

# **Treasury Management Strategy Statement and Annual Investment Strategy**

Mid-year Review Report 2014/15

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# 1 Background

The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

Accordingly, treasury management is defined as:

“The management of the local authority's investments and 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.”

# 2 Introduction

The primary requirements of the CIPFA Code of Practice on Treasury Management 2011 are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a **Mid-year Review Report** and an Annual Report covering activities during the previous year.
4. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
5. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Budget & Strategic Planning Working Group.

This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of the 2014/15 financial year to 30<sup>th</sup> September 2014;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure (prudential indicators);
- A review of the Council's investment portfolio for 2014/15;
- A review of the Council's borrowing strategy for 2014/15;
- A review of any debt rescheduling undertaken during 2014/15;
- A review of compliance with Treasury and Prudential Limits for 2014/15

### 3 Economic update (as provided by the Council's Treasury Management Advisors)

#### 3.1 Economic performance to date and outlook

##### 3.1.1 U.K.

After strong UK GDP in 2013 of 2.7% which has continued into 2014 with a further increase of 3.2% as at Q2, it appears very likely that strong growth will continue through 2014 and into 2015. Signs from the services and construction sectors are very encouraging with business investment recovering strongly. 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. 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.

Also encouraging has been the sharp fall in inflation (CPI), reaching 1.5% in 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.

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.

##### 3.1.2 U.S.

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).

##### 3.1.3 Eurozone

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. 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

### 3.1.3 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 --7.1% over the previous year.

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.

### 3.2 Interest rate forecasts

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 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.

## 4 Treasury Management Strategy Statement and Annual Investment Strategy update

The Treasury Management Strategy Statement (TMSS) for 2014/15 was approved by this Council on 5<sup>th</sup> February 2014.

- The underlying TMSS approved previously requires revision in the light of likely operational changes during the year to the credit element of the future credit methodology. The proposed changes and supporting detail for the changes are set out in section 6 Investment Portfolios on Page 7 as this is likely to proceed and will require adding to the Strategy Statement.

## 5 The Council's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

## 5.1 Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

| <b>Capital Expenditure by Service</b> | <b>2014/15 Original Estimate<br/>£000</b> | <b>Current Position<br/>£000</b> | <b>2014/15 Revised Estimate<br/>£000</b> |
|---------------------------------------|---|----------------------------------|--|
| HRA                                   | 2,273                                     | 4,326                            | 4,326                                    |
| Non HRA                               | 1,266                                     | 2,420                            | 2,420                                    |
| <b>Total</b>                          | <b>3,539</b>                              | <b>6,746</b>                     | <b>6,746</b>                             |

The increase from the original estimate of £3.207m consists of approximately £2.437m of schemes carried forward from 2013-14 plus approximately £0.770m of additional scheme approvals in the current year including Affordable Housing New Build £300k, Warm Homes grant £64k and Housing Foyer Contribution £400k.

## 5.2 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

| <b>Capital Expenditure</b> | <b>2014/15 Original Estimate<br/>£000</b> | <b>2014/15 Revised Estimate<br/>£000</b> |
|----------------------------|---|--|
| Supported                  | 0   | 0  |
| Unsupported                | 3,539                                     | 6,746                                    |
| <b>Total spend</b>         | <b>3,539</b>                              | <b>6,746</b>                             |
| Financed by:               |   |  |
| Capital receipts           | 808                                       | 1,864                                    |
| Capital grants             | 108                                       | 203                                      |
| Reserves                   | 894                                       | 2,589                                    |
| Third party contribution   | 39  | 400                                      |
| Cash backed depreciation   | 980                                       | 980                                      |
| Revenue                    | 710                                       | 710                                      |
| <b>Total financing</b>     | <b>3,539</b>                              | <b>6,746</b>                             |
| <b>Borrowing need</b>      | <b>0</b>                                  | <b>0</b>                                 |

## 5.3 Changes to the Prudential Indicators for the Capital Financing Requirement, External Debt and the Operational Boundary

The table shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period. This is termed the Operational Boundary.

