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Report of the Director of Finance to the meeting of Governance and Audit Committee to be held on 1 November 2013.

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Subject:

Treasury Management Mid Year Review up to 30th September 2013

Summary statement:

This report shows the Council's Treasury Mid Year Review up to 30th September 2013.

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Portfolio:

Corporate

Overview & Scrutiny Area:

[Insert where appropriate]

Treasury Management   Mid Year Review

Period Ending 30th September 2013

1. Summary

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) was adopted by this Council

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. Receipt by the full council 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 covering activities during the previous year.
4. Delegation by the Council 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 Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Governance and Audit Committee:

This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the 2013/14;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure (prudential indicators);
- A review of the Council's investment portfolio for 2013/14;
- A review of the Council's borrowing strategy for 2013/14;
- A review of any debt rescheduling undertaken during 2013/14;
- A review of compliance with Treasury and Prudential Limits for 2013/14.

2. Background

The Council 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 Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council 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 Council risk or cost objectives.

As a consequence 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."

3. Economic update

3.1.1 Economic performance to date

During 2013/14 economic indicators suggested that the economy is recovering, albeit from a low level. After avoiding recession in the first quarter of 2013, with a 0.3% quarterly expansion the economy grew 0.7% in Q2. There have been signs of renewed vigour in household spending in the summer, with a further pick-up in retail sales, mortgages, house prices and new car registrations.

The strengthening in economic growth appears to have supported the labour market, with employment rising at a modest pace and strong enough to reduce the level of unemployment further. Pay growth also rebounded strongly in April, though this was mostly driven by high earners delaying bonuses until after April's cut in the top rate of income tax. Excluding bonuses, earnings rose by just 1.3% y/y, well below the rate of inflation at 2.7% in May, causing continuing pressure on household's disposable income.

The Bank of England extended its Funding for Lending Scheme (FLS) into 2015 and sharpened the incentives for banks to extend more business funding, particularly to small and medium size enterprises. To date, the mortgage market still appears to have been the biggest beneficiary from the scheme, with mortgage interest rates falling further to new lows. Together with the Government's Help to Buy scheme, which provides equity loans to credit-constrained borrowers, this is helping to boost demand in the housing market. Mortgage approvals by high street banks have risen as have house prices, although they are still well down from the boom years pre 2008.

Turning to the fiscal situation, the public borrowing figures continued to be distorted by a number of one-off factors. On an underlying basis, borrowing in Q2 looked to be broadly in line with last year's figures, highlighting the Government's

difficulty in reducing borrowing while economic growth was relatively lacklustre. The 2013 Spending Review, covering only 2015/16, made no changes to the headline Government spending plan, and monetary policy was unchanged in advance of the new Bank of England Governor, Mark Carney, arriving. Bank Rate remains at 0.5% and quantitative easing also stayed at £375bn. In August, the Monetary Policy Committee (MPC) provided forward guidance that Bank Rate is unlikely to change until unemployment first falls to 7%, which was not expected until mid 2016. However, 7% is only a point at which the Monetary Policy Committee(MPC) would review Bank Rate, not necessarily take action to change it. The three month to July average rate was 7.7%.

CPI inflation (MPC target of 2.0%), fell marginally from 2.9% to 2.8% in July. The Bank of England expects inflation to fall back to 2.0% in 2015.

Financial markets sold off sharply following a Federal Reserve statement that suggested it may 'taper' its asset purchases earlier than anticipated. The resulting rise in US Treasury yields was replicated in the UK. Equity prices fell too, initially as Fed purchasing of bonds has served to underpin investor moves into equities out of low yielding bonds. However, as the market moves to realign its expectations, bond yields and equities are likely to rise further in expectation of continuing economic recovery. The statement from the Fed. was a response to the improving economic outlook in the US; increases in payroll figures showed further improvement, helping to pull the unemployment rate down from a high of 8.1% to 7.3%, and continuing house price rises helped more households to escape from negative equity.

Tensions in the Eurozone eased over the second quarter, but there remained a number of triggers for a renewed flare-up. Economic survey data improved consistently over the first half of the year, pointing to a return to growth in Q2, so ending six quarters of Eurozone recession.

3.1.2 Outlook for the next six months of 2013/14

Economic forecasting remains difficult with so many external influences weighing on the UK. Volatility in bond yields is likely during 2013/14 as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, and safer bonds. Downside risks to UK government yields and Public Works Loan Board (PWLB) rates include:

- A return to weak economic growth in the US, UK and China causing major disappointment to investor and market expectations
- The potential for a significant increase in negative reactions of populaces in Eurozone countries against austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- The Italian political situation is frail and unstable.
- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) could also generate safe haven flows into UK government debt.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.

