Gloucester City Council

Meeting:	**GLT** **Audit and Governance Committee** **Cabinet Briefing**	**30th July 2013** **23rd September 2013** **25th September 2013**
Subject:	**Treasury Management 2012/13 – Quarter 4**	
Report By:	**Report by the Corporate Director Resources**	
Wards Affected:	**All**	
Key Decision:	**No** **Budget/Policy Framework:**	**Yes**
Contact Officer:	**Kevin Buckerfield** **Email: Kevin.buckerfield@gloucester.gov.uk**	**Tel: 396416**
Appendices:	**1. Prudential and Treasury Indicators** **2. Treasury Management Investments**	

1.0 Purpose of Report

1.1 One of the requirements of the revised Code of Practice for Treasury Management in November 2011 recommends that members should be updated on treasury management activities at least twice a year, but preferably quarterly. This report fulfils that requirement.

2.0 Recommendations

2.1 Audit and Governance Committee is asked to Resolve that the report be noted and to approve any changes it may require to the prudential indicators.

3.0 Background

3.1 **During the quarter ended 31st March 2013:**

- Indicators suggest that the economy was very near to a second consecutive quarter of negative growth in Gross Domestic Product (GDP);
- Household spending strengthened, both on and off the high-street;
- Unemployment rose for the first time for a year;
- Inflation remained stubbornly above the Monetary Policy Committee (MPC)'s 2% target;
- Three members of the MPC voted for further Quantitative Easing (QE);
- UK equity prices rose and sterling fell;
- The US economic recovery gathered pace.

3.1.1 It remains touch-and-go whether the UK economy contracted again in the first quarter: if so, it would result in a triple-dip recession. On the basis of past form, the Chartered Institute of Purchasing and Supply (CIPS)/Markit business surveys point to next to no growth in the first quarter of 2013 and the first official sets of output data have been fairly disappointing. Although the index of services rose by a monthly 0.3% in January, this did not fully reverse its drop in December. Meanwhile, industrial production posted a 1.2% monthly fall in January. This was partly driven by lower output in the volatile energy sector, but manufacturing output was down 1.5% on the month too. Note also that unusually bad weather at the end of the quarter may have depressed activity in certain sectors, such as retail and construction.

3.1.2 Household spending appears to have started the year on a stronger footing. The 2.1% monthly rise in retail sales in February more than offset January's 0.7% fall. Non-high street spending has been robust too, with new car registrations up by 7.9% in the year to February.

3.1.3 The latest data tentatively suggested that the labour market's recent resilience is coming to an end. Employment continued to grow, by 131,000 in the three months to January, but this was slower than the 175,000 gain seen in the fourth quarter. The unemployment data was also softer, with the International Labour Organisation (ILO) measure showing a 7,000 rise in unemployment in the three months to January, the first increase in a year. Admittedly, the timelier claimant count measure still fell in February, albeit by a trivial 1,500. Meanwhile, pay growth remained subdued, with the headline (3 month average of the annual rate) measure of earnings falling to 1.2% in January.

3.1.4 Elsewhere, the housing market has been revived a bit by the Bank of England's Funding for Lending Scheme (FLS) which helped to bring down some mortgage rates, primarily on fixed products. The quoted interest rate on a 2-year fixed mortgage at a 90% loan-to-value ratio has fallen around 80 basis-points since the introduction of the FLS back in August 2012.

3.1.5 This is helping to support house prices. Both the Halifax and Nationwide measures reported monthly gains in February, rising by 0.5% and 0.2% respectively. The Halifax measure rose by 1.9% on a 3-month-on-3-month basis, the fastest pace since the beginning of 2010. But there were some early signs of weakness in the housing market in the first quarter. Mortgage approvals as measured by the British Bankers Association (BBA) fell in both January and February, and are now 8% lower compared with the end of last year. But this may be overstating the fall, as smaller lenders, not measured by the BBA figures, have been gaining market share recently. The broader Bank of England data, which also includes non-bank lenders, showed that approvals fell by just 1.6% in January.

3.1.6 On the fiscal front, the public borrowing figures for this year have been flattered by a number of one-offs, including the transfer of the Royal Mail pension fund and the revenues of interest generated by the Bank of England's Asset Purchase Facility. On an underlying basis, however, the Office for Budget Responsibility (OBR) forecast net borrowing of £121.9bn in 2012/13, is basically unchanged from the outturn seen in the last financial year. Underlying borrowing is now not forecast to fall substantially until 2014/15.

