CITY OF YORK COUNCIL

Cabinet **5 November 2013**

Report of the Cabinet Member for Finance, Performance and Customer Services

Treasury Management Mid Year Review and Prudential Indicators 2013/14

Summary

1. This Council is required through regulations issued under Part 1 of the Local Government Act 2003 and the revised 2011 (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management (as revised) to provide members with a mid year update on treasury management activities.

2. This report therefore ensures this council is implementing best practice in accordance with the Code. It updates on the Treasury Management activities for the period 1 April 2013 to 30 September 2013 and reviews:

   - An economic update for the 2013/14 financial year to 30 September 2013;
   - 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 2013/14;
   - A review of the Council's borrowing strategy for 2013/14;
   - A review of any debt rescheduling undertaken during 2013/14;
   - A review of compliance with Treasury and Prudential Limits for 2013/14.

Background

3. The Council's Treasury Management function is responsible for the effective management of the Council's investments, cash flows, its banking, money market and capital transactions; the

effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

Economic Background and Analysis

4. The Council's treasury management activities have operated within the following economic background:

a) During 2013/14 economic indicators suggested that the economy is recovering, albeit from a low level. After avoiding recession in the first quarter of 2013, with a 0.3% quarterly expansion the economy grew 0.7% in Q2. There have been signs of renewed vigour in household spending in the summer, with a further pick-up in retail sales, mortgages, house prices and new car registrations;

b) The strengthening in economic growth appears to have supported the labour market, with employment rising at a modest pace and strong enough to reduce the level of unemployment further. Pay growth also rebounded strongly in April, though this was mostly driven by high earners delaying bonuses until after April's cut in the top rate of income tax. Excluding bonuses, earnings rose by just 1.0% y/y, well below the rate of inflation at 2.7% in August, causing continuing pressure on household's disposable income;

c) The Bank of England extended its Funding for Lending Scheme (FLS) into 2015 and sharpened the incentives for banks to extend more business funding, particularly to small and medium size enterprises. To date, the mortgage market still appears to have been the biggest beneficiary from the scheme, with mortgage interest rates falling further to new lows. Mortgage approvals by high street banks have risen as have house prices, although they are still well down from the boom years pre 2008;

d) Turning to the fiscal situation, the public borrowing figures continued to be distorted by a number of one-off factors. On an underlying basis, borrowing in Q2 started to come down, but only slowly, as Government expenditure cuts took effect and economic growth started to show through in a small increase in tax receipts. The 2013 Spending Review, covering only 2015/16, made no changes to the headline Government spending plan, and monetary policy was unchanged in advance of the new Bank of England Governor, Mark Carney, arriving. Bank Rate remained at 0.5% and quantitative easing also stayed at £375bn. In August, the MPC provided forward guidance that Bank Rate is unlikely to change until unemployment first falls to 7%, which was not expected until mid 2016. However, 7% is only a point at which the MPC will review Bank Rate, not necessarily take action to change it. The three month to July average rate was 7.7%.

e) CPI inflation (MPC target of 2.0%), fell marginally from a peak of 2.9% in June to 2.7% in August. The Bank of England expects inflation to fall back to 2.0% in 2015;

5. Economic forecasting remains difficult with so many external influences weighing on the UK. Volatility in bond yields is likely during 2013/14 as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, and safer bonds. The overall balance of risks to economic recovery in the UK is now weighted to the upside after five months of robust good news on the economy. However just how long this period of strong economic growth will last is unknown, and it remains exposed to vulnerabilities in a number of key areas. The longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries.

6. Near-term, there is some residual risk of further Quantitative Easing (QE) if there is a dip in strong growth or if the MPC were to decide to take action to combat the market’s expectations of an early first increase in Bank Rate. If the MPC does takes action to do more QE in order to reverse the rapid increase in market rates, especially in gilt yields and interest rates up to 10 years, such action could cause gilt yields and PWLB rates over the next year or two to significantly undershoot the forecasts in the table below.

