Agenda Item	**9**
Report No	**FHR/ 153/13**

The Highland Council

Finance Housing and Resources Committee – 27 November 2013

Treasury Management Mid-year Review Report 2013/14

Report by the Director of Finance

Summary

This Treasury Management Mid-year Review Report 2013/14 is submitted to the Committee for Members' scrutiny and interests. In compliance with CIPFA's Code of Practice on Treasury Management in Local Authorities, the report will also be submitted to the Council in December 2013 for approval.

1. Background

1.1 Treasury management is defined as:

"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by this Council on 4 March 2010. The Code was further updated in November 2011.

1.2 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 - 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 the Finance, Housing and Resources Committee.

1.3 This Mid-year Review 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, provided by the Council's Treasury Advisers, Capita (formerly called Sector);
- 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.

2. Economic update (provided by Capita, Treasury Advisers to the Council)

2.1 The Council has appointed Capita as treasury adviser to the Council and part of their service is to assist the Council to formulate a view on interest rates. **Appendix 2** outlines the current City forecasts for short term (Bank Rate) and longer fixed interest rates and the table below gives the Capita view.

2.2 The market's expected rise in interest rates, has been pushed further back since the Council agreed its treasury strategy, as a result of the appointment of the new Governor of the Bank of England and the August Monetary Policy Committee forward guidance which stated that the Bank Rate was unlikely to change until unemployment first falls to 7%, which was not expected until mid 2016. Capita's interest rate forecast is as follows.

	31/10/13 Actual	**Dec 13**	**Mar 14**	**Jun 14**	**Sep 14**	**Dec 14**	**Mar 15**	**Jun 15**	**Sep 15**	**Dec 15**	**Mar 16**
BANK RATE	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
5yr PWLB	2.38	2.50	2.50	2.60	2.70	2.70	2.80	2.80	2.90	3.00	3.20
10yr PWLB	3.43	3.70	3.70	3.70	3.80	3.80	3.90	4.00	4.10	4.20	4.30
25yr PWLB	4.18	4.40	4.40	4.40	4.50	4.50	4.60	4.70	4.80	4.90	5.00
50yr PWLB	4.20	4.40	4.40	4.40	4.50	4.60	4.70	4.80	4.90	5.00	5.10

The above Capita forecasts for PWLB rates incorporate the introduction of the **PWLB certainty rate** in November 2012 which will reduce PWLB borrowing rates by 0.20% for most local authorities. Highland is also eligible for this rate reduction.

3. Treasury Management Strategy Statement and Annual Investment Strategy update

3.1 The Treasury Management Strategy Statement (TMSS) for 2013/14 was approved by this Council on 7 March 2013. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as security of capital and liquidity.

3.2 There have been no policy changes to the TMSS since it was agreed in March.

3.3 The Council will also aim to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity. In the current economic climate the Council will avoid locking into longer term deals while investment rates are down at historically low levels unless attractive rates are available with counterparties of high creditworthiness which make longer term deals worthwhile and within the risk parameters set by this Council. The Council will only invest with highly credit rated financial institutions, using Capita's suggested creditworthiness approach, including sovereign credit rating and credit default swap (CDS) overlay information provided by Capita.

3.4 Borrowing rates continue to be historically low during the first six months of the 2013/14 financial year, and the Council benefits from the PWLB certainty rate discount 20bps off normal PWLB rates.

3.5 As outlined in **Appendix 2**, there is still considerable uncertainty and volatility in the financial and banking market, both globally and in the UK. In this context, it is considered that the strategy approved on 7 March 2013 is still fit for purpose in the current economic climate.

4. Investment Portfolio 2013/14

4.1 In line with the requirements of the Code, any cash deposits placed by the Council are described as investments. 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.

4.2 The investment portfolio yield for the first six months of the year is an average rate of 0.60% against a benchmark (7 Day London Inter-bank Bid Rate – LIBID average) of 0.49%.

4.3 During the first 6 months of the year, a review of counter-party arrangements for the Council's Pension Fund has been undertaken. To expand the range of counter-parties available, and provide further options for managing the Fund's cashflow, a new banking facility was opened with RBS.

4.4 During the period of transition to the new deposit facility, and due to the positive levels of Pension fund cashflow, the single counter-party limit of £15m was applied, rather than the operational daily limit of £10m for call deposits placed with the Clydesdale Bank. This practice was necessary due to the levels of cashflow, particularly in relation to the Pension Fund during that period. This transitional arrangement has ceased now that the new RBS deposit account is in place.

