Decision maker:	Cabinet City Council
Subject:	Treasury Management Mid-Year Review for 2014/15
Date of decision:	6 November 2014 (Cabinet) 7 November 2014 (Governance, Audit & Standards Committee – Information only) 11 November 2014 (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

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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 at 30 September 2014 and of the risks attached to that position. The report also seeks to vary the investment counter party limits for unrated building societies to reflect the 2014 Building Societies Database published by KPMG in September and to obtain approval to increase the variable interest rate exposure limit to reflect the increased level of short term investments.

2. Recommendations

1. That the following actual Treasury Management indicators for the second quarter of 2014/15 be noted:

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

Prudential Indicator 2014/15	**Limit** £M	**Position at 30/9/14** £M
Authorised Limit	469	440
Operational Boundary	447	440

(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 interest rate exposures at 30 September 2014 were:

	Limit £m	**Actual** £m
Fixed Interest	332	266
Variable Interest	(196)	(218)

(d) Sums invested for periods longer than 364 days at 30 September 2014 were:

Maturing after	**Original Limit** £m	**Actual** £m
31/3/2015	170	80
31/3/2016	158	64
31/3/2017	124	8

2. That the investment counter party limits of unrated building societies be revised as follows:

	Existing Limit £	Proposed Limit £	Increase / (Decrease) £
Nottingham Building Society	6,000,000	6,000,000	0
Progressive Building Society	6,000,000	6,000,000	0
Cambridge Building Society	5,000,000	5,700,000	700,000
Furness Building Society	4,000,000	4,200,000	200,000
Leek United Building Society	3,800,000	4,200,000	400,000
Monmouthshire Building Society	3,700,000	4,800,000	1,100,000
Newbury Building Society	3,400,000	3,900,000	500,000
Hinckley & Rugby Building Society	2,900,000	2,800,000	(100,000)
Darlington Building Society	2,600,000	2,600,000	0
Market Harborough Building Society	2,100,000	2,000,000	(100,000)
Melton Mowbray Building Society	1,900,000	1,900,000	0
Tipton & Coseley Building Society	1,800,000	1,800,000	0
Marsden Building Society	1,700,000	1,700,000	0
Hanley Economic Building Society	1,600,000	1,600,000	0
Scottish Building Society	1,700,000	1,900,000	200,000
Dudley Building Society	1,600,000	1,600,000	0
Loughborough Building Society	1,400,000	1,400,000	0
Mansfield Building Society	1,400,000	1,400,000	0
Vernon Building Society	1,200,000	1,300,000	100,000
Stafford Railway Building Society	1,100,000	1,200,000	100,000
Buckinghamshire Building Society	1,100,000	0	(1,100,000)
Harpenden Building Society	1,100,000	1,400,000	300,000
Swansea Building Society	1,000,000	1,100,000	100,000
Chorley and District Building Society	0	1,000,000	1,000,000

3. That the variable interest rate exposure limit for 2014/15 be increased by (£45m) from (£196m) to (£241m), ie. from net investments of £196m to net investments of £241m.

3. 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 2014/15.

The counter party limits for unrated building societies are based on the annual Building Societies Database published by KPMG and equate to 0.5% of the building societies assets.

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 72% on 30 September as long term investments of over a year have matured and not generally been replaced. This has resulted in the variable interest rate exposure limit of (£196m - investments) being exceeded by £22m. The Council's investment portfolio is forecast to increase by a further £13m in October due to the receipt of Government grants. The Council's investment portfolio is then forecast to decrease to £255m towards the end of the year.

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.

It is recommended that the counter party limits for unrated building societies be updated to reflect the 2014 Building Societies database that was published in September.

The Council would need to invest £35m long term in order to get within the variable interest rate exposure limit. This is not recommended given the uncertainty over when base rate will increase and the uncertainty over future cash flows. The alternative is to increase the variable interest rate exposure limit. It is recommended that the variable interest rate exposure limit be increased by (£45m) from (£196m) to (£241m), ie. from net investments of £196m to net investments of £241m. This would accommodate the excess short term investments at 30 September of £22m, the forecast increase in short term investments in October of £13m, and include a contingency of £10m to cover any unexpected cash receipts.

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. 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 2014/15

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 City Council on 11 November 2014.