7. Capita Asset Services (formerly known as Sector Treasury Services) – the Council’s treasury management advisers – undertake regular review of its interest rate forecasts and have revised their view to reflect expectations for the first change in Bank Rate in the UK being dependent when unemployment is likely to fall to 7%. Capita Asset Services take the view that the unemployment rate is not likely to come down as quickly as the financial markets are currently expecting and that the MPC view is more realistic. Prospects for any increase in Bank Rate before 2016 are therefore seen as being limited. However, some forecasters are forecasting that even the Bank of England

forecast is too optimistic as to when the 7% unemployment level will be reached and so do not expect the first increase in Bank Rate until spring 2017. Table 1 is Capita's Asset Services Interest Rate forecast for both the bank rate and long term Public Works Loans Board borrowing rates (PWLB – the Debt Management Office subsidiary lending to Local Authorities at preferential rates note all figures are percentages):

	Sep 13	Dec 13	Mar 13	Jun 14	Sep 14	Dec 14	Mar 15	Jun 15	Sep 15	Dec 15	Mar 16	Jun 16
Bank Rate	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
5 Yr PWLB	2.5	2.5	2.5	2.6	2.7	2.7	2.8	2.8	2.9	3.0	3.2	3.3
10 Yr PWLB	3.7	3.7	3.7	3.7	3.8	3.8	3.9	4.0	4.1	4.2	4.3	4.4
25 Yr PWLB	4.4	4.4	4.4	4.4	4.5	4.5	4.6	4.7	4.8	4.9	5.0	5.1
50 Yr PWLB	4.5	4.4	4.4	4.4	4.5	4.6	4.7	4.8	4.9	5.0	5.1	5.2

Table 1: Capita Asset Services – Treasury Management Advisers – Interest Rate Forecast (%)

8. Table 2 shows the latest projections of bank rate for other economic forecasters against Capita's current forecast for context to provide a view as to the market expectations of the bank rate:

	Sep 13	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14	Mar 15	Jun 15	Sep 15	Dec 15	Mar 16	Jun 16
Bank Rate	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Capita	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
UBS	0.5	0.5	0.5	0.5	0.5	0.5	-	-	-	-	-	-
Capital Economics	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	-	-

Table 2: Base Rate Forecast – Economic Forecasters

Annual Investment Strategy

9. Treasury Management Strategy Statement (TMSS) for 2013/14 was approved by Council on 23 February 2013. 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 the changes already approved. The Council's Annual Investment Strategy, which is incorporated in the Strategy, outlines the Council's investment priorities as follows:
    - security of capital
    - liquidity
    - yield

    The Council continues to aim to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity.

10. Investments are placed with highly credit rated financial institutions using the creditworthiness matrices described in the Treasury Management Strategy, which includes sovereign credit ratings from the rating agencies, individual institution credit ratings from the respective credit ratings agencies and the credit default swap (CDS) overlay information provided by Capita.

11. During the period under review, the continued unsettled economic climate coupled with a risk averse approach in light of continued credit caution made it appropriate to keep investments short term with a maximum duration of 1 year for financial institutions. This limit applies to all entities in which the Council is considering investing.

12. Investments held during the first six months of 2013/14 were in accordance with Capita's creditworthiness matrices and changes to Fitch and Moody's credit ratings, remained within the Council's approved credit criteria limits contained in the Annual Investment Strategy.

Investment Portfolio

13. Investment rates available in the market have continued at historical low levels. The average level of cash balances available for investment purposes in the 6 months of 2013/14 was £63.661m (£43.418m in 12/13). The level of cash balances available is largely dependent on the timing of the Council's cash flow as a result of precept payments, receipt of grants, borrowing, payments to its suppliers of goods and services and

spend progress on the Capital Programme. These funds are therefore available on a temporary basis dependant on cash flow movement.

14. The average level of cash balances has increased compared to a year ago due to the profile of payments to the Council from the DCLG specifically in relation to the RSG. This is balanced off to an extent by the use of cash balances instead of taking long term debt to finance the Councils capital programme. This strategy remains a prudent one as investment rates continue to be significantly lower than borrowing rates.

