Treasury Management Strategy Statement and Annual Investment Strategy

Mid-year Review Report 2014/15

North Hertfordshire District Council

This template was issued on 1 October 2014

1 Background

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.

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. This council does not currently have borrowing requirements due to the capital receipts previously classed as "set-aside".

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."

2 Introduction

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) was adopted by this Council on 13 February 2014.

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 and Minimum Revenue Provision Policy - 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, Audit and Risk Committee:

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

- An economic update for the first part of the 2014/15 financial year;
- 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 2014/15;
- A review of the Council's borrowing strategy for 2014/15;
- A review of any debt rescheduling undertaken during 2014/15;
- A review of compliance with Treasury and Prudential Limits for 2014/15.

3 Economic update

3.1 Economic performance to date and outlook

3.1.1 U.K.

After strong UK GDP quarterly growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, (2013 annual rate 2.7%), and 0.7% in Q1 and 0.9% in Q2 2014 (annual rate 3.2% in Q2), 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. 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.

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 should be reversed by wage inflation rising back above the level of inflation in order to ensure that the recovery will be sustainable. 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. 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.

Also encouraging has been the sharp fall in inflation (CPI), reaching 1.5% in May and July, the lowest rate since 2009. Forward indications are that inflation is likely to fall further in 2014 to possibly near to 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 Q1 or 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.

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 2013 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 disappointed so far in 2014/15.

3.2 Interest rate forecasts

The latest forecast are as follows:

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

Capita Asset Services 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. 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 1 of 2015.

Our PWLB forecasts are based around a balance of risks. However, there are potential upside risks, especially for longer term PWLB rates, as follows: -

- A further surge in investor confidence that robust world economic growth is firmly expected, causing a flow of funds out of bonds and into equities.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Downside risks currently include:

- The situation over Ukraine poses a major threat to EZ and world growth if it was to deteriorate into economic warfare between the West and Russia where Russia resorted to using its control over gas supplies to Europe.
- UK strong economic growth is currently dependent on consumer spending and the unsustainable boom in the housing market. The boost from these sources is likely to fade after 2014.
- A weak rebalancing of UK growth to exporting and business investment causing a weakening of overall economic growth beyond 2014.
- Weak growth or recession in the UK’s main trading partners - the EU and US, inhibiting economic recovery in the UK.
- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.
- Recapitalising of European banks requiring more government financial support.
- Lack of support by populaces in Eurozone countries for 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.

- Italy: the political situation has improved but it remains to be seen whether the new government is able to deliver the austerity programme required and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.
- France: after being elected on an anti austerity platform, President Hollande has embraced a €50bn programme of public sector cuts over the next three years. However, there could be major obstacles in implementing this programme. Major overdue reforms of employment practices and an increase in competiveness are also urgently required to lift the economy out of stagnation.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Heightened political risks in the Middle East and East Asia could trigger safe haven flows back into bonds.
- There are also increasing concerns that the reluctance of western economies to raise interest rates significantly for some years, plus the huge QE measures which remain in place (and may be added to by the ECB in the near future), has created potentially unstable flows of liquidity searching for yield and therefore heightened the potential for an increase in risks in order to get higher returns. This is a return of the same environment which led to the 2008 financial crisis.

4 Treasury Management Strategy Statement and Annual Investment Strategy update

The Treasury Management Strategy Statement (TMSS) for 2014/15 was approved by this Council on 13 February 2014

- There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

Prudential Indicator 2014/15	***Original £m***	***Revised Prudential Indicator £m***
Authorised Limit	8	8
Operational Boundary	6	6
Capital Financing Requirement	23.3Cr	23.3Cr

5 The Council's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

5.1 Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure as approved in the first quarter Capital Budget Monitoring report

Capital Expenditure by Service	2014/15 Original Estimate £	Current Position £	2014/15 Revised Estimate £
Advances & Cash Incentives	613,000	0	578,000
Asset Management	648,840	17,556	730,230
CCTV	27,690	0	27,690
Community Services	90,000	93,142	261,090
Computer Software & Equipment	334,000	116,828	434,720
Growth Fund Project	670,410	17,135	573,700
Leisure Facilities	950,380	2,139	1,589,170
Museum & Arts	2,645,000	1,536,129	3,815,080
Parking	1,005,000	72,795	1,386,680
Renovation & Reinstatement Grant Expenditure	780,000	81,806	780,000
Town Centre Enhancement	100,000	0	141,160
Waste Disposal	0	22,971	0
Total	**7,864,320**	**1,960,501**	**10,317,520**

5.2 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above) and the expected financing arrangements of this capital expenditure.

