FAREHAM
BOROUGH COUNCIL

Report to
Audit and Governance Committee

Date 24 November 2014

Report of: Director of Finance and Resources

Subject: IMPLEMENTATION OF TREASURY MANAGEMENT POLICY AND STRATEGY

SUMMARY

In accordance with the revised Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management Code of Practice, the Audit and Governance Committee is the responsible body to examine and assess the effectiveness of the Council's treasury management policy and strategy.

In accordance with this role, this report sets out the mid-year review of treasury management activity up to 30 September 2014.

RECOMMENDATION

The Audit and Governance Committee is asked to note the report.

BACKGROUND

1. The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

2. The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

3. Accordingly, 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".

INTRODUCTION

4. The purpose of this report is to satisfy the requirement contained within the revised CIPFA Treasury Management Code of Practice to have a nominated responsible body, being the Audit and Governance Committee, examine and assess the effectiveness of the Council's treasury management strategy and policies.

5. The current Treasury Management Strategy, in Appendix A, was submitted to the Executive on 10 February 2014 and was formally adopted by Full Council on 21 February 2014.

MID YEAR REVIEW

6. This mid-year review has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

   - Changes to the Treasury Management Strategy;
   - An economic update for the first part of 2014/15;
   - A review of the Council's investment portfolio;
   - A review of the Council's borrowing activity;
   - A review of the Treasury Management Strategy 2014/15; and
   - A review of compliance with Treasury and Prudential Limits for 2014/15.

CHANGES TO THE TREASURY MANAGEMENT STRATEGY

7. In order to minimise the risk to investments, the Council applies minimum acceptable credit ratings of counterparties for inclusion on the lending list.

8. The main rating agencies (Fitch, Moody's and Standard & Poor's) 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 they may remove these "uplifts", making the Support, Financial Strength and Viability ratings redundant. This process may commence during this financial year. The actual timing of the changes is still subject to discussion, but this does mean immediate changes to the credit methodology are required.

9. The original Treasury Management Strategy Statement for 2014/15 states:

   The Council will use banks which are UK banks and/or are non-UK and domiciled in a country which has a minimum sovereign rating of AA and have as a minimum, the following Fitch, Moody's and Standard and Poor's credit ratings (where rated):

	Fitch	**Moody's**	**Standard and Poor's**
Short Term	F1	P-1	A-1
Long Term	A	A2	A
Viability/Financial Strength	bb-	C-	-
Support	3	-	-

10. At the 1 September 2014 Executive meeting, members approved the removal of the Viability/Financial Strength and Support ratings and that only the Short Term and Long Term ratings will be used. All other criteria remains as previously approved.

ECONOMIC UPDATE FROM TREASURY ADVISOR – CAPITA ASSET SERVICES

11. After strong UK GDP quarterly growth since early 2013, it appears very likely that strong growth will continue through 2014 and into 2015 as forward surveys for the services and construction sectors are very encouraging and business investment is also strongly recovering.

12. The manufacturing sector has also been encouraging though the latest figures indicate a weakening in the future trend rate of growth. However, for this recovery to become more balanced and sustainable in the longer term, the recovery needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance.

13. This overall strong growth has resulted in unemployment falling much faster through the initial threshold of 7%, set by the Monetary Policy Committee (MPC) last August, before it said it would consider any increases in Bank Rate. The MPC has, therefore, subsequently broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up. The MPC is particularly concerned that the current squeeze on the disposable incomes of consumers would be reversed by wage inflation rising back above the level of inflation. There also needs to be a major improvement in labour productivity, which has languished at dismal levels since 2008, to support increases in pay rates.

