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Crawley Borough Council

Report to Overview & Scrutiny Commission
10 November 2014

Report to Cabinet
12 November 2014

Treasury Management Mid Year Review 2014/2015

Report of the Deputy Head of Finance (FIN/346)

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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 2014/2015

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 note the report and the treasury activity for the first two quarters of 2014/2015.

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). The primary requirements of the code are:

- 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 Outturn 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 the Overview and Scrutiny Commission.

4.2 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 first part of the 2014/15 financial year - section 5 and appendix 1;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy - section 6;
- The Council's capital expenditure (prudential indicators) – section 7;
- A review of the Council's investment portfolio for 2014/15 – section 8 and appendix 2;
- A review of the Council's borrowing strategy for 2014/15 – section 9;
- A review of compliance with Treasury and Prudential Limits for 2014/15 – appendix 3.

5. Interest rate forecasts

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

	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.00%	2.25%	2.50%
5yr PWLB rate	2.50%	2.70%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.50%	3.50%	3.50%
10yr PWLB rate	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.20%	4.30%	4.30%
25yr PWLB rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%
50yr PWLB rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%

5.2 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 also on 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.

5.3 Our PWLB forecasts are based around a balance of risks – see appendix 1 for details.

6. Treasury Management Strategy Statement and Annual Investment Strategy update

6.1 The Treasury Management Strategy Statement (TMSS) for 2014/15 was approved by this Council on 26 February 2014. 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	**2014/15 Original Budget £'000**	**2014/15 Revised Budget £'000**	**Current Position £'000**	**2014/15 Revised Estimate £'000**
Chair of Cabinet	1,063	1,353	155	962
Customer & Corporate	791	844	210	844
Environment	7,690	8,344	4,373	8,236
Housing Services	1,425	1,458	299	1,378
Leisure & Cultural	2,340	3,868	1,011	3,208
Planning & Economic Development	-	4,632	4,632	4,632
Non-HRA	**13,309**	**20,499**	**10,680**	**19,260**
HRA	**16,506**	**21,970**	**7,477**	**21,631**
Total	**29,815**	**42,469**	**18,157**	**40,891**

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	**2014/15 Original Budget £'000**	**2014/15 Revised Budget £'000**	**Current Position £'000**	**2014/15 Revised Estimate £'000**
Non-HRA	13,309	20,499	10,860	19,260
HRA	16,506	21,970	7,477	21,63
Total spend	**29,815**	**42,469**	**18,157**	**40,891**
Financed by:				
Capital receipts	6,212	6,767	3,308	5,757
Capital grants	2,903	4,811	2,026	4,675
Capital reserves	5,038	9,788	6,160	9,695

Revenue	15,662	21,103	6,663	20,764
Total financing	**29,815**	**42,469**	**18,157**	**40,891**
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

	2014/15 Original Estimate £'000	**Current Position £'000**	**2014/15 Revised Estimate £'000**
Prudential Indicator – Capital Financing Requirement			
CFR – non housing	(330)	(330)	(330)
CFR – housing	260,325	260,273	260,273
Total CFR	**259,995**	**259,943**	**259,943**
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 2014/15 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Deputy Head of Finance 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	**2014/15 Original Indicator £'000**	**Current Position £'000**	**2014/15 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 2014/15

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 5, 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 environment, investment returns are likely to remain low.

8.2 The Council held £115.6m of investments as at 30 September 2014 (£119.0m at 31 March 2014).

Investments	**31 March 2014 £'000**	**30 September 2014 £'000**	**Rate/ Return**	**Average Life yrs**
UK Government	7,273	7,237	1.25%	3.44
Local Authorities	64,500	47,500	0.58%	1.42
UK Banks	29,255	23,121	2.26%	0.89
UK Building Societies	6,000	4,000	0.71%	0.19
Money Market Funds	-	3,900	0.48%	0.00
Supranational	-	3,109	0.71%	0.77
Overseas Banks	11,982	26,701	0.89%	0.14
Total	**119,010**	**115,568**	**1.15%**	**1.03**

A full list of investments held as at 30th September 2014 is in appendix 2.

8.3 The Deputy Head of Finance confirms 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 £898,595 and performance for the year to date is £360,000 above budget. The key reasons for this variance are:

- The Council sold its holding of gilts in mid-October when prices jumped following investors seeking a safe haven from plummeting equity values. These disposals resulted in an additional £114,000 investment income.

