Compliance with Prudential Indicators

The Council can confirm that it has complied with its Prudential Indicators for 2012/13, which were set in February 2012 as part of the Council's Treasury Management Strategy Statement). Details can be found in Appendix 1.

6. Outlook for Q3-Q4

At the time of writing this activity report in October 2012, economic growth remains elusive. Tight credit conditions and weak earnings growth are constraining consumer and corporate spending. The outlook is for official interest rates to remain low for an extended period, as shown below.

	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
Official Bank Rate													
Upside risk				0.25	0.25	0.25	0.25	0.50	0.50	0.50	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	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	-0.25	-0.25	-0.25

7. Summary

In compliance with the requirements of the CIPFA Code of Practice this report provides Members with a summary report of the treasury management activity during the first two quarters of 2012/13. As indicated in this report none of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

Appendix 1

Capital Financing Requirement

Estimates of the Council's cumulative maximum external borrowing requirement for 2012/13 to 2014/15 are shown in the table below:

	31/03/2012 Actual £m	31/03/2013 Estimate £m	31/03/2014 Estimate £m	31/03/2015 Estimate £m
Capital Financing Requirement				
HRA	154.391	154.391	154.391	154.391
Non-HRA	30.281	30.281	30.281	30.281
Less: Existing Profile of Borrowing	0.000	0.000	0.000	0.000
Less: Other Long Term Liabilities	0.000	0.000	0.000	0.000
Cumulative Maximum External Borrowing Requirement	**184.672**	**184.672**	**184.672**	**184.672**

Usable Reserves

Estimates of the Council's level of Usable Reserves for 2012/13 to 2014/15 are as follows:

	31/03/2012 Actual £m	31/03/2013 Estimate £m	31/03/2014 Estimate £m	31/03/2015 Estimate £m
Usable Reserves	47.1	50.0	50.0	50.0

Prudential Indicator Compliance

(a) Authorised Limit and Operational Boundary for External Debt

- The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of their indebted status. This is a statutory limit which should not be breached.
- The Council's Affordable Borrowing Limit was set at £200m for 2012/13.
- The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit.
- The Operational Boundary for 2012/13 was set at £186m.
- The Director of Finance & ICT confirms that there were no breaches to the Authorised Limit and the Operational Boundary during the year; borrowing at its peak was £185.5m.

(b) Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

- These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates.
- The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of investments.

Interest Rate Exposures	Existing level at 31/03/12 %	2012/13 Approved %	Actual %
Fixed			
Upper Limit for Fixed Interest Rate Exposure on Debt	83	100	83
Upper Limit for Fixed Interest Rate Exposure on Investments	(69)	(100)	(64)
Variable			
Upper Limit for Variable Interest Rate Exposure on Debt	17	25	17
Upper Limit for Variable Interest Rate Exposure on Investments	(31)	(75)	(36)

(c) Maturity Structure of Fixed Rate Borrowing

- This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

Maturity Structure of Fixed Rate Borrowing	Upper Limit %	Lower Limit %	Actual Fixed Rate Borrowing as at 30/09/12	% Fixed Rate Borrowing as at 30/09/12	Compliance with Set Limits?
Under 12 months	100	0	£0m	0	Yes
12 months and within 24 months	100	0	£0m	0	Yes
24 months and within 5 years	100	0	£0m	0	Yes
5 years and within 10 years	100	0	£0m	0	Yes
10 years and above	100	0	£153.656m	100	Yes

(d) Gross and Net Debt

- The purpose of this treasury indicator is to highlight a situation where the Authority is planning to borrow in advance of need.

Upper Limit on Net Debt compared to Gross Debt	2011/12 Actual £m	2012/13 Estimate £m	Compliance with Set Limits?
Outstanding Borrowing (at nominal value)	185.456	185.456	**Yes**
Other Long-term Liabilities (at nominal value)	0	0	-
Gross Debt	185.456	185.456	-
Less: Investments	-47.100	-50.000	-
Net Debt	**138.356**	**135.456**	**Yes**

(e) Net Debt and the Capital Financing Requirement

- This is a key indicator of prudence. In order to ensure that over the medium term net borrowing will only be for a capital purpose, the Authority should ensure that the net external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional increases to the capital financing requirement for the current and next two financial years.
- The Authority had no difficulty meeting this requirement so far in 2012/13, nor are there any difficulties envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the approved budget.

(f) Total principal sums invested for periods longer than 364 days

- This indicator allows the Council to manage the risk inherent in investments longer than 364 days.
- The limit for 2012/13 was set at £30m. £5m of investments were made for a period greater than 364 days during this period.

(g) Credit Risk

- This indicator has been incorporated to review the Council's approach to credit risk.
- The Council confirms it considers security, liquidity and yield, in that order, when making investment decisions.
- Credit ratings remain an important element of assessing credit risk, but they are not the sole feature in the Authority's assessment of counterparty credit risk. The authority considers the following tools to assess credit risk:
  - Published credit ratings of the financial institution and its sovereign;
  - Sovereign support mechanisms;
  - Credit default swaps (where quoted);
  - Share prices (where available);
  - Economic fundamentals, such as a country's net debt as a percentage of its GDP);
  - Corporate developments, news, articles, markets sentiment and momentum.

- The Council can confirm that all investments were made in line with minimum credit rating criteria set in the 2012/13 TMSS:
  - long-term ratings of A- or equivalent;
  - long-term ratings of AA+ or equivalent for non-UK sovereigns.