Capital Expenditure	2014/15 Original Estimate £	Current Position £	2014/15 Revised Estimate £
Total spend	**7,864,320**	**1,960,501**	**10,317,520**
Financed by:			
Capital receipts	2,111,070	231,533	2,506,840
Government Grants	1,016,410	98,941	935,860
IT Reserve	286,000	31,055	146,420
Other Capital Contributions	1,513,000	1,356,500	1,591,520
Revenue Contributions	0	0	4,300
S106 Funding	103,000	17,847	235,010
Total financing	**5,029,480**	**1,735,876**	**5,419,950**
Net Financing Need	**2,834,840**	**224,625**	**4,897,570**

5.3 Changes to the Prudential Indicators for the Capital Financing Requirement, External Debt and the Operational Boundary

The table shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period. This is termed the Operational Boundary.

Prudential Indicator – Capital Financing Requirement

The Capital Financing Requirement will remain negative during the year.

Prudential Indicator – External Debt / the Operational Boundary

	2014/15 Original Estimate £	Current Position £	2014/15 Revised Estimate £
Prudential Indicator – Capital Financing Requirement			
Total CFR	-23,340,016	-23,340,016	-23,340,016
Net movement in CFR	**0**	**0**	**0**
Prudential Indicator – External Debt / the Operational Boundary			
Operational Boundary	**6,000,000**	**6,000,000**	**6,000,000**
Borrowing			
PWLB	659,541	611,130	572,154
LOBO	1,000,000	1,000,000	1,000,000
Total debt 31 March	**1,659,541**	**1,611,130**	**1,572,154**
Within Operational Boundary	**4,340,459**	**4,388,870**	**4,427,846**

The operational Boundary was set to ensure there is sufficient headroom to allow for any temporary borrowing that may be required during the year.

5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2014/15 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has an approved policy for borrowing in advance of need but this will not be required in 2014/15.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Authorised limit for external debt	2014/15 Original Indicator	Current Position	2014/15 Revised Indicator
Authorised Limit	8,000,000	8,000,000	8,000,000
Borrowing	1,659,541	1,611,130	1,572,154

6 Investment Portfolio 2014/15

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. As set out in Section 3, 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 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.

The Council held £36.5m of core investments with Sterling and Tradition as at 30 September 2014 and the investment portfolio yield for the first six months of the year is 1.21%.

The average level of funds available for investment purposes in house during the quarter was £6.93M. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme. At the 30 September the Council held £36.5M core cash balances for investment purposes (i.e. funds available for more than one year). This could reduce to £32.5M during the year if expected capital receipts do not materialise and investments are taken back to fund the Capital programme.

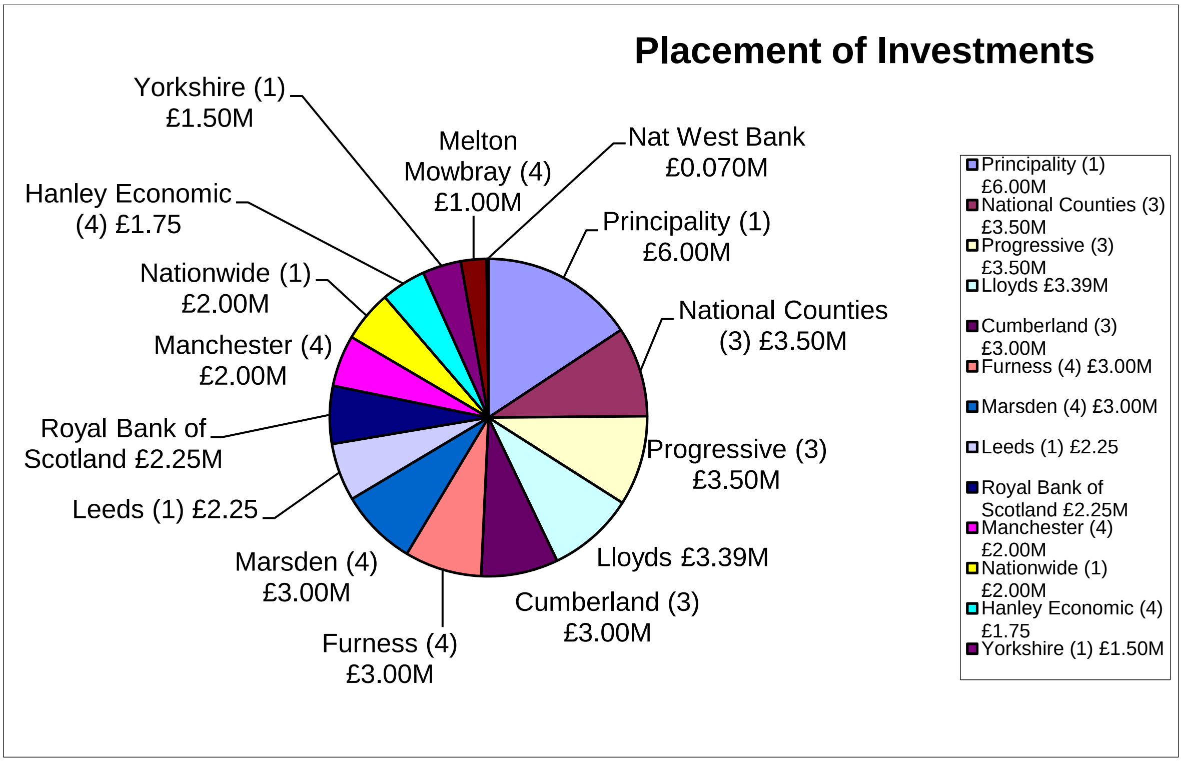
The Council will also aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in higher rates in periods up to 24 months.

