Report to: Audit Committee

Date of meeting: 10 December 2014

Report of: Alfia Gafourova – Finance Officer

Title: Treasury Management Update

1.0 SUMMARY

1.1 This report gives details of the 2014/15 Mid Year Review of the Treasury Management function.

2.0 RECOMMENDATIONS

2.1 That members note the contents of the 2014/15 Mid Year Review of the Treasury Management function.

Contact Officer:
For further information on this report please contact: -
Alfia Gafourova, Finance Officer
Telephone extension: 7437
email: alfia.gafourova@watford.gov.uk

Report approved by: Nigel Pollard, Acting Head of Finance, Shared Services

3.0 **DETAILS**

3.1 The Chartered Institute of Public Finance and Accountancy (CIPFA) defines treasury management 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”.

3.2 The Council’s 2014/15 Treasury Management Strategy (TMS) as approved by Council on 29 January 2014 is designed to ensure that cash flows are adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity before considering optimising investment return.

3.3 This report considers the UK economy and updates members with the progress on whether the Council is meeting the TMS and the policies contained therein for the first 6 months of 2014/15.

3.4 **The UK Economy for the first 6 months of 2014/15 (1/4/14 – 30/914) by Capita Asset Services (the Council’s treasury advisors)**

After strong UK GDP quarterly growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, (2013 annual rate 2.7%), and 0.7% in Q1, 0.9% in Q2 and a first estimate of 0.7% in Q3 2014 (annual rate 3.1% in Q3), it appears very likely that strong growth will continue through 2014 and into 2015 as forward surveys for the services and construction sectors, are very encouraging and business investment is also strongly recovering. The manufacturing sector has also been encouraging though the latest figures indicate a weakening in the future trend rate of growth. However, for this recovery to become more balanced and sustainable in the longer term, the recovery needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance. This overall strong growth has resulted in unemployment falling much faster through the initial threshold of 7%, set by the Monetary Policy Committee (MPC) last August, before it said it would consider any increases in Bank Rate. The MPC has, therefore, subsequently broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up. The MPC is particularly concerned that the current squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back above the level of inflation in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity, which has languished at dismal levels since 2008, to support increases in pay rates. Most economic forecasters are expecting growth to peak in 2014 and then to ease off a little, though still remaining strong, in 2015 and 2016. Unemployment is therefore expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in pay rates at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the

rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.
Also encouraging has been the sharp fall in inflation (CPI), reaching 1.2% in September, the lowest rate since 2009. Forward indications are that inflation is likely to fall further in 2014 to possibly 1%. Overall, markets are expecting that the MPC will be cautious in raising Bank Rate as it will want to protect heavily indebted consumers from too early an increase in Bank Rate at a time when inflationary pressures are also weak. A first increase in Bank Rate is therefore expected in Q2 2015 and they expect increases after that to be at a slow pace to lower levels than prevailed before 2008 as increases in Bank Rate will have a much bigger effect on heavily indebted consumers than they did before 2008.

The return to strong growth has also helped lower forecasts for the increase in Government debt by £73bn over the next five years, as announced in the 2013 Autumn Statement, and by an additional £24bn, as announced in the March 2014 Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018-19. However, monthly public sector deficit figures have disappointed so far in 2014/15.

Interest rate forecasts
The Council's treasury advisor, Capita Asset Services, has provided the following forecast

Month & Year	Bank Rate %
Dec 2014	0.50
Mar 2015	0.50
Jun 2015	0.75
Sep 2015	0.75
Dec 2015	1.00
Mar 2016	1.00
Jun 2016	1.25
Sep 2016	1.25
Dec 2016	1.50
Mar 2017	1.50
Jun 2017	1.75
Sep 2017	2.00
Dec 2017	2.25
Mar 2017	2.50

Capita Asset Services undertook a review of its interest rate forecasts on 24 October. During September and October, a further rise in geopolitical concerns, principally over Ukraine but also over the Middle East, plus fears around Ebola and an accumulation of dismal growth news in most of the ten largest economies of the world and also on the growing risk of deflation in the Eurozone, had sparked a flight from equities into safe havens like gilts and depressed PWLB rates. However, there is much volatility in rates as news ebbs and flows in negative or positive ways. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2015.

Downside risks currently include:

- UK strong economic growth is currently mainly dependent on consumer spending and the potentially unsustainable boom in the housing market. The boost from these sources is likely to fade after 2014.
- A weak rebalancing of UK growth to exporting and business investment causing a weakening of overall economic growth beyond 2014.
- Weak growth or recession in the UK's main trading partner - the EU, inhibiting economic recovery in the UK.
- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.
- Recapitalisation of European banks requiring more government financial support.
- Lack of support by populaces in Eurozone countries for 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.
- Italy: the political situation has improved but it remains to be seen whether the new government is able to deliver the austerity programme required and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.
- France: after being elected on an anti austerity platform, President Hollande has embraced a €50bn programme of public sector cuts over the next three years. However, there could be major obstacles in implementing this programme. Major overdue reforms of employment practices and an increase in competiveness are also urgently required to lift the economy out of stagnation.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Heightened political risks in the Middle East and East Asia could trigger safe haven flows back into bonds.
- Fears generated by the potential impact of Ebola around the world.
- There are also increasing concerns at the reluctance of western central banks to raise interest rates significantly for some years, plus the huge QE measures which remain in place (and may be added to by the ECB in the near future). This has created potentially unstable flows of liquidity searching for yield and, therefore, heightened the potential for an increase in risks in order to get higher returns. This is a return to a similar environment to the one which led to the 2008 financial crisis.

