

DEVON & SOMERSET FIRE & RESCUE AUTHORITY



REPORT REFERENCE NO.	RC/13/12
MEETING	RESOURCES COMMITTEE
DATE OF MEETING	13 NOVEMBER 2013
SUBJECT OF REPORT	TREASURY MANAGEMENT PERFORMANCE 2013-2014 – QUARTER 2
LEAD OFFICER	Treasurer
RECOMMENDATIONS	<i>That the performance in relation to the treasury management activities of the Authority for 2013-2014 (to September) be noted.</i>
EXECUTIVE SUMMARY	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.
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 2013.
LIST OF BACKGROUND PAPERS	Treasury Management Strategy (including Prudential and Treasury Indicators) Report DSFRA/13/3 – as approved at the meeting of the DSFRA meeting held on the 18 February 2013.

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 DSFRA on the 18th February 2013. 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**

Global economy

2.1 Indicators suggested that the economic recovery accelerated during the quarter ended 30 September;

- Household spending growth remained robust;
- Inflation fell back towards the 2% target;
- The Bank of England introduced state-contingent forward guidance;
- 10-year gilt yields rose to 3% at their peak and the FTSE 100 fell slightly to 6460;
- The Federal Reserve decided to maintain the monthly rate of its asset purchases.

Capita Interest Rate Forecasts

2.2 Capita Asset Services undertook a review of its interest rate forecasts in late September as a result of an increase in confidence in economic recovery, chiefly in the US, but more recently, also in the UK and Eurozone. The latest forecast (overleaf) now includes a first increase in Bank Rate in quarter 3 of 2016 (previously quarter 4).

	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%
5yr PWLB rate	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%
10yr PWLB rate	3.70%	3.70%	3.70%	3.80%	3.80%	3.90%	4.00%
25yr PWLB rate	4.40%	4.40%	4.40%	4.50%	4.50%	4.60%	4.70%
50yr PWLB rate	4.40%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%

Summary Outlook

2.3 UK economy

- Growth has been on an upward trend – 0.3% in Q1; 0.7% in Q2 and likely to be much stronger in Q3. The so called double dip recession at the beginning of 2012 was erased by the latest revision of statistics.
- Business surveys, consumer confidence, consumer borrowing and house prices are all on the up and may help to create a wide spread feel good factor. However, this is still a long way away from the UK getting back to sustainable strong growth.
- 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 still vulnerable to what happens in overseas markets.
- Consumer expenditure is likely to remain suppressed 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.
- There is little sign of a co-ordinated strategy for the private Capita to finance a major expansion of infrastructure investment to boost UK growth.
- Government inspired measures to increase the supply of credit to small and medium enterprises (which are key to achieving stronger growth) by banks are not succeeding.

- Gilt yields remain vulnerable to pressures to rise, especially as they are powerfully influenced by US treasury yields and American investors have been spooked by Chairman Bernanke's comments on tapering QE. The Fed's reluctance to start tapering in September has, potentially, only delayed a trend for gilt yields to rise.

2.4 Eurozone

- Most Eurozone countries are now starting to see a return to growth after a prolonged recession. The prospects for growth, at least in the short term, have also improved. However, for some countries, austerity programmes could prove to be a self-defeating spiral of falling demand, tax receipts, and GDP, leading to a rise, not fall, in debt to GDP ratios. Debt ratios in excess of 90% will cause market concern as beyond this level, the costs of servicing such debt becomes oppressive and growth inhibiting. This could, therefore, lead to an inevitable end game in the over the next few years of withdrawal from the Eurozone bloc in order to regain national control of a currency, government debt, monetary policy and, therefore, of setting national interest rates. The ECB's pledge to provide unlimited bond buying support for countries that request an official bailout means that market anxiety about these countries is likely to be subdued in the near term. However, the poor economic fundamentals and outlook for some economies could well mean that an eventual storm in financial markets has only been delayed, not cancelled.
- The European Central Bank (ECB) maintained its central policy rate at 0.5% in this quarter.
- Greece: after the agreement to a further major financial support package amounting to nearly €50bn in December 2012, it now looks almost certain that the country will need another, smaller, bailout package as progress has not been quick enough in rectifying the national finances.
- Spain: there is also increasing concern over the Spanish economy; the social cost and pain of a very high level of unemployment of 27%, similar to the level in Greece, could mean that both countries are approaching the limit of operating austerity programmes within democratic systems. Spain has, to date, resisted asking for an official national bailout, although it has received financial support to recapitalise its four largest banks.
- Italy: the general election created a highly unstable political situation where the two dominant parties initially formed an unlikely coalition due to the blocking power of the new upstart Five Star anti-austerity party which has 25% of seats and has refused to enter a coalition agreement with ANY party. There could therefore be volatility in Spanish and Italian bond yields over the next year, depending on political and economic developments.
- Germany: the general election in September returned Angela Merkel's party to power, but not with an overall majority. It will have to form a coalition, but with a new makeup, as the previous junior party was wiped out.
- Cyprus: the fallout from the bail out in March 2013 has done huge damage to the Cypriot economy and many commentators consider it is only a matter of time before another bailout will be needed – or exit from the Euro.
- The Eurozone remains particularly vulnerable to investor fears of contagion if one country gets into major difficulty.

