DEVON & SOMERSET
FIRE & RESCUE AUTHORITY

REPORT REFERENCE NO.	**RC/12/7**
MEETING	**RESOURCES COMMITTEE**
DATE OF MEETING	**20 JULY 2012**
SUBJECT OF REPORT	**TREASURY MANAGEMENT PERFORMANCE 2012/13 – QUARTER 1**
LEAD OFFICER	**TREASURER**
RECOMMENDATIONS	***(a) That the Authority be recommended to approve an amendment to its Treasury Management Policy to include the use of Certificate Deposits (CDs) and UK Government Gilts as Approved Investment Instruments, as outlined in paragraph 3 of this report; and*** ***(b) That, subject to (a) above, the performance in relation to the treasury management activities of the Authority for 2012-2013 (to June) as set out in this report 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. 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 June 2012.
LIST OF BACKGROUND PAPERS	Treasury Management Strategy (including Prudential and Treasury Indicators) Report DSFRA/12/3 – as approved at the meeting of the DSFRA meeting held on the 17 February 2012.

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) 2011 Treasury Management in Public Services Code of Practice (the Code) and the CIPFA Prudential Code. The most recent revision of the Code was adopted at the meeting of the DSFRA on the 17th February 2012. 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

Global economy

2.1 The economic outlook has generally weakened;

- Demand on the high street was volatile, as a result of temporary distortions;
- Employment rose and unemployment fell, but earnings growth remained weak;
- Inflation continued to fall;
- The Bank and the HM Treasury announced measures to help the UK banking sector;
- The MPC indicated another tranche of quantitative easing (QE);
- Gilt yields fell on the back of deteriorating economic data and safe-haven flows from the euro-zone;
- Sentiment towards the Eurozone alternately rose on the announcement of measures to address the crisis, but then fell back as measures disappointed.

2.2 The weakening business surveys since the start of Q1 suggests that the economy will be lucky to escape a third successive quarterly contraction (output shrunk by 0.4% in Q3 FY 11/12 and 0.3% in Q4 FY 11/12). Admittedly, the weighted output balance of the CIPS/Markit surveys in April and May was at a level consistent with quarterly expansion, albeit of only 0.2%. However it is not clear that the CIPS surveys have improved on the detrimental impact on output of the extra bank holiday for the Queen's Jubilee at the start of June.

2.3 The CIPS surveys does exclude the retail sector and high street spending, which performed strongly in May on the official measure, following a weak, poor-weather driven performance in April. Evidence for early June from the CBI's Distributive Trades Survey suggests that the Jubilee holiday may have boosted spending. Nevertheless, consumer confidence showed no signs of breaking out of its long-depressed state.

2.4 The labour market continued to perform relatively better. The Labour Force Survey measure of employment rose by 166,000 in the three months to April, whilst unemployment fell by 51,000 in the period February-April. The scale of the decline was more modest than the rise in employment, with the number of people looking for work outpacing jobs growth. The narrower claimant count measure of unemployment did rise by 8,000 in May, the largest increase since September 2011.

2.5 Banks' funding costs eased over the quarter, reflecting actions by the Bank of England and Treasury to boost liquidity. Two initiatives were announced in June - a 'funding for lending' scheme which would allow banks to temporarily "swap" their assets with the Bank of England in return for money they could lend to customers, and an emergency scheme that offered six-month low-cost liquidity to banks in tranches of £5bn a month. Costs, however, remained elevated and banks began to pass higher costs onto borrowers. Borrowing rates on most types of new mortgages picked up in April and May.

2.6 Trade data showed a sharp deterioration in April. The UK posted its second largest monthly trade deficit on record, driven in large part by a widening of the gap between exports and imports with countries outside the EU. Exports to the Eurozone also fell, with weakness extending from the peripheral countries to what had previously been perceived as strong economies like Germany.

2.7 Inflation fell further in the second quarter. CPI inflation fell from 3.5% in March to 2.8% in May, driven by declines in fuel and food prices. Core inflation fell from 2.5% to 2.2%. Consistent with the decline in inflation, medium-term indicators of inflation suggested that underlying price pressures remained weak. Household respondents to June's YouGov/Citigroup inflation expectations survey predicted the annual rate of inflation in a year's time would be 2.4%, the lowest year-ahead expectation since April 2010.

