Agenda item:

Decision maker: Governance and Audit and Standards Committee

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

Date of decision: 30 January 2015

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. 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 2014 and of the risks attached to that position.

2. Recommendations

1) That the following actual treasury management indicators for the first three quarters of 2014/15 be noted:

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

Prudential Indicator	**Limit** £m	**Actual** £m
Authorised Limit	511	464
Operational Boundary	445	464

(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%	4%	15%	12%	15%	46%

(c) The Council’s sums invested for periods longer than 364 days at 31 December 2014 were:

	Prudential Limit £m	Quarter 3 Actual £m
Maturing after 31/3/2015	170	116
Maturing after 31/3/2016	158	84
Maturing after 31/3/2017	124	8

(d) The Council’s fixed interest rate exposure at 31 December 2014 was £257m, ie. the Council had net fixed interest rate borrowing of £257m. This is within the Council's approved limit of £332m.

(e) The Council’s variable interest rate exposure at 31 December 2015 was (£194m), ie. the Council had net variable interest rate investments of £194m. This is within the Council's approved limit of (£241m).

2) That the Committee note that an investment was placed with Furness Building Society with a maturity of 2 years and 2 days that exceeded the 364 day duration limit for unrated building societies. This is considered to be a low risk given the inherent nature of building societies and consideration is being given to increasing the duration limit for unrated building societies in the 2015/16 Treasury Management Policy.

3. Background

The Council's treasury management operation has a cash limit of £22m and therefore can have a significant effect on the revenue available to fund the Council's front line services. In addition the Council has investments with 53 institutions amounting to £314m. If an institution defaulted on one of the Council's investments the loss would have to be borne by the General Fund.

The Council's treasury management operation does not fall under any of the Cabinet members' portfolios. Therefore treasury management monitoring reports are brought to the Governance and Standards and Audit Committee for scrutiny.

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 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

<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 Governance and Audit and Standards Committee on 30 January 2015.

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

APPENDIX A

TREASURY MANAGEMENT MONITORING REPORT FOR THE FIRST THREE QUARTERS 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 in 2013 at an annual rate 2.7%, and then in 2014 0.7% in Q1, 0.9% in Q2 2014 (annual rate 3.2% in Q2), Q3 has seen growth fall back to 0.7% in the quarter and to an annual rate of 2.6%. It therefore appears that growth has eased since the surge in the first half of 2014 leading to a downward revision of forecasts for 2015 and 2016, albeit that growth will still remain strong by UK standards. 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 than expected. The Monetary Policy Committee (MPC) is now focusing on how quickly slack in the economy is being used up. It is also particularly concerned that the squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back significantly 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. Unemployment is expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in wage growth at some point during the next three years.

Also encouraging has been the sharp fall in inflation (CPI), reaching 1.0% in November, the lowest rate since September 2002. Forward indications are that inflation is likely to remain around or under 1% for the best part of a year. The return to strong growth has helped lower forecasts for the increase in Government debt over the last year but monthly public sector deficit figures during 2014 have disappointed until November. The autumn statement, therefore, had to revise the speed with which the deficit is forecast to be eliminated.

The U.S. Federal Reserve ended its monthly asset purchases in October 2014. GDP growth rates (annualised) for Q2 and Q3 of 4.6% and 5.0% have been stunning and hold great promise for strong growth going forward. It is therefore confidently predicted that the first increase in the Fed. rate will occur by the middle of 2015.

The Eurozone (EZ) is facing an increasing threat from deflation. In November the inflation rate fell to 0.3%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the European Central Bank (ECB) did take some rather limited action in June and September to loosen monetary policy in order to promote growth and is currently expected to embark on quantitative easing early in 2015 to counter this threat of deflation and to stimulate growth.