4.5 A review of all counter-party limits is planned for the next TMSS for 2014/15, recognising changes to the Council's cashflow position (e.g. loss of Police and Fire functions, impact of Health & Social Care integration, new Pension Fund banking arrangements) as well as developments in the wider banking environment, e.g. potential for removal of Government Support for HBOS and RBS in the short to medium-term.

4.6 As illustrated in the economic update, investment rates available in the market are at a historical low point. The average level of funds available for investment purposes in the first six months of 2013/14 was £76.5m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of Council Tax payments, receipt of grants and progress on the capital programme. The Council does not currently have any funds invested for more than 1 year.

4.7 In line with the investment strategy, the Council will only place deposits with counter-parties with a high-creditworthiness. The availability of such counter-parties remains a challenge, and the returns and terms available in the market, mean that short-term investment returns remain low. To avoid use of the HM treasury debt management office, as a deposit of last resort, given the low returns available, the Council continues to use 2 Money Market Funds (MMF). The use of these MMFs, which are AAA rated, and permitted in the Council's investment strategy, has expanded the Council's available counter-parties. During the first 6 months of the year, the Council has also opened an account with Barclays Bank to further expand available counter-parties.

5. New External Borrowing

5.1 The Capital Financing Requirement (CFR) represents the accumulated net capital expenditure which the Council requires to fund by way of long term debt until the capital projects, comprising the CFR, are fully written off by way of annual loan charges to revenue accounts.

The table below shows the estimated CFR at 31/03/14 and how it is expected to be funded.

	£m
Estimated Capital Financing Requirement (CFR) at 31/03/14 (for all funds) See appendix 1 – indicator 2	£871.2m
Less PPP	-£129.5m
Estimated CFR 31/03/14	**£747.7m**
Long Term Debt 01/04/13	£677.2m
Less repaid during 2013/14	-£17.5m
Add estimated net borrowing for new capital expenditure in 2013/14	£54.7m

Add Borrowing to replace maturing loans	£17.5m
Estimated Long Term Debt at 31/03/14	£731.9m
Difference between CFR and Long-term Debt = Funding from internal balances and cash flow	£15.8m
	£747.7m

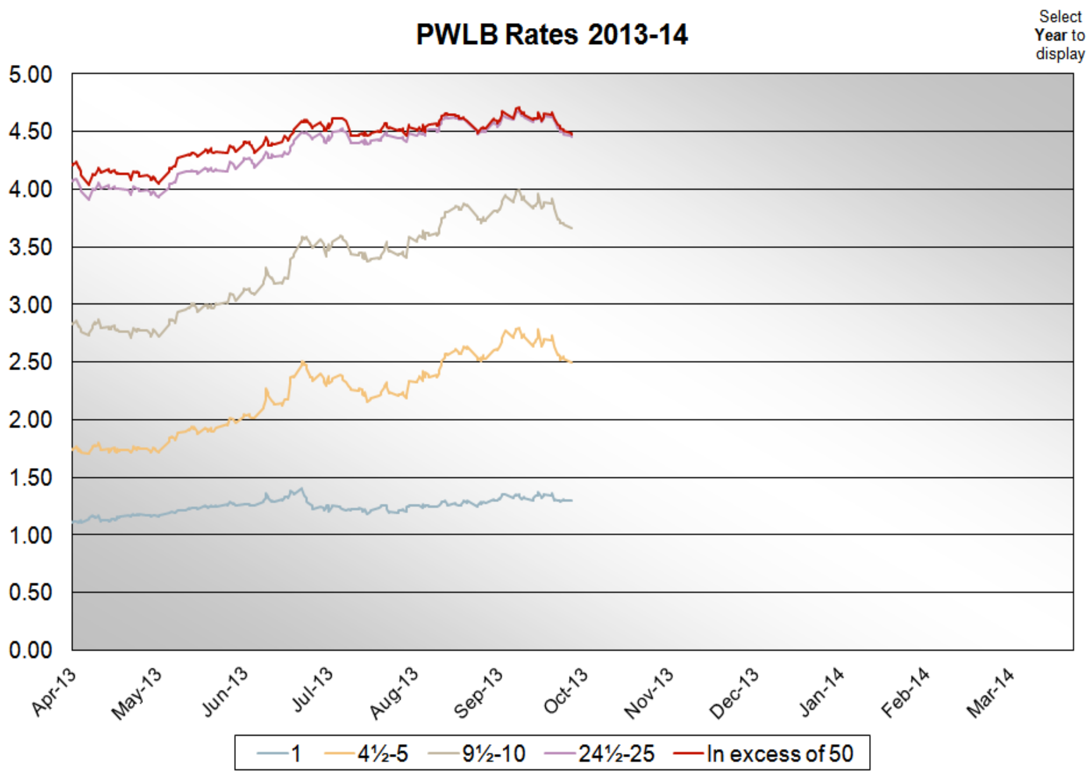
The balance of external and internal borrowing is generally driven by market conditions, and the need to take a balanced view of savings available from short-term and internal borrowing, versus the mitigation of re-financing risk which can be achieved from longer-term borrowing, but at potentially higher cost.