2.5 US

- There has been a marked improvement in consumer, investor and business confidence this year.
- Unemployment has continued on a steady, but unspectacular decline to 7.3%, but is still a long way from the target rate of 6.5% for an increase in the Fed policy rate.
- The housing market has turned a corner, both in terms of rising prices and in increases in the volume of house sales. More householders are, therefore, escaping from negative equity.
- US equities have reached all time highs.
- The package of tax increases and cuts in Government expenditure starting in 2013 does not appear to be having a major impact on depressing growth.
- GDP in Q1 was disappointingly downgraded from +2.4% to a sub-par +1.8% before rising to 2.5% in Q2.
- The shale gas revolution is providing some solid underpinning to the US economy by enhancing its international competitiveness through cheap costs of fuel.
- There has been a start to the repatriation of manufacturing production from China to the USA as Chinese labour costs have continued their inexorable rise and new forms of high tech production have made home based production more viable and flexible.

2.6 China

- Concerns that Chinese growth could be heading downwards have been allayed by recent stronger statistics. There are still concerns around an unbalanced economy which is heavily dependent on new investment expenditure, and for a potential bubble in the property Capita to burst, as it did in Japan in the 1990s, with its consequent impact on the financial health of the banking Capita.
- There are also increasing concerns around the potential size, and dubious creditworthiness, of some bank lending to local government organisations and major corporates. This primarily occurred during the government promoted expansion of credit, which was aimed at protecting the overall rate of growth in the economy after the Lehmans crisis.

2.7 Japan

- The initial euphoria generated by “Abenomics”, the huge Quantative Easing (QE) operation instituted by the Japanese government to buy Japanese debt, has tempered as the follow through of measures to reform the financial system and introduce other economic reforms, appears to have stalled.

Capita Forward View

- 2.8 Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely during the remainder of 2013/14 as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, and safer bonds.

- 2.9 Near-term, there is some residual risk of further QE - if there is a dip in strong growth or if the MPC takes action to do more QE in order to reverse the rapid increase in market rates, especially in gilt yields and interest rates up to 10 years. This could cause shorter-dated gilt yields and PWLB rates over the next year or two to significantly undershoot the forecasts in the table below. The failure in the US, (at the time of writing), over passing a Federal budget for the new financial year starting on 1 October, and the expected tension over raising the debt ceiling in mid-October, could also see bond yields temporarily dip until any binding agreement is reached between the opposing Republican and Democrat sides. Conversely, the eventual start of tapering by the Fed could cause bond yields to rise.
- 2.10 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. Increasing investor confidence in economic recovery is also likely to compound this effect as a continuation of recovery will further encourage investors to switch back from bonds to equities.
- 2.11 The overall balance of risks to economic recovery in the UK is currently weighted to the upside after five months of robust good news on the economy. However, only time will tell just how long this period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

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 18th February 2013. 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 2013 are shown in Appendix A.
- 3.4 Investment rates available in the market have continued at historically low levels.
- 3.5 The average level of funds available for investment purposes during the quarter was £32.818m (£25.991m 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	0.39%	0.41%	£77,263

- 3.6 As illustrated, the authority outperformed the 3 month LIBID benchmark by 0.02 bp. The Authority's budgeted investment target for 2013-2014 of £0.100m will also be overachieved.

Borrowing Strategy

Prudential Indicators:

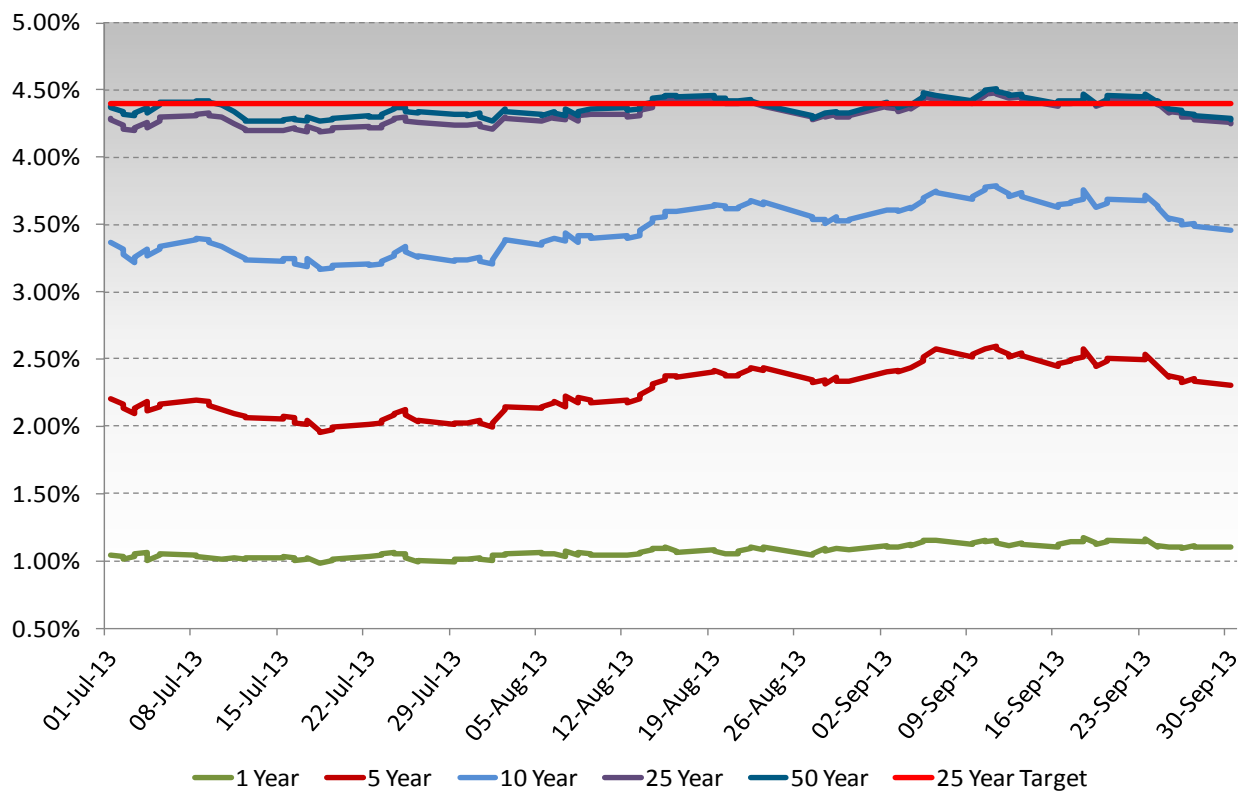
- 3.7 It is a statutory duty for the Authority to determine and keep under review the "Affordable Borrowing Limits". The Authority's approved Prudential Indicators (affordability limits) are outlined in the approved TMSS.
- 3.8 A full list of the approved limits (as amended) are included in the Financial Performance Report 2013-2014, considered elsewhere on the agenda, which confirms that no breaches of the Prudential Indicators were made in the period to September 2013 and that there are no concerns that they will be breached during the financial year.

New Borrowing

- 3.9 Capita's 25 year PWLB target rate for new long term borrowing for the quarter increased from 4.10% to 4.40%. Due to the overall financing position of the capital programme no new borrowing was undertaken during the quarter. External borrowing as at 30 September 2013 was £26.285m (£27.167m in previous quarter). No debt rescheduling was undertaken during this quarter of the year
- 3.10 PWLB certainty rates for the quarter ended 30 September 2013 are shown below. DSFRA is eligible to borrow at certainty rates.

PWLB rates quarter ended 30.9.2013

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.98%	1.95%	3.17%	4.19%	4.27%
Date	18/07/2013	18/07/2013	18/07/2013	18/07/2013	18/07/2013
High	1.17%	2.6%	3.79%	4.48%	4.51%
Date	18/09/2013	11/09/2013	11/09/2013	11/09/2013	11/09/2013
Average	1.07%	2.27%	3.47%	4.32%	4.37%



3.11 It is anticipated that use of internal borrowing and available grants will avoid the need to borrow from the PWLB in year; however this will be subject to certainty rates on offer and the delivery of the capital programme.

4. SUMMARY

4.1 In compliance with the requirements of the CIPFA Code of Practice of Treasury Management, this report provides members with the second quarter report of the treasury management activities for 2013-2014. 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 overachieve the budgeted target.

KEVIN WOODWARD
Treasurer

APPENDIX A TO REPORT RC/13/12

Investments as at 30th September 2013							
% of total investments	Counterparty	Maximum to be invested (£m)	Total amount invested (£m)	Call or Term	Date if Term	Period Invested	Interest Rate
16.23%	Bank of Scotland	5.0	1.500	T	04/10/2013	3mths	0.70%
			1.500	T	02/01/2014	6mths	0.75%
			2.000	T	08/11/2013	6mths	0.80%
22.72%	Barclays	10.0	2.000	T	20/11/2013	3mths	0.45%
			1.000	T	23/10/2013	3mths	0.45%
			2.000	T	10/11/2013	3mths	0.45%
			2.000	T	29/11/2013	6mths	0.53%
6.49%	King & Shaxson	5.0	2.000	T	21/10/2013	3mths	0.28%
16.23%	Black Rock	5.0	5.000	C			Variable
2.64%	Ignis Money Market Fund	5.0	0.812	C			Variable
16.23%	Federated Prime Rate	5.0	5.000	C			Variable
3.25%	Nationwide B/S	1.5	1.000	T	19/12/2013	6mths	0.39%
16.23%	National Westminster	5.0	5.000	T	05/11/2013	3mths	0.80%
			<u>30.812</u>				