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Report of the Director of Finance to the meeting of Governance and Audit Committee to be held on 24 October 2014.

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Subject:

Treasury Management Mid Year Review up to 30th September 2014.

Summary statement:

This report shows the Council's Treasury Mid Year Review up to 30th September 2014

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Treasury Management Mid Year Review up to 30th September 2014

1. 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 optimising 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.

Accordingly, 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. Introduction

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management was adopted by this Council on 23/3/2010

The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- 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.
- 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.
- 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 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 ;
- 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 2014/15;
- Changes to the Councils Treasury Management Policy
- Borrowing strategy for 2014/15;
- Debt rescheduling undertaken during 2014/15;

3. Economic update

3.1.1 Economic performance to date

After strong UK GDP growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, 0.8% in Q1 2014,and 0.9% in Q2. It appears very likely that strong growth will continue in 2014 as forward surveys are very encouraging. There are also positive indications that recovery is starting to broaden away from reliance on consumer spending and the housing market into construction, manufacturing, business investment and exporting. This strong growth has resulted in unemployment falling much faster through the threshold of 7%, set by the Monetary Policy Committee (MPC) last August, before it said it would consider any increases in Bank Rate. The MPC has, therefore, now broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up. Accordingly, markets are expecting a first increase around the end of 2014.

Also encouraging has been the sharp fall in inflation (CPI), reaching 1.5% in May, the lowest rate since 2009. Forward indications are that inflation is likely to fall further in 2014 to possibly 1%. The return to strong growth has also helped lower forecasts for the increase in Government debt by £73bn over the next five years, as announced in the 2013 Autumn Statement, and by an additional £24bn, as announced in the March 2014 Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018-19. However, monthly public sector deficit figures have disappointed so far in 2014/15.

In September, the Federal Reserve continued with its monthly $10bn reductions in asset purchases, which started in December 2014. Asset purchases have now fallen from $85bn to $15bn and are expected to stop by October 2014, providing strong economic growth continues. First quarter GDP figures for the US were depressed by exceptionally bad winter weather, but growth rebounded very strongly in Q2 to 4.6%.

The Eurozone is facing an increasing threat from deflation. In September, the inflation rate fell further, to reach 0.3%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the ECB did take some rather limited action in June to loosen monetary policy in order to promote growth. In September it took further action to cut its benchmark rate to only 0.05%, its deposit rate to -0.2% and to start a programme of purchases of corporate debt. However it has not embarked yet on full quantitative easing (purchase of sovereign debt).

3.1.2 Outlook for the rest of 2014/15

Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth rebounded during 2013 and the first quarter of 2014 to surpass all expectations, propelled by recovery in consumer spending and the housing market. Forward surveys are currently very positive in indicating that growth prospects are also strong for the rest of 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established. One drag on the economy has been that wage inflation has been significantly below CPI inflation, so disposable income and living standards were being eroded, (although income tax cuts had ameliorated this to some extent). However, recent falls in inflation have created the potential for the narrowing of this gap and it could narrow further during this year, especially if there is also a recovery in growth in labour productivity (leading to increases in pay rates). With regard to the US, the main world economy, it faces similar debt problems to those of the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth, although labour force participation rates remain lower than ideal.

As for the Eurozone, concerns subsided considerably during 2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy, (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed.

3.1.3 Interest rate forecasts

The Council's treasury advisor, Capita Asset Services, has provided the following forecast:

Capita Asset Services undertook a review of its interest rate forecasts in Mid August, after the Bank of England's Inflation Report. By the beginning of September a further rise in geopolitical concerns , principally over Ukraine ,but also the Middle East ,had caused a further flight into safe havens like gilts and depressed PWLB rates further. This latest forecast now includes a first increase in Bank Rate in quarter 1 of 2015 (previously quarter 4 of 2014).

