MEETING:	**AUDIT COMMITTEE**
DATE:	**18 DECEMBER 2014**
TITLE:	**TREASURY MANAGEMENT 2014/15 – MID YEAR REVIEW**
PURPOSE:	**CIPFA's Code of Practice recommends that a report on the Council's actual Treasury Management during the current financial year is produced.**
RECOMMENDATION:	**RECEIVE THE REPORT FOR INFORMATION**
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EXECUTIVE SUMMARY

During the six month period between 1 April and 30 September 2014, the Council's borrowing remained well within the limits originally set. There were no new defaults by banks in which the Council deposited money.

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1. BACKGROUND

The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires that authorities report on the performance of the treasury management function at least twice yearly (mid-year and at year end).

The Council's Treasury Management Strategy for 2014/15 was approved by full Council on 6th March 2014 which can be accessed on –

https://www.gwynedd.gov.uk/en/Council/Councillors-and-committees/Meetings,-minutes-and-agendas/Meetings,-minutes-and-agendas.aspx?pwyllgor=/2013-14/Cyngor Llawn_Full Council/2014-03-06

The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. This report covers treasury activity and the associated monitoring and control of risk.

2. EXTERNAL CONTEXT

Growth and Inflation: The recent strong performance of the UK economy continued with output growing at 0.8% in Q1 2014 and at 0.9% in Q2. The services sector once again grew strongly. On the back of strong consumption growth, business investment appeared to be recovering quickly, albeit from a low base. The annual CPI inflation rate fell to 1.5% year-on-year in August.

Revisions to the GDP methodology, now compliant with the European System of Accounting 2010, mean that growth is now estimated to be 2.7% above its pre-recession peak in Q1 2008, rather than just 0.2% higher. The general theme being that the recession was not as deep and the recovery was earlier than initially estimated. In anticipation of these revisions, the MPC has forecast growth at 3.4% in 2014.

Unemployment: The labour market continued to improve, with strong employment gains and the headline unemployment rate falling to 6.2%. However, earnings growth remained very weak, rising just 0.6% for the three months May-July 2014 when compared to the same period a year earlier. The growth in employment was masked by a large number of zero-hour contracts and involuntary part-time working.

UK Monetary Policy: The MPC made no change to the Bank Rate of 0.5% and maintained asset purchases at £375bn. However, there was a marked shift in tone from the Bank of England's Governor and other MPC members. In his Mansion House speech in June Governor Mark Carney warned that interest rates might rise sooner than financial markets were expecting. Following some mixed messages from Governor Carney later in the summer, the minutes of the August and September MPC meetings revealed a split vote with regards to the Bank Rate. Ian McCafferty and Martin Weale voted to increase Bank Rate by 0.25%, arguing economic circumstances were sufficient to justify an immediate rise. The MPC emphasised that when Bank Rate did begin to rise, it was expected to do so only gradually and would likely remain below average historical levels for some time to come.

In the Bank of England's August Inflation Report the Bank forecast growth to be around 3.5% in 2014, easing back thereafter to around its pre-crisis historical average rate. Inflation was forecast to remain at, or slightly below, 2% before reaching the target at the end of the two-year forecast period.

The Bank's Financial Policy Committee also announced a range of measures to cool the UK's housing market to avert the potential of spiralling house prices derailing a sustainable economic recovery. Key recommendations included lenders stress-testing mortgage applicants can cope with a 3% rise in interest rates; putting a 15% cap on the number of mortgages at more than 4.5 times the borrower's income; and a separate Treasury pledge banning anyone applying for a loan through the Help to Buy scheme borrowing more than 4.5 times their income. The Prudential Regulation Authority also announced that it intends to consult on capital requirements for mortgages.