- Weak growth or recession in the UK's main trading partners - the European Union (EU) and US, depressing economic recovery in the UK.
- Geopolitical risks e.g. Syria, Iran, North Korea, which could trigger safe haven flows back into bonds

Upside risks to UK government yields and PWLB rates, especially for longer term PWLB rates include: -

- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to government yields.
- Increased investor confidence that sustainable robust world economic growth is firmly expected, together with a reduction or end of Quantitative Easing (QE) operations in the US, causing a further flow of funds out of bonds into equities.
- A reversal of Sterling's safe-haven status on a sustainable improvement in financial stresses in the Eurozone.
- In the longer term - a reversal of QE in the UK; this could initially be implemented by allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held.
- Further downgrading by credit rating agencies of the creditworthiness and credit rating of UK Government debt, consequent upon repeated failure to achieve fiscal correction targets and sustained recovery of economic growth, causing the ratio of total Government debt to Gross Domestic Product (GDP) to rise to levels that provoke major concern.

The overall balance of risks to economic recovery in the UK is now weighted to the upside after five months of increasingly good news on the economy. However, economic recovery is still fragile and exposed to vulnerabilities in a number of key areas. We believe that the longer run trend is for government yields and PWLB rates to rise, due to the high volume of government issuance in the UK, and of bond issuance in other major western countries. Near-term, the prospect of further QE is evenly balanced as the MPC weighs whether to take action to combat the market's expectations of an early first increase in Bank Rate. If the MPC does takes action to do more QE in order to reverse the rapid increase in market rates, especially in gilt yields and interest rates up to 10 years, such action could cause gilt yields and PWLB rates over the next year or two to significantly undershoot the forecasts in the table below.

3.1.3 Interest rate forecasts

	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%
5yr PWLB rate	2.20%	2.20%	2.20%	2.20%	2.30%	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%
10yr PWLB rate	3.30%	3.30%	3.30%	3.30%	3.40%	3.50%	3.60%	3.80%	3.90%	4.10%	4.20%	4.30%	4.40%	4.50%
25yr PWLB rate	4.20%	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.00%	5.10%	5.10%	5.20%
50yr PWLB rate	4.30%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.10%	5.20%	5.20%	5.30%

Expectations for the first change in Bank Rate in the UK are now dependent on how to forecast when unemployment is likely to fall to 7%. Financial markets have taken a very contrary view to the MPC and have aggressively raised short term interest rates and government debt yields due to their view that the strength of economic recovery is now so rapid that unemployment will fall much faster than the Bank of England forecasts. They therefore expect the first increase in Bank Rate to be in quarter 4 of 2014. There is much latitude to disagree with this view as the economic downturn since 2008 was remarkable for the way in which unemployment did not rise to anywhere near the extent likely, as in previous recessions. This meant that labour was retained, productivity fell and now, as the MPC expects, there is major potential for a near jobless recovery as existing labour levels are worked more intensively and productivity rises back up again. The size of the work force is also expected to increase relatively rapidly. Capita Assets Services take the view that the unemployment rate is not likely to come down as quickly as the financial markets are currently expecting and that the current MPC view is more realistic. The prospects for any increase in Bank Rate before 2016 are therefore seen as being limited. However, some forecasters are forecasting that the Bank of England is too optimistic as to when the 7% level will be reached and so do not expect the first increase in Bank Rate until spring 2017.

3.2 Treasury Management Strategy Statement and Annual Investment Strategy update

The Treasury Management Strategy Statement (TMSS) for 2013/14 was approved by this Council on 21 May 2013.

Prudential Indicator 2013/14	**Original £m**	**Revised Prudential Indicator £m**
Authorised Limit	£760m	£760m
Operational Boundary	£720m	£720m
Capital Financing Requirement	£747m	£747m

3.3 The Council's Capital Position (Prudential Indicators)

3.3.1 This part of the report is structured to update:

- The Council'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.

3.3.2 Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

	2013/14 Original Estimate £m	**Current Position £m**	**2013/14 Revised Estimate £m**
Capital Expenditure	129.3	39.6	111.1

3.4 Changes to the Prudential Indicators for the Capital Financing Requirement, External Debt and the Operational Boundary

3.4.1 The table shows the Capital Financing Requirement (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

We are on target to achieve the original forecast Capital Financing Requirement

Prudential Indicator – External Debt / the Operational Boundary

	2013/14 Original Estimate £m	**2013/14 Revised Estimate £m**
CFR	747	732
Borrowing	438	418
Other long term liabilities*	250	210
Total debt 31 March	**688**	**628**

** On balance sheet PFI schemes and finance leases etc.*

3.4.2 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. Gross 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 2013/14 and next two financial years. This allows some flexibility for limited early borrowing for future years.

The Director of Finance reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is 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.