3.1.7 This year’s Budget delivered by the Chancellor of Exchequer contained many good individual measures, but they were on a small scale and their overall effect was fiscally neutral. The further 1p cut in corporation tax and the “employment allowance”, which helps to reduce employers’ national insurance contributions, were welcome moves that should help business. But giveaways were matched by further cuts, including a further 1% reduction in departmental spending in the next two fiscal years.

3.1.8 The Budget also contained a reaffirmation of the MPC’s 2% inflation target along with some minor tweaks to the MPC’s remit, which will allow the MPC more flexibility in the communication of its policy. This fell short of speculation that the government could suspend, or even scrap entirely, the 2% inflation target.

3.1.9 Inflation, meanwhile, remained high, with the Consumer Price Index (CPI) measure rising from 2.7% to 2.8% in February. The latest rises have been driven, mainly, by higher energy prices. This reflected a sharp rise in sterling oil prices as well as the final price rise from a “big six” utility company filtering through.

3.1.10 The MPC has said that it would “look through” the latest energy driven price rises when setting monetary policy. Indeed, the minutes of February’s meeting showed that three members of the MPC, including Governor, Mervyn King, voted for further quantitative easing. The size of the Bank’s asset purchase programme has remained at £375bn since November.

3.1.11 Turning to the markets, both UK and global equity prices have rallied since the start of the year, with the FTSE 100 rising from 5,897 to 6,400. Gilt prices were volatile over the quarter, with the yield on 10-year gilts hitting 2.2% in early March, before falling back to 1.72% at the end of the quarter, similar to the level seen at the start of the y

3.1.12 Internationally, the economic recovery in the US appeared to gather momentum over the first quarter. A weighted average of the Institute for Supply Management (ISM) indices is consistent with annualised GDP growth of close to 3%. What is more, the growth in private payrolls accelerated to a 3-month average of 200,000 in February. While the expiry of the payroll tax cut at the start of the year will hit real incomes, the 0.4% rise in underlying retail sales in February looks consistent with consumption growth of 2% annualised.

3.1.13 The Eurozone crisis flared up again at the end of the quarter, after it was agreed that bank deposits could be subject to a “haircut” as part of an international bail-out package for Cyprus. While a bailout package agreed by European Finance Ministers should avert disaster, the episode has raised fears about the safety of bank deposits in other periphery countries. Meanwhile, the underlying Eurozone economy looks weak. On past form the composite Eurozone Purchasing Managers Index (PMI) points to a 0.3% quarterly contraction of GDP in Q1.

3.2 Interest rate forecast

The Council's treasury advisor, Sector, provides the following forecast:

	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%
5yr PWLB rate	1.80%	1.80%	1.80%	1.90%	2.00%	2.10%	2.20%	2.40%
10yr PWLB rate	2.90%	2.90%	2.90%	3.00%	3.10%	3.20%	3.30%	3.50%
25yr PWLB rate	4.10%	4.10%	4.10%	4.20%	4.20%	4.30%	4.40%	4.60%
50yr PWLB rate	4.20%	4.20%	4.20%	4.40%	4.40%	4.50%	4.60%	4.70%

Sector undertook a review of its interest rate forecasts following the issue of the latest Bank of England Inflation Report in February 2013. Sector has left unchanged its forecast for the first increase in Bank Rate to be in March 2015. However, forecasts for Public Works Loan Board (PWLB) rates have been increased as a result of the marked recovery in confidence in equity markets, anticipating stronger economic recovery in America, supported by growth in the Far East. The rise in equity prices has, conversely, resulted in a selloff in bonds and some diminution of the UK as a safe haven from more risky assets. However, towards the end of March, the Cyprus crisis has partially reversed these general trends during the quarter, although this is likely to be a temporary phase – at least, until the next Eurozone crisis!

