

# LEICESTERSHIRE

## FIRE and RESCUE SERVICE

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17

**Meeting:** Combined Fire Authority

**Date:** 10<sup>th</sup> December 2014

**Subject:** Treasury Management Mid-year Review Report 2014/15

**Report by:** The Treasurer

**Author:** Philippa Brown (Accountant)

**For:** Discussion

### 1. Purpose

This report sets out the Combined Fire Authority's (CFA's) Treasury Management activities during the first six months of 2014/15.

### 2. Executive Summary

This mid-year review report is written in conjunction with the CFA's treasury management advisors, Capita Asset Services, and sets out the context within and the results of treasury management activities to date.

### 3. Report Detail

3.1 The CFA operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering maximising investment return.

3.2 The second main function of treasury management is the funding of the CFA's capital plans. These capital plans provide a guide to the borrowing need of the CFA, essentially the longer term cash flow planning to ensure the CFA can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, using longer term cash flow surpluses, and on occasion, any debt previously drawn may be restructured to meet CFA risk or cost objectives.

3.3 Accordingly treasury management is defined as:

*"The management of the Local Authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risk associated with those activities; and the pursuit of optimum performance consistent with those risks."*

3.4 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) was adopted by the CFA on the 15<sup>th</sup> February 2012. The primary requirements of the Code are as follows:

1. The creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the CFA's treasury management activities.
2. The creation and maintenance of Treasury Management Practices which set out the manner in which the CFA will seek to achieve those policies and objectives.
3. The receipt by the CFA of an annual Treasury Management Strategy Statement , including the Annual Investment Strategy and Minimum Revenue Provision Policy, for the year ahead, a **Mid-year Review Report** and an Annual Report (stewardship report) covering activities during the previous year.
4. The delegation by the CFA of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
5. The delegation by the CFA of the role of scrutiny of treasury management strategy and policies to a specific named body. For the CFA the delegated body is the Overview and Scrutiny Committee.

3.5 This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of the 2014/15 financial year.
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy.
- The CFA's capital expenditure (prudential indicators).
- A review of the CFA's investment portfolio for 2014/15.
- A review of the CFA's borrowing strategy for 2014/15.
- A review of any debt rescheduling undertaken during 2014/15.
- A review of compliance with Treasury and Prudential Limits for 2014/15.

### **Economic Update**

#### **3.6 Economic performance to date and outlook**

##### **UK**

After strong UK Gross Domestic Product (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 as 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.

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.

Also encouraging has been the sharp fall in inflation with the Consumer Price Index (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.

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.

### 3.7 **US**

In September, the Federal Reserve continued with its monthly \$10bn reductions in asset purchases, which started in December 2013. Asset purchases have now fallen from \$85bn to \$15bn and were expected to stop on the 29<sup>th</sup> October 2014 providing the economic outlook remains strong. First quarter GDP figures for the US were depressed by exceptionally bad winter weather but growth rebounded very strongly in Q2 to 4.6% (annualised).

The US 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.

### 3.8 **Eurozone**

The Eurozone (EZ) 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 EZ countries and includes some countries with negative rates of inflation. Accordingly, the European Central Bank (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).

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.

### 3.9 China and Japan

Japan is causing considerable concern as the increase in sales tax in April has suppressed consumer expenditure and growth. In Q2 growth was -1.8% quarter on quarter and -7.1% over the previous year. The Government is hoping that this is a temporary blip.

As for 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.

### 3.10 Interest rate forecasts

Capita Asset Services have provided the following forecast:

	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%

Capita Asset Services undertook a review of its interest rate forecasts on the 24<sup>th</sup> October 2014. 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 Public Works Loans Board (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.

The PWLB forecasts are based around a balance of risks. However, there are potential

upside risks, especially for longer term PWLB rates, as follows:

- A further surge in investor confidence that robust world economic growth is firmly expected causing a flow of funds out of bonds and into equities.
- UK inflation being significantly higher than in the wider EU and US causing an increase in the inflation premium inherent to gilt yields.

