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Crawley Borough Council

Report to Overview and Scrutiny Commission
11 November 2013

Report to Cabinet
13 November 2013

Treasury Management Mid Year Review 2013/2014

Report of the Head of Finance, Revenues and Benefits (FIN/316)

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1. Purpose

1.1 This report provides an update on the Council's Treasury Management Strategy for the two first quarters of 2013/2014

2. Recommendations

2.1 **To the Overview and Scrutiny Commission:**

That the Commission consider the report and decide what comments, if any, it wishes to submit to the Cabinet.

2.2 **To the Cabinet**

That the Cabinet is recommended to:

a) Note the report and the treasury activity for the first two quarters of 2013/2014.

3. Reasons for the Recommendations

3.1 The Council's financial regulations, in accordance with the CIPFA Code of Practice for Treasury Management, require a Treasury Management Mid Year Review to be approved. This report complies with these requirements.

4. Background

4.1 This mid year report has been prepared in compliance with the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2011).

4.2 This report details the treasury management operational activity for the first two quarters of 2013/2014. It provides an update to the Treasury Management Strategy Statement that was approved by the Full Council on 27 February 2013. An outturn report will be made after the year-end.

5. Economic update

5.1 Economic performance to date

5.1.1 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.

5.1.2 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 1.0% y/y, well below the rate of inflation at 2.7% in August, causing continuing pressure on household's disposable income.

5.1.3 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.

5.1.4 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 started to come down, but only slowly, as Government expenditure cuts took effect and economic growth started to show through in a small increase in tax receipts. 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 remained at 0.5% and quantitative easing also stayed at £375bn. In August, the 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 MPC will review Bank Rate, not necessarily take action to change it. The three month to July average rate was 7.7%.

5.1.5 CPI inflation (MPC target of 2.0%), fell marginally from a peak of 2.9% in June to 2.7% in August. The Bank of England expects inflation to fall back to 2.0% in 2015.

5.1.6 Financial markets sold off sharply following comments from Ben Bernanke (the Fed chairman) in June that suggested the Fed. may 'taper' its asset purchases earlier than anticipated. The resulting rise in US Treasury yields was replicated in the UK. Equity prices fell initially too, 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 a continuing economic recovery. Increases in payroll figures have shown further improvement, helping to pull the unemployment rate down from a high of 8.1% to 7.3%, and continuing house price rises have helped more households to escape from negative equity. In September, the Fed. surprised financial markets by not starting tapering as it felt the run of economic data in recent months had been too weak to warrant taking early action. Bond yields fell sharply as a result, though it still only remains a matter of time until tapering does start.

5.1.7 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.

5.2 Outlook for the third and fourth quarters of 2013/14

5.2.1 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 gilt yields and 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: the coalition government fell on 29 September.
- 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

5.2.2 Upside risks to UK gilt 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 gilt yields.
- Increased investor confidence that sustainable robust world economic growth is firmly expected, together with a reduction or end of 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 GDP to rise to levels that provoke major concern.

5.2.3 The overall balance of risks to economic recovery in the UK is now 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, and it remains exposed to vulnerabilities in a number of key areas. 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. Near-term, there is some residual risk of further QE if there is a dip in strong growth or if the MPC were to decide 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. The tension in the US over passing a Federal budget for the new financial year starting on 1 October and raising the debt ceiling in mid October could also see bond yields temporarily dip until agreement is reached between the opposing Republican and Democrat sides. Conversely, the eventual start of tapering by the Fed. will cause bond yields to rise.

5.3 Interest rate forecasts

	Sep-13	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%	1.25%
5yr PWLB rate	2.50%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.20%	3.30%	3.50%	3.60%	3.70%
10yr PWLB rate	3.70%	3.70%	3.70%	3.70%	3.80%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%
25yr PWLB rate	4.40%	4.40%	4.40%	4.40%	4.50%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.10%	5.10%	5.20%
50yr PWLB rate	4.50%	4.40%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.20%	5.20%	5.30%

5.3.1 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 gilt 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, unlike in previous recessions. This meant that labour was retained, productivity fell and now, as the MPC expects, there is major potential for unemployment to fall only slowly 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 and there are many currently self employed or part time employed workers who are seeking full time employment. Capita Asset 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 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 even the Bank of England forecast 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.

6. Treasury Management Strategy Statement and Annual Investment Strategy update

6.1 The Treasury Management Strategy Statement (TMSS) for 2013/14 was approved by this Council on 27 February 2013. There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

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

7.1 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.