- The Forge Wood Development will result in at least £6.5m being receivable at the end of the project. This has been accounted for by discounting £6.5m over 10 years at an interest rate of 3.89% resulting in capital receipt of £4.4m being recognised in 2013/14 and annual interest payments of £172,000 in 2014/15 rising to £243,000 in 2023/24.

8.5 <u>Investment Counterparty criteria</u>
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”. 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 the 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 Both Fitch and Moody’s provide “standalone” credit ratings for financial institutions. For Fitch, it is the Viability Rating, while Moody’s has the Financial Strength Rating. Due to the future removal of sovereign support from institution assessments, both agencies have suggested going forward that these will be in line with their respective Long Term ratings. As such, there is no point monitoring both Long Term and these “standalone” ratings.

8.8 Furthermore, 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.

8.9 As a result of these rating agency changes, the credit element of our 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 we have always taken, but a change to the use of Fitch and Moody’s ratings. Furthermore, we will continue to utilise CDS prices as an overlay to ratings in our new methodology.

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 2014/2015.

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 risks in the interest rate forecast, and appendix 3 addresses the risk to security, liquidity and yield of the Council’s investment strategy.

11. Background Papers

Treasury Management Strategy for 2014/2015 – Cabinet, 12 February 2014 [report FIN/323 refers]

Quarterly Budget Monitoring 2014/2015 Quarter 2 – Cabinet, 12 November 2014 [report FIN/347 refers]

Budget and Council Tax for 2014/15 - Cabinet, 12 February 2014 [report FIN/328 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

Report author and contact officer: Paul Windust, Corporate Accounting and Treasury Services Manager (01293 438693)

Economic performance to date and outlook

U.K.

After strong UK GDP quarterly growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, (2013 annual rate 2.7%), and 0.7% in Q1, 0.9% in Q2 and a first estimate of 0.7% in Q3 2014 (annual rate 3.1% in Q3), it appears very likely that strong growth will continue through 2014 and into 2015 as forward surveys for the services and construction sectors, are very encouraging and business investment is also strongly recovering. The manufacturing sector has also been encouraging though the latest figures indicate a weakening in the future trend rate of growth. However, for this recovery to become more balanced and sustainable in the longer term, the recovery 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 lacklustre performance. This overall strong growth has resulted in unemployment falling much faster through the initial 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, subsequently 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. The MPC is particularly concerned that the current squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back above the level of inflation in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity, which has languished at dismal levels since 2008, to support increases in pay rates. 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.

Also encouraging has been the sharp fall in inflation (CPI), reaching 1.2% in September, the lowest rate since 2009. Forward indications are that inflation is likely to fall further in 2014 to possibly 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 slow pace to lower levels than prevailed before 2008 as increases in Bank Rate will have a much bigger effect on heavily indebted consumers than they did before 2008.

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.

U.S.

In September, the Federal Reserve continued with its monthly $10bn reductions in asset purchases, which started in December 2013. Asset purchases have now fallen from $85bn to $15bn and are expected to stop on 29th October 2014, providing the economic outlook remains strong. First quarter GDP figures for the US were depressed by exceptionally bad winter weather, but growth rebounded very strongly in Q2 to 4.6% (annualised).

The U.S. 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 the weak labour force participation rate remains a matter of key concern for the Federal Reserve when considering the amount of slack in the economy and monetary policy decisions.

Eurozone

The Eurozone is facing an increasing threat from weak or negative growth and from deflation. In September, the inflation rate fell further, to reach a low of 0.3%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the ECB took 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).

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, (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 for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed.

China and Japan

Japan is causing considerable concern as the increase in sales tax in April has suppressed consumer expenditure and growth. In Q2 growth was -1.8% q/q and -7.1% over the previous year. The Government is hoping that this is a temporary blip.

As for China, Government action in 2014 to stimulate the economy appeared to be putting the target of 7.5% growth within achievable reach but recent data has raised fresh concerns. There are also major concerns as to the creditworthiness of much bank lending to corporates and local government during the post 2008 credit expansion period and whether the bursting of a bubble in housing prices is drawing nearer.

