Stevenage BOROUGH COUNCIL

Part 1
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Meeting: **EXECUTIVE / AUDIT / COUNCIL** **Council Agenda Item: 11**

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TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY - MID-YEAR REVIEW REPORT 2013/14

NON-KEY DECISION

Author – Clare Fletcher Ext No. 2933
Contributors- Lee Busby Ext No.2730
Lead Officer – Clare Fletcher Ext No. 2933
Contact Officer – Clare Fletcher Ext No. 2933

1. PURPOSE

1.1 To review the operation of the 2013/14 Treasury Management & Investment strategy for the first six months of the year, in accordance with the CIPFA Code of Practice on Treasury Management.

2. RECOMMENDATIONS

EXECUTIVE AND AUDIT COMMITTEE

2.1 That Council be recommended to approve of the 2013/14 Mid-year Treasury Management Strategy and Annual Investment Strategy Review.

COUNCIL

2.2 That subject to any comments from the Executive and the Audit Committee, the 2013/2014 Mid-year Treasury Management Strategy and Annual Investment Strategy Review be approved

3. BACKGROUND

3.1 The Chartered Institute of Public Finance & Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2011) was adopted by this Council on 27 February 2012.

3.2 One of the primary requirements of the code includes:

> "Receipt by the Council of an annual treasury management strategy report, including the annual investment strategy report - for the year ahead, a midyear review report, and an annual review report of the previous year."

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

- An economic update for the first six months of 2013/14 (Section 4).
- A review of the Treasury Management Strategy and Annual Investment Strategy (Section 5).
- A review of the Council's investment portfolio for 2013/14 (Section 6).
- A review and update of the Council's borrowing strategy for 2013/14, reflecting the Capital Strategy Update approved by Executive in September (Section 7).
- A review of compliance with Treasury and Prudential Limits for 2013/14.

4. 2013/14 ECONOMIC & INTEREST RATE REVIEW

4.1 Global Economy

4.1.1 Some Eurozone countries are now starting to see a return to growth after a prolonged recession. However, for some countries, austerity programmes could prove to be a self-defeating spiral of falling demand, tax receipts, and Gross Domestic Product (GDP), leading to a rise, not fall, in debt to GDP ratios. Debt ratios in excess of 90% will cause market concern as beyond this level, the costs of servicing such debt becomes oppressive and growth inhibiting. This could, therefore, lead to an inevitable end game in the over the next few years of withdrawal from the Eurozone bloc in order to regain national control of a currency, government debt, monetary policy and, therefore, of setting national interest rates. The European Central Bank's (ECB) pledge to provide unlimited bond buying support for countries that request an official bailout means that market anxiety about these countries is likely to be subdued in the near term. However, the poor economic fundamentals and outlook for some economies could well mean that an eventual storm in financial markets has only been delayed, not cancelled.

4.2 UK Economy

4.2.1 **Growth** - has been on a small upward trend – 0.3% in Quarter one; 0.7% in Quarter two. Business surveys, consumer confidence, consumer borrowing and house prices are rising however, this is still a long way away from the UK getting back to sustainable strong growth.

4.2.2 A fair proportion of UK GDP is dependent on overseas trade; the high correlation of UK growth to US and EU GDP growth means that the UK economy is still vulnerable to what happens in overseas markets.

4.2.3 Consumer expenditure is likely to remain suppressed by inflation being higher than increases in average earnings i.e. disposable income will continue to be eroded and Government measures to increase the supply of credit to small and medium enterprises (which are key to achieving stronger growth) by banks has not been seen to be working.

4.2.4 **Inflation –** The RPI for September 2013 was 3.2% (with CPI at 2.7% in September). CPI inflation (MPC target of 2.0%), fell marginally from a peak of 2.9% in June to 2.7% in September. The Bank of England expects inflation to fall back to 2.0% in 2015.

4.2.5 Pay growth increased in April, though this was mostly driven by high earners delaying bonuses until after April's cut in the top rate of income tax. Excluding bonuses, earnings rose by just 1.0% well below the rate of inflation at 2.7% in August, causing continuing pressure on household's disposable income.

4.2.6 **Gilts -** Gilt yields remain vulnerable to pressures to rise, especially as they are powerfully influenced by US treasury yields and American investors have been 'spooked' by Chairman Bernanke's comments on tapering QE. The Federal Bank's reluctance to start tapering in September has, potentially, only delayed a trend for gilt yields to rise.