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

APPENDIX A

TREASURY MANAGEMENT MID YEAR REVIEW 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 UPDATE

United Kingdom

After strong UK GDP quarterly growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, (2013 annual rate 2.7%), and 0.7% in Q1 and 0.9% in Q2 2014 (annual rate 3.2% in Q2), it appears very likely that strong growth will continue through 2014 and into 2015 as forward surveys for the services and construction sectors, are very encouraging and business investment is also strongly recovering. The manufacturing sector has also been encouraging though the latest figures indicate a weakening in the future trend rate of growth. However, for this recovery to become more balanced and sustainable in the longer term, the recovery needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance. This overall strong growth has resulted in unemployment falling much faster through the initial threshold of 7%, set by the Monetary Policy Committee (MPC) last August, before it said it would consider any increases in Bank Rate. The MPC has, therefore, subsequently broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up. The MPC is particularly concerned that the current squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back above the level of inflation in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity, which has languished at dismal levels since 2008, to support increases in pay rates. Most economic forecasters are expecting growth to peak in 2014 and then to ease off a little, though still remaining strong, in 2015 and 2016. Unemployment is therefore expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in pay rates at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence,

the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

Also encouraging has been the sharp fall in inflation (CPI), reaching 1.5% in May and July, the lowest rate since 2009. Forward indications are that inflation is likely to fall further in 2014 to possibly near to 1%. Overall, markets are expecting that the MPC will be cautious in raising Bank Rate as it will want to protect heavily indebted consumers from too early an increase in Bank Rate at a time when inflationary pressures are also weak. A first increase in Bank Rate is therefore expected in Q1 or Q2 2015 and they expect increases after that to be at a slow pace to lower levels than prevailed before 2008 as increases in Bank Rate will have a much bigger effect on heavily indebted consumers than they did before 2008.

The return to strong growth has also helped lower forecasts for the increase in Government debt by £73bn over the next five years, as announced in the 2013 Autumn Statement, and by an additional £24bn, as announced in the March 2014 Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018-19. However, monthly public sector deficit figures have disappointed so far in 2014/15.

United States

In September, 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 $15bn and are expected to stop in October 2014, providing strong economic growth continues. First quarter GDP figures for the US were depressed by exceptionally bad winter weather, but growth rebounded very strongly in Q2 to 4.6% (annualised).

The U.S. faces similar debt problems to those of the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth, although the weak labour force participation rate remains a matter of key concern for the Federal Reserve when considering the amount of slack in the economy and monetary policy decisions.

Eurozone (EZ)

The Eurozone is facing an increasing threat from weak or negative growth and from deflation. In September, the inflation rate fell further, to reach a low of 0.3%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the ECB took some rather limited action in June to loosen monetary policy in order to promote growth. In September it took further action to cut its benchmark rate to only 0.05%, its deposit rate to -0.2% and to start a programme of purchases of corporate debt. However, it has not embarked yet on full quantitative easing (purchase of sovereign debt).

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

China and Japan

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

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

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%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.50%
10yr PWLB rate	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.30%	4.30%
25yr PWLB rate	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.80%	4.90%	4.90%
50yr PWLB rate	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.80%	4.90%	4.90%

Capita Asset Services undertook a review of its interest rate forecasts in mid-August, after the Bank of England's Inflation Report. By the beginning of September, a further rise in geopolitical concerns, principally over Ukraine but also over the Middle East, had caused a further flight into safe havens like gilts and depressed Public Works Loans Board (PWLB) rates further. However, there is much volatility in rates as news ebbs and flows in negative or positive ways. This latest forecast includes a first increase in Bank Rate in quarter 1 of 2015.

Capita's PWLB forecasts are based around a balance of risks. However, there are potential upside risks, especially for longer term PWLB rates, as follows: -

- A further surge in investor confidence that robust world economic growth is firmly expected, causing a flow of funds out of bonds and into equities.

- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Downside risks currently include:

- The situation over Ukraine poses a major threat to EZ and world growth if it was to deteriorate into economic warfare between the West and Russia where Russia resorted to using its control over gas supplies to Europe.

- UK strong economic growth is currently dependent on consumer spending and the unsustainable boom in the housing market. The boost from these sources is likely to fade after 2014.

