Agenda item:

Decision maker: Governance and Audit and Standards Committee

Subject: Treasury Management Monitoring Report for the First Quarter of 2014/15

Date of decision: 26 September 2014

Report by: Head of Financial Services & Section 151 Officer

Wards affected: All

Key decision: No
Budget & policy framework decision: No

1. 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 as at 30 June 2014 and of the risks attached to that position.

2. Recommendations

That the following actual treasury management indicators for the first quarter of 2014/15 be noted:

(a) The Council's debt at 30 June:

Prudential Indicator	**Limit** £m	**Actual** £m
Authorised Limit	511	441
Operational Boundary	445	441

(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	20%	20%	30%	30%	40%	40%	60%	70%
Actual	4%	1%	3%	5%	9%	13%	16%	49%

(c) The Council's sums invested for periods longer than 364 days at 30 June 2014 were:

	Prudential Limit £m	Quarter 1 Actual £m
Maturing after 31/3/2015	170	70
Maturing after 31/3/2016	158	59
Maturing after 31/3/2017	124	8

(d) The Council's fixed interest rate exposure at 30 June 2014 was £262m, ie. the Council had net fixed interest rate borrowing of £262m. This is within the Council's approved limit of £332m.

(e) The Council's variable interest rate exposure at 30 June 2014 was (£224m), ie. the Council had net variable interest rate investments of £224m. This is in excess of the Council's approved limit of (£196m).

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 three months of 2014/15

4. Reasons for Recommendations

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.

` **5. Equality impact assessment (EIA)**

The contents of this report do not have any relevant equalities impact and therefore an equalities impact assessment is not required.

6. Legal Implications

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.

7. Finance 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 26 September 2014.

……………………………………………

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

APPENDIX A

TREASURY MANAGEMENT MONITORING REPORT FOR THE FIRST QUARTER OF 2014/15

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 18 March 2014 provide the framework within which treasury management activities are undertaken.

2. ECONOMIC BACKGROUND

After strong UK GDP growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, and 0.8% in Q1 2014, it appears very likely that strong growth will continue into 2014 as forward surveys are very encouraging. There are also positive indications that recovery is starting to broaden away from reliance on consumer spending and the housing market into construction, manufacturing, business investment and exporting. This strong growth has resulted in unemployment falling much faster through the threshold of 7%, set by the Monetary Policy Committee (MPC) last August, before it said it would consider any increases in Bank Rate. The MPC has, therefore, now broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly the slack is being used up. Accordingly, markets are expecting a first increase in base rate around the end of 2014.

There was a sharp fall in inflation (CPI), reaching 1.5% in May, the lowest rate since 2009. Consumer price inflation increased to 1.9% year-on-year to June 2014. Although this continues the trend of below 2% inflation during 2014, the rise was stronger than expected and is only the second time since June 2013 that inflation has risen compared to the previous month. Forward indications are that inflation is likely to fall overall in 2014 to possibly as low as 1%. The return to strong growth has also helped lower forecasts for the increase in Government debt by £73bn over the next five years, as announced in the Autumn Statement, and by an additional £24bn, as announced in the March 2014 Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018-19. However, monthly public sector deficit figures have disappointed in this quarter.

In June, the Federal Reserve continued with its monthly $10bn reductions in asset purchases, which started in December 2014. Asset purchases have now fallen from $85bn to $35bn and are expected to stop by Q3 2014, providing strong economic growth continues this year. First quarter GDP figures were depressed by exceptionally bad winter weather, but growth rates since then look to be recovering well.

The Eurozone is facing an increasing threat from deflation. In May, the inflation rate fell further, to reach 0.5%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the ECB did take some rather limited action in June to loosen monetary policy in order to promote growth.

3. INTEREST RATE FORECAST

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

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

Capita Asset Services undertook a review of its interest rate forecasts in May, after the Bank of England's Inflation Report. However, more recent developments to the Bank of England's forward guidance have necessitated a second updating in this quarter carried out on 30 June. This latest forecast now includes a first increase in Bank Rate in quarter 1 of 2015 (previously quarter 4 of 2015).

Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth rebounded during 2013 and the first quarter of 2014 to surpass all expectations, propelled by recovery in consumer spending and the housing market. Forward surveys are currently very positive in indicating that growth prospects are also strong for the rest of 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for the recovery to become more firmly established. One drag on the economy has been that wage inflation has been significantly below CPI inflation, so disposable income and living standards were being eroded, (although income tax cuts had ameliorated this to some extent). However, recent falls in inflation have created the potential for the narrowing of this gap and it could narrow further during this year, especially if there is also a recovery in growth in labour productivity (leading to increases in pay rates). With regard to the US, the main world economy, it faces similar debt problems to those of the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth, although labour force participation rates remain lower than ideal.

