CLACKMANNANSHIRE COUNCIL	**THIS PAPER RELATES TO ITEM 10 ON THE AGENDA**

Report to **Council**

Date: **18th December 2014**

Subject: **Treasury Management Update at 30th September 2014**

Report by: **Chief Accountant**

1.0 Purpose

1.1. The purpose of this report is to present an update of Treasury Management activity for the period to 30th September 2014.

2.0 Recommendations

2.1. It is recommended that the Council note and consider this mid year review of the Council's Treasury Management activities.

3.0 Background

3.1 The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management recommends that members be updated on treasury management activities regularly (TMSS, annual and midyear reports). This report therefore ensures this Council is implementing best practice in accordance with the Code.

3.2 The report covers the following:

- Economic background
- Interest rate forecast
- Outlook
- Annual Investment Strategy
- New borrowing
- Debt Rescheduling
- Compliance with Treasury and Prudential Limits

4.0 Economic background

4.1 After strong UK GDP quarterly growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, (2013 annual rate 2.7%), and 0.7% in Q1, 0.9% in Q2 and a first estimate of 0.7% in Q3 2014 (annual rate 3.1% in Q3), it appears very likely that strong growth will continue through 2014 and into 2015.

4.2 Forward surveys for the services and construction sectors are very encouraging and business investment is also strongly recovering. The manufacturing sector has also been encouraging though the latest figures indicate a weakening in the future trend rate of growth. However, for this recovery to become more balanced and sustainable in the longer term, the recovery needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance.

4.3 This overall strong growth has resulted in unemployment falling much faster through the initial threshold of 7%, set by the Monetary Policy Committee (MPC) last August, before it said it would consider any increases in Bank Rate. The MPC has, therefore, subsequently broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up. The MPC is particularly concerned that the current squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back above the level of inflation in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity, which has languished at dismal levels since 2008, to support increases in pay rates. Most economic forecasters are expecting growth to peak in 2014 and then to ease off a little, though still remaining strong, in 2015 and 2016. Unemployment is therefore expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in pay rates at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

4.4 Also encouraging has been the sharp fall in inflation (CPI), reaching 1.2% in September, the lowest rate since 2009. Forward indications are that inflation is likely to fall further in 2014 to possibly 1%. Overall, markets are expecting that the MPC will be cautious in raising Bank Rate as it will want to protect heavily indebted consumers from too early an increase in Bank Rate at a time when inflationary pressures are also weak. A first increase in Bank Rate is therefore expected in Q2 2015 and they expect increases after that to be at a slow pace to lower levels than prevailed before 2008 as increases in Bank Rate will have a much bigger effect on heavily indebted consumers than they did before 2008.

4.5 The return to strong growth has also helped lower forecasts for the increase in Government debt by £73bn over the next five years, as announced in the 2013 Autumn Statement, and by an additional £24bn, as announced in the

March 2014 Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018/19. However, monthly public sector deficit figures have disappointed so far in 2014/15.

4.6 The Eurozone is facing an increasing threat from weak or negative growth and from deflation. In September, the inflation rate fell further, to reach a low of 0.3%. However, this is an average for all Eurozone (EZ) countries and includes some countries with negative rates of inflation. Accordingly, the ECB took some rather limited action in June to loosen monetary policy in order to promote growth. In September it took further action to cut its benchmark rate to only 0.05%, its deposit rate to -0.2% and to start a programme of purchases of corporate debt. However, it has not embarked yet on full quantitative easing (purchase of sovereign debt).

4.7 Concern in financial markets for the Eurozone subsided considerably during 2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy, (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed.

4.8 In the US the economic outlook continues to look strong with asset purchases ceasing by the end of October 2014. First quarter GDP figures were depressed by exceptionally bad winter weather but growth rebounded very strongly in Q2 to 4.6% (annualised).

4.9 The U.S. faces similar debt problems to those of the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth, although the weak labour force participation rate remains a matter of key concern for the Federal Reserve when considering the amount of slack in the economy and monetary policy decisions.

4.10 Both Japan and China are both causing considerable concern in the marketplace. In Japan, the increase in sales tax in April has suppressed consumer expenditure and growth. In Q2 growth was -1.8% q/q and -7.1% over the previous year. The Government is hoping that this is a temporary blip.

4.11 In China, Government action in 2014 to stimulate the economy appeared to be putting the target of 7.5% growth within achievable reach but recent data has raised fresh concerns. There are also major concerns as to the creditworthiness of much bank lending to corporates and local government during the post 2008 credit expansion period and whether the bursting of a bubble in housing prices is drawing nearer.

