Agenda Item No. 9

Governance, Audit and Scrutiny Committee **3 December 2013**	**Report by the** **Director of Finance and Assets/** **S.151 Officer**

TREASURY MANAGEMENT MID-YEAR UPDATE REPORT 2013/14

REPORT EXECUTIVE SUMMARY

This report provides an update on the Authority's treasury management activities for the first half of the financial year 2013/14.

RECOMMENDATIONS

1. (a) That Members consider the treasury management activities undertaken during the first half of 2013/14 and the Prudential Indicators as outlined in paragraphs 32 and 33 and detailed in Appendix 1.

   (b) That the Prudential indicators continue to be monitored on a monthly basis and reported to Members as part of the monthly 'Management Accounts and Prudential Indicators' report.

BACKGROUND

2. Treasury Management, as defined by the Chartered Institute of Public Finance and Accountancy (CIFPA) Code of Practice 2009 is:

   ''The management of the organisation'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 the optimum performance consistent with those risks.''

3. The Authority on 15 March 2013 approved the annual Treasury Management Policy Statement and agreed a range of Prudential Indicators aimed at ensuring effective treasury management and affordability of capital plans.

4. This report ensures compliance with recommended practice as outlined in the Code, by providing Members with an update on treasury management undertaken since the beginning of the financial year and highlighting key Prudential Indicator information.

ECONOMIC BACKDROP 2013/14

5. The UK Economic recovery has accelerated, with strong growth of 0.7% in quarter two, it appears that UK GDP is likely to have grown at an even faster pace in quarter three with official data showing growth in all sectors of the UK economy.

6. Eurozone business surveys suggested that the Eurozone economy continued to expand in quarter three, albeit at a moderate pace.

7. In the UK, consumer spending continued to rise and the quarter three increases may beat the increase seen in quarter two, with the Bank of England's Agents Scores, BRC and CBI retail sales indicators showing stronger growth in quarter three. Demand in the housing market has also continued to grow at a fast pace, supported with the Government's help to buy scheme. Mortgage approvals for new house purchase rose to their highest level since February 2008 in August. Consequently house prices continued to rise, however Office for National Statistics data shows that only prices in London continued to increase with all other regions showing modest falls.

8. The unemployment rate fell to 7.7% in July, down from 7.8% in June. Employment rose by 80,000 in the three months to July, supported by an even bigger rise in full-time employment. Indeed, the cumulative fall in unemployment of 68,900 in July and August was the biggest two month fall since May and June 1997. The claimant count unemployment rate fell from 4.4% at the end of quarter two to 4.2% in August. Despite this the headline (three month average of the annual) rate of pay growth fell from 2.2% in June to just 1.1% in July. Excluding bonuses earnings growth increased slightly to 1.1% year on year, but this remained well below the rate of CPI inflation of 2.7% in August, meaning real wages continued to fall.

9. The economic recovery may finally be feeding through to the public finances. Although the government registered a surprise deficit in July (a month that normally

delivers a surplus), in August net borrowing was ‘just’ £13.2bn, compared to £14.4bn in August 2012.

10. The new governor of the Bank of England took office in July. Alongside the August quarterly inflation report, the Bank introduced its new policy of forward guidance in which the Monetary Policy Committee (MPC) pledged not to raise official interest rates or reduce the size of its asset purchase facility until the unemployment rate falls below 7%. On the MPC’s current forecasts, the unemployment rate is most likely to reach 7% in late 2016.

11 CPI inflation fell from its peak of 2.9% in June to 2.7% in August, largely due to a reduction in the contribution from petrol prices and a reduction in core inflation from 2.3% in June to 2% in August.

ECONOMIC FORECAST

12. The Authority’s Treasury Management Advisers, Capita Asset Services, provide the following view on the economic outlook going forward:

13. The August inflation report included a number of statistics that indicated that the economic recovery had seen a significant shift up in gear in all of the three sectors of services, manufacturing/industrial and construction. The inflation report then upgraded the growth forecasts for 2013 from 1.2% to 1.4% and for 2014 from 1.7% to 2.5%. However Bank Governor Mark Carney stated that although the increase was welcome the recovery was not yet at “escape velocity” to ensure a strong and sustainable return to growth after what has been the weakest recovery on record after a recession.