3.6 **The Council's Capital Position (Prudential Indicators)**

The Council's capital expenditure plans are one of the key drivers of treasury management activity. The outputs of the capital expenditure plans are reflected in prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

The capital expenditure plans are financed in full by capital receipts, grants or capital reserves. Over the next three years there are no planned shortfalls of resources which would result in a funding need (borrowing).

3.7 **Capital Financing Requirement (CFR), External Debt and Operational Boundary**

The CFR and Operational Boundary estimates are shown below:

Prudential Indicator	2014/15 Original Estimate	Current Borrowing Position	2014/15 Revised Estimate
Capital Financing Requirement	£2.3m	£2.6m	£2.6m
External Debt / the Operational Boundary			
Borrowing	£10m	£10m	£10m

3.8 **Limits to Borrowing Activity**

The first key control over the treasury activity is a Performance Indicator (PI) to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2014/15 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

3.9 **The Authorised Limit**

This PI, which is required to be set and revised by Members, controls the overall level of borrowing and represents the limit beyond which borrowing is prohibited. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Authorised Limit For External Debt	2014/15 Original Indicator	Current Borrowing Position	2014/15 Revised Indicator
Borrowing	£13m	£13m	£13m

3.10 **Investment Portfolio 2014/15**

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 set out in Section 2, 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 Council held £34m of investments as at 30 September 2014. (See table below) This information is reported in the monthly Members Information Bulletin.

Institution	Principal (£)
Clydesdale Bank plc	3,000,000
Lloyds Bank plc	9,000,000
Nat West Bank plc	8,000,000
Santander UK plc	5,000,000
Total Banks	***25,000,000***
Nationwide Building Society	4,000,000
Skipton Building Society	5,000,000
Total Building Societies	***9,000,000***
Total	***34,000,000***

The approved limits within the Annual Investment Strategy were not breached during the first six months of 2014/15.

3.11 **Clydesdale Bank plc**

The investment with Clydesdale is a long-standing investment made in April 2010. The Council placed funds with Clydesdale to support local businesses. When the Bank's credit rating was downgraded and it no longer met the criteria as outlined within the Treasury Management Strategy, its continuing use as a counterparty has been approved by Leadership Team.

The Council improved the rate from 0.50% to 0.70% keeping the benefit of 30 days notice to minimise the risk, with effect from October 2014.

3.12 **Security**

The Council's maximum security risk benchmark for the current portfolio was set as 0.01% risk of default when compared to the whole portfolio. The benchmarks are an average risk of default measure, and would not constitute an expectation of loss against a particular investment. The benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members. As this data is collated, trends and analysis will be collected and reported.

In line with the TMS, the Council has managed to invest with those institutions who offered the best rate and the investment portfolio is above the overall benchmark during the year to date.

3.13 **Liquidity**

The Council set liquidity facilities/benchmarks to maintain:

- Bank overdraft - £0m.
- The benefit of instant access to its funds on the general account with Lloyds.

The liquidity arrangements were adequate during the year to date.

3.14 **Yield**

The budget for interest earnt on investments for 2014/15 is £240,000; interest received up to the end of September was £101,000.

The approved benchmark measure of yield is a return of 0.12% above the average bank rate of 0.50%. The returns up to 30 September 2014 averaged 0.58%, against a benchmark rate of 0.62%.

The average yield return was lower than the benchmark for the year to date.

Table of Monthly Interest Rates to Date:

Month	**Rate Achieved**
April	0.58%
May	0.58%
June	0.59%
July	0.57%
August	0.59%
September	0.60%

The Council keeps all investments short term. There are no sums invested for greater than 364 days. Counterparties have been downgraded over the past few years, most investments have been limited to a 6 months period. This has resulted in lower interest rates being achieved.

The current investment counterparty criteria selection approved in the Treasury Management Strategy is being met.

3.15 **Credit Ratings**

The main rating agencies (Fitch, Moody's and Standard & Poor's) provide credit ratings for financial institutions. The credit rating of counterparties is monitored regularly.

4.0 IMPLICATIONS

4.1 Financial

4.1.1 As continued in the body of the report.

4.2 Legal Issues (Monitoring Officer)

4.2.1 There is no requirement to make any amendments to the Treasury Management Strategy at this stage.

4.3 Equalities

4.3.1 None specific.

4.4 Potential Risks

4.4.1 There are no risks associated with the decision members are being asked to make, i.e. to note this report.

Background Papers:

Treasury Management Strategy 2014/15;
UK Economic Forecasts provided by Capita Asset Services;

Data source: Logotech Treasury Management system