REPORT TO:	Executive Board
DATE:	12th December 2013
REPORTING OFFICER:	Operational Director – Finance
PORTFOLIO:	Resources
TITLE:	Treasury Management 2013/14 Mid Year Review
WARDS:	Borough-Wide

1.0 PURPOSE OF REPORT

1.1 The purpose of the report is to update the Board about activities undertaken at the mid-year point of 2013/14 as required by the Treasury Management Policy.

2.0 RECOMMENDED: That the report be noted and Council approve the revised Prudential Indicators and Counterparty List as set out in Appendix 1 and 2 respectively.

3.0 SUPPORTING INFORMATION

3.1 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operation is to ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering maximising investment return.

3.2 The second main function of the treasury management function is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need 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 debt previously drawn may be restructured to meet Council risk or cost objectives.

3.3 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011 was adopted by the Council on the 10th February 2011.

3.4 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 this Council the delegated body is Executive Board.

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

- An economic update for the first six months of 2013/14;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure (prudential indicators);
- A review of the Council's investment portfolio for 2013/14;
- A review of the Council's borrowing strategy for 2013/14;
- A review of any debt rescheduling undertaken during 2013/14;
- A review of compliance with Treasury and Prudential Limits for 2013/14.

4.0 KEY CHANGES TO THE TREASURY AND CAPITAL STRATEGIES

4.1 There have been no material changes to the treasury or capital strategies for the first 6 months of 2013/14.

5.0 ECONOMIC UPDATE

5.1 The economic update and forecast covered between 5.2 and 5.11 has been provided by the Council's specialist financial advisors, Capita Asset Services.

5.2 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.

5.3 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.

5.4 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.

5.5 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 month to July average rate was 7.7%.

5.6 Consumer Price Index (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.

5.7 Financial markets sold off sharply following comments from Ben Bernanke (the Federal Reserve 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 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.

5.8 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

5.9 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 Quantitative Easing 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 (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 Gross Domestic Product (GDP) to rise to levels that provoke major concern.

5.10 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 Federal Reserve will cause bond yields to rise.

5.11 <u>Economic Forecast</u>

	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 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.

6.0 TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY UPDATE

6.1 The Treasury Management Strategy Statement (TMSS) for 2012/13 was approved by this Council on the 6th March 2013.

7.0 THE COUNCIL'S CAPITAL POSITION (PRUDENTIAL INDICATORS)

7.1 As part of the Councils ongoing requirement to report to members the current capital position, the Council is required to prepare prudential indicators and report on any significant variations to those set as part of the Treasury Management Strategy. These indicators can be found in Appendix One to this report.

7.2 The estimated Capital Financing Requirement (CFR) has been revised from £124.63m to £123.30m as a result of slippage in the 2012/13 programme.

7.3 There are no further material changes expected to the capital programme as set out in the original budget for the remainder of 2013/14.

7.4 The Authorised Limit for External Debt and Operational Boundary for External Debt have both increased by £30m in order for the Council to be in a position to undertake borrowing in preparation for the milestone payments towards the construction cost of the Mersey Gateway project.

If such borrowing were to be undertaken, the Council would:-

• Ensure that there is a clear link between the capital programme and maturity profile of the existing debt portfolio which supports the need to take funding in advance of need.
• Ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered.
• Evaluate the economic and market factors that might influence the manner and timing of any decision to borrow.
• Consider the merits and demerits of alternative forms of funding.
• Consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use.
• Consider the impact of borrowing in advance and temporarily increasing investment cash balances (until required to finance capital expenditure) and the consequent increase in exposure to counterparty risk, and other risks, and the level of such risks given the controls in place to minimise them.

7.5 The Operational Director - Finance reports that no difficulties are envisaged for the current or future years in complying with any of the prudential indicators.

8.0 INVESTMENT AND BORROWING PORTFOLIO

Investments

8.1 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 introduction of the Funding for Lending scheme has reduced market investment rates even further. The continuing Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk adverse environment, investment returns are likely to remain low.

8.2 The Council held £52.65m of investments as at 30th September 2013 (£47.85m at 31st March 2013) and the investment portfolio yield for the first six months of the year is 1.04% against the 7-day LIBID rate of 0.36%.

There was one occasion in April when a counterparty limit was breached with the NatWest Bank (the Council's bank) for £50,000 for three days. The decision was taken to exceed the counterparty limit based on the grounds of security and liquidity and the need to access the funds to match cash flow requirements during that time. The Operational Director - Finance confirms that there were no further breaches of approved limits within the Annual Investment Strategy during the first six months of 2013/14.