7.2 Prudential Indicator for Capital Expenditure

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

Capital Expenditure by Service	**2013/14 Original Estimate £'000**	**Current Position £'000**	**2013/14 Revised Estimate £'000**
Housing	1,447	968	2,799
Leisure	2,956	539	2,577
Environment	2,398	337	2,019
Cabinet	810	15	518
Customer & Corporate Services	740	28	630
Non-HRA	**8,352**	**1,887**	**8,542**
HRA	**12,498**	**4,308**	**12,342**
Total	**20,850**	**6,195**	**20,884**

7.3 Changes to the Financing of the Capital Programme

7.3.1 The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, 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**	**Current Position £'000**	**2013/14 Revised Estimate £'000**
Non-HRA	8,352	1,887	8,542
HRA	12,498	4,308	12,342
Total spend	**20,850**	**6,195**	**20,884**
Financed by:			
Capital receipts	3,021	1,131	4,402
Capital grants	2,603	447	1,818
Capital reserves	2,266	163	1,902
Revenue	12,960	4,454	12,763
Total financing	**20,850**	**6,195**	**20,884**
Borrowing need	**0**	**0**	**0**

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

7.4.1 The table 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.

7.4.2 Prudential Indicator – Capital Financing Requirement
We are on target to achieve the original forecast Capital Financing Requirement.

7.4.3 Prudential Indicator – External Debt / the Operational Boundary

	2013/14 Original Estimate £'000	**Current Position £'000**	**2013/14 Revised Estimate £'000**
Prudential Indicator – Capital Financing Requirement			
CFR – non housing	(330)	(330)	(330)
CFR – housing	260,325	260,325	260,325
Total CFR	**259,995**	**259,995**	**259,995**
Net movement in CFR	**0**	**0**	**0**
Prudential Indicator – External Debt / the Operational Boundary			
Borrowing	260,325	260,325	260,325
Other long term liabilities	0	0	0
Total debt 31 March	**260,325**	**260,325**	**260,325**

7.5 Limits to Borrowing Activity

7.5.1 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 Head of Finance, Revenues and Benefits reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

7.5.2 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 £'000**	**Current Position £'000**	**2013/14 Revised Indicator £'000**
Borrowing	270,325	260,325	270,325
Other long term liabilities	0	0	0
Total	270,325	260,325	270,325

8. Investment Portfolio 2013/14

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. 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 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.

8.2 The Council held £109.1m of investments as at 30 September 2013 (£94.6m at 31 March 2013).

Investments	**31 March 2013 £'000**	**30 September 2013 £'000**	**Rate/Return**	**Average Life yrs**
In house	60,963	75,465	+1.36%	0.84
Investec	33,667	33,644	+0.02%	0.81
Total	**94,630**	**109,109**	**+0.95%**	**0.83**

A full list of investments held as at 30th September 2013 is in appendix 1.

8.3 The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2013/14.

8.4 The Council's budgeted investment return for 2013/14 is £1,105,167 and performance for the year to date is £210,000 below budget.

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

9. Borrowing

9.1 The Council borrowed £260.325m in March 2012 for HRA self-financing. There has been no requirement for further borrowing in 2013/2014.

10. Implications

10.1 The financial implications are addressed throughout this report. There are no legal implications arising in this report.

10.2 Risks are highlighted throughout this report, but appendix 1 addresses the risk to security, liquidity and yield of the Council's investment strategy.

11. Background Papers

Treasury Management Strategy for 2013/2014 – Cabinet, 13 February 2013 [report FIN/291 refers]
Quarterly Budget Monitoring 2013/2014 Quarter 2 – Cabinet, 13 November 2013 [report FIN/314 refers]
Budget and Council Tax for 2013/14 - Cabinet, 13 February 2013 [report FIN/293 refers]

“Treasury Management in the Public Services - Code of Practice and Cross-Sectoral Guidance Notes”, 2011 Edition - Chartered Institute of Public Finance and Accountancy
“The Prudential Code for Capital Finance in Local Authorities”, 2011 Edition - Chartered Institute of Public Finance and Accountancy

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APPENDIX 1

Treasury Report for 30 September 2013

The following table shows the position at 30 September 2013 against the benchmarks set in the 2013/14 Treasury Strategy.