3. INTEREST RATE FORECAST

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

	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank rate	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	1.75%	2.00%
5yr PWLB rate	2.20%	2.20%	2.30%	2.50%	2.60%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.60%
10yr PWLB rate	2.80%	2.80%	3.00%	3.20%	3.30%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
50yr PWLB rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%

Capita Asset Services undertook a review of its interest rate forecasts on 5 January 2015 after a proliferation of fears in financial markets around the plunge in the price of oil that had caused a flight from equities into bonds and from exposure to the debt and equities of emerging market oil producing countries to safe havens in western countries. These flows were compounded by further fears that Greece could be heading towards an exit from the Euro after the general election on January 25 and financial flows generated by the increasing likelihood that the ECB would soon be starting on full blown quantitative easing (QE) purchase of Eurozone government debt. In addition, there has been a sharp increase in confidence that the US will start increasing the Fed. rate by the middle of 2015 due to the stunning surge in GDP growth in quarters 2 and 3 of 2014. This indicated that the US is now headed towards making a full recovery from the financial crisis of 2008.

The result of the combination of the above factors is that we have seen bond yields plunging to phenomenally low levels, especially in long term yields. These falls are unsustainable in the longer term but just how quickly these falls will unwind is hard to predict. In addition, positive or negative developments on the world political scene could have a major impact in either keeping yields low or prompting them to recover back up again. We also have a UK general election coming up in May 2015; it is very hard to predict what its likely result will be and the consequent impact on the UK economy, and how financial markets will react to those developments.

This latest forecast includes a move in the timing of the first increase in Bank Rate from quarter 2 of 2015 to quarter 4 of 2015 as a result of the sharp fall in inflation due to the fall in the price of oil and the cooling of the rate of GDP growth in the UK, albeit, that growth will remain strong by UK standards, but not as strong as was previously forecast. The Governor of the Bank of England, Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when average disposable income is only currently increasing marginally as a result of wage inflation now running slightly above the depressed rate of CPI inflation, though some consumers will not have seen that benefit come through for them. In addition, whatever party or coalition wins power in the next general election, will be faced with having to implement further major cuts in expenditure and / or increases in taxation in order to eradicate the annual public sector net borrowing deficit.

4. NET DEBT

The Council's net borrowing position excluding accrued interest at 31 December 2014 was as follows:

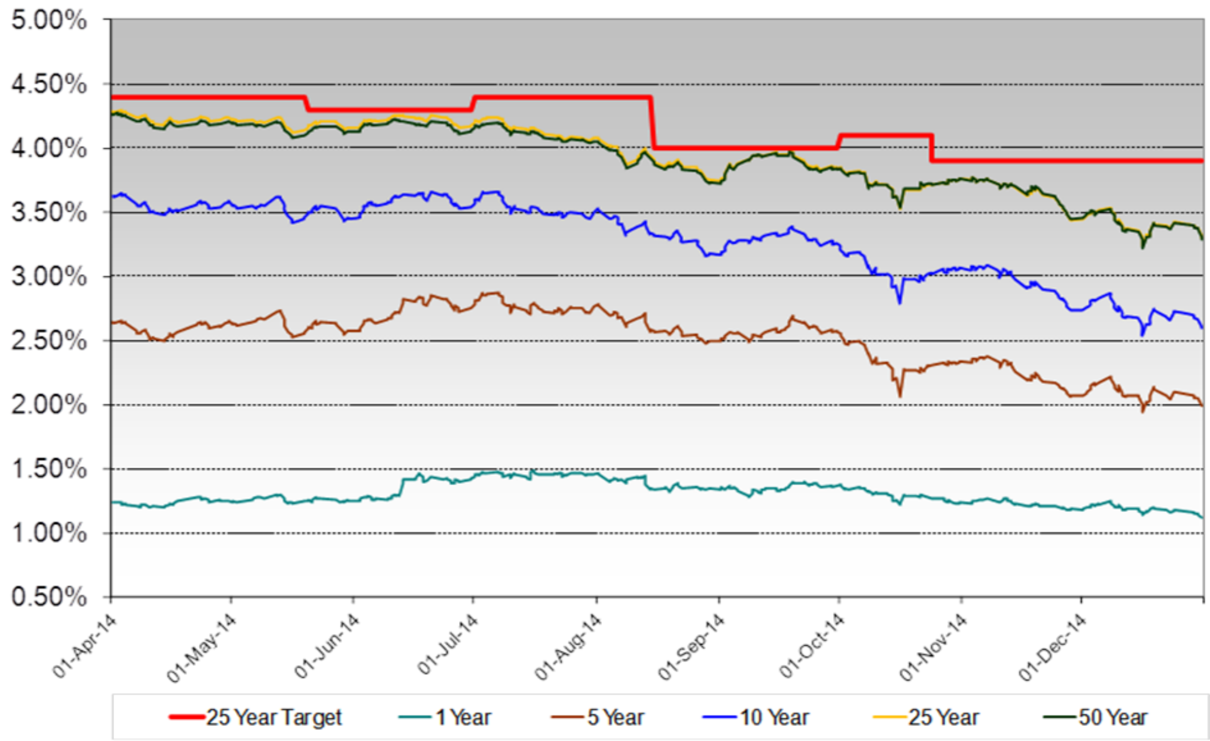
	1 April 2014	31 December 2014
	£'000	£'000
Borrowing	354,822	377,304
Finance Leases	3,775	3,214
Service Concession Arrangements (including PFIs)	83,373	83,144
Gross Debt	**441,970**	**463,662**
Investments	(296,761)	(313,594)
Net Debt	**145,209**	**150,068**

