COLCHESTER

Scrutiny Panel

Item 16

11 November 2014

Report of	**Assistant Chief Executive**	**Author**	**Steve Heath** ☏ **282389**
Title	**Treasury Management Strategy Statement – Mid-Year Review Report 2014/15**		
Wards affected	Not applicable		

The Panel is invited to review treasury management activity during the first six months of 2014/15

1. Action required

1.1 To consider treasury management performance for the first six months of 2014/15, and recommend the approval of any changes to the Treasury Management Strategy Statement for the year.

2. Reason for scrutiny

2.1 The Chartered Institute of Public Finance and Accountancy's (CIPFA) revised Code of Practice on Treasury Management was adopted by this Council on 17 February 2010. The primary requirements of the Code include the creation and maintenance of a Treasury Management Policy Statement and Practices, the production of an annual Treasury Management Strategy Statement for the year ahead, a **Mid-year Review Report** and an Annual Report covering activities during the previous year. This mid-year report has been prepared in compliance with CIPFA's Code of Practice on treasury Management.

3. Introduction

3.1 The Council operates a balanced budget, which broadly means that income raised during the year will meet its expenditure. Part of the treasury management operation ensures that the cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate security and liquidity before considering investment returns.

3.2 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.

3.3 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."

3.4 The Council employ Capita Asset Services to provide a consultancy service in respect of treasury management, to include advice on both debt and investments. During the year they have provided advice on borrowing, investments, counterparty credit details and general capital accounting information.

4. Economic update

Performance to date

4.1 After strong UK GDP quarterly growth in 2013, and Q1 and Q2 2014, it appears very likely that strong growth will continue into 2015. However, for the recovery to become more balanced and sustainable in the longer term, it needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent performance. Most economic forecasters are expecting growth to peak in 2014 and then to ease off a little, though still remaining strong, in 2015 and 2016. Unemployment is therefore expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in pay rates at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

4.2 Also encouraging has been the sharp fall in inflation (CPI) to the lowest rate since 2009. Forward indications are that inflation is likely to fall further in 2014 to possibly near to 1%. Overall, markets are expecting that the MPC will be cautious in raising Bank Rate as it will want to protect heavily indebted consumers from too early an increase in Bank Rate at a time when inflationary pressures are also weak. A first increase in Bank Rate is therefore expected in Q2 2015, and they expect increases after that to be at a slower pace to lower levels than prevailed before 2008 as increases in Bank Rate will have a much bigger effect on heavily indebted consumers.

4.3 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.

4.4 The Eurozone is facing an increasing threat from weak or negative growth and from deflation. Accordingly, the ECB took some rather limited action in June to loosen monetary policy in order to promote growth. However, it has not embarked yet on full quantitative easing (purchase of sovereign debt).

4.5 Concern in financial markets for the Eurozone 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.

Outlook

4.6 The latest Capita Asset Services interest rate forecast is shown in **Appendix A**. Capita Asset Services undertook a review of its interest rate forecasts on 24 October. During September and October, a further rise in geopolitical concerns, principally over Ukraine but also over the Middle East, plus fears around Ebola and an accumulation of dismal growth news in most of the ten largest economies of the world and the growing risk of deflation in the Eurozone, had sparked a flight from equities into safe havens like gilts and depressed PWLB rates. However, there is much volatility in rates as news ebbs and flows in negative or positive ways. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2015.

