Report to Cabinet

Subject: Prudential Code Indicator Monitoring 2014/15 and Quarterly Treasury Activity Report for Quarter ended 30 September 2014

Date: 13 November 2014

Author: Corporate Director (Chief Financial Officer)

Wards Affected

All

Purpose

To inform members of the performance monitoring of the 2014/15 Prudential Code Indicators, and to advise members of the quarterly treasury activity as required by the Treasury Management Strategy.

Key Decision

This is not a key decision.

Background

1.1 The Council is required by regulations issued under the Local Government Act 2003 to report on its Prudential Code indicators and treasury activity. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

1.2 For 2014/15 the minimum reporting requirements are that the Full Council should receive the following reports:

- An annual treasury strategy in advance of the year (the TMSS).
- A mid-year treasury update report (this report).
- An annual review following the end of the year describing the activity compared to the strategy.

In accordance with best practice, quarterly monitoring reports for treasury activity are provided to members, and that this exceeds the minimum requirements.

1.3 The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report provides details of the position at 30 September and highlights compliance with the Council's policies.

Proposal

2.1 Economic update

After annual UK growth of 2.7% in 2013 it is anticipated that strong growth will continue through 2014 and into 2015. Forward surveys for the services and construction sectors are encouraging, whilst business investment is also recovering. The manufacturing sector has also been encouraging, however the latest figures indicate a weakening in the future trend rate of growth. For the recovery to become more balanced, and sustainable in the long term, it will be necessary to move away from dependence on consumer expenditure and the housing market towards exporting, particularly of manufactured goods.

Strong growth has resulted in unemployment falling faster through the initial threshold of 7% set by the Monetary Policy Committee (MPC) as the level at which it would consider increases in bank rate. The MPC subsequently broadened its forward guidance by adopting five qualitative principles, and looking at a wider range of around eighteen indicators in order to form a view on how much capacity there is in the economy, and how quickly that capacity is being used up. The MPC is particularly concerned that the current squeeze on consumers' disposable income needs to be reversed by wage inflation rising back above the level of inflation, to ensure that the recovery will be sustainable. However, such an increase in pay rates needs to be supported by an improvement in labour productivity, which has been poor since 2008. Most economic forecasters expect growth to peak in 2014 and then to ease off a little, whilst remaining strong in 2015 and 2016. Unemployment is therefore expected to continue its downward trend.

There has been a sharp fall in the rate of inflation (CPI) which reached 1.2% in September, the lowest rate since 2009. Forward indications are for further falls in 2014, possibly reaching 1%.

The return to strong growth has helped lower forecasts for the increase in government debt by £73bn over the next 5 years, as announced in the Autumn Statement, and by a further £24bn as announced in the March 2014 Budget - which also forecast a significant budget surplus of £5bn in 2018/19. However, monthly public sector deficit figures have been disappointing so far this year.

In September, the US Federal Reserve (the Fed) continued its monthly reduction in asset purchase, which has now fallen from $85bn to $15bn per

month and is expected to stop shortly, providing strong growth continues.

The Eurozone is facing an increasing threat from deflation. In September, the inflation rate fell to 0.3%, however this is an average and includes some countries with negative rates of inflation. Accordingly the European Central Bank (ECB) took further limited action in September to loosen monetary policy in order to promote growth.

Japan is causing considerable concern as its increase in sales tax in April has supressed consumer expenditure and growth. There are also concerns regarding China's growth, and the creditworthiness of much of its bank lending in the post 2008 credit expansion period.

2.2 Interest rate forecasts

The Council's treasury advisor, Capita Asset Services (CAS) undertook a review of its interest rate forecasts in mid-August after the Bank of England's inflation report. By the beginning of September a further rise in geopolitical concerns, principally over Ukraine but also over the Middle East, had caused a further flight into safe havens like gilts, and depressed PWLB rates further, therefore a further review was undertaken. There remains much volatility with regard to rates but overall, markets are expecting that the MPC will be cautious in raising Bank Rate.