4.3 The forward view of our Treasury Advisors (Sector)

4.3.1 There remain huge uncertainties in economic forecasts due to the following major difficulties:

4.3.2 Major volatility in bond yields is likely during the remainder of 2013/14 as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, and safer bonds..

4.3.2 Near-term, there is some residual risk of further Quantitative Easing (QE) - if there is a dip in strong growth or if the MPC takes action to do more QE in order to reverse the rapid increase in market rates, especially in gilt yields and interest rates up to 10 years. This could cause shorter-dated gilt yields and PWLB rates over the next year or two to significantly undershoot the forecasts in the table in paragraph 4.4.3.

4.3.3 The delay in the US, over passing a Federal budget for the new financial year starting on 1 October, and the expected tension over raising the debt ceiling in mid-October, could also see bond yields temporarily dip until any binding agreement is reached between the opposing Republican and Democrat sides. Conversely, the eventual start of tapering by the Fed could cause bond yields to rise.

4.3.4 The longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. Increasing investor confidence in economic recovery is also likely to compound this effect as a continuation of recovery will further encourage investors to switch back from bonds to equities.

4.3.5 It is Sectors view that the overall balance of risks to economic recovery in the UK is currently weighted to the upside after five months of robust good news on the economy. However, only time will tell just how long this period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas and the Bank Governor Mark Carney put this into perspective by describing the increases in growth as not yet being "escape velocity" to ensure a return to strong and sustainable growth, after what has been the weakest recovery on record after a recession.

4.4 Interest Rate Review September 2013

4.4.1 In the last Mid-Year Treasury Report for 2012/13 our Treasury advisors were forecasting rates to be stable at 0.5% for the year, rising to 0.75% in the third quarter of 2014. The current view is that the bank rate of 0.5% will remain well into June 2015, with the latest forecast including the first increase in Bank Rate in quarter 3 of 2016.

4.4.2 The Bank of England has issued forward guidance with its Inflation Report which said that the Bank will not start to consider raising interest rates until the jobless rate (Labour Force Survey not the claimant count measure) has fallen to 7% or below. This would require the creation of about 750,000 jobs and was forecast to take three years. The UK unemployment rate currently stands at 2.5 million i.e. 7.7 % on the LFS measure.

4.4.3 Sector's current interest rate forecast is shown in the following table:

Table One: Interest rate projections as at 30 September 2013.

	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%
5yr PWLB rate	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%
10yr PWLB rate	3.70%	3.70%	3.70%	3.80%	3.80%	3.90%	4.00%
25yr PWLB rate	4.40%	4.40%	4.40%	4.50%	4.50%	4.60%	4.70%
50yr PWLB rate	4.40%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%

5. TREASURY MANAGEMENT REVIEW

5.1 Update of 2013/14 Treasury Management Strategy and Annual Investment Strategy

5.1.1 The Treasury Management Strategy Statement (TMSS) for 2013/14 was approved by Council on 27 February 2013. The council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as follows:

- Security of capital
- Liquidity
- Yield

5.1.2 The Council will always aim to achieve the optimum return (yield) on investments, however security and liquidity have a higher priority. In the current economic climate it is considered appropriate to keep investments short term and only invest with highly credit rated financial institutions, using Sector's suggested creditworthiness approach, including sovereign credit rating and considering the appropriateness on a counterparty basis of credit default swap (CDS) overlay information provided by Sector, our Treasury advisors (most of our investments are in overnight accounts of the highest quality, presenting a low risk).

5.1.3 Changes as part of the 2012/13 Treasury Management review and 2013/14 Treasury Management Strategy have meant that no further changes are recommended in this Mid-Year review. The previously approved changes included:

1. Following the downgrading of part-nationalised institutions from F1+ to F1 in October 2011, the Treasury Management Strategy was updated to include that investments be made in the following order:

- the Council would favour F1+ institutions, and then
- F1 part-nationalised institutions, and then
- other F1 institutions,

2. Use of Triple A rated Money Market Funds up to a limit of £15Million, with no more than £5Million with any one Fund, and no more than 35% of the Council's total investments included in MMFs

3. Increase in variable rate investment limits to £40Million.

6. INVESTMENT PORTFOLIO 2013/14

6.1 In accordance with the Code, the council's priority is to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the council's risk appetite.

