TO:	Council
FROM:	Executive Director Resources and Transformation
DATE:	6th November 2014

TITLE OF BRIEFING PAPER: **Treasury management annual report 2013-14 and mid-year review for 2014-15**

1. PURPOSE

1.1 To advise Members of Treasury Management performance for 2013-14, and update Members with regard to the position to date in 2014-15.

2. RECOMMENDATIONS

2.1 The Council is recommended to

(a) note the Outturn position for 2013-14 and

(b) agree the proposed changes to the Council's Treasury Management Strategy for 2014-15, to allow a higher level of Non-Specified short term investments in UK banks, and to add a new category of Approved Investment Counterparty, for Banks and other organisations/securities holding long-term credit ratings no lower than BBB+ .

3. BACKGROUND

3.1 In March 2012 the Council agreed a Treasury Management Strategy for 2012-13, and adopted CIPFA's 2011 *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*, and an updated Treasury Management Policy Statement.

3.2 In March 2014 the Council agreed a Treasury Management Strategy for 2014-15.

4. RATIONALE

4.1 The CIPFA Treasury Management Code requires the Council to approve a Treasury Management Strategy (including various Treasury Management indicators) before the start of each financial year, and to consider both the outturn after each year end, and the mid-year position in each current year. The Council has determined to combine the outturn and mid-year review into a single report.

5. KEY ISSUES

5.1 Treasury priorities

5.1.1 The Council has operated within CIPFA and statutory guidance and requirements in respect of Treasury Management practice. The approved Treasury Management Policy Statement, more detailed Treasury Management Practices and each year's Annual Strategy have all emphasised the importance of security and liquidity over yield.

5.2 Outturn 2013-14

5.2.1 Strategy for the year

5.2.1.1 The Treasury Management Strategy for 2013-14 was approved by Council on 4th March 2013. The main aspects of the strategy are outlined below.

5.2.1.2 With short-term interest rates expected to continue to be lower than long-term rates it was acknowledged, for another year, that it may continue to be more cost effective not to borrow and instead reduce the level of investments. However it was recognised that long-term interest rates were expected to rise in the future so the short-term savings would need to be balanced against potential longer term costs.

5.2.1.3 Long-term borrowing would be taken if it became apparent that there was a risk of significantly increased interest rates or if it was required to maintain cash flow balances.

5.2.1.4 Any balances over and above that required to maintain basic liquidity could be invested either in the medium term (out to a year) or the longer term (over a year). Priority was given to security of funds and liquidity (accessibility) over yield (or return).

5.2.1.5 The limits to investment by reference to amount, duration and credit rating were largely unchanged from those applying in previous years, with the addition a widening of the scope for investments away from just bank and building society deposits, to potentially allow investments to be made with any public or private sector organisation with satisfactory credit rating criteria.

5.2.2 Economic Review

5.2.2.1 At the beginning of the year, financial markets were concerned about weak growth in the Eurozone, the UK and Japan. Only two major economies – the US and Germany – had growth above pre-crisis levels, and even these were still below trend. The Eurozone had stabilised after a turbulent period and the risk of a near-term disorderly collapse had significantly diminished. The USA had just avoided the fiscal cliff and a technical default in early 2013.

The Bank of England, under Mark Carney, set out forward guidance in August, pledging not to consider raising interest rates until the ILO unemployment rate fell below a 7% threshold (then only expected to be reached in 2016). Though it was stressed that this level was a threshold for consideration rather an automatic trigger, markets began pricing in a much earlier rise than was warranted and, as a result, gilt yields rose quickly.

