Treasury Management Strategy Statement and Annual Investment Strategy Mid-Year Review Report 2014/15

EXECUTIVE MEMBER: Councillor Gillian Troughton
LEAD OFFICER: Angela George, Interim Finance Manager
REPORT AUTHOR: Leanne Barwise, Senior Accounting Officer

WHY HAS THIS REPORT COME TO EXECUTIVE?
This mid-year report has been prepared and is reported in compliance with the Chartered Institute of Public finance Accountancy's (CIPFA) Code of Practice on Treasury Management which was adopted by this Authority on 14 December 2009. The report briefly covers the following:

- An economic update for the 2014/15 financial year to 30 September 2014 (paragraph 3);
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy (paragraph 4);
- The Council's capital expenditure (prudential indicators – paragraph 5);
- A review of the Council's investment portfolio for 2014/15 (paragraph 6);
- A review of the Council's borrowing strategy for 2014/15 (paragraph 6.2);
- A review of any debt rescheduling undertaken during 2014/15 (not applicable);
- A review of compliance with Treasury and Limits for 2014/15 (prudential indicators - paragraph 5)

Recommendations:
Executive is asked to:
1. Note the Mid-Year Review and treasury activity detailed throughout this report.
2. Note the forecast investment income is expected to exceed the revised budget by £13k subject to current economic conditions prevailing to year end (see paragraph 6).
3. Recommend to Council for approval the changes to the credit methodology whereby viability, financial strength and support ratings will not be considered as key criteria in the choice of creditworthy investment counterparties (see paragraph 2).

1. INTRODUCTION

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. KEY CHANGES TO THE TREASURY & CAPITAL STRATEGIES

The Council has a pool of counterparties (Banks/Institutions etc) that are considered high quality which may be used to place investments; this is called the counterparty list. The criteria that form the basis of our counterparty list was reported within the Treasury Management Strategy 2014/15 in February 2014 and approved by Council. However, the main rating agencies (Fitch, Moody's and Standard & Poor's) have advised they may change the way they review a counterparty. The agencies provided some institutions with a ratings "uplift" due to implied levels of sovereign support and have recently indicated they may remove these "uplifts", making the Support, Financial Strength and Viability ratings redundant. The removal of these ratings would result in a change to our criteria and subsequently our Counterparty list which is why approval is sought through this report. Further explanation can be found in paragraph 6.1 of this report.

We ask Executive to recommend to Council for approval:
As a result of these potential rating agency changes, our future counterparty criteria will focus solely on the Short and Long Term ratings of an institution (where previously we included the potentially redundant Financial Strength/Viability & Support in addition to these).

3. ECONOMIC UPDATE FROM OUR TREASURY ADVISORS

3.1 Economic Performance to date & outlook

The UK has demonstrated strong growth (GDP) since quarter 2 of 2013 to date which will continue through 2014 and into 2015. This has resulted in unemployment falling much faster through the initial threshold of 7% unemployment, set by the Monetary Policy Committee (MPC) in August 2013. Unemployment is expected to keep on its downward trend and this is likely to eventually result in significant increases in pay rates at some point during the next three years.

Inflation (CPI), has fallen sharply reaching 1.2% in September, the lowest rate since 2009. It is anticipated inflation will fall further in 2014 possibly as low as 1% with expectation that the MPC will be cautious in raising Bank Rate (to protect those consumers heavily in debt 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 2015, at the earliest, and they expect increases after that to be at a slow pace.

The return to strong growth has also helped reduce the forecasts in relation to the increase in Government debt and forecasting a return to a significant budget surplus, (of £5bn), in 2018-19.

The performance of the UK economy is largely influenced by the US and the Eurozone. Performance in the US has been good whilst the Eurozone faces an increasing threat from weak or negative growth and from deflation. With unemployment of 25% in some of the Mediterranean states and Italy and France doing little to correct their economies, the Eurozone is likely to provide little support to the UK economy and may well see UK monetary policy held lower for longer.

3.2 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%

Bank rate is the primary rate which determines the interest rate earned and therefore payable to the Council from out investments and the Public Works Loans Board (PWLB) rate is an example of the interest rate that we would pay on any borrowing from the PWLB.

Capita Asset Services undertook a review of its interest rate forecasts in mid-August 2014, after the Bank of England's Inflation Report. 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 in February 2014 and the points clarified in the Treasury Management Outturn at Council in May 2014. There are no policy changes to the TMSS; the details in this report update the position in light of the updated economic position and budgetary changes already approved.