3.3 Summary Outlook

UK economy

As has become usual, the Bank of England February Inflation Report downgraded its forecasts for growth and pushed back the timing of economic recovery. In addition, it also raised its forecasts for inflation (peaking at 3.2% in Q3 this year) and pushed back the timing of when inflation would fall back to the 2% target rate by eighteen months, to Q1 2016. The Bank has, therefore, continued its trend of correcting it's repeated over optimism on the speed and strength of recovery and it is now forecasting growth reaching about 1.9% in two years time.

In both the Chancellor's Autumn Statement, and then his March budget, he again extended the timetable for reducing the annual budget deficit and total outstanding debt due to weak growth depressing tax revenues and increasing benefit payments. The one slightly more optimistic area has been the housing market, as the Funding for Lending Scheme looks to be having a positive effect in improving the supply of credit via mortgages.

In summary, our concerns around a slowdown in prospects for GDP growth in the western world are as follows: -

UK

- The Bank of England February 2013 Inflation Report has again pushed back the timing of a return to trend growth and the rate at which inflation will fall back towards the target rate of 2%. If quarter 1 2013 results in negative growth, this would be the first triple dip recession since records began in 1955. Over the year to Q4 2012, total growth came in at only 0.2%.

- A fair proportion of UK GDP is dependent on overseas trade; the high correlation of UK growth to US and EU GDP growth means that the UK economy is likely to register weak growth over both 2013 and 2014.

- Consumers are likely to remain focused on paying down debt. Weak consumer sentiment and job fears will all act to keep consumer expenditure suppressed; this will be compounded by inflation being higher than increases in average earnings i.e. disposable income will continue to be eroded.

- The Coalition government is hampered in promoting growth by the need to tackle the budget deficit. However, the March budget did contain measures to boost house building and the supply of mortgages, and brought forward, by one year to April 2014, the start of a £10,000 tax free allowance for incomes.

- Little sign of a co-ordinated strategy for the private sector to finance a major expansion of infrastructure investment to boost UK growth.

- There is a limited potential for more QE in 2013, which would help to keep gilt yields lower than they would be without further QE.

- In February 2013 Moody's downgraded the UK's AAA credit rating one notch to AA+. There was little reaction in financial markets, as this had been widely anticipated. Fitch put its AAA rating on negative watch in March.

Eurozone

- Most Eurozone countries are now battling against negative economic growth in 2013, although Germany is experiencing a resurgence of business confidence and surveys are pointing towards a resumption of growth. Growth prospects, for many Eurozone countries, are poor due to the need to adopt austerity programmes to bring government deficits under control.

- Although market anxiety about Greece has subsided after the agreement to a further major financial support package amounting to nearly €50bn, in December, concerns still remain that the eventual end game could be that Greece is eventually forced to exit (dubbed "Grexit") the Eurozone and to return to the drachma.

- There is also increasing concern that the contraction in Spain's economy and the very high level of unemployment of 25%, similar to Greece's level, could mean that both countries could get into a downward deflationary spiral, which makes achieving fiscal correction increasingly difficult and possibly unachievable. The European Central Bank's (ECB's) pledge to provide unlimited bond buying support for countries that request an official bailout means that market anxiety about Spain and Greece is likely to be subdued in the immediate future. However, the poor economic fundamentals and outlook for both economies could well mean that a

storm in financial markets has only been delayed, not cancelled. Spain has resisted asking for an official national bailout, although it has received financial support to recapitalise its four largest banks.

- The general election in Italy has created a highly unstable political situation where no party can form a viable coalition to govern without the support of the new upstart Five Star anti-austerity party. Five Star has won a blocking vote 25% of seats and has refused to enter a coalition agreement. It looks increasingly likely that there will be another general election – which could have been as inconclusive a result as the first!

- There could therefore be volatility in Spanish and Italian bond yields over the next year, depending on political and economic developments.

- A general election is due in Germany in the autumn of 2013. It currently looks likely that this will lead to little change in current policy on the Euro and support for peripheral countries. However, polls are indicating that 25% of the electorate now favour Germany leaving the Euro and stopping the flow of money from Germany to profligate southern countries. Any further disasters in the Eurozone could see this sentiment increase significantly.

- A bailout for Cyprus was eventually agreed in the last week of March after a traumatic first proposal was resoundingly rejected by the Cypriot Parliament. Financial markets remained largely calm after the final agreement and there has been little evidence to date, of potential contagion to other peripheral Eurozone countries. Slovenia, however, looks increasingly likely to be the next in line for a bailout, so their bond yields have risen. However, huge damage will be done to the Cypriot economy by the fallout from this bailout and many commentators consider it is only a matter of time before another bailout will be needed – or exit from the Euro.