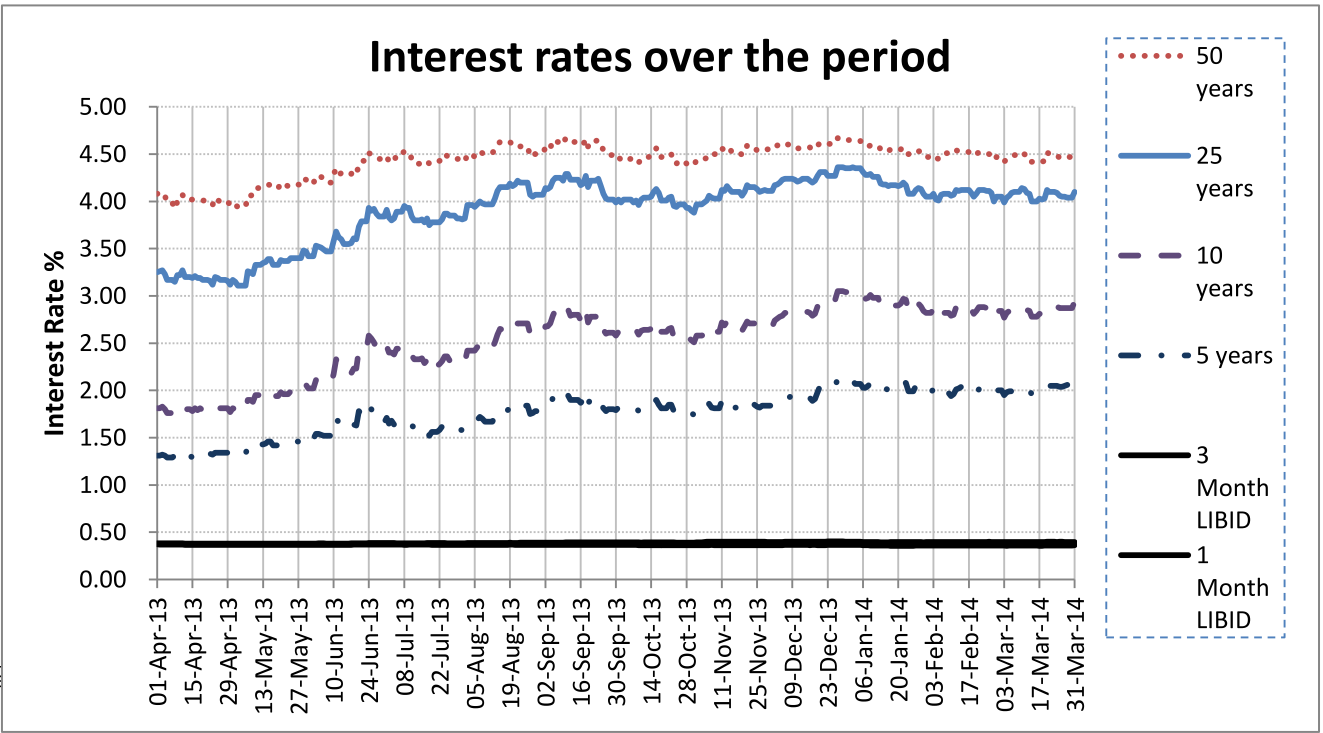
The UK's subsequent economic growth, along with falling unemployment levels – mainly down to the dominant service sector, and an increase in household consumption – came quicker than forecast, but business investment did not recover so convincingly and there was limited productivity growth. Fears over a housing bubble were tempered by evidence that net mortgage lending only grew gradually. Inflation fell, helped largely by the easing commodity prices and discounting by retailers, and this also reduced the pressure on the Bank to raise rates, as did stubbornly high levels of underemployment, and negative real wage growth.

In February the Bank stepped back from forward guidance relying on a single indicator – the unemployment rate – to more complex measures which included spare capacity within the economy. The Bank also implied that when official interest rates were raised, the increases would be gradual – this helped underpin the 'low for longer' interest rate outlook despite the momentum in the economy.

Ahead of market expectation – global markets had got used to continuing high liquidity levels – the US Federal Reserve began to slow down its quantitative easing (QE) in December 2013. By March 2014, asset purchases had fallen significantly and there was an expectation that QE would end by October 2014. The US dollar rose, US bond yields went up, and emerging markets suffered large capital outflows.

With the Eurozone struggling to show sustainable growth, the European Central Bank cut main policy interest rates to 0.25% and the deposit rate to zero. Markets continue to worry over poor growth and potential deflation.

An economic slowdown in China, and geopolitical tensions in the Middle



East and the Ukraine have all contributed to market uncertainty, and cast doubts over the ability of the US and UK to sustain their expansion.

5.2.2.2 Government borrowing costs – gilt yields – ended the year higher than they began. The peak in yields was during autumn 2013, with a bigger increase in 5-year and 10-year gilt yields, and a less pronounced increase for longer dated gilts. This drove the changes in PWLB borrowing rates set out above.

Nominal investment rates, measured through the London Inter-Bank Bid Rate, also shown above, increased in line with market anticipation of future interest rate changes, though actual returns available to local authorities in conventional investment deposits remained low.

