Cabinet

20 November 2013

Mid-Year Report for the Period to 30 September 2013 on Treasury Management Service

Report of Corporate Management Team
Don McLure, Corporate Director Resources
Councillor Alan Napier, Cabinet Portfolio Holder for Finance

Purpose of the Report

1 The regulatory framework of treasury management requires the Council to receive a mid year treasury review, in addition to the forward looking annual treasury strategy and backward looking performance against the previous strategy.

2 As well as meeting the above requirement this report also incorporates the needs of the 'Prudential Code', which can be regarded as being best operational practice, to ensure adequate monitoring of our capital expenditure plans and the Council's prudential indicators (PIs). The treasury strategy and PIs were previously reported to Council as part of the Medium Term Financial Plan 2013/14 – 2016/17 on 20 February 2013.

3 The purpose of the report also supports the objective in the revised CIPFA Code of Practice on Treasury Management and the Communities and Local Government Investment Guidance. These state that Members should receive and scrutinise the treasury management service.

Background

Economic Performance to Date

4 During 2013/14 macro economic indicators suggest that the economy is recovering, albeit from a low level. After avoiding recession in the first quarter of 2013, with a 0.3% quarterly expansion the economy grew 0.7% in Qtr. 2. There have been signs of renewed vigour in household spending in the summer, with a further pick-up in retail sales, mortgages, house prices and new car registrations.

5 The improvement in economic growth appears to have supported the labour market, with employment rising at a modest pace and strong enough to reduce the level of unemployment. Pay growth also rebounded strongly 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% year on year, well below the rate of inflation at 2.7% in August, causing continuing pressure on households' disposable income.

6 The Bank of England extended its Funding for Lending Scheme (FLS) into 2015 and sharpened the incentives for banks to extend more business funding, particularly to small and medium size enterprises. To date, the mortgage market still appears to have been the biggest beneficiary from the scheme, with mortgage interest rates falling further to new lows. Together with the Government's Help to Buy scheme, which provides equity loans to credit-constrained borrowers, this is helping to boost demand in the housing market. Mortgage approvals by high street banks have risen as have house prices, although they are still well down from the boom years pre 2008.

7 Public borrowing figures continue to be distorted by a number of one-off factors. On an underlying basis, borrowing in Quarter 2 started to come down, but only slowly, as Government expenditure cuts took effect and economic growth started to show through in a small increase in tax receipts. The 2013 Spending Review, covering only 2015/16, made no changes to the headline Government spending plan, and monetary policy was unchanged in advance of the new Bank of England Governor, Mark Carney, arriving in July. Bank Rate remained at 0.5% and quantitative easing also stayed at £375bn. In August, the Monetary Policy Committee (MPC) provided forward guidance that Bank Rate is unlikely to change until unemployment first falls to 7%, which was not expected until mid 2016. However, 7% is only a point at which the MPC will review Bank Rate, not necessarily take action to change it. The three month to July average rate was 7.7%.

8 Consumer Price Index (CPI) inflation (MPC target of 2.0%), fell marginally from a peak of 2.9% in June to 2.7% in August. The Bank of England expects inflation to fall back to 2.0% in 2015.

9 Financial markets sold off sharply following comments from Ben Bernanke (the United States Federal Reserve chairman) in June that suggested the Federal Reserve (Fed) may 'taper' its asset purchases earlier than anticipated. The resulting rise in US Treasury yields was replicated in the United Kingdom where equity prices fell initially, as Fed' purchasing of bonds has served to underpin investor moves into equities out of low yielding bonds. However, as the market moves to realign its expectations, bond yields and equities are likely to rise further in expectation of a continuing economic recovery.

10 In September, the Fed surprised financial markets by not starting tapering as it felt the run of economic data in recent months had been too weak to warrant taking early action. Bond yields fell sharply as a result, though it still only remains a matter of time until tapering does start.

11 Tensions in the Eurozone eased over the second quarter, but there remained a number of triggers for a renewed flare-up. Economic survey data improved consistently over the first half of the year, pointing to a return to growth in Quarter 2, so ending six quarters of Eurozone recession.

Outlook for the Final Six Months of 2013/14

12 Economic forecasting remains difficult with so many external influences weighing on the UK. Volatility in bond yields is likely during 2013/14 as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, and safer bonds. Downside risks to UK gilt yields and Public Works Loan Board (PWLB) rates include:

- 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: the coalition government fell on 29 September.
- 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

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

- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- Increased investor confidence that sustainable robust world economic growth is firmly expected, together with a reduction or end of Quantitive Easing operations in the US, causing a further 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.
- In the longer term - a reversal of Quantitive Easing (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.
- 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, causing the ratio of total Government debt to GDP to rise to levels that provoke major concern.

