Decision maker:	Cabinet City Council
Subject:	Treasury Management Mid Year Review for 2013/14
Date of decision:	7 November 2013 (Governance, Audit & Standards Committee – Information only) 2 December 2013 (Cabinet) 10 December 2013 (City Council)
Report by:	Chris Ward, Head of Financial Services and Section 151 Officer
Wards affected:	All

Key decision:	No
Budget & policy framework decision:	Yes

---

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 30 September 2013. Appendix B contains proposed changes to the Council's approved investments.

2. Purpose of report

The purpose of the report is to inform members and the wider community of the Council's Treasury Management position at 30 September 2013 and of the risks attached to that position, and to revise the list of approved investments.

3. Recommendations

1. That the following actual Treasury Management indicators for the second quarter of 2013/14 be noted:

(a) The Council's debt at 30 September was as follows:

Prudential Indicator 2013/14	Limit £M	Position at 30/9/13 £M
Authorised Limit	469	444
Operational Boundary	447	444

(b) 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	25%	25%	25%	25%	30%	30%	30%	70%
Actual	4%	1%	3%	5%	9%	13%	11%	54%

(c) The Council's interest rate exposures at 30 September 2013 were:

	Limit £m	Actual £m
Fixed Interest	320	258
Variable Interest	(320)	(163)

(d) Sums invested for periods longer than 364 days at 30 September 2013 were:

Maturing after	Original Limit £m	Actual £m
31/3/2014	218	87
31/3/2015	208	45
31/3/2016	198	30

2. That the investment limit for registered social landlords (RSLs) be set at £80m in total.

3. That investments be placed with RSLs on the basis of a single credit rating. (A credit rating from at least two credit rating agencies will be required for other institutions).

4. That investment counter party limits and duration limits be amended as shown in the table below:

	Current Maximum Investment in a Single Organisation	**Recommended** Maximum Investment in a Single Organisation
Category 1 United Kingdom Government including the Debt Management Office Deposit Facility	Unlimited investments for up to 5 years	Unlimited investments for up to 5 years
Category 2 Local authorities in England, Scotland and Wales	£20m for up to 5 years	£26m for up to 5 years
Category 3 Banks with a short term credit rating of F1+ and a long term rating of Aa-. Aaa rated money market funds	£20m for up to 732 days	£26m for up to 5 years
Category 4 Banks with a short term credit rating of F1 and a long term rating of A+. Building societies with a short term credit rating of F1 and a long term rating of A. Corporate bonds with a long term credit rating of Aa-	£15m for up to 732 days	£19m for up to 5 years for banks and building societies. £19m for up to 4 years for corporate bonds.
Category 5 Banks with a short term credit rating of F1 and a long term rating of A. Building societies with a short term credit rating of F1 and a long term rating of A-. Corporate bonds with a long term credit rating of A+	£13m for up to 364 days	£13m for up to 5 years for banks and building societies. £13m for up to 4 years for corporate bonds.
Category 6 Banks with a short term credit rating of F1 and a long term rating of A-. Corporate bonds with a long term credit rating of A	£10m for up to 364 days	£10m for up to 5 years for banks. £10m for up to 4 years for corporate bonds.
Category 7 Corporate bonds with a long term credit rating of A-	£6m for up to 364 days	£6m for up to 4 years

	Current Maximum Investment in a Single Organisation	**Recommended** Maximum Investment in a Single Organisation
Category 8 Building societies with a BBB credit rating	£10m for up to 364 days	£10m for up to 364 days
Category 9 Building societies with single credit rating and unrated building societies	£6m for up to 364 days. Smaller building societies have lower investment limits.	£6m for up to 364 days. Smaller building societies have lower investment limits.
Category 10 Banks with a short term credit rating of F3 and a long term rating of Bbb-	£6m for up to 95 days.	No investments permitted
Category 11 RSLs with a double A long term credit rating	New Category	£26m for up to 5 years or 10 years if secured
Category 12 RSLs with a single A long term credit rating	New Category	£20m for up to 5 years or 10 years if secured

5. That the Council resumes investing in the Euro zone.

4. Background

CIPFA's Treasury Management Code requires a Treasury Management Mid Year Review to be considered by the City Council. The report in Appendix A covers the first six months of 2013/14.

5. Reasons for Recommendations

It is felt that the risk climate has improved and the proposals within this report also seek to diversify the Council's approved counter party list.

Some of the fears surrounding the continued existence of the Eurozone have now subsided following the decision by the European Central Bank to announce unlimited support for Governments who request external aid. Although no country has, as yet, sought help, just the offer of such backing has seen yields on peripheral government bonds fall back materially.

There were two major UK funding announcements in 2012. The first was the Extended Collateral Term Repo facility which provided institutions, via regular auctions, with access to 6 month funding at Bank Rate plus 0.25%. The second was the Funding for Lending Scheme (FLS) which also allowed financial institutions access to low cost funding for an extended period. Returns on cash deposits declined quickly from June 2012 after the Bank of England announced the FLS. The FLS was designed to stimulate lending to individuals and companies by offering cheap funding to the banking sector. The influx of cheap Bank of England cash reduced banks' demand for cash from other sources and consequently placed downward pressure on market rates so that London Inter Bank bid rates (LIBID) are now 0.39% for 3 month deposits, 0.46% for 6 month deposits and 0.75% for 12 month deposits. Consequently the return on the Council's investments has fallen from 0.96% for 2012/13 to 0.62% for the first six months of 2013/14 as existing investments made prior to June 2012 mature and are replaced by new investments at the lower rates now prevailing. In order to obtain better interest rates it is necessary to invest beyond the duration of the FLS.

Increasing the overall duration of the investment portfolio will increase risk, but it is felt that the risk of financial institutions collapsing is much reduced compared to during the height of the banking crisis. Increasing the duration of the investment portfolio will also enable risks to be spread over more sectors of the economy including registered social landlords (RSLs) and commercial companies through investments in corporate bonds.

