Agenda item:

Decision maker: Cabinet

Subject: Treasury Management Monitoring Report for the Third Quarter of 2012/13

Date of decision: 24 January 2012 (Governance and Audit and Standards Committee)
4 February 2012 (Cabinet)

Report by: Head of Financial Services & Section 151 Officer

Wards affected: All

Key decision: No
Budget & policy framework decision: No

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1. Summary

The Chartered Institute of Public Finance and Accountancy (CIPFA) defines Treasury Management as "The management of the organisation's 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". The risks associated with treasury management include credit risk, liquidity risk, interest rate risk and refinancing risk. The report contained in Appendix A reports on the City Council's treasury management position as at 31 December 2012.

2. Purpose of report

The purpose of the report in Appendix A is to inform members and the wider community of the Council's Treasury Management position at 31 December 2012 and of the risks attached to that position.

3. Background

In March 2009 the CIPFA Treasury Management Panel issued a bulletin on Treasury Management in Local Authorities. The bulletin states that “in order to enshrine best practice it is suggested that authorities report formally on Treasury Management activities at least twice yearly and preferably quarterly”. The report in Appendix A covers the first nine months of 2012/13

4. Recommendations

That the following actual treasury management indicators for the third quarter of 2012/13 be noted:

(a) The Council’s net debt at 31 December 2012 was:

	Prudential Limit £m	**Quarter 3 Actual** £m
Gross Debt - Maximum	484	463
Investments - Minimum	(212)	(258)
Net Debt	**272**	**205**

(b) The Council’s debt at 31 December was as follows:

Prudential Indicator	**Limit** £M	**Actual** £M
Authorised Limit	508	463
Operational Boundary	484	463

(c) The maturity structure of the Council’s borrowing was

	Under 1 Year	**1 to 2 Years**	**3 to 5 Years**	**6 to 10 Years**	**11 to 20 Years**	**21 to 30 Years**	**31 to 40 Years**	**41 to 50 Years**
Lower Limit	0%	0%	0%	0%	0%	0%	0%	0%
Upper Limit	6%	6%	18%	30%	60%	60%	60%	80%
Actual	1%	4%	3%	5%	9%	12%	8%	58%

(d) The Council's sums invested for periods longer than 364 days at 31 December 2012 were:

	Prudential Limit £m	Quarter 3 Actual £m
Maturing after 31/3/2013	150	**96**
Maturing after 31/3/2014	90	**35**
Maturing after 31/3/2015	80	**15**

(e) The Council's fixed interest rate exposure at 31 December 2012 was £261m, ie. the Council had net fixed interest rate borrowing of £261m

(f) The Council's variable interest rate exposure at 31 December 2012 was (£160m), ie. the Council had net variable interest rate investments of £160m

5. Implications

The net cost of Treasury Management activities and the risks associated with those activities have a significant effect on the City Council's overall finances. Effective Treasury Management provides support to the organisation in the achievement of its business and service objectives.

6. Equality impact assessment (EIA)

A preliminary equalities impact assessment on Treasury Management Policy was carried out in March 2012.

7. City Solicitor's Comments

The Section 151 Officer is required by the Local Government Act 1972 and by the Accounts and Audit Regulations 2011 to ensure that the Council's budgeting, financial management, and accounting practices meet the relevant statutory and professional requirements. Members must have regard to and be aware of the wider duties placed on the Council by various statutes governing the conduct of its financial affairs.

8. Head of Finance's comments

All financial considerations are contained within the body of the report and the attached appendices

………………………………………………………………..
Signed by Head of Financial Services

Appendices:

Appendix A: Treasury Management Monitoring Report

Background list of documents: Section 100D of the Local Government Act 1972

The following documents disclose facts or matters, which have been relied upon to a material extent by the author in preparing this report:

	Title of document	Location
1	Treasury Management Files	Financial Services
2		

The recommendation(s) set out above were approved/ approved as amended/ deferred/ rejected by the Cabinet on 4 February 2012.

………………………………………………
Signed by: the Leader of the Council

APPENDIX A

TREASURY MANAGEMENT MONITORING REPORT FOR THE THIRD QUARTER OF 2012/13

1. GOVERNANCE

The Treasury Management Policy Statement, Annual Minimum Revenue Provision for Debt Repayment Statement and Annual Investment Strategy approved by the City Council on 20 March 2012 provide the framework within which treasury management activities are undertaken.

