Agenda item:

Decision maker: Governance and Audit and Standards Committee

Subject: Treasury Management Monitoring Report for the Third Quarter of 2013/14

Date of decision: 30 January 2014

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 2013.

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 2013 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 2013/14

4. Recommendations

That the following actual treasury management indicators for the third quarter of 2013/14 be noted:

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

Prudential Indicator	**Limit** £M	**Actual** £M
Authorised Limit	514	443
Operational Boundary	449	443

(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	1%	4%	3%	5%	9%	13%	11%	54%

(c) The Council's sums invested for periods longer than 364 days at 31 December 2013 were:

	Prudential Limit £m	**Quarter 3 Actual** £m
Maturing after 31/3/2014	218	101
Maturing after 31/3/2015	208	59
Maturing after 31/3/2016	198	44

(d) The Council's fixed interest rate exposure at 31 December 2013 was £255m, ie. the Council had net fixed interest rate borrowing of £255m. This is within the Council's approved limit of £320m.

(e) The Council's variable interest rate exposure at 31 December 2013 was (£128m), ie. the Council had net variable interest rate investments of £128m. This is within the Council's approved limit of £320m.

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.

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6. Equality impact assessment (EIA)

A preliminary equalities impact assessment on Treasury Management Policy was carried out in March 2013.

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 and Section 151 Officer

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 Governance and Audit and Standards Committee on 30 January 2014.

……………………………………………….
Signed by: the Chair of the Governance and Audit and Standards Committee

APPENDIX A

TREASURY MANAGEMENT MONITORING REPORT FOR THE THIRD QUARTER 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. The prudential indicators were revised by the City Council on 12 November 2013 when the revised capital programme for 2013/14 was approved.

2. ECONOMIC BACKGROUND

The market view is that the Bank of England's target level for unemployment of 7%, before it will review changing Bank Rate, will be reached much sooner than the Bank's view back in August of towards the end of 2016. In its latest quarterly Inflation Report this month, the Bank has shortened this period to possibly as early as the end of 2014. Financial markets have also moved their expectations back from their over optimism, which reached fever pitch in September, and are now expecting a first increase in Bank Rate in Q2 2015. The Council employs Capita Asset Services to provide interest rate forecasts and this is not Capita's view however. The Bank has been at pains to emphasise that reaching a 7% unemployment rate is not a trigger for the first increase in Bank Rate, but this target is only an assurance that they will not increase Bank Rate before that rate is reached. 7% is, therefore, merely a point at which the Monetary Policy Committee (MPC) would start to ask the question whether Bank Rate warrants being increased. This question will then be dependent on MPC forecasts for inflation and growth. The MPC does have a twin mandate of controlling inflation and supporting the Government's policy for growth and employment. Provided inflation looks likely to stay near to the target rate of 2% (Bank forecast is now 1.9% Q4 2015), the MPC are likely to give priority to supporting growth and employment. This could mean a continuation of loose monetary policy and consequently an extended period of historically low Bank Rate compared to what we have viewed as being 'normal' rates.

Capita expect the first increase in Bank Rate to be in the second quarter of 2016. Capita are
only forecasting the Bank Rate to reach 1.25% in Q1 2017. This is a slow rate of increase because Capita have major reservations that the current bout of strong economic growth (the Bank has now increased its growth forecasts for 2014 to 2.8% and for 2015 to 2.5%), will wilt as the major stimulus has come from consumer spending and an uplift in borrowing to buy property. Whilst the release of this burst of pent up demand to buy property is having a very welcome effect on the economy, this surge is very likely to fade in time and will then leave a major question mark over where growth is going to come from. Basically, there are four main areas of demand in the UK economy: -

1. Consumers – but most consumers are trying to pay down debt. In addition, most consumers are experiencing declining disposable income as wage increases are less than inflation. This will not reverse until productivity and business investment improve so as to warrant paying higher wages. It is mainly higher wages that could provide a solid stimulus to an increase in consumer expenditure which would then underpin strong growth.

2. Government – committed to austerity programmes to reduce its expenditure.

3. Foreigners buying our exports – but the EU, our major export market, is likely to experience tepid growth, at best, for the next few years

4. Business investment in fixed capital formation; but this has fallen from 13.5% to 10.4% of gross domestic product (GDP) over the last six years. Labour productivity has fallen significantly over the last six years, and so there should be potential to improve productivity in order to facilitate increased levels of production. Export markets also look relatively weak, so again, there is little need to invest in order to expand production for that reason. Finally, the Bank keeps on commenting on the level of surplus capacity in the economy so there is an issue as to how long it will take for that capacity to absorb increases in levels of production before new investment appears on the agenda of companies.