	Sept 14	Dec 14	Mar 15	Jun 15	Sept 15	Dec 15	Mar 16	Jun 16	Sept 16	Dec 16	Mar 17	Jun 17
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	2.00%	2.00%
5yr PWLB rate	2.70%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.60%
10yr PWLB rate	3.40%	3.50%	3.60%	3.10%	3.50%	3.50%	4.00%	4.10%	4.10%	4.20%	4.30%	4.30%
25yr PWLB rate	4.00%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.10%	4.80%	4.80%	4.90%	4.90%
50yr PWLB rate	4.00%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.80%	4.90%	4.90%

3.2 Treasury Management Strategy Statement and Annual Investment Strategy update

The Treasury Management Strategy Statement (TMSS) for 2014/15 was approved by this Council on 25/03/14.
There are no policy changes to the TMSS

Prudential Indicator 2014/15	**Original**
Authorised Limit	£720m
Operational Boundary	£690m
Capital Financing Requirement	£707m

3.3 The Council's Capital Position (Prudential Indicators)

3.3.1 Prudential Indicator for Capital Expenditure

The current capital spend is £119m compared to the original estimate of £125m

The Council plans to fund any borrowing from its own internal cash balances.

There is no change to the expected level of notional borrowing required to fund this capital expenditure and therefore no change to the forecasted Capital Financing Requirement.

The table shows the Capital Finance Requirement, 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.

	2014/15 Original Estimate £m
Capital Finance Requirement	707
Borrowing	460
Other long term liabilities*	260
Total debt 31 March	**720**

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

3.3.2 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. 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 2014/15 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2014/15 Original Estimate £m
Gross borrowing	393
Plus other long term liabilities*	218
Gross borrowing	611
Capital Finance Requirement* (year end position)	707

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

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. There has been no change to this limit.

Authorised limit for external debt	2014/15 Original Indicator
Borrowing	£460m
Other long term liabilities*	£260m
Total	£720m

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

3.4 Investment Portfolio 2014/15

3.4.1 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 3.1.3, 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 potential for a prolonging of the Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment, investment returns are likely to remain low.

The Council held £135m of investments as at 30 September (£138m at 31 March 2014) and the investment portfolio yield for the first six months of the year is 0.59% against a benchmark of 0.39%.

The Director of Finance confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2014/15.

The Council's budgeted investment return for 2014/15 is £600k, and performance for the year to date is £100k above budget.

3.4.2 Changes to the Council Treasury Management Policy

The main rating agencies (Fitch, Moody's and Standard & Poor's) have historically provided some institutions with a rating uplift due to implied levels of sovereign support. In the evolving regulatory regime, both these implied sovereign support levels are going to be removed and this process will commence this year. The actual timing of the changes is still subject to discussion, but this does mean immediate changes to the credit methodology is required.

It is important to stress that the rating agency changes do not reflect any changes in the underlying status of the institution or credit environment, merely the implied level of support that has been built into ratings through the financial crisis. The eventual removal of Government support will only take place when the regulatory environment has ensured that financial institutions are much stronger and less prone to failure in a financial crisis.

Fitch has already begun assessing its Support ratings, with a clear expectation that these will be lowered to 5, which is defined as "A bank for which there is a possibility of external support, but it cannot be relied upon." With all institutions likely to drop to these levels, there is little to no differentiation to be had by assessing Support ratings.

Due to the following credit rating changes undertaken by Fitch the following change to the Treasury Policy are recommended.

The Fitch support rating be removed from the credit rating requirements. All other credit criteria to stay the same.

3.5 Borrowing Strategy 2014/2015

The Council's capital financing requirement (CFR) for 2014/15 is £707m. 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 general trend has been a decrease in interest rates during the six months, across longer dated maturity bands, but a rise in the shorter maturities, reflecting in part the expected rise in the Bank rate..

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

3.6 Debt Rescheduling

No debt rescheduling was undertaken during the first six months of 2014/15.

3.7 Other

No other issues

4. Options

4.1 None

5. Financial and Resources Appraisal

5.1 The financial implications are set out in section 1,2 and 3

6. Risk Management

6.1 None

7. Legal Implications

7.1 Any relevant implication consideration are set out in the report.

8. Other Implications

8.1 Equal Rights implications – no direct implications

8.2 Sustainability implications – no direct implications

8.3 Greenhouse Gas Emissions Impact – direct implications

8.4 Community safety implications – no direct implications

8.5 Human Rights Act – direct implications

8.6 Trade Union – no direct implications

8.7 Ward Implications – no direct implications

9. Not for publication documents – none

10.Recommendations

That the changes to the Treasury Policy set out in section 3.4.2 be noted and referred to Council for adoption.

11. Appendices

11.1 None

12. Background Documents

Treasury Management Practices

Treasury Management Schedules