**CABINET – 21 November 2013**

**Report of the Head of Finance & Property Services**

**Lead Member: Councillor Tom Barkley**

**Part A**

ITEM 8 **Treasury Management Strategy, Annual Investment Strategy and MRP Policy – Mid-Year Review for the 6 Months to 30 September 2013**

Purpose of Report

This report reviews the Treasury Management Strategy and the Annual Investment Strategy, plus the various Prudential Borrowing and Treasury Indicators for the first six months of 2013/14. In addition, it includes a recommendation to amend the Annual Investment Strategy to reflect proposed changes to the use of external investment managers.

Recommendations

1. That it be recommended to Council to note this mid-year review of the Treasury Management Strategy Statement, Prudential Borrowing and Treasury Indicators plus the Annual Investment Strategy as shown in Part B.

2. That it be recommended to Council to approve the amendments to the 2013/14 Annual Investment Strategy as set out in Appendix 3 of Part B.

Reasons

1. To ensure that the Council's governance and management procedures for Treasury Management reflect best practice and comply with the Revised CIPFA Treasury Management in the Public Services Code of Practice, Guidance Notes and Treasury Management Policy Statement, and that funding of capital expenditure is taken within the totality of the Council's financial position and that borrowing and investment is only carried out with proper regard to the Prudential Code for Capital Finance in Local Authorities.

2. To allow the increase of in-house investments limits in view of the proposed intention to bring all investments in-house rather than use an external fund manger.

Policy Justification and Previous Decisions

The Treasury Management Strategy Statement, Prudential & Treasury Indicators and Annual Investment Strategy must be approved by Council each year and reviewed half yearly. This review is set out in the attached report as Part B. The Strategy for the year was approved by Council on 25 February 2013.

Implementation Timetable including Future Decisions and Scrutiny

This report will be available for Overview Scrutiny Group on 18 November 2013, should they wish to consider it, and for the Audit Committee on 3 December 2013.

Report Implications

The following implications have been identified for this report.

Financial Implications

There are no direct financial implications arising from this report.

Risk Management

| Risk Identified | Likelihood | Impact | Risk Management Actions Planned |
|---|---|---|---|
| That the increase of in-house limits will expose the Council to further risk of loss. | Unlikely | Major | The Council will continue to follow its current creditworthiness policy and will not be investing in any new instruments. |

Risks associated with the Treasury Policy etc in general are included in Part B.

Key Decision: No

Background Papers: None

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## Part B

### 1. Treasury Management Update – Half Year Ended 30 September 2013

The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management recommends that members be updated on treasury management activities regularly. This report therefore ensures this Council is implementing best practice in accordance with the Code.

### 2. Economic Background and Summary Outlook

This section does not cover the last six months economic outcomes in detail as these have been adequately covered in the media. However, it does include some brief highlights and a forward look. The last three months to 30 September saw:

- Indicators suggested that the economic recovery accelerated;
- Household spending growth remained robust;
- Inflation fell back towards the 2% target;
- The Bank of England introduced state-contingent forward guidance;
- 10-year gilt yields rose to 3% at their peak and the FTSE 100 fell slightly to 6460;
- The Federal Reserve decided to maintain the monthly rate of its asset purchases.

3. UK economy

A recent Bank of England Inflation Report upgraded growth forecasts for 2013 from 1.2% to 1.4% and for 2014 from 1.7% to 2.5%. However, Bank Governor Mark Carney put this into perspective by describing this welcome increase as not yet being “escape velocity” to ensure we return to strong and sustainable growth, after what has been the weakest recovery on record after a recession. Inflation was forecast to be little changed from the previous Report – falling back to 2% within two years and staying there during year three.

4. In addition to the stimulus provided by QE, the Funding for Lending Scheme (FLS), is aimed at encouraging banks to expand lending to small and medium size enterprises. The FLS seems to be having a positive effect in terms of encouraging house purchases (though levels are still far below the pre-crisis level), and causing a significant increase in house prices – but only in London and the south east. FLS is also due to be bolstered by the second phase of Help to Buy aimed to support purchasing of second hand properties, which started in October.