6.2 A full list of investments held as at 1st April and at 30th September 2013, are shown below in Table two. The investments were all in accordance with Sector's counterparty list, based on changes to Fitch, Moodys and S&P's credit ratings and giving consideration to the effect of credit default swap (CDS) credit ratings during the first six months of 2013/14 on term deposits, and the Council's own criteria of achieving a minimum of a Fitch F1 short term rating.

6.3 The table two below shows that we had 100% of investments in call or overnight accounts in April and also at the end of September.

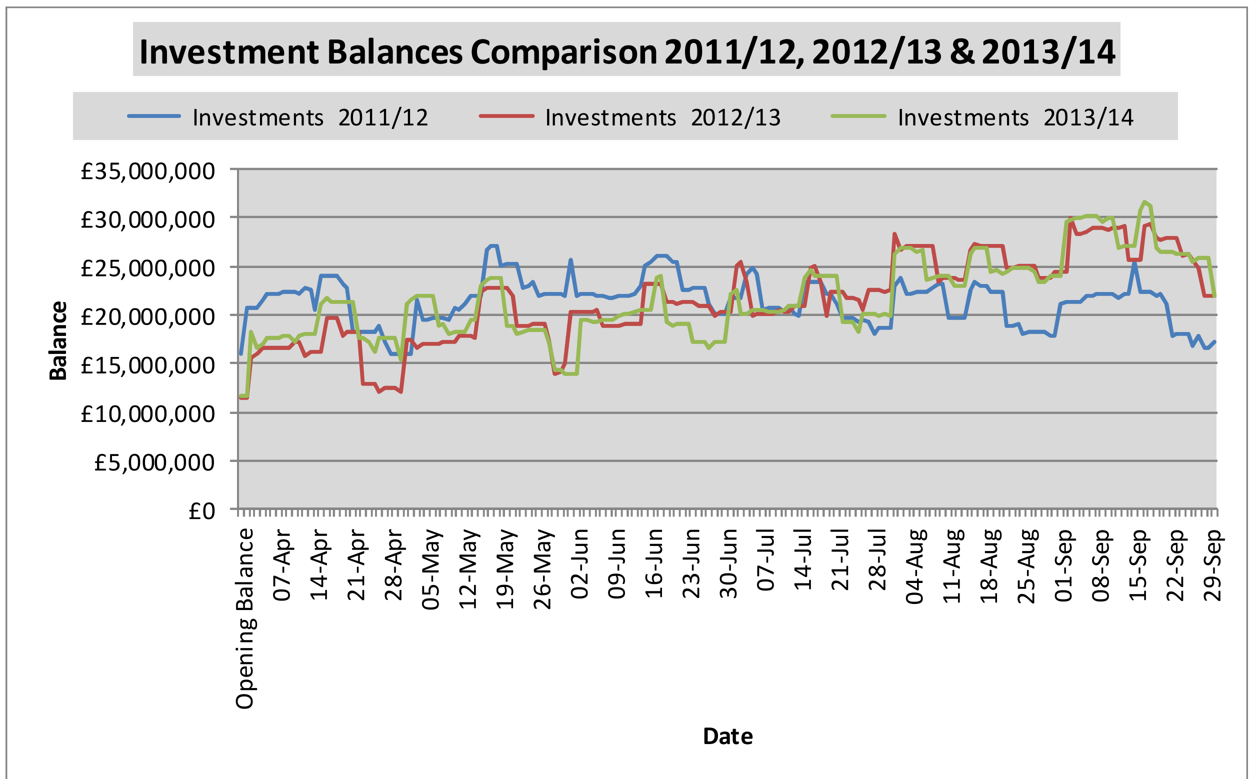
Table two

Investments	Country	1st April 2013	Average Rate of Return
Santander – Call Account	UK	5,000,000	0.88%
Nat West – Call Account	UK	1,650,000	0.85%
Handelsbanken – 35 day notice	Sweden	5,000,000	0.71%
Total		**11,650,000**	
Investments		**30th September 2013**	**Average Rate of Return**
Santander – Call Account	UK	5,000,000	0.88%
Bank of Scotland – Call Account	UK	3,740,000	0.44%
Nat West – Call Account	UK	1,500,000	0.54%
Handelsbanken – 35 day notice	Sweden	5,000,000	0.54%
IGNIS - Money Market Fund	UK	3,415,000	0.43%
Morgan Stanley - Money Market Fund	UK	3,415,000	0.41%
Total		**22,070,000**	

6.4 There were no breaches of prudential indicators for investments, during the first six months of the year. Members will remember that last year there was a technical breach of the Strategy because more than the counter party limit of £5Million was placed with the Debt Management Office (DMO). The Strategy was subsequently changed in December 2012 to allow unlimited funds with the DMO (recognising its ‘safe haven’ status). However the DMO’s investment rates are poor and the limits on counter parties and the Money Market fund parameters minimise the use of the DMO on a day to day basis. Since the 1 April 2013 there have been no deposits made with the Debt Management Office (DMO).