- A weak rebalancing of UK growth to exporting and business investment causing a weakening of overall economic growth beyond 2014.

- Weak growth or recession in the UK's main trading partners - the EU and US, inhibiting economic recovery in the UK.

- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.

- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.

- Recapitalising of European banks requiring more government financial support.

- Lack of support by populaces in Eurozone countries for austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.

- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.

- Heightened political risks in the Middle East and East Asia could trigger safe haven flows back into bonds.

- There are also increasing concerns that the reluctance of western economies to raise interest rates significantly for some years, plus the huge QE measures which remain in place (and may be added to by the ECB in the near future), has created potentially unstable flows of liquidity searching for yield and therefore heightened the potential for an increase in risks in order to get higher returns. This is a return of the same environment which led to the 2008 financial crisis.

4. NET DEBT

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

	1 April 2014	**30 September 2014**
	£'000	£'000
Borrowing	354,822	353,146
Finance Leases	3,775	3,401
Service Concession Arrangements (including Private Finance Initiative)	83,373	83,221
Gross Debt	**441,970**	**439,768**
Investments	(296,761)	(305,132)
Net Debt	**145,209**	**134,636**

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 Council's estimated capital financing requirement (CFR) for 2014/15 is £415m. The CFR denotes the Council's underlying need to borrow for capital purposes. The Council has borrowings of £440m. The Council's borrowings currently exceed its underlying need to borrow by £25m. This position arose through the £84m of borrowing taken in 2011/12 to take advantage of the very low PWLB rates.

No borrowing has been undertaken in the first six months of 2014/15.

As outlined below, the general trend has been a decrease in interest rates during the six months, across longer dated maturity bands, but a rise in the shorter maturities, reflecting in part the expected rise in the Bank rate.

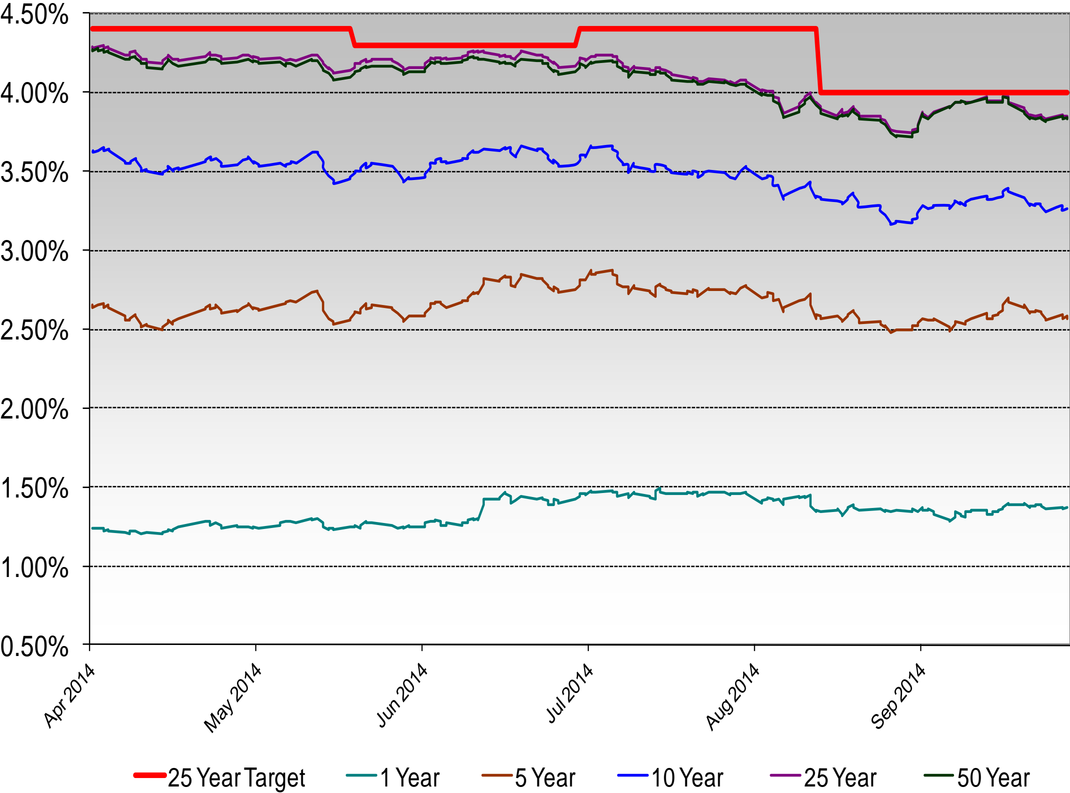
It is anticipated that further borrowing will not be undertaken during this financial year.

