REPORT FOR: CABINET

Date:	12 December 2013
Subject:	Treasury Management Strategy Statement and Annual Investment Strategy – Mid-year Review 2013/14
Key Decision:	No
Responsible Officer:	Simon George, Director of Finance and Assurance
Portfolio Holder:	Councillor Tony Ferrari, Portfolio Holder for Finance
Exempt:	No
Decision subject to Call-in:	Yes, except for the recommendation to Council
Enclosures:	Appendix 1 - Counterparty Policy Appendix 2 – Prudential Indicators

Section 1 – Summary and Recommendations

This report sets out the mid-year review of treasury management activities for 2013/14.

Recommendations:

That the Cabinet:

(a) Note the half year treasury management activity for 2013/14.

(b) Recommend that the Governance, Audit and Risk Management Committee consider and review the report.

(c) Recommend to the Council that the minimum credit criterion for The Royal Bank of Scotland be amended from F1 to F2 as discussed in paragraphs 5.2 and 5.3 below.

Reason: (for recommendation)

(a) To promote effective financial management and comply with the Local Authorities (Capital Finance and Accounting) Regulations 2003 and other relevant guidance.

(b) To keep Cabinet Members informed of treasury management activities and performance.

Section 2 – Report

1. Background

1.1 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure.

1.2 Part of the treasury management operation ensures that this cash flow is adequately planned, with surplus monies being invested with low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

1.3 The second main function of the treasury management service is the funding of the Council's capital programme. The programme provides a guide to the borrowing needs of the Council, essentially the longer term cash flow planning, to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any borrowings previously made may be restructured to meet Council risk or cost objectives.

1.4 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."

2. Introduction

2.1 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) has been adopted by the Council.

2.2 The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

3. 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 and an Annual Report (stewardship report) covering activities during the previous year.

4. 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.

5. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For the Council the delegated body is the Governance, Audit and Risk Management Committee.

2.3 This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- Forecast outturn position
- Economic update for the 2013/14 financial year to 30 September 2013;
- Review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- Capital expenditure ;
- Review of the investment portfolio for 2013/14;
- Review of the borrowing strategy for 2013/14;
- Review of any debt rescheduling undertaken during 2013/14;
- Review of compliance with Treasury and Prudential Limits for 2013/14.

3. Forecast outturn Position

3.1 There is a forecast net underspend of £730,000 on the capital financing and investment income budget resulting from a forecast underspend on minimum revenue provision due to slippage on the 2012-13 capital programme as detailed in the table below:

	Latest Budget	**Forecast Outturn**	**Variation**	
	£000	**£000**	**£000**	**%**
Cost of Borrowing	8,481	8,484	0	0.0
Investment Income	-1,572	-1,572	0	0.0
Minimum Revenue Provision	13,234	12,504	-730	-5.5
Total	**20,143**	**19,355**	**-730**	**-3.6**

4. Economic update for the 2013/14 financial year to 30 September 2013

4.1 This commentary has been provided by the Council's Treasury Management Advisers, Capita Asset Services

4.2 Economic performance to date

During 2013/14 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 Q2. 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.

The strengthening 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 further. 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.

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.

Turning to the fiscal situation, the public borrowing figures continued to be distorted by a number of one-off factors. On an underlying basis, borrowing in Q2 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. 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 months to July average unemployment rate was 7.7%.

Consumer Price Index 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.

Financial markets sold off sharply following comments from Ben Bernanke (the US Federal Reserve Board Chairman) in June that suggested the Federal Reserve. may 'taper' its asset purchases earlier than anticipated. The resulting rise in US Treasury yields was replicated in the UK. Equity prices fell initially too, as the Federal Reserve 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. Increases in payroll figures have shown further improvement, helping to pull the unemployment rate down from a high of 8.1% to 7.3%, and continuing house price rises have helped more households to escape from negative equity. In September, the Federal Reserve 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.

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 Q2, so ending six quarters of Eurozone recession.

4.3 Outlook for the next six months of 2013/14

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 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

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 quantitative easing 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 robust good news on the economy.