15. Investment return (calculated as the amount of interest earned against the average cash balance for the period) during the first six months of 2013/14 is shown in table 3:

	2012/13 (full year)	**2013/14 (part year)**
CYC Rate of return	1.461%	0.539%
Benchmarks		
Bank of England Base Rate	0.500%	0.500%
7 Day LIBID	0.394%	0.362%
30 Day LIBID	0.428%	0.367%

Table 3: CYCs investment rate of return performance vs. benchmarks

16. The average rate of return is lower in 2013/14 than it was a year ago due to the investment return yield curve being flat and offering little by way of returns on investments up to 1 year in duration. The higher rate investments that were contributing significantly to the 1.461% rate of return in 2012/13 have now matured leaving the Council holding only short term investments.

17. Figure 1 shows the interest rates available on the market between 7 days and 1 year and also the rate of return that the Council has achieved for the first six months of 2013/14. It shows that favourable / competitive interest rates have been obtained for investments whilst ensuring the required liquidity and security of funds for the Council.

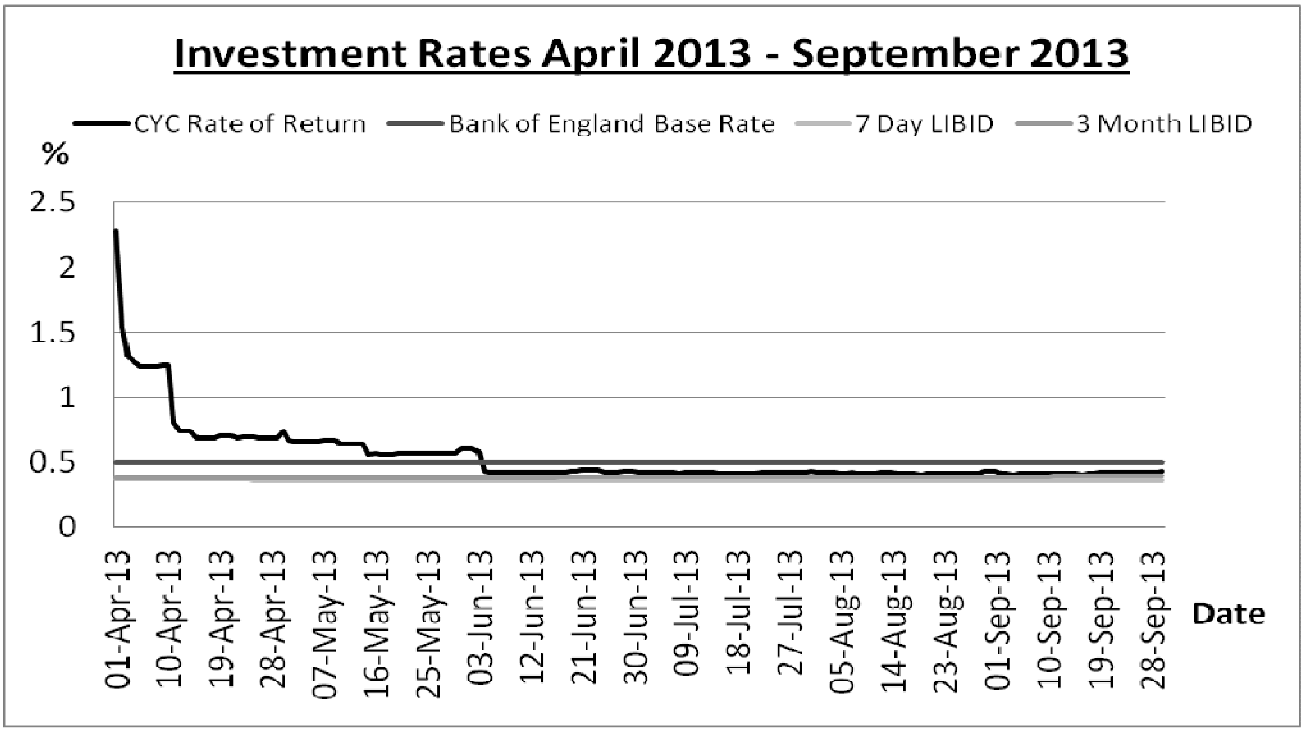

Figure 1 CYC Investments vs Money Market Rates

18. Figure 1 also shows the interest rates available for investment have remained flat over the course of the year to date. The main driver of this as set out above is the uncertainty over the rate of economic recovery and the continued impact of the excess liquidity being provided to the market by Central Banks, such as the £80bn made available to UK Banks through the Funding for Lending Scheme at rates of around 0.5%.