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 together with £25m of new borrowing taken out in November have 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

PWLB Certainty Rates for the first three quarters of 2014/15 are shown in then graph below:



PWLB rates have been generally falling since July. However there have been resurgences of confidence in the financial markets that have led to increases in gilts and PWLB rates in the first half of September, mid-October and early December. However, none of these increases has been sustained.

The City Council has an allocation to borrow £43m from the PWLB at the Project Rate (0.20% below the Certainty Rate) to part fund the City Deal and the development of Dunsbury Hill Farm. It was intended to draw down this borrowing in 2015/16. However because of PWLB rates being relatively low and the forecasts for PWLB rates predicting an upward trend it was decided to borrow part of the allocation early. Consequently £25m was borrowed from the PWLB at the project rate at 3.19% for 15 years on 17 November.

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

Prudential Indicator 2013/14	**Limit** £m	**Position at 31/12/14** £m
Authorised Limit	511	464
Operational Boundary	445	464

The operational boundary is intended to warn the Section 151 Officer and the Council if there is a possibility of the authorised limit being exceeded. The operational boundary differs from the authorised limit in that it is based on expectations of the maximum external debt of the authority according to probable, not simply possible, events and is consistent with the maximum level of external debt projected by the Council's estimates.

The operational boundary has been exceeded through the Council borrowing earlier than planned in order to secure a low interest rate on its borrowing. The fact that the Council's borrowing has exceeded its operational boundary is not indicative of there being a risk of the authorised limit being exceeded in these circumstances. The operational boundary will be reset when the proposed Treasury Management Strategy for 2015/16 is considered by the City Council in March.

