BODY:	**AUDIT & GOVERNANCE COMMITTEE**
DATE:	**4 December 2013**
SUBJECT:	**Treasury Management Mid-year Review Report**
REPORT OF:	**Chief Finance Officer**
Ward(s):	All
Purpose:	To provide Members with a mid year review of treasury management activity.
Contact:	Janet Martin, Senior Accountant Telephone Number 01323 415983.
Recommendations:	Members are asked to note the contents of this report.

1.0 Introduction

1.1 Treasury Management is 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.

1.2 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2012 was adopted by Cabinet on 6 February 2013 and requires regular reports to this committee on the Treasury Management activities undertaken.

1.3 This mid year report covers the following:

- An economic update for the first six months of 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.

2.0 Economic Update

2.1 The quarter ended 30 September summary:

- Indicators suggested that the economic recovery accelerated;
- Household spending growth remained robust;
- Inflation fell back towards the 2% target;
- The Bank of England introduced state-contingent forward guidance;
- 10-year gilt yields rose to 3% at their peak and the FTSE 100 fell slightly to 6460;
- The Federal Reserve decided to maintain the monthly rate of its asset purchases.

After strong growth of 0.7% in Q2, it appears that UK GDP is likely to have grown at an even faster pace in Q3. Consumer spending continued to rise and may beat the increase seen in Q2. While the 1.1% monthly rise in retail sales in July was almost entirely offset by a 0.9% fall in August, the unusually warm weather in August is likely to have had a part to play in this.

The run of good news on the labour market continued, with the ILO unemployment rate falling to 7.7% in July from 7.8% in June. Employment rose by 80,000 in the three months to July, supported by an even bigger rise in full-time employment. This meant that the ratio of full-time to part-time workers continued to rise after it troughed last summer.

Meanwhile, the cost of new credit has continued to fall, perhaps in response to the extension of the Bank of England's Funding for Lending Scheme (FLS) earlier this year. The quoted interest rate on a 5-year fixed mortgage at a 75% loan-to-value ratio was 3.34% in August, 7 basis points lower than in June and 77 basis points lower than when the FLS was introduced in July 2012.

Demand in the housing market continued to grow at a fast pace, supported by the FLS and the Government's Help to Buy scheme, which provide equity loans to credit-constrained borrowers. The RICS housing market survey reported that new buyer enquiries hit their highest level on record in August. Mortgage approvals for new house purchase rose to their highest level since February 2008 in August. Consequently, house prices continued to rise, with the Halifax and Nationwide measures recording 6.2% and 3.5% y/y rises in August, respectively.

The new Governor of the Bank of England, Mark Carney, took office in July. Alongside the August Quarterly Inflation Report, the Bank introduced its new policy of forward guidance in which the Monetary Policy Committee (MPC) pledged not to raise official interest rates, or reduce the size of the asset purchase facility, until the ILO unemployment rate falls to 7%. On the MPC's current forecasts, the unemployment rate is most likely to reach 7% in late 2016.

Meanwhile, CPI inflation fell from a 2013 peak of 2.9% in June to 2.7% in August. The fall was primarily the result of a drop in the contribution from petrol prices and a reduction in core inflation from 2.3% in June to 2% in August. CPI inflation looks likely to have edged down again in September, perhaps to about 2.5%, reflecting a further fading of both energy prices and core inflation.

Meanwhile, Eurozone business surveys suggested that the economy continued to expand in Q3, albeit at a moderate pace.

2.3 **Outlook for the next six months of 2013/14**

Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely during the remainder of 2013/14 as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, and safer bonds.

Near-term, there is some residual risk of further Quantitative Easing (QE)- if there is a dip in strong growth or if the Monitory Policy Committee 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. This could cause shorter-dated gilt yields and PWLB rates over the next year or two to significantly undershoot the forecasts in the table below.

The longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. Increasing investor confidence in economic recovery is also likely to compound this effect as a continuation of recovery will further encourage investors to switch back from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently weighted to the upside after five months of robust good news on the economy. However, only time will tell just how long this period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

Downside risks currently include:

- The conflict in the UK between market expectations of how quickly unemployment will fall as opposed to the Bank of England's forecasts
- Prolonged political disagreement over the US Federal Budget and raising the debt ceiling
- 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) which could also generate safe haven flows into UK gilts.
- 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 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

The potential for upside risks to UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- A sharp upturn in investor confidence that sustainable robust world economic growth is firmly expected, causing a surge in the 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.
- 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 which could result in the ratio of total government debt to GDP to rise to levels that undermine investor confidence in the UK and UK debt.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- In the longer term – an earlier than currently expected 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.

2.4 Capita's (previously Sector) Interest rate forecast is shown in the table below.

	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%
3m LIBID	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%
6m LIBID	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%
12m LIBID	0.80%	0.80%	0.80%	0.80%	0.80%	0.80%	0.80%
5yr PWLB rate	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%
10yr PWLB rate	3.70%	3.70%	3.70%	3.80%	3.80%	3.90%	4.00%
25yr PWLB rate	4.40%	4.40%	4.40%	4.50%	4.50%	4.60%	4.70%
50yr PWLB rate	4.40%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%

Capita Asset Services undertook a review of its interest rate forecasts in

late September as a result of an increase in confidence in economic recovery, chiefly in the US, but more recently, also in the UK and Eurozone. The latest forecast now includes a first increase in Bank Rate in quarter 3 of 2016 (previously quarter 4).

