REPORT NO: 290/2013

CABINET

17 December 2013

2013/14 MID-YEAR TREASURY MANAGEMENT & PRUDENTIAL INDICATORS MONITORING REPORT

Report of the Director of Resources

STRATEGIC AIM:	**Delivering Council Services within our MTFP**		
KEY DECISION	NO	DATE ITEM FIRST APPEARED ON FORWARD PLAN	September 2013

1. PURPOSE OF THE REPORT

1.1 Revisions to the regulatory framework of treasury management during 2009 introduced a requirement that the Council receive a mid-year treasury review report, in addition to the forward looking annual treasury strategy and backward looking annual treasury report required previously.

1.2 This report meets the requirement above and incorporates the needs of the Prudential Code to ensure adequate monitoring of capital expenditure plans and the Council's prudential indicators (PIs). The treasury strategy and PIs were contained in report 29/2013 which was approved by Cabinet on 5 February 2013.

1.3 The underlying purpose of this report supports the objective in the revised CIPFA Code of Practice on Treasury Management and the Communities and Local Government (CLG) Investment Guidance that Members receive and adequately scrutinise the treasury management service.

1.4 The report is structured to highlight the key changes to the Council's capital activity (the PIs), the economic outlook, and the actual and proposed treasury management activity (borrowing and investment).

2. RECOMMENDATIONS

2.1 **That Cabinet notes the report.**

3. REASONS FOR THE RECOMMENDATIONS

3.1 To comply with the regulations as set out in paragraph 1.2.

4. BACKGROUND

4.1 The underlying economic environment remains difficult for the Council, foremost being the continued challenging concerns over investment counterparty risk. This background encourages the Council to continue maintaining investments short term and with high quality counterparties. The downside of such a policy is that investment returns remain low.

4.2 The outlook for the next six months of 2013/14 (commentary provided by Capita Asset Services, formerly Sector, and the Council's Treasury Advisors) is as follows:

Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely during the remainder of 2013/14 as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, and safer bonds.

Near-term, there is some residual risk of further Quantitative Easing - if there is a dip in strong growth or if the Monetary Policy Committee 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. This could cause shorter-dated gilt yields and Public Works Loans Board (PWLB) rates over the next year or two to significantly undershoot the forecasts in the table below. The failure in the US, (at the time of writing), over passing a Federal budget for the new financial year starting on 1 October, and the expected tension over raising the debt ceiling in mid-October, could also see bond yields temporarily dip until any binding agreement is reached between the opposing Republican and Democrat sides. Conversely, the eventual start of tapering by the Federal Reserve could cause bond yields to rise.

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. Increasing investor confidence in economic recovery is also likely to compound this effect as a continuation of recovery will further encourage investors to switch back from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently 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; it also remains exposed to vulnerabilities in a number of key areas.

Downside risks currently include:

- The conflict in the UK between market expectations of how quickly unemployment will fall as opposed to the Bank of England's forecasts
- Prolonged political disagreement over the United States (US) Federal Budget and raising the debt ceiling
- 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.
- 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 European Union (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

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

- A sharp upturn in investor confidence that sustainable robust world economic growth is firmly expected, causing a surge in the 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.
- 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 which could result in the ratio of total government debt to Gross Domestic Product (GDP) to rise to levels that undermine investor confidence in the UK and UK debt.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- In the longer term – an earlier than currently expected 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.

4.3 Capita's interest rate forecast is as follows:

	Current	**March 2014**	**March 2015**	**March 2016**	**March 2017**
	%	%	%	%	%
Bank Rate	0.50	0.50	0.50	0.50	1.25
3 Month LIBID	0.40	0.50	0.50	0.50	1.30
6 Month LIBID	0.50	0.60	0.60	0.70	1.40
12 Month LIBID	0.80	0.80	0.80	1.40	2.30
5 Year PWLB	2.50	2.50	2.80	3.10	3.40
10 Year PWLB	3.70	3.60	3.90	4.20	4.50
25 Year PWLB	4.40	4.40	4.60	5.00	5.10
50 Year PWLB	4.40	4.40	4.70	5.10	5.20