5.2.3 Treasury management performance

5.2.3.1 Debt and investment positions at the start and end of the year were as follows:

	31 Mar 2014 Principal (£ M)	Rate / Return	Avg Life (Yrs)	31 Mar 2013 Principal (£ M)	Rate / Return	Avg Life (Yrs)
Fixed rate funding:						
PWLB	119.4	4.53%	22.8	116.8	4.53%	23.6
Market	10.4	4.50%	40.7	10.4	4.50%	41.7
	129.8			**127.2**		
Variable rate funding:						
PWLB	0.0			0.0		
Market	13.5	6.28%	17.2	13.5	6.28%	18.2
	13.5			**13.5**		
Loans taken by BwDBC	**143.3**	**4.69%**	**23.5**	**140.7**	**4.69%**	**24.3**
Debt from PFI arrangements	73.0			74.5		
Other long term liabilities – debt managed by LCC	18.1	2.5%		18.8	2.4%	
Total debt	**234.4**			**234.0**		
Total investments	**28.4**	**0.38%**		**31.6**	**0.49%**	

Borrowing rates are not weighted for duration.

Average lives for PWLB / money market loans only (excludes £0.4m irredeemable stock)

Investment rates show the return across the year

5.2.3.2 The key changes to the Council's overall debt position across the year were:

a) Taking out one new PWLB loan, for £5m as a maturity loan @ 3.77% for 12 years – this was partly offset by principal repayments (all on EIP loans) of around £2.3m.

b) Repayments of part of the outstanding debt recognised on the balance sheet for the PFI debt for Building Schools for the Future, and for debt managed by LCC.

5.2.3.3 The accounting adjustments recognising PFI assets and liabilities on the balance sheet are designed to show our effective long term control over the assets concerned, and the parallel "indebtedness" arising from financing the cost of them, but do not add to the "bottom line" met by the Council Tax payer.

5.2.3.4 No debt restructuring was undertaken in the year, as no opportunities for achieving material benefits from doing so were identified.

5.2.3.5 The take on of new PWLB loans still left the Council's debt almost £40m less than its Capital Financing Requirement (outstanding indebtedness arising from the Capital Programme). Investment balances were, therefore, significantly lower than they would otherwise have been. Together with the still lower interest rates available and the operation of cautious and short-term approach to investment, this reduced the amount of interest earned on balances.

5.2.3.6 In summary, the outturn position in respect of interest costs and income is as follows:

Outturn 2012-13 £'000		Original Budget 2013-14 £'000	Outturn 2013-14 £'000
6,628	Interest paid on borrowing	7,558	7,062
5,013	PFI interest paid	0	6,760
(161)	Interest receipts	(121)	(274)
7,129	Provision for debt repayment – non-PFI	7,544	7,399
722	Provision for debt repayment - PFI	0	1,497

5.2.3.7 Interest paid on borrowing in 2013-14 was around £0.5m less than the Original Estimate, which had allowed for higher levels of borrowing across 2013-14. As already noted, there was only limited new long term borrowing, with only part-year effect interest costs.

5.2.3.8 As with the required balance sheet adjustments, PFI interest charges did not add to the "bottom line" faced by the Council Taxpayer, as grants covered their cost.

5.2.3.9 The daily average investment balance across the year was around £50m (£48m in 2012-13). Balances tend to fall to their lowest point around December. Overall interest earned was up, to £0.27m in 2013-14 (£0.16m in 2012-13), but this was mainly because of additional income from returns now arising on investment in the Local Education Partnership (which delivered the BSF Programme). Interest earned on cash balances fell again and earned an average rate of 0.38% (compared to 0.49% in 2012-13).

5.2.3.10 Interest rates have been low for several years, and the rates available from the limited range of institutions the Council were squeezed even further in 2013-14. Funds have continued to be invested for short periods, and more often with the government's Debt Management Office, to lessen risk – this also contributed to the very low returns.

5.2.3.11 The position with regard to performance against Treasury and Prudential Indicators is summarised in the Appendix. There were no breaches of the Borrowing Limits and the main element to highlight is that the outturn capital spend was £52.6m, which is lower than the £75.8m forecast. This in turn meant that the outturn Capital Financing Requirement was £273.4m, which is lower than the original forecast at the start of the year of £294.7m.

5.2.4 Treasury management consultancy

5.2.4.1 The Council contracted with Sterling Consultancy Services, under a new contract (after tendering) running from April 2012 to 31st March 2016. Sterling Consultancy Services was acquired by Arlingclose Limited in October 2012. Arlingclose continues to provide advice and information on the Council's investment and borrowing activities, although responsibility for final decision making remains with the Council and its officers.