Investments as at 30 Sept 2014

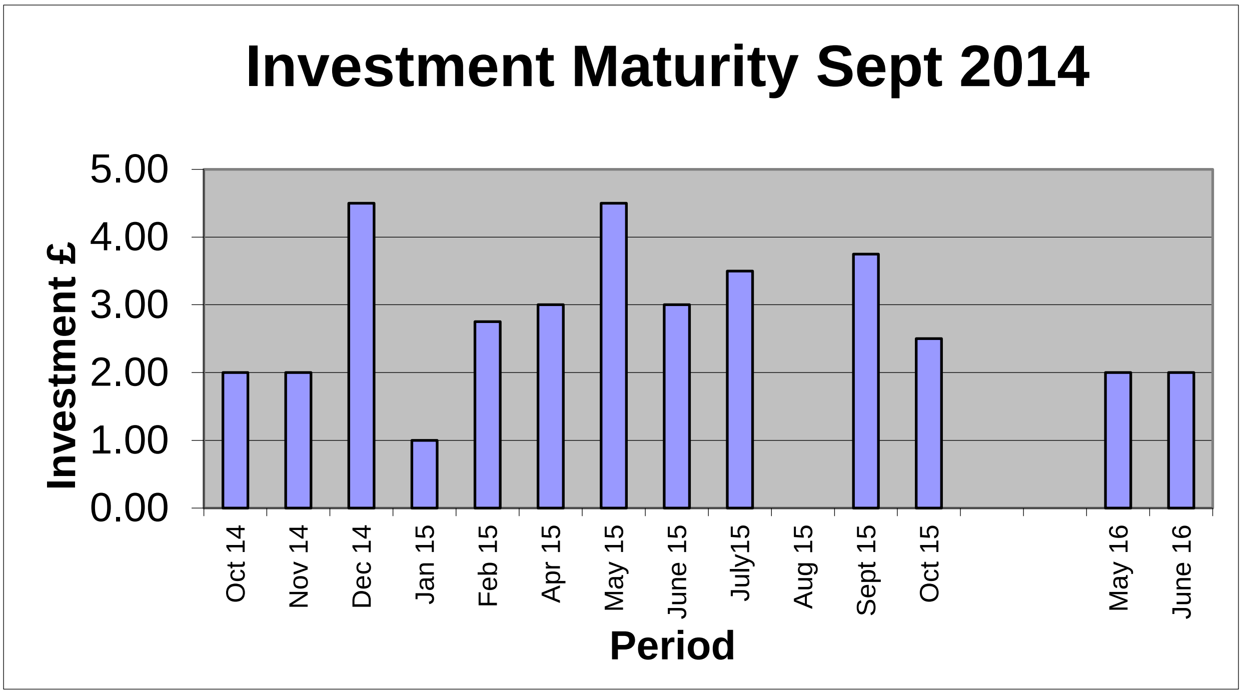
	Amount £	Average Interest Rate %
Managed By NHDC		
Lloyds Bank	1,634,783	0.4
Nat West Bank	70,000	0.25
NHDC Total	1,704,783	0.34
Managed by Sterling Banks		
Building Societies	16,500,000	1.37
Sterling Total	16,500,000	1.37
Managed by Tradition		
Banks	4,000,000	2.40
Building Societies	16,000000	1.31
Tradition Total	20,000,000	1.65
TOTAL	41,511,835	1.53

