TREASURY MANAGEMENT MID-YEAR UPDATE

Cabinet – 5 December 2013

Report of the:	Chief Finance Officer
Status:	For Consideration
Also considered by:	Finance and Resources Advisory Committee – 12 November 2013
Key Decision:	No

Executive Summary: Members approved the Investment Strategy as part of the budget-setting process in February 2013. In considering that Strategy Members were advised that, given the current economic climate, the Strategy would need to be monitored and reviewed, where necessary, during the year.

This report gives details of treasury activity in the first half of the current financial year, recent developments in the financial markets and fulfils the reporting requirements of the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management.

In the light of falling investment rates, options for increasing the yield on the Council's investment portfolio are considered and Members' views will be welcomed.

An update on the Council's Icelandic bank investment is also provided.

This report supports the Key Aim of Effective Management of Council Resources.

Portfolio Holder	Cllr. Ramsay
Contact Officer	Roy Parsons, Principal Accountant - Ext 7204

Recommendation to Cabinet: It be RESOLVED that the Treasury Management Mid-Year Update for 2013/14 be approved

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Reason for recommendation: As required by both the Council's Financial Procedure Rules and the CIPFA Code, a mid-year report of treasury management activity is to be presented to Members for approval.

Background

1 The Council is required through regulations issued under the Local Government Act 2003 to produce an annual Treasury Management Strategy Statement, which includes the Annual Investment Strategy and Minimum Revenue Provision Policy,

for the year ahead, a mid-year review report and an Annual Report covering activities during the previous year.

2 During 2013/14 the minimum reporting requirements are that the Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 19/2/2013).
- a mid year treasury update report (this report).
- an annual report following the year describing the activity compared to the strategy.

3 In addition, monthly reports from our treasury management advisors, Capita Asset Services (formerly known as Sector Treasury Services) are emailed to Members of the Finance and Resources Advisory Committee.

4 As requested at a previous meeting of the Finance and Resources Advisory Committee, our Relationship Director at Capita Asset Services, Mr Richard Bason attended its meeting on 12 November 2013. He gave a short presentation and answered Members' questions relating to the Council's treasury management activities.

Introduction

5 This **mid-year update report** has been prepared in compliance with CIPFA's Code of Practice on Treasury Management and covers:

(a) An economic update for the 2013/14 financial year to 30 September 2013;

(b) interest rate forecasts;

(c) a review of the Treasury Management Strategy Statement and Annual Investment Strategy;

(d) a review of the Council's investment portfolio for 2013/14;

(e) proposals for increasing yield; and

(f) an update on the Icelandic bank investment.

Economic Update

6 During 2013/14 economic indicators suggested 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.

7 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% y/y, well below the rate of inflation at 2.7% in August, causing continuing pressure on household's disposable income.

8 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.

9 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 (QE) also stayed at £375bn. In August, the Bank of England's Monetary Policy Committee (MPC) provided forward guidance that Bank Rate is unlikely to change until unemployment first falls to 7%, which was not expected until mid 2016. However, 7% is only a point at which the MPC will review Bank Rate, not necessarily take action to change it. The three month to July average rate was 7.7%. CPI inflation (MPC target of 2.0%), fell marginally from a peak of 2.9% in June to 2.7% in August. The Bank of England expects inflation to fall back to 2.0% in 2015.

10 Financial markets sold off sharply following comments from Ben Bernanke, the US Federal Reserve (Fed) chairman in June that suggested the Fed 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 Fed purchasing of bonds has served to underpin investor moves into equities out of low yielding bonds. However, as the market moves to realign its expectations, bond yields and equities are likely to rise further in expectation of a continuing economic recovery. 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 Fed surprised financial markets by not starting tapering as it felt the run of economic data in recent months had been too weak to warrant taking early action. Bond yields fell sharply as a result, though it still only remains a matter of time until tapering does start.

11 Tensions in the Eurozone eased over the second quarter, but there remained a number of triggers for a renewed flare-up. Economic survey data improved consistently over the first half of the year, pointing to a return to growth in Q2, so ending six quarters of Eurozone recession.

Outlook for the next six months of 2013/14

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

- A return to weak economic growth in the US, UK and China causing major disappointment to investor and market expectations.

