County Council

3 December 2014

Mid-Year Report for the Period to 30 September 2014 on Treasury Management Service

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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 2014/15 – 2016/17 on 26 February 2014.

3 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 how it is good practice for Members to receive and scrutinise their Council's treasury management service.

4 Cabinet considered and agreed the content of this report on 19 November 2014 and agreed to forward it to Full Council for information.

Background

Economic Performance to Date

5 The Council's Treasury Management advisers, Capita Asset Services have provided a commentary on Economic Performance. The following paragraphs detail their thoughts on and knowledge of the economy in the UK, US, Eurozone, Japan and China.

6 In the UK, after strong UK GDP quarterly growth in 2013/14, it appears very likely that strong growth will continue through 2014 and into 2015 as forward surveys for the services and construction sectors, are very encouraging and business investment is also strongly recovering.

7 The UK 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.

8 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, before it said it would consider any increases in Bank Rate. The MPC has, therefore, subsequently broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up.

9 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.

10 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. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

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

12 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 to lower levels than prevailed before 2008 as increases in Bank Rate will have a much bigger effect on heavily indebted consumers than they did before 2008.

13 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. However, monthly public sector deficit figures have disappointed so far in 2014/15.

14 In September, the US 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).

15 The US faces similar debt problems to those of the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth, although the weak labour force participation rate remains a matter of key concern for the Federal Reserve when considering the amount of slack in the economy and monetary policy decisions.

16 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 Eurozone countries and includes some countries with negative rates of inflation. Accordingly, the European Central Bank (ECB) took some rather limited action in June to loosen monetary policy in order to promote growth. In September it took further action to cut its benchmark rate to only 0.05%, its deposit rate to -0.2% and to start a programme of purchases of corporate debt. However, it has not embarked yet on full quantitative easing (purchase of sovereign debt).

17 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, (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed.

18 Japan is causing considerable concern as the increase in sales tax in April has suppressed consumer expenditure and growth. In Q2 growth was -1.8% quarter on quarter and -7.1% over the previous year. The Government is hoping that this is a temporary blip.

19 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.

Forecast of Treasury Advisors (Capita)

Capita's Interest Rate Forecast

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

Rate	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	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.75	2.00	2.00
5 yr PWLB	2.70	2.70	2.80	2.90	3.00	3.00	3.10	3.20	3.30	3.40	3.50	3.50
10 yr PWLB	3.40	3.50	3.60	3.70	3.80	3.90	4.00	4.10	4.10	4.20	4.30	4.30
25 yr PWLB	4.00	4.10	4.20	4.30	4.40	4.50	4.60	4.70	4.80	4.80	4.90	4.90
50 yr PWLB	4.00	4.10	4.20	4.60	4.40	4.50	4.60	4.70	4.80	4.80	4.90	4.90

21 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 Q1 of 2015.

22 Capita's PWLB forecasts are based around a balance of risks. However, there are potential upside risks, especially for longer term PWLB rates, as follows: -

- A further surge in investor confidence that robust world economic growth is firmly expected, causing a flow of funds out of bonds and into equities.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

23 Downside risks currently include:

- The situation over Ukraine poses a major threat to Eurozone and world growth if it was to deteriorate into economic warfare between the West and Russia where Russia resorted to using its control over gas supplies to Europe.
- UK strong economic growth is currently dependent on consumer spending and the unsustainable boom in the housing market. The boost from these sources is likely to fade after 2014.
- A weak rebalancing of UK growth to exporting and business investment causing a weakening of overall economic growth beyond 2014.
- Weak growth or recession in the UK's main trading partners - the EU and US, inhibiting economic recovery in the UK.
- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.

- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.
- Recapitalising of European banks requiring more government financial support.
- Lack of support by populaces in Eurozone countries for 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.
- Italy: the political situation has improved but it remains to be seen whether the new government is able to deliver the austerity programme required and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.
- France: after being elected on an anti austerity platform, President Hollande has embraced a €50bn programme of public sector cuts over the next three years. However, there could be major obstacles in implementing this programme. Major overdue reforms of employment practices and an increase in competiveness are also urgently required to lift the economy out of stagnation.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Heightened political risks in the Middle East and East Asia could trigger safe haven flows back into bonds.
- There are also increasing concerns that the reluctance of western economies to raise interest rates significantly for some years, plus the huge QE measures which remain in place (and may be added to by the ECB in the near future), has created potentially unstable flows of liquidity searching for yield and therefore heightened the potential for an increase in risks in order to get higher returns. This is a return of the same environment which led to the 2008 financial crisis.