5. The Bank of England also issued forward guidance with the Inflation Report which said that the Bank will not start to consider raising interest rates until the jobless rate (Labour Force Survey / ILO i.e. 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 / ILO measure. The Bank's guidance is subject to three provisos, mainly around inflation; breaching any of them would sever the link between interest rates and unemployment levels. This actually makes forecasting Bank Rate much more complex given the lack of available reliable forecasts by economists over a three year plus horizon. The Capita Asset Services (CAS, formerly Sector) view is that the recession since 2007 was notable for how unemployment did not rise to the levels that would normally be expected in a major recession. The latest Inflation Report noted that productivity has sunk to 2005 levels. They are, therefore, concerned that there has been a significant level of retention of labour, which will mean that a significant amount of GDP growth can be accommodated without a major reduction in unemployment.

6. CAS's current views on the UK are centred around the following: -

- Growth has been on an upward trend – 0.3% in Q1; 0.7% in Q2 and likely to be much stronger in Q3. The so called double dip recession at the beginning of 2012 was erased by the latest revision of statistics.
- Business surveys, consumer confidence, consumer borrowing and house prices are all on the up and may help to create a wide spread feel good factor. However, this is still a long way away from the UK getting back to sustainable strong growth.
- 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.
- 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.
- The coalition government is hampered in promoting growth by the need to tackle the budget deficit. However, the March Budget did contain measures to boost house building and the supply of mortgages, and brought forward, by one year to April 2014, the start of a £10k tax free allowance for incomes.
- There is little sign of a co-ordinated strategy for the private sector to finance a major expansion of infrastructure investment to boost UK growth.
- Government inspired measures to increase the supply of credit to small and medium enterprises (which are key to achieving stronger growth) by banks are not succeeding.
- 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 Fed's

reluctance to start tapering in September has, potentially, only delayed a trend for gilt yields to rise.

7. Eurozone

- Most Eurozone countries are now starting to see a return to growth after a prolonged recession. The prospects for growth, at least in the short term, have also improved. However, for some countries, austerity programmes could prove to be a self defeating spiral of falling demand, tax receipts, and 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 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 ECB's 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.
- The Eurozone remains particularly vulnerable to investor fears of contagion if one country gets into major difficulty.

8. US

- There has been a marked improvement in consumer, investor and business confidence this year.
- Unemployment has continued on a steady, but unspectacular decline to 7.3%, but is still a long way from the target rate of 6.5% for an increase in the Fed policy rate.
- The housing market has turned a corner, both in terms of rising prices and in increases in the volume of house sales. More householders are, therefore, escaping from negative equity.
- US equities have reached all time highs.
- The package of tax increases and cuts in Government expenditure starting in 2013 does not appear to be having a major impact on depressing growth.
- The shale gas revolution is providing some solid underpinning to the US economy by enhancing its international competitiveness through cheap costs of fuel.
- There has been a start to the repatriation of manufacturing production from China to the USA as Chinese labour costs have continued their inexorable rise and new forms of high tech production have made home based production more viable and flexible.

9. China

- Concerns that Chinese growth could be heading downwards have been allayed by recent stronger statistics. There are still concerns around an unbalanced economy which is heavily dependent on new investment expenditure, and for a

potential bubble in the property sector to burst, as it did in Japan in the 1990s, with its consequent impact on the financial health of the banking sector.

- There are also increasing concerns around the potential size, and dubious creditworthiness, of some bank lending to local government organisations and major corporates.

10. 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.

11. Downside risks currently include:

- The conflict in the UK between market expectations of how quickly unemployment will fall as opposed to the Bank of England's forecasts
- Prolonged political disagreement over the US Federal Budget and raising the debt ceiling
- A return to weak economic growth in the US, UK and China causing major disappointment to investor and market expectations.
- The potential for a significant increase in negative reactions of populaces in Eurozone countries against austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- The Italian political situation is frail and unstable.
- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Weak growth or recession in the UK's main trading partners - the EU and US, depressing economic recovery in the UK.
- Geopolitical risks e.g. Syria, Iran, North Korea, which could trigger safe haven flows back into bonds

12. Upside risks to UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- A sharp upturn in investor confidence that sustainable robust world economic growth is firmly expected, causing a surge in the flow of funds out of bonds into equities.
- A reversal of Sterling's safe-haven status on a sustainable improvement in financial stresses in the Eurozone.
- Further downgrading by credit rating agencies of the creditworthiness and credit rating of UK Government debt, consequent upon repeated failure to achieve fiscal correction targets and sustained recovery of economic growth which could result in the ratio of total government debt to GDP to rise to levels that undermine investor confidence in the UK and UK debt.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

- In the longer term – an earlier than currently expected reversal of QE in the UK; this could initially be implemented by allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held.