6. MATURITY STRUCTURE OF BORROWING

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

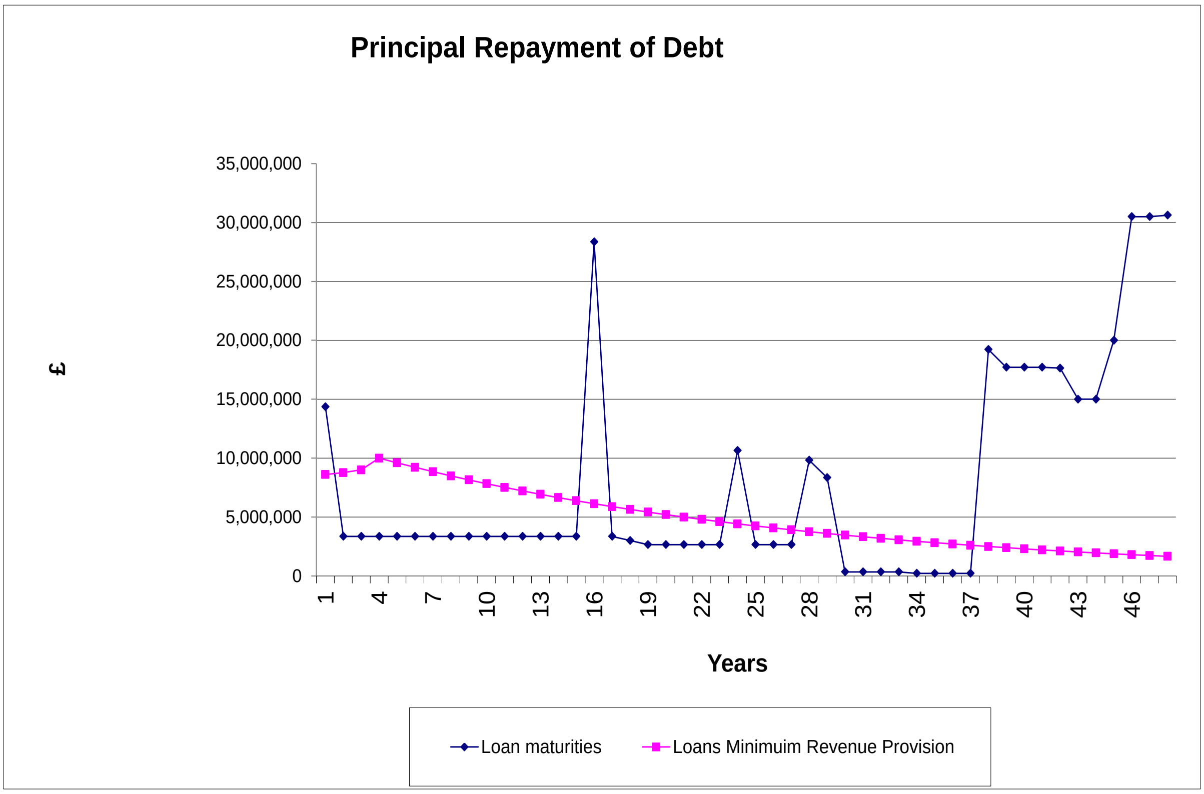
During 2007/08 the Council rescheduled £70.8m of debt. This involved repaying loans from the Public Works Loans Board (PWLB) early and taking out new loans from the PWLB with longer maturities ranging from 45 to 49 years. The effect of the debt restructuring was to reduce the annual interest payable 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 46% 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.