Eurozone inflation continued to fall towards zero (HICP inflation registered just 0.3% in September), and there was mounting evidence that the already feeble recovery was losing pace. The unemployment rate remained stubbornly high at 11.5%. The European Central Bank lowered its official benchmark interest rate from 0.15% to 0.05%. The rate it pays on commercial bank balances held with it was also cut further into negative territory from -0.1% to -0.2% and the Marginal Lending Facility rate cut further to 0.3%. The ECB also announced a programme of acquiring Asset Backed Securities (ABS) from banks in an effort to encourage lending which was viewed as being one step away from full blown Quantitative Easing (QE) adopted by the US, UK and Japanese central banks. The minutes of the Bank of England's MPC meeting in September noted that "*weakness in the euro area had been the most significant development during the month"* and that, if it led once again to uncertainty about the sustainability of euro-area public and external debt, it could damage confidence and disrupt financial markets

There was no change from the US Federal Reserve as the central bank kept policy on its current track with a reduction in asset purchases by $10 billion per month. Asset purchases are expected to end by October 2014, expectations therefore turned towards the timing of rate increases. The US economy rebounded strongly in Q2 with annualised growth of 4.6%.

Market reaction: Gilt yields have continued to decline and hit a financial year low at the end of August, before ticking upwards in the run up to the Scottish referendum. What has driven yields lower is a combination of factors but the primary drivers have been the escalation of geo-political risk within the Middle East and Ukraine alongside the slide towards deflation within the Eurozone (EZ).

Local Context

At 31/3/2014 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £173.3m, while usable reserves and working capital which are the underlying resources available for investment were £68m.

At 31/3/2014, the Council had £114.9m of borrowing and £27.1m of investments. The Council's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.

Borrowing Strategy

At 30/9/2014 the Council held £111.3m of loans, (a decrease of £0.9m on 31/3/2014), as part of its strategy for funding previous years' capital programmes.

The Council's chief objective when borrowing continues to be striking an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

Affordability and the "cost of carry" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained lower than long-term rates, and are likely to remain lower at least over the forthcoming two years, it was more cost effective in the short-term to use internal resources instead of borrowing.

The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the Council with this 'cost of carry' and breakeven analysis.

Borrowing Activity in 2014/15

	Balance on 01/04/2014 £'000	Maturing Debt £'000	New Borrowing £'000	Balance on 30/09/2014 £'000	Avg Rate % and Avg Life (yrs)
Capital Financing Requirement (CFR)	173,309				
Short Term Borrowing[1]	1,155	(1,174)	45	26	0.00
Long Term Borrowing	111,027	0	268	111,295	5.78
TOTAL BORROWING	**112,182**	**(1,174)**	**312**	**111,321**	5.78
Other Long Term Liabilities	2,484			2,484	6.17
TOTAL EXTERNAL DEBT	**114,667**	**(1,174)**	**312**	**113,805**	5.79
Increase/ (Decrease) in Borrowing £'000				(862)	

PWLB Certainty Rate and Project Rate Update: The Council qualified for borrowing at the 'Certainty Rate' (0.20% below the PWLB standard rate) for a 12 month period from 01/11/2013. In August the Council submitted its application to the Welsh Government along with the 2014/15 Capital Estimates Return to access this reduced rate for a further 12 month period from 01 November 2014.

LOBOs: The Council holds £16.2m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. The next set date is in 2018.

Debt Rescheduling: The premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Council's portfolio and therefore unattractive for debt rescheduling activity. As a consequence, no rescheduling activity was undertaken.

[1] Loans with maturities less than 1 year.

Changes in the debt portfolio over the quarter have achieved a reduction in the level of borrowing, as well as a reduction in credit risk, by repaying loans from investment balances.

Investment Activity

The Council holds significant invested funds, representing income received in advance of expenditure, plus balances and reserves held.

The Welsh Government's Investment Guidance gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

Investment Activity in 2014/15

Investments	Balance on 01/04/14 £'000	Investments Made £'000	Maturities/ Investments Sold £'000	Balance on 30/09/14 £'000	Average Rate (%)
Short term Investments (call accounts, deposits) Banks and Building Societies with ratings of A- or higher	47,825	144,405	(136,630)	55,600	0.70
Money Market Funds	0	41,781	(33,426)	8,355	0.44
Covered Bond	0	1,000	0	1,000	2.09
TOTAL INVESTMENTS	**47,825**	**187,186**	**(170,056)**	**64,955**	
Increase in Investments £'000				17,130	

Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy, as set out in the Treasury Management Strategy Statement for 2014/15.

Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

Credit Risk

Counterparty credit quality as measured by credit ratings is summarised below:

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating
31/03/2014	5.69	A	5.80	A
30/06/2014	5.19	A+	5.12	A+
30/09/2014	5.01	A+	3.21	AA

Scoring:
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-AAA = highest credit quality = 1
- D = lowest credit quality = 26
-Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

Investments were made with banks and building societies and included call accounts, fixed-rate term deposits and certificates of deposit, Money Market Funds, and a Covered Bond.

Counterparty Update

The European Parliament approved the EU Bank Recovery and Resolution Directive (BRRD) on April 15, 2014. Taking the view that potential extraordinary government support available to banks' senior unsecured bondholders will likely diminish within its two-year rating horizon for investment-grade entities, in April Standard & Poor’s revised the Outlook of Barclays, Deutsche Bank, Credit Suisse and ING Bank from Stable to Negative (note, this is not the same as a rating review negative). In May, Moody’s also changed the outlook from stable to negative for 82 European banks and from positive to stable for two European banks. The institutions affected on the Council’s lending list are Nationwide Building Society, Pohjola Bank, Svenska Handelsbanken, Landesbank Hessen-Thuringen, Bank Nederlandse Gemeenten and Nordea Bank.

In August Moody’s changed its outlook for the UK banking system from stable to negative, citing the reduction of government support for systemic banks as the reason. Although the agency believes that the stand-alone financial strength of UK institutions is improving they believed that this is more than offset by the potential bail-in risk now faced by investors. Similarly, in August S&P revised the outlooks for major Canadian banks to negative following the government’s announcement of a potential bail-in policy framework.

There was strong likelihood that the UK, alongside Germany and Austria, would accelerate the adoption of the BRRD and that the implementation of bail-in resolutions would be fast-tracked in these countries to 1st January 2015, a full year ahead of other EU nations.

Banks in the UK and EU face banks face stress tests this autumn, which may result in some institutions having to additionally bolster their capital buffers. The extent to which this might be required, and the form they will have to take, casts uncertainty over capital requirements in the system.

Budgeted Income and Outturn

The average cash balances were £65.7m during the period. The UK Bank Rate has been maintained at 0.5% since March 2009. Short-term money market rates have remained at relatively low levels. New deposits were made at an average rate of 0.85%. Investments in Money Market Funds generated an average rate of 0.44%.

The Council's budgeted investment income for the year is estimated at £0.3m. The Council anticipates an investment outturn of £0.35m for the whole year.

Update on Investments with Icelandic Banks

The Council has now recovered 94% of its investments in Heritable Bank. It is likely that further distributions will be received, although the administrators have not made an official estimate of final recoveries yet.

CIPFA issued further guidance on the accounting treatment surrounding these transactions in September 2013 when LAAP 82 (update 8) was issued. CIPFA has no plans to issue any additional updates.

Compliance with Prudential Indicators

The Council confirms compliance with its Prudential Indicators for 2014/15, which were set in March 2014 as part of the Council's Treasury Management Strategy Statement.

Treasury Management Indicators

The Council measures and manages its exposures to treasury management risks using the following indicators:

Interest Rate Exposures: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed will be:

	2014/15	**2015/16**	**2016/17**
Upper limit on fixed interest rate exposure	100%	100%	100%
Actual	100%		
Upper limit on variable interest rate exposure	50%	50%	50%
Actual	0%		

Maturity Structure of Borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	Upper	**Lower**	**Actual**
Under 12 months	25%	0%	0.19%
12 months and within 24 months	25%	0%	1.78%
24 months and within 5 years	50%	0%	18.58%
5 years and within 10 years	75%	0%	5.75%
10 years and within 20 years	100%	0%	35.28%
20 years and within 30 years	100%	0%	13.88%
30 years and within 40 years	100%	0%	0%
40 years and above	100%	0%	24.55%

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than 364 days: The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested for periods longer than 364 days are:

	2014/15	**2015/16**	**2016/17**
Limit on principal invested beyond year end	£30m	£20m	£10m
Actual	£1m	£1m	£1m

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score] of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment.

	Target	**Actual**
Portfolio average credit score	6.0	4.06

Investment Training

During the period officers have attended investment training with Arlingclose and CIPFA relevant to their roles.

