County Council

9 December 2015

Mid-Year Report for the Period to 30 September 2015 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 2015/16 – 2017/18 on 25 February 2015.

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 that Members should receive and scrutinise the treasury management service. Cabinet agreed the content of this report on 18 November 2015.

Background

Economic Performance to Date

4 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 (EZ), Japan and China.

5 Following the UK having the strongest GDP growth rates of any G7 country in 2013 of 2.2% and 2.9% in 2014; (the 2014 growth rate was also the strongest UK rate since 2006), the 2015 growth rate is likely to be a leading rate in the G7 again, possibly being equal to that of the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% year on year) with an improvement in quarter 2 of 2015 to +0.7% (+2.4% year on year).

6 Growth is expected to weaken to about +0.5% in quarter 3 of 2015 as the economy faces difficulties for exporters from the appreciation of Sterling against the Euro and weak growth in the European Union (EU), China and emerging markets, as well as the dampening effect of the Government's continuing austerity programme, although the pace of reductions was eased in the May 2015 Budget.

7 The Bank of England's August 2015 Inflation Report had included a forecast for growth to remain around 2.4% – 2.8% over the next three years, driven mainly by strong consumer demand as a result of the pressure on the disposable incomes of consumers being reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero over the last quarter.

8 Investment expenditure is also expected to support growth. However, since the report was issued, the Purchasing Manager's Index, (PMI), for services on 5 October indicates a further decline in the growth rate to only +0.3% in quarter 4 of 2015, which would be the lowest rate since the end of 2012. Worldwide economic statistics and UK consumer and business confidence have also weakened, so it is likely that the next Inflation Report in November may cut those forecasts.

9 The Bank of England's August Inflation Report forecast was notably subdued in respect of inflation which was forecast to possibly get back up to the 2% target within the 2-3 year time horizon. However, with the price of oil taking a downward direction and Iran expected to soon rejoin the world oil market after the impending lifting of sanctions, there could be several more months of low inflation to come. This is also due to world commodity prices generally being depressed by the Chinese economic downturn.

10 There are therefore considerable risks around whether inflation will rise in the near future as strongly as had previously been expected; this will make it more difficult for the central banks of both the US and the UK to raise rates as soon as had been forecast until recently. The risks include the recent major concerns around the slowdown in Chinese growth, the knock-on impact on the earnings of emerging countries due to falling oil and commodity prices, and the volatility seen in equity and bond markets in 2015 so far, which could potentially impact the real economies rather than just financial markets.

11 The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by 3.9% in quarter 2 of 2015. There had been confident expectations during the summer that the Federal Reserve could start increasing rates at its meeting on 17 September 2015, or if not, by the end of 2015. However, recent news concerning Chinese and Japanese growth and the knock-on impact on emerging countries that are major suppliers of commodities, have been cited as the main reason for the Federal Reserve's decision not to start increasing rates. The 'nonfarm payrolls'[1] figures for September and revised

[1] A statistic researched, recorded and reported by the US Bureau of Labour Statistics intended to represent the total number of paid US workers of any business excluding general government employees, non-profit employees, individuals who work within private households and farm employees. This monthly information on salaries is an indicator of the health of the US economy.

August figures, issued on 2 October, were disappointingly weak and confirmed concerns that US growth is likely to weaken. This has pushed back expectations of a first rate increase from 2015 into 2016.

12 In the Eurozone (EZ), the European Central Bank (ECB) began a massive €1.1 trillion programme of quantitative easing (QE) to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to continue initially to September 2016. This already appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to a significant improvement in economic growth.

13 GDP growth rose to 0.5% in quarter 1 of 2015 (1.0% year on year) but came in at +0.4% (+1.5% year on year) in quarter 2 of 2015 and looks as if it may maintain this pace in quarter 3. However, the recent pessimistic Chinese and Japanese news has raised questions as to whether the ECB will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation from the current level of around zero to its target of 2%.

Forecast of Treasury Advisors (Capita)

Capita's Interest Rate Forecast

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

Rate	**Dec-15 %**	**Mar-16 %**	**Jun-16 %**	**Sep-16 %**	**Dec-16 %**	**Mar-17 %**	**Jun-17 %**	**Sep-17 %**	**Dec-17 %**	**Mar-18 %**	**Jun-18 %**
Bank	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.50	1.50	1.75	1.75
5 yr PWLB	2.40	2.50	2.60	2.80	2.90	3.00	3.10	3.20	3.30	3.40	3.50
10 yr PWLB	3.00	3.20	3.30	3.40	3.50	3.70	3.80	3.90	4.00	4.10	4.20
25 yr PWLB	3.60	3.80	3.90	4.00	4.10	4.20	4.30	4.40	4.50	4.60	4.60
50 yr PWLB	3.60	3.80	3.90	4.00	4.10	4.20	4.30	4.40	4.50	4.60	4.60

15 Capita Asset Services undertook its last review of interest rate forecasts on 11 August shortly after the quarterly Bank of England Inflation Report. Later in August, fears around the slowdown in China and Japan caused major volatility in equities and bonds and produced a move from equities into safer investments like gilts which caused PWLB rates to fall below the forecasts detailed in paragraph 14 for quarter 4 of 2015. However, there is much volatility in rates as news moves in negative or positive ways. In September, news in respect of Volkswagen, and other corporates, has compounded downward pressure on equity prices. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2016.

