POLICY AND RESOURCES SCRUTINY COMMITTEE – 10TH NOVEMBER 2015

SUBJECT: **TREASURY MANAGEMENT AND CAPITAL FINANCING PRUDENTIAL INDICATORS QUARTER 1 AND QUARTER 2 MONITORING REPORT (1ST APRIL 2015 TO 30TH SEPTEMBER 2015)**

REPORT BY: **ACTING DIRECTOR OF CORPORATE SERVICES AND SECTION 151 OFFICER**

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1. PURPOSE OF REPORT

1.1 To present Members with details of Treasury Management activities and Capital Financing, together with the related Prudential Indicators for the period 1st April 2015 to 30th September 2015.

1.2 To review the Treasury Management Strategy for 2015/16 as set out in the Annual Investment Strategy and Capital Financing Prudential Indicators Report.

2. SUMMARY

2.1 The Code of Practice on Treasury Management in the Public Services 2009, which was adopted by the Council on 12th October 2010, sets out a framework of operating procedures, which is encompassed in the Treasury Management Practices (TMPs). TMP6 (Reporting Requirements and Management Information Arrangements) provides for the submission of monitoring reports to the appropriate Committee on a quarterly basis.

2.2 Under the provisions of the Local Government Act 2003, The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003 [The Capital Regulations], and the CIPFA's "The Prudential Code for Capital Finance in Local Authorities" [the Code], the Authority is obliged to approve and publish a number of indicators relevant to Capital Finance and Treasury Management.

2.3 The Authority's Annual Investment Strategy and Capital Financing Prudential Indicators for 2015/16 were approved by Council on 25th February 2015.

3. LINKS TO STRATEGY

3.1 Treasury Management Strategy 2015/16 as agreed by Council on 25th February 2015.

4. THE REPORT

4.1 Treasury Management

4.1.1 Borrowing Activity

The current policy of internal borrowing is not sustainable in the long-term, but where prudent the policy of internal borrowing will be utilised. As at the 31st March 2015 the internal borrowing position was £8m.

The Annual Treasury Management Strategy approved by Council in February 2015 indicated that there would be a need to borrow £12.3m in 2015/16 to part fund the General Fund Capital Programme. £5.0m of this total would be met through supported borrowing approvals £4m for Bargoed Cinema and £3.3m LGBI 21st Century Schools. The Authority will not be borrowing for Bargoed Cinema as the project has been terminated. A further £75.9m was planned to be borrowed for the HRA Subsidy Buyout as reported to Members on 17th December 2014.

During the period covered by this report a single PWLB loan of £75.9m was raised for the HRA and for the purpose of exiting the Subsidy arrangement. The loan was raised on the 2nd April 2015 at a rate of 4.17% and will be held for 21.6 years. Loan proceeds were transferred to the Welsh Government that resulted in the Authority exiting the Subsidy arrangement. No General Fund borrowing has been undertaken as at 30th September 2015.

Borrowing rates during the reported period have remained volatile and have averaged higher than the forecasted rates as reported in the 2015/16 Treasury Management Strategy, but remain lower than the budget rate. Although Economic recovery in the UK continues to strengthen, falling inflation is considered to be a threat towards UK economic recovery, as well as external global. Since PWLB rates are priced off UK Gilts, the trend for Gilt yields remain on an upward path in the medium term with continuing concerns about the Eurozone, and other geo-political events, weighing on risk appetite, while inflation expectations remain subdued. The uncertainties surrounding the timing of UK and US monetary policy tightening, and the Chinese stock market led turmoil, are likely to prompt short term volatility in gilt yields.

During the period covered by this report, PWLB loans to the value of £4.53m were repaid on maturity. Such loans had an average interest rate of 5.46%. £30k of the WRU Loan was also repaid. Total debt outstanding as at 30th September 2015 was £289.4m and comprised of £249.2m PWLB loans; £40m market loans (LOBOs); and £240k WRU loan.

The Authority holds four LOBO (Lender's Option Borrower's Option) loans with a total value of £40m. Two of the four loans have a six monthly interest rate review option. With respect to all four LOBO loans the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. £20m of these LOBOs had options reviewed during quarter one, none of which were exercised by the lender. As at 30th September a further £30m of LOBOS have options that will be reviewed during the remainder of 2015/16 financial year. This represents 10.4% of the Authority's debt portfolio that is subjected to variable interest rate movement, which is within the Council's determination of 30%. The Authority acknowledges there is an element of refinancing risk even though in the current interest rate environment lenders are unlikely to exercise their options.

4.1.2 Rescheduling

The Annual Strategy allows for the utilisation of debt rescheduling providing for both in year and future year savings and additional revenue resources. No rescheduling opportunities presented themselves during the period covered by this report.