5. Treasury Management Strategy Statement 2014/15

5.1 The Council's Treasury Management Strategy Statement (TMSS) for 2014/15 was approved by full Council on 19 February 2014. The strategy is as follows:

- The UK bank rate has been unchanged from a historically low 0.5% since March 2009. The view from the Council's treasury advisers is that the Bank Rate is expected to remain unchanged until quarter 2 of 2016.
- The Council is currently maintaining an under-borrowed position. The borrowing strategy is to reduce the difference between gross and net debt by continuing to 'borrow internally', which is primarily due to investment rates on offer being lower than long term borrowing rates. This has the advantages of maximising short-term savings and reducing the Council's exposure to interest rate and credit risk. This approach is intended to be maintained during the year.
- The investment policy reflects the Council's low appetite for risk, emphasising the priorities of security and liquidity over that of yield. The main features of the policy are as follows:
    - The Council will only invest with institutions with the highest credit ratings, taking into account the views of all credit rating agencies and other market data when making investment decisions.
    - The Council will use the creditworthiness service provided by Capita Asset Services, which combines data from credit rating agencies with credit default swaps and sovereign ratings. However, whereas this service uses ratings from all agencies in a weighted scoring system, the Council will continue to follow the approach suggested by CIPFA of using the lowest rating from all the agencies (i.e. the lowest common denominator).
    - The Council will only use approved counterparties from countries with the highest credit rating of 'AAA', together with those from the UK.
    - The Council will continue to avoid longer term deals while investment rates are at such low levels, unless attractive rates are available within the risk parameters set by the Council. The suggested budgeted return on investments placed for up to 100 days during the year is 0.50%.
- The Council's Prudential and Treasury Indicators for 2014/15 through to 2016/17 were produced to support capital expenditure and treasury management decision making, and are designed to inform whether planned borrowing and the resultant revenue costs are affordable and within sustainable limits. They take into account all the economic forecasts and proposed borrowing and investment activity detailed in the TMSS.
- The Minimum Revenue Provision (MRP) Policy Statement for 2014/15 stated that the historic debt liability will continue to be charged at 4%, with the charge for more recent capital expenditure being based on the useful life of the asset and charged using the equal annual instalment method.

5.2 The details in this report update the position in the light of the latest economic performance. There are no proposed policy changes to the TMSS for 2014/15. However, our Treasury Advisers are amending their credit methodology, which is used when making investment decisions (see Section 8).

6. The Council's Capital Position (Prudential Indicators)

6.1 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.

6.2 The table below shows the original estimates for capital expenditure when the Prudential Indicators were agreed, along with the latest forecast. 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 2014/15	Original Estimate £'000	Current Position £'000	Revised Estimate £'000
Total Spend	23,316	6,511	24,874
Total Financing	20,396	6,511	22,188
Borrowing Need	2,920	0	2,686

6.3 The following table shows the CFR, which denotes the underlying need to incur borrowing for capital purposes. It also shows two further prudential indicators relating to the level of borrowing. The **Operational Boundary** reflects the Council's expected debt position during the year, whilst the **Authorised Limit** controls the overall level beyond which borrowing is prohibited. This is the statutory limit determined by section 3 (1) of the Local Government Act 2003, and reflects a level of borrowing that could be afforded in the short-term, but is not sustainable in the longer term. The table demonstrates that the Council has maintained gross borrowing within its authorised limit during the first six months of 2014/15.

	Original Estimate £'000	Current Position £'000	Revised Estimate £'000
Capital Financing Requirement			
CFR - non housing	26,183	26,693	28,186
CFR - housing	126,323	124,577	124,577
Total CFR (year end position)	152,506	151,270	152,763
Net movement in CFR	276	0	1,493
The Operational Boundary			
Borrowing	143,651	136,094	138,780
Other long term liabilities	1,593	2,229	2,229
Total	**145,244**	**138,323**	**141,009**
The Authorised Limit			
Borrowing	166,013	163,941	165,634
Other long term liabilities	1,593	2,229	2,229
Total	**167,606**	**166,170**	**167,863**

6.4 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. 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 the next two financial years. This allows some flexibility for limited early borrowing for future years. No difficulties are envisaged for the current or future years in complying with this prudential indicator.