The pie chart below shows the spread of investment balances as at 30 Sept 2014. The figures shown are in millions whilst the figure in brackets denotes the value of the building societies total assets:

(1) Building Societies with Assets over £4.5bn
(2) Building Societies with Assets between £2.5bn - £4.5bn
(3) Building Societies with Assets between £1.0bn - £2.5bn
(4) Building Societies with Assets between £0.3bn - £1.0bn



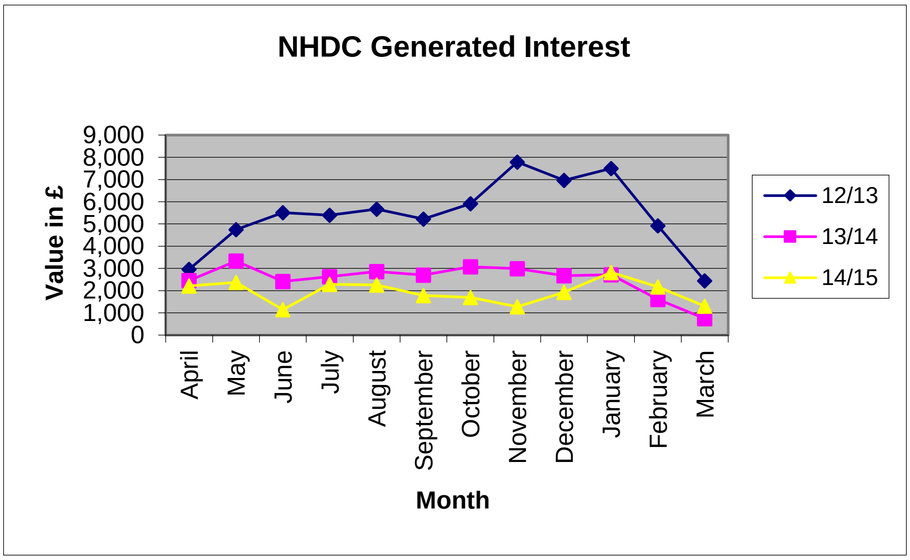
The chart below shows the Council's investment maturity profile. (This does not include the £0.070M held in the Nat West Liquidity account or £1.64M of the £3.39M held in the Lloyds current account which can be called back on any day). No new deals in the second quarter were placed for longer than a year. As investments mature with the Cash Managers during the second half of the year, the length of the deal will depend on our need to fund capital expenditure. Investments may be kept short to cover any short fall in cashflow towards the end of the financial year.



Investment performance for quarter ended 30 September 2014

The Council's budgeted investment return for 2014/15 is £0.492M, and performance for the year to date is in line with the budget.

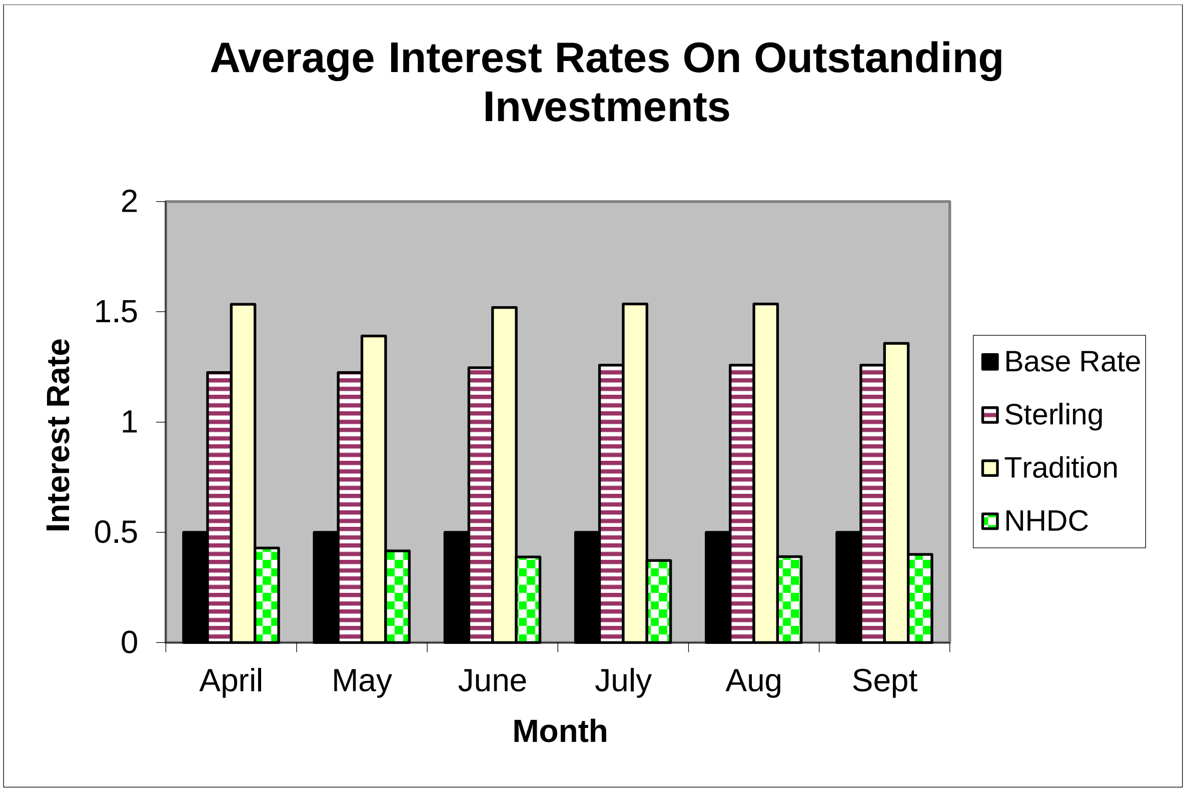
The graph below shows the level of interest expected to be generated from the cash available in-house over the year which is maintained to ensure adequate cashflow. Cash balances have historically reduced over January to March each year as there were no Council tax receipts in February and March. Receipts are now spread more evenly as many residents are choosing to pay council tax over 12 months.