There is currently a duration limit of 732 days for banks with a double A credit rating and 364 days for banks with a single A credit rating. The current duration limits for building societies are 732 days for societies with a credit rating of Aa or A+, and 364 days for societies with a credit rating of less than A+. It is recommended that the maximum duration of investments in banks and building societies with at least a single A credit rating be increased to five years.

Corporate bonds are tradable debt instruments issued by commercial companies. A corporate bond can be purchased from either the company that issued it or from another investor in the secondary market. Having purchased a corporate bond, the Council can either hold it to maturity and receive a fixed return or sell it to another investor prior to maturity. The market price of corporate bonds is influenced by movements in interest rates and the credit quality of the company that issued it. The Annual Investment Strategy approved by the City Council on 19 March 2013 allows for investments to be made in corporate bonds with a AA credit rating that mature within two years and corporate bonds with an A credit rating that mature within one year. On 30 September 2013 the Council held one corporate bond valued at £2.3m. In practice there has been an inadequate supply of corporate bonds of the credit quality and duration required by the existing Annual Investment Strategy. It is therefore recommended that the maximum duration for corporate bonds with at least a single A credit rating be increased to four years reflecting the lower likelihood of Government support in the event of a commercial company collapsing.

There are over 30 registered social landlords (RSLs) with a single or double A credit rating. RSLs are subject to Government regulation but their debts are not guaranteed by the Government. As RSLs own houses, lending to RSLs can be secured by a charge against the RSLs properties. However RSLs are normally only rated by one credit rating agency and typically borrow large amounts of money, £20m or more over a minimum of five to ten years. It is recommended that RSLs with a double A credit rating be given a counter party limit of £26m and that RSLs with a single A credit rating be given an investment limit of £20m. It is also recommended that investments be placed with RSLs that have a credit rating from a single credit rating agency. The requirement for other institutions would continue to be a minimum of two credit ratings from different agencies. It is recommended that the maximum duration of investments with RSLs be 5 years or 10 years if the investment is secured by a charge against the RSLs properties.

Published default rates suggest that the Council's current counter party limits for counter parties with a double A credit rating could prudently be increased. The global corporate average default rates (1981 to 2012) published by Standard and Poor suggest that a double A rated counter party is three times less likely to default than a single A rated counter party on a one year investment. The current Annual Investment Strategy provides a counter party limit of £13m for banks with an A credit rating. On this basis the counter party limit for banks with a double A credit rating could be increased to £39m. Whilst this would not increase the probability of a default, it would increase the severity of the consequences of a default as an investment in a double A rated bank could represent 15% of the Council's investment portfolio. It is therefore recommended that the counter party limit for double A rated banks be increased by £6m from £20m to £26m. This would represent 10% of the Council's investment portfolio at 30 September 2013. It is recommended that the counter party limit for triple A rated money market funds also be increased to £26m. It is also recommended that the counter party limit for banks with an A+ credit rating; building societies an A credit rating; and corporate bonds with an Aa- credit rating be increased by £4m from £15m to £19m.

It is currently the Council's practice not to place investments with institutions domiciled in the Euro zone. Whilst there are still risks arising from the sovereign debt crisis in the Euro zone, a degree of stability appears to have been achieved. Therefore it is recommended that the Council resumes investing in the Euro zone. This will increase the number of banks the Council can lend to and also increase the number of corporate bonds that will meet the Council's investment criteria. It is recommended that the Council continue to restrict its investments to institutions domiciled in countries with a sovereign credit rating of at least AA+. This will restrict the Council's investments in the Euro zone to the stronger economies such as Finland, France, Germany and the Netherlands.

When the Annual Investment Strategy was approved by the City Council on 19 March 2013 the Co-operative Bank's lowest short term credit rating was F3 and its lowest long term credit rating was Bbb from Fitch. In June Fitch downgraded the Co-operative Bank's short term credit rating to B and its long term rating to Bb-. The downgrade reflects the rating agencies concerns that the bank's capital requirements are greater than originally anticipated. The bank indicated that it required £1.5bn of additional capital – with the rating agency expecting £1bn to come from the bail-in of junior bondholders and the remaining £0.5bn from the Co-operative Group in 2014. Fitch also considers the negative reputational impact the press has had on the banking franchise, with depositor and investor confidence waning. The other credit agency that rates the Co-operative Bank, Moody's, has also down graded the bank to below investment grade. It is therefore recommended that the Council should not place investments with the Co-operative Bank. The Council's main current accounts are with the Co-operative Bank and there will be balances on these accounts although these should not exceed £300,000. The Council has no other funds placed with the Co-operative Bank.

The effect of the above recommendations on the Council's investment counter parties is shown in Appendix B.

6. Options considered and rejected

Returns could also be improved by investing in triple B rated banks, increasing investment limits with lower rated institutions, or investing in banks domiciled in countries that do not have a sovereign credit rating of at least Aa+.

Published default rates suggest that a triple B rated institution is substantially more likely to default than a single A rated institution. The global corporate average default rates (1981 to 2012) published by Standard and Poor suggest that a triple B rated counter party is three times more likely to default than a single A rated counter party on a one year investment. Triple B rated institutions typically pay around 0.1% more interest than single A rated institutions. It is felt that the additional 0.1% interest does not justify the additional risk.

It is recommended that the investment limits for double A rated corporate bonds, A+ rated banks and A rated building societies has been increased to better reflect published default rates with the proviso that investments in a single counter party should be limited to approximately 10% of the investment portfolio. However, increasing the investment limits of lower rated institutions would not be consistent with the published default rates, so no recommendations are made in this regard.

Investing in institutions domiciled in countries that do not have an AA+ sovereign credit rating could generate a return that is around 0.2% greater than an institution with a similar credit rating in a country that does have an AA+ sovereign credit rating. The additional risk attached to investing in institutions domiciled in countries that do not have an AA+ sovereign credit rating is difficult to quantify, but the removal of this criteria could result in funds being invested in non-core Euro zone counties exposing the Council to the economic weaknesses of those economies and funds being invested in politically volatile regions such as the Middle East.