However, only time will tell just how long this period of 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. Near-term, there is some residual risk of further quantitative easing 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 Federal Reserve will cause bond yields to rise.

4.4 Interest rate forecasts

	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 rate	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%
10yr PWLB rate	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 rate	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 rate	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%

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

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 Q4 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. 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 and so do not expect the first increase in Bank Rate until spring 2017.

5. Review of the Treasury Management Strategy Statement and Annual Investment Strategy

5.1 The Council approved a Treasury Management Strategy Statement for 2013/14 on 14 February 2013, which complies with the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management (2011) and Prudential Code for Capital Finance.

5.2 Included within the Treasury Management Strategy Statement are the minimum credit criteria for the measure of credit worthiness of institutions used as counterparties. For the UK nationalised banks (RBS and Lloyds/HBOS) the minimum short term criterion is F1 as defined by Fitch Ratings. RBS still retains this rating but both the other agencies to which the Council refers, Moody's and Standard and Poor's, now rate RBS below that level. Were Fitch to follow the same line the Council would not be able to use RBS as a counterparty. As the Treasury Management Strategy Statement allows the Council to invest up to 50% of its cash balances with RBS this would severely restrict its ability to manage these balances. The view of the Council's Treasury Management Adviser, Capita, is that so long as RBS remains largely in the ownership of the Government and taxpayer (currently 82%) there is little risk to its future viability and that it would be appropriate for it to be retained on the Council's counterparty list.

5.3 The Cabinet is therefore asked to recommend to Council that the Treasury Management Strategy Statement be amended to allow for RBS to remain as a counterparty subject to its Short-term rating being at Fitch F2 or above,

6. Capital expenditure

6.1 The table below shows the original budget for 2013-14 as adjusted for "carry forwards" and other items and the forecast outturn.

Service	"Adjusted" budget	Forecast outturn	Variance
	£'000	£'000	£'000
Community Health and Wellbeing	8,048	5,998	-2,050
Children and Families	23,212	16,440	-6,772
Environment and Enterprise	20,457	19,154	-1,303
Resources	13,449	11,814	-1,635
Total General Fund	**65,166**	**53,406**	**-11,760**
Housing Revenue Account	8,390	7,779	-611
General Fund funding			
Grants	27,784	21,356	-6,428
Section 106	439	432	-7
RCCO	110	47	-63
Capital Receipts	12,000	2,575	-9,425
Borrowing	24,833	28,996	4,163
Total	**65,166**	**53,406**	**-11,760**
HRA funding			
Grants	42	42	0
Direct Revenue Funding	8,348	7,737	-611
Total	**8,390**	**7,779**	**-611**

6.2 The most significant variance is due to the re-profiling of the Children and Families programme in line with the additional grant funding made available by the DfE for the school expansion programme.

6.3 At present the whole of the capital programme reliant on borrowing can be financed from internal resources.

7. Review of the investment portfolio for 2013-14

7.1 In summary, the Council's debt and investment position as at 30 September 2013 was as follows:

	31 March 2013	Average Rate	Average Life yrs	30 Sept 2013	Average Rate	Average Life yrs
	£M	**%**	**Yrs**	**£M**	**%**	**Yrs**
Fixed Rate Funding						
- PWLB	218.5	4.09	38.2	218.5	4.09	37.7
- Market	131.8	4.65	34.4	131.8	4.65	34.1
Total Debt	**350.3**	**4.30**	**36.8**	**350.3**	**4.30**	**36.3**
Investments:						
- In-House	103.2	1.83	276 days	140.8	1.47	188 days
Total Investments	**103.2**			**140.8**		

7.2 The Council manages its investments in-house and invests with the institutions listed in the approved lending list for up to the approved periods. The Council permits investments for a range of periods from overnight to three years, dependent on the Council's cash flows, its interest rate view and the interest rates on offer, although the average duration is less than a year.