The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date:

PWLB certainty rates, half year ended 30th September 2014

(Please note that the graph below is unable to show separate lines for 25 and 50 year rates at some points as those rates were almost identical)

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.20%	2.48%	3.16%	3.75%	3.73%
Date	10/04/2014	28/08/2014	28/08/2014	29/08/2014	29/08/2014
High	1.48%	2.86%	3.66%	4.29%	4.26%
Date	15/07/2014	04/07/2014	20/06/2014	02/04/2014	01/04/2014
Average	1.34%	2.65%	3.67%	4.10%	4.17%



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

Prudential Indicator 2014/15	Limit £M	Position at 30/9/14 £M
Authorised Limit	469	440
Operational Boundary	447	440

7. MATURITY STRUCTURE OF BORROWING

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

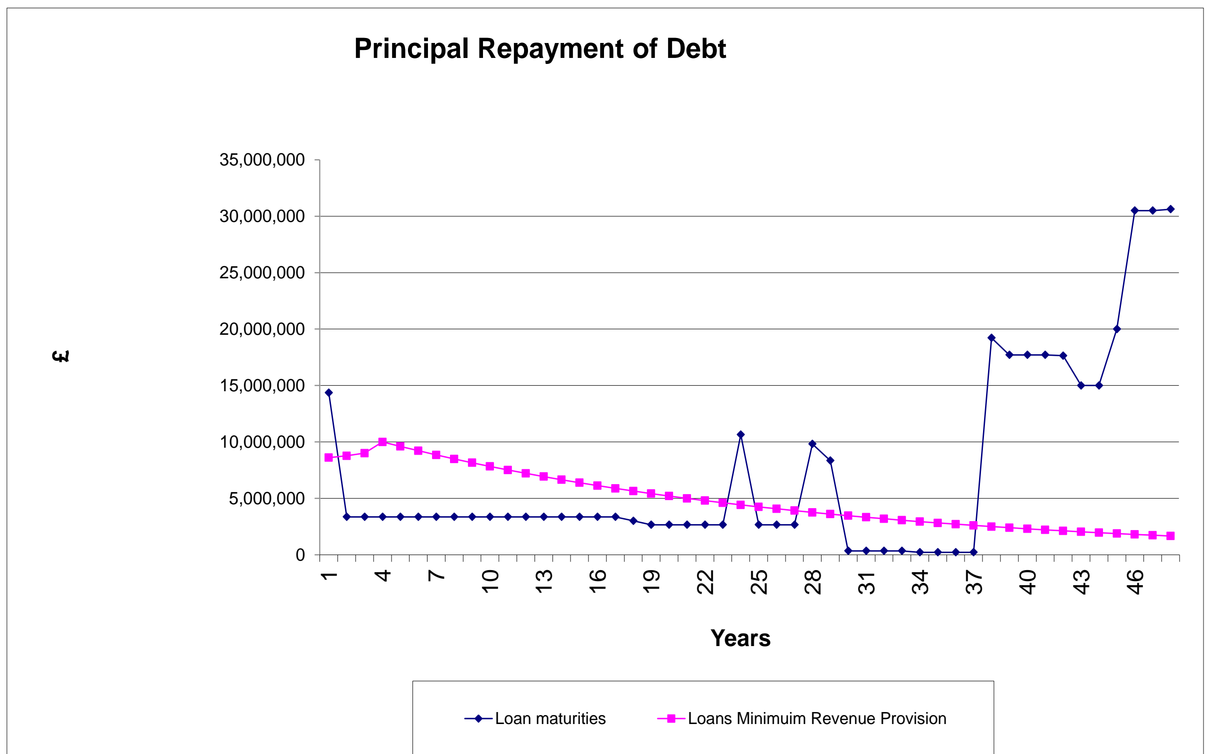
During 2007/08 the Council rescheduled £70.8m of debt. This involved repaying loans from the Public Works Loans Board (PWLB) early and taking out new loans from the PWLB with longer maturities ranging from 45 to 49 years. The effect of the debt restructuring was to reduce the annual interest payable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



