DEVON & SOMERSET
FIRE & RESCUE AUTHORITY

REPORT REFERENCE NO.	**RC/11/4**
MEETING	**RESOURCES COMMITTEE**
DATE OF MEETING	**28 JANUARY 2011**
SUBJECT OF REPORT	**TREASURY MANAGEMENT PERFORMANCE 2010/2011 (TO DECEMBER 2011)**
LEAD OFFICER	**TREASURER**
RECOMMENDATIONS	That the performance in relation to the treasury management activities of the Authority for 2010/2011 (to December) be noted.
EXECUTIVE SUMMARY	The Chartered Institute of Public Finance and Accountancy (CIPFA) issued the revised Code of Practice for Treasury Management in November 2009, following consultation with Local Authorities during the summer. The revised Code suggests that Members should be informed of Treasury Management activities at least twice a year, but preferably quarterly. This report therefore ensures this Authority is embracing Best Practice in accordance with CIPFA's revised Code of Practice.
RESOURCE IMPLICATIONS	As indicated within the report.
EQUALITY IMPACT ASSESSMENT	An initial assessment has not identified any equality issues emanating from this report.
APPENDICES	Appendix A – Investments held as at 30 December 2010.
LIST OF BACKGROUND PAPERS	Treasury Management Strategy (including Prudential and Treasury Indicators) Report DSFRA/10/3Policy – as approved at the meeting of the DSFRA meeting held on the 19 February 2010.

1. INTRODUCTION

1.1 The Treasury Management Strategy for Devon and Somerset FRA had been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2001. The adoption of the Code was originally made at the meeting of the DSFRA held on the 16th March 2007. A revised Code of Practice has recently been issued which was adopted by the authority at the budget meeting held on 19 February 2010. The Authority fully complies with the primary requirements of the Code, which includes:

- The creation and maintenance of a Treasury Management Policy Statement, which sets out the policies and objectives of the Authority's treasury management activities.
- The creation and maintenance of Treasury Management Practices, which set out the manner in which the Authority will seek to achieve those policies and objectives.
- The Receipt by the full Authority of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.
- The 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.

1.2 Treasury management in this context is defined as:

"The management of the local authority'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. "

1.3 The preparation of this report demonstrates that the Authority is implementing best practice in accordance with the code.

2. ECONOMIC BACKGROUND

2.1 The quarter ended 31st December 2010 saw the following:

- Activity indicators strengthening again, suggesting that the recovery still has a reasonable amount of momentum;
- Spending on the high street continuing to recover;
- Conditions in the labour market deteriorating further;
- House prices continuing to fall with some regional exceptions;
- The public finances deteriorating, tentatively questioning whether the government can meet its fiscal forecasts;
- The UK's trade deficit widens further, pouring cold water on hopes of an export-led recovery;
- CPI inflation rise and pipeline pressures continuing to build

- The Monetary Policy Committee (MPC) shying away from doing more quantitative easing (QE);
- UK equities surging and gilt yields rising;
- Economic growth picking up strongly in the US and maintaining pace in the euro-zone.

2.2 Activity indicators suggested that the recovery still has a reasonable amount of momentum. The CIPS/Markit surveys improved in the third quarter and are now consistent again with modest growth, having briefly pointed to a double-dip in prior months. The surveys suggested that the recovery weakened in the construction sector, but strengthened in the larger manufacturing sector. GDP (Gross Domestic Product) expanded by 0.7%q/q in the third quarter of 2010.

2.3 There were signs that consumer spending improved during the quarter. Retail sales volumes rose by a solid 0.7% and 0.3% in October and November respectively. Survey evidence has suggested that December's heavy snowfall has not had too much of a negative effect on retail spending over the festive period as a whole, with consumers making up for weaker spending in early December during the post-Christmas "sales" period.

2.4 The resilience of consumer spending during the quarter was in sharp contrast to the renewed deterioration of conditions in the labour market. Employment on the Labour Force Survey (LFS) measure fell by 33,000 in the three months to October, which was far less than the large rises seen a few months ago. As a result, ILO unemployment rose by 35,000 over the same period.