- The potential for a significant increase in negative reactions of populaces in Eurozone countries against austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.

- The Italian political situation is frail and unstable: the coalition government fell on 29 September.

- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts.

- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.

- Weak growth or recession in the UK's main trading partners - the EU and US, depressing economic recovery in the UK.

- Geopolitical risks e.g. Syria, Iran, North Korea, which could trigger safe haven flows back into bonds.

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

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

- Increased investor confidence that sustainable robust world economic growth is firmly expected, together with a reduction or end of 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.

14 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 QE if there is a dip in strong growth or if the MPC were to decide to take action to combat the market's expectations of an early first increase in Bank Rate. If the MPC does takes action to do more QE in order to reverse the rapid increase in market rates, especially in gilt yields and interest rates up to 10 years, such action could cause gilt yields and PWLB rates over the next year or two to significantly undershoot the forecasts in the table below. The tension in the US over passing a Federal budget for the new financial year starting on 1 October and raising the debt ceiling in mid October could also see bond yields temporarily dip until agreement is reached between the opposing Republican and Democrat sides. Conversely, the eventual start of tapering by the Fed will cause bond yields to rise.

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%

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

Treasury Management Strategy and Annual Investment Strategy update

16 The Treasury Management Strategy Statement (TMSS) and Prudential Indicators for 2013/14 were approved by the Council on 19 February 2013. There are no policy changes to the TMSS thus far and the details in this report merely update the position in the light of updated economic data.

17 The same goes for the Council's Prudential Indicators, namely the Capital Financing Requirement, External Debt and the Operational Boundary and the Limits To Borrowing Activity.

Investment portfolio for 2013/14

18 In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As described above, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. Indeed, the introduction of the Funding for Lending scheme has reduced market investment rates even further. The potential for a prolonging of the Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment, investment returns are likely to remain low.

19 The Council held £35.058m of investments as at 30 September 2013, excluding the Icelandic bank investment (£26.856m at 31 March 2013) and the investment portfolio yield for the first six months of the year was 0.82% against 7 Day and 3 Month LIBID benchmarks of 0.39% and 0.54% respectively. A list of investments as at 30 September 2013 appears at Appendix A.

20 The approved limits within the Annual Investment Strategy were breached just once during the first six months of 2013/14. At the end of April 2013, a large capital receipt was received late on a Friday afternoon. This caused the balance held in the Business Premium Account at Barclays to reach £4.75m, which, together with £2m of fixed deposits, exceeded the £6m limit we had set. It was too late in the day to reinvest the money, but the position was corrected on the following Monday.

21 The Council's budgeted investment return for 2013/14 is £260k, and performance for the year to date is £24k above budget. At this stage, the year-end forecast is expected to be nearer £17k above budget.

Proposals for increasing yield

22 As mentioned above, we are in a low interest rate environment and this is likely to continue for the foreseeable future. A number of longer dated investments at interest rates over 2% have already, or are or due to, mature in 2013/14.

Reinvestment rates that fit with the current Investment Strategy are around 1% at best. This has caused the overall rate of return on the portfolio to fall steadily since April 2013. The likelihood is that investment interest in 2014/15 will be somewhat lower than that achieved in 2013/14, thereby adding extra pressure to the Council's budget.

23 When the time comes to consider the Annual Investment Strategy for 2014/15, Members may wish to take account of the options for increasing yield listed in Appendix B. As always, there will be risks to the security and liquidity of investments by following this path and much depends on our appetite for accepting these risks.

24 The rates achievable in the longer end of the market do appear attractive, but can be volatile. At the time of writing this report, the rates quoted in Option C of Appendix B have moved down significantly, but equally they could rise again at short notice. At this point in time, longer term lending to other local authorities is very appealing. 3 year money is currently being dealt at 1.45% to 1.50%, 4 year at 1.85% and 5 year at 2.20%. There is also the possibility of negotiating on a semi-annual rather than annual coupon, which would slightly improve the notional rate of return. An added attraction is the good credit quality of local authorities.

25 At the meeting of the Finance and Resources Advisory Committee on 12 November 2013, Members considered these alternative options. The feeling was that Property Funds were a little too risky at this point in time and could perhaps be considered for the 2015/16 Strategy. However, the options of investing in highly rated foreign banks (outside the EU area) and extending the maximum duration period to two years were considered worthy of further investigation by officers for the 2014/15 Strategy.