5.2 Long Term borrowing rates have remained below Capita's central target rate for new external long term borrowing which was used for the loan charge budget.

Furthermore, borrowing to date has been primarily been on a short-term basis, or through internal borrowing (running down cash deposits). This has largely been driven by market conditions, favourably low short-term rates, and cashflows in the early part of the year. Therefore, there has been no longer-term borrowing undertaken in the year to date. However, PWLB rates will continue to be monitored and longer term borrowing will be considered when rates are favourable.

5.3 The general trend has been a slight rise in interest rates during the six months, across all maturity bands.

The graph below shows the movement in PWLB rates for the first six months of the year.



5.4 It is anticipated that over the remainder of the financial year, additional new long-term borrowing will be undertaken depending on the rates. The introduction of the new PWLB certainty rate discount from November 2012 offers lower borrowing rates. However, markets remain volatile, and favourable short-term borrowing opportunities are likely to be available to the Council, and will be considered where appropriate. Overall, it is considered probable that the year-end out-turn will reflect borrowings achieved at rates lower than had been originally anticipated when budgets were set, and current revenue budget monitoring reflects a forecast underspend on the loan charge budget.

5.5 In consultation with Capita, the market situation is constantly monitored and borrowing strategies reviewed on a regular basis.

6. Debt Rescheduling

6.1 No debt rescheduling was undertaken during the first six months of 2013/14 due to breakage costs.

7. Compliance with Treasury and Prudential Limits

7.1 It is a statutory duty for the Council to determine and keep under review the “Affordable Capital Expenditure Limits”. The Council’s approved Treasury and Prudential Indicators (affordability limits) are outlined in the approved Treasury Management Strategy Statement (TMSS) agreed in March 2013.

7.2 During the financial year to date the Council has 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 are shown in **Appendix 1**, comparing the initial limits agreed for the year, and updated year-end forecasts.

8. Recommendation

Members are invited to scrutinise this Treasury Management Mid-year Review Report 2013/14.

Members are asked to note that, in compliance with CIPFA's Code of Practice on Treasury Management in Local Authorities, this report will also be submitted to Council for approval in December 2013.

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Date:	4 November 2013
Background Papers:	Logotech Reports, Excel Loans Fund files and Oracle Ledger prints

Appendix 1

Prudential and Treasury Indicators

The original Prudential Indicators agreed within the TMSS March 2013 pre-dated the agreement by the Council of a new 10 year capital programme in June 2013. The revised estimates set out below reflect updated indicators taking account of that new capital programme.

The Estimates of Capital Expenditure below in indicator 3 and 4 include expenditure in relation the National Housing Trust which is self-financing, due to recovery of interest costs and under-writing of capital and interest guarantees by the Scottish Government.

A. Indicators for Affordability, Prudence and Capital Expenditure

Prudential Indicator		2013/14 Original Estimate (TMSS March 2013)	2013/14 Revised Estimate	Explanation of Indicator
1.	**Capital Expenditure**			Expressed in absolute terms rather than as a ratio, these show the overall levels of capital investment irrespective of how they are being funded. The increase in revised estimate reflects the higher level of capital programme agreed by the Council in June 2013.
	Estimates of Capital Expenditure (Gross)			
	General Fund including PPP	£73.9m	£97.1m	
	Housing Revenue Account	£30.3m	£41.6m	
	Total	**£104.2m**	**£138.7m**	
	Estimates of Capital Expenditure (Net)			Net capital expenditure is the borrowing or funding requirement for new capital investment in each year. The increase in revised estimate reflects the higher level of capital programme agreed by the Council in June 2013.
	General Fund including PPP	£44.2m	£61.8m	
	Housing Revenue Account	£19.9m	£27.8m	
	Total	**£64.1m**	**£89.6m**	