2.5 House prices have also continued to fall during the quarter. The Nationwide measure fell by 0.7% m/m in October and 0.3%m/m in November, before rising by 0.4%m/m in December. The Halifax house price measure rose by 1.9% m/m in October, this only offset around half of the fall in September. The measure subsequently posted a small 0.1% m/m drop in November but a fall of 1.3% in December.

2.6 Public finances appear to have deteriorated during the quarter. Borrowing on the PSNB (Public Sector Net Borrowing) measure was in line with 2009/10's figure in October but was £6bn higher than a year before in November. The figures therefore cast doubt on whether the Government will be able to meet its borrowing forecast of £149bn this year, some £7bn lower than last year's total. Elsewhere, there are still few signs that the external sector has begun to support the overall recovery. The trade in goods deficit widened again from £8.4bn to £8.5bn in October, while the overall deficit also grew from £3.8bn to £3.9bn. While export goods volumes rose by 2.2% m/m in October, import goods volumes rose by a larger 2.6%.

2.7 CPI (consumer price inflation) inflation edged up from 3.1% to 3.2% in October and then to 3.3% in November. Part of the rise may have reflected retailers pushing up their prices ahead of the VAT rise in January 2011. The rise also seems to have reflected the surge in commodity prices during the quarter and earlier in the year. If these commodities hold onto their recent price gains, then their inflationary effects will build over the next few months.

2.8 Encouraging activity data and strong inflation data prevented the Monetary Policy Committee (MPC) from following the Fed in sanctioning more quantitative easing (QE) at its November meeting. The majority of members on the MPC have continued to vote for official interest rates to remain on hold at 0.5%; the minutes to their meetings suggested that most members thought that the risks that CPI inflation would overshoot the 2% target in two years time had grown. Some members also expressed concern about the recent rise in households' inflation expectations.

2.9 Sector provides the following interest rate forecast:

Sector's Interest Rate View	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13
Sector's Bank Rate View	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.25%	2.75%	3.00%	3.25%
5yr PWLB Rate	3.30%	3.30%	3.40%	3.50%	3.60%	3.80%	3.90%	4.10%	4.30%	4.60%	4.80%	4.90%
10yr PWLB View	4.40%	4.40%	4.40%	4.50%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%	5.40%
25yr PWLB View	5.20%	5.20%	5.20%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%	5.60%	5.70%
50yr PWLB Rate	5.20%	5.20%	5.20%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%	5.60%	5.70%

- Sector has undertaken a review of its interest rate forecasts to update them for recent events and in particular, the sell off in the bond markets that we have seen in November and December.
- Sector has not changed it's view on Bank Rate, or the outlook for the UK economy, so this revised forecast is mainly focused on revisions to the 5 and 10 year forecasts to reflect this sell off.
- In recent months sentiment has focused on the potential for faster US economic recovery, which brings with it an increase in the potential for inflationary pressures and concerns as to whether the Fed will act quickly and resolutely enough to stop those pressures from building. There are also concerns at the extent to which US government debt is going to increase which means that extra sales will have to be made at a lower price to attract buyers i.e. that yields will rise. QE2 purchases of debt by the Fed would normally be expected to depress yields by increasing the price of bonds. However, what we have seen since the beginning of November is exactly the opposite – a steady rise in Treasury yields and right across the board from 5 to 30 years.
- In the UK, sentiment has shifted in terms of concerns around the build up of inflationary pressures and there is an increase in concern as to the credibility of the MPC when inflation has been so much above its 2% target for such a long time. The MPC will be particularly concerned that the public's inflation expectations could become unhinged and while we have not changed our Bank Rate forecast in this revision, there is a risk that the MPC may feel they will need to take action earlier than Q4, i.e. Q3, in order to do a damage limitation exercise to its credibility.
- In line with widespread comment that the Bank of England's previous forecasts for growth were on the optimistic side, the November Inflation Report did downgrade the forecast for 2011 to about 2.3%. However, the Bank then slightly upgraded its forecast for growth in 2012 to around 3%, helped by the continuation of strong monetary policy stimulus through an exceptionally low Bank Rate and the current level of QE.