2. ECONOMIC BACKGROUND

During the year, the Bank of England has downgraded its forecasts concerning the speed and strength of recovery and is now only forecasting growth of 1% in 2013 and 2% in 2014. The Bank is still expecting a rebound in growth over the next two years as a result of:

- The impact of a further increase in quantitative easing (QE) in July 2012, taking the total from £325bn to £375bn
- The transfer of £35bn from the Bank to the Treasury representing the interest on the gilts it has bought. This has the same effect as a further £35bn of QE
- The introduction of the Funding for Lending scheme under which the Bank of England will make at least £80bn of cheap funding available to banks for on lending to households and companies.

However, there is still some concern that the Bank's forecasts for recovery could still turn out to be optimistic. The return to positive growth of 1% in the third quarter of 2012 followed three quarters of negative growth. Quarter 4 of 2012 could see a return to negative growth. Year on year growth to quarter 3 was 0%.

Mervyn King, the Governor of the Bank, has made some strong comments that the Bank will not cut the base rate to near 0% from 0.5% currently as he is of the view that this would actually make conditions in the economy worse, due to its adverse effects on savings rates and pension funds.

The troika of the Euro Zone governments, European Central Bank (ECB), and the IMF, have agreed to provide more support to tide Greece over as it struggles to hit its austerity targets. Although Greece is now less likely to be forced to leave the Euro zone, sovereign bond yields in both Spain and Italy rose sharply before the ECB stated it would provide unlimited support in buying government debt of countries that asked for a bailout. However, Spain is still prevaricating over asking for a bailout and the Italian Prime Minister has announced his resignation.

The UK faces a combination of stronger inflation and weaker growth. In addition, the Government is faced with a significant shortfall in reducing the annual budget deficit due to tax revenues not keeping pace with public expenditure increases, primarily benefits payments. The housing market also looks as if it will continue to be weak for a long time yet and the construction industry is contracting.

In summary, the Council's consultants, Sector Treasury Services, have the following concerns around a slowdown in prospects of GDP growth in the western world:

- <u>United States</u>

    - GDP growth is likely to remain weak at around 2% - but that is a lot better than the prospects for the UK and EU

    - The Federal Reserve is unlikely to increase the central interest rate until 2015

    - The fiscal cliff (budget deficit) urgently needs a long term resolution despite the potential for political gridlock between a Republican House of Representatives and Democrat President and Senate

    - The housing market is showing some signs of having turned a corner

- <u>European Union</u>

    - Austerity programmes in various Euro Zone countries are starting to show signs of having an effect in reducing growth rates in "core" Euro Zone countries

- United Kingdom

    - The Bank of England's November 2012 inflation report has again pushed back the timing of a return to trend growth and the rate at which inflation will fall back towards the target rate of 2%

    - A fair proportion of UK GDP is dependent on overseas trade; the high correlation of UK growth to US and EU GDP growth means that the UK economy is likely to register weak growth in the next two years

    - Consumers are likely to remain focused on paying down debt; inflation eroding disposable income, weak consumer sentiment and job fears will act to keep consumer expenditure suppressed

    - The government is hampered in promoting growth by the need to tackle the budget deficit

    - Alongside Euro zone concerns, there is potential for even more QE to keep gilt yields depressed during the next twelve months

- China

    - Increasing concerns that efforts to stimulate the economy could fail to avoid a hard landing. There are now many parts of the economy flashing distress signals.

3. INTEREST RATE FORECAST

We continue to be in uncertain times where event risk is, potentially, never far from occurring. The updated Sector forecast is based around an expectation that we are not heading into a disorderly break-up of the Euro zone, but rather a managed, albeit painful, resolution of the current crisis. Under this assumed scenario, growth within the Euro zone will be depressed for a couple of years and this would also lower UK growth as the EU is the UK's biggest export market.

These developments have pushed back Sector's expectations of the timing of the eventual start of increases in Bank Rate and the expected eventual rise in gilt yields and Public Works Loans Board (PWLB) rates.