5.0 Interest Rate Forecast

5.1 The Council's Treasury Advisors - Capita Asset Services have provided the following interest rate forecast, reviewed on 24th October:

	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.00%	2.25%	2.50%
5yr PWLB rate	2.50%	2.70%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.50%	3.50%	3.50%
10yr PWLB rate	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.20%	4.30%	4.30%
25yr PWLB rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%
50yr PWLB rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%

5.2 During September and October, a further rise in geopolitical concerns, principally over Ukraine but also over the Middle East, plus fears around Ebola and an accumulation of dismal growth news in most of the ten largest economies of the world and also on the growing risk of deflation in the Eurozone, had sparked a flight from equities into safe havens like gilts and depressed PWLB rates. However, there is much volatility in rates as news ebbs and flows in negative or positive ways. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2015 and a slow but steady rise in PWLB rates over the next three years.

6.0 Outlook

6.1 Economic forecasting remains difficult with so many external influences weighing on the UK. Bank Rate forecasts provided by Capita Assets Services and also MPC decisions, will be liable to further amendments depending on how economic data transpires over 2014 and 2015. Forecasts for average earnings beyond the three year horizon will be heavily dependent on economic and political developments.

6.2 Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds. The overall longer trend is for gilt yields and PWLB rates to rise, due to high volume of gilt issuance in the UK, and bond issuance in other major western countries. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

6.3 The overall balance of risks to economic recovery in the UK remains weighted to the downside. Only time will tell just how long this current period of strong economic growth will last as it remains exposed to vulnerabilities in a number of key areas.

6.4 The Eurozone and financial flows from emerging markets in particular pose significant risks and caution must be exercised in respect of all interest rate forecasts at the current time. The general expectation for an eventual trend of gently rising gilt yields and PWLB rates is expected to remain unchanged, as market fundamentals will focus on sheer volume of UK gilt issuance (and also US Treasury issuance) and the price of those new debt issues. Negative (or positive) developments in the EZ sovereign debt crisis could significantly impact safe-haven flows of investor money into UK, US and German bonds and produce shorter term movements away from our central forecasts.

6.5 With interest rates remaining low and an increase in rates not forecast until 2015/16, the Council's opportunities to secure investment returns on any surplus cash are limited.

7.0 Annual Investment Strategy

7.1 The Treasury Management Strategy Statement (TMSS) for 2014/15, which includes the Annual Investment Strategy, was approved by the Council on 15th May 2014. The intention of the Strategy is to provide security of investment and minimisation of risk.

7.2 It can be confirmed that the approved limits within the Annual Investment Strategy were not breached during the 6 months to 30th September 2014. There are no policy changes to the TMSS; the details in this report update the position in light of the updated economic position and budgetary changes already approved.

7.3 In accordance with the code it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As set out in Section 3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. Indeed, the Funding for Lending scheme has reduced market investment rates even further. The potential for a prolonging of the Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment, investment returns are likely to remain low. However the interest rate with the Councils bankers is still favourable at 0.4%.

As at 30th September 2014 the Council held £19.6m of short term investments (£18m at 31 March 2014). The average level of funds available for investment purposes during the half year was £12.4m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of payments, receipt of grants and progress on the Capital Programme.

7.4 The benchmark investment returns over the 6 months ended 30th September 2014 are illustrated in the undernoted table:

Benchmark	Benchmark Return
7 day	0.35%
1 month	0.37%
3 month	0.42%
6 month	0.55%
12 month	0.88%

7.5 The Council's budgeted cash investment return for 2014/15 was 0.59%. The Council achieved an actual investment return of 0.55% for the period to 30th September. This comprised 0.98% return on 12 month deposit outperforming the benchmark by 0.1%, and 0.4% on everyday cash balances which also outperforms the benchmark return for both 7 day and 1 month investments.

8.0 New Borrowing

8.1 In the first 6 months to 30th September 2014 the Council repaid £10m of maturing debt which was budgeted to be replaced. Due to low interest rates, short term temporary borrowing was undertaken to replace this debt. An additional £5m was also undertaken on a short term basis to December 14 to fund budgeted Capital Expenditure. The requirement for which will be reviewed during the second half of the financial year.

