



## Report to Cabinet

**Subject:** Prudential Code Indicator Monitoring 2015/16 and Quarterly Treasury Activity Report for Quarter ended 30 September 2015

**Date:** 12 November 2015

**Author:** Corporate Director (Chief Financial Officer)

### Wards Affected

All

### Purpose

To inform members of the performance monitoring of the 2015/16 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 2015/16 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, considered by Cabinet on 19 February 2015 and subsequently approved by Full Council on 3 March 2015).
  - 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 this exceeds the minimum requirements. This report, in respect of quarter 2, represents the mid-year treasury review.

- 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 2015 and highlights compliance with the Council's policies.

## **Proposal**

### 2.1 Economic update

UK GDP growth was strong in 2013 and 2014, at 2.2% and 2.9% respectively, indeed growth for 2014 was the strongest since 2006. Growth is expected to weaken in Q3 of 2015 as exporters face challenges resulting from the strength of the pound against the euro. In addition, weaker growth is expected in the EU, China and emerging markets, and the dampening effect of the Government's austerity programme is likely to continue, albeit the pace of reduction was eased in the budget. Overall, growth is currently expected to remain around 2.4% to 2.8% over the next three years, driven mainly by consumer demand as the squeeze on disposable incomes eases. The Bank of England (BOE) inflation report was subdued, with inflation forecast to barely return to the 2% target within the next 2 to 3 years, and this was followed by a fresh downturn in the price of oil. There are thus considerable risks around whether inflation will rise as strongly as expected in the near future, and this will make it more difficult for the central banks of both the UK and US to raise rates as soon as was forecast.

The US economy made a strong comeback after weak growth in Q1 of 2015. Whilst there had been a confident expectation that the central bank would start increasing rates in September 2015, recent downbeat news around growth in China and Japan meant that this was not the case, and the current expectation is for no rise until 2016.

In the Eurozone, the European Central Bank (ECB) began a 1.1 trillion euro programme of quantitative easing (QE) in March 2015 and this is expected to run until September 2016. The programme appears to have had a positive effect in helping the recovery of consumer and business confidence, and starting to improve economic growth. However, the recent downbeat news from China and Japan may mean the ECB needs to boost its QE programme if it is to significantly improve Eurozone growth and to get inflation up from the current level of around zero to its target of 2%.

## 2.2 Interest rate forecasts

Capita Asset Services (CAS) undertook a review of its interest rate forecast on 11 August, shortly after the BOE quarterly inflation report. Later in August, fears around the slowdown in China and Japan caused major volatility and a flight from equities (shares) into safe havens such as gilts, which caused PWLB rates to fall. Volatility continued in September with news in respect of Volkswagen and this has compounded the downward pressure on equity prices.

Despite turbulence since August causing a sharp downturn in PWLB rates, the overall trend for gilt yields and PWLB rates is still expected to rise due to the high issuance of bonds in the UK and other western countries. Increasing investor confidence in an eventual world recovery is expected to compound this effect, as recovery will encourage investors to switch from bonds to equities.

The overall balance of risk to economic recovery in the UK is currently evenly balanced and it remains exposed to vulnerabilities in a number of key areas including geopolitical risk in Eastern Europe, the Middle East and Asia, a resurgence of the Eurozone sovereign debt crisis, and uncertainty around the risk of a UK exit from the EU.

CAS has provided the following forecast, indicating that a first rise in Bank Rate is now expected to be in Q2 of 2016.

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
<b>Bank rate</b>	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%
<b>5yr PWLB rate</b>	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%
<b>10yr PWLB rate</b>	3.00%	3.20%	3.30%	3.40%	3.50%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
<b>25yr PWLB rate</b>	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%
<b>50yr PWLB rate</b>	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%

## 2.3 Investment strategy

The Treasury Management Strategy Statement (TMSS) for 2015/16 was approved by Council on 3 March 2015.

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 period from 1 April to 30 September 2015, significant use has been made of a Money Market Fund currently achieving around 0.44%. 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.

The Treasury Activity Report for the quarter ended 30 September 2015 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 investment interest of £49,264 was generated during the period from 1 April to 30 September 2015. This represents an equated rate of 0.75% and outperforms the benchmark 7 day LIBID rate, which averaged 0.35% for the same period. In cash terms this represents additional income to the General Fund of around £26,300 and was achieved by positive investment management. Performance in respect of the longer 3 month LIBID rate, which averaged 0.43%, still represents additional income of £21,000.

Rates in the market remain very low and as loans mature it is challenging to replace them, since security and liquidity will always be the overriding factors in the Council's treasury management. Interest rates are not expected to start rising until at least Q2 of 2016, and then only gradually, and not significantly. It is currently anticipated that the outturn for investment interest will be broadly in line with the original estimate of £92,400.

Credit ratings advice continues to be taken from CAS and the Chief Financial Officer has adopted the CAS credit rating methodology for the selection of investment counterparties. This employs a sophisticated modelling approach utilising credit ratings from all three of the main rating agencies to give a suggested maximum duration for investments. Accordingly it does not give undue preponderance to one agency's ratings.

The methodology subsequently applies an "overlay" to take account of positive and negative credit watches and/or credit outlook information, which may increase or decrease the suggested duration of investments. It then applies a second overlay based on the credit default swap spreads for institutions, the monitoring of which has been shown to give an early warning of likely changes in credit ratings. It also incorporates sovereign

ratings to ensure selection of counterparties from only the most creditworthy countries.

The CAS modelling approach combines all the various factors in a weighted scoring system and results in a series of colour coded bands which indicate the creditworthiness of counterparties. The colour bandings are as follows:

- Yellow 60 months (AAA rated Government debt or its equivalent)
- Purple 24 months
- Blue 12 months (nationalised or semi nationalised UK banks)
- Orange 12 months
- Red 6 months
- Green 100 days
- No colour not to be used

All credit ratings are monitored weekly and the Council is also alerted to interim changes via its use of the CAS creditworthiness service, however ratings under the methodology will not necessarily be the sole determinant of the quality of an institution. Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

The ultimate decision on what is prudent and manageable for the Council will be 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 2015.

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.

It is not currently anticipated that any new borrowing will be undertaken during 2015/16.

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 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 to 30 September 2015.

## 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 2015.

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 2015 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 2015/16, 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 £3,666,000. This differs to the original estimate of £3,227,400 due to the inclusion of approved carry-forward requests from 2014/15 and to approved variations to the capital programme during 2015/16.

#### ii) Capital Financing Requirement (CFR)

The projected closing CFR for 2015/16 is £11,481,800. This is lower than the approved indicator of £11,894,200, mainly due to slippage in the capital programme, and to savings on the 2014/15 capital programme that reduced the borrowing requirement.

iii) Ratio of Financing Costs to Net Revenue Stream

The projected outturn of 10.05% shows a reduction from the approved indicator of 10.39%. This is due to reductions in MRP as a result of slippage and savings on the capital programme 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 2015/16 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. Following the maturity of a £1m PWLB loan during the quarter 1 July to 30 September, the Council's gross debt at 30 September 2015 was £8.812m 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 2015/16 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 2015, and demonstrates that all activities are contained within the currently approved limits.

### **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 2015/16 for quarter ended 30 September 2015.
2. Definitions of LIBOR and LIBID
3. Prudential and Treasury Indicators for 2015/16 as at 30 September 2015.

### **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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