Funds could also be invested in share capital or property through collective investment vehicles. However this is not recommended as it would put the capital sum at risk through movements in prices.

7. 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.

`

8. Equality impact assessment (EIA)

A preliminary equalities impact assessment on Treasury Management Policy has been carried out.

9. 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.

10. 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 & Section 151 Officer

Appendices:

Appendix A: Treasury Management Mid Year Review 2013/14
Appendix B: Investment Counter Party List

<u>Background list of documents: Section 100D of the Local Government Act 1972</u>

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 City Council on 10 December 2013.

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

APPENDIX A

TREASURY MANAGEMENT MID YEAR REVIEW OF 2013/14

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 19 March 2013 provide the framework within which Treasury Management activities are undertaken.

2. ECONOMIC UPDATE

The quarter ended 30 September saw indicators suggest that the economic recovery accelerated; household spending growth remaining robust; inflation falling back towards the 2% target; the Bank of England introduce state-contingent forward guidance; 10-year gilt yields rise to 3% at their peak and the FTSE 100 fall slightly to 6460; and the Federal Reserve decide to maintain the monthly rate of its asset purchases.

3. INTEREST RATE FORECAST

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

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

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

After the Bank of England's previous Inflation Report included a somewhat encouraging shift towards optimism in terms of a marginal upgrading of growth forecasts, the August Inflation Report was published in the midst of a welter of economic statistics which suggest a major simultaneous shift up in gear for the economy in all of the three sectors of services, manufacturing / industrial and construction. It is therefore not surprising that the Report upgraded growth forecasts for 2013 from 1.2% to 1.4% and for 2014 from 1.7% to 2.5%. However, Bank Governor Mark Carney put this into perspective by describing this welcome increase as not yet being “escape velocity” to ensure we return to strong and sustainable growth, after what has been the weakest recovery on record after a recession. As for inflation, it was forecast to be little changed from the previous Report – falling back to 2% within two years and staying there during year three.

In addition to the stimulus provided by Quantitative Easing (QE), the Funding for Lending Scheme (FLS) is aimed at encouraging banks to expand lending to small and medium size enterprises. The FLS certainly seems to be having a positive effect in terms of encouraging house purchases (though levels are still far below the pre-crisis level), and causing a significant increase in house prices – but only in London and the south east. The FLS is also due to be bolstered by the second phase of Help to Buy aimed to support purchasing of second hand properties, which is now due to start in October.

The Bank of England also issued forward guidance with the Inflation Report which said that the Bank will not start to consider raising interest rates until the jobless rate (Labour Force Survey (LFS) / International Labour Organisation (ILO), i.e. not the claimant count measure has fallen to 7% or below. This would require the creation of about 750,000 jobs and was forecast to take three years. The UK unemployment rate currently stands at 2.5 million i.e. 7.7 % on the LFS / ILO measure. The Bank's guidance is subject to three provisos, mainly around inflation; breaching any of them would sever the link between interest rates and unemployment levels. This actually makes forecasting Bank Rate much more complex given the lack of available reliable forecasts by economists over a three year plus horizon. The Capita Asset Services view is that the recession since 2007 was notable for how unemployment did not rise to the levels that would normally be expected in a major recession. The latest Inflation Report noted that productivity has sunk to 2005 levels. Capita Asset Services are, therefore, concerned that there has been a significant level of retention of labour, which will mean that a significant amount of GDP growth can be accommodated without a major reduction in unemployment.

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

Near-term, there is some residual risk of further QE - if there is a dip in strong growth or if the MPC takes action to do more QE in order to reverse the rapid increase in market rates, especially in gilt yields and interest rates up to 10 years. This could cause shorter-dated gilt yields and PWLB rates over the next year or two to significantly undershoot the forecasts. The failure in the US, over passing a Federal budget for the new financial year starting on 1 October, and the expected tension over raising the debt ceiling in mid October, could also see bond yields temporarily dip until any binding agreement is reached between the opposing Republican and Democrat sides. Conversely, the eventual start of tapering by the Fed could cause bond yields to rise.

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

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

Downside risks currently include:

- The conflict in the UK between market expectations of how quickly unemployment will fall as opposed to the Bank of England's forecasts
- Prolonged political disagreement over the US Federal Budget and raising the debt ceiling
- A return to weak economic growth in the US, UK and China causing major disappointment to investor and market expectations.
- The potential for a significant increase in negative reactions of populaces in Eurozone countries against austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- The Italian political situation is frail and unstable.
- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Weak growth or recession in the UK's main trading partners - the EU and US, depressing economic recovery in the UK.
- Geopolitical risks e.g. Syria, Iran, North Korea, which could trigger safe haven flows back into bonds

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

- A sharp upturn in investor confidence that sustainable robust world economic growth is firmly expected causing a surge in the flow of funds out of bonds into equities.
- A reversal of Sterling's safe-haven status on a sustainable improvement in financial stresses in the Eurozone.
- Further downgrading by credit rating agencies of the creditworthiness and credit rating of UK Government debt, consequent upon repeated failure to achieve fiscal correction targets and sustained recovery of economic growth which could result in the ratio of total government debt to GDP to rising to levels that undermine investor confidence in the UK and UK debt.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- In the longer term – an earlier than currently expected reversal of QE in the UK; this could initially be implemented by allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held.

