Agenda Item No:

Report to: Audit Committee

Date of Meeting: 21 January 2015

Report Title: **Treasury Management - Mid Year Report 2014-15**

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Purpose of Report

This report advises the Audit Committee of the Treasury Management activities and performance during the current year. It provides the committee with the opportunity to review the Treasury Management Strategy and make appropriate recommendations to Cabinet to take account of any issues or concerns that have arisen since approving it in February 2014.

Recommendation(s)

1. **The Committee recommend to Cabinet that the Strategy remains unaltered.**
2. **To note that the investments made are in compliance with the investment strategy and the latest advice provided from the Council's Treasury Management advisers.**

Reasons for Recommendations

The Code of Practice on Treasury Management requires, as a minimum, a mid-year review of Treasury Management Strategy and performance. This is intended to highlight any areas of concern that have arisen since the original strategy was approved (February 2014). It is a requirement of the Code of Practice that the Mid year review is considered by full Council.

Introduction

1. The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties.

2. The other main part of the treasury management service is the funding of the Council's capital plans. Whilst parts of the Capital programme are financed by grants, contributions or capital receipts, the unfinanced elements will determine the borrowing needs of the Council - essentially the longer term cash flow planning to ensure the Council can fund its capital spending. The management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

3. Accordingly treasury management is defined as:

   "The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

4. The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) has been adopted by this Council and this Council fully complies with its requirements.

5. The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the Full Council of an annual Treasury Management Strategy Statement (including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead), a Mid-year Review Report (as a minimum) and an Annual Report covering activities during the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body which in this Council is the Audit Committee.

6. The purpose of this report is to meet one of the above requirements of the CIPFA Code, namely the Mid Year review of treasury management activities, for the financial year 2014/15.

7. This mid-year report covers

a) An economic update for the first nine months of 2014/15;
b) The Council's treasury position
c) A review of the Council's borrowing strategy in 2014/15
d) A review of the Council's investment strategy in 2014/15
e) A review of compliance with treasury management prudential indicator limits for 2014/15

Economic Update

Economic performance to date

8. Strong UK GDP quarterly growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, (2013 annual rate 2.7%), were followed by 0.7% in Q1, 0.9% in Q2 and 0.7% in Q3 2014 (annual rate 3.0% in Q3). It hopeful that growth will continue into 2015 as forward surveys for the services and construction sectors are encouraging and business investment is also more modestly recovering.

9. This overall 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.

10. It is forecasted that growth will peak in 2014 and then to ease off a little in 2015 and 2016. Unemployment is therefore expected to keep on its downward trend and this is likely to feed through into a return to increases in real pay rates at some point during the next three years.

11. Also encouraging has been the sharp fall in inflation (CPI) during 2014 after being consistently above the MPC's 2% target between December 2009 and December 2013. CPI Inflation fell to 1.2% in September 2014, a five year low, whilst RPI was 2.3%. Forward indications are that inflation is likely to fall further in the first half of 2015 to possibly near to or below 1% and then to remain near to the 2% target level over the MPC's two year ahead time horizon. Overall, markets are expecting that the MPC will be cautious in raising the Bank Rate as it will want to protect heavily indebted consumers from too early an increase in the Bank Rate at a time when inflationary pressures are also weak. A first increase in the Bank Rate is therefore currently forecast for Q2 2015 and the Bank has said that increases after that will be at a slow pace and to lower levels than prevailed before 2008.

12. The return to growth in 2013 and 2014 helped to lower forecasts for the increase in Government debt in the 2013 Autumn Statement, and 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 in the first seven months of 2014/15 and the autumn statement in December 2014 pushed back the achievement of a budget surplus until 2019-20.

13. **The Eurozone (EZ).** The Eurozone is facing an increasing threat from weak or negative growth and from deflation. In November, the inflation rate fell further, to reach a low of 0.3%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the 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. During November, the ECB stated that if this latest programme failed to stimulate growth, then it would soon embark on full quantitative easing (purchase of sovereign debt). Current fears over Greece have seen the value of the Euro fall in the currency exchange markets.

Outlook for the next six months

14. Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds. Comments by the ECB in respect of the potential start of quantitative easing in early 2015 have also sharply depressed gilt yields during the closing weeks of 2014.

15. The overall 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. Over time, an increase in investor confidence in world economic recovery is also likely to compound this effect as recovery will further encourage investors to switch from bonds to equities.

16. The overall balance of risks to economic recovery in the UK is currently evenly weighted. However, only time will tell just how long this period of economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

    Downside risks to UK gilt yields and PWLB rates include:

    - Commencement of substantial quantitative easing by the ECB in early 2015.
    - Weak growth or recession in the UK's main trading partner - the EU, inhibiting economic recovery in the UK.
    - UK economic growth is currently mainly dependent on consumer spending and the potentially unsustainable boom in the housing market. The boost from these sources is likely to fade after 2014.
    - 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.
    - Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.