	Original Estimate £'000	Current Position £'000	Revised Estimate £'000
External Borrowing	136,094	136,094	136,094
Plus other long term liabilities	1,593	2,229	2,229
Gross Borrowing	137,687	138,323	138,323
CFR (year end position)	152,506	151,270	152,763

7. Borrowing

7.1 When 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 £136m and has utilised £13m of cash flow funds in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate, but will require ongoing monitoring in the event that the upside risk to gilt yields prevails.

7.2 No new long-term or temporary borrowing has been undertaken so far this financial year in accordance with the TMSS. The general trend in PWLB interest rates 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. However, it is anticipated that no new borrowing will be undertaken during this financial year.

7.3 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 2014/15.

8. Investments

8.1 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. 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 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 averse environment, investment returns are likely to remain low.

8.2 The Council held £44.2m of investments as at 30 September 2014 (£34.7m at 31 March 2014) and the investment portfolio yield for the first six months of the year is 0.54% against the three-month LIBID benchmark of 0.42%. A full list of investments held as at 30 September 2014 is shown in **Appendix B**. It should be noted that the level of investments held, and therefore the total returns available, are likely to reduce during the remainder of the year as a result of cash flow fluctuations and the continuing strategy of internal borrowing.

8.3 The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function. Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2014/15.

8.4 The Council's budgeted investment return for 2014/15 is £180k, and performance for the year to date is expected to be in line with the budget.

Investment Counterparty Criteria

8.5 The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. More recently, in response to the evolving regulatory regime, the agencies have indicated they may remove these "uplifts", making the Support, Financial Strength and Viability ratings redundant. This process may commence during this financial year. The actual timing of the changes is still subject to discussion, but this does mean immediate changes to our Treasury Advisers' credit methodology are required.

8.6 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 implied Government support will only take place when the regulatory and economic environments have ensured that financial institutions are much stronger and less prone to failure in a financial crisis.

8.7 As a result of these rating agency changes, the credit element of the future methodology will focus solely on the Short and Long Term ratings of an institution. Rating Watch and Outlook information will continue to be assessed where it relates to these categories. This is the same process for Standard & Poor's that has always been taken, but a change to the use of Fitch and Moody's ratings. Furthermore, Capita Asset Services will continue to utilise CDS prices as an overlay to ratings in their new methodology.

9. Strategic Plan references

9.1 Prudent treasury management underpins the budget required to deliver all Strategic Plan priorities.

10. Publicity considerations

10.1 **Appendix B** to the attached background paper is confidential.

11. Financial implications

12.1 The Central Loans and Investment Account (CLIA) comprises the Council's borrowing costs and investment income. The CLIA is difficult to predict and can be affected by several factors. The majority of the Council's debt is on fixed rates reflecting the longer-term nature of the borrowing decisions. Investments are generally made for shorter periods, making returns more variable. This mix is generally more beneficial when interest rates are high or increasing. It is important to add that the exposure to interest rate movements is regularly monitored to minimise risks to changes in returns.

12.2 The outturn position for the CLIA is currently projected to be a favourable variance of £50k. The main factors affecting the forecast are the intention to continue to internally borrow due to the low levels of investment returns available, and a higher than expected level of cash balances available. The position will continue to be reviewed as part of the regular budget monitoring reports.

13. Risk Management implications

13.1 Risk Management is essential to effective treasury management. The Council's Treasury Management Policy Statement contains a section on treasury Risk Management (TMP1).

13.2 TMP1 covers the following areas of risk all of which are considered as part of our treasury management activities:

- Credit and counterparty risk
- Liquidity risk
- Interest rate risk
- Exchange rate risk
- Refinancing risk
- Legal and regulatory risk
- Fraud, error and corruption, and contingency management
- Market risk

14. Other Standard References

14.1 Having considered consultation, equality, diversity and human rights, health and safety and community safety implications, there are none which are significant to the matters in this report.

Background Papers
Appendix A: Capita Asset Services Interest Rate Forecast
Appendix B: Outstanding Temporary Investments 2014/15 (**confidential**)