8.2 Repayments of £0.6m were also made in the first 6 months of the year toward the Council's PFI and finance lease.

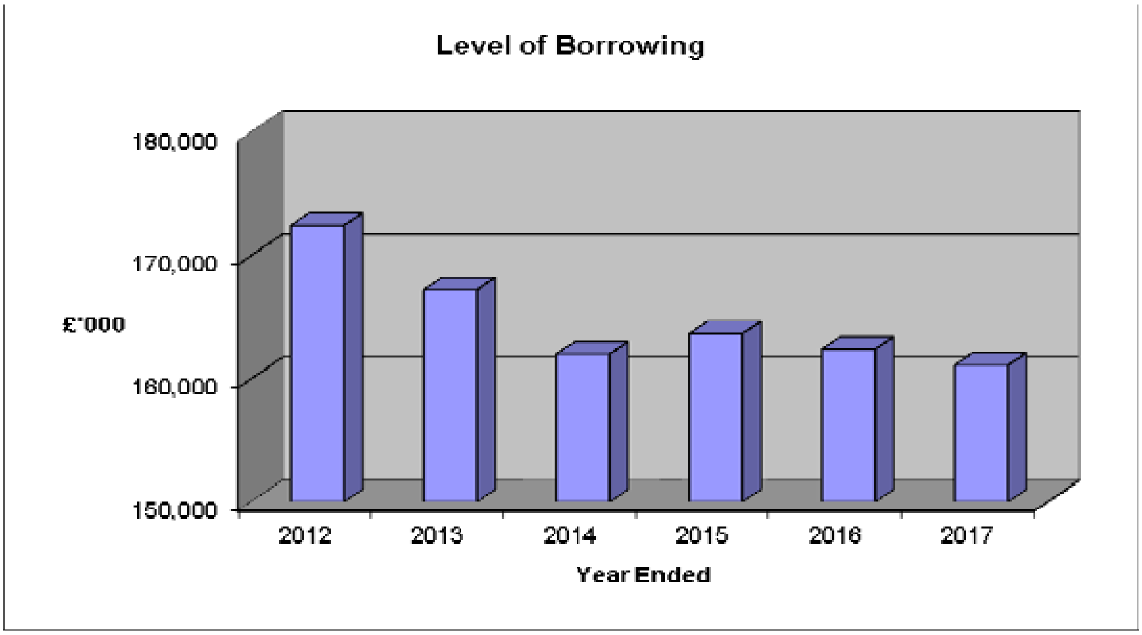
8.3 During the 6months to 30 September the Council invested in a Social Housing Project with a third party and undertook an additional PWLB loan of £2.9m to fund this investment. This loan is fully funded through repayments from the third party and underwritten by the Scottish Government. This therefore increased the Council's long term borrowing by £2.9m.

8.4 The Council's external borrowing position as at 30 September 2014 is illustrated in the undernoted table:

	March 2014 £000	September 2014 £000
Public Works Loan Board	91,702	84,647
Temporary Loans (< 1 year)	0	15,000
Market Loans	24,019	24,019
Other long term liabilities	46,248	45,627
Total	**161,969**	**169,293**

8.5 The Council continues to work towards reducing overall external debt in line with the Treasury Strategy. This is illustrated in the following chart, demonstrating actual and forecast level of debt up to 2016/17. In line with the Treasury Strategy maturing debt in previous years has not been replaced due to the running down of internal cash balances. Cash balances are now at a sufficient level therefore maturing debt in the current and future years is assumed to be replaced however, the repayments towards PFI and finance leases contiunue to reduce the Council's overall level of external debt.

8.6 The level of cash balances and interest rates will continue to be monitored and reviewed if significant changes occurred.



9.0 Borrowing in advance of need

9.1 The Council has not borrowed in advance of need during the 6 months ended 30th September and has no intention to borrow in advance in 2014/15.

10.0 Debt Rescheduling

10.1 Debt rescheduling opportunities have been limited in the current economic climate and following the increase in the margin added to gilt yields which has impacted PWLB rates since October 2010. Consequently no debt rescheduling was undertaken during the year.

11.0 Compliance with Treasury and Prudential Limits

11.1 It is a statutory duty for the Council to determine and keep under review the affordable capital expenditure limits. The Council's Treasury and Prudential Indicators (affordability limits) are included in the approved Treasury Management Strategy Statement.

11.2 During the financial year the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices. The prudential and treasury indicators are shown in appendix 2.

12.0 Conclusions

12.1 Additional long term borrowing of £2.9m was undertaken during the 6 months to 30th September 2014 to fund a long term investment in Social Housing.

12.2 Short term loans totalling £15m were undertaken to repay matured debt and to fund budgeted capital expenditure.

12.3 The Council has repaid £0.6m towards PFI and Finance Leases during the first 6 months of the financial year.

12.4 The Council continues to outperform the benchmark return in interest on investments and cash balances are at a level of c£19.6m which contributes to supporting the Council's capital financing requirement internally.