Consequently, Sector now expects the first rise in Bank Rate to be in the first quarter of 2015.

Sector's PWLB forecasts are based around a balance of risks. Downside risks have already been covered. However, Sector flag up the potential for upside risks, especially for longer term PWLB rates, as follows:

- UK inflation being significantly higher than in the wider EU and US causing an increase in the inflation premium in gilt yields
- Reversal of QE; this could initially be allowing gilts held by the Bank to mature without reinvesting new purchases, followed later by outright sale of gilts currently held
- Reversal of Sterling's safe haven status on an improvement in financial stresses in the Euro zone
- Investors reverse de-risking by moving money from government bonds into shares in anticipation of a return to worldwide economic growth
- The possibility of a UK credit rating downgrade

PWLB rates and bond yields are difficult to predict as we are experiencing exceptional levels of volatility which are highly correlated to political developments in the sovereign debt crisis.

The Council's treasury advisor, Sector, provides the following forecast. PWLB rates are based on the new Certainty Rate.

	NOW	Mar 13	Jun 13	Sep 13	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14	Mar 15	Jun 15	Sep 15	Dec 15	Mar 16
BANK RATE	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25	1.50	1.75
5 yr PWLB	1.70	1.50	1.50	1.60	1.60	1.70	1.70	1.80	2.00	2.20	2.30	2.50	2.70	2.90
10 yr PWLB	2.64	2.50	2.50	2.60	2.60	2.70	2.70	2.80	3.00	3.20	3.30	3.50	3.70	3.90
25 yr PWLB	3.87	3.80	3.80	3.80	3.80	3.90	3.90	4.00	4.10	4.30	4.40	4.60	4.80	5.00
50 yr PWLB	4.03	4.00	4.00	4.00	4.00	4.10	4.10	4.20	4.30	4.50	4.60	4.80	5.00	5.20

4. GROSS AND NET DEBT

The Council's net borrowing position at 31 December 2012 was as follows:

	1 April 2012	31 December 2012
	£'000	£'000
Borrowing	361,524	359,006
Finance Leases	5,335	4,709
Service Concession Arrangements (including PFIs)	85,483	84,521
Transferred debt administered by HCC	15,079	14,452
Gross Debt	**467,421**	**462,688**
Investments	(238,637)	(258,149)
Net Debt	**228,784**	**204,539**
Limit for Net Debt	**272,053**	**272,053**

The Council has a high level of investments relative to its gross debt due to a high level of reserves, partly built up to meet future commitments under the Private Finance Initiative schemes and future capital expenditure. The £84m of borrowing taken in 2011/12 to take advantage of the very low PWLB rates has also temporarily increased the Council's cash balances.

The current high level of investments increases the Council's exposure to credit risk, ie. the risk that an approved borrower defaults on the Council's investment. In the interim period where investments are high because loans have been taken in advance of need, there is also a short term risk that the rates (and therefore the cost) at which money has been borrowed will be greater than the rates at which those loans can be invested. The level of investments will fall as capital expenditure is incurred and commitments under the Private Finance Initiative (PFI) schemes are met.

5. BORROWING ACTIVITY

No new borrowing was undertaken during the first three quarters of 2012/13.

The Council's debt at 31 December was as follows:

Prudential Indicator 2012/13	**Limit** £M	**Position at 31/12/12** £M
Authorised Limit	508	463
Operational Boundary	484	463

Interest rates across the interest rate yield curve generally fell during the first three quarters of 2012, but remain volatile. The low points were generally seen during the summer.

PWLB rates for the first three quarters of 2012/13

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.00%	1.52%	2.52%	3.81%	3.96%
Date	06/08/12	23/07/12	23/07/12	18/07/12	01/06/12
High	1.33%	2.15%	3.28%	4.39%	4.43%
Date	19/04/12	20/04/12	02/04/12	02/04/12	02/04/12
Average	1.18%	1.80%	2.80%	4.04%	4.20%

6. MATURITY STRUCTURE OF BORROWING

In recent years the cheapest loans have often been very long loans repayable at maturity.