As for the Eurozone, concerns subsided considerably during 2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy. It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed.

4. NET DEBT

The Council's net borrowing position excluding accrued interest at 30 June 2014 was as follows:

	1 April 2014	30 June 2014
	£'000	£'000
Borrowing	354,822	353,980
Finance Leases	3,775	3,676
Service Concession Arrangements (including PFIs)	83,373	83,297
Gross Debt	**441,970**	**440,953**
Investments	(296,761)	(315,659)
Net Debt	**145,209**	**125,294**

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 and the receipt of £48.8m of City Deal Grant on 28 March 2014 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 quarter of 2014/15.

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

Prudential Indicator 2013/14	**Limit** £m	**Position at 30/6/14** £m
Authorised Limit	511	441
Operational Boundary	445	441

Short term interest rates up to 10 years have generally risen where-as longer term rates have generally fallen during the first quarter of 2014/15. The low points were seen in April and May.

PWLB certainty rates for the first quarter of 2014/15

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.20%	2.50%	3.42%	4.12%	4.08%
Date	08/04/14	14/04/14	16/05/14	16/05/14	16/05/14
High	1.47%	2.85%	3.66%	4.30%	4.28%
Date	17/06/14	20/06/14	20/06/14	03/04/14	02/04/14
Average	1.29%	2.66%	3.56%	4.22%	4.18%

6. MATURITY STRUCTURE OF BORROWING

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

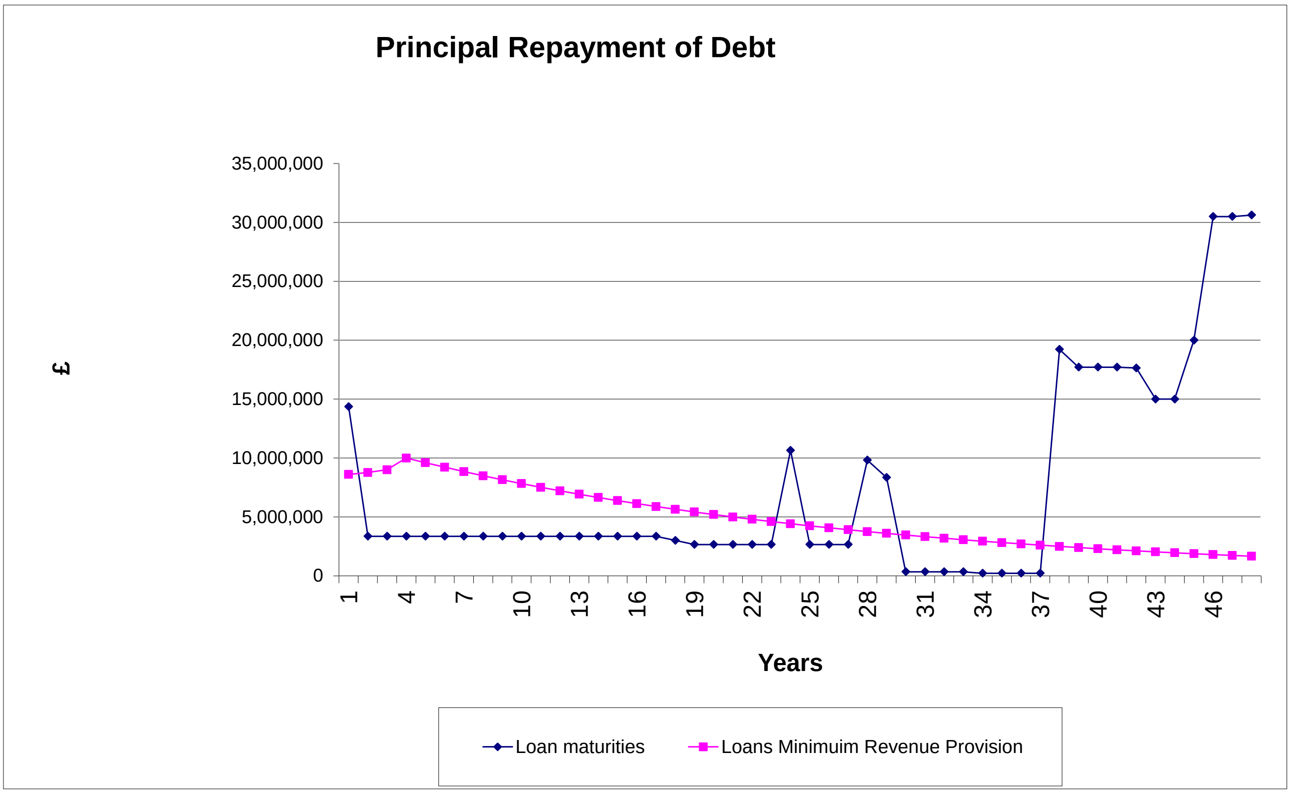
During 2007/08 the Council rescheduled £70.8m of debt. This involved repaying loans from the Public Works Loans Board (PWLB) early and taking out new loans from the PWLB with longer maturities ranging from 45 to 49 years. The effect of the debt restructuring was to reduce the annual interest payable 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 45 years. The remaining £84m is repayable in equal instalments of principal over periods of between 17 and 27 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 49% 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 18 March 2014 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	20%	20%	30%	30%	40%	40%	60%	70%
Actual	4%	1%	3%	5%	9%	13%	16%	49%