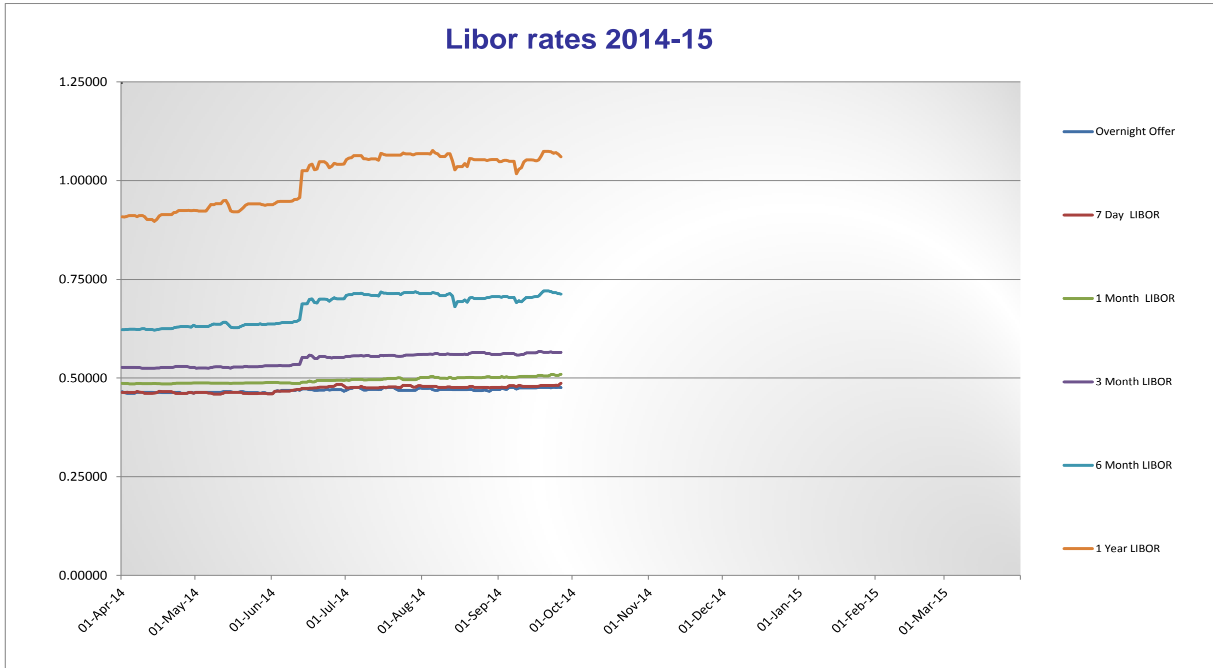
This means that it is necessary to invest the funds set aside for the repayment of debt with its attendant credit and interest rate risks (see sections 10 and 12). The City Council could reschedule its debt, but unless certain market conditions exist at the time, premium payments have to be made to lenders.

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

8. INVESTMENT ACTIVITY

In accordance with the Government's statutory guidance, 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. It is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. Indeed, the Funding for Lending scheme has reduced market investment rates even further.



The Council held £305m of investments as at 30 September 2014 (£297m at 1 April 2014) and the investment portfolio yield for the first five months of the year is 0.77%. The investment portfolio yield for the first three months of the year was 0.76%.

The Council's budgeted investment return for 2014/15 is £1,531k, and performance for the year to date is £401k above budget.

9. REVSION OF INVESTMENT COUNTER PARTIES

The counter party limits for unrated building societies are based on the annual Building Societies Database published by KPMG in September and equate to 0.5% of building societies' assets.

The Building Societies Data base for 2014 shows that the current reporting season has undoubtedly been a strong one for the building society sector, with 32 of 45 societies reporting increases in total assets. This marked increase in total assets is even more noticeable when the impact of the sector's largest participant, Nationwide, is excluded: the remaining 44 societies increased total assets by £3.8 billion, or 3.1%. As in previous years, many of the most impressive rates of increase in total assets continue to be seen at some of the smallest societies. This increase in total assets continues to be largely fuelled by lending to home-owners, with gross mortgage lending of £44.2 billion undertaken by the sector, constituting 25.1% of UK gross mortgage lending.