17. 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 QE 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 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.
- A surge in investor confidence that a return to robust world economic growth is imminent causing a flow of funds out of bonds into equities.

18. If the MPC does takes action to do more QE in order to reverse a 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.

Interest rate forecasts

	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank Rate View	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.00%	2.25%	2.50%
3 Month LIBID	0.50%	0.60%	0.80%	0.90%	1.10%	1.30%	1.40%	1.60%	1.90%	2.10%	2.10%	2.30%	2.40%	2.60%
6 Month LIBID	0.70%	0.80%	1.00%	1.10%	1.20%	1.40%	1.50%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.80%
12 Month LIBID	0.90%	1.00%	1.20%	1.30%	1.40%	1.70%	1.80%	2.10%	2.20%	2.30%	2.40%	2.60%	2.80%	3.00%
5yr PWLB Rate	2.50%	2.70%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.50%	3.50%	3.50%
10yr PWLB Rate	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.20%	4.30%	4.30%
25yr PWLB Rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%
50yr PWLB Rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%

(The Capita Assets Services forecasts above are for PWLB certainty rates.)

The Council's Treasury Position – 31 December 2014

Borrowing

19. The Council's debt and investment position at the 31 December was as follows:

Table 1 **Debt**	31 March 2014 Principal	Rate	Maturity	30 December 2014 Principal	Rate
PWLB Loan 1	£7.5m	4.80%	2033	£7.5m	4.80%
PWLB Loan 2	£1.0m	2.02%	2016	£1.0m	2.02%
PWLB Loan 3	£1.0m	1.63%	2018	£1.0m	1.63%
PWLB Loan 4	£2.0m	0.55% (Variable Rate)	2019	£2.0m	0.56% (Variable Rate)
PWLB Loan 5	£0m		2044	£0.9m	3.78%
PWLB Loan 6	£0m		2044	£1.8m	3.78%
Total Debt	£11.5m	3.54%		£14.2m	3.59%

20. At the 31 December 2014 the Council had debt amounting to £14.2m (all PWLB debt).

Investments in 2014-15

21. In terms of investments the Council had £24.85m invested as at 31 December 2014 with a variety of institutions (this level varies on a daily basis throughout the year).

22. The table below provides a snapshot of where the investments are placed (as at 31 December 2014)

Counter Party	Rate/ Return	Start Date	End Date	Principal	Term
Barclays Bank PLC	0.65%	25/04/2012		£0.001m	On Call
CBA	0.20%	22/12/2014	05/01/2015	£2.85m	
Nordea Bank	0.60%	01/10/2014	01/04/2015	£5m	
Lloyds 1	4.45%	05/01/2012	10/01/2017	£1.0m	Fixed
Lloyds 2	1.97%	26/03/2013	26/03/2018	£1.0m	Fixed
Lloyds 1 year fixed	0.95%	11/04/2014	10/04/2015	£5.0m	Fixed
Nat west	0.60%	21/08/2013		£5.0m	On call 90 day notice
Standard Chartered	0.65%	01/10/2014	01/04/2015	£5.0m	
				£ 24.85m	

23. The performance for the first 9 months of 2014/15 provided an average return of 0.65% (excluding Local Authority Mortgage Scheme (LAMS). This compares to 0.91% for the same period last year

24. The total interest receivable for the first 9 months is £125,000 (excluding Local Authority Mortgage Scheme). This compares to £166,000 for the same period last year.

Borrowing Strategy

25. The Council has £14.2m of PWLB debt, and could potentially borrow up to a level of £17.0m. This figure takes account of capital spending of some £4.5m in 2014/15 of which some £2.8m has been funded by new borrowing to date.

26. A new capital scheme involving the construction of a new industrial unit has been approved by the council in the year. This has an estimated capital cost of £700,000 and is likely to be financed through borrowing in 2015/16.

27. The coastal space regeneration project (£3.62m) achieved 38 units of the 51 projected but at a reduced cost of £2.7m. This is the sum that has been borrowed rather then the £3.62m originally predicated.

28. Whilst the borrowing rates are attractive on a historical basis the difference between the return on investment and the cost of borrowing is significant – the revenue cost falling on the Council taxpayer. Rates have reduced when compared to last year so careful attention is being made when placing funds for longer periods of time.

29. The Council also keeps under review the potential for making premature debt repayments in order to reduce borrowing costs as well as reducing counterparty risk by reducing investment balances. However, the cost of the early repayment premiums that would be incurred and the increase in risk exposure to significantly higher interest rates for new borrowing, continue to make this option unattractive. No debt rescheduling is being contemplated at present

Investment Strategy

30. Priority is given to security and liquidity of investments in order to reduce counterparty risk to the maximum possible extent.