Interest rate forecast – risks

Upside risks

- A further surge in investor confidence that robust world economic growth is firmly expected, causing a flow of funds out of bonds and into equities.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Downsize risks

- The situation over Ukraine poses a major threat to EZ and world growth if it was to deteriorate into economic warfare between the West and Russia where Russia resorted to using its control over gas supplies to Europe.
- Fears generated by the potential impact of Ebola around the world
- UK strong economic growth is currently mainly dependent on consumer spending and the potentially unsustainable boom in the housing market. The boost from these sources is likely to fade after 2014.
- A weak rebalancing of UK growth to exporting and business investment causing a weakening of overall economic growth beyond 2014.
- Weak growth or recession in the UK's main trading partner - the EU, inhibiting economic recovery in the UK.
- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.

- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.
- Recapitalisation of European banks requiring more government financial support.
- Lack of support by populaces in Eurozone countries for 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.
- Italy: the political situation has improved but it remains to be seen whether the new government is able to deliver the austerity programme required and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.
- France: after being elected on an anti austerity platform, President Hollande has embraced a €50bn programme of public sector cuts over the next three years. However, there could be major obstacles in implementing this programme. Major overdue reforms of employment practices and an increase in competiveness are also urgently required to lift the economy out of stagnation.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Heightened political risks in the Middle East and East Asia could trigger safe haven flows back into bonds.
- There are also increasing concerns at the reluctance of western central banks to raise interest rates significantly for some years, plus the huge QE measures which remain in place (and may be added to by the ECB in the near future). This has created potentially unstable flows of liquidity searching for yield and, therefore, heightened the potential for an increase in risks in order to get higher returns. This is a return to a similar environment to the one which led to the 2008 financial crisis.

APPENDIX 2

Detailed holdings at 30 September 2014

	Total	Limit	Rating
UK Government	£7.19m	unlimited	AA+
Local Authorities			
Birmingham City Council	£5.00m	£15.00m	AA+
Cornwall Council	£5.00m	£15.00m	AA+
Kingston Upon Hull City Council	£5.00m	£15.00m	AA+
Lancashire County Council	£13.00m	£15.00m	AA+
London Borough of Enfield	£3.00m	£15.00m	AA+
Peterborough City Council	£4.00m	£15.00m	AA+
Thurrock Council	£5.50m	£15.00m	AA+
West Dunbartonshire Council	£2.00m	£15.00m	AA+
Worthing Borough Council	£5.00m	£15.00m	AA+
UK Banks			
Bank of Scotland plc	£2.10m	£15.00m	A
Barclays Bank	£5.02m	£10.00m	A
Royal Bank of Scotland	£5.00m	£15.00m	A
Santander UK Plc	£2.00m	£10.00m	A
Standard Chartered Bank	£9.00m	£10.00m	AA-
UK Building Societies			
Nationwide Building Society	£4.00m	£10.00m	A
Money Market Funds			
Ignis	£3.90m	£15.00m	AAA
Supranational			
European Investment Bank	£3.11m	unlimited	AAA
Overseas Banks			
DBS Bank	£6.00m	£10.00m	AA-
National Australia Bank	£5.10m	£10.00m	AA-
Nordea Group	£3.00m	£10.00m	AA-
Oversea Chinese Banking Corporation	£5.00m	£10.00m	AA-
Skandinaviska Enskilda Banken	£3.00m	£10.00m	A+
Svenska Handelsbanken	£2.70m	£10.00m	AA-
United Overseas Bank	£2.00m	£10.00m	AA-
	£115.62m		