4.1.3 Long-Term Investments

During the reported period the Authority was holding £19.6m of long-term investments where the maturity date is greater than 365 days. These investments are in accordance with the new Investment Strategy. The long-term investments comprise of covered bonds with UK banks/ building societies and have an AAA rating. The covered bonds are secured investments and collateralised against the counterparty's assets.

4.1.4 Short-Term Investments (Deposits) – Up to 364 Days

The value of short-term deposits as at 30th September 2015 was £126.5m and is made up of a spread of periods up to 2.5 years. The average rate for these deposits was 0.61%, which is a significant improvement over placing deposits with the Debt Management Office (DMO) who continue to pay a rate of 0.25%. The rate of return is above the target rate, as detailed in the Annual Treasury Management Strategy report to Council, of 0.25%. The improvement in returns reflect the Authority's change in investment strategy and lending to high creditworthy counterparties that consist of banks; building societies; supranational institutions; the DMO, local authorities; and corporates using a range of investment products such as corporate bonds; covered bonds; cash deposits and treasury bills. Whilst the returns have improved, the riskiness of the investment portfolio has been quantified with a weighted average credit score equivalent to an AA rating. The UK government is currently rated by two credit rating agencies at AA+. Therefore the Authority's portfolio is one notch below the UK Government rating.

The portfolio as at 30th September 2015 comprised of the following types of investments:

Counterparty	Investment Product	Sector	£m
Banks	Certificate of Deposits	Financial	19.4
Banks & building societies	Fixed-term cash deposits	Financial	24.0
Banks & building societies	Covered bonds	Financial	9.6
Corporates	Bonds	Automobile/ Transport Infrastructure/ Utilities/ Insurance	24.5
Debt Management Office	Fixed-term cash deposits	UK Government	12.1
Local Authorities	Fixed-term cash deposits	Public sector	1.3
Supranational Institutions	Bonds	Sovereign/ Financial	5.5
UK Government	Treasury Bills	UK Government	30.1
Total Investments as at 30th September 2015			126.5

4.1.5 Economic Outlook

Economic growth slowed in Q1 2015 to 0.4%, year-on-year growth to March 2015 was 2.7%. Q2 2015 GDP growth was confirmed at 0.7%, with year/year growth showing slight signs of slowing, decreasing to 2.4%. GDP has now increased for ten consecutive quarters, breaking a pattern of slow and erratic growth from 2009. The annual rate for consumer price inflation (CPI) briefly turned negative in April, falling to -0.1%, before fluctuating between 0.0% and 0.1% over the next few months. In the August Quarterly Inflation Report, the Bank of England projected that GDP growth will continue around its average rate since 2013. The Bank of England's projections for inflation remained largely unchanged from the May report with them expecting inflation to gradually increase to around 2% over the next 18 months and then remain there in the near future.

The outcome of the UK general election largely fought over the parties' approach to dealing with the consequences of the structural deficit and the pace of its removal, saw some very big shifts in the political landscape and put the key issue of the UK's relationship with the EU at the heart of future politics.

The US economy slowed to 0.6% in Q1 2015 due to bad weather, spending cuts by energy firms and the effects of a strong Dollar. However, Q2 GDP showed a large improvement at a twice-revised 3.9% (annualised). The Fed decided not to act at its September meeting as many had been anticipating to increase interest rates as a result of global economic conditions, but have signalled rates rising before the end of the calendar year.

Eurozone/ Global economies- Whilst the Greek issue has been resolved for now after tense negotiations, global economies continue to remain at risk from economic shocks. August and September saw the Chinese stock market (Shanghai Composite Index) which had risen a staggering 50%+ since the beginning of 2015, dropped by 43% in less than three months with a reported $3.2 trillion loss to investors, on the back of concerns over growth and after regulators clamped down on margin lending activity in an effort to stop investors borrowing to invest and feeding the stock market bubble. In August the People's Bank of China changed the way the yuan is fixed each day against the US dollar and allowed an aggressive devaluation of the currency. This had a negative impact on Asian, European and US markets impacting currencies, equities, commodities, oil and metals. Chinese stocks have recovered marginally since and are trading around the same level as the start of the year. Concerns remain about slowing growth and potential deflationary effects.

Outlook for Q3 and Q4 2015/16: Arlingclose's expectation for the first rise in the Bank Rate (base rate) remains the second calendar quarter of 2016. The pace of interest rate rises will be gradual and the extent of rises limited. The appropriate level for Bank Rate for the post-crisis UK economy is likely to be lower than the previous norm. It is expected that the bank rate will remain between 2.0% and 3.0%. There is also sufficient momentum in the US economy for the Federal Reserve to raise interest rates in 2015, although risks of issues from China could possibly push this back as witnessed in August 2015. Forecasted Bank Rate is shown in the table below.