Downside risks currently include:

- The situation over Ukraine poses a major threat to EZ and world growth if it was to deteriorate into economic warfare between the West and Russia where Russia resorted to using its control over gas supplies to Europe.
- Fears generated by the potential impact of Ebola around the world.
- UK strong economic growth is currently mainly dependent on consumer spending and the potentially unsustainable boom in the housing market. The boost from these sources is likely to fade after 2014.
- A weak rebalancing of UK growth to exporting and business investment causing a weakening of overall economic growth beyond 2014.
- Weak growth or recession in the UK's main trading partner, the EU, inhibiting economic recovery in the UK.
- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
- A resurgence of the EZ sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and EZ governments to deal with the potential size of the crisis.
- Recapitalisation of European banks requiring more government financial support.
- Lack of support by populaces in EZ countries for 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.
- Italy: the political situation has improved but it remains to be seen whether the new government is able to deliver the austerity programme required and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.
- France: after being elected on an anti-austerity platform, President Hollande has embraced a €50bn programme of public sector cuts over the next three years. However, there could be major obstacles in implementing this programme. Major overdue reforms of employment practices and an increase in competitiveness are also urgently required to lift the economy out of stagnation.
- Monetary policy action failing to stimulate sustainable growth in western economies especially the EZ and Japan.
- Heightened political risks in the Middle East and East Asia could trigger safe haven flows back into bonds.
- There are also increasing concerns at the reluctance of western central banks to raise interest rates significantly for some years, plus the huge Quantitative Easing

(QE) measures which remain in place (and may be added to by the ECB in the near future). This has created potentially unstable flows of liquidity searching for yield and therefore heightened the potential for an increase in risks in order to get higher returns. This is a return to a similar environment to the one which led to the 2008 financial crisis.

### **Treasury Management Strategy Statement and Annual Investment Strategy Update**

- 3.11 The Treasury Management Strategy Statement (TMSS) for 2014/15 was approved by the CFA on the 12<sup>th</sup> February 2014. 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 budgetary changes already approved.

### **The CFA's Capital Position (Prudential Indicators)**

- 3.12 This part of the report is structured to update:
- The CFA's capital expenditure plans.
  - How these plans are being financed.
  - The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow.
  - Compliance with the limits in place for borrowing activity.

### **Prudential Indicator for Capital Expenditure**

- 3.13 This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget:

<b>Capital Expenditure</b>	<b>2014/15 Original Estimate £</b>	<b>Spent or Committed as at the 30<sup>th</sup> September 2014 £</b>	<b>2014/15 Revised Estimate £</b>
Vehicles	429,432	459,640	646,893
Property	2,723,956	2,316,528	3,309,136
Other Requirements	331,120	129,643	1,777,327
<b>Total</b>	<b>3,484,508</b>	<b>2,905,811</b>	<b>5,733,356</b>

These changes are explained in detail in the separate report on the Revised Capital Estimate.

### **Changes to the Financing of the Capital Programme**

- 3.14 The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the Capital Programme and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the CFA by way of the Capital Financing Requirement (CFR) although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision or MRP). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	2014/15 Original Estimate £	Position at 30 <sup>th</sup> September 2014 £	2014/15 Revised Estimate £
Financed by:			
Capital Grants	1,233,997	1,048,713	2,215,404
Revenue	138,672	130,171	341,224
Capital Receipts	269,500	133,250	133,250
<b>Total financing</b>	<b>1,642,169</b>	<b>1,312,134</b>	<b>2,689,878</b>
<b>Borrowing need</b>	<b>1,842,339</b>	<b>1,593,677</b>	<b>3,043,478</b>
<b>TOTAL</b>	<b>3,484,508</b>	<b>2,905,811</b>	<b>5,733,356</b>

**Changes to the Prudential Indicators for the Capital Financing Requirement, External Debt and the Operational Boundary**

- 3.15 The table shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period. This is termed the Operational Boundary. The CFA is on target to achieve the original forecast Capital Financing Requirement.

	2014/15 Original Estimate £000	Current Position £000	2014/15 Revised Estimate £000
<b>Prudential Indicator – Capital Financing Requirement</b>			
CFR	24,087	24,187	24,087
<b>Net movement in CFR</b>	<b>(893)</b>	<b>1,606</b>	<b>(893)</b>
<b>Prudential Indicator – External Debt / the Operational Boundary</b>			
Borrowing	19,353	15,728	19,353
Other long term liabilities (finance leases)	6,734	5,757	6,734
<b>Total debt as at the 31st March</b>	<b>26,087</b>	<b>21,485</b>	<b>26,087</b>