	Benchmark		Actual	
Liquidity				
Weighted Average Life (years)	Avg 1.20	Max 1.50	0.83	☑
Short-term deposits (<1 week's notice)	>£2m		£11.9m	☑
Max sums invested >365 days	£50m		£18.3m	☑
Security				
Overall risk of default	0.15%		0.039%	☑
1 year	0.03%		0.016%	☑
2 years	0.22%		0.084%	☑
3 years	0.40%		0.000%	☑
4 years	0.56%		0.400%	☑
5 years	0.74%		0.135%	☑
Non-specified investments	70%		44%	☑
Yield				
In-house (annualised)	0.45%		1.36%	☑
Investec (cumulative)	0.12%		0.02%	☑
Other				
Limit on fixed rate investments	£100m		£94.2m	☑
Limit on variable rate investments	£40m		£14.9m	☑
Limit on fixed rate debt	£271.4m		£260.3m	☑
Limit on variable rate debt	£10m		£0	☑
Limits to Borrowing Activity				
Operational Boundary	£261.4m		£260.3m	☑
Authorised Limit	£271.4m		£260.3m	☑

Detailed holdings at 30 September 2013

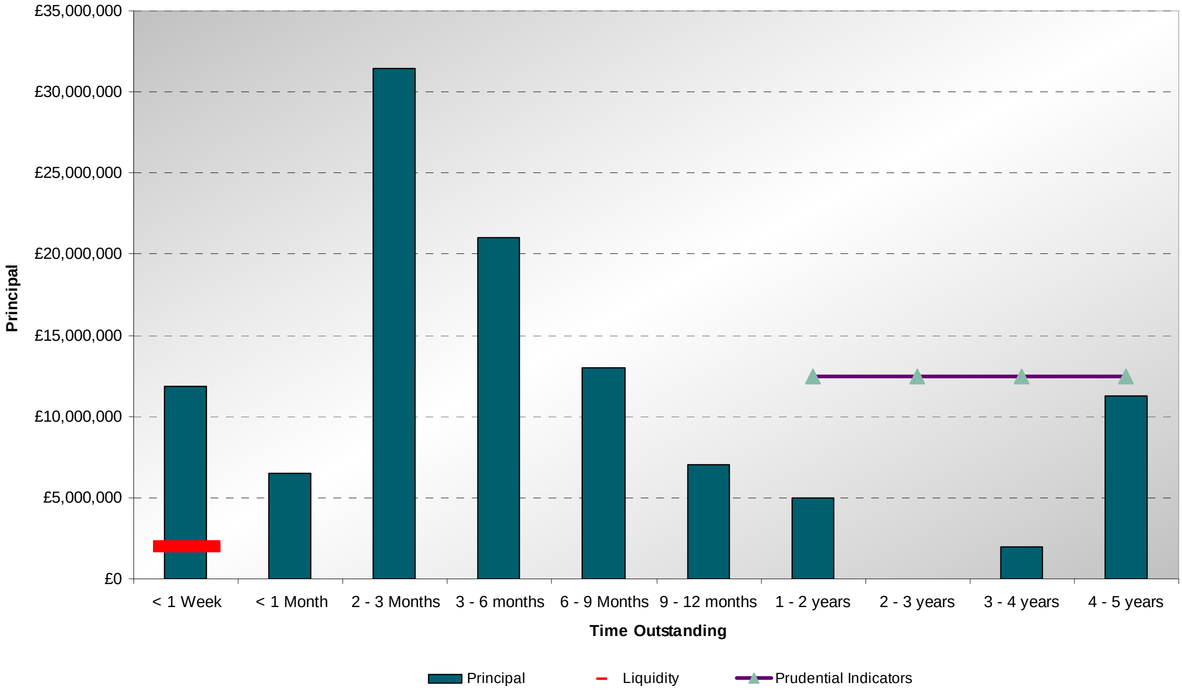
	Investec	In-House	Total	Limit	Rating
UK Government	£4.93m	£2.33m	£7.26m	unlimited	AAA
UK Banks					
Bank of Scotland plc		£5.00m	£5.00m	£10.00m	A
Barclays Bank		£5.00m	£5.00m	(a)	A
HSBC Bank plc		£5.00m	£5.00m	£15.00m	AA-
Royal Bank of Scotland		£6.86m	£6.86m	£15.00m	A
Santander UK Plc		£2.00m	£2.00m	(b)	A
Standard Chartered Bank	£5.01m	£4.00m	£9.01m	£10.00m	AA-
UK Building Societies					
Coventry Building Society		£1.00m	£1.00m	£10.00m	A
National Counties Building Society		£2.00m	£2.00m	£3.00m	None
Nationwide Building Society		£4.00m	£4.00m	£10.00m	A
Skipton Building Society		£2.00m	£2.00m	£3.00m	BBB-
West Bromwich Building Society		£2.00m	£2.00m	£3.00m	B
Local Authorities					
Aberdeen City Council		£3.00m	£3.00m	£15.00m	AAA
Birmingham City Council		£10.00m	£10.00m	£15.00m	AAA
Lancashire County Council		£5.00m	£5.00m	£15.00m	AAA
Rugby Borough Council		£1.50m	£1.50m	£15.00m	AAA
Peterborough City Council		£4.00m	£4.00m	£15.00m	AAA
Money Market Funds					
Investec GSF	£0.19m		£0.19m	£15.00m	AAA
Supranational					
European Bank for Reconstruction	£0.83m		£0.83m	£15.00m	AAA
Overseas Banks					
Bank of Nova Scotia	£2.16m		£2.16m	£10.00m	AA-
Citibank NA	£0.01m		£0.01m	£1.00m	A
Commonwealth Bank of Australia	£3.30m		£3.30m	£15.00m	AA-
Deutsche Bank AG	£5.00m		£5.00m	(c)	A+
ING Bank	£2.70m		£2.70m	Matured 08 October 13	A+
National Australia Bank	£1.20m		£1.20m	£15.00m	AA-
Nordea Group	£5.00m	£3.00m	£8.00m	£15.00m	AA-
Rabobank		£5.00m	£5.00m	£15.00m	AA
Svenska Handelsbanken	£3.31m	£2.78m	£6.09m	£15.00m	AA-
	£33.64m	£75.47m	£109.11m		