5.2.4.2 Over the duration of their support to the Council, Arlingclose (or previously Sterling) have reviewed the Council's Treasury management procedures and activities. They have provided member training; ongoing officer training; support for and review of treasury decisions, reports and strategies; feedback on accounting for treasury activities; benchmarking with other authorities; guidance on borrowing and investment opportunities; forecasts of interest rates; and regular updates on credit ratings and other information on credit quality. The quality of the support provided has been of a high standard.

5.3 Strategy review 2014-15

5.3.1 Original strategy

5.3.1.1 The Treasury Management Strategy for 2014-15 was approved by Council on 3rd March 2014. The Council adopted the latest (2011) edition of the CIPFA *Code of Practice on Treasury Management* in March 2012.

5.3.1.2 The Treasury Strategy set at the start of 2014-15 was very much the same as for 2013-14, with the recognition that there was still significant capital expenditure to take place on a number of major projects, and a large degree of under-borrowing still outstanding against the Council's accumulated Capital Financing Requirement. The uncertainty over timing of still anticipated future increases in borrowing costs, and short run strong cash positions, meant that it was still possible that the Council would be able to continue to defer borrowing and generate further net interest savings, as it has over a number of years.

5.3.1.3 The uncertainty over the timing of the take up of borrowing also suggested a continuing cautious approach to investing surplus cash balances, with the emphasis still being placed on prioritising security and liquidity over yield.

5.3.2 Update on the economy and current interest rate projections

5.3.2.1 The recent strong performance of the UK economy continued with output growing quickly, back to the levels at the pre-crisis peak of Q1 2008. The service sector still dominates, generating most of the growth. On the back of strong consumption growth, business investment is now recovering, albeit from a low base.

Strong employment gains and a fall in the headline unemployment to 6.4% were offset by continued weak earnings growth (with total pay for the three months to June lower than in the previous year) and high levels of involuntary part-time work and zero-hour contracts.

CPI inflation for September fell to 1.2% year-on-year, lower than anticipated. Expectations remain that inflation will likely remain close to, but a little below, the Bank of England's Monetary Policy Committee (MPC) 2% target for the next couple of years.

Measures being taken to cool the UK's housing market include lenders "stress-testing" mortgage applicants (over their ability to cope with higher interest rates) and limits to mortgages at more than 4.5 times the borrower's income. The Prudential Regulation Authority will consult on capital requirements for mortgages.

The Bank of England MPC left the Bank Rate at 0.5% and maintained asset purchase levels. However, there has been a change of tone, with some now voting in favour of an increase in Bank Rate. The MPC has emphasised that when Bank Rate does rise, it is expected to do so only gradually and to remain below average historical levels for some time.

In the Eurozone, the European Central Bank lowered its official benchmark interest rate from 0.15% to 0.05% and is paying negative interest on commercial bank balances placed with it. It also announced it will acquire Asset Backed Securities (ABS) from banks, to encourage lending – one step away from full blown QE adopted by the US, UK and Japanese central banks.

The US Federal Reserve kept policy on track, with further reductions in asset purchases, which are now expected to end later in the year – debate has now turned towards the timing of rate increases. The US economy grew strongly again in Q2, with more of the growth being driven by domestic demand and less by restocking by businesses.

Gilt yields continued to decline, falling in early October to their lowest levels this Financial Year. The main drivers were the geo-political risks in the Middle East and Ukraine, and deflationary pressures within the Eurozone.

5.3.2.2 The Council's current projections for interest rates, based on the latest central forecast from our advisors Arlingclose is below:

Month	Bank Rate	3 month LIBID	1 Year LIBID	PWLB Certainty Rates 10 Yrs	20 Yrs	50 Yrs
30/09/14	*0.50*	*0.44*	*0.94*	*3.26*	*3.76*	*3.83*
Dec 14	0.50	0.55	0.95	3.40	4.00	4.00
Mar 15	0.50	0.60	1.00	3.60	4.20	4.15
June 15	0.50	0.65	1.05	3.65	4.35	4.30
Sept 15	0.75	0.85	1.20	3.80	4.45	4.45
Dec 15	0.75	1.00	1.35	3.95	4.50	4.55
Mar 16	1.00	1.15	1.45	4.10	4.55	4.65
June 16	1.00	1.25	1.55	4.25	4.60	4.75
Sept 16	1.25	1.40	1.65	4.40	4.65	4.80
Dec 16	1.25	1.50	1.70	4.50	4.70	4.80
Mar 17	1.50	1.65	1.80	4.60	4.75	4.85
June 17	1.50	1.70	1.90	4.60	4.75	4.90