Authorised limit for external debt	**2013/14 Original Indicator £**	**2013/14 Revised Indicator £**
Borrowing	490	490
Other long term liabilities*	270	270
Total	760	760

** Includes on balance sheet PFI schemes and finance leases etc.*

3.5 Investment Portfolio 2013/14

In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council'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 in line with the 0.5% Bank Rate. Indeed, the introduction of the Funding for Lending scheme has reduced market investment rates even further. 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 Council held £158.8m of investments as at 30 September 2013 (£156.8m at 31 March 2013) and the investment portfolio yield for the first six months of the year is 0.7% against a benchmark of 0.4%.

The Director of Finance confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2013/14.

The Council's budgeted investment return for 2013/14 is £1m, and performance for the year to date is above budget.

3.6 Borrowing

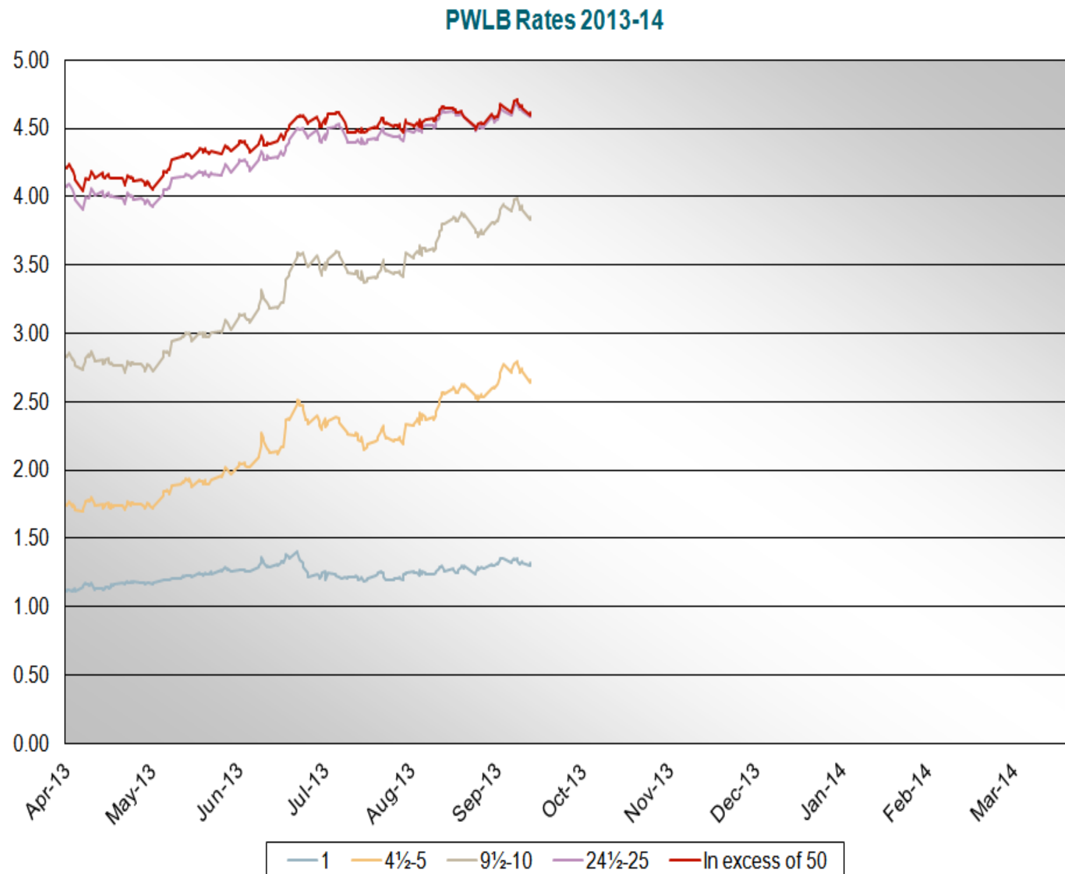
The Council's capital financing requirement (CFR) for 2013/14 is £747m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing).

The balance of external and internal borrowing is generally driven by market conditions. The Council has borrowings of £418m and has utilised £71m of cash flow funds in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate.

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

It is anticipated that further borrowing will not be undertaken during this financial year.

The graph and table below show the movement in PWLB rates for the first six months of the year



3.7 Debt Rescheduling

No debt rescheduling undertaken.

4. Financial and Resources Appraisal

4.1The financial implication are set out in Section 3

5. Risk Management and Governance Issues

5 None

6 Legal implications

6.1 Any relevant legal considerations are set out in the report.

7 Other Implications

7.1 Equal & Diversity – no direct implications
7.2 Sustainability implications – no direct implications
7.3 Greenhouse Gas Emissions Impacts – no direct implications
7.4Community Safety Implications – no direct implications
7.5 Human Rights Act – no direct implications
7.6 Trade Unions – no direct implications
7.7 Ward Implication – none

8 Not for publications documents

8.1 None

9 Recommendations

9.1.Be noted by the Governance and Audit Committee and passed to full council for adoption.

10. Appendices

10.1 None

11. Background Documents

Treasury Management Practices

Treasury Management Schedules