7.3 A total of £140.8m (£112.3 million as at Sept 2012) investments were placed on deposit as at 30 September 2013.

7.4 The table below sets out the position as at 30 September 2013.

	2012/13 Sept 2012		March 2013		2013/14 Sept 2013	
	£m	%	£m	%	£m	%
Specified Investments						
Banks	19.9	17.7	0.1	0.1	10.1	7.2
Building Societies	0.0	0.0	0.0	0.0	0.0	0.0
Money Market Funds	24.6	21.9	0.0	0.0	1.6	1.1
Non –Specified Investments						
Banks	59.8	53.3	98.1	95.1	104.1	73.9
Building Societies	8.0	7.1	5.0	4.8	5.0	3.6
Enhanced Money Market Funds	0.0	0.0	0.0	0.0	20.0	14.2
Total	112.3	100.0	103.2	100.0	140.8	100.0

Specified investments are those with such low risk that the possibility of loss of principal is negligible and non-specified investments are all other assets.

7.5 A more detailed analysis of the investment portfolio as at 30 September 2013 is shown in appendix 1.

7.6 The credit ratings of the main UK banks were lowered in the last quarter of, 2011. Prior to that all the counterparties in use as at September 2011 achieved the credit quality to be classified as the more secure "specified investments" and only those investments with a maturity of over 12 months were classed as "non specified".

7.7 Following the changes to credit ratings at the end of 2011, only one bank in use meets the criteria for specified investments, Svenska Handelsbanken, with all the others are non specified.

7.8 Cabinet and Council (February 2012) (supported by GARMC) agreed to lower the long term and short term threshold for non specified investments. This enabled continued use of Lloyds, RBS, Barclays and Nationwide as counterparties. Although Santander continues to meet the same criteria, on the advice of Sector it has been suspended as a counterparty.

7.9 With the fall in UK base rates in 2008/09 from 5% to 0.5%, the yield on offer for short term investments plunged. Although base rates have not changed subsequently the interest rates being paid on investments have declined further in the last year as UK monetary policy has been to provide cheap funding to banks. Interest rates for money market and call accounts have fallen to as low as 0.3%. For much of 2013, Lloyds and RBS have paid significantly higher rates than the other banks. Combined with the longer maturities permitted for these two banks, they attracted most new deposits in the year.

7.10 The impact of the changes in credit ratings and counterparty limits has meant that there are very few banks and building societies in the portfolio and, at 30 September 2013 investments were only outstanding with the following institutions:

Lloyds Bank Plc (including Bank of Scotland Plc)
The Royal Bank of Scotland Plc
Nationwide Building Society
Svenska Handelsbanken AB
Ignis Short Duration Cash Fund
Insight Liquidity Plus
Deutsche Bank AG London
Fidelity Instant Cash Fund

7.11 During the first half year of 2013-14 the most significant investment decisions taken were:

Dominating use of Lloyds and The Royal Bank of Scotland which, at 30 September, accounted for 48% and 26% of the portfolio respectively. The Lloyds percentage allocation has subsequently been reduced to prepare for the reduction in overall balances which is likely to occur in the last three months of the year.

Initial investment of £10m each in the enhanced money market funds managed by Ignis and Insight.

7.12 Overall, the Council remains a cautious investor placing security and liquidity considerations ahead of income generation. As mentioned above, many banks and buildings societies in which the Council safely invested for many years have been removed from the counterparty list and maximum maturities have been reduced from 5 years to 3 years (Lloyds and RBS) and 3 months for all other counterparties. These changes have restricted the opportunity to add value to the short term investment portfolio. The policy will be kept under review.

7.13 The performance of the investment portfolio is benchmarked on a quarterly basis by Sector both against their risk adjusted model and the returns from other local authorities. As at 30 September 2013, the average yield on the portfolio of 1.47% which placed the Council in the top 10% of the average average for the 180 local authorities monitored by the Council's cash management adviser. This return compares favourably with the average 3 month Libid rate of 0.38%. The reasons for this relatively good performance are that the Council invests heavily in the part nationalised banks and not at all with Government institutions, it has a significant proportion of its funds in longer maturities and it placed some deposits before the recent interest rates decline.