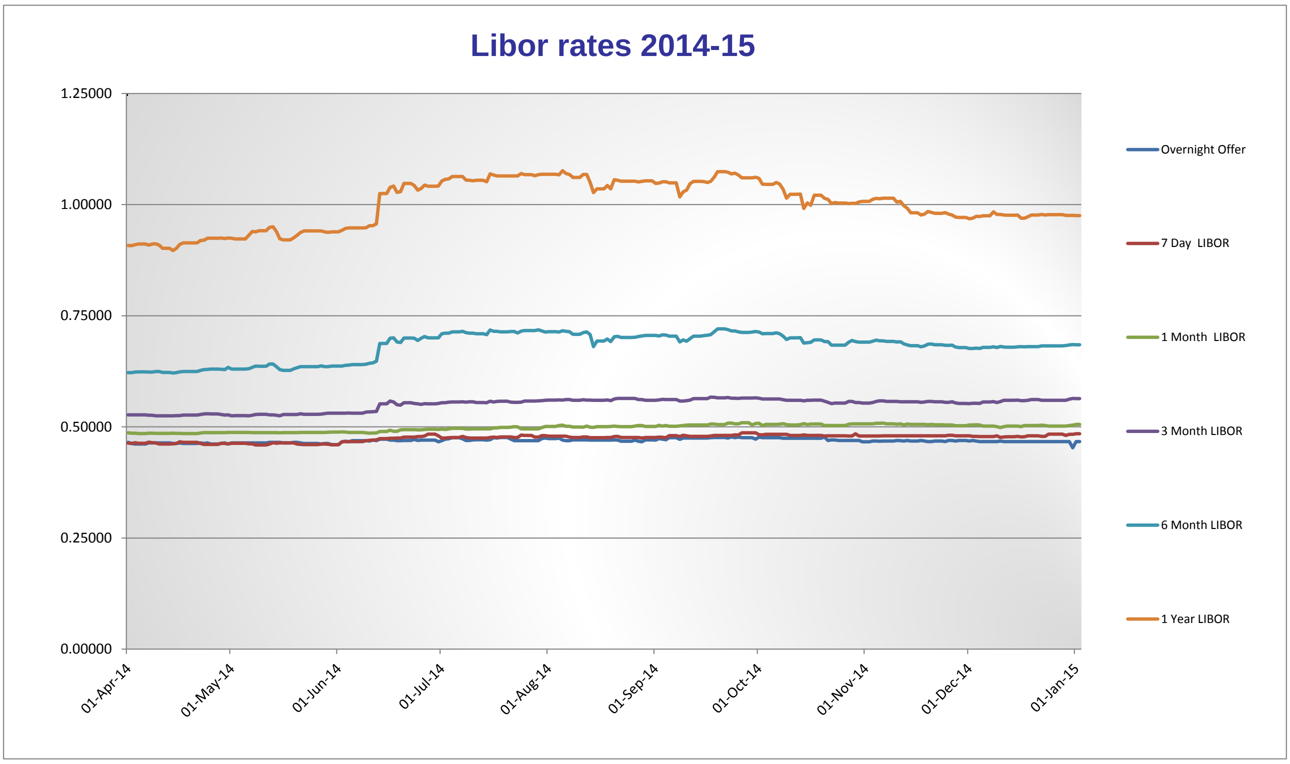
	Under 1 Year	**1 to 2 Years**	**3 to 5 Years**	**6 to 10 Years**	**11 to 20 Years**	**21 to 30 Years**	**31 to 40 Years**	**41 to 50 Years**
Lower Limit	0%	0%	0%	0%	0%	0%	0%	0%
Upper Limit	20%	20%	30%	30%	40%	40%	60%	70%
Actual	4%	1%	3%	4%	15%	12%	15%	46%

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.

The City Council set a duration limit for all investment counter parties on 18 March 2014. A deposit with a duration of 2 years and 2 days was placed with Furness Building Society which exceeded the duration limit for unrated building societies of 364 days. This is considered to be a low risk given the inherent nature of building societies and consideration is being given to increasing the duration limit for unrated building societies in the 2015/16 Treasury Management Policy so that it better reflects the risks associated with these institutions relative to other institutions on the Council's list of approved investments.

Short term market interest rates for the first three quarters of 2014/15 are shown in the graph below:



Short term market interest rates in excess of a month have increased overall in the first three quarters of 2014/15 although there has been some tailing off in the third quarter.

The Council held £314m of investments as at 31 December 2014 (£297m at 31 March 2014). As existing investments matured, the Council was able to replace them with investments yielding a higher return without significantly increasing the Council's exposure to credit risk. Consequently the investment portfolio yield for the first eight months of the year has increased to 0.88%. The investment yield for the first five months of the year was 0.77%.

The Council's budgeted investment return for 2014/15 is £1,531k, and performance for the year to date is £868k 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 earlier than had been anticipated at the end of 2013/14 contributed to the higher cash balances in 2014/15. Interest earned on the City Deal Grant will be transferred to an Earmarked Reserve.