- The overall balance of risks to economic recovery in the UK is now weighted to the upside after five months of good news on the economy. However, only time will tell just how long this period of relatively strong economic growth will last, and it remains exposed to vulnerabilities in a number of key areas.
- 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. Short term, there is some residual risk of further QE if there is a dip in strong growth or if the MPC were to decide to take action to combat the market's expectations of an early first increase in Bank Rate. If the MPC does 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, such action could cause gilt yields and PWLB rates over the next year or two to significantly undershoot the forecasts in the table below.
- The tension in the US over passing a Federal budget for the new financial year starting on 1 October and raising the debt ceiling in mid October could also see bond yields temporarily dip until agreement is reached between the opposing Republican and Democrat sides. Conversely, the eventual start of tapering by the Fed will cause bond yields to rise.

Forecast of Treasury Advisors (Sector)

Sector's Interest Rate Forecast

	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25
5yr PWLB	2.50	2.50	2.50	2.60	2.70	2.70	2.80	2.80	2.90	3.00	3.20	3.30	3.50	3.60	3.70
10 yr PWLB	3.70	3.70	3.70	3.70	3.80	3.80	3.90	4.00	4.10	4.20	4.30	4.40	4.50	4.60	4.60
25yr PWLB	4.40	4.40	4.40	4.40	4.50	4.50	4.60	4.70	4.80	4.90	5.00	5.10	5.10	5.10	5.20
50yr PWLB	4.50	4.40	4.40	4.40	4.50	4.60	4.70	4.80	4.90	5.00	5.10	5.20	5.20	5.20	5.30

14 The above Sector forecasts for PWLB rates incorporate the introduction of the PWLB certainty rate in November 2012 which has reduced PWLB borrowing rates by 0.20% for most local authorities, including Durham.

15 Expectations for the first change in Bank Rate in the UK are now dependent on how to forecast when unemployment is likely to fall to 7%. Financial markets have taken a very contrary view to the MPC and have aggressively raised short term interest rates and gilt yields due to their view that the strength of economic recovery is now so rapid that unemployment will fall much faster than the Bank of England forecasts. They therefore expect the first increase in Bank Rate to be in quarter 4 of 2014. There is much latitude to disagree with this view as the economic downturn since 2008 was remarkable for the way in which unemployment did not rise to anywhere near the extent likely, unlike in previous recessions. This meant that labour was retained, productivity fell and now, as the MPC expects, there is major

potential for unemployment to fall only slowly as existing labour levels are worked more intensively and productivity rises back up again.

16 The size of the work force is also expected to increase relatively rapidly and there are many currently self-employed or part time employed workers who are seeking full time employment. Capita Asset Services take the view that the unemployment rate is not likely to come down as quickly as the financial markets are currently expecting and that the MPC view is more realistic. The prospects for any increase in Bank Rate before 2016 are therefore seen as being limited. However, some forecasters are forecasting that even the Bank of England forecast is too optimistic as to when the 7% level will be reached

Treasury Management Strategy Statement and Investment Strategy Update

17 The Treasury Management Strategy Statement (TMSS) for 2013/14 was approved by the Council on 20 February 2013.

Capital Expenditure

18 This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed by Council.

Capital Expenditure by Service	2013/14 Original Estimate (£m)	2013/14 Approved Revisions (£m)	2013/14 Revised Estimate (£m)
Assistant Chief Executive	3.959	-1.414	2.545
Children and Adults Services	56.046	21.780	77.826
Neighbourhoods	32.533	5.837	38.370
Regeneration and Economic Development	49.318	-0.322	48.996
Resources	17.605	-11.500	6.105
Other			
Total General Fund	159.461	14.381	173.842
HRA	49.271	6.312	55.583
Total GF and HRA	208.732	20.693	229.425

19 Taking into account reprofiling from the 2012/13 capital programme, additional approved grant funded expenditure and reprofiling into future years, the revised capital expenditure budget for the General Fund is £173.842m and for the HRA is £55.583m.

20 Details of the individual capital projects and scheme funding can be found in the Quarter 2 Forecast of Revenue and Capital Outturn 2013/14 for General Fund and Housing Revenue Account – Period to 30 September 2013.

Impact of Capital Expenditure Plans

21 The table below draws together the main strategy elements of the capital expenditure plans, 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). This will be reduced in part by revenue charges for the repayment of debt which is known as the Minimum Revenue Provision.

22 On the General Fund the underlying borrowing requirement has been revised down by £0.782m.

Capital Expenditure	2013/14 Original Estimate (£m)	2013/14 Revised Estimate (£m)
General Fund	159.461	173.842
Financed by:		
Capital receipts	19.774	19.784
Capital grants	66.498	74.884
Capital Reserves	0.155	0.672
Revenue and Reserves	0.832	7.082
Total Financing	87.259	102.422
Borrowing Need	72.202	71.420

23 On the HRA has the underlying borrowing requirement has been revised up by £4.763m.

Capital Expenditure	2012/13 Original Estimate (£m)	2012/13 Revised Estimate (£m)
HRA	49.270	55.582
Financed by:		
Capital receipts	0.426	0.426
Capital grants	19.400	19.400
Capital Reserves	16.306	16.306
Revenue	7.763	9.312
Total Financing	43.895	45.444
Borrowing Need	5.375	10.138

Capital Financing Requirement

24 The table shows the capital financing requirement (CFR), which is the underlying external need to borrow for a capital purpose.