It is recommended that the investment counter party limits for unrated building societies be amended to reflect the Building Societies Database for 2014.

It is recommended that the investment counter party limits of 10 building societies be increased to reflect the growth of their asset base. It is also recommended that Chorley and District Building Society be added to the Council's approved investment counter party list with a limit of £1,000,000 reflecting the growth of this building society.

It is recommended that the investment counter party limit for Hinkley and Rugby Building Society be reduced by £100,000 from £2,900,000 to £2,800,000, and that the investment counter party limit for Market Harborough Building Society be reduced by £100,000 from £2,100,000 to £2,000,000 to reflect the reduction in the asset base of these building societies. The Council does not currently have any investments in these building societies.

It is recommended that Buckinghamshire Building Society be removed from the list of approved investment counter parties due to its increased reliance on wholesale funding. The Council does not have any investments with Buckinghamshire Building Society.

The recommended changes to the investment counter party limits of unrated building societies are summarised in the table below.

	Existing Limit £	Proposed Limit £	Increase / (Decrease) £
Nottingham Building Society	6,000,000	6,000,000	0
Progressive Building Society	6,000,000	6,000,000	0
Cambridge Building Society	5,000,000	5,700,000	700,000
Furness Building Society	4,000,000	4,200,000	200,000
Leek United Building Society	3,800,000	4,200,000	400,000
Monmouthshire Building Society	3,700,000	4,800,000	1,100,000
Newbury Building Society	3,400,000	3,900,000	500,000
Hinckley & Rugby Building Society	2,900,000	2,800,000	(100,000)
Darlington Building Society	2,600,000	2,600,000	0
Market Harborough Building Society	2,100,000	2,000,000	(100,000)
Melton Mowbray Building Society	1,900,000	1,900,000	0
Tipton & Coseley Building Society	1,800,000	1,800,000	0
Marsden Building Society	1,700,000	1,700,000	0
Hanley Economic Building Society	1,600,000	1,600,000	0
Scottish Building Society	1,700,000	1,900,000	200,000
Dudley Building Society	1,600,000	1,600,000	0
Loughborough Building Society	1,400,000	1,400,000	0
Mansfield Building Society	1,400,000	1,400,000	0
Vernon Building Society	1,200,000	1,300,000	100,000
Stafford Railway Building Society	1,100,000	1,200,000	100,000
Buckinghamshire Building Society	1,100,000	0	(1,100,000)
Harpenden Building Society	1,100,000	1,400,000	300,000
Swansea Building Society	1,000,000	1,100,000	100,000
Chorley and District Building Society	0	1,000,000	1,000,000