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

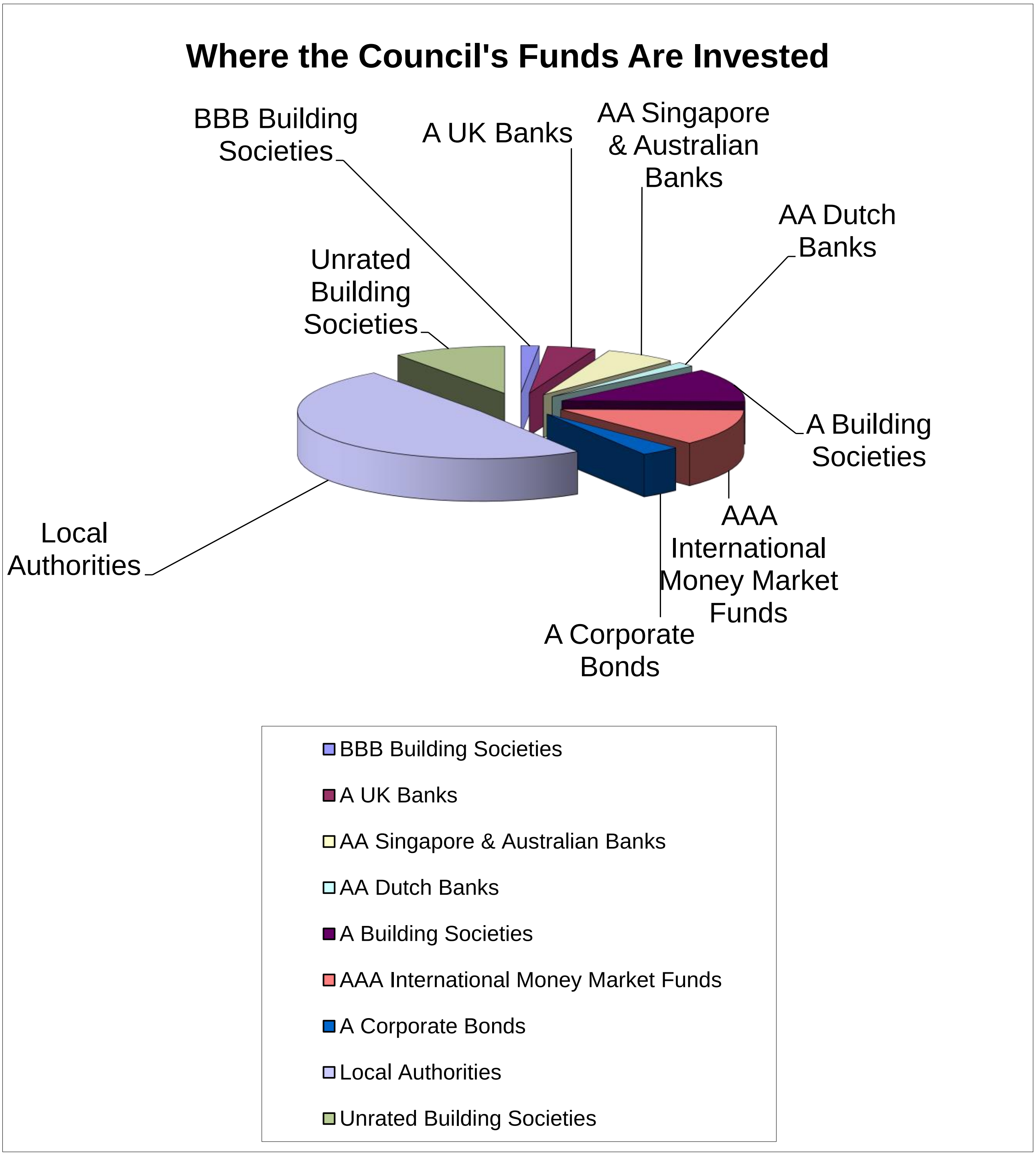
<u>Support Rating</u>

5 from Fitch

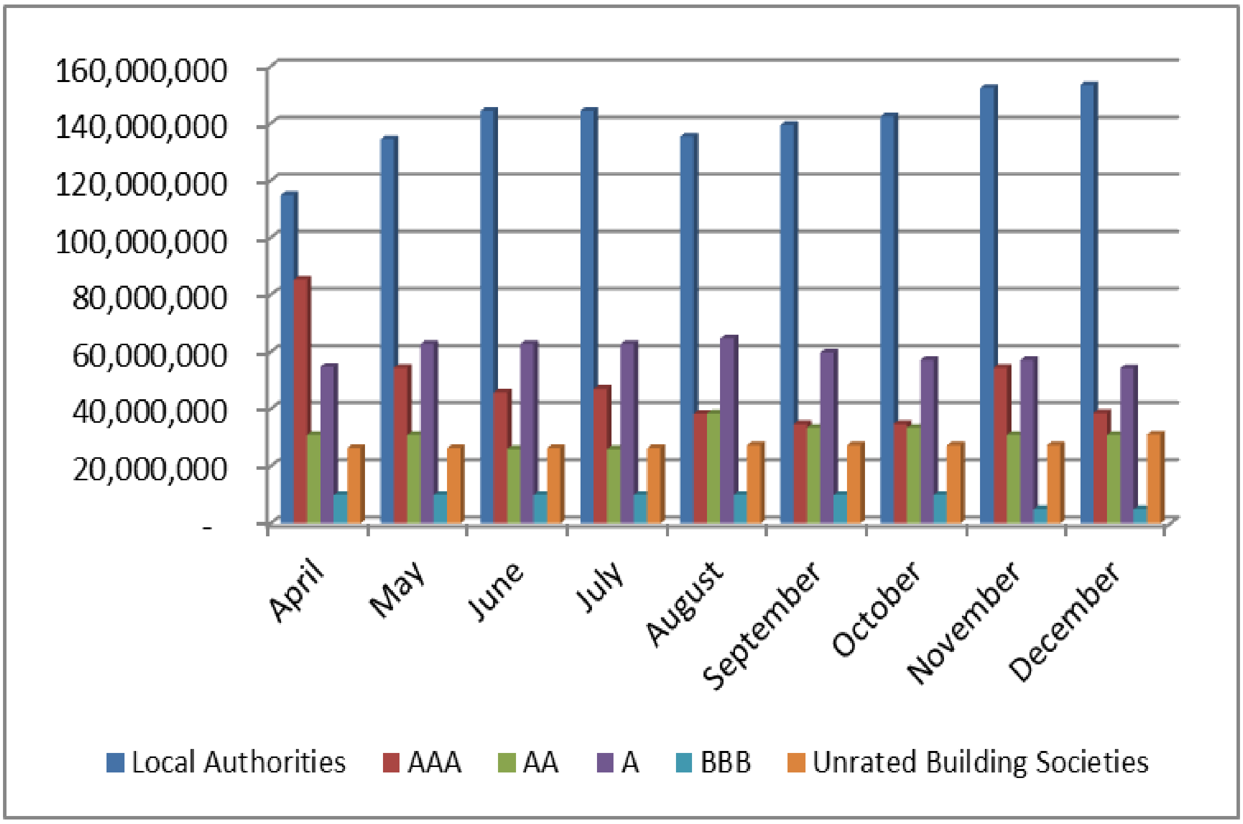
Under the Council's Annual Investment Strategy counter parties are categorised by their credit ratings for the purposes of assigning investment limits.

At 30 June 2014 the City Council had on average £5.9m invested with each institution.