5. THE COUNCIL'S PORTFOLIO 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 set in February 2014.

Capital Expenditure	2014/15 Original Estimate £000's	2014/15 Revised forecast spend £000's	Current spend as at 30 September 2014 £000's
Total	1,340	2,788	686

As detailed in the table above, a gross capital programme budget for 2014/15 of £1,340,000 was approved by Council on 13 February 2014. This was later increased by £2,256,270 to account for slippage from 2013/14 resulting in a revised gross capital expenditure budget of

£3,596,270 at 30th September 2014. (This is subject to a further bid of £22k relating to the ventilation at Moresby Depot which has been approved but not yet added to the capital programme until the outcome of the feasibility study is known.)

A detailed Capital Programme 2014/15 Budget Monitoring Report as at Quarter 2 is presented elsewhere on this agenda.

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 (i.e. paid for in year of spend) and unsupported (not paid for in year of spend) elements of the capital programme, and the expected financing arrangements of this capital expenditure. Any borrowing element in the table would increase the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this would be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). Any direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	2014/15 Original Estimate £000's	2014/15 Revised forecast spend £000's	Current spend as at 30 September 2014 £000's
Supported	1,340	2,783	685
Unsupported	0	5*	1*
Total spend	**1,340**	**2,788**	**686**
Financed by:			
Useable Capital receipts	1,079	1,609	194
Other Reserves & Contributions	0	0	0
External Funding	261	1,174	491
Total financing	**1,340**	**2,783**	**685**
Borrowing need	**0**	**5***	**1***

*whilst this increases the authorities Capital Financing Requirement (CFR - underlying need to borrow) it relates to the purchase of a vehicle via a purchase agreement thus eliminating the borrowing need.

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

The table below 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.**

We are on target to achieve the amended forecast Capital Financing Requirement as outlined in the following table.

	2014/15 Original* Estimate £000's	2014/15 Revised** Estimate £000's
Prudential Indicator – Capital Financing Requirement		
CFR – non housing	8,465	7,925
Net movement in CFR	**0**	**(540)**
Prudential Indicator – External Debt / the Operational Boundary		
Borrowing	5,000	5,000
Other long term liabilities***	6,289	5,749
Total debt 31 March	**11,289**	**10,749**

** These are the balances detailed in the 13/14 financial statements*
***Revised as at mid-year point - 30 September 2014*
****On balance sheet PFI schemes and finance leases etc.*

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 and necessary.

Limits to Borrowing Activity	2014/15 Original Estimate £000's	2014/15 Revised Estimate £000's
Gross borrowing	5,000	5,000
Plus other long term liabilities*	6,289	5,749
Less investments	(25,668)**	(18,000)***
Net borrowing	**(14,379)**	**(7,251)**
CFR (year-end position)	**8,465**	**7,925**

**Includes on balance sheet PFI schemes and finance leases, **This balance is inflated due to timing of NNDR payments, ***Estimate based on our typical core funds at year end excluding NNDR issues.*

The Section 151 Officer reports that no difficulties are envisaged for the current year 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. This limit needs to be set and revised by Members. It reflects the level of borrowing which, while not desirable, 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.

Authorised limit for external debt	2014/15 Original Indicator	2014/15 Revised Indicator
Borrowing	9,000	9,000
Other long term liabilities*	8,000	8,000
Total	17,000	17,000

**Includes on balance sheet PFI schemes and finance leases.*

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 continues to be a very difficult investment market in terms of earning a similar level of interest rates saw in previous decades, as rates are very low and in line with the 0.5% Bank Rate. The Funding for Lending scheme (a scheme which offers banks an incentive to boost UK lending by borrowing at favourable rates) has reduced market investment rates even further. The current economic issues with the Eurozone necessitate a low risk and short term strategy leading to our investment returns remaining low.

The Treasury Management budget was set by Council alongside other revenue budgets in February 2014. In light of the continued reduction in investment income over the years, the 2014/15 budget for investment returns was reduced to £152,822 with the expectation that the rates of return that were previously achieved with the part nationalised banks (the highest rate achieved 2013/14 was 1.05%) would not be offered in 2014/15. Although the current interest rates offered by the banks are not comparable to previous years, we have placed larger deals for longer periods; mitigating any potential reduction in investment income whilst maintaining full compliance with the Treasury Management Strategy and maximizing investment returns. The forecast at year end *was* a budget surplus and the treasury management investment income budget was therefore increased at period 6 to £201,822. As can been seen in the table below, the full year forecast for investment interest at 30 September 2014 is still expected to slightly exceed the revised budget by £13k (£215k forecast) if current market conditions prevail to the end of the financial year.

Anticipated Investment Return 2014/15:

Revised Budget £	Received to 30 September 2014	Interest earned on current outstanding investments	Forecast of expected investments to 31/03/15	Total Forecast position as at 31/03/15	Variance £
201,822	82,062	93,194	39,291	214,547	12,725

The Council held £45m of funds in investments as at 30 September 2014 (not all of which belongs to the authority but were held due to timing issues of receipt and onward payment of NNDR). Of this, £20m was held in instant access Call accounts/Money Market Funds (and therefore would be deemed as cash equivalent within the year end accounts) the remainder being held in fixed term deposits for various periods not exceeding 1 year. The average investment portfolio yield for the first six months of the year is 0.4% against current base rate of 0.5%.