2.8 The MPC voted narrowly against pursuing more quantitative easing (QE) at its June meeting. The consensus view was that the MPC would decide on further purchases in July. The Governor of the Bank of England said in June that, as a consequence of the Eurozone crisis, he was already more pessimistic than suggested by the forecasts published in the Bank's Inflation Report only six weeks earlier.

2.9 Market sentiment towards the Eurozone remained volatile as successive 'rescue packages' first raised, and then disappointed, expectations. The economic news suggested that the Eurozone economy contracted sharply in the second quarter, while Eurozone unemployment rose to 11.1% in May, the highest rate since the creation of the euro in 1999.

2.10 Sector's interest rate forecast

	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%	0.75%	1.00%	1.25%	1.25%	1.50%
5yr PWLB rate	2.10%	2.20%	2.20%	2.30%	2.40%	2.50%	2.60%	2.80%	3.00%	3.20%	3.40%
10yr PWLB rate	3.00%	3.20%	3.30%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%
25yr PWLB rate	4.20%	4.30%	4.30%	4.40%	4.50%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%
50yr PWLB rate	4.30%	4.40%	4.40%	4.50%	4.60%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%

2.11 The Sector central forecast is for the first increase in Bank Rate to be in the first quarter of 2014 but there is downside risk to this projection. With growth predictions for the U.K continuing to be reduced on an almost monthly basis by both the Office for Budget Responsibility and economic commentators generally, and financial markets unconvinced that politicians have resolved the Euro-one sovereign debt crisis in the medium-term, we are likely to continue to experience high levels of volatility.

Summary Outlook

2.12 The outlook for the global economy remains clouded with uncertainty. The UK economy has struggled to generate a sustained recovery so this offers little hope for a strong recovery in 2012, and possibly even into 2013. Consumer and business confidence levels are generally low and it is not easy to see potential for a significant increase in the growth rate in the short term.

UK

- Austerity measures, aimed at getting the public sector deficit into order over the next four years, may start losing support unless the economy starts to revive soon;
- Some £80bn is going to be made available by the Government to the banks to parcel through to business but it is not clear that all of this will be taken up;
- The housing market, a gauge of consumer confidence, remains subdued although house prices are being supported by the weak £ relative to some of the other main currencies;
- Economic forecasts for 2012 and beyond have been revised lower on a near quarterly basis;
- The Bank of England embarked on a £50bn third round of Quantitative Easing (QE) at the start of July to stimulate economic activity. It is unlikely to be the last tranche of QE and the total now stands at £375bn;
- Inflation has eased from its peak of 5.2% (CPI) in September 2011, now standing at 2.8% with the outlook brighter given commodity and oil prices seem to be in decline, at least for the moment
- "Safe haven" status has underpinned demand for gilts and kept yields at historic lows. Unlikely to see material change in near term.

3. TREASURY MANAGEMENT STRATEGY STATEMENT

Annual Investment Strategy

3.1 The Authority's Annual Investment Strategy, which is incorporated in the Treasury Management Strategy Statement (TMSS) was approved by the Authority on the 17th February 2012. It 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 a significant proportion of investments short term to cover short term cash flow needs but also to seek out value available in significantly higher rates in periods up to 12 months 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 30 June 2012 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 £17.980m. 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 for quarter
3 Month LIBID	0.87%	0.90%	£(21,537)

3.6 As illustrated, the authority outperformed the 3 month LIBID benchmark by 0.03 bp. The Authority's budgeted investment return for 2012-2013 is £0.100m, and performance so far this year indicates that this figure will be met by March 2013.

3.7 As was reported in the last report in May 2012, given the level of cash balances held and the restricted number of counterparties left on our approved list, following the removal of most building societies, we have been exploring alternatives to using bank call accounts which typically pay a rate less than base. In the last quarter we have already moved some cash from call accounts to AAA money market funds, which typically pay a rate 0.25 to 0.30 base points above base. This will release longer term investment possibilities with existing counterparties. The use of money market funds is permitted within the Treasury Management Policy (Schedule 4 – Approved instruments, Methods and Techniques).

3.8 In recent weeks we have also been exploring other alternatives with Sector and from those discussions the advice received is that the use Treasury Bills, Certificate of Deposits and UK government Gilts offer alternative investment with relatively low risk. Brief details of how each of these options operate are provided below.