14. Most economic forecasters are expecting growth to peak in 2014 and then to ease off a little, though still remaining strong, in 2015 and 2016. Unemployment is therefore

expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in pay rates at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

15. Also encouraging has been the sharp fall in inflation (CPI), reaching 1.2% in September, the lowest rate since 2009. Forward indications are that inflation is likely to fall further in 2014 to possibly 1%. Overall, markets are expecting that the MPC will be cautious in raising Bank Rate as it will want to protect heavily indebted consumers from too early an increase in Bank Rate at a time when inflationary pressures are also weak. A first increase in Bank Rate is therefore expected in Q2 2015 and they expect increases after that to be at a slow pace to lower levels than prevailed before 2008 as increases in Bank Rate will have a much bigger effect on heavily indebted consumers than they did before 2008.

16. The return to strong growth has also helped lower forecasts for the increase in Government debt by £73bn over the next five years, as announced in the Autumn Statement, and by an additional £24bn, as announced in the March 2014 Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018-19. However, monthly public sector deficit figures have been disappointing so far in 2014/15.

INVESTMENT PORTFOLIO

17. 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.

18. In the current economic conditions, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. Indeed, the introduction of the Funding for Lending scheme has reduced market investment rates even further. The potential for a prolonging of the Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment, investment returns are likely to remain low.

19. The total of fixed term investments and call accounts, as at 30 September 2014 was £47.1 million, as summarised below. The activity during the year for fixed investments is detailed in Appendix B.

Investments	**Externally Managed £m**	**Internally Managed £m**	**Call Accounts £m**	**Total £m**
At 1 April 2014	**10.0**	**18.0**	**12.8**	**40.8**
New	5.0	14.0	58.5	77.5
Repaid	5.0	9.0	57.2	71.2
At 30 Sept 2014	**10.0**	**23.0**	**14.1**	**47.1**

20. The increase in funds of £6.3 million during the first half of the year was mainly due to the timing of precept payments, receipts of grants and progress on the

capital programme.

Investment Structure

21. The structure of investments at 30 September is shown in the table below. Over the past couple of years, most investments have been held on short periods to mitigate the risks that have been seen during the recession. At the same time, officers have actively sought to spread investments across a wider range of counterparties rather than operating at the upper limit for investments to limit the exposure to financial loss.

Investment Structure	**Externally Managed £m**	**Internally Managed £m**	**Call £m**	**Total £m**
For periods of less than 1 month	1.0	1.0	12.1	14.1
For periods of 1 to 3 months	2.0	5.0	2.0	9.0
For periods of 3 to 6 months	0	5.0	0	5.0
For periods of 6 to 12 months	4.0	11.0	0	15.0
For periods of 1 to 2 years	3.0	1.0	0	4.0
Total Investments at 30 Sept 2014				
Investments for periods < 365 days	7.0	22.0	14.1	43.1
Investments for periods 365+ days	3.0	1.0	0	4.0

22. Throughout this period of uncertainty, officers have been taking advice from the Council's treasury advisor, Capita Asset Services, to ensure that decisions are taken in light of the latest facts at the time. This has given rise to lower interest rates being secured but this is the lowest priority consideration compared to the security of investments and the liquidity of cash flow.

23. The Council's fixed term investments are partly managed externally by Tradition UK Ltd. The role of the broker is to determine the most appropriate investment option within criteria set by the Council. All cash transfers are made by Council officers and Executive approval has been given for the allocation of up to £13 million to the externally managed portfolio. This retains sufficient funds within the direct management of officers, while still ensuring that maximum yield is achieved from the longer term investments.

24. The investment structure is sufficient to meet the capital programme and other large cash outflows.

25. To increase the liquidity of the Council's investments, call accounts with Nat West, Santander, HSBC and Svenska Handelsbanken are being used. These accounts offer quick access to funds however they do attract a lower rate of interest than some of the fixed term investments shown in the table above.

26. The balance within each call/notice account as at 30 September 2013 is set out in the following table:

Call Accounts	£m
NatWest	3.1
Santander – 95 Day Notice	2.0
Svenska Handelsbanken	3.0
HSBC	6.0
Total	**14.1**

BORROWING ACTIVITY

27. The Council's external long term debt amounted to £40.4 million as at 1 April 2014. This is as a result of the HRA reforms (£40m) and the Hampshire County Council interest free loan for Portchester Community Centre (£0.4m). Borrowing may be required later in the year for the Daedalus capital scheme.