14. In addition to the stimulus provided by quantitative easing, the Funding for lending scheme (FLS), is aimed at encouraging banks to expand lending to small and medium enterprises. The FLS scheme certainly seems to be having a positive effect in terms of encouraging house purchases (though levels are still far below the pre-crisis level), and causing a significant increase in house prices – but only in London and the south east. FLS is also due to be bolstered by the second phase of Help to Buy aimed to support purchasing of second hand properties, which started in October.

15. Capita Asset Services Forward guidance caveats are as follows:

16. The Bank of England also issued forward guidance with the inflation report which said that the Bank will not start to consider raising interest rates until the jobless rate (not the claimant count measure) has fallen to 7% or below. This would require the creation of about 750,000 jobs and was forecast to take three years. The UK unemployment rate currently stands at 2.5 million i.e. 7.7%. The Bank’s guidance is subject to three provisos, mainly around inflation; breaching any of them would sever the link between interest rates and unemployment levels. This actually makes forecasting Bank Rate much more complex given the lack of available reliable forecasts by economists over a three year plus horizon. The view from Capita Asset Services is that the recession since 2007 was notable for how unemployment did NOT rise to the levels that would normally be expected in a major recession. The latest Inflation Report noted that production had sunk to 2005 levels. Capita Asset Services are, therefore, concerned that there has been a significant amount of retention of labour, which will mean that a significant amount of GDP growth can be accommodated without a major reduction in unemployment.

17. The overall balance of risks is, therefore, 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; it also remains exposed to vulnerabilities in a number of key areas.

18. Downside risks currently include:

- The conflict in the UK between market expectations of how quickly unemployment will fall as opposed to the Bank of England's forecasts.

- 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.

- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows in 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 to UK bonds.

19. The potential for upside risks to UK gilt yields and PWLB rates, especially for longer term PWLB rates include:

- A sharp upturn in investor confidence that sustainable robust world economic growth is firmly expected, causing a surge in the flow of funds out of bonds to equities.

- A reversal of Sterling's safe-haven status on a sustainable improvement in financial stresses in the Eurozone.

- 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 which could result in the ratio of total government debt to GDP to rise to levels that undermine investor confidence in the UK and UK debt.

- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

- In the longer term – an earlier than currently expected 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.

20. Based on the above, it is Capita Asset Service's view that there is unlikely to be any increase in Bank Rate until December 2016.

21. Investment and borrowing strategies will, as ever, continue to be kept under close scrutiny by the Director of Finance and Assets/S.151 Officer during the remainder of the financial year in light of changing market conditions.

INVESTMENT ACTIVITY

22. The Authority's temporary investments totalled £31.6M as at 30 September 2013, with a further £694K in the Authority's Special Interest Bearing Account (SIBA).

Table 1 – Investment income earned April to September 2013

Interest Earned April to September 2013	Rate of return April to September 2013	Benchmark return at 30 September 2013*	Difference (Favourable) April to September 2013
£58k	0.37%	0.36%	0.01%

* Benchmark set as 7 day compounded LIBID

23. The Authority's rate of return is in line with the benchmark return provided by Capita Asset Services.

24. Interest earned during the first six months of 2013/14 exceeded the budget by £33k.

BORROWING

Short-Term Borrowing

25. The Authority has not taken any short-term borrowing in the first six months of the year. The Authority is likely to undertake short-term borrowing in the second half of the financial year to meet temporary cash shortfalls. The spending profile of a number of major one-off projects makes cash-flow planning unusually difficult and short-term borrowing will be used to smooth out the cash-flow where required. The main examples of this are:

- **East Coast and Hertfordshire Control Project** – the Authority is the financial lead for this project which has £5.89M of grant funding remaining. Expenditure will be incurred on a series of separate procurement exercises which form part of the overall solution but the timing is difficult to predict;

- **Clough Road** – the scheme is now underway and milestone payments will depend on the rate of progress with construction;

- **Retirement benefits** – timing is often uncertain given that most employees only need to give one month's notice of their intention to retire from the Service.