This Council has applied for and received confirmation that having complied with Prudential Indicators the PWLB Certainty Rate would be applied to future borrowing. This would reduce the interest rate by 0.2%.

3.0 Treasury Management Strategy Statement and Annual Investment Strategy Update

3.1 The Treasury Management Strategy Statement (TMSS) for 2013/14 was approved by Cabinet on 6 February 2013. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as follows:

- Security of capital
- Liquidity.

There are no policy changes to the TMSS.

3.2 The Council aims to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity and to obtain an appropriate level of return which is consistent with the Council's risk appetite.

3.3 As outlined in Section 2 above, there is still considerable uncertainty and volatility in the financial and banking market, both globally and in the UK. In this context, it is considered that the strategy approved on 6 February 2013 is still fit for purpose in the current economic climate.

4.0 The Council's Capital Position (Prudential Indicators)

4.1 Prudential Indicator for Capital Expenditure

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

Capital Expenditure	2013/14 Original Estimate £000	Position as at 30.9.13 £000	2013/14 Revised Estimate £000
General Fund	13,883	1,870	15,109
HRA	7,115	1,445	12,798
Total	**20,998**	**3,315**	**27,907**

4.2 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases

the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	**2013/14 Original Estimate £000**	**2013/14 Revised Estimate £000**
Total spend	**20,998**	**27,907**
Financed by:		
Capital receipts	2,861	5,053
Capital grants	8,192	6,760
Capital reserves	7,046	8,445
Revenue	1,089	1,753
Total financing	**19,188**	**22,011**
Borrowing need	**1,810**	**5,896**

The increase in the revised estimated capital spend in 2013-14 is mainly due to re-profiling of previously approved schemes and the following new approved schemes:

- Supporting Housing and Economic Progress Initiative (SHEP);
- Increase of LA New Build;
- Investment Capital;
- Homelessness Change;
- 46 Upperton Gardens.

4.3 **Changes to the Prudential Indicators for the Capital Financing Requirement, External Debt and the Operational Boundary.**

The table below shows the 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.

	2013/14 Original Estimate £m	2013/14 Revised Estimate £m
Prudential Indicator – Capital Financing Requirement		
CFR – non housing	21.6	22.0
CFR – housing	36.7	38.8
Total CFR	58.4	60.8
Net movement in CFR	1.8	5.0
Prudential Indicator – External Debt / the Operational Boundary		
Borrowing	56.9	
Serco Paisa Loans	1.5	
Total debt 31 March	58.4	

The revised estimate has been increased from the original forecast Capital Financing Requirement due to the increased borrowing for SHEP and WEL Investment.

4.4 **Limits to Borrowing Activity**

One 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. Net 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 Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2013/14 Original Estimate £m	Position As at 30.9.13 £m	2013/14 Revised Estimate £m
Gross borrowing	37.8	34.7	40.7
Serco Paisa Loans	1.2	1.5	1.2
Less investments	(0.5)	(5.0)	(0.5)
Net borrowing	38.5	31.2	41.7
CFR (year end position)	58.4	57.8	60.9

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	Current Position
Borrowing	71.9	34.7
Other long term liabilities*	1.5	1.5
Total	73.4	36.2

5.0 Investment Portfolio 2013/14

5.1 As illustrated in the economic background section above, investment rates available in the market are at a historical low point. The average level of temporary funds available for investment purposes in the first six

months of 2013/14 was £9.48m arising from the timing of precept payments, receipt of grants and progress on the capital programme.

5.2 A full list of investments held as at 30th September 2013, during the first six months of 2013/14 is shown in appendix 1, and summarised below:

Investments	30th September 2013	Rate of Return
Counterparty	£000	%
Foreign Banks	0	
British Banks	4,950	0.79
Building Societies	0	
Total	4,950	0.79

The above excludes £5,000 cash invested overnight on 30th September with the Council's own bankers, the Co-op.

On 10 May 2013 the Council received notification from Sector (now Capita) that the Co-op Bank was being down graded by the rating agencies to 'junk status'. Officers immediately reviewed the practice of holding excess funds over night with the Co-op bank with no limit, which is normal practice. Internally a working limit of £500,000 was set. This has had consequences on the ability to invest elsewhere due to the limited number of counterparties available that met the criteria set out in the TMSS and the limit of £4m as a maximum amount to be held with any particular bank or building society. This limit was breached on a number of occasions. These were always with banks which are part owned by the Government and considered to be very safe, only held on call and always for a minimal time.

Santander are now back on the recommended lending list and are now available as an alternative investment to avoid this problem for the future.

Apart from the breaches mentioned above, approved limits within the Annual Investment Strategy were not breached during the first six months of 2013/14.