## 13. Interest Rate Forecast

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

| | 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% |

Capita Asset Services undertook a review of its interest rate forecasts in late September as a result of an increase in confidence in economic recovery, chiefly in the US, but more recently, also in the UK and Eurozone. The latest forecast now includes a first increase in Bank Rate in quarter 3 of 2016 (previously quarter 4).

## 14. Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2013/14, which includes the Annual Investment Strategy, was approved by the Council on 25 February 2013. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield

**15.** The Council will also aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in higher rates in periods up to 12 months, with highly credit rated financial institutions, using our suggested

creditworthiness approach, including sovereign credit rating and Credit Default Swap (CDS) overlay information provided by Capita Asset Services.

16. Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the six months ended 30 September 2013.

17. Investment rates available in the market have continued at historically low levels and have fallen further during the six months as a result of the Funding for Lending Scheme. The average level of funds available for investment purposes during the six months was £15.0m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme. The Council holds £9.7m of core cash balances for investment purposes (i.e. funds available for more than one year) and these are currently invested by our fund managers, Investec Asset Management Ltd.

18. Investment performance for the six months ended 30 September 2013 was:

| Benchmark | Benchmark Return | Council In-House Performance | Investment Interest Earned | Investec Performance | Investment Interest Earned | Total Interest Earned |
|---|---|---|---|---|---|---|
| | % | % | £'000 | % | £'000 | £'000 |
| **7 day LIBID** | 0.36% | 1.31% | 195 | 0.02% | 2 | 197 |

19. As illustrated, the Council outperformed the benchmark by 0.95%. This was primarily due to the council having a £6m investment at 2.85%. However, this investment matured in early September 2013 and the funds have now been invested at 0.98% so this will have a material effect on interest receivable over the coming year.

20. The Council's budgeted investment return for 2013/14 is £300k, and whilst performance for the year to date is in line with the budget it is unlikely that the target will be achieved in the full year due to the continuing low level of interest rates and the much lower rate on the new £6m loan.

21. **Investment Managers**

    As can be seen from the above table in paragraph 18 the performance of the council's fund managers was significantly below the benchmark. This was mainly due to the stance they took on long dated UK gilts which have seen prices fall since they acquired them. The amount that Investec Fund Managers Ltd currently invests for the Council of £9.7m is below the size of portfolio they would usually actively manage and the fees in the current year may outweigh the return that is expected.

22. The expected return from Investec in 2013/14 is only 0.1% and at such a marginal rate this no longer justifies the use of them. CAS have advised that it would be better to bring the investment back in-house and at least one other neighbouring

district council has done likewise recently due to the low returns their fund manager was achieving.

23. It is intended to terminate the contract with Investec in December 2013 when it falls due for renewal. As these funds are not required on a daily basis they will be invested in the current range of institutions available to the Council for up to one year. There is no intention to widen the range of institutions and types of investments that the Council can use.

24. For clarity, the proposed Specified Investments and new limits are set out in Appendix 3.

25. **Borrowing**

    No new borrowing was undertaken during the half year and the Council has not borrowed in advance of need during the six months ended 30th September 2013 and has no intention to borrow in advance during 2013/14. Similarly, no debt rescheduling was undertaken during the half year.

26. Compliance with Treasury and Prudential Limits

    It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits and the Council's approved Treasury and Prudential Indicators (affordability limits) are included in the approved TMSS.

    During the financial year to date the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices. The prudential and treasury Indicators are shown in appendix 1.

27. **Heritable Bank Plc**

    The Council originally had £1m invested with the Heritable Bank Plc, which is a subsidiary of Landsbanki, one of the failed Icelandic banks. At the current time the process of recovering assets is still ongoing with the administrators and they have made a number of payments to date. These currently amount to £975k which represents 94% of the total amount owed. We are still waiting for an update from the administrators about the likelihood of further dividends.