6.5 Investment rates available in the market remain at a historical low point. The average level of funds available for investment purposes in the first six months of 2013/14 was £21.778Million (£21,587 Million, April to September 2012), with balances fluctuating between £11.650million and £31.59million. These are funds available on a temporary basis, the level of funds available is determined by the timing of precept payments, principal and interest payments, receipt of grants and progress on the capital programme.

6.6 Although the Council had no fixed rate investments, the invested balances for April to September did not exceed £40Million, which is the limit set within the Treasury Management Strategy for variable investments for the year. A chart of investment for the 2013/14 year to date, and the comparative balances for the previous years are shown below.



6.7 The Council achieved returns for the first six months of the year of 0.56% on its investments, which exceeds the 7 day LIBOR benchmark rate of 0.49%. The LIBOR benchmark rates are shown in table three.

Benchmark	Benchmark Return
7 day	0.49%

1 month	0.49%
3 months	0.51%
6 months	0.59%
12 months	0.89%

6.8 The forecast interest rate return for the year is projected to be 0.56%, compared to the Council's original budgeted investment return for 2013/14 of 0.67%. The Council is earning more interest than originally forecast due to higher than planned cash balances, but investment rates remain low which has seen a reduction in call account and money market fund rates which the Council is currently investing in.

6.9 In addition to the Council's treasury investments, covered by the specified and non-specified investment policy, In 2012/13 the Council undertook to make deposits to guarantee mortgage advances agreed under the Local Authority Mortgage (LAM) Scheme. This formed part of the Council's capital expenditure, as this is a fully funded scheme there is no impact on the Council's capital finance requirement (CFR). The LAM scheme is not classified as an investment and as such is not subject to the Treasury Management Strategy.

7. Review of External Borrowing

7.1 The Capital Financing Requirement (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.

7.2 The opening CFR for 2013/14 was £230.095Million of which £214.655Million relates to the Housing Revenue Account (HRA). The **HRA CFR** is made up of external borrowings of £17.004Million decent homes and £196.911Million self financing debt. It also includes £0.74Million internal borrowing (through the use of investment balances). The **General Fund CFR** totals £15.440Million.

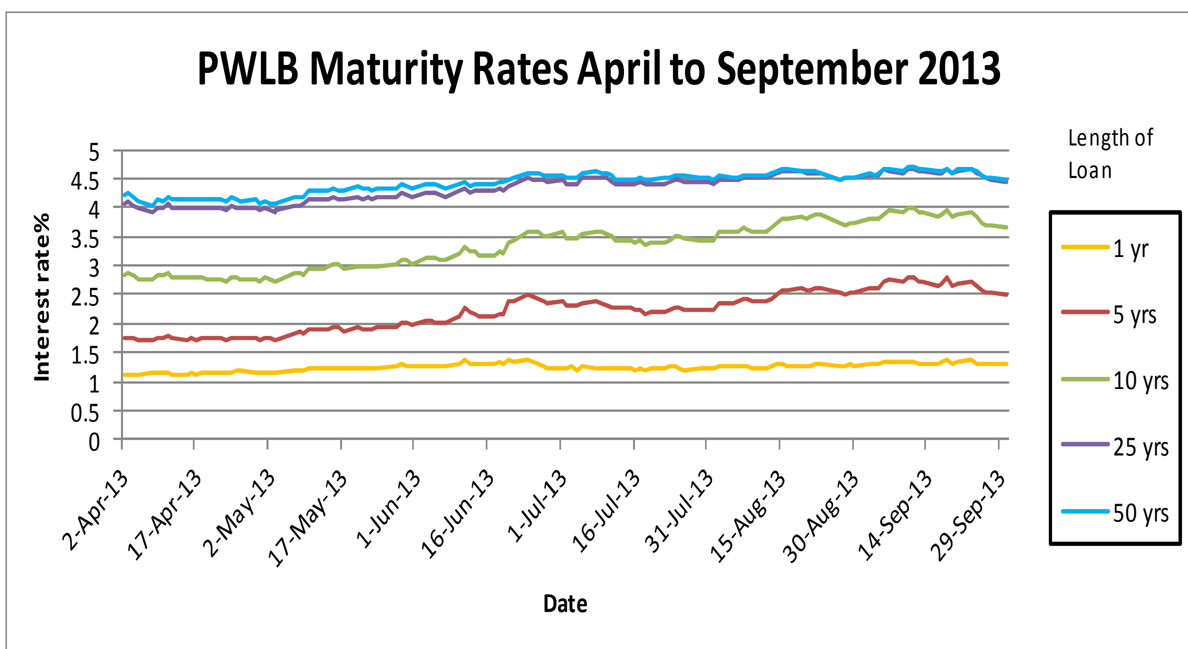
7.3 The Council's current loan portfolio is at Appendix B. It includes nine HRA Decent Homes loans taken out up to 31st March 2011 of £17.004 million and a further 16 self financing loans of £196.911Million taken out in March 2012. The HRA is currently £3.030Million below its debt cap of £217.685Million.