**Limits to Borrowing Activity**

- 3.16 The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2014/15 and next two financial years. This allows some flexibility for limited early borrowing for future years. The CFA has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2014/15 Original Indicator £000	2014/15 Actual as at 30 <sup>th</sup> September 2014 £000	2014/15 Revised Indicator £000
Borrowing	19,353	15,728	19,353
Other long term liabilities (finance leases)	6,734	5,757	6,734
Less investments	-3,145	-7,816	-3,145
<b>Net borrowing</b>	<b>22,942</b>	<b>13,669</b>	<b>22,942</b>
<b>CFR (year-end position)</b>	<b>24,087</b>		<b>24,087</b>

The Treasurer reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator and that there is no need to revise the indicator at this stage in the year.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Authorised limit for external debt	2014/15 Original Indicator £000	Current Position £000	2014/15 Revised Indicator £000
Borrowing	21,853	15,728	21,853
Other long term liabilities (finance leases)	7,234	5,757	7,234
<b>Total</b>	<b>29,087</b>	<b>21,485</b>	<b>29,087</b>

No revision to this indicator is felt necessary at this time.

### **Investment Portfolio 2014/15**

3.17 In accordance with the Code, it is the CFA's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the CFA's risk appetite. As set out above, 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.

3.18 The CFA held £7.796m of investments as at the 30<sup>th</sup> September 2014 (this was £5.471m at the 31<sup>st</sup> March 2014) and the investment portfolio yield for the first six months of the year is 0.59%. A full list of investments held as at the 30<sup>th</sup> September 2014 is:

Type of Deposit	Counterparty	Amount	Rate
		£	%
Call account	Santander	£1,354,443	0.4000
Call account	Bank of Scotland	£384,591	0.4000
Fixed Term Deposit	Bank of Scotland	£1,500,000	0.9500
30 day notice call account	Nat West	£518,292	0.5500



Deposit Fund	CCLA	£25,095	0.3695
Fixed Term Deposit	Nationwide	£2,000,000	0.5600
Fixed Term Deposit	Lloyds	£2,000,000	0.7000
Call Account	Nat West	£13,919	0.5000

- 3.19 The Treasurer is required to report that the approved limits within the Annual Investment Strategy were breached during the first six months of 2014/15. It has been difficult on occasion to remain within the limits set and maintain sufficient liquidity and on eighteen days the limits have been breached. The highest % within this period has been 67% with National Westminster Bank when the balance was at £5.287m. The CFA's budgeted investment income for 2014/15 is £62,470. Performance to the end of September is £27,430 which is broadly in line with expectations.

### **Investment Counterparty Criteria**

- 3.20 The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

The main rating agencies (Fitch, Moody's and Standard & Poor's) have through much of the financial crisis provided some institutions with a ratings "uplift" due to implied levels of sovereign support. More recently in response to the evolving regulatory regime, the agencies have indicated they may remove these "uplifts". This process may commence during this financial year. The actual timing of the changes is still subject to discussion, but this does mean immediate changes to the credit methodology are required.

It is important to stress that the rating agency changes do not reflect any changes in the underlying status of the institution or credit environment, merely the implied level of support that has been built into ratings through the financial crisis. The eventual removal of implied Government support will only take place when the regulatory and economic environments have ensured that financial institutions are much stronger and less prone to failure in a financial crisis.

Both Fitch and Moody's provide "standalone" credit ratings for financial institutions. For Fitch, it is the Viability Rating, while Moody's has the Financial Strength Rating. Due to the future removal of sovereign support from institution assessments both agencies have suggested going forward that these will be in line with their respective Long Term ratings. As such there is no point monitoring both Long Term and these "standalone" ratings.

Furthermore, Fitch has already begun assessing its Support ratings with a clear expectation that these will be lowered to 5 which is defined as "A bank for which there is a possibility of external support, but it cannot be relied upon." With all institutions likely to drop to these levels there is little to no differentiation to be had by assessing Support ratings.

As a result of these rating agency changes, the credit element of the future methodology will focus solely on the Short and Long Term ratings of an institution. Rating Watch and Outlook information will continue to be assessed where it relates to these categories. This is the same process for Standard & Poor's that has always been taken but a change to the use of Fitch and Moody's ratings. Furthermore, Credit Default Swaps (CDS) prices will continue to be utilised as an overlay to ratings in the new methodology.