The Governor of the Bank of England has repeatedly stated that increases in Bank Rate will be slow and gradual due to concerns about the impact of increases on indebted consumers. The latest forecast from CAS includes a further move in the timing of the first Bank Rate increase from Q1 to Q2 of 2015 and it notes that the overall balance of risks to economic recovery in the UK is weighted to the downside. Economic forecasting remains difficult and the expected timing of the first rate rise could yet be moved out still further.

CAS has provided the following forecast:

	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.00%	2.25%	2.50%
5yr PWLB rate	2.50%	2.70%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.50%	3.50%	3.50%
10yr PWLB rate	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.20%	4.30%	4.30%
25yr PWLB rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%
50yr PWLB rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%

2.3 Investment strategy

The Treasury Management Strategy Statement (TMSS) for 2014/15 was approved by Council on 3 March 2014.

The Council's investment priorities remain the security of capital and good liquidity. Whilst the Council will always seek to obtain the optimum return (yield) on its investments, this will at all times be commensurate with proper levels of security and liquidity. In the current economic climate and with heightened credit concerns, it is considered appropriate either to keep investments short–term to cover cash flow needs, or to extend the period up to one year with selected government-backed counterparties.

During the April to September 2014 period, significant use has been made of a call account facility paying 0.6%, however the rate available from this counterparty fell to 0.25% in August and it is likely that this facility will now be used only infrequently. Recently, as a result, increased use has been made of a Money Market Fund achieving around 0.40%. This fund is an AAA rated investment vehicle which allows the pooling of many billions of pounds worth of funds into a highly diversified fund. Whilst the rate of return remains low, it is still well in excess of overnight treasury deposit rates.

The Treasury Activity Report for the quarter ended 30 September 2014 is attached at Appendix 1, in accordance with the Treasury Management Strategy. For reference, definitions of LIBOR and LIBID are given at Appendix 2.

Members will note that an equated rate of 0.79% has been achieved for the period to 30 September 2014 which, whilst very low, outperforms both the 7 day and 3 month LIBID rates of 0.36% and 0.44% by 0.43% and 0.35% respectively. This has been achieved as a result of the 2014/15 impact of prudent investments made in 2013/14. Rates in the market remain poor and as these loans mature it is challenging to replace them, since security and liquidity will always remain the overriding factors in the Council's treasury management. Interest rates are not expected to start rising until the final quarter of the financial year, and then only gradually, and not significantly. At Q2, the outturn position for investment interest is still expected to be broadly in line with the current approved estimate of £103,700.

Credit ratings advice continues to be taken from CAS, however the ultimate decision on what is prudent and manageable for the Council is taken by the Chief Financial Officer under the approved scheme of delegation.

2.4 New borrowing

No new long-term borrowing was undertaken during the quarter ended 30 September 2014.

The council's Capital Financing Requirement (CFR) represents its "underlying" need to borrow to finance capital investment. Due to favourable interest rates, borrowing in advance of need is sometimes desirable, with the result that the CFR can differ to the actual borrowing planned in the year.

In view of borrowing previously undertaken in advance of need, it is not currently anticipated that any new borrowing will be undertaken during 2014/15.

Interest rates remain low, and the PWLB certainty rate, available to all authorities providing relevant information to CLG, allows the Council to take advantage of a discount of 20 basis points. Advice will be taken from CAS with regard to the amount and timing of any additional borrowing, and should conditions become advantageous, some further borrowing in advance of need will also be considered by the Chief Financial Officer.

2.5 Debt rescheduling

Debt rescheduling opportunities are limited in the current economic climate, and due to the structure of interest rates. Advice in this regard will continue to be taken from CAS.

No debt rescheduling has been undertaken during the period from 1 April 2014 to 30 September 2014.

2.6 Compliance with Prudential and treasury indicators

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limit. The Council's approved Prudential and Treasury Indicators (affordability limits) are included in the Treasury Management Strategy Statement (TMSS) approved by Council on 3 March 2014.