4.4 The Assistant Director of Finance can report that the basis of the treasury management strategy, the investment strategy and the Prudential Indicators (PIs) are not materially changed, except as detailed below in Section 5:

5. KEY PRUDENTIAL INDICATORS

5.1 This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes to the capital expenditure plans on the PIs and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity

Prudential Indicator 2013/14	Original £000	Revised Prudential Indicator £000
Authorised Limit	28,000	28,000
Operational Boundary	22,000	22,000
Gross Debt	22,016	22,016
Capital Financing Requirement	25,477	27,138

5.2 **Capital Expenditure and Financing** – This table shows the revised estimates for capital expenditure and any changes to the financing of the capital programme.

	2013/14 Original Estimate £000	2013/14 Revised Estimate £000
Capital Expenditure	**3,608**	**11,970**
Financed by:		
Capital Receipts	438	0
Capital Grants	2,369	9,054
Capital Reserves	0	0
Revenue	0	416
Contributions	0	111
Net financing need for the year	**801**	**2,389**

The 2013/14 revised estimate for capital expenditure is significantly higher than the 2013/14 original estimate. The majority of the increase is the carry forward of underspends (£6.803m) as reported in the Outturn Report to Cabinet on 4 June (122/2013). Other movements in the programme include:

- The addition of Travel4Rutland (£2.048m) project;
- Additional Capital Education Allocations (£400k) project;
- The replacement of the Catmose fire escape and fire alarm (£75k);
- the Catmose Swimming Pool repairs (£130k);
- amendments to the highways capital programme (£347k) and

- the above are offset by re-profiling of capital expenditure to move it into 2014/15 e.g. Digital Rutland (£1.457m) and Oakham Town Centre (£255k).

All of these movements are explained more fully in the Quarter 1 (Cabinet reports 177/2013 and appendix 6 to that report) and Quarter 2 budget monitoring reports (241/2013 and appendix 5 to that report).

The net financing need for the year increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced by the revenue charges for the repayment of debt (Minimum Revenue Position).

5.3 **Capital Financing Requirement** – the table below shows the CFR, which is the underlying need to borrow for capital purposes. It also shows the expected debt position over the period. This is the Operational Boundary.

	2013/14 Original Estimate £000	**2013/14 Revised Estimate £000**
Prudential Indicator – CFR		
CFR	**25,477**	**27,138**
Movement in CFR	(409)	1,252
Movement in CFR represented by		
Net financing need for the year (see table in 5.2)	801	2,389
MRP	(1,210)	(1,137)
Movement in CFR	**(409)**	**1,252**
Prudential Indicator – External Debt/Operational Boundary		
External Borrowing	22,016	22,016
Total debt 31 March	**22,016**	**22,016**

5.4 Limits to borrowing activity – the first key control over the treasury activity is a PI to ensure that, over the medium term, net external borrowing (borrowings less investments) will only be for a capital purpose. Net external borrowing should not, except in the short term, exceed the total CFR in the preceding year plus the estimates of any additional CFR for 2013/14 and the next two financial years. This allows some flexibility for early borrowing for future years.

	2013/14 Original Estimate £000	**2013/14 Revised Estimate £000**
External borrowing *	22,016	22,016
Less investments	(14,000)	(14,000)
Net borrowing	8,016	8,016
CFR (Year-end position)	25,477	27,138

* This is the actual borrowing that was outstanding at the end of 2012/13 and is reported in the Statement of Accounts for 2012/13 as reported to Audit and Risk Committee on 24 September 2013 (report 220/2013). It will remain the same throughout the year as all the loans the Council has are maturity loans i.e. the principal is not repaid until the end of the loan period.

The Assistant Director of Finance reports that no difficulties are envisaged for the current or future years in complying with this PI.