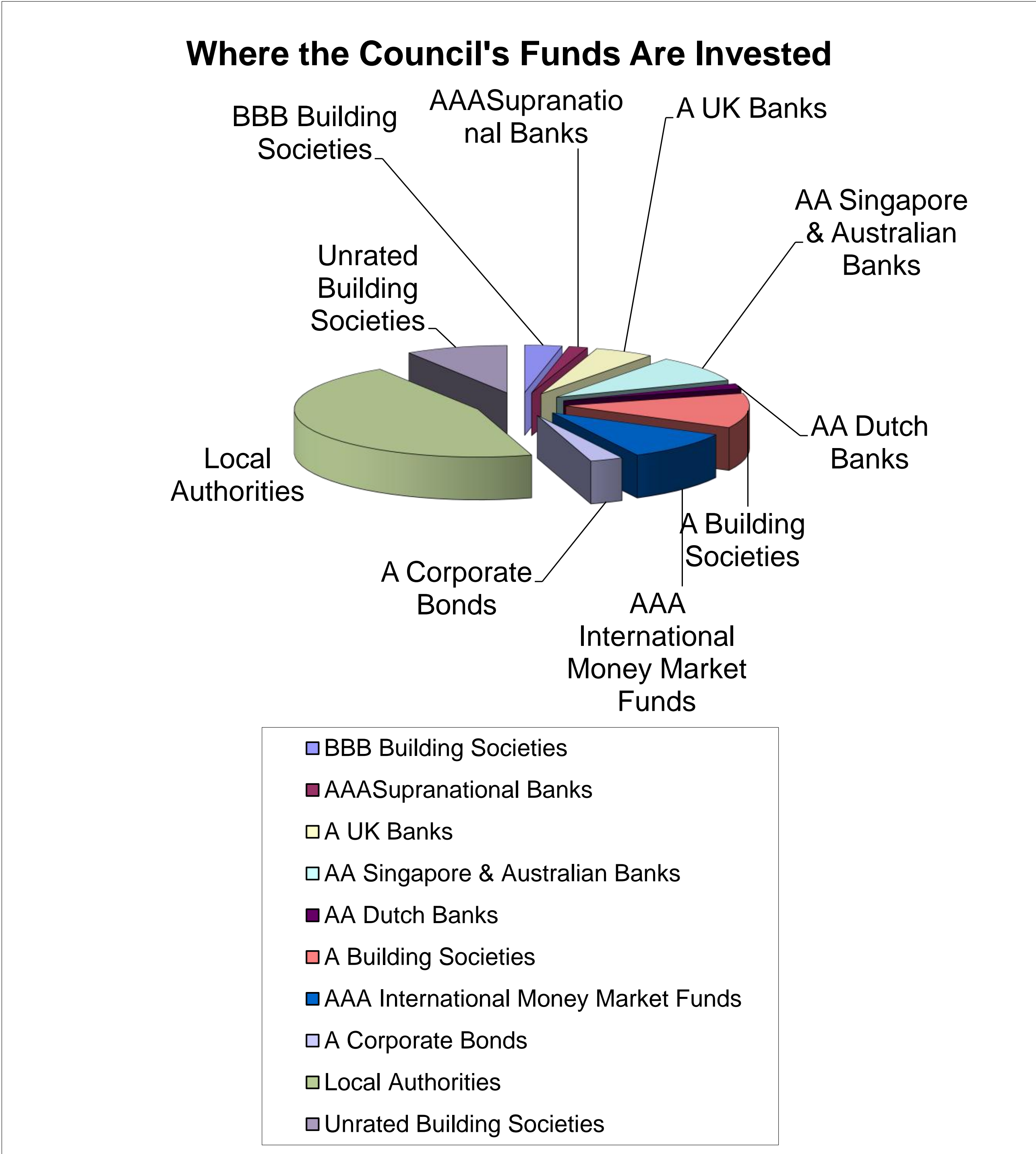
In all other respects the current investment counter parties approved in the Annual Investment Strategy is meeting the requirements of the treasury management function.

10. SECURITY OF INVESTMENTS

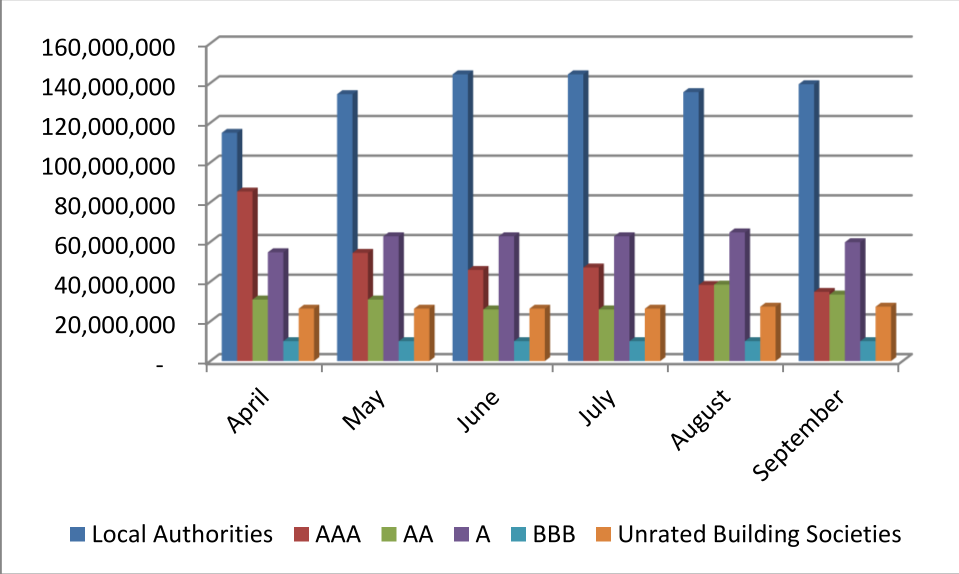
The risk of default has been managed through limiting investments in any institution to £26m or less depending on its credit rating and spreading investments over countries and sectors.