	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Average
Official Bank Rate														
Upside risk			0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.32
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	1.75	1.75	1.08
Downside risk				-0.25	-0.25	-0.50	-0.50	-0.75	-0.75	-1.00	-1.00	-1.00	-1.00	-0.70

4.1.6 <u>Counterparty Update</u>

All three credit ratings agencies have reviewed their ratings in the past six months to reflect the loss of government support for most financial institutions and the potential for varying loss given defaults as a result of new bail-in regimes in many countries. Despite reductions in government support many institutions have seen upgrades due to an improvement in their underlying strength and an assessment that that the level of loss given default is low.

At the end of July 2015, the Authority's treasury advisors, Arlingclose, advised an extension of recommended durations for unsecured investments in certain UK and European institutions following improvements in the global economic situation and the receding threat of another Eurozone crisis. A similar extension was advised for some non-European banks in September, and certain non-rated UK building societies also being extended.

In September 2015, Volkswagen (VW) was found to have been cheating emissions tests over several years in many of their diesel vehicles. This scandal is still playing out and the full extent of the financial implications yet to become clear, with potential wider economic implications to Germany since the German car making industry accounts for a large chunk of exports (17.9% of Germany's €1.1 trillion in exported goods last year).

The Authority currently holds two VW Financial Services corporate bonds with a total nominal value of £3.7m, which mature in May 2016. Whilst Arlingclose recommend suspending VW (as non-financial corporate bond counterparty) for new investments, the Authority has been advised to hold existing investments with VW until maturity. The ratings of the VW Group were placed on Rating Watch Negative by Fitch, CreditWatch with negative implications by S&P and the outlook revised to negative by Moody's. Moody's also revised the outlook on VW Financial Services to negative.

4.1.7 Local Authority Counterparty Limits

This report seeks to clarify the monetary and duration limits that need to apply when lending to local authorities, which is not clear from Appendix 3 of the approved Treasury Management Strategy 2015/16. In its current wording local authorities are classified under the Government category. For future guidance the Authority can on only lend £5m up to 5 years with a local authority.

4.2 Prudential Indicators

4.2.1 Capital Financing Requirement

The Capital Financing Requirement (CFR) measures the Authority's underlying need to borrow for a capital purpose. In accordance with best professional practice, the Authority does not associate borrowing with particular items or types of expenditure. In practice, the raising and repaying of loans is determined primarily by professional / expert advice, and may not necessarily take place in the relevant year. In order to create an operating environment within which the Treasury Manager can legitimately react to appropriate advice, the various authorised limits as identified in Appendix 1 are set at a level in excess of the CFR. In the financial year to date, the Authority has been operating within the approved limits.

Appendix 2 shows a projected CFR value of £342.66m as at 31st March 2016. The actual CFR as at 31st March 2015 was £273.49m. The increase in the projected CFR is due to the HRA Subsidy buyout and treating the cost of buyout as capital expenditure.

4.2.2 Prudential Indicators – "Prudence"

The Prudential Indicators for Treasury Management are shown in Appendix 1 and the Authority is currently operating within the approved limits.

4.2.3 Prudential Indicators – "Affordability"

There is a requirement to analyse and report the capital financing costs, and express those costs as a percentage of the net revenue streams of the Authority. These are identified in Appendix 2 and currently show a projected reduction from the original budget.

4.2.4 Capital Expenditure and Funding

A summary of capital expenditure and funding is attached at Appendix 3 and shows no change against the planned position. The Capital Strategy Group is currently reviewing this and an update will be provided in the next Treasury Management monitoring report.

5. EQUALITIES IMPLICATIONS

5.1 This report is for information purposes, so the Council's Equalities Impact Assessment (EqIA) process does not need to be applied.

6. FINANCIAL IMPLICATIONS

6.1 As detailed throughout the report.

7. PERSONNEL IMPLICATIONS

7.1 There are no direct personnel implications arising from this report.

8. CONSULTATIONS

8.1 There are no consultation responses that have not been reflected in this report.

9. RECOMMENDATIONS

9.1 Members are asked to note the contents of this report.

10. REASONS FOR THE RECOMMENDATIONS

10.1 Compliance with the CIPFA "Code of Practice for Treasury Management in the Public Services".

11. STATUTORY POWER

11.1 Local Government Acts 1972 and 2003.

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Appendices:
Appendix 1 – Treasury Management Prudential Indicators – Prudence
Appendix 2 – Capital Finance Prudential Indicators – Affordability
Appendix 3 – Capital Expenditure and Funding