5.3.3 Treasury performance to date

5.3.3.1 Thus far, cash balances have continued to hold up, and only limited short term borrowing has been undertaken.

Analysis of debt outstanding

	Start of Apr 2014 £' 000	£ ' 000	End of Sept 2014 £' 000	£ ' 000
TEMPORARY DEBT				
Less than 3 months	0		2,185	
Greater than 3 months	0		0	
		0		2,185
LONGER TERM DEBT				
Bonds	23,503		23,503	
Mortgages	17		17	
PWLB	119,403		117,475	
Stock & Annuities	404		404	
		143,327		141,399
Lancs County Council transferred debt		18,075		17,894
Recognition of Debt re PFI Arrangements		73,031		73,031
TOTAL DEBT		234,433		234,509
Less: Temporary Lending		(28,350)		(29,915)
		206,083		204,594

5.3.3.2 Investments have continued to be made with a limited range of banks, building societies and Money Market Funds, along with the Government's Debt Management Office, earning interest at low levels (generally below 0.4%).

5.3.3.3 Savings of around £0.4m on the £7.8m Original Estimate for external interest payments have already been reported through Corporate Monitoring, reflecting lower borrowing last year, and this year to date. Investment returns remain low, as initially projected (Original Estimate was around £0.12m). Further interest savings may arise depending upon market conditions and the resilience of the Council's cash flow.

5.3.3.4 Latest budget projections anticipate that around £20m long term borrowing will be undertaken later in this year, as revenue cash balances will reduce and there is a risk of increases to longer term interest rates. Though other borrowing options are under consideration – including mainly taking short term borrowing - it is likely that most of any long term borrowing will be from the PWLB.

5.3.4 Updated investment and borrowing strategy

5.3.4.1 The UK is implementing the final "bail-in" provisions of the EU Bank Recovery and Resolution Directive in January 2015, a year ahead of most other countries. This will seek to minimise the level of government support in the event of bank problems, and credit rating agencies have stated that they will review bank ratings (which currently are uplifted for potential government support) in line with implementation of this directive. There is therefore a risk that some major UK banks' credit ratings will fall this financial year.

The Council has a choice of either preparing to invest without using some or all of the major UK banks or amending the Investment Strategy to allow investment in lower rated banks. It is proposed to take the latter course - mainly to optimise the range of counterparties - by taking two actions:

(a) expanding the existing level of headroom within our Non-Specified Investment Limits, as follows:

Non-Specified Investment Limits	**Original 14-15 Limit**	**Proposed New 14-15 Limit**
Total long-term investments	£7 M	£7 M
Total investments without credit ratings or rated below A-		
Building Societies	£10 M	£7 M
Council's current account bank	£3 M	£3 M
Other major UK banks	-	£6 M
Money Market Funds (if credit ratings position amended)	£15 M	£15 M
Total investments in foreign countries rated below AA+	£2 M	£2 M
Total non-specified investments	**£37 M**	**£40 M**

Thus far, the only Non-Specified Investments made during 2014-15 have been with the Council's current account banker, and with up to £3M in low rated or unrated building societies (i.e. in those other than the Nationwide).

(b) adding a new category to our Approved Investment Counterparties.

The Council's original 14/15 approved schedule was:

Approved Investment Counterparties	Cash limit	Time limit
Banks and other organisations/securities holding long-term credit ratings no lower than AA (or equivalent)	£5M each	364 days
Banks and other organisations/securities holding long-term credit ratings no lower than AA- (or equivalent)	£4M each	364 days
Banks and other organisations/securities holding long-term credit ratings no lower than A- (or equivalent)	£3M each	6 months
The Council's current account banker - provided long term credit rating no lower than BBB- (or equivalent)	£3M	next day
UK building societies not meeting the above criteria, with a minimum asset size of £500 million, unless rated below BBB (or equivalent)	£1M each	6 months
Money market funds	£5M each	n/a
UK Central Government	no limit	364 days
UK Local Authorities* (irrespective of credit rating)	£4M each	364 days

* as defined in the Local Government Act 2003

It is therefore proposed to add the following category:

Banks and other organisations/securities holding long-term credit ratings no lower than BBB+ (or equivalent)	£3M	3 months

5.3.4.2 If the Council finds itself needing to expand the level of Non-Specified Investments, it will of course closely monitor all available indications as to the credit-worthiness of the institutions to be used, and continue to take a cautious and prudent approach to the amount and duration of investments, with control of day to day investment policy still exercised through the Council's Treasury Management Group.