Turning to the US, the Federal Reserve has announced that it will start to taper its asset purchases. However, UK gilt yields are still closely tracking movements in US treasury yields and these could, therefore, be volatile as the political deadlock and infighting between Democrats and Republicans over the budget, and the raising of the debt limit, has only been deferred, rather than resolved.

3. INTEREST RATE FORECAST

We are in times when events can precipitate major volatility in markets. While Ireland has made very good progress towards probably being able to exit from its bail out soon, it looks increasingly likely that Greece is now going to need a third bailout package, though not one on the same scale as the first two. Concerns are also rising over Portugal requiring another bailout. Slovenia looks increasingly like it is heading towards a bailout. A growing lack of confidence in the Euro Zone (EZ) austerity programmes could cause bond yields to rise for EZ countries. This could help maintain UK gilts as a safe haven and so depress gilt yields close to current levels for an extended period.

Capita's forecast is based on an initial assumption that we will not be heading into a major resurgence of the EZ debt crisis, or a break-up of the EZ, but rather that there will be a managed, albeit painful and tortuous, resolution of the debt crisis where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be tepid for the next couple of years and is, therefore, likely to dampen UK growth, as the EU is our biggest export market. Capita is also concerned that some EZ countries experiencing low growth, will, over the next few years, see a significant increase in total government debt to GDP ratios. There is a potential danger for these ratios to rise to the point where markets lose confidence in the financial viability of one, or more, countries. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a resurgence of the EZ debt crisis. While the European Central Bank (ECB) has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the large countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

Capita's Public Works Loans Board (PWLB) forecasts are based around a balance of risks. Potential for upside risks, especially for longer term PWLB rates, are as follows:-

- a further increase 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
- a reversal of Sterling’s safe-haven status on an improvement in financial stresses in the EZ
- A reversal of QE; 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.

PWLB rates and bond yields are unpredictable as we are experiencing exceptional levels of volatility which are highly correlated to political developments, (or lack of them), in the sovereign debt crisis. The PWLB rate forecasts below are based on the new Certainty Rate (minus 20 bps) which has been accessible since 1st November 2012.

	NOW	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
BANK RATE	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.00	1.25
3 month LIBID	0.40	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.60	0.70	0.90	1.30
6 month LIBID	0.50	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.70	0.80	1.00	1.20	1.40
12 month LIBID	0.80	0.80	0.80	0.80	0.80	0.80	0.80	0.80	1.00	1.20	1.40	1.60	1.80	2.00	2.30
5 yr PWLB	2.50	2.50	2.50	2.60	2.70	2.70	2.80	2.80	2.90	3.00	3.10	3.20	3.30	3.40	3.40
10 yr PWLB	3.70	3.60	3.60	3.70	3.80	3.80	3.90	3.90	4.00	4.10	4.20	4.30	4.30	4.40	4.50
25 yr PWLB	4.40	4.40	4.40	4.50	4.50	4.60	4.60	4.70	4.80	4.90	5.00	5.10	5.10	5.10	5.10
50 yr PWLB	4.40	4.40	4.40	4.50	4.50	4.60	4.70	4.80	4.90	5.00	5.10	5.20	5.20	5.20	5.20

4. NET DEBT

The Council's net borrowing position excluding accrued interest at 31 December 2013 was as follows:

	1 April 2013	**31 December 2013**
	£'000	£'000
Supported Borrowing	185,802	184,493
Housing Revenue Account (HRA) Self Financing (Unsupported)	85,665	85,061
Other Unsupported Borrowing	86,706	86,102
Sub Total - Borrowing	**358,173**	**355,656**
Finance Leases (Unsupported)	**4,538**	**3,966**
Private Finance Initiative (PFI) Schemes (Supported)	73,349	73,185
Waste Disposal Service Concession Arrangement (Unsupported)	10,872	10,400
Sub Total Service Concession Arrangements (including PFIs)	**84,221**	**83,585**
Gross Debt	**446,932**	**443,207**
Investments	(246,068)	(228,834)
Net Debt	**200,864**	**214,373**

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 £184m (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. BORROWING ACTIVITY

No new borrowing was undertaken during the first three quarters of 2013/14.