4. NET DEBT

The Council's net borrowing position excluding accrued interest at 30 September 2013 was as follows:

	1 April 2013	30 September 2013
	£'000	£'000
Supported Borrowing	185,802	184,933
Housing Revenue Account (HRA) Self Financing (Unsupported)	85,665	85,264
Other Unsupported Borrowing	86,706	86,300
Sub Total - Borrowing	**358,173**	**356,497**
Finance Leases (Unsupported)	**4,538**	**4,176**
Private Finance Initiative (PFI) Schemes (Supported)	73,349	73,240
Waste Disposal Service Concession Arrangement (Unsupported)	10,872	10,558
Sub Total Service Concession Arrangements (including PFIs)	**84,221**	**83,798**
Gross Debt	**446,932**	**444,471**
Investments	(246,068)	(260,969)
Net Debt	**200,864**	**183,502**

Prior to 1 April 2004 local authorities were only permitted to borrow to the extent that the Government had granted credit approvals. When the Government granted credit approvals it also increased the Council's revenue grant to cover most of the cost of the resulting borrowing. This is known as supported borrowing and accounts for £185m (or 52%) of total borrowing.

From 1 April 2004 the Council was permitted to borrow without government support, known as unsupported borrowing. On 28 March 2012 the Council made a capital payment of £88.6m to the Government under the HRA Self Financing arrangements in order to avoid future and greater payments to the Government. This was funded by unsupported borrowing.

Revenue grants from the Government also cover most of the £73m financing element of the Milton Cross School, highways and learning disabilities facilities private finance initiative (PFI) schemes.

In essence the Government funds most of the financing costs associated with 58% of the Council's debt.

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. However these reserves are fully committed and are not available to fund new 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.

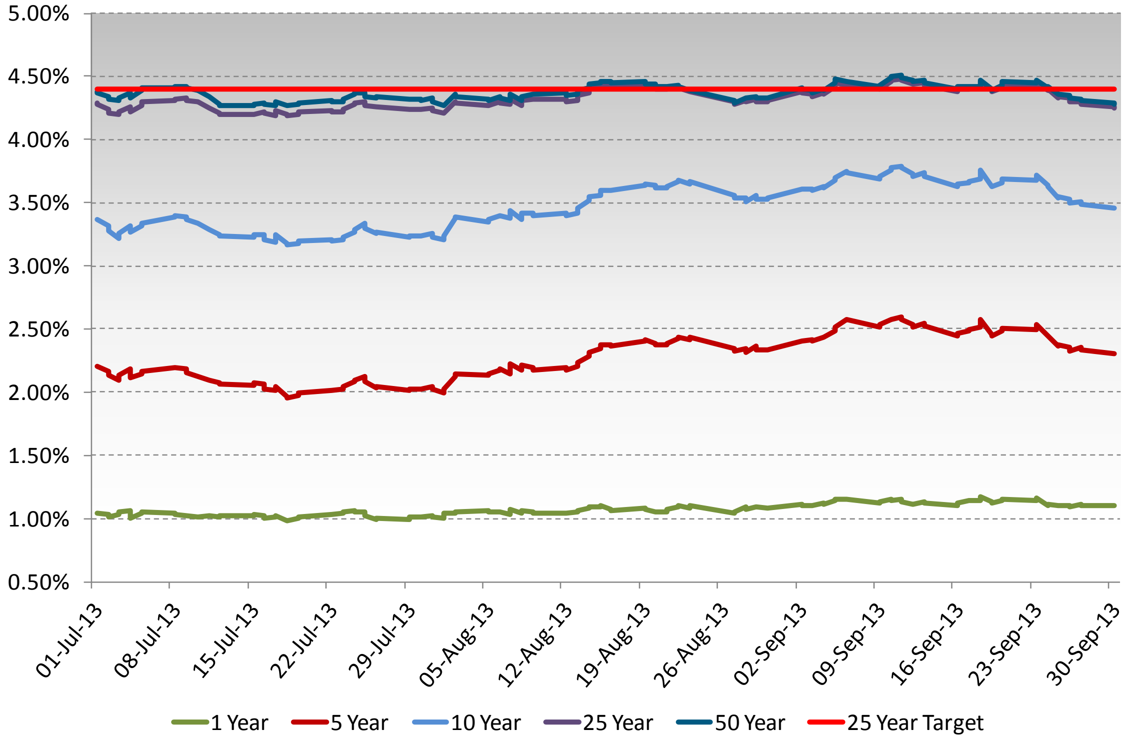
5. DEBT RESCHEDULING

Under certain circumstances it could be beneficial to use the Council's investments to repay its debt. However this normally entails paying a premium to the lender, namely the Public Works Loans Board (PWLB). Debt rescheduling is only beneficial to the revenue account when the benefits of reduced net interest payments exceed the cost of any premiums payable to the lender. Debt rescheduling opportunities have been limited in the current economic climate and by the structure of interest rates following increases in PWLB new borrowing rates in October 2010.

No debt rescheduling was undertaken during the first half of the year.

6. BORROWING ACTIVITY

The graph below shows the movement in PWLB rates for the first six months of the year:



PWLB certainty rates, quarter ended 30th September 2013

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.98%	1.95%	3.17%	4.19%	4.27%
Date	18/07/2013	18/07/2013	18/07/2013	18/07/2013	18/07/2013
High	1.17%	2.6%	3.79%	4.48%	4.51%
Date	18/09/2013	11/09/2013	11/09/2013	11/09/2013	11/09/2013
Average	1.07%	2.27%	3.47%	4.32%	4.37%

No borrowing has been undertaken in the first six months of 2013/14.

The Council's debt at 30 September was as follows:

Prudential Indicator 2012/13	**Limit** £M	**Position at 30/9/12** £M
Authorised Limit	469	444
Operational Boundary	447	444

It is anticipated that further borrowing will not be undertaken during this financial year.