5.5 **Authorised Limit** – this PI controls the overall level of borrowing. It represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, whilst not desired, would be affordable in the short term, but would not be sustainable in the longer term. It is the expected maximum level of borrowing that might be required with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

	2013/14 Original Estimate £000	**2013/14 Revised Estimate £000**
Borrowing	28,000	28,000
Other Long Term Liabilities	0	0
Total	28,000	28,000

6. Investment Portfolio 2013/14 (commentary provided by Capita)

6.1 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. 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. The continuing Euro zone sovereign debt crisis, and its potential impact on banks, prompts a low risk and short term strategy. Given this risk averse environment, investment returns are likely to remain low.

6.2 The Council held £21.0m of investments as at 30 September 2013 and the constituent parts of the investment position are:

Sector	**Country**	**Up to 1 year**	**1 - 2 years**	**2 – 3 years**
		£000	**£000**	**£000**
Banks	UK	5,000	0	0
Banks in Administration*	UK	60	0	0
Building Societies	UK	12,000	0	0
Money Market Funds		3,912	0	0
Total		**20,972**	**0**	**0**

* This refers to the £1m invested with Heritable Bank. As at 2 December 2013, the Council has received repayments totaling £0.953m which represents 94.02% of the investment and interest. This exceeds the projected amount of 86 to 90 pence in the pound and leaves £60,665 not yet recovered. The latest dividend was received on 23 August 2013 and the administrators have notified the Council that this may be the last dividend to be repaid for some time. Any further dividends are subject to an outcome of a legal trial, for which the date is unknown.

6.3 The Assistant Director of Finance confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2013/14.

6.4 The current investment counterparty criteria selection approved in the Treasury Management Strategy Statement is meeting the requirement of the treasury management function.

6.5 The revised budget position for investment income is:

	2013/14 Original Estimate £000	**Received to 30/9/2013 £000**	**2013/14 Revised Estimate £000**
Investment Income	151.0	51.6	113.0

6.6 The Director for Resources can report that return to date averages 0.44%, against a 7 day LIBID of 0.36%.

7. TREASURY STRATEGY 2013/14

7.1 The expected borrowing need is set out below:

	2013/14 Original Estimate £000	**2013/14 Revised Estimate £000**
CFR (year-end position)	25,477	27,138
Net borrowing at 31/3/2014	8,016	8,016
(Under)/Over borrowing	(17,461)	(19,122)

The Council is currently under borrowed to address investment counterparty risk. There is interest rate risk, as longer term borrowing rates may rise. This position is being carefully monitored.

7.2 There have been no debt repayments or rescheduling during the first half of 2013/14.

8. TREASURY MANAGEMENT INDICATORS

8.1 There are four treasury activity limits, which were previously prudential indicators. The purpose of these are to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to reduce costs/improve performance. The indicators are:

- Upper limits on variable interest rate exposure – This identifies a maximum limit for variable interest rates based upon the debt position net of investments.
- Upper limits on fixed interest rate exposure – Similar to the previous indicator this covers a maximum limit on fixed interest rates.
- Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.
- Total principal funds invested for greater than 364 days – These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

	2013/14 Original Estimate	**2013/14 Revised Estimate**
Interest rate exposures		
	Upper	**Upper**
Limits on fixed interest rates	£25.000m	£25.000m
Limits on variable interest rates	£7.500m	£7.500m

8.2 **Maturity Structures Of Borrowing** – These gross limits are set to reduce the Council's exposure to large fixed rate loans (those instruments which carry a fixed interest rate for the duration of the instrument) falling due for refinancing

Maturity structure of fixed interest rate borrowing 2013/14		
	Upper	**Lower**
Under 12 months	25%	0%
12 months to 2 years	25%	0%
2 years to 5 years	20%	0%
5 years to 10 years	20%	0%
10 years and above	100%	0%
Maximum principal sums invested > 364 days	25%	

9. RISK MANAGEMENT

RISK	IMPACT	COMMENTS
Time	Low	We are required to report to Members mid-year on performance against the strategy.
Viability	Low	We have complied with the Treasury Management Strategy and the Prudential Code.
Finance	High	This is a critical activity of the Finance Section.
Profile	Low	This is a 'back office' function therefore has a low profile in the public eye.
Equality and Diversity	Low	Equality Impact Assessment completed, there are no particular issues in this area.

Background Papers
Background File Ref: Treasury Strategy 2013/14

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