The Section 151 Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2014/15.

A full list of investments held as at 30 September 2014 is presented at Appendix A.

6.1 Investment Counterparty criteria

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 (i.e. in the UK Lloyds remains a part nationalised bank). 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 (from a 4), 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 to 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 Swap (CDS) prices as an overlay to ratings in our new methodology.

6.2 Borrowing

The Council's capital financing requirement (CFR) is currently estimated at £7.9m for 2014/15. The CFR denotes the Council's underlying need to borrow for capital purposes. The Council's underlying need to borrow is supported by finance leases for both the Copeland Centre (PFI) and vehicles.

The Council's debt portfolio contains one remaining Market Loan of £5 million. We continually assess the position of this loan with our Treasury Consultants, Capita Asset Services, to see whether we are securing the best terms for the Council. At the current time, the advice is to leave this loan in its present form, as the penalty for repaying early would be prohibitive.

In the event that further borrowing is necessary, the Section 151 Officer, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time and taking into account contemporaneous forecasts. If this resulted in the authority exceeding its authorised limit (a control on the maximum level of borrowing the authority can incur - currently £17m) then Members would need to approve changes to the appropriate performance indicators within the strategy.

7. STATUTORY OFFICER COMMENTS

The Monitoring Officer's comments are: No further Comment

The Section 151 Officer's comments are: Included in the report

EIA Comments: None

Policy Framework: Within the Treasury Management Strategy 2014/15 approved by Council 2014

Other consultee comments, if any:

8. HOW WILL THE PROPOSALS BE PROJECT MANAGED AND HOW ARE THE RISKS GOING TO BE MANAGED?

The Treasury Management function is continually monitored and is reported to Executive throughout the year. It also forms part of the revenue monitoring report reported to CLT on a monthly basis. The principles set out in the Treasury Management Strategy ensure that we have a balance between security and liquidity of funds and the yield achieved, with security remaining the principle concern in the current economic climate.

9. WHAT MEASURABLE OUTCOMES OR OUTPUTS WILL ARISE FROM THIS REPORT?

As stated above the position will continue to be closely monitored and the Treasury Management Strategy 2015/16 will and presented to Full Council for approval prior to the start of the new financial year.

List of Appendices

Appendix A: Temporary investments as at 30 September 2014.

Appendix A

TEMPORARY INVESTMENTS AT 30/09/14

	AMOUNT	PERIOD OF LOAN	VALUE DATE	MATURITY DATE	RATE	VARIABLE/ FIXED	BASE RATE
BARCLAYS	4,990,000	INSTANT CALL			0.50%	VAR	**
FEDERATED INVESTORS MMF	2,990,000	INSTANT MMF			0.39%	VAR	
IGNIS MMF	4,990,000	INSTANT MMF			0.42%	VAR	
LGIM MMF	4,990,000	INSTANT MMF			0.44%	VAR	
GOLDMAN SACHS MMF	2,166,000	INSTANT MMF			0.39%	VAR	
LLOYDS GROUP	7,450,000	364 DAYS FIXED	21/05/2014	20/05/2015	0.95%	FIX	
LLOYDS GROUP	2,540,000	364 DAYS FIXED	01/04/2014	31/03/2015	0.95%	FIX	
RBS	7,440,000	90 DAYS NOTICE	18/09/2014	06/01/2015	0.40%	VAR	
RBS	2,540,000	90 DAYS NOTICE	30/06/2014	03/10/2014	0.40%	VAR	
SANTANDER	5,000,000	90 DAYS FIXED	25/07/2014	23/10/2014	0.53%	FIX	
TOTAL	**45,096,000**				0.44%		0.50%

SUMMARY

	BALANCE	LIMIT	AVAILABLE
BARCLAYS	4,990,000	5,000,000	10,000
BLACKROCK MMF	0	5,000,000	5,000,000
FEDERATED INVESTORS MMF	2,990,000	5,000,000	2,010,000
IGNIS MMF	4,990,000	5,000,000	10,000
INSIGHT MMF	0	5,000,000	5,000,000
LGIM MMF	4,990,000	5,000,000	10,000
GOLDMAN SACHS MMF	2,166,000	5,000,000	2,834,000
DMADF	0	Unlimited	Unlimited
LLOYDS GROUP	9,990,000	10,000,000	10,000
RBS	9,980,000	10,000,000	20,000
SANTANDER	5,000,000	5,000,000	0
	45,096,000		**14,904,000**