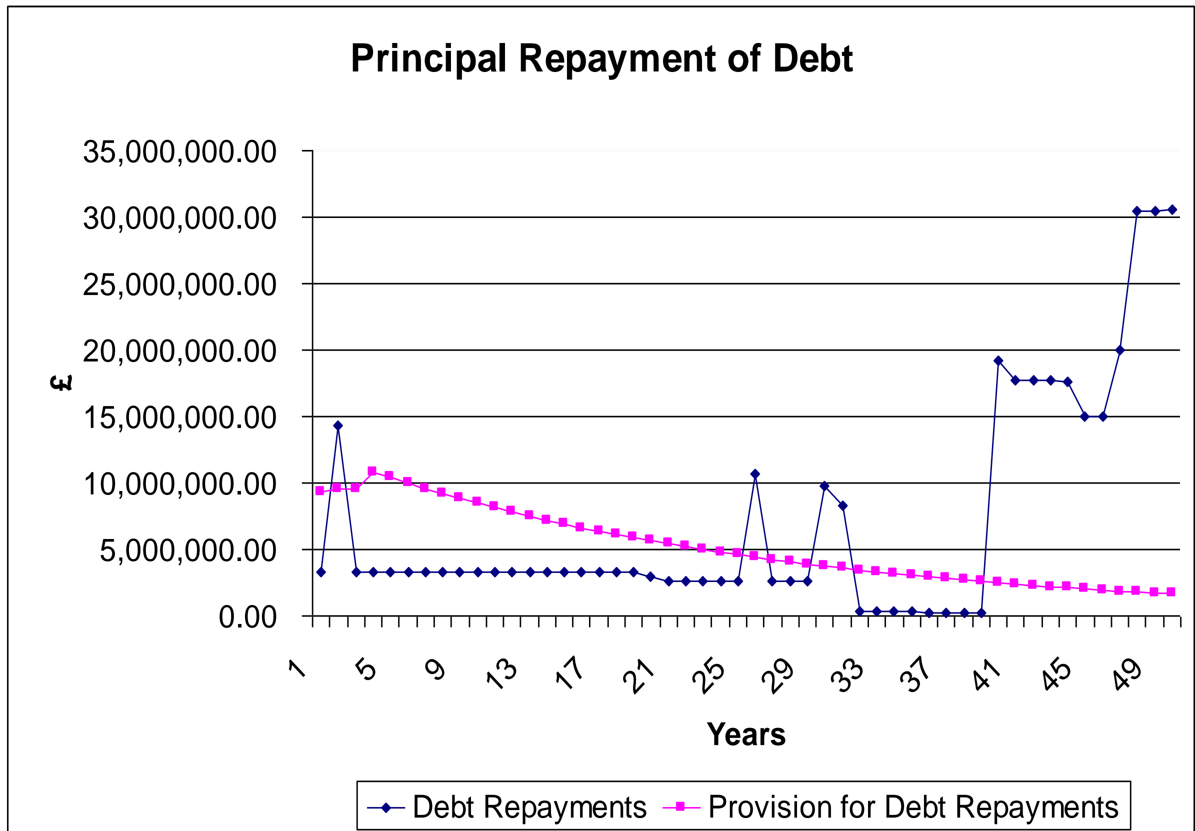
During 2007/08 the Council rescheduled £70.8m of debt. This involved repaying loans from the Public Works Loans Board (PWLB) early and taking out new loans from the PWLB with longer maturities ranging from 45 to 49 years. The effect of the debt restructuring was to reduce the annual interest payable on the Council's debt and to lengthen the maturity profile of the Council's debt.

£50m of new borrowing was taken in 2008/09 to finance capital expenditure. Funds were borrowed from the PWLB at fixed rates of between 4.45% and 4.60% for between 43 and 50 years.

A further £173m was borrowed in 2011/12 to finance capital expenditure and the HRA Self Financing payment to the Government. Funds were borrowed from the PWLB at rates of between 3.48% and 5.01%. £89m of this borrowing is repayable at maturity in excess of 48 years. The remaining £84m is repayable in equal instalments of principal over periods of between 20 and 31 years.

As a result of interest rates in 2007/08 when the City Council rescheduled much of its debt and interest rates in 2008/09 and 2011/12 when the City Council undertook considerable new borrowing 58% of the City Council's debt matures in over 40 years time.