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

Prudential Indicator 2013/14	Limit £M	Position at 31/12/13 £M
Authorised Limit	514	443
Operational Boundary	449	443

Interest rates across the interest rate yield curve generally rose during the first three quarters of 2013/14, but remain volatile. The low points were generally seen in April.

PWLB rates for the first three quarters of 2013/14

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.11%	1.70%	2.71%	3.91%	4.04%
Date	02/04/13	08/04/13	23/04/12	8/04/13	05/04/13
High	1.43%	2.98%	4.10%	4.68%	4.71%
Date	27/12/13	30/12/13	30/12/13	11/09/13	11/09/13
Average	1.27%	2.35%	3.49%	4.40%	4.46%

6. MATURITY STRUCTURE OF BORROWING

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

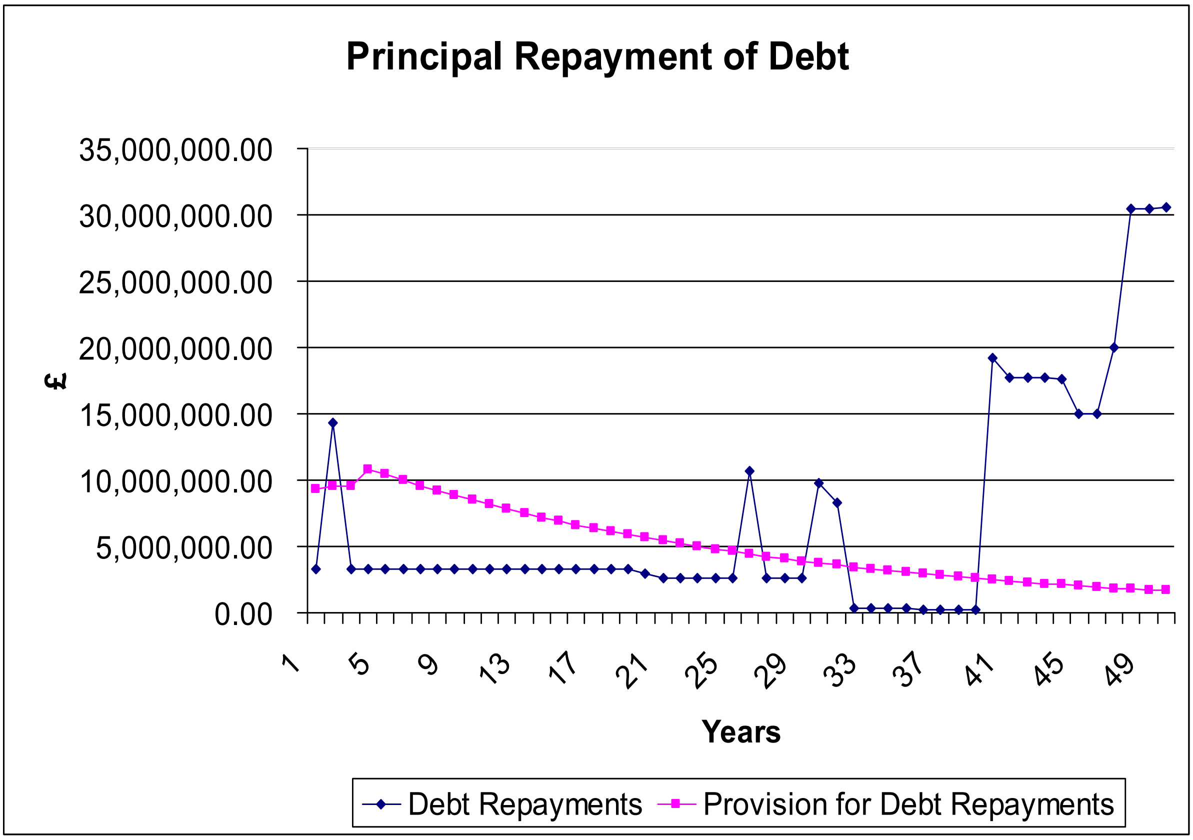
During 2007/08 the Council rescheduled £70.8m of debt. This involved repaying loans from the Public Works Loans Board (PWLB) early and taking out new loans from the PWLB with longer maturities ranging from 45 to 49 years. The effect of the debt restructuring was to reduce the annual interest payable 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 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 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 19 March 2013 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	1%	4%	3%	5%	9%	13%	11%	54%

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 Council held £229m of investments as at 31 December 2013 (£246m at 31 March 2013) and the investment portfolio yield for the first eight months of the year is 0.61%.

