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| REPORT REFERENCE NO. | RC/14/14 |
| MEETING | RESOURCES COMMITTEE |
| DATE OF MEETING | 20 NOVEMBER 2014 |
| SUBJECT OF REPORT | TREASURY MANAGEMENT PERFORMANCE 2014-2015 – MID YEAR REVIEW |
| LEAD OFFICER | TREASURER |
| RECOMMENDATIONS | <p>(a) <i>That it be recommended to the Devon and Somerset Fire and Rescue Authority that changes to credit methodology whereby previous standalone ratings for viability and financial strength and the support ratings will no longer be considered as key criteria in the choice of creditworthy investment counterparties but will be incorporated into Long Term ratings, as outlined in paragraphs 3.7 to 3.11 of report RC/14/14; and,</i></p> <p>(b) <i>Subject to (a) above, that the performance in relation to the treasury management activities of the Authority for 2014-2015 (to September) be noted.</i></p> |
| | <p>The Chartered Institute of Public Finance and Accountancy (CIPFA) issued a Code of Practice for Treasury Management. The Code suggests that members should be informed of Treasury Management activities at least twice a year, but preferably quarterly. This report therefore ensures this Authority is embracing Best Practice in accordance with CIPFA's Code of Practice.</p> |
| RESOURCE IMPLICATIONS | As indicated within the report. |
| EQUALITY IMPACT ASSESSMENT | An initial assessment has not identified any equality issues emanating from this report. |
| APPENDICES | Appendix A – Investments held as at 30 September 2014. |
| LIST OF BACKGROUND PAPERS | Treasury Management Strategy (including Prudential and Treasury Indicators) Report DSFRA/14/3 – as approved at the meeting of the DSFRA meeting held on the 24 February 2014. |

1. INTRODUCTION

1.1 The Treasury Management Strategy for Devon and Somerset FRA had been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) 2011 Treasury Management in Public Services Code of Practice (the Code) and the CIPFA Prudential Code. The most recent revision of the Code was adopted at the meeting of the Devon and Somerset Fire and Rescue Authority (DSFRA) on the 18th February 2013 (Minute DSFRA/53(b) refers). The Authority fully complies with the primary requirements of the Code, which includes:

- The creation and maintenance of a Treasury Management Policy Statement, which sets out the policies and objectives of the Authority's treasury management activities.
- The creation and maintenance of Treasury Management Practices, which set out the manner in which the Authority will seek to achieve those policies and objectives.
- The Receipt by the full Authority 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.
- The delegation by the authority of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

1.2 Treasury management in this context is defined as:

"The management of the local authority'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. "

1.3 The preparation of this report demonstrates that the Authority is implementing best practice in accordance with the code.

2. ECONOMIC BACKGROUND

Economic performance and Outlook

2.1 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 as forward surveys for the services and construction sectors, are very encouraging and business investment is also recovering strongly. The manufacturing sector has also been encouraging though the latest figures indicate a weakening in the future trend rate of growth.

2.2 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.

- 2.3 The MPC has 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.
- 2.4 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.
- 2.5 Also encouraging has been the sharp fall in inflation (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.
- 2.6 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.
- 2.7 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.
- 2.8 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 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).
- 2.9 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.

Capita Interest Rate Forecasts

- 2.9 Capita Asset Services undertook a review of its interest rate forecasts on 24 October. 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.

| | 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% |

3. **TREASURY MANAGEMENT STRATEGY STATEMENT**

Annual Investment Strategy

- 3.1 The Authority's Annual Investment Strategy, which is incorporated in the Treasury Management Strategy Statement (TMSS) was approved by the Authority on the 24th February 2014. It outlines the Authority's investment priorities as follows:
- Security of Capital
 - Liquidity
- 3.2 The Authority will also aim to achieve the optimum return on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep a significant proportion of 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 the Capita suggested creditworthiness matrices, including Credit Default Swap (CDS) overlay information provided by Capita.
- 3.3 A full list of investments held as at 30 September 2014 are shown in Appendix A of this report.
- 3.4 Investment rates available in the market have been broadly stable during the quarter and have continued at historically low levels as a result of the ultra-low Bank Rate and other extraordinary measures such as the Funding for Lending Scheme.
- 3.5 The average level of funds available for investment purposes during the quarter was £37.119m (£33.743m in previous quarter). 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.

| Benchmark | Benchmark Return | Authority Performance | Investment interest to quarter 2 |
|---------------|------------------|-----------------------|----------------------------------|
| 3 Month LIBID | 0.43% | 0.46% | £38,081 |

- 3.6 As illustrated, the Authority outperformed the 3 month LIBID benchmark by 0.03 bp. It is also forecast that the Authority's will exceed the budgeted investment target for 2014-2015 of £0.100m.