	2012/13 Outturn Position (£m)	2013/14 Original Estimate (£m)	2013/14 Revised Estimate (£m)
CFR – Non Housing	372.657	453.302	437.578
CFR – Housing	232.171	239.637	242.310
Total CFR	604.828	692.939	679.888

Borrowing Strategy

25 The CFR shown above indicates the requirement for the Council to borrow to support its capital activities. This borrowing can be in the form of external sources (e.g. PWLB) or internal resources (e.g. use of reserves, working capital).

26 The Corporate Director Resources, under delegated powers, will adopt the most appropriate form of borrowing depending on the prevailing interest rates at the time.

27 Due to the overall financial position of the Council, no new borrowing has been raised during the period.

28 The overall borrowing position at 30 September 2013 was £437m, of which £221m relates to the General Fund and £216m to the Housing Revenue Account.

29 It is anticipated that further loans could be arranged during 2013/14 financial year, as a result of the overall financial position and underlying need to borrow.

Limits to Borrowing Activity

30 The first key control over the treasury activity is a Performance Indicator (PI) to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Net 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 2013/14 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has an approved policy for borrowing in advance of need, and this will be used if it is considered prudent.

31 The Corporate Director Resources reports that no difficulties are envisaged for the current or future years in complying with this PI. The table below summarises the position.

32 A further PI 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.

Authorised limit for external debt	2013/14 Original Indicator (£m)	2014/15 Original Indicator (£m)	2015/16 Original Indicator (£m)
Borrowing	694.000	729.000	732.000
Other long term liabilities	52.000	51.000	50.000
Total	746.000	780.000	782.000

Investment Portfolio

33 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 introduction of 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.

34 The Council held £128m of investments at 30 September 2013, and the constituent parts of the investment position are:

Sector	Country	0-3 months	3-6 months	6-12 months
Banks	UK	£39m	£27m	£49m
Building Societies	UK	£13m	0	0
Total	£128m	£52m	£27m	£49m

35 As set out earlier in the report, 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. The continuing Euro zone sovereign debt crisis, and its potential impact on banks, prompts a low risk and short term strategy. Given this risk averse environment, investment returns are likely to remain low.

36 The investment portfolio yield for the first six months of the year is 0.98% against a benchmark 7 day London Inter Bank Bid Rate (the rate at which banks take deposits from each other) yield of 0.36%.

37 The original budgeted investment return for 2013/14 was £1.441m, however it is now expected that this will be exceeded by around £0.250m.

Icelandic Deposits

38 The County Council had £7m deposited across the Icelandic banks Glitnir Bank hf (£4m), Landsbanki (£2m) and Kaupthing Singer and Friedlander Ltd (£1m), which all effectively collapsed financially in October 2008.

39 The Council's recovery position at 30 September 2013 is as follows:

- Glitnir: a full distribution was made in March 2012, however an element of the distribution is in the Icelandic Kroner currency, which has been placed in an escrow account in Iceland due to currency controls currently operating in the country. As a result this element is subject to exchange rate risk, over which the Council has no control.

- Landsbanki: 53.7% of an anticipated 100% recovery has been repaid. Again, a small element of the distribution is in Icelandic Kroner which has been placed in an escrow account in Iceland due to currency controls and is subject to exchange rate risk. However, the administration of the insolvent estate of Landsbanki is likely to continue for several years which creates a further level of uncertainty around the timing of recoveries through the administration process.

- Kaupthing Singer and Friedlander: 79% of the outstanding balance has been repaid. 85.25% recovery is anticipated in the long run.

40 Following a decision of the Icelandic Supreme Court on 25 September 2013, the Winding up Boards of both Landsbanki and Glitnir must apply the Central Bank of Iceland's official selling rates as at the date of the distribution when calculating the value of payments being made to Creditors in Icelandic Kroner (ISK). Previously, the exchange rate as at 22 April 2009 had been applied to all distributions made. The impact of this decision is that there is on-going uncertainty in relation to the sterling value of future distributions.

Recommendations and Reasons

41 It is recommended that Cabinet:

i. Note the contents of the mid-year review report and agree to report further to Full Council.

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Appendix 1: Implications

Finance -

Details of the overall financing of the Council's anticipated capital expenditure, along with forecast borrowing and investment income returns are provided in the report.

Staffing –

None

Risk –

None

Equality and Diversity / Public Sector Equality Duty –

None

Accommodation -

None

Crime and Disorder -

None

Human Rights -

None

Consultation -

None

Procurement -

None

Disability issues -

None

Legal Implications –

None