### Prudential Indicator – Capital Financing Requirement

We are on target to achieve the original forecast Capital Financing Requirement

## Prudential Indicator – External Debt / the Operational Boundary

|  | 2014/15<br>Original<br>Estimate<br>£000 | Current Position<br>£000 | 2014/15<br>Revised<br>Estimate<br>£000 |
|--|---|--------------------------|--|
| <b>Prudential Indicator – Capital Financing Requirement</b>            |   |                          |  |
| CFR – non housing  | 151                                     | 151                      | 151                                    |
| CFR – housing  | 31,484                                  | 31,484                   | 31,484                                 |
| Total CFR  | 31,635                                  | 31,635                   | 31,635                                 |
| <b>Net movement in CFR</b>   | <b>-404</b>                             | <b>-404</b>              | <b>-404</b>                            |
| <b>Prudential Indicator – External Debt / the Operational Boundary</b> |   |                          |  |
| Borrowing  | 34,861                                  | 34,861                   | 34,413                                 |
| Other long term liabilities  | 151                                     | 177                      | 151                                    |
| <b>Total debt 31 March</b>   | <b>35,012</b>                           | <b>35,038</b>            | <b>34,564</b>                          |

### 5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2014/15 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

|                                  | 2014/15<br>Original<br>Estimate<br>£000 | Current Position<br>£000 | 2014/15<br>Revised<br>Estimate<br>£000 |
|----------------------------------|---|--------------------------|--|
| Gross borrowing                  | 31,861                                  | 31,861                   | 31,413                                 |
| Plus other long term liabilities | 151                                     | 177                      | 151                                    |
| Gross borrowing                  | 32,012                                  | 32,038                   | 31,564                                 |
| CFR (year end position)          | 31,635                                  | 31,638                   | 31,638                                 |

The Head of Central Services reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

| <b>Authorised limit for external debt</b> | 2014/15<br>Original<br>Indicator<br>£000 | Current Position<br>£000 | 2014/15<br>Revised<br>Indicator<br>£000 |
|---|--|--------------------------|---|
| Borrowing                                 | 44,860                                   | 44,860                   | 44,860                                  |
| Other long term liabilities               | 140                                      | 140                      | 140                                     |
| Total                                     | 45,000                                   | 45,000                   | 45,000                                  |

## 6 Investment Portfolio 2014/15

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 Section 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. Indeed, the Funding for Lending scheme has reduced market investment rates even further. The potential for a prolonging of the Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment, investment returns are likely to remain low.

The Council held £18.2m of investments as at 30 September 2014 (£14.7m at 31 March 2014) and the investment portfolio yield for the first six months of the year is 0.61% against the seven day money market rate of 0.30 %.

The Head of Central Services confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2014/15.

The Council's budgeted gross investment return for 2014/15 is £51,870, and performance for the year is forecast to exceed the budget by at least £35,000 due to the higher level of balances and the lengthening of the portfolio.

### Investment Counterparty Criteria-Key Changes to the Treasury Strategy

The current investment counterparty criteria selection approved in the TMSS requires the following changes incorporated:

The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. More recently, in response to the evolving regulatory regime, the agencies have indicated they may remove these "uplifts". This process may commence during this financial year. The actual timing of the changes is still subject to discussion, but this does mean immediate changes to the credit methodology are required.

It is important to stress that the rating agency changes do not reflect any changes in the underlying status of the institution or credit environment, merely the implied level of support that has been built into ratings through the financial crisis. The eventual removal of implied Government support will only take place when the regulatory and economic environments have ensured that financial institutions are much stronger and less prone to failure in a financial crisis.

Both Fitch and Moody's provide "standalone" credit ratings for financial institutions. For Fitch, it is the Viability Rating, while Moody's has the Financial Strength Rating. Due to the future removal of sovereign support from institution assessments, both agencies have suggested going forward that these will be in line with their respective Long Term ratings. As such, there is no point monitoring both Long Term and these "standalone" ratings.