7. MATURITY STRUCTURE OF BORROWING

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

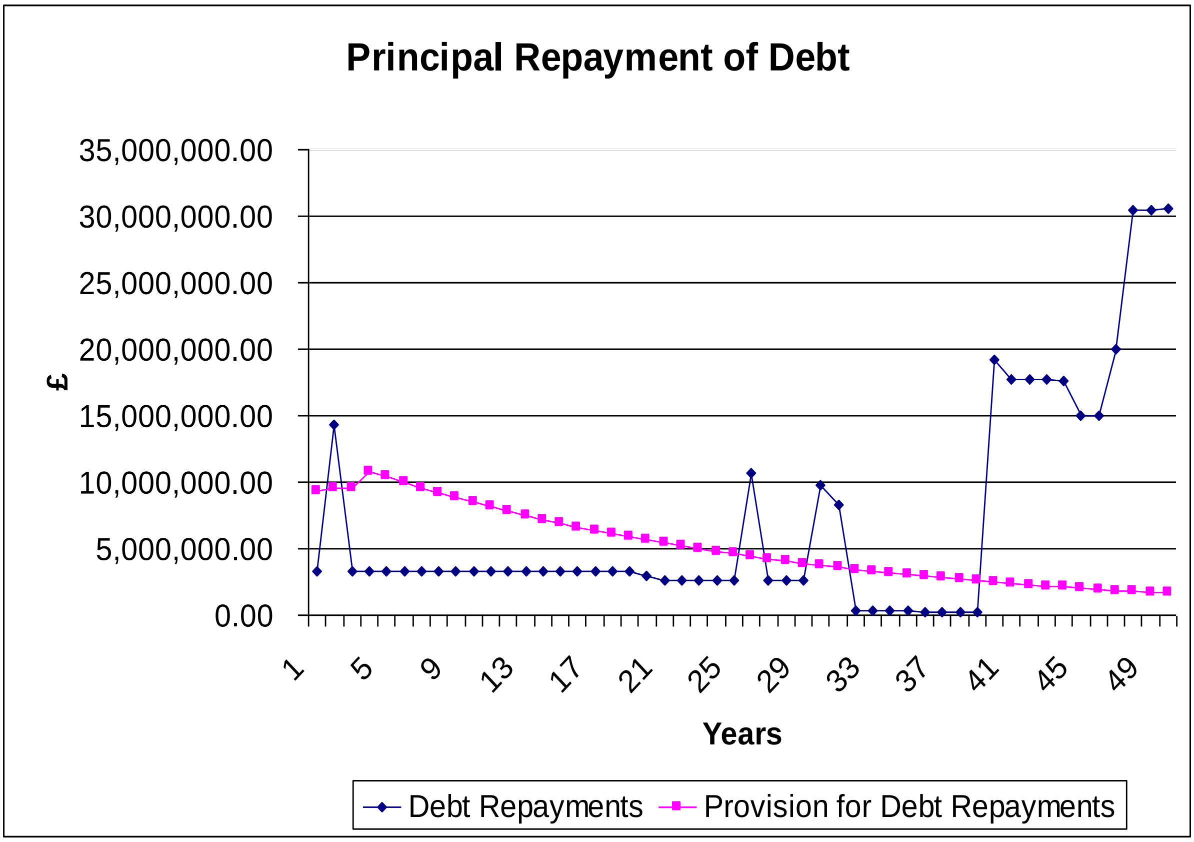
During 2007/08 the Council rescheduled £70.8m of debt. This involved repaying loans from the Public Works Loans Board (PWLB) early and taking out new loans from the PWLB with longer maturities ranging from 45 to 49 years. The effect of the debt restructuring was to reduce the annual interest payable 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 installments 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 54% 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 10 and 12). 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 19 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	25%	25%	25%	25%	30%	30%	30%	70%
Actual	4%	1%	3%	5%	9%	13%	11%	54%

8. INVESTMENT ACTIVITY

Investment rates available in the market have continued at historically low levels and have fallen further during the quarter as a result of the Funding for Lending Scheme.

The Council held £261m of investments as at 30 September 2013 (£246m at 1 April 2013). Returns on cash deposits declined quickly from June 2012 after the Bank of England announced the Funding for Lending Scheme (FLS). The FLS was designed to stimulate lending to individuals and companies by offering cheap funding to the banking sector. The influx of cheap Bank of England cash reduced banks' demand for cash from other sources and consequently placed downward pressure on market rates so that London Inter Bank bid rates (LIBID) are now 0.39% for 3 month deposits, 0.46% for 6 month deposits and 0.75% for 12 month deposits. Consequently the return on the Council's investments has fallen from 0.96% in 2012/13 to 0.62% for the first six months of 2013/14 as existing investments made prior to June 2012 mature and are replaced by new investments at the lower rates now prevailing.

The Council's budgeted investment return for 2013/14 is £1,646k, and performance for the year to date is £42k above budget.

9. INVESTMENT COUNTER PARTY CRITERIA

It is felt that the risk climate has improved and the proposals within this report also seek to diversify the Council's approved counter party list.

Some of the fears surrounding the continued existence of the Eurozone have now subsided following the decision by the European Central Bank to announce unlimited support for Governments who request external aid. Although no country has, as yet, sought help, just the offer of such backing has seen yields on peripheral government bonds fall back materially.

There were two major UK funding announcements in 2012. The first was the Extended Collateral Term Repo facility which provided institutions, via regular auctions, with access to 6 month funding at Bank Rate plus 0.25%. The second was the Funding for Lending Scheme (FLS) which also allowed financial institutions access to low cost funding for an extended period. Returns on cash deposits declined quickly from June 2012 after the Bank of England announced the FLS. The FLS was designed to stimulate lending to individuals and companies by offering cheap funding to the banking sector. The influx of cheap Bank of England cash reduced banks' demand for cash from other sources and consequently placed downward pressure on market rates so that London Inter Bank bid rates (LIBID) are now 0.39% for 3 month deposits, 0.46% for 6 month deposits and 0.75% for 12 month deposits. Consequently the return on the Council's investments has fallen from 0.96% for 2012/13 to 0.62% for the first six months of 2013/14 as existing investments made prior to June 2012 mature and are replaced by new investments at the lower rates now prevailing. In order to obtain better interest rates it is necessary to invest beyond the duration of the FLS.