Prudential Indicator		2013/14 Original (Estimate TMSS March 2013)	2013/14 Revised Estimate	Explanation of Indicator
2.	**Capital Financing Requirement (CFR) as at 31/03/14**			These indicators represent the level of the Council's underlying need to borrow or finance by other long-term liabilities for a capital purpose. This includes past and future borrowing or funding.
	General Fund excluding PPP	£544.5m	£548.4m	
	PPP	£129.5m	£129.5m	
	Total	**£674.0m**	**£677.9m**	
	Housing Revenue Account	£181.5m	£167.5m	
	Total	**£855.5m**	**£845.4m**	
	Joint Boards	£24.1m	£25.8m	
	Total (incl Joint Boards)	**£879.6m**	**£871.2m**	
3.	**Treasury Position as at 31/03/14**			This indicator shows the expected borrowing position, net of investments.
	Borrowing	£728.1m	£739.9m	
	Other Long Term Liabilities	£129.5m	£129.5m	
	Total Debt	**£857.6m**	**£869.4m**	
	Investments	£50.0m	£50.0m	
	Net Borrowing	**£807.6m**	**£819.4m**	
4.	**Authorised Limit for Borrowing**			These indicators identify 2 limits in relation to the Council's total external debt. The Authorised Limit is the maximum level of external borrowing which should not be exceeded. The limit is linked to the estimated level of borrowing assumed in the Capital Programmes. An Operational Boundary is also required which represents the Director of Finance's estimate of the day to day limit for the Treasury Management activity based on the most likely i.e. prudent but not worst case scenario.
	Borrowing	£846.1m	£846.1m	
	Other Long Term Liabilities	£129.5m	£129.5m	
5.	**Operational Boundary for Borrowing**			
	Borrowing	£773.1m	£773.1m	
	Other Long Term Liabilities	£129.5m	£129.5m	

Prudential Indicator		2013/14 Original (Estimate TMSS March 2013)	2013/14 Revised Estimate	Explanation of Indicator
6.	**Ratio of financing costs to net revenue stream**			These indicators show the capital financing costs (interest charges, the provision for the repayment of debt and the financing of PPP outstanding capital investment liability) as a percentage of government grant (revenue), Council Tax, Rents and other income. This allows the authority to track how much of its annual income is needed to pay for its capital investment plans and outstanding funding liabilities compared to its day to day running costs. For this mid-year report no significant variance from original estimates is assumed.
	General Fund including PPP	10.1%	9.7%	
	Housing Revenue Account	31.4%	34.3%	
7.	**Estimates of the Incremental impact of capital investment** decisions on the B and D Council tax	£38.68	£21.58	These indicators demonstrate the **notional** impact of varying new capital investment expressed as a cost on the Band D Council Tax and Rents. These are notional rather than actual increases in Council Tax and rent, as the Council has or will utilise savings and other measures to fund its capital plans, to minimise the impact on tax and rent levels. For this mid-year report no significant variance from original estimates is assumed.
8.	**Estimates of the Incremental impact of capital investment** decisions on the housing rent levels (Weekly figures based on a 48 week year are shown in brackets).	£112.62 (£2.35)	£103.33 (£2.15)	
9.	**Interest rate exposures of debt net of investments**			Interest rate exposures of debt net of investments are required to be set in compliance with the Code. This limits the Council's exposure to both fixed and variable interest rate movements as part of the overall risk management strategy for Treasury Management activities. It promotes a prudent strategy aimed to avoid the adverse effects of fluctuating interest rates. The limits are based on estimates of net capital advances outstanding.
	Upper Limit (Fixed)	£750.1m	£750.1m	
	Upper Limit (Variable)	£262.5m	£262.5m	

In addition to the above the Council is required as a Prudential Indicator to:

- Adopt the CIPFA Code of Practice.
- Ensure that over the medium term borrowing will only be for a capital purpose (i.e. net external borrowing is less than the CFR).

The compliance for these indicators is highlighted in the body of the report.

Appendix 2

Economic update (provided by Capita, Treasury Advisers to the Council)

Global economy

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.

Capita's view for the next six months of 2012/13

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 at paragraph 2.2. 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.