(a) Limit removed on 22 June 2012. £5m matures 17 October 2014.

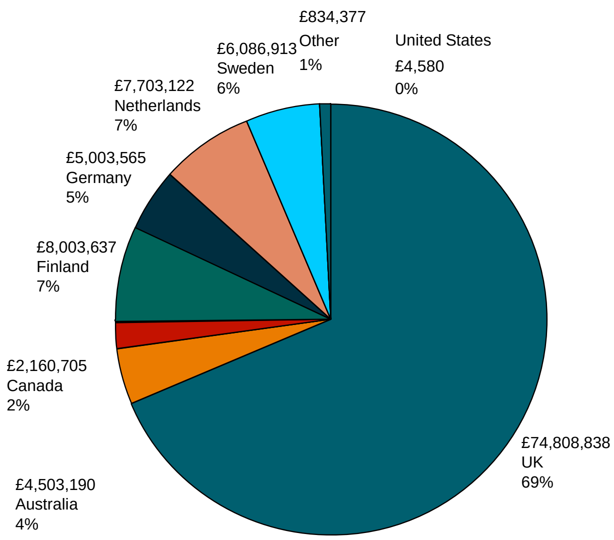
(b) Limit removed from 01 April 2012 due to a change in strategy. Investment matures 04 October 2016.

(c) Limit removed on 22 June 2012. £5m matures 18 November 2013.

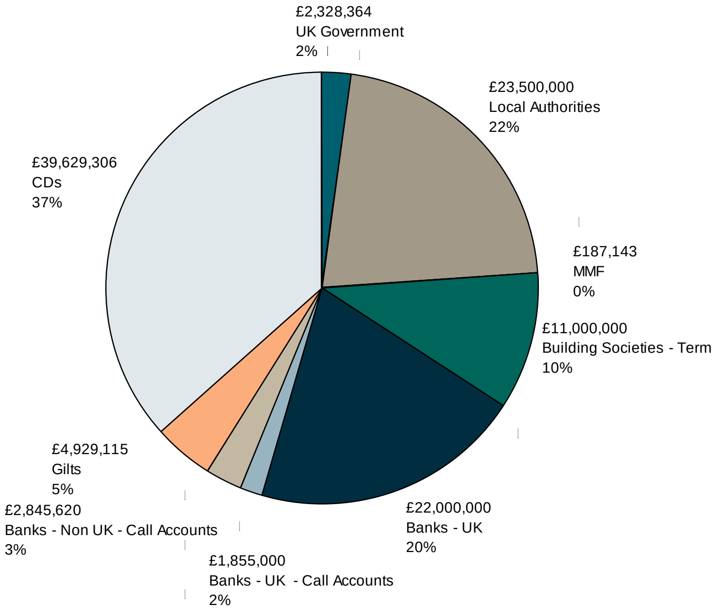
Compliance with Liquidity and Prudential Indicator Limits



Country Limits



Sector Diversification



These charts include investments made by Investec.