During the financial year to date the Council has at all times operated within the treasury limits and Prudential Indicators set out in the council's TMSS, and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators as at 30 September 2014 are shown at Appendix 3.

These indicators are based on estimates of expected outcomes, and are key indicators of "affordability". They are monitored on a quarterly basis, and Appendix 3 compares the approved indicators with the projected outturn for 2014/15, and shows variances on some of the indicators, as described below:

a) Prudential Indicators:

i) Capital Expenditure

The latest projected outturn shows that capital expenditure is expected to be £4,310,300. This differs to the original estimate of £2,902,100 due to the inclusion of approved carry-forward requests from 2013/14 and approved variations to the capital programme during 2014/15.

ii) Capital Financing Requirement (CFR)

The projected closing CFR for 2014/15 is £12,441,153. This is lower than the approved indicator of £12,546,300 due to the above amendments to the capital programme and to additional capital receipts generated.

iii) Ratio of Financing Costs to Net Revenue Stream

The projected outturn of 6.43% shows a minor reduction from the approved indicator of 6.44%. This is due to a reduction in MRP as a result of slippage on the capital programme in 2013/14, largely offset by a revenue contribution to capital expenditure in 2014/15.

iv) Maximum gross debt

The Council must ensure that its gross debt does not, except in the short term, exceed the opening capital financing requirement, plus estimates of any additional CFR for 2014/15 and the following two financial years. This allows flexibility for early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes. Gross debt at 30 September was £10.812m which was well within the approved indicator.

Treasury Management Indicators:

These indicators are based on limits, beyond which activities should not pass without management action. They include two key indicators of affordability and four key indicators of prudence.

Affordability

i) Operational boundary for external debt.
ii) Authorised limit for external debt.

Prudence

iii) Upper limit for fixed interest exposure – represented by the maximum permitted net outstanding principal sum borrowed at fixed rates. Please note that a negative indicator represents a position of net investment.

iv) Upper limit for variable interest rate exposure – represented by the maximum permitted net outstanding principal sum borrowed at variable rates. Please note that a negative indicator represents a position of net investment.

v) Maximum new principal sums to be invested during 2014/15 for periods in excess of 364 days - such investments are classified as a "non-specified". This indicator is subject to the overall limit for non-specified investments set in the TMSS.

vi) Upper limits for the maturity structure of borrowing - set to reduce the Council's exposure to large fixed rate sums falling due for refinancing.

Appendix 3 shows the actual position as at 30 September 2014, and demonstrates that all activities are contained within the currently approved limits.

2.6 Other

The main rating agencies (Fitch, Moodys and Standard & Poors) have through much of the financial crisis, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. More recently, in response to the evolving regulatory regime, the agencies have indicated that they may remove these uplifts, making their "support", "financial strength" and "viability" ratings redundant. This process may commence during the current financial year although the timing of the changes is still subject to discussion. The Council currently sets the following criteria for the selection of its investment counterparties:

- Short term F1
- Long Term A
- Viability BBB
- Support 1

Once any changes have been implemented by the rating agencies, any necessary changes to the Council's agreed selection criteria will be reported to members.

As a result of the potential rating agency changes the credit element of the CAS credit methodology will now focus solely on the short and long term ratings of an institution.

Alternative Options

There are no alternative options, this report being a requirement of the Council's Treasury Management Strategy Statement (TMSS).

Financial Implications

No specific financial implications are attributable to this report.

Appendices

1. Treasury Activity Report 2014/15 for quarter ended 30 September 2014.
2. Definitions of LIBOR and LIBID
3. Prudential and Treasury Indicators as at 30 September 2014.

Background Papers

None identified.

Recommendation

That:

Members note the report, together with the Treasury Activity Report for Quarter 2 at Appendix 1, and the Prudential and Treasury Indicator Monitoring for Quarter 2 at Appendix 3.

Reasons for Recommendations

To comply with the requirements of the Council's Treasury Management Strategy Statement.

For more information, please contact:

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