The Council's budgeted investment return for 2013/14 is £0.257m. Performance for the year to date is £0.045m above budget.

The Department for Transport has indicated that it may pay a substantial capital grant to the Council during the latter months of 2013/14 which had previously not been anticipated to be received until 2014/15. In view of this, the counter party limits for two banks has been increased. Both of these banks have a current credit rating of AA-, the highest rating of all of the banks and building societies on the Council's counterparty list. A revised list is attached. (Appendix Two)

New Borrowing

8.7 The Council's capital financing requirement (CFR) for 2013/14 has been revised down to £123.30. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions.

8.8 Due to the overall financial position and the underlying need to borrow for capital purposes, external borrowing sourced to finance the Capital Programme at 30th September 2013 of £70m has been secured from the PWLB / market as follows:

Source	Value (£m)	Rate (%)	Start	End	Period
Eurohypo	10,000	4.42	06/02/2006	06/02/2066	720 months
PWLB	10,000	3.70	23/01/2006	23/01/2056	600 months
PWLB	10,000	2.24	09/11/2011	09/11/2016	60 months
PWLB	10,000	1.76	15/02/2012	15/02/2016	48 months
PWLB	10,000	1.92	18/05/2012	18/05/2017	60 months
Market	10,000	1.05	17/09/2012	18/09/2015	36 months
Market	5,000	1.00	31/10/2012	23/10/2015	36 months
Market	5,000	1.15	25/01/2013	25/01/2016	36 months
Total	**70,000**				

9.0 DEBT RESCHEDULING

9.1 Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. During the first six months of 2013/14 the following debt rescheduling was undertaken:

Market loan balance at 01/04/13 of £473,682 was repaid in full in July 2013. This had previously been scheduled to be repaid over a remaining period of 9 years with an interest rate of 4%.

11.0 POLICY IMPLICATIONS

11.1 None

12.0 OTHER IMPLICATIONS

12.1 None

13.0 IMPLICATIONS FOR THE COUNCIL'S PRIORITIES

13.1 **Children and Young People in Halton**

None

13.2 **Employment, Learning and Skills in Halton**

None

13.3 **A Healthy Halton**

None

13.4 **A Safer Halton**

None

13.5 **Halton's Urban Renewal**

None

14.0 RISK ANALYSIS

14.1 The main risks with Treasury Management are security of investment and volatility of return. To combat this, the Authority operates within a clearly defined Treasury Management Policy and annual borrowing and investment strategy, which sets out the control framework

15.0 EQUALITY AND DIVERSITY ISSUES

15.1 There are no issues under this heading.

16.0 LIST OF BACKGROUND PAPERS UNDER SECTION 100D OF THE LOCAL GOVERNMENT ACT 1972

16.1 There are no background papers under the meaning of the Act.

APPENDIX ONE

HBC Treasury Management Prudential and Treasury Management Indicators 2013/14 to date

		Original £m	Revised £m
Prudential Indicators			
Total capital expenditure	£m	43.91	72.20
Capital Financing Requirement (CFR) 2012/13	£m	124.63	123.30
Treasury Management			
Adopted CIPFA Code of Practice for Treasury management		yes	yes
Authorised limit for external debt	£m	104.32	134.32
Operational boundary for external debt	£m	93.82	123.82

Appendix TWO

Counterparty List for 2013/14

	Limits less than 3 months £m	Limits more than 3 months £m
Banks		
HSBC Plc	30.00	20.00
Santander UK Plc	15.00	10.00
Barclays Plc	15.00	10.00
Lloyds TSB/BOS	30.00	20.00
National Westminster Plc (Liquidity Account)	15.00	10.00
Standard Chartered Bank Plc	20.00	15.00
Royal Bank of Scotland Plc	30.00	20.00
Clydesdale Bank	10.00	7.50
Building Society		
Nationwide BS	15.00	10.00
Yorkshire BS	10.00	7.50
Coventry BS	10.00	7.50
Skipton BS	10.00	7.50
Local Authorities	5.00	2.50
DMADF	2.50	2.50

Note: the proposed limits for 2013/14 for HSBC Plc and Standard Chartered Bank Plc have been increased. All other Counterparty limits remain the same as set out in the Treasury Management Strategy Statement for 2013/14.