US

- There has been a strong resurgence of confidence in US financial markets as the “fiscal cliff” has been largely averted or postponed. Confidence has bolstered recovery in employment and the housing market and has provided the wider economy with a solid base for optimism looking forward. This is reflected by US equities reaching all time highs.

- The Federal Reserve is unlikely to increase the central rate until 2015, as it has now set a specific target of first reducing unemployment to 6.5% (currently 7.7% at the end of March).

- The housing market is showing signs of having turned a corner, both in price rises and the volume of house sales.

China

- Efforts to stimulate the economy appear to be succeeding. However, there are still concerns around an unbalanced economy, heavily dependent on new investment expenditure, and for a potential bubble in the property sector to burst, as it did in Japan in the 1990s, with its consequent impact on the financial health of the

banking sector. There are also increasing concerns around the potential size, and dubious creditworthiness, of some lending to local government organisations and major corporates during the Government promoted expansion of credit, aimed at protecting the overall rate of growth in the economy since the Lehmans crisis.

3.4 Sector's forward view

- Economic forecasting remains difficult with so many external influences weighing on the UK. Major 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. Equity prices have staged an ongoing rise since mid 2012. Correspondingly, there had been a trend of a fall in bond prices and a rise in bond yields, until the Cyprus crisis reversed this trend in late February. Key areas of uncertainty include:

- 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.

- Failure of Italian political parties to form a viable coalition after the general election due to the blocking vote of the Five Star anti-austerity party, which has refused co-operation with any major party.

- The impact of the Eurozone crisis on financial markets and the banking sector.

- Monetary policy action failing to stimulate growth in western economies.

- The impact of the UK Government's austerity plan on confidence and growth.

- 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 recovery of economic growth.

- The potential for weak growth or recession in the UK's main trading partners - the EU and US;

- The overall balance of risks to economic recovery in the UK remains weighted to the downside. Sector believes that 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. However, near-term, the prospect of further QE is likely to keep gilt yields lower than they would otherwise be. However, any concerns that central banks are getting to the point where they are likely to view the beneficial effects of further QE as being exhausted, could lead to the reversal of this effect.

- Given the weak outlook for economic growth, Sector sees the prospects for any increase in Bank Rate before 2015 as very limited indeed, and the first increase could be even further delayed if growth disappoints.

4.0 Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2013/14, which includes the Annual Investment Strategy, was approved by the Council on 10th April 2013. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield

4.1 The Council will also aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover short term cash flow needs but also to seek out value available in significantly higher rates in periods up to 12 months with highly credit rated financial institutions, using Sector's suggested creditworthiness approach, including sovereign credit rating and Credit Default Swap (CDS) overlay information provided by Sector.

4.2 Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the quarter ended 31st March 2013.

4.3 Investment rates available in the market have continued at historically low levels and have fallen further during the quarter as a result of the Funding for Lending Scheme. The average level of funds available for investment purposes during the quarter was £16.8m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme.

4.4 Investment performance for quarter ended 31st March 2013

Benchmark	Benchmark Return	Council Performance	Investment Interest Earned
7 day	0.36%	1.69%	£70,232

As illustrated, in Qtr 4 the Council outperformed the benchmark by 1.33 basis points (bps). The Council's budgeted investment return for 2012/13 is **£270,000**, and performance for the year to date is £86,000 above budget.