The Council's budgeted investment return for 2013/14 is £1,646k, and performance for the year to date is £166k above budget.

The Councils Annual Investment Strategy sets an investment limit for each institution. A number of investment limits were revised as part of the Mid-Year Review approved by the City Council on 10 December 2013. The investment limits for unrated building societies are set at 0.5% of their total assets. As part of the review the investment limits of unrated building societies were revised to reflect the latest data published by KPMG. As part of this review the investment limit for Darlington Building Society was reduced by £0.1m from £2.7m to £2.6m, and the investment limit for Hanley Economic Building Society was also reduced by £0.1m from £1.7m to £1.6m. The Council had invested £2.7m in Darlington Building Society and £1.7m in Hanley Economic Building Society prior to the investment limits being reviewed. As a consequence of this, the Council's investments in both of these building societies now exceed their investment limit by £0.1m. These investments mature on 10 January 2014 and 17 April 2014 respectively. As the investment limits have been exceeded through a slight decrease in these building societies' total assets rather than a fundamental weakness, it is proposed to let these investments mature rather than to attempt to negotiate a premature repayment.

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 £26m and spreading investments over countries and sectors.

The 2013/14 Treasury Management Policy approved by the City Council on 19 March 2013 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:

<u>Short Term Rating</u>

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

<u>Long Term Rating</u>

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

<u>Viability / Financial Strength Rating</u>

bbb from Fitch or C- from Moody’s

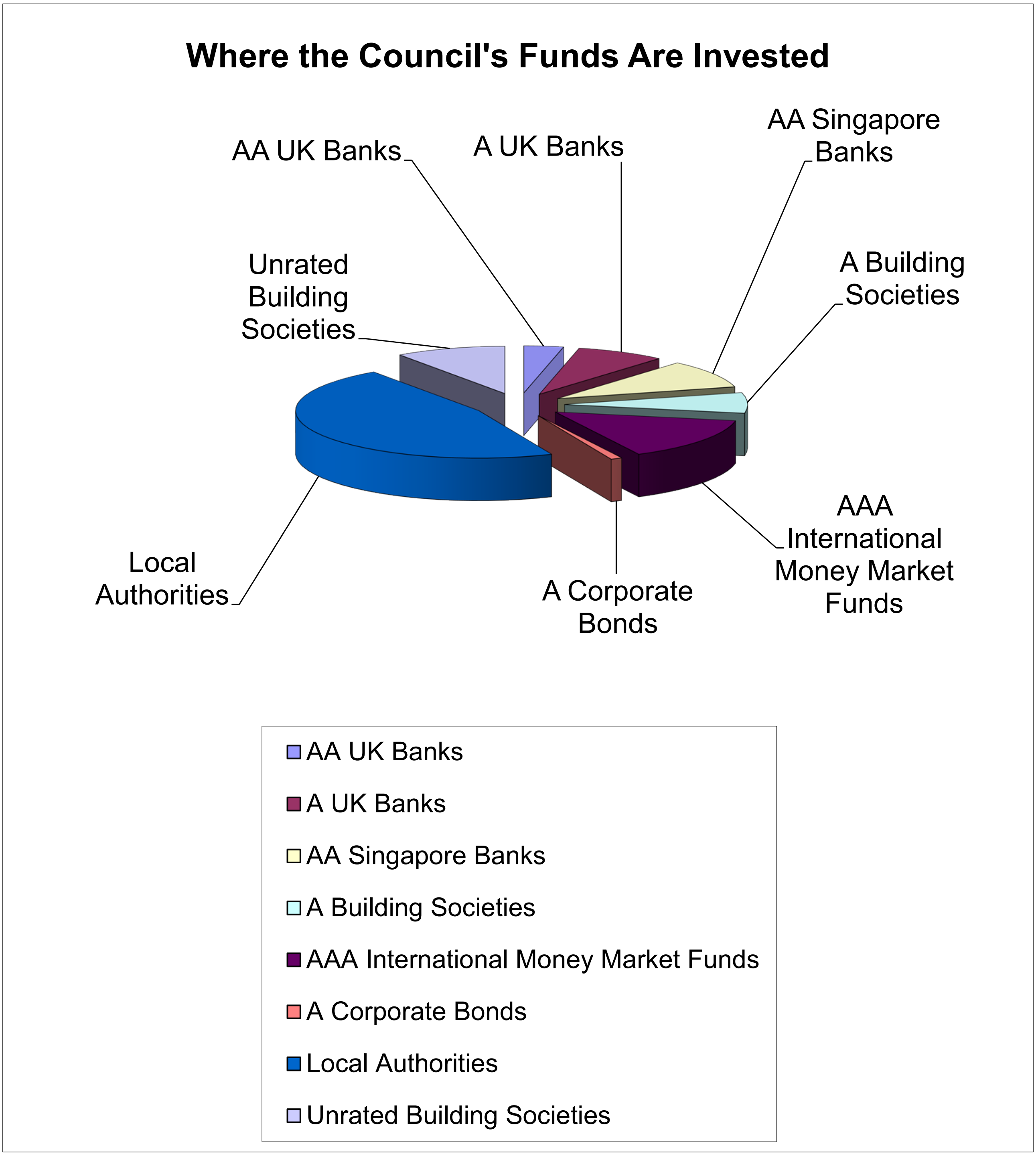
<u>Support Rating</u>

5 from Fitch

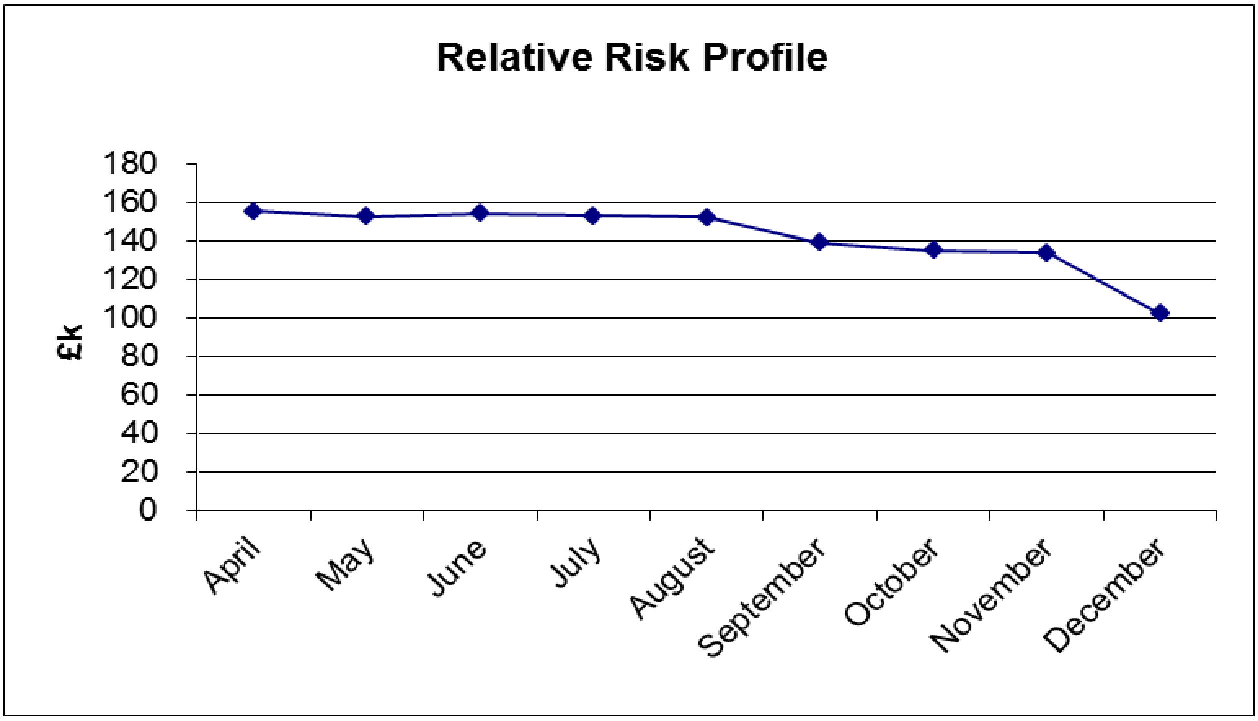
Under the Council’s Annual Investment Strategy counter parties are categorised by their credit ratings for the purposes of assigning investment limits.

At 31 December 2013 the City Council had on average £5.9m invested with each institution.