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. Investment rates available in the market have been broadly stable during the quarter and have continued at historically low levels as a result of the ultra-low base rate and other extraordinary measures such as the Funding for Lending Scheme.

The Council held £316m of investments as at 30 June 2014 (£297m at 31 March 2014) and the investment portfolio yield for the first three months of the year is 0.76%.

The Council’s budgeted investment return for 2014/15 is £1,531k, and performance for the year to date is £234k above budget. This is due to having more surplus cash than anticipated to invest and being able to obtain better returns than was anticipated in a low interest rate environment.

The receipt of the £48.8m City Deal Grant at the end of 2013/14 and receipts of Government revenue grants early in 2014/15 were invested in AAA rated instant access money market funds pending reinvestment over a longer term. AAA rated money market funds offer a generally very safe form of investment as they are well diversified and consist investments of a short duration. However, money market funds often invest in the same financial institutions as the Council invests in directly, and different money market funds can invest in the same financial institutions. This can result in a concentration of risk that cannot be controlled. Therefore the 2014/15 Annual Investment Strategy approved by the City Council on 18 March 2014 limited investments in money market funds to £80m. The aggregate limit for investments in money market funds was exceeded on 22 days between 1 April and 8 May by up to £12.7m.

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 2014/15 Treasury Management Policy approved by the City Council on 18 March 2014 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, Hampshire Community Bank, 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