At 30 September 2014 the City Council had on average £6.4m invested with each institution.

The chart below shows how the Council's funds were invested at 30 September 2014.



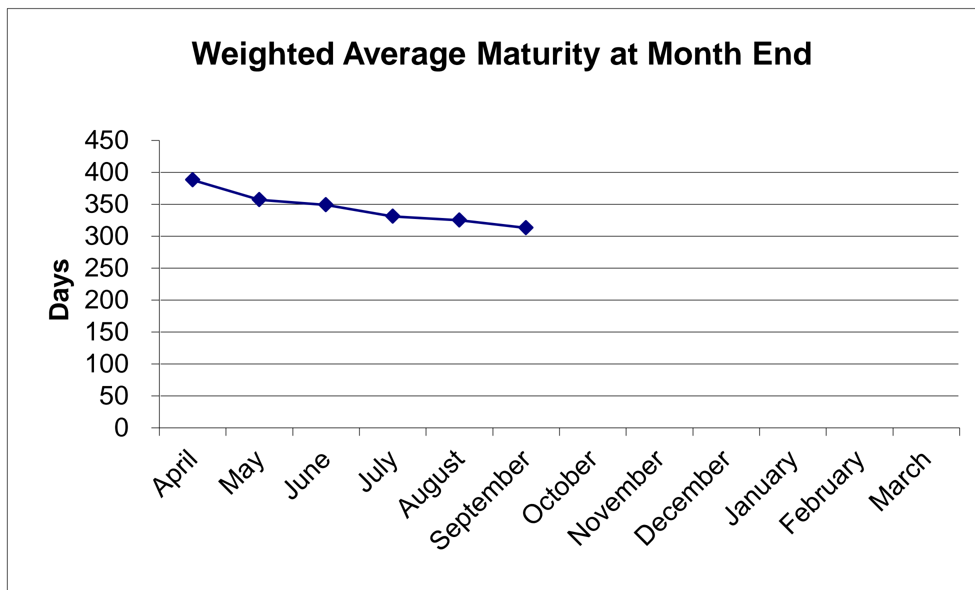
The chart below shows how the Council's investment portfolio has changed in terms of the credit ratings of investment counter parties over the first six months of 2014/15.



It can be seen from the graph above that investments in AAA rated counter parties, consisting entirely of AAA rated instant access money market funds have declined over the first six months of 2014/15. These investments have largely been replaced by investments in other local authorities which generally offer a better return than investments in AAA rated money market funds.

11. LIQUIDITY OF INVESTMENTS

The weighted average maturity of the City Council's investment portfolio started at 388 days in April and decreased to 313 days in September 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.



TheTreasury 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 £29.8m 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	80
31/3/2016	158	64
31/3/2017	124	8

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 18 March 2014 is shown below.

	Limit **£m**	**Actual** **£m**
Maximum Projected Gross Borrowing – Fixed Rate	398	353
Minimum Projected Gross Investments – Fixed Rate	(66)	(87)
Fixed Interest Rate Exposure	332	266

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)	(218)
Variable Interest Rate Exposure	(196)	(218)

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 72% on 30 September 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 £22m.

The Council would need to invest £35m long term in order to get within the variable interest rate exposure limit. This is not recommended given the uncertainty over when base rate will increase and the uncertainty over future cash flows. The alternative is to increase the variable interest rate exposure limit. It is recommended that the variable interest rate exposure limit be increased by (£45m) from (£196m) to (£241m), ie. from net investments of £196m to net investments of £241m. This would accommodate the excess short term investments at 30 September of £22m, the forecast increase in short term investments in October of £13m, and include a contingency of £10m to cover any unexpected cash receipts.

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:

<u>Effect of +/- 0.5% Rate Change</u>	**2014/15 (Part Year)** £'000	**2015/16** £'000	**2016/17** £'000
Long Term Borrowing	2	55	55
Investment Interest	(118)	(913)	(618)
Net Effect of +/- 0.5% Rate Change	**(116)**	**(858)**	**(563)**