(h) HRA Limit on Indebtedness

- This purpose of this indicator is for the Council to report on the level of the limit imposed at the time of implementation of self-financing by the Department for Communities and Local Government.

HRA Limit on Indebtedness	31/03/2012 Actual £m	31/03/2013 Estimate £m	31/03/2014 Estimate £m	31/03/2015 Estimate £m
HRA CFR	154.391	154.391	154.391	154.391
HRA Debt Cap (as prescribed by CLG)	185.456	185.456	185.456	185.456
Difference	31.065	31.065	31.065	31.065

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Appendix 2

Money Market Data and PWLB Rates

The average, low and high rates correspond to the rates during the financial year and rather than those in the tables below

Table 1: Bank Rate, Money Market Rates

Date		Bank Rate		O/N LIBID	7-day LIBID	1-month LIBID	3-month LIBID	6-month LIBID	12-month LIBID	2-yr SWAP Bid	3-yr SWAP Bid	5-yr SWAP Bid
01/04/2012		0.50		0.55	0.55	0.61	1.00	1.33	1.84	1.22	1.30	1.59
30/04/2012		0.50		0.50	0.65	0.60	0.99	1.32	1.84	1.35	1.43	1.68
31/05/2012		0.50		0.48	0.65	0.57	0.97	1.30	1.82	1.20	1.20	1.34
30/06/2012		0.50		0.50	0.50	0.55	0.83	1.13	1.65	0.96	0.99	1.25
31/07/2012		0.50		0.50	0.65	0.45	0.63	0.92	1.43	0.76	0.77	1.02
31/08/2012		0.50		0.50	0.52	0.40	0.57	0.81	1.23	0.75	0.78	1.03
30/09/2012		0.50		0.25	0.52	0.40	0.47	0.66	0.95	0.70	0.76	1.00
Average		**0.50**		0.46	0.54	0.51	0.79	1.08	1.57	1.01	1.05	1.28
Maximum		**0.50**		0.55	0.65	0.61	1.00	1.33	1.84	1.38	1.45	1.72
Minimum		**0.50**		0.25	0.30	0.40	0.47	0.66	0.95	0.70	0.76	1.00
Spread		**0.00**		0.30	0.35	0.21	0.53	0.67	0.89	0.68	0.69	0.72

Table 2: PWLB Borrowing Rates - Fixed Rate, Maturity Loans

Change Date	Notice No	1 year	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
02/04/2012	130/12	1.29	2.07	3.25	4.22	4.43	4.46	4.41
30/04/2012	166/12	1.31	2.09	3.15	4.13	4.38	4.42	4.39
31/05/2012	210/12	1.19	1.76	2.74	3.79	4.13	4.19	4.16
29/06/2012	248/12	1.20	1.84	2.83	3.79	4.11	4.19	4.16
31/07/2012	292/12	1.01	1.57	2.58	3.60	3.97	4.07	4.05
31/08/2012	336/12	1.07	1.62	2.61	3.62	4.05	4.14	4.11
28//09/2012	376/12	1.15	1.67	2.64	3.71	4.12	4.20	4.14
	Low	1.17	1.52	2.52	3.16	3.57	3.81	3.94
	Average	1.41	1.80	2.81	3.43	3.81	4.03	4.15
	High	1.69	2.15	3.28	3.92	4.23	4.39	4.45

Table 3: PWLB Borrowing Rates - Fixed Rate, Equal Instalment of Principal (EIP) Loans

Change Date	Notice No	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
02/04/2012	130/12	1.56	2.14	3.29	3.91	4.23	4.38
30/04/2012	166/12	1.60	2.15	3.19	3.81	4.14	4.31
31/05/2012	210/12	1.37	1.81	2.78	3.41	3.81	4.03
29/06/2012	248/12	1.41	1.89	2.87	3.45	3.80	4.01
31/07/2012	292/12	1.17	1.63	2.62	3.32	3.61	3.85
31/08/2012	336/12	1.22	1.67	2.65	3.25	3.64	3.90
28//09/2012	376/12	1.29	1.72	2.68	3.31	3.73	3.99
	Low	1.14	1.57	2.56	3.18	3.58	3.81
	Average	1.37	1.85	2.85	3.45	3.82	4.04
	High	1.64	2.21	3.32	3.94	4.24	4.39

Table 4: PWLB Variable Rates

	1-M Rate	3-M Rate	6-M Rate	1-M Rate	3-M Rate	6-M Rate
	Pre-CSR	Pre-CSR	Pre-CSR	Post-CSR	Post-CSR	Post-CSR
02/04/2012	0.59	0.60	0.62	1.49	1.50	1.52
30/04/2012	0.58	0.60	0.62	1.48	1.50	1.52
31/05/2012	0.58	0.58	0.58	1.48	1.48	1.48
29/06/2012	0.58	0.57	0.56	1.48	1.47	1.46
31/07/2012	0.56	0.54	0.49	1.46	1.44	1.39
31/08/2012	0.55	0.54	0.52	1.45	1.44	1.42
28//09/2012	0.57	0.56	0.54	1.47	1.46	1.44
Low	0.55	0.53	0.48	1.45	1.43	1.38
Average	0.578	0.5743	0.5668	1.478	1.4743	1.4668
High	0.60	0.60	0.62	1.50	1.50	1.52