Treasury Management Strategy Statement and Investment Strategy Update

24 The Treasury Management Strategy Statement (TMSS) for 2014/15 was approved by the Council on 26 February 2014.

Capital Expenditure

25 The following table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed by Council.

Capital Expenditure by Service	2014/15 Original Estimate (£m)	2014/15 Approved Revisions (£m)	2014/15 Revised Estimate (£m)
Assistant Chief Executive	3.471	0.984	4.455
Children and Adults Services	56.839	16.965	73.804
Neighbourhoods	38.840	8.351	47.191
Regeneration and Economic Development	56.269	-9.736	46.533
Resources	10.873	-1.887	8.986
Other			
Total General Fund	**166.292**	**14.677**	**180.969**
HRA	50.489	-0.456	50.033
Total GF and HRA	**216.781**	**14.221**	**231.002**

26 Taking into account reprofiling from the 2013/14 capital programme, additional approved grant funded expenditure and reprofiling into future years, the revised capital expenditure budget for the General Fund is £180.969m and for the HRA is £50.033m.

27 Details of the individual capital projects and scheme funding can be found in the Quarter 2 Forecast of Revenue and Capital Outturn 2014/15 for General Fund and Housing Revenue Account – Period to 30 September 2014.

Impact of Capital Expenditure Plans

28 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.

29 On the General Fund the underlying borrowing requirement has been revised upwards by £31.399m.

Capital Expenditure	2014/15 Original Estimate (£m)	2014/15 Revised Estimate (£m)
General Fund	166.292	180.969
Financed by:		
Capital receipts	20.474	10.229
Capital grants	69.055	61.369
Revenue and Reserves	4.993	6.202
Total Financing	94.522	77.800
Borrowing Need	**71.770**	**103.169**

30 On the HRA the underlying borrowing requirement has been revised downwards by £0.488m.

Capital Expenditure	2014/15 Original Estimate (£m)	2014/15 Revised Estimate (£m)
HRA	50.489	50.033
Financed by: Capital receipts Capital grants Revenue and Reserves	 1.547 19.286 24.589	 1.547 19.318 24.589
Total Financing	45.422	45.454
Borrowing Need	**5.067**	**4.579**

Capital Financing Requirement

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

	2013/14 Outturn Position (£m)	2014/15 Original Estimate (£m)	2014/15 Revised Estimate (£m)
CFR – Non Housing	374.611	433.985	465.384
CFR – Housing	232.649	237.423	236.935
Total CFR	**607.260**	**671.408**	**702.319**

Borrowing Strategy

32 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).

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

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

35 The overall borrowing position at 30 September 2014 was £433m, of which £221m relates to the General Fund and £212m to the Housing Revenue Account.

36 Further loans of £25m are due to be taken up in December 2014 as a result of the overall financial position and underlying need to borrow.

Limits to Borrowing Activity

37 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 2014/15 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.

38 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.

39 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	**2014/15 Original Indicator (£m)**	**2015/16 Original Indicator (£m)**	**2016/17 Original Indicator (£m)**
Borrowing	711.000	737.000	733.000
Other long term liabilities	51.000	52.000	56.000
Total	**762.000**	**789.000**	**789.000**

Investment Portfolio

40 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.

41 As set out in 'Economic Performance to Date' (paragraphs 4 to 22), 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.

42 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.

43 The credit rating agencies are undertaking a review of the implied levels of support that are currently built into their ratings. The rationale for the change is the evolving regulatory background and unwillingness of Governments to step in if there is a problem with an institution.

44 The primary drive is to remove implied levels of support previously built into ratings. In time, this will likely see most, if not all, Support ratings drop to 5 (indicating little or no likelihood of sovereign support).