The Government has issued guidance on making provision for the repayment of debt which the Council is legally obliged to have regard to. The City Council is required to make greater provision for the repayment of debt in earlier years. Therefore the City Council is required to provide for the repayment of debt well in advance of it becoming due. This is illustrated in graph below.



This means that it is necessary to invest the funds set aside for the repayment of debt with its attendant credit and interest rate risks (see sections 8 and 10). The City Council could reschedule its debt, but unless certain market conditions exist at the time, premium payments have to be made to lenders.

CIPFA's Treasury Management in the Public Services Code of Practice which the City Council is legally obliged to have regard to requires local authorities to set upper and lower limits for the maturity structure of their borrowing. The limits set by the City Council on 20 March together with the City Councils actual debt maturity pattern are shown below.

	Under 1 Year	**1 to 2 Years**	**3 to 5 Years**	**6 to 10 Years**	**11 to 20 Years**	**21 to 30 Years**	**31 to 40 Years**	**41 to 50 Years**
Lower Limit	0%	0%	0%	0%	0%	0%	0%	0%
Upper Limit	6%	6%	18%	30%	60%	60%	60%	80%
Actual	1%	4%	3%	5%	9%	12%	8%	58%

7. INVESTMENT ACTIVITY

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 Sections 2 and 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. The continuing Euro zone sovereign debt crisis, and its potential impact on banks, prompts a low risk strategy. Given this risk adverse environment, investment returns are likely to remain low.

The Council held £258m of investments as at 31 December 2012 (£239m at 31 March 2012) and the investment portfolio yield for the first eight months of the year is 0.97%.

The Council's budgeted investment return for 2012/13 is £2,212k, and performance for the year to date is £232k above budget.

8. SECURITY OF INVESTMENTS

The risk of default has been managed through investing only in financial institutions that meet minimum credit ratings, limiting investments in any institution to £20m and spreading investments over countries and sectors.

The 2012/13 Treasury Management Policy approved by the City Council on 20 March 2012 only permits deposits to be placed with the Council's subsidiaries, namely MMD (Shipping Services) Ltd, the United Kingdom Government, other local authorities, certain building societies and institutions that have the following credit ratings:

Short Term Rating

F2 (or equivalent) from Fitch, Moody's (P-3) or Standard and Poor (A-3)

Long Term Rating

Triple B (triple BBB category) or equivalent from Fitch, Moody's or Standard & Poor