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



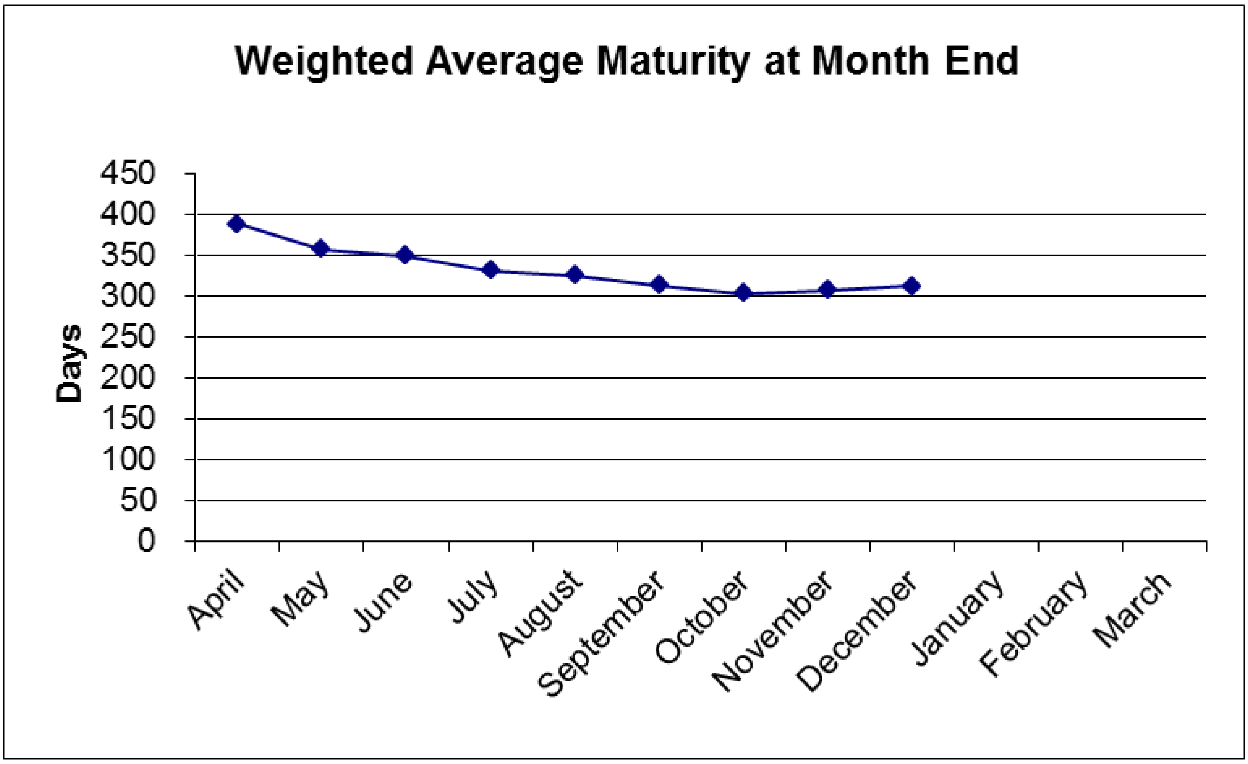
The chart below shows how the Council's investment portfolio has changed in terms of the credit ratings of investment counter parties over the first nine months of 2014/15.



It can be seen from the graph above that investments in AAA rated counter parties, consisting mainly of AAA rated instant access money market funds have declined over the first nine 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.

9. LIQUIDITY OF INVESTMENTS

The weighted average maturity of the City Council’s investment portfolio started at 388 days in April and decreased to 303 days in October 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. The weighted average maturity of the investment portfolio has since increased to 312 days as capital expenditure slipped and the forecasts of when the first increase in base rate will be have been pushed back as confidence within the financial markets has waned. This is shown in the graph below.



The 2014/15 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 £38.6m 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	116
31/3/2016	158	84
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	377
Minimum Projected Gross Investments – Fixed Rate	(66)	(120)
Fixed Interest Rate Exposure	332	257

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	(241)	(194)
Variable Interest Rate Exposure	(241)	(194)

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	(31)	(838)	(685)
Net Effect of +/- 0.5% Rate Change	**(31)**	**(783)**	**(630)**