Long-Term Borrowing

26. Long-term loans are taken out either to replace existing loans which have matured or to fund capital expenditure. Under the Prudential Regime there are no longer centrally imposed limits on borrowing, but individual Authorities are required to determine themselves what is a sustainable and affordable level of borrowing as an integral part of their Medium-Term Financial Planning processes.

27. The Authority's level of borrowing was £18.6M as at 30 September 2013, with an equated average rate of interest payable at 4.29%. An expected £819k of interest is projected to be payable on external debt for 2013/14.

28. The Authority has not undertaken any new long-term borrowing so far this financial year and is unlikely to during the remainder of the 2013/14 financial year.

29. Limited opportunities for rescheduling of debt in order to secure savings in interest have been available given the prevailing market climate, thus no re-scheduling has been undertaken during the course of the financial year to date. The Authority continues to monitor the market in conjunction with its treasury management advisors with a view to capitalising on opportunities should they arise during the remainder of the year.

PRUDENTIAL INDICATORS

30. Appendix 1 details the Prudential Indicators agreed by Members at the Fire Authority on 15 March 2013 and shows for comparison the actual figures as at 30 September 2013.

31. During the period April to September 2013, the Authority operated wholly within the limits approved.

Capital Expenditure

32. The S.151 Officer considers the current capital programme to be affordable and sustainable with the revenue effects of capital investment built into the Medium-Term Financial Plan. Through the Service and Finance Planning Process the Authority has ensured alignment of its capital resources to key strategic priorities.

Treasury Management

33. External debt is currently £14.4M below the agreed authorised limit for 2013/14 and the maturity structure for both borrowing and investments remain within the approved upper and lower limits. Subsequent borrowing or re-scheduling will take in to account prevailing interest rates on offer from the Public Works Loans Board, the current maturity structure of loans, balanced with the need to reduce capital risk by maintaining prudently low levels of cash-balances.

STRATEGIC PLAN COMPATIBILITY

34. Treasury management is an integral part of the financial management of the Authority. Utilising approved borrowing and investment strategies will maximise investment income whilst minimising exposure to liquidity and market risks.

FINANCIAL/RESOURCES/VAULE FOR MONEY IMPLICATIONS

35. The Authority's approach to investment of surplus funds is designed to further mitigate against potential losses as a consequence of counterparty failure and reflects a prudent approach to treasury management activity.

LEGAL IMPLICATIONS

36. The Authority must comply with the requirements of the CIPFA Code of Practice on Treasury Management and the Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008. This report ensures such compliance.

EQUALITY IMPACT ASSESSMENT/HR IMPLICATIONS

37. No direct issues arise from this report.

CORPORATE RISK MANAGEMENT IMPLICATIONS

38. The application of and regular monitoring thereafter of a prudent Treasury Management Policy and related Prudential Indicators ensures that the Authority effectively manages financial risks such as exposure to interest rate changes, liquidity and market risk whilst minimising borrowing costs and maximising investment income. As an integral part of the financial planning process, it ensures that the financial plans upon which the Authority's Strategic Plan is based are effective and robust.

HEALTH AND SAFETY IMPLICATIONS

39. No issues arising.

COMMUNICATIONS ACTIONS ARISING

40. No direct issues arising.

DETAILS OF CONSULTATION

41. The Authority's current approved Treasury Management Strategy reflects guidance and market information supplied by the Authority's treasury management advisors.

BACKGROUND PAPERS

42. 'Treasury Management and Capital Expenditure Prudential Indicators, Treasury Management Policy Statement 2013/14 and Minimum Revenue Provision for 2013/14' – Report to Fire Authority 15 March 2013.
CIPFA Code of Practice on Treasury Management 2009
CIPFA Treasury Management Guidance - March 2009

RECOMMENDATIONS RESTATED

43. (a) That Members consider the treasury management activities undertaken during the first half of 2013/14 and the Prudential Indicators as outlined in paragraphs 32 and 33 and detailed in Appendix 1.

(b) That Prudential indicators continue to be monitored on a monthly basis and reported to Members as part of the monthly 'Management Accounts and Prudential Indicators' report.

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