Viability / Financial Strength Rating

bbb from Fitch or C- from Moody's

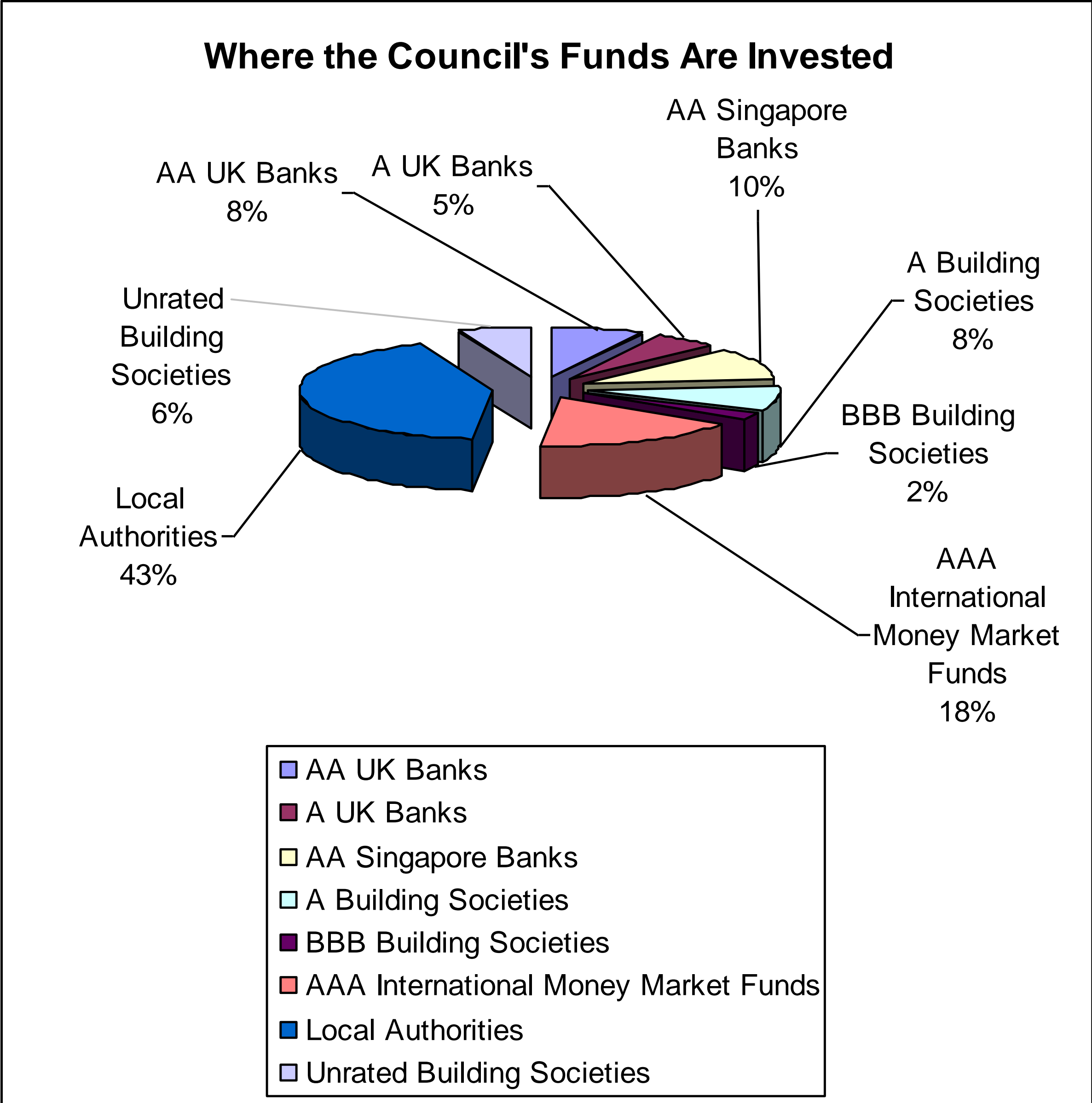
Support Rating

5 from Fitch

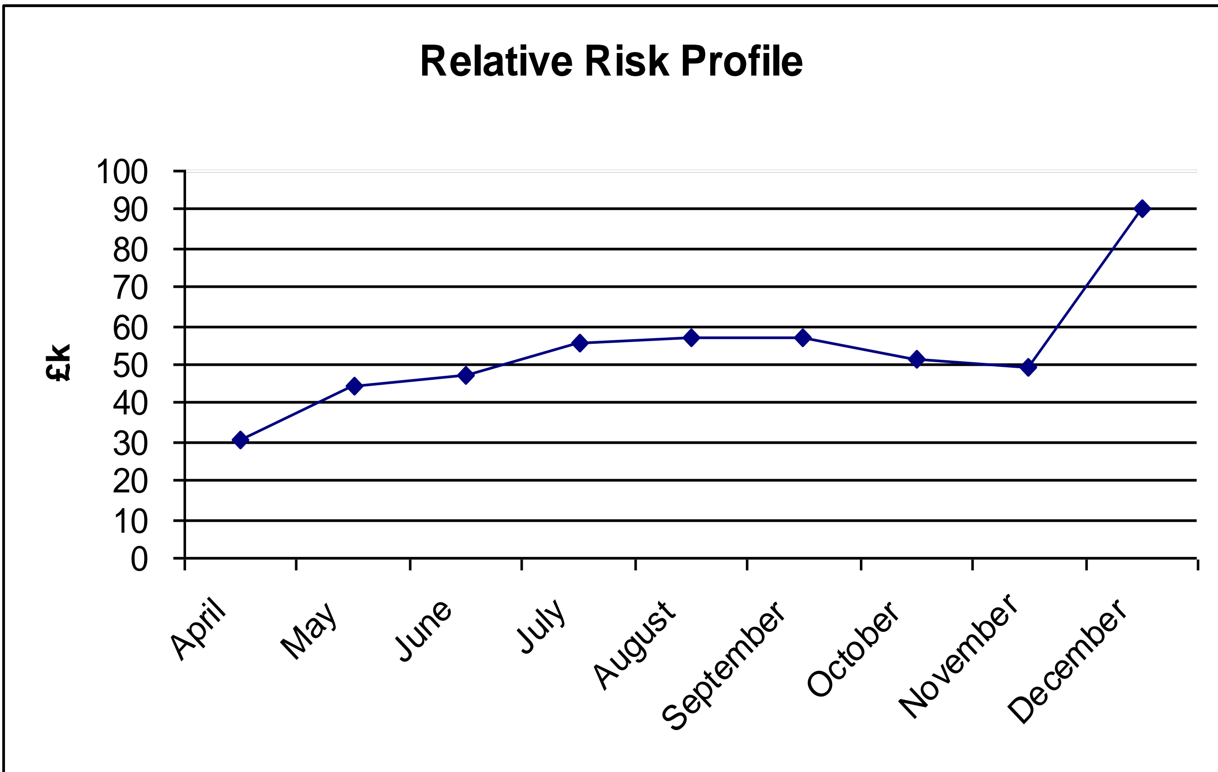
Under the Council's Annual Investment Strategy counter parties are categorised by their credit ratings for the purposes of assigning investment limits.