45 Furthermore, the removal of implied sovereign support will see Long Term ratings gravitate towards Viability ratings (Fitch) and Financial Strength ratings (Moody's - via its Baseline Credit Assessment rating). As such, there will be little reason to use either Support ratings or the "standalone" ratings from Fitch (Viability) and Moody's (Financial Strength). It is therefore proposed to discontinue their use.

46 It is intended to continue to use the following minimum short and long term ratings detailed in the Annual Investment Strategy.

47 The proposed selection criteria for approved counterparties will be:

1. Banks 1 **–** the Council will only use banks which are UK banks and have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated):

	Fitch	**Moody's**	**Standard & Poors**
Short Term	F1	P1	A-1
Long Term	A-	A3	A-

2. Non UK Banks 1 **–** the Council will only use non UK banks which have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings:

	Fitch	**Moody's**	**Standard & Poors**
Sovereign Rating	AAA	AAA	AAA
Short Term	F1+	P1	A1+
Long Term	AA-	Aa3	AA-

3. Banks 2 - Part nationalised UK banks – Lloyds Bank and Royal Bank of Scotland. These banks can be included if they continue to be part nationalised or they meet the ratings in Banks 1 above.

4. Banks 3 – Co-operative Bank - The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.

5. Bank subsidiary and treasury operation. The Council will use these where the parent bank has provided an appropriate guarantee or has the necessary ratings outlined above.

6. Building societies. The Council will use societies which meet the ratings for banks outlined above.

7. Money Market Funds

8. UK Government (including gilts, Treasury Bills and the Debt Management Account Deposit Facility)

9. Local authorities, parish councils etc.

Use of additional information other than credit ratings

48 Additional requirements under the Code of Practice require the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties.

49 This additional market information (for example Credit Default Swaps, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties. The relative value of investments will be reviewed in relation to the counterparty size to ensure an appropriate ratio.

Time and Monetary Limits applying to Investments

50 The time and monetary limits for institutions on the Council's Counterparty List are as follows (these will cover both Specified and Non-Specified Investments):

	Long Term Rating	**Money Limit**	**Time Limit**
Banks 1 category high quality	AA-	£50m	2 years
Banks 1 category medium quality	A-	£25m	100 days
Banks 2 category – part-nationalised	N/A	£60m	2 years
Banks 3 category – Council's banker	B	£25m	3 months
DMADF/Treasury Bills	AAA	unlimited	6 months
Local Authorities	N/A	£10m each	5 years
Money Market Funds	AAA	£10m each (overall £50m)	liquid

51 The Council held £154m of investments at 30 September 2014, and the constituent parts of the investment position are:

Sector	Country	0-3 months	3-6 months	6-12 months
Banks	UK	£53m	0	£42m
Banks	Non UK	£12m	0	0
Building Societies	UK	0	£8m	£21m
Central Government/Other Local Authorities	UK	£1m	0	0
Money Market Funds	UK	£17m	0	0
Total		**£83m**	**£8m**	**£63m**

52 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.

53 The investment portfolio yield for the first six months of the year is 0.61% against a benchmark 7 day London Inter Bank Bid Rate (the rate at which banks take deposits from each other) yield of 0.35%.

54 The original budgeted investment return for 2014/15 was £1.441m, however it is now expected that this will be exceeded by around £0.248m.

Icelandic Deposits

55 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.

56 The Council's recovery position at 30 September 2014 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.

- During 2013/14, the Council sold its claims against the insolvent estate of Landsbanki through a competitive auction process. The proceeds of the sale were paid in Pounds Sterling and were received in February 2014 so the Council is no longer a creditor of Landsbanki.

- Kaupthing Singer and Friedlander: 83.5% of the outstanding balance has been repaid. 85.75% recovery is anticipated in the long run.

57 Following a decision of the Icelandic Supreme Court on 25 September 2013, the Winding up Board of 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

58 It is recommended that Council:

a) Note the contents of the mid-year review

b) Agree the proposed rating changes to remove the "standalone" ratings from Fitch (Viability) and Moody's (Financial Strength) as a selection criteria for approved counterparties.

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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