



FLINTSHIRE COUNTY COUNCIL

TREASURY MANAGEMENT

MID YEAR REPORT 2013/14

1.00 PURPOSE OF REPORT

- 1.01 To provide members with a mid year update on matters relating to the Council's Treasury Management function.

2.00 BACKGROUND

- 2.01 Treasury management comprises the management of the Council's 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.
- 2.02 The Council's primary objectives for the investment of its surplus funds are to protect the principal sums invested from loss, and to ensure adequate liquidity so that funds are available for expenditure when needed. The generation of investment income to support the provision of local authority services is an important, but secondary, objective.
- 2.03 The Council's policy is to appoint external consultants to provide advice on its treasury management function. The current external adviser is Arlingclose Ltd.
- 2.04 The Council has adopted the 2011 edition of the CIPFA Treasury Management in the Public Services: Code of Practice, which requires the Council to approve a treasury management strategy before the start of each financial year, a mid-year report, and an annual report after the end of each financial year.
- 2.05 In addition, the Welsh Government (WG) Guidance on Local Government Investments recommends that local authorities amend their investment strategies in light of changing internal or external circumstances.
- 2.06 This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the WG Guidance.
- 2.07 The Council approved the 2013/14 Treasury Management Strategy at its meeting on 1st March 2013.

3.00 ECONOMIC & INTEREST RATE REVIEW APRIL – SEPTEMBER 2013.

Provided by Arlingclose Ltd the Council's Treasury Management advisors.

Growth: The UK economy showed some improvement, with consumer spending boosting growth. GDP for the first quarter of 2013 was +0.3% and for the second quarter was +0.7%. Recent data suggests a similar rate in quarter three. Revisions by the Office of National Statistics to GDP back-data showed the UK

avoided a double-dip recession in 2012, but that the downturn in 2008-09 was deeper than previously estimated. Growth is now still over 3% below its peak back in 2007.

Some positive signs for household spending emerged. The deterioration in real earnings growth (i.e. earnings less inflation) slowed, which implied a slower erosion of purchasing power. Consumer confidence improved. Household savings rates remained high, which is unsurprising given the uncertain economic outlook, but appear to be on a downward track, suggesting spending was being driven by borrowing or lower savings. This raises questions about the sustainability of the recovery at these rates of growth.

Inflation: Annual CPI was 2.8% in July. Inflation rose in line with expectations and is expected to remain close to this level throughout the autumn. Further out, inflation should fall back towards the 2% target as external price pressures fade and a revival in productivity growth curbs domestic cost pressures. The oil price (Brent Crude) climbed above \$100/barrel on the back of political unrest in Egypt and the unresolved crisis in Syria.

Monetary Policy: There was no change to UK monetary policy with official interest rates and asset purchases maintained at 0.5% and £375bn respectively. The main development for UK monetary policy was the start of Mark Carney's tenure as Governor and the implementation of forward guidance. Within the August Inflation Report, the Bank stated its forward guidance, the main element of which is to defer monetary tightening until the ILO Unemployment Rate falls below 7% (among a raft of caveats). The Bank projected that the probability of this happening would remain below 50% until 2016. The Governor has had to defend the Bank's guidance in the face of rising financial market expectations on the back of the encouraging economic data.

In his testimony to Congress on 22nd May the US Federal Reserve Chairman Ben Bernanke stated that, if the nascent recovery in the US economy became established, the Fed would reduce its \$85bn monthly asset purchase programme (QE). The apparent movement by the Fed towards tapering its open-ended QE programme prompted extreme asset price volatility in bonds and equities, as investors sought to crystallise gains driven by excessive liquidity. As a consequence, government bond yields spiked. There is a growing expectation that the Federal Reserve will seek to taper asset purchases before the end of the calendar year.

Global: Whilst the outlook for the global economy appeared to have improved over the first half of calendar 2013/14, significant economic risks remain, particularly in China and the Eurozone. The Chinese banking system is facing tighter liquidity conditions as officials seek to slow down rampant credit growth, and, despite the time gained by the ECB to allow individual members and the

Eurozone as a whole to reform their economies, the Eurozone debt crisis has not gone away. The region appears to be dragging itself out of recession and September's German general election passed with little incident but political uncertainties, particularly in Italy, could derail any progress towards a more balanced and stable regional economy. The US recovery appeared to be in train, but a lack of agreement on the federal budget by the end of September caused a partial government shutdown at the start of October, which could have an effect on GDP growth. Political risks also remain regarding the debt ceiling.

Outlook: At the time of writing this activity report in September 2013, the UK economic outlook appears to have improved. The projected path for growth has risen, but remains relatively subdued, with a distinct reliance on household consumption, which itself remains under pressure given the deterioration in real earnings growth, high unemployment and general low confidence.

A variety of other factors will continue to weigh on a domestic recovery, including on-going fiscal consolidation, muted business confidence and subdued foreign demand. While the economic recovery may pick up steam, forward guidance from the Bank of England suggests that monetary policy is unlikely to be tightened until the ILO Unemployment Rate falls below 7%. The Bank projected this level would be reached in 2016.