Treasury Bills

3.9 Treasury Bills (T-bills) are the most marketable money market securities. These financial instruments are issued on a discount basis by HM Treasury, by tender, usually to central, clearing and investment banks. T-bills are short-term securities, issued with one-month, three-month and six months maturities from their issue date, at which point the holder receives a full par value from the government. T-bills are typically purchased for a price that is less than their par (face) value. The interest earned is effectively the difference between the purchase price of the security and what you get at maturity.

3.10 T Bills have low credit risk as the borrower is the UK Government, currently AAA rated. T Bills are liquid instruments meaning investors can enter and exit the market quickly and easily. The associated yield, however, is low with T Bills, compared to other AAA rated instruments e.g.: MMF. T Bills offer access to primary market and the secondary market. T Bills can generate a Capital loss should you choose to trade in the secondary market if the price you receive is lower than the price you purchased at.

Certificate of Deposits (CDs)

3.11 A CD is a bearer instrument which certifies that a sum of money has been deposited with the bank issuing the certificate, at a fixed yield, and that on the stated maturity date the deposit will be repaid with interest. The CD can be sold in the secondary market, if immediate access to cash is required by the holder of the CD. A CD gives flexibility i.e. you can trade out of it so long as there is a secondary market for that CD. Because of this increased liquidity, the rates on CD's are usually lower than that of fixed term deposits. The same credit quality criteria apply as to a fixed deposit.

3.12 CDs have better liquidity than fixed term deposits as they can be sold before maturity; however a liquid market must exist for the CD in the future for the sale to take place. Market risk for fixed deposits is low as once a rate is fixed, it remains the same for the entire duration of the investment. CD prices, however, are not fixed and fluctuate from day to day; which means that a CD bought today could be worth less tomorrow. This is not an issue if the CD is held to maturity and the Counterparty is in a position to make full repayment on this date.

3.13 The use of CD's would allow the Authority to access counterparties with good credit quality, which are not currently active in the local authority fixed deposit market.

Gilts

3.14 Gilts are bonds issued by the UK government to finance its Public Sector Borrowing Requirement. A conventional Gilt pays the holder a fixed cash payment (or coupon) every six months until maturity, at which point the holder receives their final coupon payment and the return of the principal. Gilts are AAA rated instruments, so are considered very safe investments as the debt is guaranteed by the UK government. Gilts are AAA rated instruments and with counterparty risk being a key investment concern in the current markets, Gilts offer safe haven status in this area. Gilts also offer a semi annual income stream from the coupon payments, with the principal being returned at maturity. If a Gilt were bought but then later sold at a lower level, a capital loss would be incurred; however if a Gilt were held to maturity this would not be an issue

3.15 Treasury bills, CD's and Gilts are considered to be appropriate alternative investment options for the Authority to use to assist in the delivery of its investment strategy of placing security and liquidity before yield. The use of Treasury Bills is already permitted under the Treasury Management Policy; however CD's and Gilts are not currently included as approved investment instruments.

3.16 It is proposed therefore that it be recommended to the next meeting of the Fire and Rescue Authority that CD's and Gilts be added to the list of approved investment instruments that the Authority will use.

Borrowing Strategy

Prudential Indicators:

3.17 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.

3.18 A full list of the approved limits (as amended) are included in the Financial Performance Report 2012-2013, considered elsewhere on the agenda, which confirms that no breaches of the Prudential Indicators were made in the period to June 2012 and that there are no concerns that they will be breached during the financial year.