13.0 Sustainability Implications

13.1 None

14.0 Resource Implications

14.1 Financial Details

14.2 The full financial implications of the recommendations are set out in the report. This includes a reference to full life cycle costs where appropriate.

Yes ☑

14.3 Finance have been consulted and have agreed the financial implications as set out in the report. =

Yes ☑

14.4 Staffing

14.5 None

15.0 Exempt Reports

15.1 Is this report exempt? Yes ☐ (please detail the reasons for exemption below) No ☑

16.0 Declarations

The recommendations contained within this report support or implement our Corporate Priorities and Council Policies.

(1) **Our Priorities** (Please tick ☑)

The area has a positive image and attracts people and businesses	☐
Our communities are more cohesive and inclusive	☐
People are better skilled, trained and ready for learning and employment	☐
Our communities are safer	☐
Vulnerable people and families are supported	☐
Substance misuse and its effects are reduced	☐
Health is improving and health inequalities are reducing	☐
The environment is protected and enhanced for all	☐
The Council is effective, efficient and recognised for excellence	☑

(2) Council Policies (Please detail)

Treasury Management Policy Statement and Practices

17.0 Equalities Impact

17.1 Have you undertaken the required equalities impact assessment to ensure that no groups are adversely affected by the recommendations?

N/A

Yes ☐ No ☐

18.0 Legality

18.1 In adopting the recommendations contained in this report, the Council is acting within its legal powers. Yes ☑

19.0 Appendices

19.1 Please list any appendices attached to this report. If there are no appendices, please state "none".

Appendix 1 – Investment Portfolio as at 30th September 2014

Appendix 2 - Prudential and Treasury Indicators as at 30th September 2014

20.0 Background Papers

20.1 Have you used other documents to compile your report? (All documents must be kept available by the author for public inspection for four years from the date of meeting at which the report is considered)

Yes ☑ (please list the documents below) No ☐

Treasury Management Strategy 2014/15 - report to Council May 2014

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APPENDIX 1: Investment Portfolio as at 30th September 2014

Borrower	Principal (£000)	Interest Rate	Start Date	Maturity Date	Lowest Long Term Rating	Historic Risk of Default
Bank of Scotland Plc	5,000	0.98%	03/10/2013	03/10/2014	A	0.001%
Bank of Scotland Plc	14,611	0.4%	Instant Access		A	0.000%
Other Accounts	36	0%				0%
Total Cash and Cash Equivalents	**19,647**	**0.55%**				**0.0%**

Long Term Investments	Principal (£000)
CSPB Developments Ltd	564
CSPB Investments	1
Clackamannanshire Regeneration	4,906
Coalsnaughton LLP	2,976
Total Long Term investments	**8,447**

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TOTAL INVESTMENTS	**28,094**

APPENDIX 2: Prudential and Treasury Indicators as at 30th September 2014

Treasury Indicators	2014/15 Budget £'000	2014/15 Outturn as at 30th September 14 £'000
Authorised limit for external debt	187,000	187,000
Operational boundary for external debt	175,000	175,000
Gross external debt	160,721	169,293
Investments	18,000	19,610
Net borrowing	142,721	149,683

Maturity structure of fixed rate borrowing – upper and lower limits (excluding PFI and Finance Leases)	Upper and Lower Limits	Fixed Rate Borrowing as at 30th September 13 £'000	% of Total Fixed Rate Borrowing
Under 12 months	25% - 0%	5,000	3.3%
12 months to 2 years	25% - 0%	16,000	10.6%
2 years to 5 years	50% - 0%	11,200	7.4%
5 years to 10 years	75% - 0%	3,769	2.5%
10 years and above	100% - 0%	69,197	45.9%

Prudential Indicators	2014/15 Budget £'000	2014/15 Outturn as at 30th September 14 £'000
Capital expenditure - General Fund Services	14,609	12,725
Capital expenditure - Housing Revenue Account	10,586	10,189
Capital Financing Requirement (CFR) - General Fund	139,563	143,490
Capital Financing Requirement (CFR) - HRA	32,028	31,946
Annual change in CFR - General Fund	3,927	1,346
Annual change in CFR - HRA	883	(82)
In year borrowing requirement	4,810	1,264
Ratio of financing costs to net revenue stream - General Fund	8.05%	8.05%
Ratio of financing costs to net revenue stream - HRA	17.54%	17.12%