Report to Cabinet

Subject: Prudential Code Indicator Monitoring 2014/15 and Quarterly Treasury Activity Report for Quarter ended 31 December 2014

Date: 12 February 2015

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
- 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 31 December and highlights compliance with the Council's policies.

Proposal

2.1 Economic update

After strong UK growth of 2.7% in 2013, and 0.7% and 0.9% in Quarters 1 and 2 of 2014 respectively, Q3 has seen growth fall back to 0.7% and an annualised rate of 2.6%. Whilst forecasts for 2015 and 2016 have been revised downwards, growth is expected to remain strong by UK standards. For the recovery to become more balanced and sustainable in the longer term, there needs to be a move away from dependence on consumer expenditure and the housing market, to exporting - especially of manufactured goods.

Overall strong growth has resulted in unemployment falling faster than expected and the Monetary Policy Committee (MPC) is now focussing on how quickly the slack in the economy is being used up. The MPC is particularly concerned that the squeeze on consumer' disposable income should be reversed by wage inflation rising back significantly above the general level of inflation in the economy, in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity to support increases in pay rates. Unemployment is expected to maintain its downward trend, and this is likely to eventually feed through into a return to significant increases in wage growth at some point in the next three years. It remains unclear how much future increases in pay rates will counteract the depressive effects of increases in bank rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, and these are all areas that the MPC will keep under regular review.

The level of CPI inflation has fallen sharply, reaching 1% in November, the lowest rate since September 2002. Furthermore, it has recently been announced that CPI fell further in December to a rate of 0.5%, and forward indications are that inflation is likely to remain low for some time.

The return to strong growth has helped lower forecasts for the increase in Government debt over the last year, however monthly public sector deficit figures were disappointing until November and the Autumn Statement therefore had to revise the speed with which the deficit is forecast to be eliminated.

The US Federal Reserve (The Fed) ended its monthly asset purchases in October 2014. Annualised GDP growth rates for Q2 and Q3 of 4.6% and

5% respectively hold great promise for strong US growth going forward. It is predicted that the first increase in the Fed rate will occur by mid 2015.

The Eurozone (EZ) is facing an increasing threat from deflation. In November the inflation rate fell to 0.3%, however this is an average for all EZ countries and includes some with negative rates of inflation. Accordingly the European Central Bank (ECB) took limited action in June and September to loosen monetary policy in order to promote growth, and it is currently expected that it will embark on quantitative easing early in 2015, both to counter the threat of deflation, and to stimulate growth.

2.2 Interest rate forecasts

Capita Asset Services (CAS) undertook a review of its interest rate forecasts on 5 January 2015 after fears in the financial markets regarding the plunge in the price of oil had caused a flight from equities into bonds, and from exposure to debt and equities of emerging market oil-producing countries to safe havens in western countries. This was compounded by further fears that Greece could be heading towards an exit from the euro after its general election on 25 January, and financial flows generated by the increasing likelihood that the ECB would soon be starting quantitative easing (QE) purchases of Eurozone government debt. In addition there has been a sharp increase in confidence that the US will start increasing the Fed rate by mid-2015. A surge in growth in Q2 and Q3 of 2014 indicates that the US is now headed towards making a full recovery from the financial crisis of 2008.

The result of the above combination of factors is that bond yields have fallen to unsustainable levels, although how quickly these falls will unwind is hard to predict. Positive or negative developments on the world political scene could have a major impact on keeping yields low, or on prompting them to recover. There is also a UK general election in May 2015, the result of which it is impossible to predict, together with the consequent impact on the UK economy.

The latest CAS forecast includes a move in the timing of the first increase in bank rate from Q2 of 2015 to Q4 of 2015, as a result of the sharp fall in inflation and the cooling of UK growth. The governor of the Bank Of England, Mark Carney, has repeatedly stated that increases in bank rate will be slow and gradual, largely due to MPC concerns about the impact of any increases on heavily indebted consumers. In addition, whichever party or coalition wins power at the general election will be faced with having to implement further major cuts and/or increases in taxation in order to eradicate the annual public sector net borrowing deficit.

CAS has provided the following forecast:

	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%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	1.75%	2.00%
5yr PWLB rate	2.20%	2.20%	2.30%	2.50%	2.60%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.60%
10yr PWLB rate	2.80%	2.80%	3.00%	3.20%	3.30%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
50yr PWLB rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%

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 December 2014 period, significant use was initially made of a call account facility with Royal Bank of Scotland (RBS) paying 0.6%, however the rate offered by RBS fell to 0.25% in August and is now likely to be used only infrequently. Accordingly, increased use has been made of a Money Market Fund achieving just over 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 quite low, it is still well in excess of overnight treasury deposit rates, and of the RBS facility.

The Treasury Activity Report for the quarter ended 31 December 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 0.76% has been achieved for the period to 31 December 2014 which, whilst very low, outperforms both the 7 day and 3 month LIBID rates of 0.35% and 0.43% by 0.41% and 0.33% 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 low and as 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 now expected to start rising until at least Q4 of 2015, and then only gradually, and not significantly. The projected outturn position for 2014/15 for investment interest has been estimated at £95,000 which represents a reduction of £8,700 on the current approved estimate of £103,700. The impact of this reduction is included in the Q3 revenue budget monitoring report elsewhere on this agenda.

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 31 December 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 31 December 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 31 December 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 £3,582,800. 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, including significant slippage at Q3.

ii) Capital Financing Requirement (CFR)

The projected closing CFR for 2014/15 is £12,457,100. This is slightly lower than the approved indicator of £12,546,300 due to the above amendments to the capital programme, including Q3 slippage, offset by additional capital receipts generated.

iii) Ratio of Financing Costs to Net Revenue Stream

The projected outturn of 7.27% shows an increase from the approved indicator of 6.44%. This is due to the inclusion of revenue contributions to capital expenditure totalling £154,000 in 2014/15, together with a reduction in the estimate for investment interest, partially offset by a reduction in MRP as a result of slippage on the capital programme in 2013/14.

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 31 December 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 31 December 2014, and demonstrates that all activities are contained within the currently approved limits.

2.6 Other

2.6.1 Rating Agencies

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. CAS advises that 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.

2.6.2 PWLB

A letter was sent to CFOs on Christmas Eve suggesting that the PWLB was to be abolished. The Council's treasury advisers, CAS, have subsequently held discussions with the PWLB about their governance arrangements, to obtain some clarity on the proposals. They advise that:

- The role of the PWLB <u>commissioners</u> will be removed
- The PWLB will in time be re-named – but it is <u>not</u> being abolished.
- The background to this change is the National Infrastructure Bill, the main basis of which is to support the government's long-held plans for investment in long-term national infrastructure projects.

Further information will be provided by CAS as such time as it is available.

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, an adjustment to the budget for investment income being dealt with in the revenue budget monitoring report elsewhere on this agenda.

Appendices

1. Treasury Activity Report 2014/15 for quarter ended 31 December 2014.
2. Definitions of LIBOR and LIBID
3. Prudential and Treasury Indicators for 2014/15 as at 31 December 2014.

Background Papers

None identified.

Recommendation

That:

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