19. Figure 2 shows the investments portfolio by type split deposits in short term call accounts, fixed term investments and money market funds (MMFs). All of the MMFs are have an AAA credit rating, the call accounts are all A or AA- rated and the fixed terms investments are A rated.

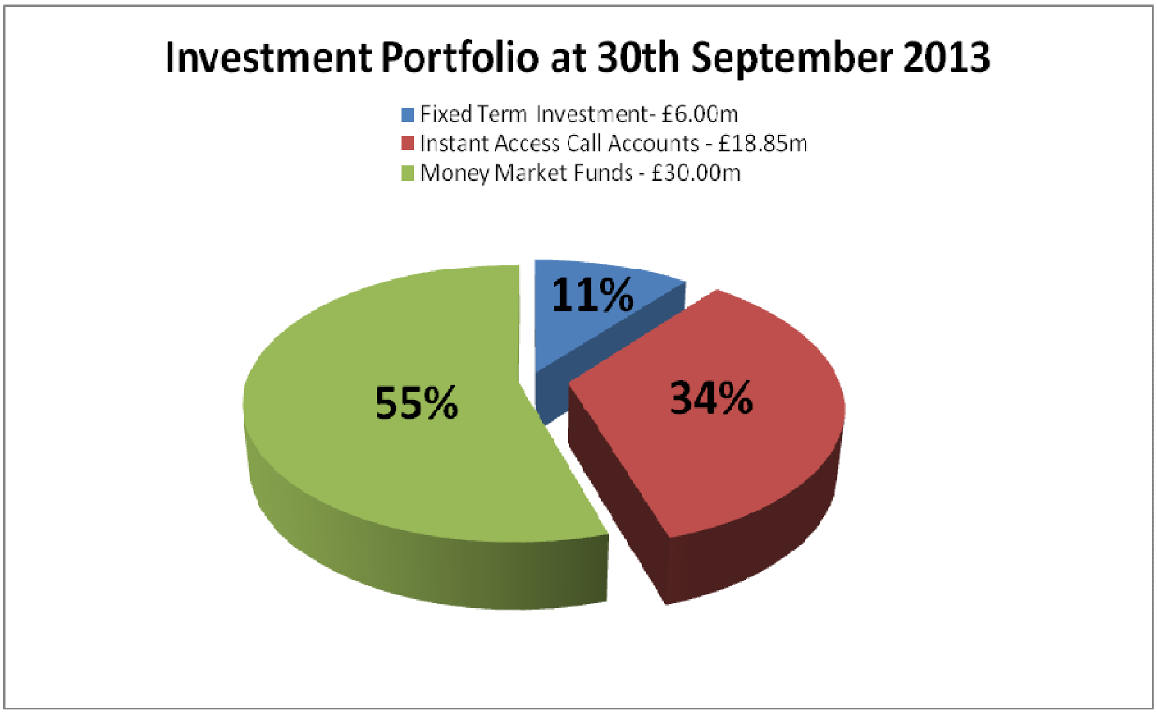

Figure 2 Investment Portfolio by type at 30 September 2013

Borrowing Portfolio

20. The Council undertakes long term borrowing in accordance with the investment requirements of the capital programme and all borrowing is therefore secured for the purpose of its asset base.

21. The level of borrowing taken by the Council is determined by the Capital Finance Requirement (the Councils underlying need to borrow for capital expenditure purposes). Borrowing needs to be affordable, sustainable and prudent and the treasury management budget supports the borrowing finance costs in the longer term.

22. Under regulation, the Council can borrow in advance of need in line with its future borrowing requirements in accordance with the Capital Financing Requirement. The markets will continue to be closely monitored to ensure that advantage is taken of favourable rates in 2012/13 and the increased borrowing requirement is not as dependant on interest rates in any one year.