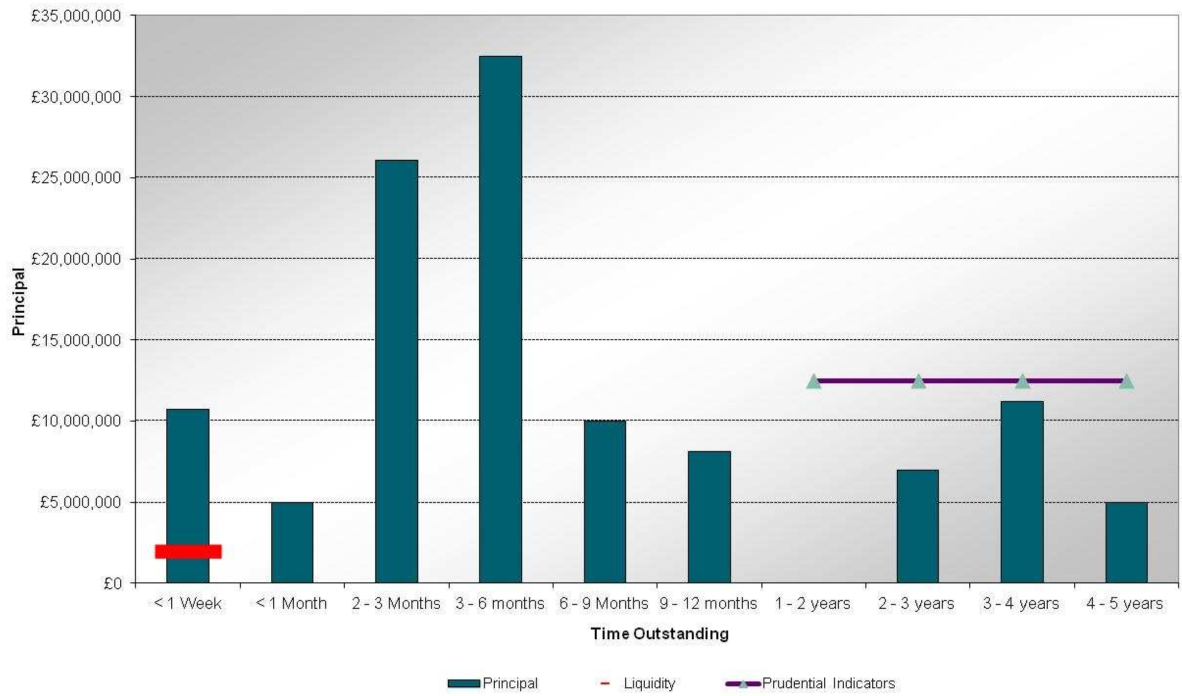
APPENDIX 3

Treasury Report for 30 September 2014

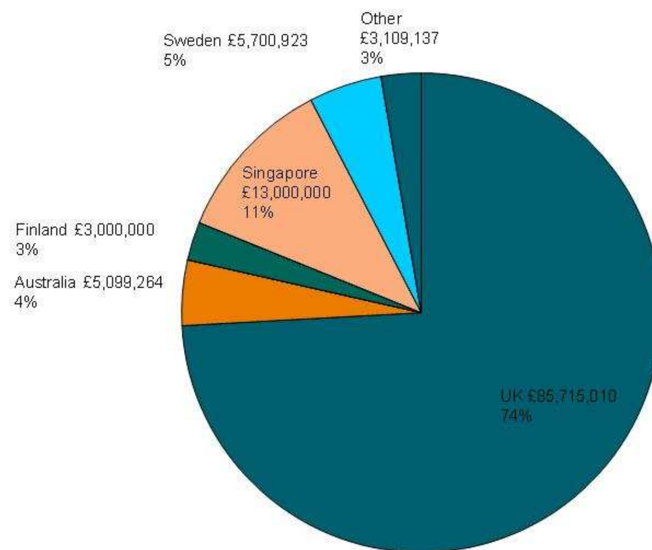
The following table shows the position at 30 September 2014 against the benchmarks set in the 2014/15 Treasury Strategy.

	Benchmark		Actual	
Liquidity				
Weighted Average Life (years)	Avg 1.20	Max 1.50	1.08	☑
Short-term deposits (<1 week’s notice)	>£2m		£10.7m	☑
Max sums invested >365 days	£50m		£23.2m	☑
Security				
Overall risk of default	0.15%		0.046%	☑
1 year	0.03%		0.009%	☑
2 years	0.22%		0.000%	☑
3 years	0.40%		0.283%	☑
4 years	0.56%		0.141%	☑
5 years	0.74%		0.188%	☑
Non-specified investments	70%		38%	☑
Yield	0.55%		1.09%	☑
Other				
Limit on fixed rate investments	£140m		£108.9m	☑
Limit on variable rate investments	£40m		£6.7m	☑
Limit on fixed rate debt	£270.3m		£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	☑

Compliance with Liquidity and Prudential Indicator Limits



Country Limits



Sector Diversification