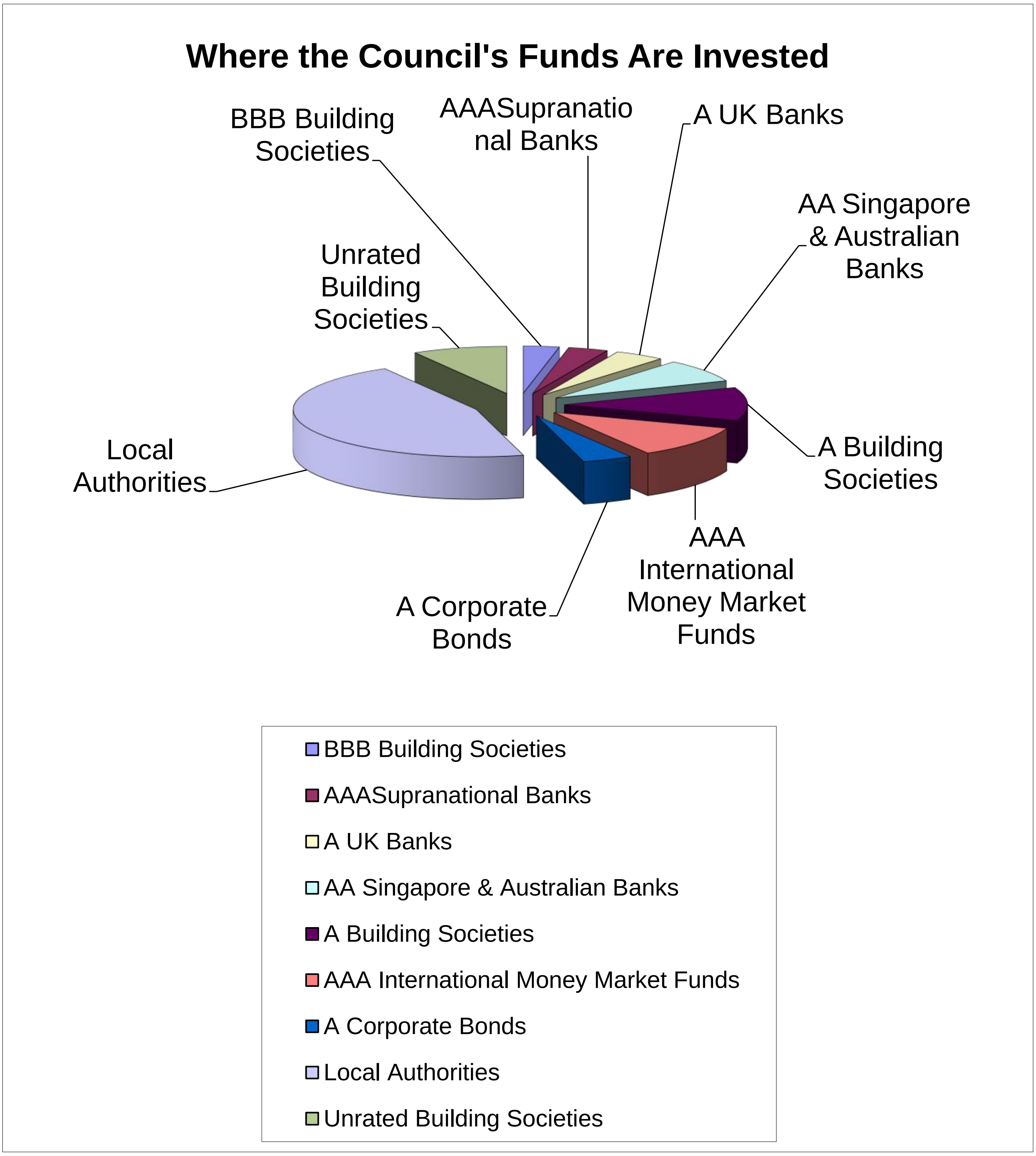
<u>Support Rating</u>

5 from Fitch

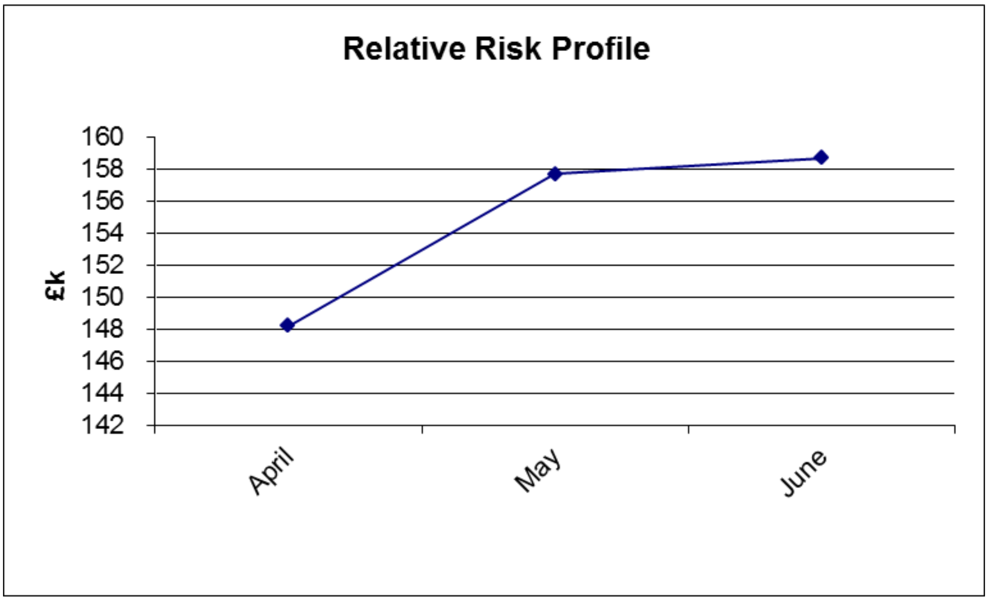
Under the Council's Annual Investment Strategy counter parties are categorised by their credit ratings for the purposes of assigning investment limits.

At 30 June 2014 the City Council had on average £6.1m invested with each institution.

The chart below summarises how the Council's funds were invested at 30 June.