16 Despite market turbulence since late August causing a sharp downturn in Public Works Loan Board (PWLB) rates, the overall trend in the longer term will be for gilt yields and PWLB rates to rise when economic recovery is firmly established. This is likely to be accompanied by rising inflation and consequent increases in

Bank Rate, and the eventual unwinding of QE. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

17 The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

18 The disappointing US nonfarm payrolls figures and UK PMI services figures at the beginning of October have served to reinforce a trend of increasing concerns that growth is likely to be significantly weaker than had previously been expected. This, therefore, has markedly increased concerns, both in the US and UK, that growth is only being achieved by monetary policy being highly aggressive with central rates at near zero and huge QE in place.

19 In turn, this is also causing an increasing debate as to how realistic it will be for central banks to start reversing such aggressive monetary policy until such time as strong growth rates are more firmly established and confidence increases that inflation is going to get back to around 2% within a 2-3 year time horizon. Market expectations in October for the first Bank Rate increase have therefore shifted back sharply into the second half of 2016.

20 Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven[2] flows.
- UK economic growth turns significantly weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or the start of Federal Reserve rate increases, causing a flight to safe havens

21 The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- Uncertainty around the risk of a UK exit from the EU.

---

[2] Investments expected to retain value or even increase value in times of market turbulence.

- The ECB severely disappointing financial markets with a programme of asset purchases which proves insufficient to significantly stimulate growth in the EZ.

- The commencement by the US Federal Reserve of increases in the funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.

- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Treasury Management Strategy Statement and Investment Strategy Update

22 The Treasury Management Strategy Statement (TMSS) for 2015/16 was approved by the Council on 25 February 2015.

Capital Expenditure

23 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	**2015/16 Original Estimate (£m)**	**2015/16 Approved Revisions (£m)**	**2014/15 Revised Estimate (£m)**
Assistant Chief Executive	3.768	1.587	5.355
Children and Adults Services	34.366	14.403	48.769
Neighbourhoods	35.691	10.262	45.953
Regeneration and Economic Development	61.307	-19.089	42.218
Resources	13.348	0.675	14.023
Total General Fund	**148.480**	**7.838**	**156.318**

24 Taking into account reprofiling from the 2014/15 capital programme, additional approved grant funded expenditure and reprofiling into future years, the revised capital expenditure budget for the General Fund is £156.318m.

25 Details of the individual capital projects and scheme funding can be found in the Quarter 2 Forecast of Revenue and Capital Outturn 2015/16 for the General Fund – Period to 30 September 2015.

Impact of Capital Expenditure Plans

26 The following table 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.

27 On the General Fund, the underlying borrowing requirement has been revised downwards by £13.136m.

Capital Expenditure	2015/16 Original Estimate (£m)	2015/16 Revised Estimate (£m)
General Fund	148.480	156.318
Financed by: Capital receipts Capital grants Revenue and Reserves	 16.619 36.041 0.280	 16.631 53.579 3.704
Total Financing	52.940	73.914
Borrowing Need	**95.540**	**82.404**

Capital Financing Requirement

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

	2014/15 Outturn Position (£m)	2015/16 Original Estimate (£m)	2015/16 Revised Estimate (£m)
CFR – Non Housing	392.459	507.927	494.791
CFR – Housing	244.000	0.000	0.000
Total CFR	**636.459**	**507.927**	**494.791**

Borrowing Strategy

29 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).

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

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

32 The overall borrowing position at 30 September 2015 was £246m. This relates to General Fund borrowing as all Housing debt was repaid as part of the transfer of housing stock.

Limits to Borrowing Activity

33 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 2015/16 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.

34 The Corporate Director Resources reports that no difficulties are envisaged for the current or future years in complying with this PI.

35 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	**2015/16 Original Indicator (£m)**	**2016/17 Original Indicator (£m)**	**2017/18 Original Indicator (£m)**
Borrowing	508.000	506.000	489.000
Other long term liabilities	53.000	55.000	56.000
Total	**561.000**	**561.000**	**545.000**

Investment Portfolio

36 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 'Capita's Interest Rate Forecast', 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.

37 The continuing potential for a re-emergence of a 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.

38 The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial austerity period, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. From 2015, in response to the evolving regulatory regime, all three agencies have begun removing these "uplifts" with the timing of the process determined by regulatory progress at the national level.