Increasing the overall duration of the investment portfolio will increase risk, but it is felt that the risk of financial institutions collapsing is much reduced compared to during the height of the banking crisis. Increasing the duration of the investment portfolio will also enable risks to be spread over more sectors of the economy including registered social landlords (RSLs) and commercial companies through investments in corporate bonds.

There is currently a duration limit of 732 days for banks with a double A credit rating and 364 days for banks with a single A credit rating. The current duration limits for building societies are 732 days for societies with a credit rating of Aa or A+, and 364 days for societies with a credit rating of less than A+. It is recommended that the maximum duration of investments in banks and building societies with at least a single A credit rating be increased to five years.

Corporate bonds are tradable debt instruments issued by commercial companies. A corporate bond can be purchased from either the company that issued it or from another investor in the secondary market. Having purchased a corporate bond, the Council can either hold it to maturity and receive a fixed return or sell it to another investor prior to maturity. The market price of corporate bonds is influenced by movements in interest rates and the credit quality of the company that issued it. The Annual Investment Strategy approved by the City Council on 19 March 2013 allows for investments to be made in corporate bonds with a AA credit rating that mature within two years and corporate bonds with an A credit rating that mature within one year. On 30 September 2013 the Council held one corporate bond valued at £2.3m. In practice there has been an inadequate supply of corporate bonds of the credit quality and duration required by the existing Annual Investment Strategy. It is therefore recommended that the maximum duration for corporate bonds with at least a single A credit rating be increased to four years reflecting the lower likelihood of Government support in the event of a commercial company collapsing.

There are over 30 registered social landlords (RSLs) with a single or double A credit rating. RSLs are subject to Government regulation but their debts are not guaranteed by the Government. As RSLs own houses, lending to RSLs can be secured by a charge against the RSLs properties. However RSLs are normally only rated by one credit rating agency and typically borrow large amounts of money, £20m or more over a minimum of five to ten years. It is recommended that RSLs with a double A credit rating be given a counter party limit of £26m and that RSLs with a single A credit rating be given an investment limit of £20m. It is also recommended that investments be placed with RSLs that have a credit rating from a single credit rating agency. The requirement for other institutions would continue to be a minimum of two credit ratings from different agencies. It is recommended that the maximum duration of investments with RSLs be 5 years or 10 years if the investment is secured by a charge against the RSLs properties.

The extent to which the duration of the investment portfolio can be increased will be determined by the Council's cash flows. The Government's statutory Guidance on Investments requires the Council to consider the security, liquidity and yield of investments in that order. The extent to which the duration of the investment portfolio can be increased will be determined by the Council's future cash requirements.

Published default rates suggest that the Council's current counter party limits for counter parties with a double A credit rating could prudently be increased. The global corporate average default rates (1981 to 2012) published by Standard and Poor suggest that a double A rated counter party is three times less likely to default than a single A rated counter party on a one year investment. The current Annual Investment Strategy provides a counter party limit of £13m for banks with an A credit rating. On this basis the counter party limit for banks with a double A credit rating could be increased to £39m. Whilst this would not increase the probability of a default, it would increase the severity of the consequences of a default as an investment in a double A rated bank could represent 15% of the Council's investment portfolio. It is therefore recommended that the counter party limit for double A rated banks be increased by £6m from £20m to £26m. This would represent 10% of the Council's investment portfolio at 30 September 2013. It is recommended that the counter party limit for triple A rated money market funds also be increased to £26m. It is also recommended that the counter party limit for banks with an A+ credit rating; building societies an A credit rating; and corporate bonds with an Aa- credit rating be increased by £4m from £15m to £19m.

It is currently the Council's practice not to place investments with institutions domiciled in the Euro zone. Whilst there are still risks arising from the sovereign debt crisis in the Euro zone, a degree of stability appears to have been achieved. Therefore it is recommended that the Council resumes investing in the Euro zone. This will increase the number of banks the Council can lend to and also increase the number of corporate bonds that will meet the Council's investment criteria. It is recommended that the Council continue to restrict its investments to institutions domiciled in countries with a sovereign credit rating of at least AA+. This will restrict the Council's investments in the Euro zone to the stronger economies such as Finland, France, Germany and the Netherlands.

When the Annual Investment Strategy was approved by the City Council on 19 March 2013 the Co-operative Bank's lowest short term credit rating was F3 and its lowest long term credit rating was Bbb from Fitch. In June Fitch downgraded the Co-operative Bank's short term credit rating to B and its long term rating to Bb-. The downgrade reflects the rating agencies concerns that the bank's capital requirements are greater than originally anticipated. The bank indicated that it required £1.5bn of additional capital – with the rating agency expecting £1bn to come from a bail-in of junior bondholders and the remaining £0.5bn from the Co-operative Group in 2014. Fitch also considers the negative reputational impact the press has had on the banking franchise, with depositor and investor confidence waning. The other credit agency that rates the Co-operative Bank, Moody's, has also down graded the bank to below investment grade. It is therefore recommended that the Council should not place investments with the Co-operative Bank. The Council's main current accounts are with the Co-operative Bank and there will be balances on these accounts although these should not exceed £300,000. The Council has no other funds placed with the Co-operative Bank.

The effect of the above recommendations on the Council's investment counter parties is shown in Appendix B.

Returns could also be improved by investing in triple B rated banks, increasing investment limits with lower rated institutions, or investing in banks domiciled in countries that do not have a sovereign credit rating of at least Aa+.

Published default rates suggest that a triple B rated institution is substantially more likely to default than a single A rated institution. The global corporate average default rates (1981 to 2012) published by Standard and Poor suggest that a triple B rated counter party is three times more likely to default than a single A rated counter party on a one year investment. Triple B rated institutions typically pay around 0.1% more interest than single A rated institutions. It is felt that the additional 0.1% interest does not justify the additional risk.

It is recommended that the investment limits for double A rated corporate bonds, A+ rated banks and A rated building societies be increased to better reflect published default rates with the proviso that investments in a single counter party should be limited to approximately 10% of the investment portfolio. However, increasing the investment limits of lower rated institutions would not be consistent with the published default rates, so no recommendations are made in this regard.