5.0 New borrowing:

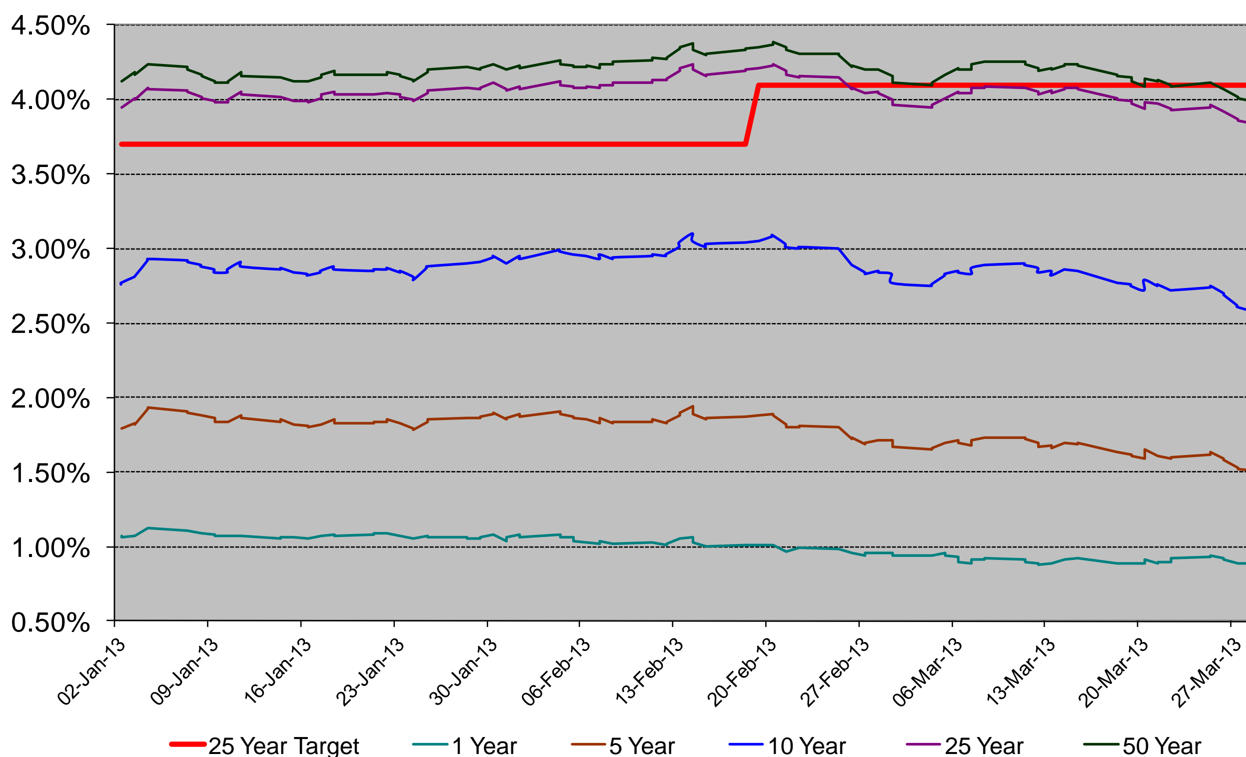
5.1 Sector's 25 year PWLB target rate for new long term borrowing for the quarter was raised from 3.70% to 4.10% in its revised February forecasts.

5.2 No Long-term borrowing was undertaken during the quarter.

5.3 Gilt yields (on which PWLB rates are based), generally rose during the quarter until near the end of February, since when they have fallen back on safe haven flows caused by the Cyprus crisis.

5.4 PWLB certainty rates quarter ended 31.3.2013.

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.88%	1.51%	2.59%	3.84%	3.99%
Date	12/03/13	28/03/13	28/03/13	28/03/13	28/03/13
High	1.12%	1.94%	3.10%	4.24%	4.39%
Date	04/01/13	14/02/13	14/02/13	14/02/13	20/02/13
Average	1.00%	1.78%	2.87%	4.05%	4.20%



5.5 To minimise investment risk, the Council has reduced external investments in lieu of new external borrowing. At the commencement of 2012/13 external investments were £15.8 million and by the year end investments were reduced to £6 million.

5.6 **Borrowing in advance of need.**

This Council has not borrowed in advance of need during the quarter ended 31st March or for the year as a whole.

6.0 Debt Rescheduling

6.1 Debt rescheduling opportunities have been limited in the current economic climate and structure of interest rates following increases in PWLB new borrowing rates in October 2010 and as a result no debt rescheduling was undertaken during the quarter.

7.0 Compliance with Treasury and Prudential Limits

7.1 It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits (affordable capital expenditure limits – Scottish local authorities). The Council's approved Treasury and Prudential Indicators (affordability limits) are included in the approved TMSS.

7.2 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.