23. On the reverse side, the Council's level of borrowing can also be below the Capital Financing Requirement. This would mean that instead of increasing the Council's level of borrowing, surplus funds held for investment purposes would be utilised instead, decreasing the level of surplus funds being available for

investment. In the current interest rate environment where investment rates on holding investments are below borrowing rates consideration is given to the value of taking borrowing or whether it is better for the council to keep investment balances lower.

24. The treasury management function has not taken any new borrowing during 2013/14 but continues to closely monitor the borrowing environment for opportunities that arise and receive regular updates from Capita services in respect of borrowing timings and amounts.

25. The Council's long-term borrowing started the year at a level of £258.6m. No loans are due for repayment in this financial year and new borrowing has been taken in the 1st 6 months of 2012/13. The HRA amounts to 54% of the borrowing portfolio at £139.944m and the GF is 46% with borrowing at £118.671m, a total of £258.615m. Table 4 shows the Council's opening borrowing position, movements and current position for debt split by fund:

	General Fund	Housing Rev Acc	Total	Interest Rate
	£m	£m	£m	%
Opening Debt April 13	**118.671**	**139.944**	**258.615**	**3.76**
Repaid	0.000	0.000	0.000	0.00
New	0.000	0.000	0.000	0.00
Closing Debt Sept 13	**118.671**	**139.944**	**258.615**	**3.76**

Table 4 – CYCs current debt position September 13

26. Figure 3 illustrates the 2013/14 maturity profile of the Council's debt portfolio to 30 September 2013 split by general fund and HRA. The maturity profile shows that there is no large concentration of loan maturity in any one year, thereby spreading the interest rate risk dependency