**APPENDIX 1: Prudential and Treasury Indicators as at 30th September 2013**

| Treasury Indicators | 2013/14 Budget £'000 | 30/9/13 Actual £'000 |
|---|---|---|
| Authorised limit for external debt | 96,000 | 81,190 |
| Operational boundary for external debt | 87,758 | 81,190 |
| Gross external debt | 87,758 | 81,190 |
| Investments | 19,775 | 22,851 |
| Net borrowing | 67,983 | 58,339 |

| Maturity structure of fixed rate borrowing - upper and lower limits | | |
|---|---|---|
| Up to 10 years | 0% | 0% |
| 10 years to 20 years | 23% | 23% |
| 20 years to 30 years | 47% | 47% |
| 30 years to 40 years | 18% | 18% |
| 40 years to 50 years | 12% | 12% |

| | | |
|---|---|---|
| Upper limit of fixed interest rates based on net debt | 100% | 97.5% |
| Upper limit of variable interest rates based on net debt | 90% | 2.5% |

| | | |
|---|---|---|
| Upper limit for principal sums invested for over 364 days | 24.7% | 6.2% |

| Prudential Indicators | 2013/14 Budget £'000 | 30/9/13 Actual £'000 |
|---|---|---|
| Capital expenditure – General Fund | 1,949 | 97 |
| Capital expenditure - HRA | 12,988 | 3,011 |
| Capital Financing Requirement (CFR) - GF | -164 | -164 |
| Capital Financing Requirement (CFR) - HRA | 85,366 | 85,366 |
| Annual change in CFR - GF | 383 | 383 |
| Annual change in CFR - HRA | 3,412 | 3,412 |
| In year borrowing requirement | 3,795 | 3,795 |
| Ratio of financing costs to net revenue stream - GF | 0.32% | 0.32% |
| Ratio of financing costs to net revenue stream - HRA | 12.85% | 12.85% |
| Incremental impact of capital investment decisions:- | | |
| a) Increase in council tax (band change) per annum. | 1.53 | 1.53 |
| b) Increase in average housing rent per week. | 0.00 | 0.00 |
| | | |

## APPENDIX 2: Investment Portfolio

Investments held as at 30th September 2013 compared to our counterparty list:

| Institution | Maturity Date | Interest Rate % | Principal £'000 |
|---|---|---|---|
| Bank of Scotland | 02/09/2014 | 0.98% | 6,000 |
| Money Market Funds | I day | 0.41% | 6,130 |
| Svenska Handelsbanken AB | 1 day | 0.60% | 1,000 |
| Investec | Various | N/A | 9,721 |
| **Total** | | | **22,851** |

**APPENDIX 3: Annual Investment Strategy**

As mentioned in paragraph 23 of the main report it is intended to bring back the funds currently invested with Investec due to the return they are making which is below the benchmark. For the sake of clarity this will not alter the council's current:

- Investment Policy
- Creditworthiness policy
- Country limits
- Investment Strategy

(all these were agreed by Council on 25 February 2013)

What will alter are the monetary limits applying to institutions or investment vehicles, although the council will only continue to invest directly in 'Specified Investments'.

**SPECIFIED INVESTMENTS:** All such investments will be sterling denominated, with maturities up to maximum of 1 year, meeting the minimum 'high' colour criteria where applicable. A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made it will fall into one of the above categories.

The criteria in this appendix are intended to be the operational criteria in normal times. At times of heightened volatility, risk and concern in financial markets, this strategy may be amended by temporary operational criteria further limiting investments to counterparties of a higher creditworthiness and/or restricted time limits

The criteria, time limits and monetary limits applying to institutions or investment vehicles are:

| | **Minimum credit criteria / colour band** | **Max % of total investments or £ limit per institution** | **Max. maturity period** |
|---|---|---|---|
| DMADF – UK Government, including Treasury Bills | N/A | 100% | 12 months |
| Money market funds | AAA | £5m any one institution and £12m in total. | Liquid |
| Local authorities | N/A | £4m any one institution and £8m in total | 12 months |

| | Minimum credit criteria / colour band | Max % of total investments or £ limit per institution | Max. maturity period |
|---|---|---|---|
| Term deposits with banks and building societies | Purple | £8m per institution and £12.0m in total. | Up to 1 year |
| | Blue | £7m per institution and £12m in total. | Up to I year |
| | Orange | £6m per institution and £12.0m in total. | Up to 1 year |
| | Red | £5m per institution and £9m in total. | Up to 6 months |
| | Green | £4m per institution and £12.5m in total. | Up to 3 months |
| | No Colour | Nil | Not for use |