8.0 Other

8.1 During 2012/13 the Council has successful moved to an under-borrowing position. In previous years the Council's level of external debt exceeded the capital financing requirement. As at 31st March 2011 this over-borrowing amounted to £23.7m and the position had reduced to £18.5m at 31st March 2012. The position at 31st March 2013 is almost level with a small under-borrowing of £0.6m.

8.2 This under-borrowing reflects that the Council resources such as reserves and provisions will have reduced debt rather than be externally invested. This strategy is sensible, at this point in time, for two reasons. Firstly, there is no differential between the marginal borrowing rate and investment rate so there is nothing to be gained by investing Council resources externally. Secondly, by using the resources to reduce debt the Council will reduce exposure to investment counterparty risk.

9.0 Future Work and Conclusions

9.1 This report presents in summary form the mid year position for prudential indicators and treasury management for 2011/12

10.0 Financial Implications

10.1 As set out in the report

11.0 Legal Implications

11.1 The Local Government Act 2003 sets out a framework of borrowing and investment powers for local authorities. The Prudential Code for Capital Finance in Local Authorities underpins the system of local authority Capital Finance. The code lies at the heart of the prudential system: so long as the Council arranges its affairs prudently in accordance with the code, it has freedom and flexibility to borrow and invest without a requirement for Government permission.

11.2 The Council should therefore ensure that its strategy is compliant with and incorporates the requirements of the Prudential Code.

12.0 Risk & Opportunity Management Implications

12.1 There is a risk long term interest rates will increase more than forecast, resulting in a higher cost of borrowing. The effect of this will be minimised by taking the required borrowing when rates are thought to be at the lowest or before they are expected to rise. As a result of the housing finance reform the cost of HRA borrowing will no longer be met by housing subsidy.

12.2 There is a risk short term rates will reduce faster than forecast, resulting in reduced interest receipts. The effect of this will be minimised, where possible, by 'locking into' higher rates for longer periods.

12.3 The risk of deposits not being returned by the counterparty is minimised by only investing with counterparties on the approved lending list. All counterparties on this list meet minimum credit rating criteria, ensuring the risk is kept extremely low.

13.0 People Impact Assessment (PIA):

Due to this being a report seeking approval on a process not directly involving people, there is no requirement to complete an impact assessment, as discrimination is unlikely to occur with any particular group of people or individuals.

14.0 Other Corporate Implications

14.1 Community Safety
None

14.2 Sustainability
None

14.3 Staffing & Trade Union
None

APPENDIX 1:

Prudential and Treasury Indicators as at 31st March 2013

Treasury Indicators	2012/13 Budget £'000	Quarter 4 Actual £'000
Authorised limit for external debt	£75m	£74.6
Operational boundary for external debt	£73m	£74.6
Gross external debt	£60m	£74.6
Investments	N/A	£5m
Net borrowing	N/A	£69.6m
Maturity structure of fixed rate borrowing - upper and lower limits		
Under 12 months	0% - 85%	41.3%
12 months to 2 years	0% - 85%	0%
2 years to 5 years	0% - 85%	18.4%
5 years to 10 years	0% - 90%	5.7%
10 years and above	5% - 95%	34.6%
Upper limit of fixed interest rates based on net debt	100%	59.2%
Upper limit of variable interest rates based on net debt	100%	40.8%
Upper limit for principal sums invested for over 364 days	£2m	Nil

Prudential Indicators	2012/13 Budget £'000	Quarter 4 Actual £'000
Capital expenditure :- • **HRA** • **GF**	 7,955 5,223	 7,772 5,237
Capital Financing Requirement (CFR) :- • **HRA** • **GF**	 58,156 16,880	 57,942 16,516
Annual change in CFR :- • **HRA** • **GF**	 4,450 0	 4,236 (364)
In year borrowing requirement	Nil	Nil

Incremental impact of capital investment decisions:-		
a) Increase in council tax (band change) per annum.	£3.83	£0.76
b) Increase in average housing rent per week (housing authorities only).	£0.00	£0.35

APPENDIX 2:

Investment portfolio

Investments held as at 31st March 2013 compared to Sector's counterparty list:

Name	£'000	Date of Redemption	Counterparty Limits
One Savings	£3,000	3/05/2013	£5m
One Savings	£2,000	9/05/2013	£5m
Goldman Sachs	£1,000	Overnight	£5m
Total Investments as at 31/3/13	**£6,000**		