5.3 Investment performance against bench mark was as follows:

Benchmark	Benchmark Return	Council Performance	Interest Earnings
7 day	0.36%	0.64%	£35,350

5.4 The authority outperformed the benchmark by 0.28%. The budgeted investment return for 2013/14 is £50,000. Performance for the year to date is above target, with the outturn likely to exceed the budget slightly due to locking into higher rates for longer periods with Lloyds Bank.

5.5 **Investment Counterparty criteria**

The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

6.0 Borrowing

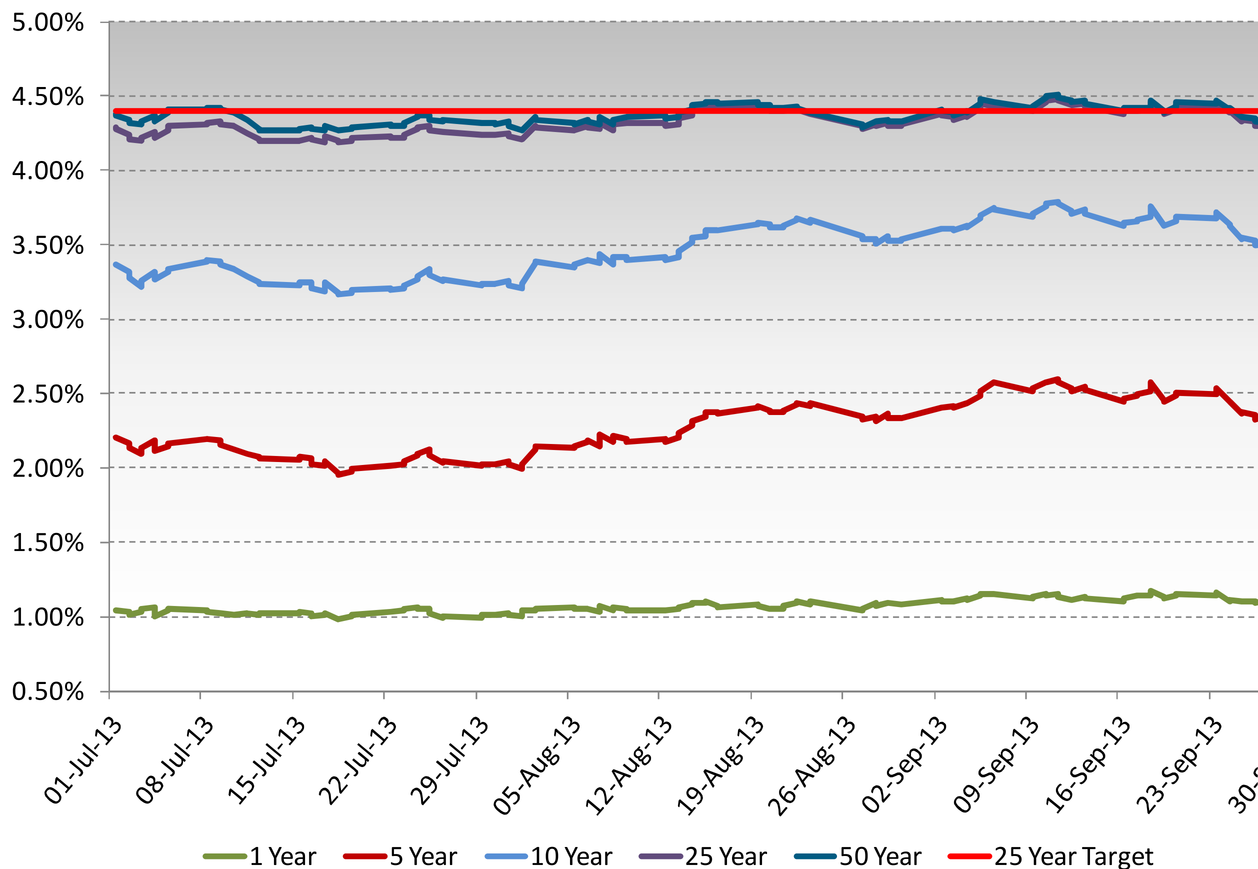
6.1 The following debt has been repaid during the first 6 months :

- £3m – 15 April 2013 (Temporary Debt)
- £1.5m – 24 September 2013 (PWLB)

No new debt has been taken during the first 6 months.

6.2 The Council's revised estimated capital financing requirement (CFR) for 2013/14 is £60.9m. 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 table above at 5.4 shows the Council has borrowings of £34.7m and has utilised £21.6m of cash flow funds in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate.

6.3 The graph below shows the movement in PWLB rates for July to September 2013.



7.0 Debt Rescheduling

7.1 Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. No debt rescheduling was undertaken during the first six months of 2013/14.

8.0 Compliance with Treasury and Prudential Limits

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

8.2 During the financial year to date the Council has operated within the treasury limits (except the occasional breaches of investment limits noted in this report) and Prudential Indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices.

9.0 Consultation

9.1 None.

10.0 Resource Implications

10.1 None

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Background Papers:

The Background Papers used in compiling this report were as follows:

- CIPFA Treasury Management in the Public Services code of Practice (the Code)
- TMSS Policy
- Annual Investment Strategy

To inspect or obtain copies of background papers please refer to the contact officer listed above.