The table below details the latest forecast for the Bank of England base rate as provided by our advisors Arlingclose:

	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14	Mar 15	Jun 15	Dec 15	Mar 16	Jun 16	Sep 16
Interest Rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%

4.00 BORROWING REQUIREMENTS AND DEBT MANAGEMENT

4.01 PWLB (Public Works Loans Board) Certainty Rate Update.

The Authority qualifies for borrowing at the 'Certainty Rate' (0.2% below the PWLB standard rate) for a 12 month period from 1st November 2012. In August the Authority submitted its application to WG along with the 2013-14 Capital Estimates Return to access this reduced rate for a further 12 months from 1st November 2013.

4.02 Borrowing Activity to 30th September 2013.

The total long term borrowing outstanding, brought forward into 2013/14 totalled £172.1 million. Loans with the Public Works Loans Board are in the form of fixed rate (£143.1m) and variable rate (£10m). The remaining £18.95m is variable in the form of Lobo's (Lender's Option, Borrower's Option). The Council's average borrowing rate is currently 5.42%.

	Balance 1/04/2013 £m	Debt Maturing £m	New Debt £m	Balance 30/09/2013 £m
Capital Financing Requirement	184.6			184.6
Long Term Borrowing	172.1	0.00	0.00	172.1
TOTAL BORROWING	172.1	0.00	0.00	172.1
Other Long Term Liabilities	7.4	0.00	0.00	7.4
TOTAL EXTERNAL DEBT	179.5	0.00	0.00	179.5
Increase/ (Decrease) in Borrowing £m				0.0

4.03 The Capital Financing Requirement (CFR) measures the Authority's underlying need to borrow for a capital purpose. The calculation of the CFR is taken from the amounts held in the Balance Sheet relating to capital expenditure and financing.

4.04 No new long term borrowing has been undertaken so far during 2013/14.

Affordability (interest costs charged on new loans) and the "cost of carry" (costs associated with new loans) remain 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.

4.05 Loans at Variable Rates

The extent of variable rate borrowing the Council can potentially undertake is influenced by the level of Reserves and Balances. The interest rate on the Council's £10m variable rate loans averaged 0.545%.

The uncertain interest rate outlook further supports the case for maintaining variable rate debt. As the economy still appears unsettled official interest rates are forecast to remain low for much longer, the Council has determined that exposure to variable rates is warranted. It also assists with the affordability and budgetary perspective in the short-to-medium term.

Any upward move in interest rates and interest paid on variable rate debt would be offset by a corresponding increase in interest earned on the Council's variable

rate investments. The interest rate risk associated with the Council's strategic exposure of £10m is regularly reviewed with our treasury advisor against clear reference points, this being a narrowing in the gap between short and longer term interest rates by 0.5%. This strategic exposure to variable interest rates will be regularly reviewed and, if appropriate, reduced by switching into fixed rate loans.

4.06 Internal Borrowing

Given the significant cuts to local government funding putting pressure on Council finances, the strategy will be to minimise debt interest payments without compromising the longer-term stability of the portfolio.

The differential between the cost of new longer-term debt and the return generated on the Council's temporary investment returns was significant at around 3.5%.

The use of internal resources in lieu of borrowing has therefore continued to be the most cost effective means of funding capital expenditure, with £5.1m utilised for this purpose. This has lowered overall treasury risk by reducing both external debt and temporary investments.

The Council acknowledges that this position is not sustainable over the medium term and borrowing options and the timing of such borrowing continue to be assessed, with current expectations that the Council will need to borrow for capital purposes from 2014/15 onwards.

4.07 Lender's Option Borrower's Option Loans (LOBOs)

The option to change the terms on £18.95m of the Council's LOBOs was not exercised by the lender.

4.08 Debt Rescheduling

During the 2nd quarter of 2013/14, consideration was given to a potential opportunity to reschedule some of the Council's debt. Although the increase in PWLB repayment rates during the quarter lowered the premium that would apply on premature redemption of loans, the premia was still expensive, therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence.

The Head of Finance, in conjunction with the Council's treasury advisors will continue to review any potential opportunities for restructuring the Council's debt in order to take advantage of potential savings as interest rates change and to enhance the balance of the long term portfolio (amend the maturity profile and/or the balance of volatility).

5.0 INTERIM INVESTMENT AND PERFORMANCE REPORT

- 5.01 The Welsh Government's Investment Guidance gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles.
- 5.02 The maximum investments the Authority had on deposit at any one time totalled £83.3m. The average investment balance for the period was £71.1m and the average rate of return was 0.60%, generating investment income of £212k. The investment income received for the reporting period exceeded the budgeted figure of £201k by £11k.
- 5.03 Investments have been made with UK banks and building societies up to periods of 12 months, as well as utilising investment opportunities afforded by money market funds, instant access accounts, Debt Management Office and other Local Authorities.
- 5.04 The average debt balance held was £172.1m and the average rate paid was 5.42%, generating interest payable of £3.506m in line with budget forecasts.