7.4 The average interest payable on all the Council's loans is 3.34%. The debt relating to the HRA is in two tranches, decent homes proportion being an

average of 3.84% and self financing an average of 3.31%, giving the HRA an average debt rate of 3.36%. The self financing rates are lower because of the government's one off discounted rate available for the implementation of self financing. The General Fund average rate of interest is 2.25% and relates to the Town Square purchase. The General Fund rate is lower than that of the HRA because the debt repayment terms are much shorter. The average rate of 2.25% is lower than the estimated loan rate for the Town Square estimated to be 2.69% at the time Member's approved the purchase.

7.5 There were no breaches of the Strategy on borrowing limits and the Council was under borrowed by £15.440Million at the beginning of the year, preferring to use internal cash balances rather than take on external debt. Since the 1 April loans totalling £4Million have been taken. The Council has chosen to use investment balances (0.56%) rather than borrow externally at 3%+, however this policy will not be sustainable on-going as cash balances diminish. The current borrowing projections contained within the General Fund 2013/14 budget are to externally borrow to fund the 2013/14 capital programme (£3.26Million) and the remaining funding for the Town Square purchase (£3.039Million).

7.6 The general trend in movement of rates has been a slight increase in shorter term PWLB interest rates during the last six months, as shown below:



7.7 The council will aim to minimise borrowing for the year through close management of cash balances (internal borrowing) where possible, in order to minimise borrowing costs to the Council. It should be noted that the actual borrowing taken out is not the same as the council's underlying need to borrow, as reflected in the capital financing requirement (CFR).

8. Review of Treasury and Prudential Limits

8.1 The Treasury Management Prudential Indicators are shown in full at Appendix A. The indicators have been updated to reflect changes to the General Fund and HRA budgets and latest Medium Term Financial Strategies (MTFS).

8.2 Previously reported operational and authorised boundary prudential indicators showed the HRA maximum levels as the government imposed debt cap. This has been reduced to show the maximum amount the Council currently expects to borrow.

8.3 There are no proposed changes to the Treasury Management Strategy.

9. IMPLICATIONS

9.1 Financial Implications

This report is of a financial nature and reviews the treasury management function for the 2013/14 financial year.

9.2 Legal Implications

None

9.3 Equality and Diversity Implications

There are no Equality Impact implications identified within the report.

9.4 Risk Management Implications

There is a risk that counterparties will further diminish with the global economic position	Action has been taken to ensure that sufficient creditworthy counterparties are available, on a sliding scale of credit-worthiness.	Low risk – currently running investment balances down, to minimise borrowing requirement. This will minimise amounts available to invest.
There is a risk that gilt rates may move, affecting adversely the borrowing cost to the council.	Market sentiment at present shows sterling as sound. At present the pressure on gilts looks downward.	Medium risk – difficult to hedge, as would need to borrow early to minimise risk, at extra cost.

BACKGROUND DOCUMENTS

- BD1 - Treasury Management Report

APPENDICES

- Appendix A – Prudential and Treasury Indicators
- Appendix B – Loan Portfolio