Investing in institutions domiciled in countries that do not have an AA+ sovereign credit rating could generate a return that is around 0.2% greater than an institution with a similar credit rating in a country that does have an AA+ sovereign credit rating. The additional risk attached to investing in institutions domiciled in countries that do not have an AA+ sovereign credit rating is difficult to quantify, but the removal of this criteria could result in funds being invested in non-core Euro zone counties exposing the Council to the economic weaknesses of those economies and funds being invested in politically volatile regions such as the Middle East.

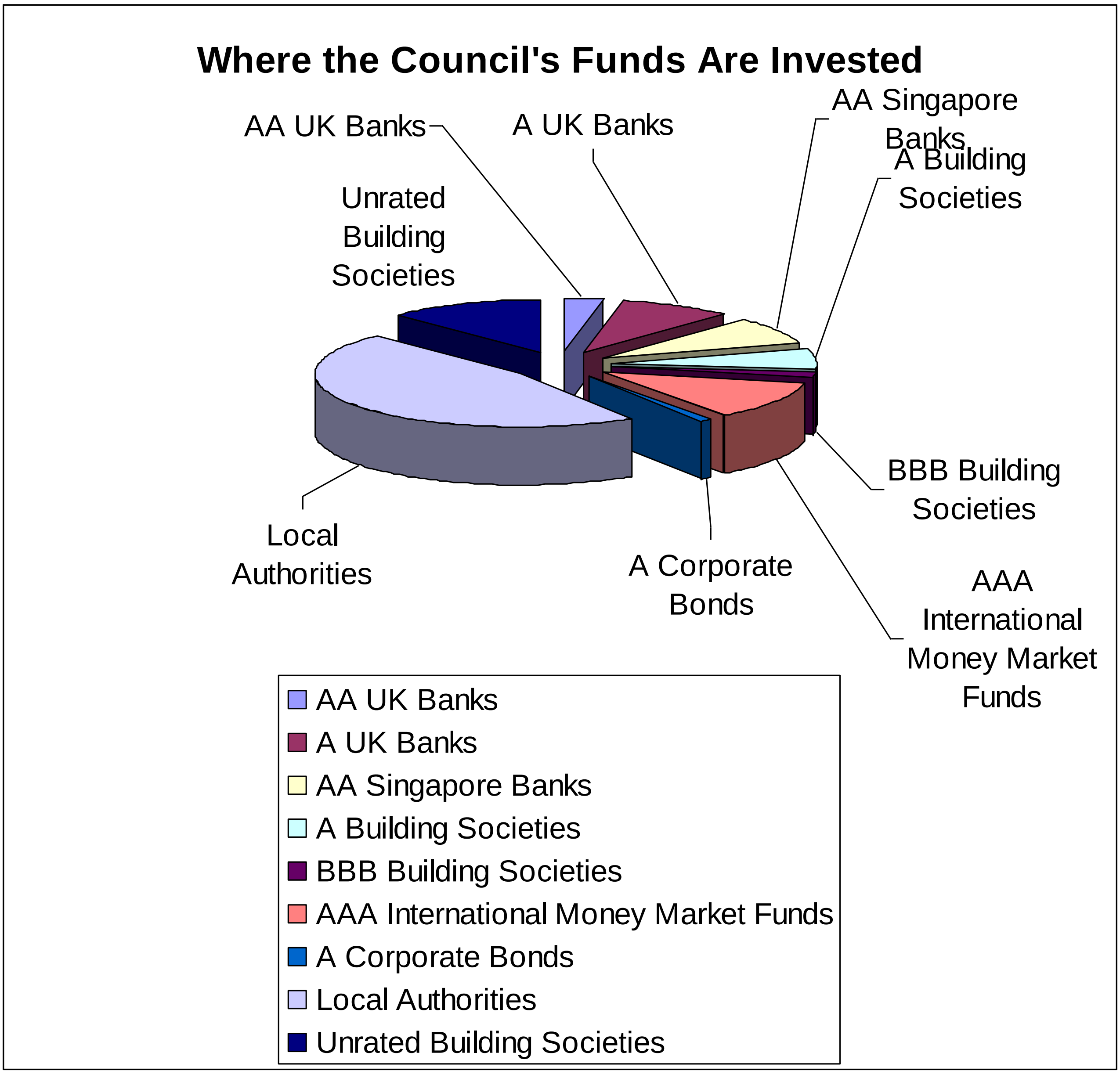
Funds could also be invested in share capital or property through collective investment vehicles. However this is not recommended as it would put the capital sum at risk through movements in prices.

10. SECURITY OF INVESTMENTS

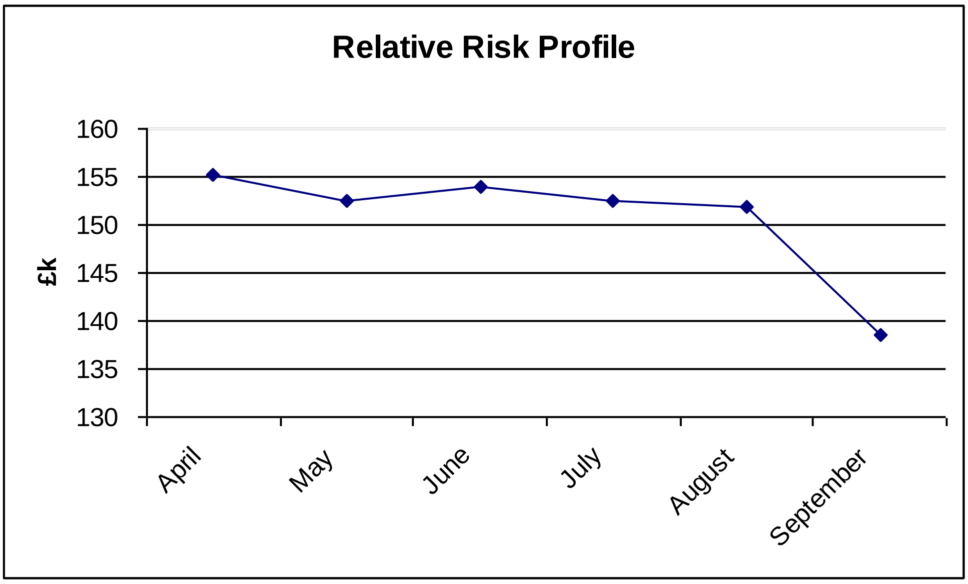
The risk of default has been managed through limiting investments in any institution to £20m or less depending on its credit rating and spreading investments over countries and sectors. It is recommended that the maximum investment in any single institution (apart from the UK Government for which there is no limit) be increased to £26m (see Section 9).