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



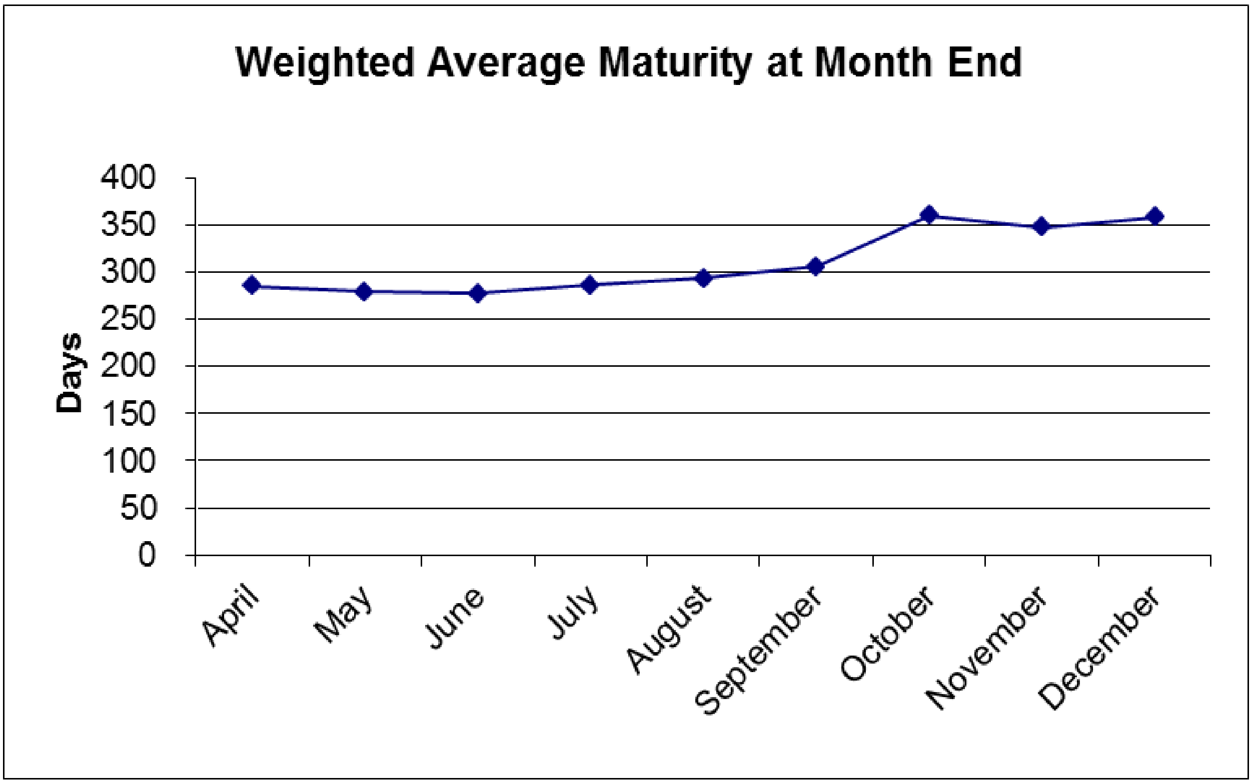
The credit rating agencies publish default rates for each rating category. Multiplying these default rates by the amount invested in each credit rating category provides a measure of risk that can be used as a benchmark to determine whether the City Council's investment portfolio is becoming more or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



The City Council's investment portfolio became relatively less risky over the first three quarters of 2013/14. This is largely due to an investment in a triple B rated building society maturing in September and a number of investments in unrated building societies maturing in December. Although the Council was able to increase its returns by lending to triple B and unrated building societies, the Funding for Lending Scheme 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.

9. LIQUIDITY OF INVESTMENTS

The weighted average maturity of the City Council's investment portfolio started at 285 days in April and increased to 358 days in December as funds were available to invest longer to get a higher return. 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 31 December £33.2m 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	101
31/3/2015	208	59
31/3/2016	198	44

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 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)	(101)
Fixed Interest Rate Exposure	320	255

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)	(128)
Variable Interest Rate Exposure	(320)	(128)

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	**2013/14** **£'000**	**2014/15** **£'000**	**2015/16** **£'000**	**2016/17** **£'000**
Long Term Borrowing	-	2	163	270
Investment Interest	(54)	(785)	(1,089)	(953)
Net Effect of +/- 0.5% Rate Change	**(54)**	**(783)**	**(926)**	**(683)**