Update on Icelandic bank investment

26 This authority currently has an investment of £1m frozen in Landsbanki Islands hf. The investment was placed on 25 June 2007 at 6.32%, to mature on 25 June 2009.

27 The Icelandic Government has stated its intention to honour all its commitments as a result of their banks being placed into receivership. The UK Government, Administrators and other agencies continue to work with the Icelandic Government to help bring this about. The Local Government Association is coordinating the efforts of all UK authorities with Icelandic investments.

28 At the current time, the process of recovering assets is still ongoing with the Administrators. Following the successful outcome of legal test cases in the Icelandic Supreme Court in late 2011, the deposits made by local authorities now rank as priority claims. The Administrators have commenced the process of dividend payments and four such payments have been received amounting to approximately 54% of our claim. The latest assumption is that 100% of the Council's investment (and interest up to 22 April 2009) will be recovered in the period up to 2018.

29 One recent development is the resolution of the foreign exchange (FX) dispute in the Icelandic Supreme Court. Our claim was converted to Icelandic Kronur on 22

April 2009 and subsequent dividends have been paid in a basket of currencies including Euros, US Dollars, Sterling and Icelandic Kronur. Originally, the Administrators calculated the four partial payments by reference to the FX rates as at 22 April 2009 rather than the FX rates on the date of the relevant distribution. The Court held that the Administrators must apply the Central Bank of Iceland's official selling rate at the date of distribution when calculating the portion of the claim amount that is satisfied by each partial payment. The effect has been to very slightly reduce the percentage of the claim deemed to have been satisfied. This means that the amount (in Icelandic Kronur terms) we can expect to receive for the balance of our claim will be larger, but the actual amounts received will be dependent on FX rates as at the date of distribution.

Key Implications

Financial

30 The management of the Council's investment portfolio and cash-flow generated balances plays an important part in the financial planning of the authority. The security of its capital and liquidity of its investments is of paramount importance.

Legal Implications and Risk Assessment Statement

31 Under Section 151 of the Local Government Act 1972, the Section 151 Officer has statutory duties in relation to the financial administration and stewardship of the authority, including securing effective arrangements for treasury management.

32 This annual review report fulfils the requirements of The Chartered Institute of Public Finance & Accountancy's Code of Practice on Treasury Management 2009.

33 Treasury management has two main risks :

- Fluctuations in interest rates can result in a reduction in income from investments; and
- A counterparty to which the Council has lent money fails to repay the loan at the required time.

34 Consideration of risk is integral in our approach to treasury management. However, this particular report has no specific risk implications as it is not proposing any new actions, but merely reporting performance over the last six months.

Equality Impacts

Consideration of impacts under the Public Sector Equality Duty:		
Question	Answer	Explanation / Evidence
a. Does the decision being made or recommended through this paper have potential to disadvantage or discriminate against	No	The recommendation is concerned with investment management and does not directly impact upon a service provided to the community.

Consideration of impacts under the Public Sector Equality Duty:		
Question	Answer	Explanation / Evidence
different groups in the community?		
b. Does the decision being made or recommended through this paper have the potential to promote equality of opportunity?	No	
c. What steps can be taken to mitigate, reduce, avoid or minimise the impacts identified above?		No mitigating steps are required.

Conclusions

35 The overall return on the Council's investments is exceeding the budget in 2013/14 by approximately £24,000 as at the end of September 2013, but this is expected to have reduced by the end of the financial year.

36 The economic situation both globally and within the Eurozone in particular remains volatile with inevitable consequences for the UK economy. Treasury management has been conducted against this background and with a cautious investment approach.

37 In order to maintain returns on the Council's investment portfolio, there are various options to increase yield that are worthy of consideration.

38 Recovery of the Icelandic deposit is ongoing and further updates will be provided as and when monies are received.

Appendices: Appendix A – Investment portfolio at 30 September 2013

Appendix B – Alternative investment options to increase yield

Background Papers: Treasury Management Strategy for 2013/14 - Council 19 February 2013

Adrian Rowbotham
Chief Finance Officer