8. Review of the borrowing strategy for 2013/14

8.1 Total long term debt of £350.3m at September 2013 is made up of £131.8m bank loans and £218.5m PWLB loans. The current borrowing strategy is to use internal balances to fund capital expenditure rather than take on new borrowing.

8.2 The table below analyses the maturity profile of borrowing. Two methods to record the maturity of lender option borrower option (LOBO) loans are shown. The lenders of LOBOs are permitted to reset interest rates five years after advancing the loan (and annually thereafter) such that the loans may have to be repaid sooner than the permitted life if rates are increased. In total there are LOBO loans outstanding of £83.8 million. The table shows LOBO's using both their final maturity (LHS) and also using the earliest date that the interest rate can be changed as the final maturity (RHS).

Maturity structure of borrowing at 30 September 2013	upper limit %	lower limit %	LOBO final maturity £m	%	LOBO interest reset date £m	%
under 1 year	20	0	16.0	4.5%	49.8	14.2%
1 year and within 2 years	20	0	0.0	0.0%	0.0	0.0%
2 years and within 5 years	30	0	10.0	2.9%	60.0	17.1%
5 years and within 10 years	40	10	27.0	7.7%	27.0	7.7%
10 years and above	90	30	297.3	84.9%	213.5	61.0%
Total			350.3	100.0%	350.3	100.0%

9. **Review of any debt rescheduling undertaken during 2013/14**

9.1 In view of the debt profile, interest rates being paid and the potential cost of re-payment no rescheduling has been recommended during the current year.

10. Review of compliance with Treasury and Prudential Limits for 2013/14.

10.1 Appendix 2 compares the expected outturn for the prudential indicators with 2012-13 and that approved by the February 2013 Council.

SECTION 3 - FINANCIAL IMPLICATIONS

11. Financial matters are integral to the report.

SECTION 4 - PERFORMANCE ISSUES

12. The Council meets the requirement of the CIPFA Code of Practice for Treasury Management and therefore is able to demonstrate best practice for Treasury Management. The report above demonstrates how value for money has been achieved by maximising investment income and minimising borrowing costs, while complying with the Code and Council Policy.

SECTION 5 - ENVIRONMENTAL IMPACT

13. There is no environmental impact.

SECTION 6 - RISK MANAGEMENT IMPLICATIONS

14. Risk included on Directorate risk register? Yes

15. Separate risk register in place? No

16. Under the current economic climate there is a risk that the Council could lose its deposits due to failure of a counterparty.

SECTION 7 – EQUALITIES IMPLICATIONS

17. There is no direct equalities impact.

SECTION 8 – CORPORATE PRIORITIES

18. This report deals with Treasury Management activity and the Prudential Code which underpin the delivery of the Council's priorities.

Section 9 - Statutory Officer Clearance

Name: Dawn Calvert Date: 19 November 2013	x	on behalf of Chief Financial Officer
Name: Caroline Eccles Date: 19 November 2013	x	on behalf of Monitoring Officer

Section 10 – Performance Officer Clearance

Name: Martin Randall Date: 15 November 2013	x	on behalf of Divisional Director, Strategic Commissioning

Section 11 – Environmental Impact Officer Clearance

Name: Andrew Baker Date: 29 November 2013	x	on behalf of the Corporate Director (Environment & Enterprise)

Section 12: Contact Details and Background Papers

Contact: Ian Talbot (Treasury & Pension Fund Manager)
Tel: 020 8424 1450
Email: ian.talbot@harrow.gov.uk

Background Papers: Report "Treasury Management Strategy Statement, Prudential Indicators and Minimum Revenue Provision (MRP) Policy and Strategy 2013/14" to Cabinet on 14 February 2013
http://www.harrow.gov.uk/www2/ieListDocuments.aspx?CId=249&MId=61076&Ver=4

Call-In Waived by the Chairman of Overview and Scrutiny Committee	**NOT APPLICABLE** *[Call-in applies,* except for the recommendation to Council*]*