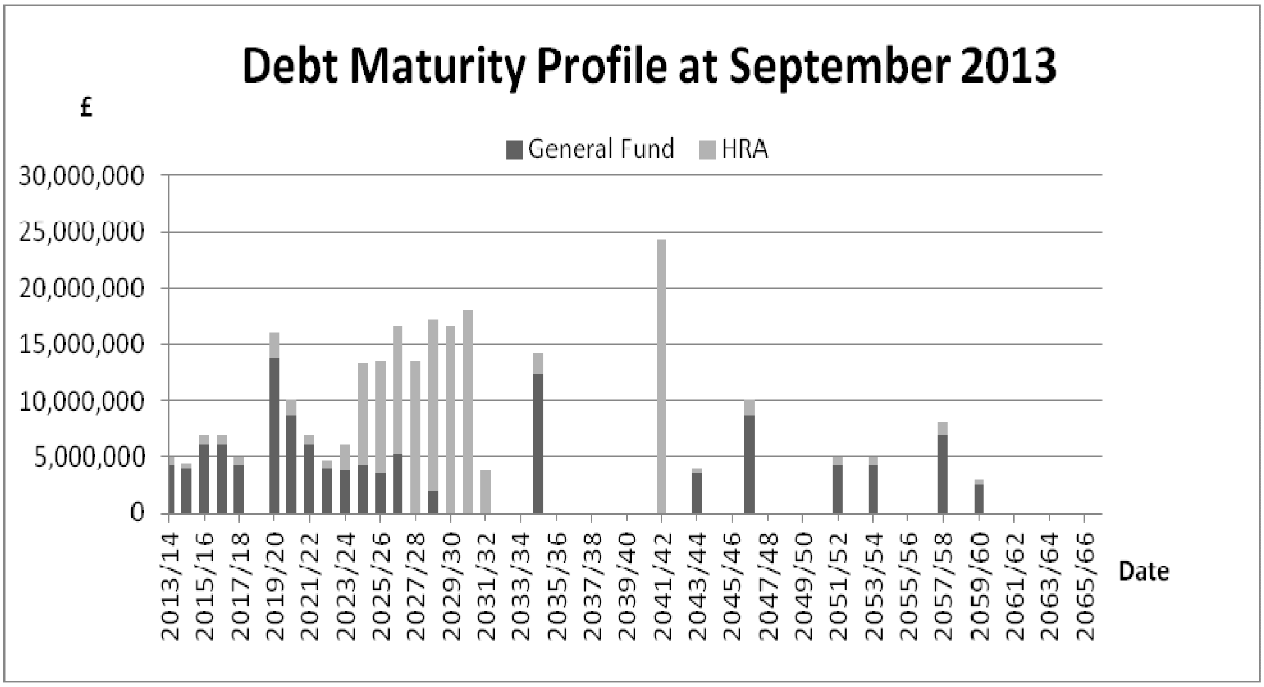

Figure 3 – Debt Maturity Profile 13/14

27. Capita Asset Services forecast that overall future Public Works Loans Board (PWLB) rates will begin to rise from their current position across all durations from September 14 onwards (as shown in table 1). As ever there is still expected to be volatility in the market over the coming months were opportunities may present themselves for borrowing at advantageous levels.

28. In general, gilt yields (on which PWLB rates are based) have risen during the year as shown in table 4, however as the year to date high and low value demonstrate there has been significantly fluctuations to the end of September 13. This is highlighted in the 3.5-4 yrs, 4-4.5 yrs and the 9.5-10 years that all have spreads of over 1%. Table 4 shows the variations in PWLB borrowing rates over the course of the year to date:

	PWLB borrowing rates by duration of loan (years)							
	1	**1-1.5**	**2.5-3**	**3.5-4**	**4-5.5**	**9.5-10**	**24-25**	**49.5-50**
2 Apr 13	1.12	1.15	1.35	1.53	1.75	2.84	4.08	4.23
30 Sept 13	1.30	1.42	1.87	2.19	2.50	3.66	4.45	4.48
Yr High	1.39	1.53	2.06	2.43	2.78	3.98	4.67	4.70
Yr Low	1.11	1.12	1.25	1.41	1.61	2.58	3.78	4.07

Yr Avg	1.25	1.33	1.67	1.94	2.21	3.34	4.34	4.44
Spread	0.28	0.41	0.81	1.02	1.17	1.40	0.89	0.63

Table 4 – PWLB Borrowing Rates (%) – to 30 September 13

29. Figure 4 shows the fluctuation in PWLB rates since April 2011 to the end of September 2013. PWLB rates remain relatively low at today's values compared to the historic levels seen over the last 5 years. The triangles highlight when new borrowing was taken in the financial year 2011/12.