Furthermore, Fitch has already begun assessing its Support ratings, with a clear expectation that these will be lowered to 5, which is defined as "A bank for which there is a possibility of external support, but it cannot be relied upon." With all institutions likely to drop to these levels, there is little or no differentiation to be had by assessing Support ratings.

As a result of these rating agency changes, the credit element of our future methodology will focus solely on the Short and Long Term ratings of an institution. Rating Watch and Outlook information will continue to be assessed where it relates to these categories. This is the same process for Standard & Poor's that we have always taken, but a change to the use of Fitch and Moody's ratings. Furthermore, we will continue to utilise Credit Default Swaps (CDS) prices as an overlay to ratings in our new methodology.

## 7 Borrowing

The Council's capital financing requirement (CFR) for 2014/15 is £31.635m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Table 5.4 shows the Council has borrowings of £31.861m which presently exceeds the CFR, however a loan of £448,000 will be repaid before the end of the financial year to reduce the level of borrowings accordingly. This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

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.

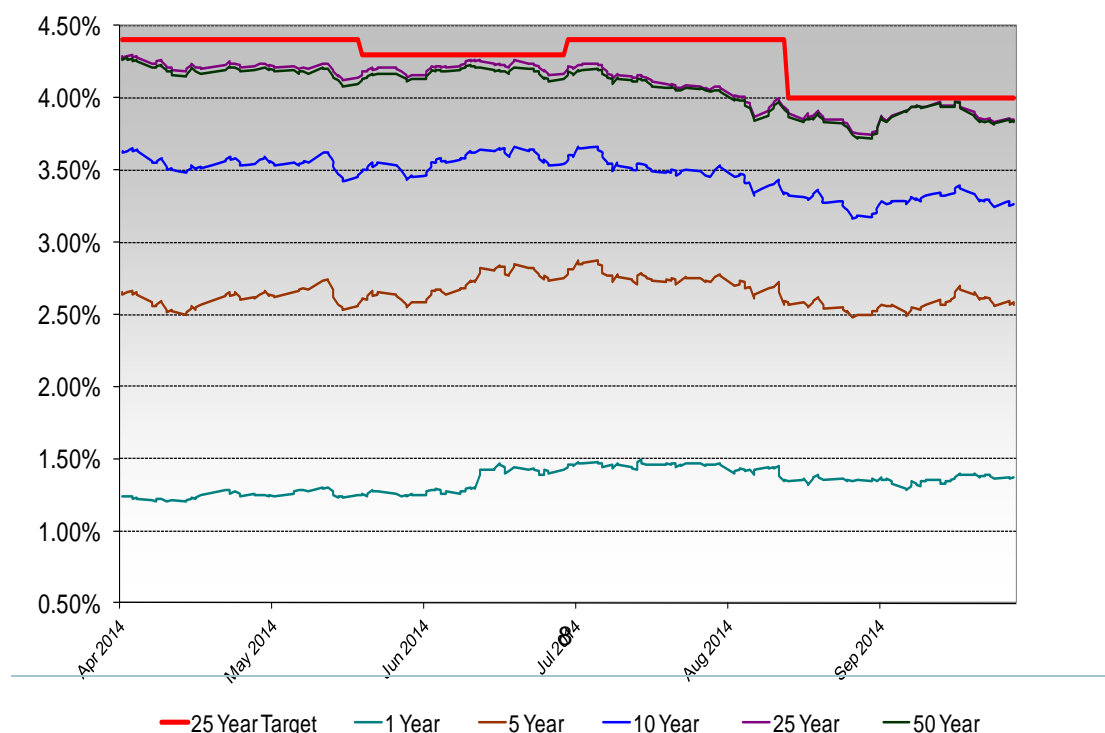
No new external borrowing has been undertaken and it is anticipated that no further borrowing will be required in this financial year.

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%      |





## 8 Debt Rescheduling

No debt rescheduling was undertaken during the first six months of 2014/15.