28. The Council has taken out ten £4 million loans from the PWLB with duration of between 40 and 50 years at an average interest rate of 3.50% as detailed in the table below:-

Repayment Date	Loan Amount	Interest Rate
30/09/2052	£4m	3.52%
30/09/2053	£4m	3.51%
30/09/2054	£4m	3.51%
30/09/2055	£4m	3.51%
30/09/2056	£4m	3.50%
30/09/2057	£4m	3.50%
30/09/2058	£4m	3.50%
30/09/2059	£4m	3.49%
30/09/2060	£4m	3.49%
30/09/2061	£4m	3.48%
Total	**£40m**	**3.50% average**

29. Interest payable for 2014/15 is budgeted at £1,870,900 and will be met by the HRA. £1,400,400 relates to the PWLB loans and £470,500 for interest on internal borrowing between the General Fund and the HRA.

INTEREST RATE FORECAST

30. The Council's treasury advisor, Capital Asset Services, 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%

31. Capita Asset Services undertook a review of its interest rate forecasts on 24 October. During September and October, a further rise in geopolitical concerns, principally over Ukraine but also over the Middle East, plus fears around Ebola and an accumulation of dismal growth news in most of the ten largest economies of the world and also on the growing risk of deflation in the Eurozone, had sparked a flight from equities into safe havens like gilts and depressed PWLB rates. However, there is much volatility in rates as news ebbs and flows in negative or positive ways. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2015.

STRATEGY COMPLIANCE

32. The Council’s Treasury Management Strategy Statement for 2014/15 in Appendix A, which includes the Annual Investment Strategy 2014/15, was approved by the Council on 21 February 2014. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield

33. The Council will also aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs but also to seek out value available in higher rates in periods up to 12 months with highly credit rated financial institutions.

34. The compliance with the various elements of the strategy are set out in the following table:-

Compliance on Individual Elements	Yes/No	Notes
Borrowing only up to “supported” level	Yes	No borrowing this quarter
All investments with approved institutions	Yes	Treasury management advisors provide updated list of approved institutions each month
All individual investments within prescribed financial limits	Yes	There are currently 6 institutions where the total investment is at the

		maximum level. They are Lloyds Bank (£8m limit), HSBC, (£6m limit), Skipton BS, West Brom BS, Leeds BS and Principality (£2m limit).

35. No changes to the Council's Treasury Management Strategy Statement and Annual Investment Strategy 2014/15 are considered necessary at this time as the rules currently being applied to investments are much tighter than those approved within the Treasury Management Strategy.

COMPLIANCE WITH TREASURY AND PRUDENTIAL LIMITS

36. It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. The Council's approved Treasury and Prudential Indicators (affordable limits) were approved by the Executive at its meeting on 10 February 2014.

37. Performance for the first half of the year is shown in Appendix C and the purpose of each indicator is explained in more detail in Appendix D. During the financial year to date the Council has operated within the treasury limits and the Prudential Indicators.

RISK ASSESSMENT

38. In the current economic climate and the heightened credit concerns, there are risks that financial institutions holding Council investments could default and be unable to fulfil their commitments to repay the sums invested with them.

39. To help mitigate this risk, the Council maintains a list of approved institutions based on a grading system operated by the Council's treasury management advisers. Maximum limits are also set for investments with individual institutions

Background Papers: None

Reference Papers: 10 February 2014 Executive Report - Treasury Management Policy and Strategy 2014/15

Appendices:
Appendix A - Treasury Management Strategy 2014/15
Annex A - Summary of Prudential and Treasury Indicators
Appendix B - Total investment activity to 30 September 2014 with each approved institution
Appendix C - 2014/15 Prudential Indicators - Half-Yearly Performance
Appendix D - Details of Prudential Indicators

Enquiries:

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