	Investments		Borrowing	
	Interest received £'000	Interest rate %	Interest paid £'000	Interest rate %
Actual	212	0.60	3,506	5.42
Budget	201	0.60	3,506	5.42
Difference	+11	-	-	-

5.06 *Credit Risk (security)*

Counterparty credit quality was assessed and monitored with reference to credit ratings; credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; any potential support mechanisms and share price. The minimum long-term counterparty credit rating outlined in the 2013/14 Treasury Management Strategy was A-/A3/A- across rating agencies Fitch, S&P and Moody's.

Counterparty Update (provided by Arlingclose Ltd)

In April Fitch downgraded the UK's long-term sovereign rating by one notch from AAA to AA+, the second of the rating agencies to do so (Moody's had downgraded the UK's ratings in February to Aa1). Where assigned, local authorities' ratings, which benefit from an uplift due to their close and direct links to central government, were also downgraded.

The proposed sale of 632 Lloyds' branches to the Co-op Bank – referred to as Project Verde – fell through in April. These branches were transferred in September to TSB Bank, a new bank which will be sold through a listing on the stock market in 2014.

In the Chancellor's Mansion House speech on 19th June he signalled his intention to sell the government's stake in the Lloyds Banking Group reasonably soon and a 6% stake was indeed sold to institutional investors on 17th September at a price of 75p. The situation was more complicated with RBS since its problems were greater and reflected in its share price. It appeared that a 'good bank' and 'bad bank' split for RBS was being favoured by the Chancellor and sat behind the announcement concerning the departure of RBS Chief Executive, Stephen Hester, who disagreed with that route.

Moody's placed the RBS's long-term of A3 on review for downgrade on 5th July 2013, amid concerns about the impact of any potential breakup of the bank on creditors. Although the probability of losses remains low there is a possibility of capital impairment especially as the government has clearly indicated that it will not put up any further taxable funds. As a precautionary measure the Council has reduced its maximum duration on RBS investments to overnight.

5.07 *Liquidity*

In keeping with the WAG's Government's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds and call accounts.

5.08 *Yield*

The Council sought to optimise returns commensurate with its objectives of security and liquidity. The Council's investment yield is outlined in 5.02.

6.00 UPDATE ON INVESTMENTS WITH ICELANDIC BANKS

6.01 The Winding up Board of Landsbanki made distributions to the Council as a priority creditor, in February, May and October 2012 totaling £1.76m. A fourth distribution was made in September 2013 bringing the total received to date to £1.95m.

6.02 The Winding Up Board published details of Landsbanki's (LBI's) financial position as at 31st December 2012 on its website. This showed that LBI's assets, including partial repayments already made in respect of priority claims were

greater than the sum of the priority claims. It is therefore still considered likely that UK local authorities will recover 100% of their deposits, although this is still subject to potential future exchange rate fluctuations, which will have an effect on the total amount recovered. The final impact on the Council will not be known until the distribution process is completed which is not likely to be concluded for some years yet.

7.00 COMPLIANCE

- 7.01 The Council can confirm that it has complied with its Prudential Indicators for the period April to September 2013. These were approved on 1st March 2013 as part of the Council's 2013/14 Treasury Management Strategy.
- 7.02 In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during the period April – September 2013/14. None of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.
- 7.03 The treasury function operated within the limits detailed in the 2013/14 Treasury Management Strategy with one exception. The 2013/14 strategy permits investing with counterparties rated at A- for a maximum period of 6 months and a limit of £5m per counterparty (in 2012/13 the strategy was to invest with counterparties rated A or above with a limit of £7m per counterparty).

On the 3rd April 2013 an 'on-call account' investment of £7m was made with a counterparty rated by Moody's at A-, which therefore breached our investment criteria. This was a procedural issue and no loss was incurred by the Council as a consequence. Once the error was discovered action was taken immediately to reduce the investment to the agreed limit of £5m and working practices have since been strengthened.

8.00 OTHER ITEMS

- 8.01 Other treasury management related activity that took place during April – September 2013 includes:
- The Head of Finance received a monthly update on treasury activities.
 - The Treasury Management Annual Report 2012/13 was reported to Audit Committee in July. Cabinet and Council reviewed and approved the report during September.
 - Quarterly Treasury Management updates were reported to the Audit Committee.
 - The Council continues to be an active member of both the CIPFA Treasury Management Forum and the CIPFA Benchmarking Club.

- Internal Audit reviewed the treasury management function and concluded that in their opinion the operation provides a substantial level of assurance.
- The treasury management team are currently assessing the merits of an alternative IT system for recording all treasury management activity. Further updates will be provided in future reports to the Audit Committee.

9.00 CONCLUSION

- 9.01 In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during the first half of 2013/14.
- 9.02 As indicated in this report none of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