39 The process has been part of a wider reassessment of methodologies by each of the rating agencies. In addition to the removal of implied support, new methodologies are now taking into account additional factors, such as regulatory capital levels. In some cases, these factors have "netted" each other off, to leave underlying ratings either unchanged or little changed. A

consequence of the new methodologies is that they have also lowered the importance of the (Fitch) Support and Viability ratings and have seen the (Moody's) Financial Strength rating withdrawn by the agency.

40 In keeping with the agencies' new methodologies, the credit element of the Council's own credit assessment process now focuses solely on the Short and Long Term ratings of an institution. While this is the same process that has always been used by Standard & Poor's, this has been a change to the use of Fitch and Moody's ratings. It is important to note that the other key elements to the process, the assessment of Rating Watch and Outlook information as well as the Credit Default Swap (CDS) overlay have not been changed.

41 The evolving regulatory environment, along with the rating agencies' new methodologies also means that sovereign ratings are now of lesser importance in the assessment process. Where through the crisis, typically, the highest sovereign rating was assigned to criteria, the new regulatory environment is attempting to break the link between sovereign support and domestic financial institutions. The Council continues to specify a minimum sovereign rating of AAA for non-UK banks. This is in relation to the fact that the underlying domestic and where appropriate, international, economic and wider political and social background will still have an influence on the ratings of a financial institution.

42 It is important to note that these rating agency changes do not reflect any changes in the underlying status or credit quality of the institution, merely a reassessment of their methodologies in light of enacted and future expected changes to the regulatory environment in which financial institutions operate.

43 While some banks have received lower credit ratings as a result of these changes, this does not mean that they are less credit worthy than they were previously. Rather, in the majority of cases, this mainly reflects the fact that implied sovereign government support has effectively been withdrawn from banks. They are now expected to have sufficiently strong balance sheets to be able to withstand foreseeable adverse financial circumstances without government support. In many cases, the balance sheets of banks are now much more robust than they were before the 2008 financial crisis when they had higher ratings. However, this is not universally applicable, leaving some entities with modestly lower ratings than they had through much of the "support" phase of the financial crisis.

44 The Council held £236m of investments at 30 September 2015, and the constituent parts of the investment position are:

Sector	Country	0-3 months	3-6 months	6-12 months
Banks	UK	£19m	£19m	£104m
Banks	Non UK	0	0	0
Building Societies	UK	0	0	£27m
Central Government/Other Local Authorities	UK	£1m	0	0
Money Market Funds	UK	£66m	0	0
Total		**£86m**	**£19m**	**£131m**

45 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. As a result investment returns are likely to remain low.

46 The investment portfolio yield for the first six months of the year is 0.65% against a benchmark 7 day London Inter Bank Bid Rate (the rate at which banks take deposits from each other) yield of 0.36%.

47 The original budgeted investment return for 2015/16 was £1.641m, however it is now expected that this will be exceeded by around £0.964m. This is in the main due to a higher than anticipated level of cash balances.

Icelandic Bank Deposits

48 The County Council inherited £7m of deposits on 1 April 2009 from the former Derwentside District Council that had been invested in three Icelandic banks; Glitnir Bank hf (£4m); Landsbanki (£2m) and Kaupthing Singer and Friedlander Ltd (£1m), which all went into administration in October 2008.

49 The Council has been pursuing recovery of the £7m since then and the position with Glitnir and Landsbanki is now closed. The Council received £6.2m (including accrued interest) in respect of £6m principal deposited.

50 All monies within Kaupthing, Singer and Friedlander are currently subject to the respective administration and receivership processes. The Council's recovery position at 30 September 2015 is that £0.836m of the outstanding balance (including accrued interest) has been repaid. In the long run, it is anticipated £0.857m of the principal deposited will be recovered.

51 In total up to 30 September, the Council has therefore recovered £7.036m against the original £7m and for reporting purposes it is recommended that this matter can now be closed.

Recommendations and Reasons

52 It is recommended that Council:

a) Note the contents of the mid-year review report for 2015/16.

b) Agree with Cabinet's decision on 18 November 2015 that no further reporting on the Icelandic Bank Deposit is required on the basis that the full £7m at risk has been recovered.

Background papers

(a) County Council – 25 February 2015 – General Fund Medium Term Financial Plan 2015/16 to 2017/18, Revenue and Capital Budget 2015/16 and 2015/16 Council House and Garage Rent Proposals

(b) County Council – 23 September 2015 – Treasury management Outturn 2014/15

(c) Cabinet – 18 November 2015 – Forecast of Revenue and Capital Outturn for General Fund and Housing Revenue Account – Period ended 30 September 2015

(d) Capita Treasury Solutions – Treasury Management Strategy Statement and Annual Investment Strategy – Mid Year Review 2015/16 – English Authorities

Contact: **Jeff Garfoot** **Tel:** **03000 261946**

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.

The £7m of investment at risk with the three Icelandic Banks has now been recovered.

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