Where the Council's Funds Are Invested
BBB Building Societies
AAASupranational Banks
A UK Banks
AA Singapore & Australian Banks
Unrated Building Societies
A Building Societies
Local Authorities
AAA International Money Market Funds
A Corporate Bonds
BBB Building Societies
AAASupranational Banks
A UK Banks
AA Singapore & Australian Banks
A Building Societies
AAA International Money Market Funds
A Corporate Bonds
Local Authorities
Unrated Building Societies

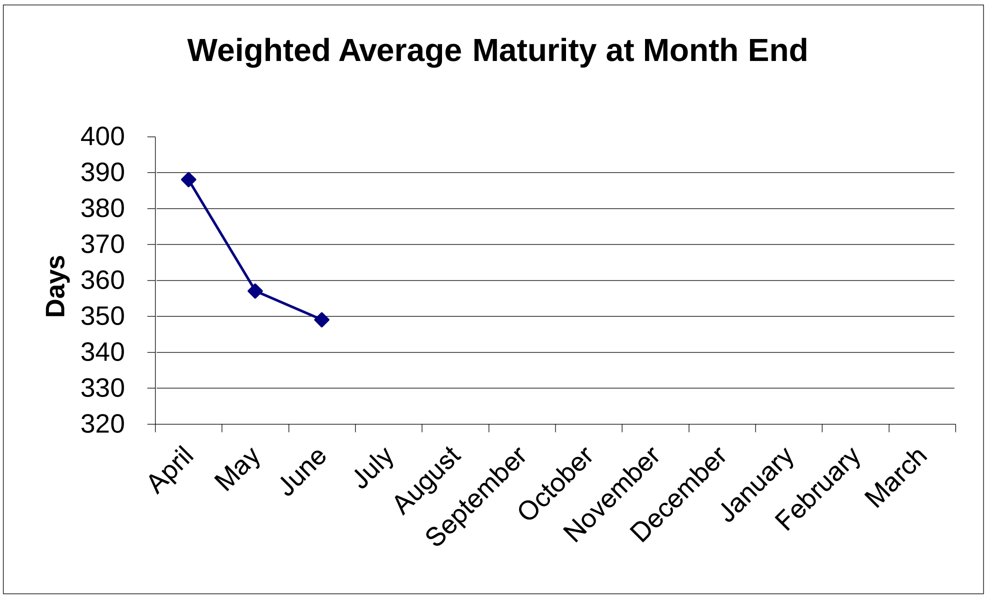
The credit rating agencies publish default rates for each rating category. Multiplying these default rates by the amount invested in each credit rating category provides a measure of risk that can be used as a benchmark to determine whether the City Council's investment portfolio is becoming more or 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 2014/15 as investments in AAA rated instant access money market funds were reinvested over a longer duration with counter parties with double A and single A credit ratings.

9. LIQUIDITY OF INVESTMENTS

The weighted average maturity of the City Council's investment portfolio started at 388 days in April and decreased to 349 days in June as long term investments matured and were not replaced due to uncertainties over the Council's future cash flows and over the timing of the first increase in base rate which will drive up the returns on the Council's investments. 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 June £43.4m 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 limits set by the City Council on 18 March 2014 is shown below.

Maturing after	Limit £m	Actual £m
31/3/2015	170	70
31/3/2016	158	59
31/3/2017	124	8

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 18 March 2014 is shown below.

	Limit **£m**	**Actual** **£m**
Maximum Projected Gross Borrowing – Fixed Rate	398	354
Minimum Projected Gross Investments – Fixed Rate	(66)	(92)
Fixed Interest Rate Exposure	332	262

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 18 March 2014 is shown below.

	Limit **£m**	**Actual** **£m**
Minimum Projected Gross Borrowing – Variable Rate	-	-
Maximum Projected Gross Investments – Variable Rate	(196)	(224)
Variable Interest Rate Exposure	(196)	(224)

The Council's investments of surplus cash are higher than anticipated, principally due to the receipt of all of the £48.8m City Deal Grant on 28 March 2014 which had been expected to be received at a later date and be phased over the next two financial years. In addition, the proportion of the investment portfolio consisting of short term investments of under one year, which are not considered to be fixed rate because of their short term nature, has increased from 64% on 1 April to 71% on 30 June as long term investments of over a year have matured and not been replaced. This has resulted in the variable interest rate exposure limit of (£196m - investments) being exceeded by £28m.

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. However, this risk is limited by the very low market interest rates available for investments.

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

Effect of +/- 0.5% Rate Change	**2014/15 £'000**	**2015/16 £'000**	**2016/17 £'000**
Long Term Borrowing	2	55	55
Investment Interest	(839)	(967)	(290)
Net Effect of +/- 0.5% Rate Change	**(837)**	**(912)**	**(235)**