At 31 December 2012 the City Council had on average £7.6m invested with each institution.

The chart below summarises how the Council's funds were invested at 31 December.



The credit rating agencies publish default rates for each rating category. Multiplying these default rates by the amount invested in each credit rating category provides a measure of risk that can be used as a benchmark to determine whether the City Council's investment portfolio is becoming more or less risky over time as shown in the graph below.



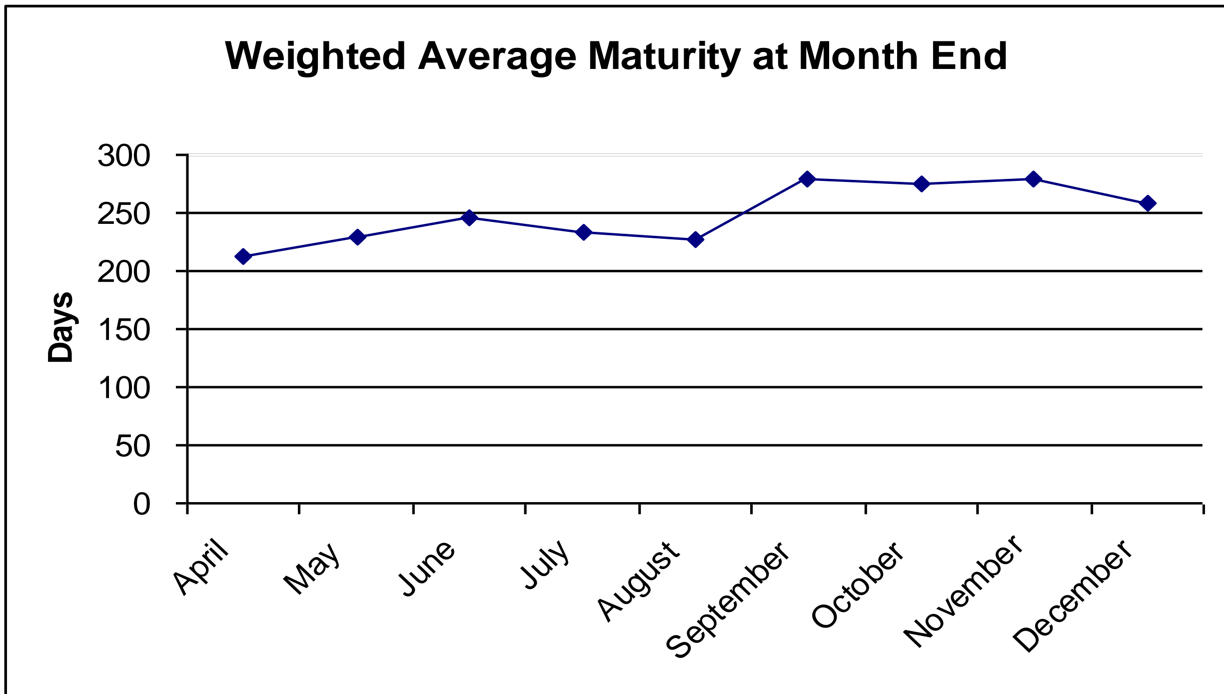
The City Council’s investment portfolio became relatively more risky over the first quarter of 2012/13. This is largely due to much less use being made of AAA rated money market funds that pay relatively low levels of interest. Reducing the use of money market funds is also likely to reduce the Council’s exposure to the Euro-zone.