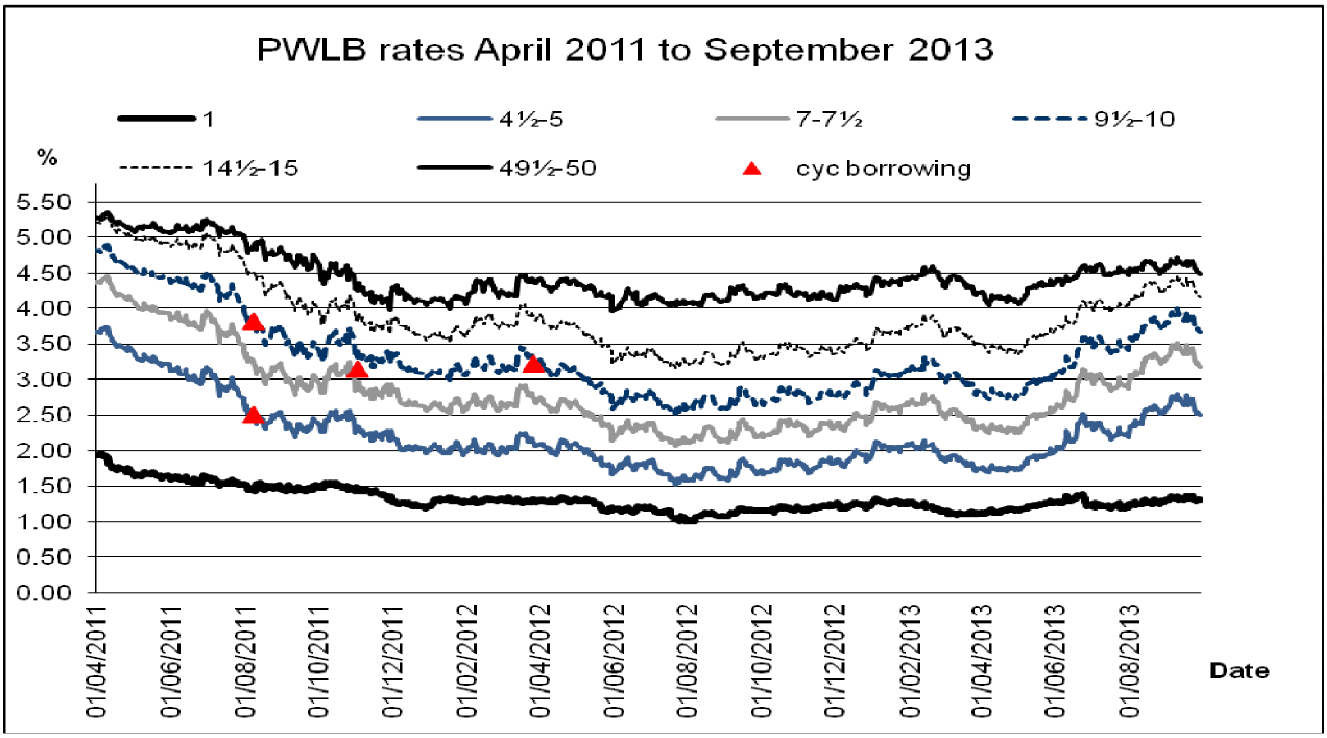

Figure 4 – PWLB rates vs CYC Borrowing Levels

Compliance with Prudential Indicators

30. The Prudential Indicators for 2013/14, included in the Treasury Management Strategy Statement are based on the requirements of the Council's capital programme and approved at Council on 23 February 2013.

31. It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits" included in the Prudential Indicators. The monitoring of the Prudential Indicators

is attached at Annex A. During the financial year 2013/14 to date the Council has operated within the treasury limits and Prudential Indicators set out.

Consultation and Options

32. The report shows the six month position of the treasury management portfolio in 2012/13. The treasury management budget was set in light of the council's expenditure plans and the wider economic market conditions, based on advice from Capita - the Council's Treasury Management advisors. It is a statutory requirement to provide the information detailed in the report.

Analysis

33. The report is a statutory requirement and as such there are no specific options to analyse.

Council Plan

34. The Council Plan has five priorities which all require a budget to achieve. The treasury management function aims to achieve the optimum return on investments commensurate with the proper levels of security, and endeavours to minimise the interest payable by the Council on its debt structure. It thereby contributes to all Council Plan priorities.

Financial

35. The financial implications are in the body of the report.

Human Resources Implications

36. There are no HR implications as a result of this report.

Equalities

37. There are no equalities implications as a result of this report.

Legal Implications

38. Treasury Management activities have to conform to the Local Government Act 2003, the Local Authorities (Capital; Finance and Accounting) (England) Regulations 2003 (SI 2003/3146), which specifies that the Council is required to have regard to the

CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice and also the *Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008* (SI 2008/414), which clarifies the requirements of the Minimum Revenue Provision guidance.

Crime and Disorder Implications

39. There are no crime and disorder implications as a result of this report.

Information Technology Implications

40. There are no IT implications as a result of this report.

Property Implications

41. There are no property implications as a result of this report.

Risk Management

42. The Treasury Management function is a high-risk area because of the level of large money transactions that take place. As a result of this there are procedures set out for day to day treasury management operations that aim to reduce the risk associated with high volume high value transactions. These are detailed in the Treasury Management Strategy Statement at the start of each financial year.

Recommendations

43. Members are required, in accordance with the Local Government Act 2003 (revised), to:
    - Note the Treasury Management activities in 2012/13
    - Note the Prudential Indicators set out at Annex A and note the compliance with all indicators.

Reason – to ensure the continued performance of the Council's Treasury Management function.

Appendix A

Contact Details

<table>
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<tr><td colspan="3">Wards Affected:</td><td>All</td><td>√</td></tr>
<tr><td colspan="5">For further information please contact the author of the report</td></tr>
</table>

Annexes

Annex A – Prudential Indicators 2013/14