- However, inherent in this optimistic forward looking view are major assumptions around a continuation of healthy world growth rates. This dependency is due to a combination of negative factors that are likely to dampen the UK growth rate: -
    - the public sector will be a negative contributor to the UK growth rate;
    - personal expenditure growth rates are likely to be weak;
    - many corporates and people will be focused on cutting back over-borrowing in the years of easy and cheap credit;
    - corporate and personal borrowing by borrowers seeking credit will be held back by banks caution in expanding credit when banks are faced with having to refinance huge sums of wholesale funding maturing over the next few years plus repaying all loans made by the Bank of England under the SLS scheme, which closes in early 2012.
- Sector still maintains that the general trend beyond the next twelve months of rising gilt yields and PWLB rates is expected to remain unchanged as market fundamentals must eventually re-establish the current disconnect between the sheer volume of UK gilt issuance and the price of issue of new debt. Negative (or positive) developments in the EU sovereign debt crisis could significantly impact current safe haven flows of investor money into UK gilts and produce shorter term movements away from our central forecasts.
- As there are significant potential downside risks to these forecasts and to the pace of both UK and world recovery, we would suggest that authorities err on the side of caution when setting their investment budgets.
- Any forecasts beyond a one year time horizon will be increasingly subject to being significantly amended as and when world events and financial markets change.

3. TREASURY MANAGEMENT STRATEGY STATEMENT

Annual Investment Strategy

3.1 The Authority's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Authority's investment priorities as follows:

- Security of Capital
- Liquidity

3.2 The Authority will also aim to achieve the optimum return on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term, and only invest with highly credit rated financial institutions using the Sector suggested creditworthiness matrices, including Credit Default Swap (CDS) overlay information provided by Sector.

3.3 A full list of investments held as at 31 December 2010 are shown in Appendix A.

3.4 Investment rates available in the market have continued at historically low levels.

3.5 The average level of funds available for investment purposes during the quarter was £16.787m. 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 and progress on the Capital Programme.

Benchmark	Benchmark Return	Authority Performance	Investment Interest Earned
7 day LIBID	0.43%	0.77%	£32,064

3.6 As illustrated, the authority outperformed the benchmark by 34 bp**.** The Authority's budgeted investment return for 2010/11 is £0.070m, and performance so far this year indicates that this figure will be exceeded.

Borrowing Strategy

Prudential Indicators:

3.7 It is a statutory duty for the Authority to determine and keep under review the "Affordable Borrowing Limits". The Authority's' approved Prudential Indicators (affordability limits) are outlined in the approved TMSS.

3.8 A full list of the approved limits (as amended) are included in the Financial Performance Report 2010/2011, considered elsewhere on the agenda, which confirms that no breaches of the Prudential Indicators were made in the period to December 2010.