There was a sharp increase in the riskiness of the investment portfolio in December. This is due to investments in unrated building societies which were added to the list of approved investments in the Mid Year Review. For the purposes of calculating the risk profile of the portfolio unrated building societies are assumed to be equivalent to a BBB-credit rating.

The above graph should be read in relative terms. A default occurs when sums due are not paid on time. A default does not mean that the sum invested will be lost permanently.

9. LIQUIDITY OF INVESTMENTS

The weighted average maturity of the City Council's investment portfolio started at 212 days in April and increased to 258 days in December as funds were available to invest longer to get a higher return. This is shown in the graph below.



The 2012/13 Treasury Management Policy seeks to maintain the liquidity of the portfolio, ie. the ability to liquidate investments to meet the Council's cash requirements, through maintaining at least £10m in instant access accounts. At 31 December £45.4m was invested in instant access accounts. Whilst short term investments provide liquidity and reduce the risk of default, they do also leave the Council exposed to falling interest rates.

Under CIPFA's Treasury Management Code it is necessary to specify limits on the amount of long term investments, ie. Investments exceeding 364 days that have maturities beyond year end in order to ensure that sufficient money can be called back to meet the Council's cash flow requirements. The Council's performance against the revised limits set by the City Council on 11 December 2012 is shown below.

Maturing after	**Limit** £m	**Actual** £m
31/3/2013	150	96
31/3/2014	90	35
31/3/2015	80	15

10. INTEREST RATE RISK

This is the risk that interest rates will move in a way that is adverse to the City Council's position.

The CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes require local authorities to set upper limits for fixed interest rate exposures. Fixed interest rate borrowing exposes the Council to the risk that interest rates could fall and the Council will pay more interest than it need have done. Long term fixed interest rate investments expose the Council to the risk that interest rates could rise and the Council will receive less income than it could have received. However fixed interest rate exposures do avoid the risk of budget variances caused by interest rate movements. The Council's performance against the limits set by the City Council on 20 March 2012 is shown below.

	Limit **£m**	**Actual** **£m**
Maximum Projected Gross Borrowing – Fixed Rate	378	359
Minimum Projected Gross Investments – Fixed Rate	-	(98)
Fixed Interest Rate Exposure	378	261

The CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes also require local authorities to set upper limits for variable interest rate exposures. Variable interest rate borrowing exposes the Council to the risk that interest rates could rise and the Council's interest payments will increase. Short term and variable interest rate investments expose the Council to the risk that interest rates could fall and the Council's investment income will fall. Variable interest rate exposures carry the risk of budget variances caused by interest rate movements. The Council's performance against the limits set by the City Council on 20 March 2012 is shown below.

	Limit **£m**	**Actual** **£m**
Minimum Projected Gross Borrowing – Variable Rate	-	-
Maximum Projected Gross Investments – Variable Rate	(378)	(160)
Variable Interest Rate Exposure	(378)	(160)

The City Council is particularly exposed to interest rate risk because all the City Council's debt is made up of fixed rate long term loans, but most of the City Council's investments are short term. Future movements in the Bank Base Rate tend to affect the return on the Council's investments, but leave fixed rate long term loan payments unchanged.

The risk of a 0.5% increase in interest rates to the Council is as follows:

Effect of +/- 0.5% Rate Change	**2012/13** **£'000**	**2013/14** **£'000**	**2014/15** **£'000**	**2015/16** **£'000**
Long Term Borrowing	-	2	55	55
Investment Interest	(54)	(853)	(1,023)	(1,041)
Net Effect of +/- 0.5% Rate Change	**(54)**	**(851)**	**(968)**	**(986)**