BOROUGH COUNCIL OF WELLINGBOROUGH **AGENDA ITEM 9**

Resources Committee **30 October 2013**

Report of the Head of Finance

MID YEAR REPORT ON TREASURY MANAGEMENT

1 Purpose of Report

This report aims to keep members informed of treasury management activity, in line with the Treasury Management Strategy Statement (TMSS) which was approved by this Committee on 20th March 2013.

2 Executive Summary

This report combines the actual performance and investments held as at 30th September 2013 with an overall out line of expected performance for the remainder of the financial year.

It also includes as an appendix an update on the current UK economy and the forecast for interest rates going forwards. The market and economy are key factors in the level of returns that can be expected from investments and this information should help members understand the wider economic picture and its influences over the rate of return achieved.

3 Appendices

Appendix 1 - Summary of Investment transactions at 30th September 2013

Appendix 2 – Summary of Economic background and Outlook

4. **Proposed Action:**

4.1 **The Committee is invited to RESOLVE the report be noted.**

5. Background

5.1 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management and the Council's treasury management policy requires periodic reports on the routine activity of the treasury management function and operations to be reported to Committee, which includes a mid-year update report. This report fulfils that requirement.

6 Discussion

Key changes to the agreed Strategy agreed in March 2013

6.1 At Resources Committee and Full Council in July 2013 an amendment to the agreed Investment strategy was recommended and agreed.

6.2 This allowed for greater flexibility in investments by amending the credit worthiness policy to allow for longer dated investments and increased counter party limits for the better quality counterparties.

Annual Investment Strategy:

6.3 The Treasury Management Strategy Statement (TMSS) for 2013/14 was approved by Council on 20th March 2013. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as follows:

- Security of Capital
- Liquidity of investments

6.4 The Council also aims to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity.

6.5 The Council has previously invested mainly in Building Societies, which do not necessarily have high credit ratings as defined by the recognised credit rating agencies e.g. Fitch and Moody's. However, Building Societies are providing better rates of return, with a good history of credit and as such the credit risk of investing with them is considered acceptable within the parameters outlined in the TMSS but need to be monitored carefully.

6.6 As investments in building societies have matured, they have been placed with domestic banks to mitigate some of the credit risk that having a disproportionate amount of investments held in one sector may have had.

6.7 The Treasury Management Strategy allows for up to £20m (if we exclude our current banking provider) to be invested in named domestic banks and £32m in named domestic building societies. Wellingborough's portfolio of investments currently comprises of £10m with the domestic Banks and £18m with domestic building societies.

6.8 As illustrated in the economic background in Appendix 2, investment rates available in the market are still historically low.

6.9 The average level of funds available for investment purposes in the first half of 2013/14, as reported above, was £28m. Many of these funds were non-reserve backed working capital balances and as such were temporary in nature, and the level of funds was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme.

6.10 Longer term core cash balance, backed by reserves, can be invested for longer and as a result of the changes to the TMSS agreed at Council in July 2013 longer term deals have now been incorporated to the portfolio. These longer term deals have helped to enhance the level of return on investments.

2013-14 Performance to date

6.11 Appendix 1 shows a detailed list of the investments held at 30th September 2013.

6.12 These totalled £28,000,000, with interest earned to-date since 1st April 2013 amounting to £158,955.74, and the average rate of return for the six month period was 1.15%, compared to the average three months LIBID (London Interbank Bid Rate) interest rate for the same period of 0.48%.

6.13 The Council's budgeted investment return for 2013/14 is £545k. However, performance for the year to date is approx £270k below budget.

6.14 The average interest rate achieved to the 30th September of 0.72% is below the rate assumed in the Medium Term Financial Strategy (1.86%) and as such the pressure on the budget for Investment income has been reported as part of the Revenue Monitoring for the year.

6.15 The interest rate achieved to date includes investments placed some time ago at rates higher than are available now on the market. Therefore, as older investments mature they are being replaced with investments at lower rates of interest. However, the changes to the TMSS agreed at July Council has meant that over the remaining 6 months of the year the average rate of return is forecast to be 0.93% for the full year. This is still considerably lower than the budgeted rate and is a direct result of a change in the market since the budget estimates were compiled.

6.16 The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2013/14.

6.17 The Council has complied fully with the requirements of its approved Treasury Management Strategy during the period including use of approved counterparties and investment limits.

6.18 Sector, the Council's treasury management advisers have provided an overview of the current economic climate and this is provided at Appendix 2, as it helps to set the scene within which the Council's treasury management function operates.

6.19 Given our advisers forecast for base rate it is advised that we keep our investment returns projections for revenue estimate purposes low and as such the budget for the coming years will be amended to reflect the new forecasts.

7 Legal Powers

Local Government Act 2003.

8 Financial and Value For Money Implications

As stated in the report.

9 Risk Analysis

Nature of risk	**Consequences if realised**	**Likelihood of occurrence**	**Control measures**
Fall in interest rates	Reduced income	Medium	Maintaining as high an average interest rate as possible through a mix of short and longer term fixed and variable rate investments.
Less funds available for investment	Reduced income	Medium	Regular budget monitoring, allowing for remedial action to

Nature of risk	Consequences if realised	Likelihood of occurrence	Control measures
			be taken.
Loss of capital	Reduced funds available for both capital and revenue purposes	Low	Financial ratings of counterparties and limits on amounts invested. Reviews of Council's lending policies.

10 Implications for Resources

No direct implications for staffing or property.

11 Implications for Stronger and Safer Communities

No direct implications.

12 Implications for Equalities

No direct implications.

13 Author and Contact Officer

H Essom, Technical Accountant

14 Consultees

R Micklewright, Director of Resources

L Elliott, Head of Finance.

15 Background Papers

Treasury Management Strategy statement 2013-14

Appendix 1

Summary of Investments at 23rd September 2013

Loans Investment Number	Borrower	Interest Rate	Period of Loan	Value of Investment	Required for:
		%		£	
I 3291	Progressive B S	2.00	364D	1,000,000	Investment
I 3293	Royal Bank of Scotland	1.58	364D	2,000,000	Housing Benefits
I 3295	Royal Bank of Scotland	0.80	CALL	2,000,000	Cashflow
I 3296	Nationwide B.S.	0.80	364D	2,000,000	NNDR/Housing Benefit
I 3297	Skipton B S	0.90	364D	2,000,000	NNDR Pooling
I 3298	Leeds B S	0.68	364D	3,000,000	Investment
I 3299	Barclays Bank	0.70	1YR	2,000,000	Investment
I 3300	Skipton B S	0.91	364D	1,000,000	Investment
I 3302	Royal Bank of Scotland	0.80	CALL	1,000,000	Cashflow
I 3305	Yorkshire B S	0.40	364D	2,000,000	Investment
I 3306	Coventry B S	0.47	246D	2,000,000	NNDR/Housing Benefit
I 3308	Newcastle B S	0.90	364D	1,000,000	NNDR/Salaries
I 3309	National Counties B S	1.00	1YR	2,000,000	Investment
I 3310	Bank of Scotland	0.40	CALL	1,000,000	Cashflow
I 3311	Nottingham B S	0.95	1YR	2,000,000	Investment
I 3313	Bank of Scotland	0.40	CALL	2,000,000	Cashflow
	Total			28,000,000	

Appendix 2

Summary of Economic Background and Outlook

Economic performance to date

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.

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.

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.

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 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.

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

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

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 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.

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.

3.3 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%

(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.