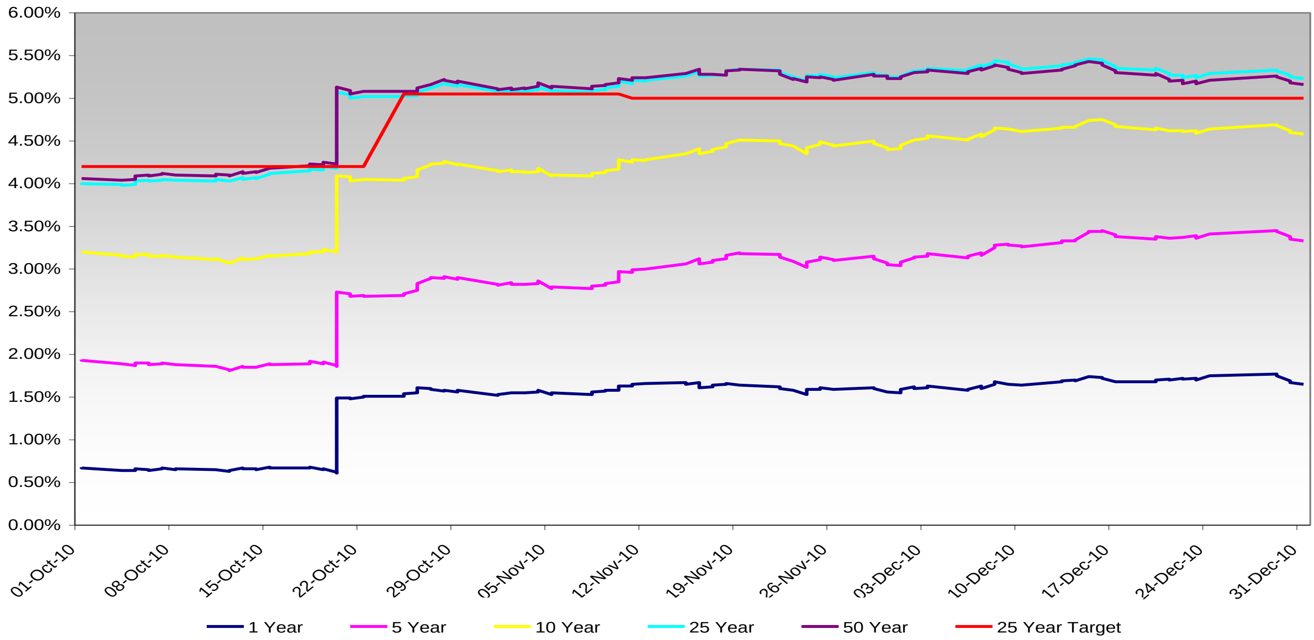
3.9 Sector's 25 year target rate for new long term borrowing for the quarter started at 4.20% and ended at 5.00%. No new borrowing was taken during the third quarter of the year.

3.10 No debt rescheduling has been undertaken during the third quarter of the year.

3.11 As shown below, most interest rates have generally been on an increasing trend during the quarter across all bands. The graph below shows rates all spiking up on the 20th October due to the PWLB policy change following the Spending Review, where the PWLB have increased the average rate of interest rate on all new loans to an average of 1.00% above Government's cost of borrowing. The low points during the quarter were seen in the early part of October before the PWLB policy change. The high points were seen in late December.

PWLB rates quarter ended 31.12.2010

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.61%	1.81%	3.07%	3.98%	4.04%
Date	20/10/10	12/10/10	12/10/10	04/10/10	04/10/10
High	1.77%	3.45%	4.75%	5.46%	5.43%
Date	29/12/10	16/12/10	16/12/10	15/12/10	15/12/10
Average	1.41%	2.82%	4.13%	4.98%	4.99%



4. SUMMARY

4.1 In compliance with the requirements of the CIPFA Code of Practice of Treasury Management, this report provides members with a summary report of the treasury management activities for the second quarter of 2010/2011. As is indicated in this report, none of the Prudential Indicators have been breached, and a prudent approach has been taken in relation to investment decisions taken so far, with priority being given to liquidity and security over yield. Whilst investment returns have reduced from the previous year, as a consequence of the fall in interest rates, the authority is still achieving returns above the LIBID 7 day rate, which is the benchmark return for this type of short term investments.

KEVIN WOODWARD
Treasurer

Investments as at 31st December 2010

% of total investments	Counterparty	Maximum to be invested (£m)	Total amount invested (£)	Call or Term	Date if Term	Interest Rate
26.91%	Santander UK & Cater Allen	5.0	1.000	T	17/01/2011	1.32%
			1.500	T	01/02/2011	1.33%
			1.182	C		0.80%
7.31%	Bank of Scotland	5.0	1.000	T	15/07/2011	2.00%
10.96%	Barclays	10.0	1.500	T	17/01/2011	0.98%
10.96%	Coventry B/S	1.5	1.500	T	28/02/2011	0.70%
10.96%	Kent Reliance B/S	1.5	1.500	T	10/02/2011	0.75%
10.96%	Newcastle B/S	1.5	1.500	T	31/03/2011	0.90%
10.96%	Norwich & Peterborough B/S	1.5	1.500	T	14/01/2011	0.90%
10.96%	West Bromwich B/S	1.5	1.500	T	03/01/2011	0.78%
			13.682			