The Table below shows the average rates achieved on investments made during the second quarter.

	Ave Interest Rate on Deals made
	%
NHDC	0.39
Sterling	0.95
Tradition	0.88

Base rate started the year at 0.5% and remained constant through the first six months. The graph below shows the average rate of interest on outstanding Investments at 30 September.



As can be seen from the graph, the average rate of interest on outstanding investments for NHDC (cash managed internally) is consistently lower than that of the Cash Managers. This is because the investments made by NHDC during the year are to meet cash flow requirements and are therefore made for short periods. At present, rates in the shorter periods are lower than the longer periods. The Cash Managers have more long term investments and the turnover of investments is small in comparison to NHDC.

The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the second quarter of 2014/15.

Investment Counterparty criteria

The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function but will be reviewed when setting next year's TMSS.

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". This process may commence during this financial year but the actual timing of the changes is still subject to discussion.

The recent Government Bill on Banking Reform will mean financial institutions will no longer be able to rely on Government support if they get into difficulties. In light of these developments, we may wish to consider the level of risk in our 15/16 strategy.

It is important to stress that the rating agency changes do not reflect any changes in the underlying status of the institution or credit environment, merely the implied level of support that has been built into ratings through the financial crisis. The eventual removal of implied Government support will only take place when the regulatory and economic environments have ensured that financial institutions are much stronger and less prone to failure in a financial crisis.

7 Borrowing

The Council's capital financing requirement (CFR) for 2014/15 is -£23.3m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The CFR is negative as the Council has more cash investments than borrowing. The balance of external and internal borrowing is generally driven by market conditions.

It is anticipated that long term borrowing will not be undertaken during this financial year.

The table below shows the movement in PWLB certainty rates for the first six months of the year to date:

PWLB certainty rates, half year ended 30th September 2014

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.20%	2.48%	3.16%	3.75%	3.73%
Date	10/04/2014	28/08/2014	28/08/2014	29/08/2014	29/08/2014
High	1.48%	2.86%	3.66%	4.29%	4.26%
Date	15/07/2014	04/07/2014	20/06/2014	02/04/2014	01/04/2014
Average	1.34%	2.65%	3.67%	4.10%	4.17%

Loans Outstanding as at 30 September 2014

	Amount	Average Interest Rate	Cumulative Rate
	£	%	%
Public Works Loans Board	611,130	8.65	8.85
Lender Option Borrower Option	1,000,000	10.125	10.1
Temporary Loans 364 Days and Under	0	0	0
	1,611,130	9.568	8.534

The Council has reduced the overall debt liability by repaying £0.048M of PWLB loans in the second quarter. The total of loan repayments during the year will be £2,057,387. This is made up of the temporary loans of £1.97M and PWLB loans.

8 Debt Rescheduling

No debt rescheduling was undertaken during the first six months of 2014/15. At present it is not financially beneficial to repay debt early.