31. The Council has a limit of £5m with any one institution (rated A or above, supported by Government, and given a blue (12month) rating by Sector). This represents a level of up to 25% of the investment portfolio with any one institution or group at any one time. It is also necessary, at times, to invest sums of this size in order to attract the larger institutions which have the higher credit ratings.

32. The continuing Eurozone problems have led to a number of downgrades to banks' credit ratings, making it increasingly difficult to spread investments across a number of institutions. The Head of Finance has the authority to amend the limits.

    Table 3 below compares the Estimated Interest Payable and Received and associated fees for the year 2014/15.

Table 3	2014 -15 Budget year £000's	2014 -15 Estimated Outturn £000's
Gross Interest Payable	576	450
Gross Interest Received	(282)	(218)
Fees	13	13
Investment Property (Income) / Expense (net)	(73)	21
Other (e.g. PWLB Discount)	(53)	(53)
Net Cost	181	213

33. From the table above whilst the overall budget position is generally in line with forecasts, both the level of interest payable and receivable are lower than forecast. This is due to the difference in timing and loan value in respect of the Amicus Horizon in relating to the Coastal Space Regeneration project.

34. The net interest on the deposits in respect of the LAM scheme for the year will amount to some £27,700 and will be transferred into the mortgage reserve in order to meet potential defaults (none at present).

Compliance with Treasury Limits

35. During the financial year to date there have been a few occasions where it has not been possible to find institutions to take the Council's money given the strict criteria in place. In these circumstances the Council will place money in its existing call accounts and this can thus result in the investments exceeding general limits. Where such an occasion looks likely to arise the approval of the Head of Finance is required in compliance with the Council's Treasury Management Practices.

36. The Prudential Indicators have been complied with - reproduced in Appendix 1 for reference.

37. There was an under spend in the Capital programme in 2013/14 with some expenditure being carried forward into 2014/15. The Council's overall borrowing requirement has not however increased and therefore there are no negative implications for the Council's revenue budget. The revisions will be taken account of in the Council's revised budget for 2014/15 and in future year estimates.

Financial Implications

38. The Council's 2014/15 budget estimated a 1% return on investments. Based on current market conditions this will be increasingly difficult to achieve given the lower interest rates currently available. However savings from the timing of new borrowing should help to ensure overall budget projections are achieved.

Risk Management

39. The Council spreads its risk on investments by limiting the amount of monies with any one institution or group and limiting the timeframe of the exposure. In determining the level of the investment and period the Council considers formal credit ratings (Fitch) along with its own advisers (Capita Asset Services) ratings advice.

40. The security of the principal sum remains of paramount importance to the Council.

Wards Affected

Ashdown, Baird, Braybrooke, Castle, Central St. Leonards, Conquest, Gensing, Hollington, Maze Hill, Old Hastings, Ore, Silverhill, St. Helens, Tressell, West St. Leonards, Wishing Tree

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Area(s) Affected

Central Hastings, East Hastings, North St. Leonards, South St. Leonards

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Policy Implications

Please identify if this report contains any implications for the following:

Equalities and Community Cohesiveness	No
Crime and Fear of Crime (Section 17)	No
Risk Management	Yes
Environmental Issues	No
Economic/Financial Implications	Yes
Human Rights Act	No
Organisational Consequences	No
Local People's Views	No

Officer to Contact

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APPENDIX 1

PRUDENTIAL INDICATOR	2013/14	2014/15	2015/16	2016/17	2017/18
(2). TREASURY MANAGEMENT PRUDENTIAL INDICATORS	£'000	£'000	£'000	£'000	£'000
Authorised Limit for external debt -					
borrowing	£20,000	£20,000	£20,000	£20,000	£20,000
other long term liabilities	£10,000	£10,000	£10,000	£10,000	£10,000
TOTAL	£30,000	£30,000	£30,000	£30,000	£30,000
Operational Boundary for external debt -					
borrowing	£20,000	£20,000	£20,000	£20,000	£20,000
other long term liabilities	£10,000	£10,000	£10,000	£10,000	£10,000
TOTAL	£30,000	£30,000	£30,000	£30,000	£30,000
Upper limit for fixed interest rate exposure Net principal re fixed rate borrowing / investments OR:-	100 %	100 %	100 %	100 %	100 %
Upper limit for variable rate exposure Net principal re variable rate borrowing / investments OR:-	100 %	100 %	100 %	100 %	100 %
Upper limit for total principal sums invested for over 364 days – LAMS Scheme and Coastal Space	£5,620	£5,620	£6,000	£6,000	£6,000

Maturity structure of fixed rate borrowing during 2013/14	upper limit	lower limit
under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%