At 30 September 2013 the City Council had on average £6.1m invested with each institution.

The chart below shows how the Council's funds were invested at 30 September 2013.



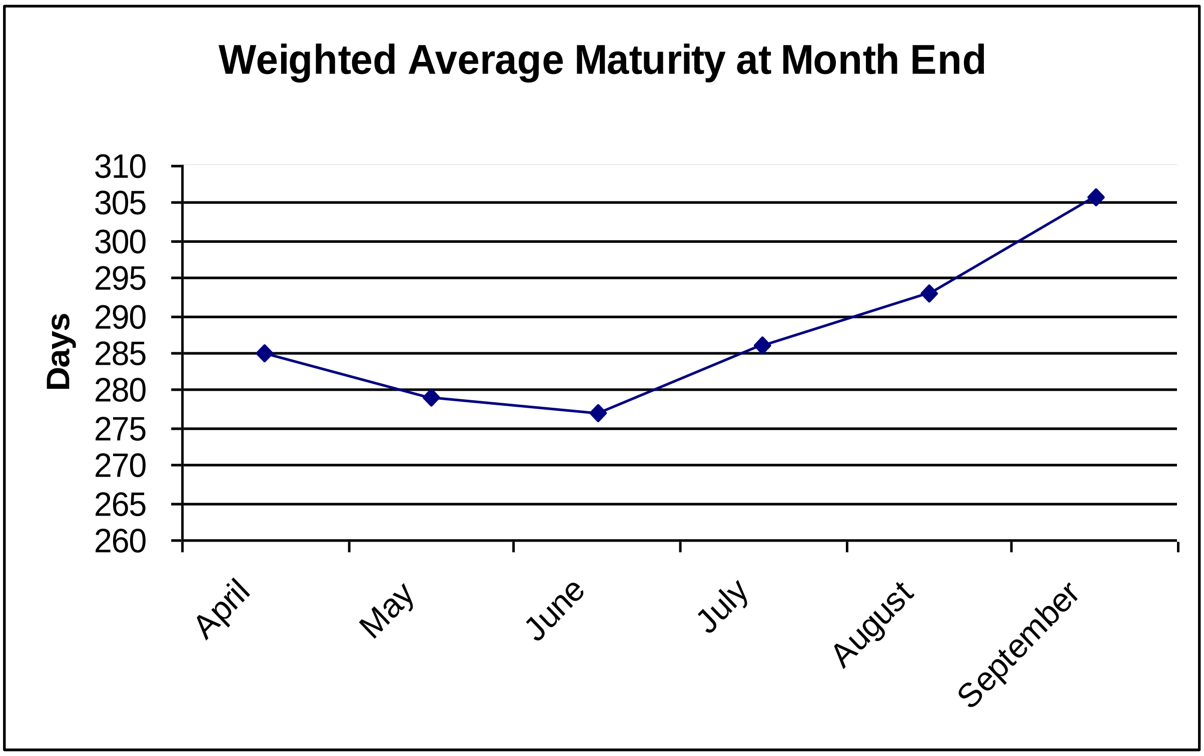
The credit rating agencies publish default rates for each rating category. Multiplying these default rates by the amount invested in each credit rating category provides a measure of risk that can be used as a benchmark to determine whether the City Council's investment portfolio is becoming more or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



The City Council's investment portfolio became relatively less risky over the first two quarters of 2013/14. This is largely due to an investment in a triple B rated building society maturing in September. Although the Council was able to increase its returns by lending to triple B and unrated building societies, the FLS has enabled these institutions to obtain cheap funding from the Bank of England and the interest offered by such institutions is now much reduced. 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.

11. LIQUIDITY OF INVESTMENTS

The weighted average maturity of the City Council's investment portfolio has fluctuated between 285 and 306 days in first half of 2013/14. The maturity profile of the investment portfolio has been lengthened in the second quarter to obtain better rates of return in an economic environment where interest rates are low and are not expected to rise by much before 2016. This is shown in the graph below.



The 2013/14 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 30 September £31.2m 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 limits set by the City Council on 19 March 2013 is shown below.

Maturing after	**Limit** £m	**Actual** £m
31/3/2014	218	87
31/3/2015	208	45
31/3/2016	198	30

12. 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 19 March 2013 is shown below.

	Limit **£m**	**Actual** **£m**
Maximum Projected Gross Borrowing – Fixed Rate	355	356
Minimum Projected Gross Investments – Fixed Rate	(35)	(98)
Fixed Interest Rate Exposure	320	258

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 19 March 2013 is shown below.

	Limit **£m**	**Actual** **£m**
Minimum Projected Gross Borrowing – Variable Rate	-	-
Maximum Projected Gross Investments – Variable Rate	(320)	(163)
Variable Interest Rate Exposure	(320)	(163)

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. This could favour the City Council if short term interest rates rise.

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

Effect of +/- 0.5% Rate Change	**2013/14 (Part Year)** £'000	**2014/15** £'000	**2015/16** £'000
Long Term Borrowing	-	2	55
Investment Interest	(74)	(688)	(733)
Net Effect of +/- 0.5% Rate Change	**(74)**	**(686)**	**(678)**