## **Borrowing**

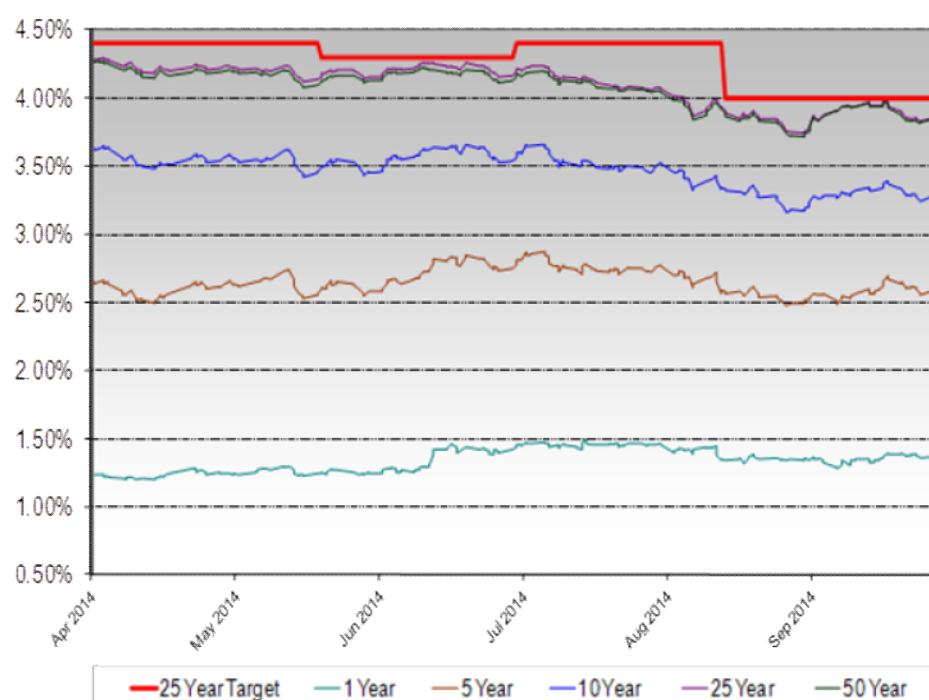
3.21 The CFA's CFR movement relating to 2014/15 is £0.893m downwards with an over-borrowed position from 2013/14 of £0.748m. The CFR denotes the CFA's underlying need to borrow for capital purposes. If the CFR is positive the CFA may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. The tables in 3.22 show that the CFA has current borrowings of £21.485m. The CFA is utilising £0.858m of cash flow funds in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate.

No new long term external borrowing has been undertaken from the PWLB in this financial year to date. A temporary loan of £1m was taken from North Yorkshire County Council from 30/06/2014 to 28/07/2014 at 0.44%. No finance leases have been taken out in 2014/15.

It is anticipated that some long-term and lease borrowing will be undertaken during this financial year.

### 3.22 PWLB certainty rates, half year ended 30th September 2014

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.20%	2.48%	3.16%	3.74%	3.72%
Date	08/04/14	28/08/14	28/08/14	01/09/14	29/08/14
High	1.49%	2.87%	3.66%	4.30%	4.28%
Date	16/07/14	03/07/14	20/06/14	03/04/14	02/04/14
Average	1.35%	2.66%	3.47%	4.10%	4.07%



### **Debt Rescheduling**

3.23 Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. During the first six months of the year no debt rescheduling was undertaken.

#### **4. Report Implications / Impact**

##### **4.1 *Legal (including crime and disorder)***

None.

##### **4.2 *Financial (including value for money, benefits and efficiencies)***

These are included in the main body of the report.

##### **4.3 *Risk (including corporate and operational, health and safety and any impact on the continuity of service delivery)***

The report deals with the results of the attitude to risk adopted by the CFA in its treasury management activities.

##### **4.4 *Staff, Service Users and Stakeholders (including the Equality Impact Assessment)***

None.

##### **4.5 *Environmental***

None.

##### **4.6 *Impact upon Our Plan Objectives***

None.

#### **5. Recommendations**

The CFA is asked to note the Treasury Management activities during the first six months of 2014/15.

#### **6. Background Papers**

- a) Medium Term Financial Plan (CFA Report - 12<sup>th</sup> February 2014).
- b) Financial Budget Monitoring as at the 30<sup>th</sup> September 2014 (Policy Committee Report - 5<sup>th</sup> November 2014).

#### **7. Appendices**

None.