Investment Counterparty criteria

- 3.7 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.
- 3.8 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.
- 3.9 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.
- 3.10 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.
- 3.11 As a result of these rating agency changes, it is recommended that the credit element of the Authority's 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 we have always taken, but a change to the use of Fitch and Moody's ratings. Furthermore, we will continue to utilise CDS prices as an overlay to ratings in our new methodology.

Borrowing Strategy

Prudential Indicators:

- 3.12 It is a statutory duty for the Authority to determine and keep under review the "Affordable Borrowing Limits". The Authority's approved Prudential Indicators (affordability limits) are outlined in the approved Treasury Management Strategy (TMSS).

- 3.13 The projected performance against these Indicators is included in a separate report on the agenda for this meeting entitled “Financial Performance Report 2014-2015 – Quarter 2”, which confirms that no breaches of the Prudential Indicators were made in the period to September 2014 and that there are no concerns that they will be breached during the financial year.

Current external borrowing

- 3.14 Total external borrowing with the Public Works Loan Board (PWLB) as at 30 September 2014 stands at £26.059m (£26.214m in previous quarter), forecast to reduce to £25.944m by 31st March 2015 as a result of further principal repayments. All of this debt is at fixed rate with the remaining principal having an average rate/life of 4.231%/31.08 years.

Loan Rescheduling/Borrowing in Advance of Need

- 3.15 External borrowing of £26.059m as at 30 September 2014 exceeds the Capital Financing Requirement (CFR) figure of £23.430m, which reflects that borrowing of £2.629m has been taken out in advance of spending. This is as a result of slippage against the 2013-14 capital programme being more than forecast. At this time this does not represent a breach of prudential indicators, as borrowing is permitted to be above current CFR as long as future CFR estimates for current and next two financial years will utilise these loans. The Authority also maintains an Authorised Limit i.e. £31.120m and as loans fall below this, there is no immediate action required.
- 3.16 It is forecast that capital spending in the next two years will increase the CFR sufficiently to reverse this over borrowing position. However, as discussed at the last meeting of Resources Committee on 1 September 2014, consideration will also be given to the viability of early debt repayment during 2014-15 which would bring the debt figure closer to the CFR figure. Any such repayment would bring benefits in terms of future savings on interest payments but the PWLB would require a premium payment to be made to reflect the early repayment. Our external advisors have already completed a review of our debt portfolio to identify those individual loans which may be subject to early repayment; however their advice at this stage is to await potential further increases in PWLB later in the year which would have the effect of reducing early repayment premium payments.