New Borrowing

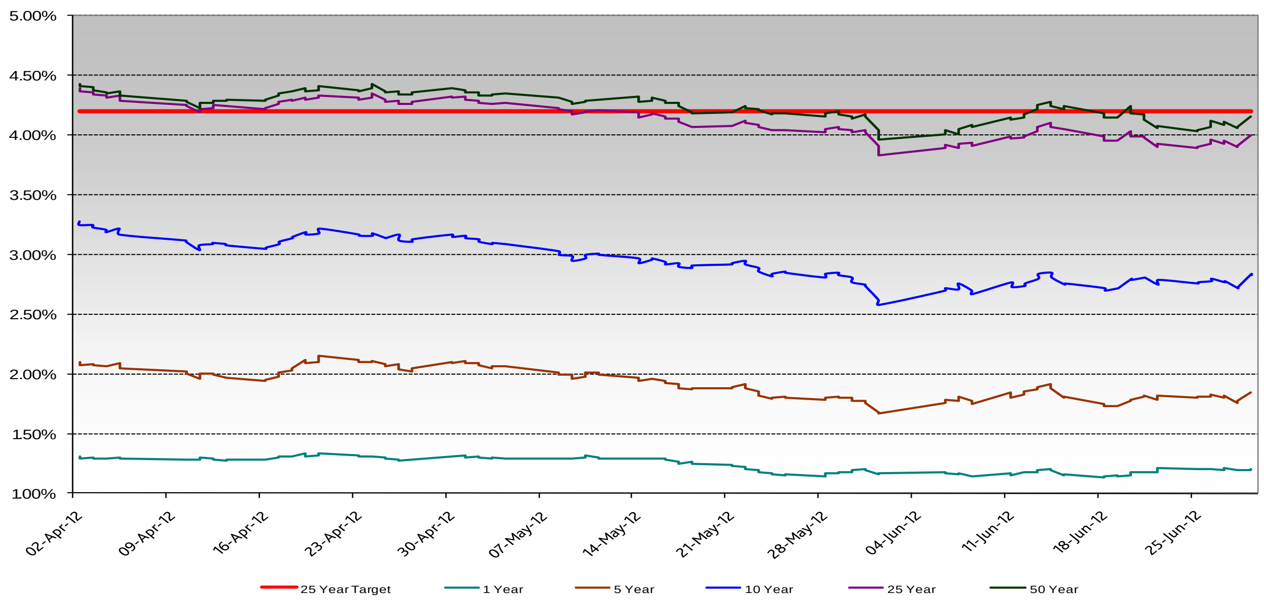
3.19 Sector's 25 year PWLB target rate for new long term borrowing for the quarter remained at 4.20%. Whilst there was no underlying need for the Authority to borrow during the period for capital purposes (the Capital Financing Requirement - CFR), new external borrowing of £2m was undertaken in June 2012 from the PWLB / Market at a rate of 3.28%. This borrowing was taken out on the 12 June when 15 year rates were at historically low levels and therefore represents excellent value for money over the long term.

3.20 This new borrowing increased total external borrowing as at 30 June 2012 to £29.066m, compared to a figure as at 31 March 2012 of £27.066m. No debt rescheduling was undertaken during this quarter of the year

3.21 As shown below, interest rates across the interest rate yield curve generally fell during the quarter. The low points during the quarter were generally seen during June.

PWLB rates quarter ended 30.6.2012

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.13%	1.67%	2.58%	3.83%	3.96%
Date	18/06/12	01/06/12	01/06/12	01/06/12	01/06/12
High	1.33%	2.15%	3.28%	4.39%	4.43%
Date	19/04/12	20/04/12	02/04/12	02/04/12	02/04/12
Average	1.24%	1.92%	2.95%	4.13%	4.24%



3.22 It is anticipated that internal borrowing and available grants will reduce the call on any further borrowing and therefore it is not intended that any further borrowing will be undertaken this financial year.

4. SUMMARY

4.1 In compliance with the requirements of the CIPFA Code of Practice of Treasury Management, this report provides members with a first quarter report of the treasury management activities for 2012-2013. 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 are still low as a consequence of the fall in interest rates, the Authority is still anticipating that the investment returns will be greater than originally budgeted.

KEVIN WOODWARD
Treasurer

Investments as at 30th June 2012

% of total investments	Counterparty	Maximum to be invested (£m)	Total amount invested (£m)	Call or Term	Date if Term	Interest Rate
8.41%	Cater Allen	5.0	1.500	T	02/07/2012	1.59%
23.97%	Bank of Scotland	5.0	1.500	T	16/07/2012	2.05%
			2.000	T	01/02/2013	2.00%
			0.777	C		0.75%
30.87%	Barclays	10.0	2.000	T	30/11/2012	1.24%
			1.750	T	07/12/2012	1.19%
			1.750	T	07/12/2012	0.93%
			0.008	C		0.10%
24.19%	Ignis Money Market Fund	5.0	4.316	C		Variable
6.95%	Black Rock	5.0	1.239	C		Variable
5.61%	Nationwide B/S	1.5	1.000	T	29/08/2012	0.93%
			17.840			