5.3.4.3 The Council's professional treasury advisers, Arlingclose, consider these additional flexibilities appropriate and prudent. Making such changes now, ahead of any potential changes in bank ratings, avoids having to take urgent decisions at short notice.

5.3.4.4 It is proposed that otherwise the criteria for Investments - and the Treasury and Prudential Limits and Indicators - remain unchanged.

5.3.4.5 It is proposed that the Borrowing Strategy remain unchanged, with the Council looking to take new borrowing as determined by cash flow requirements and by reference to movements in long term interest rates.

5.3.4.6 The Council will again be able to take advantage of the Public Works Loan Board (PWLB) Certainty Rate, which is set 0.2 percentage points below standard PWLB rates (currently 1.0% above the UK government bond yield). The Council will seek to take borrowing across the remainder of the financial year, looking to balance the short term risks of carrying excessive cash against the longer term risks of PWLB rates continuing to move upwards.

5.4 Risk management

5.4.1 The Council's primary objectives for the management of its investments are to give priority to the security and liquidity of its funds before seeking the best rate of return. The majority of its surplus cash is therefore held as short-term investments with the UK Government, highly rated banks and pooled funds. In addition, the Council holds some investments that entail a slightly higher level of risk, including callable deposits (where there is a risk that changing interest rates may mean that the loan does not run to full term) and unrated building society deposits (where risks have been mitigated by limiting the amount and duration of exposure).

5.4.2 The Council's primary objective for the management of its debt is to ensure its long-term affordability. The majority of its loans (£119 m) have been borrowed from the Public Works Loan Board at long-term fixed rates of interest.

5.4.3 The other significant element of the Council's debt is £23.5m of "lender's option, borrower's option" (LOBO) loans with initially fixed (and initially low) rates of interest. Under these instruments the Lender can, at certain times, exercise an option to increase the rate payable on the debt, and the Borrower has the choice then either to accept the proposed increase or repay the whole loan (which would mean, effectively, having to live with whatever the market conditions for interest rates were at that point). This exposes the Council to some risk of rising long-term interest rates, but that is mitigated by the fact that £10m of this debt (forming a large part of the lowest interest rate elements) can only be "called" once in every five years. Recent estimates based on the current projected future interest rates, suggest LOBOs are unlikely to be called in the next 5 years (assuming no extraneous influences).

5.4.4 The combination of short duration investments and long duration debt exposes the Council to the risk of falling investment income during periods of low interest rates. Both longer-term investments and any variable rate instruments would hedge against that risk, though the Council currently holds neither of these. However this risk is viewed as of lower priority compared to the requirements of optimising the security and liquidity of investments.

6. POLICY IMPLICATIONS

6.1 None.

7. FINANCIAL IMPLICATIONS

7.1 The financial implications arising from the 2013-14 Treasury Outturn and latest position for 2014-15 have been incorporated into Corporate Budget Monitoring Reports in 2014-15.

8. LEGAL IMPLICATIONS

8.1 Under the Local Government Act 2003, local authorities determine locally their levels of capital investment and associated borrowing. The Prudential Code has been developed to support local authorities in taking these decisions, and the Council is required by Regulation to have regard to the Code when carrying out its duties under Part 1 of the Local Government Act 2003.

8.2 The Department for Communities and Local Government has issued Guidance on Local Government Investments, under the Local Government Act 2003, effective from 1st April 2010. Under this, authorities should manage their investments within an approved strategy, setting out what categories of investment they will use and how they assess and manage the risk of loss of investments.

9. RESOURCE IMPLICATIONS

9.1 None.

10. EQUALITY IMPLICATIONS

10.1 None.

11. CONSULTATIONS

11.1 None.

Contact officer:	Ron Turvey, Deputy Finance Manager – Ext. 5303
Date:	16th October 2014
Background papers:	Treasury Management strategies for 2013-14 and 2014-15 approved at Council 4th March 2013 and 3rd March 2014 respectively.