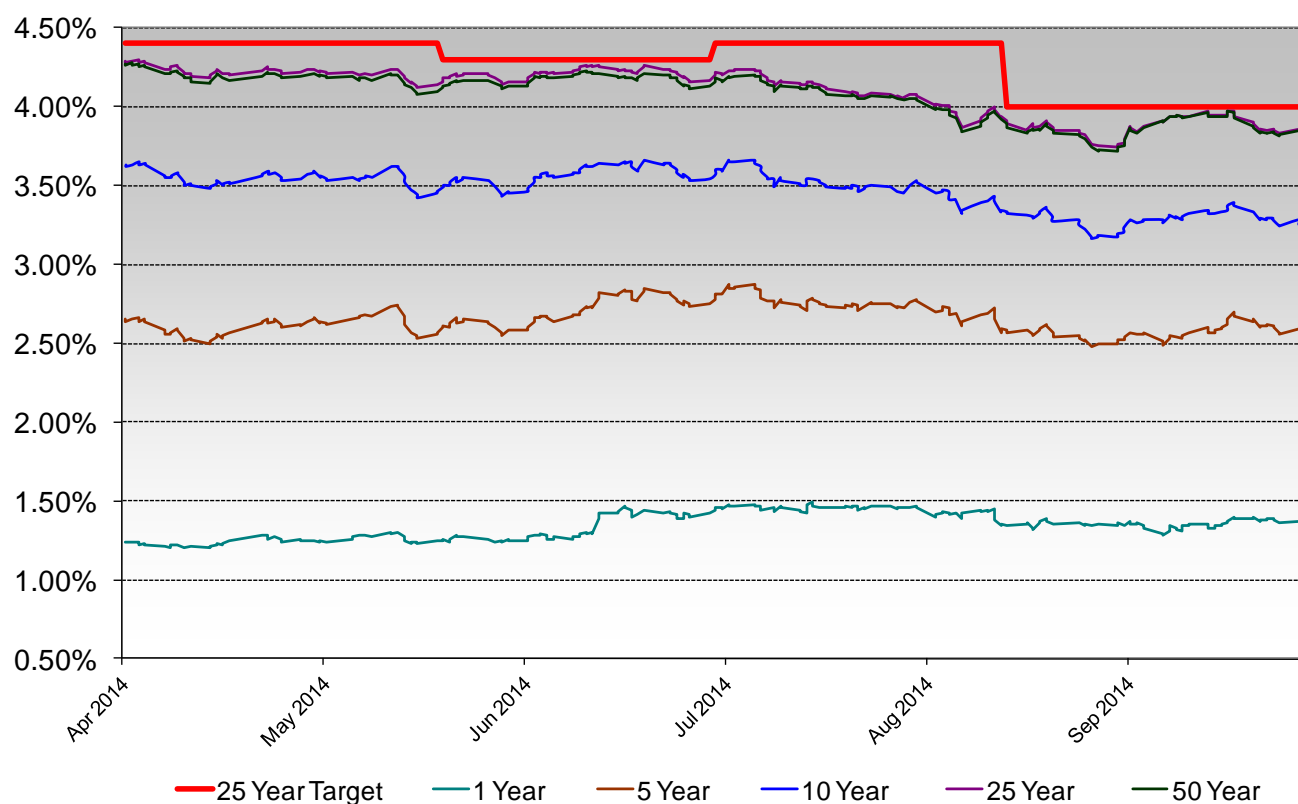
New Borrowing

- 3.17 No new borrowing was undertaken during the quarter and none is planned during 2014-15, as it is forecast that all capital spending will be funded from revenue funding and government grants.
- 3.18 PWLB certainty rates for the quarter ended 30 September 2014 are shown below. DSFRA is eligible to borrow at certainty rates.

PWLB rates quarter ended 30.09.2014

| | 1 Year | 5 Year | 10 Year | 25 Year | 50 Year |
|---------|------------|------------|------------|------------|------------|
| Low | 1.20% | 2.48% | 3.16% | 3.74% | 3.72% |
| Date | 08/04/2014 | 28/08/2014 | 28/08/2014 | 01/09/2014 | 29/08/2014 |
| High | 1.49% | 2.87% | 3.66% | 4.30% | 4.28% |
| Date | 16/07/2014 | 03/07/2014 | 20/06/2014 | 03/04/2014 | 02/04/2014 |
| Average | 1.35% | 2.66% | 3.47% | 4.10% | 4.07% |

3.19 Borrowing rates for the first six months are shown below.



4. SUMMARY

4.1 In compliance with the requirements of the CIPFA Code of Practice of Treasury Management, this report provides members with the Mid-Year report of the treasury management activities for 2014-2015 to September 2014. As is indicated in this report, none of the Prudential Indicators have been breached, and a prudent approach has been taken in relation to investment decisions taken so far, with priority being given to liquidity and security over yield. Whilst investment returns are still low as a consequence of the fall in interest rates, the Authority is anticipating that investment returns will over achieve the budgeted target.

KEVIN WOODWARD
Treasurer

APPENDIX A TO REPORT RC/14/14

| Investments as at 30 September 2014 | | | | | |
|---|------------------------|-----------------------|--------------|-----------------|------------------|
| Counterparty | Maximum to be invested | Total amount invested | Call or Term | Period invested | Interest rate(s) |
| | £m | £m | | | |
| Bank of Scotland | 5.000 | 2.000 | T | 6 mths | 0.70% |
| | | 1.500 | T | 1 yr | 0.95% |
| | | 1.500 | T | 9 mths | 0.80% |
| Barclays | 10.000 | 2.000 | T | 3 mths | 0.61% |
| | | 3.000 | T | 6 mths | 0.61% |
| | | 3.000 | T | 3 mths | 0.48% |
| | | 0.123 | C | Instant Access | Variable |
| Goldman Sachs | 5.000 | 5.000 | T | 6 mths | 0.69% |
| Nationwide B/S | 2.000 | 2.000 | T | 6 mths | 0.63% |
| National Westminster Bank | 5.000 | 5.000 | T | 3 mths | 0.40% |
| Svenska Handelsbanken | 5.000 | 5.000 | C | Instant Access | Variable |
| Federated Prime Rate Money Market Funds | 5.000 | 4.503 | C | Instant Access | Variable |
| Ignis Sterling Liquidity Money Market Fund | 5.000 | 1.000 | C | Instant Access | Variable |
| Black Rock Money Market Fund | 5.000 | 0.044 | C | Instant Access | Variable |
| | | | | | |
| | | | | | |
| Total invested as at 30th September 2014 | | 35.670m | | | |