Outlook for Q3 and Q4 2014/15

The stronger economic growth seen in the UK over the past six months is likely to use up spare capacity more quickly than previously assumed. Arlingclose has brought forward the timing for the first rise in Bank Rate to Q3 2015.

In addition to two MPC members having voted for an interest rate rise in August and September, the rhetoric from Committee members has in general become more hawkish. However, Arlingclose expect that the lack of inflationary pressure will allow policymakers to hold off monetary tightening for longer than the market currently expects. The near-term risk is that the Bank Rate could rise sooner than anticipated, which is captured in the 'upside risk' range of Arlingclose's forecast table below.

The focus is now on the rate of increase and the medium-term peak. Arlingclose's expectations are that rates will rise slowly and to a lower level than in the past.

	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Official Bank Rate											
Upside risk	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	**0.50**	**0.50**	**0.50**	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**	**1.25**	**1.50**	**1.50**
Downside risk				0.25	0.25	0.50	0.50	0.75	0.75	1.00	1.00

Appendix A

Prudential Indicators 2014/15

The Local Government Act 2003 requires the Council to have regard to CIPFA's *Prudential Code for Capital Finance in Local Authorities* (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

Estimates of Capital Expenditure: The Council's planned capital expenditure and financing may be summarised as follows:

Capital Expenditure and Financing	2013/14 Actual £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
Total Expenditure	**45.0**	**45.0**	**32.4**	**14.6**
Capital Receipts	1.4	2.1	1.2	0
Government Grants	22.4	21.4	12.7	8.4
Reserves	5.6	6.5	4.9	1.3
Revenue	4.9	3.3	2.5	0
Borrowing	10.7	11.7	11.1	4.9
Total Financing	**45.0**	**45.0**	**32.4**	**14.6**

Estimates of Capital Financing Requirement: The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose.

Capital Financing Requirement	31/03/14 Actual £m	31/03/15 Estimate £m	31/03/16 Estimate £m	31/03/17 Estimate £m
Total	**173.3**	**177.7**	**181.4**	**178.9**

The CFR is forecast to rise by £5.6m over the next three years as capital expenditure financed by debt outweighs resources put aside for debt repayment.

Gross Debt and the Capital Financing Requirement: In order to ensure that over the medium term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Debt	31/03/14 Actual £m	30/09/14 Actual £m	31/03/15 Estimate £m	31/03/16 Estimate £m	31/03/17 Estimate £m
Borrowing	112.4	111.3	111.3	131.3	129.5
Finance leases	2.5	2.5	2.3	2.2	2.1
Total Debt	**114.9**	**113.8**	**113.6**	**133.5**	**131.6**

Total debt is expected to remain below the CFR during the forecast period.

The actual debt levels are monitored against the Operational Boundary and Authorised Limit for External Debt, below.

Operational Boundary for External Debt: The operational boundary is based on the Council's estimate of most likely, i.e. prudent, but not worst case scenario for external debt.

Operational Boundary	2013/14 £'000	2014/15 £'000	2015/16 £'000	2016/17 £'000
Borrowing	175,000	175,000	175,000	175,000
Other long-term liabilities	0	0	0	0
Total Debt	**175,000**	**175,000**	**175,000**	**175,000**

Authorised Limit for External Debt: The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	2013/14 £'000	2014/15 £'000	2015/16 £'000	2016/17 £'000
Borrowing	195,000	195,000	195,000	195,000
Other long-term liabilities	0	0	0	0
Total Debt	**195,000**	**195,000**	**195,000**	**195,000**

Ratio of Financing Costs to Net Revenue Stream: This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2013/14 Actual %	2014/15 Estimate %	2015/16 Estimate %	2016/17 Estimate %
Total	4.86	5.34	5.59	5.78

Incremental Impact of Capital Investment Decisions: This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax levels. The incremental impact is the difference between the total revenue budget requirement of the current approved capital programme and the revenue budget requirement arising from the capital programme proposed.

Incremental Impact of Capital Investment Decisions	**2014/15 Estimate £**	**2015/16 Estimate £**	**2016/17 Estimate £**
General Fund - increase in annual Band D Council Tax	0	0	0

Adoption of the CIPFA Treasury Management Code: The Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* in March 2011.