Appendix 1

Treasury Management Half Yearly Report - 2013/14

1. Background

The Council 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 security and liquidity initially before considering optimising investment return (yield).

The second main function of a treasury management service is the funding of an authority's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasions any debt previously drawn may be restructured to meet Council risk or cost objectives. Currently, however, the Council has not chosen to finance its capital investment by way of borrowing, so these activities are not presently engaged in.

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 risks associated with those activities; and the pursuit of optimum performance consistent with those risks. "

2. Introduction

The treasury management function is carried out in accordance with the Chartered Institute of Public Finance and Accountancy's (CIPFA) current Code of Practice on Treasury Management (revised November 2011). The original Code was adopted by this Council on 24 February 2010.

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. Receipt by the Full Council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, and an Annual Report (stewardship report) covering activities during the previous year. In addition, the production of a Mid-Year Review Report for scrutiny by Members. For this Council the delegated body to review treasury management and receive the Mid-Year Review Report is the Audit and Risk Committee.
4. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices. For this Council the delegated body is the Cabinet (for implementing) and the Audit and Risk Committee (for monitoring).
5. Delegation by the Council for the execution and administration of treasury management decisions. For this Council this is delegated to the Executive Director (Resources and Support Services).
6. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Transformation and Resources Overview and Scrutiny Committee.

This mid-year Review Report to members is intended to provide a mid-year update of the treasury management strategy and performance for the period April –September of this financial year. It has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the 2013/14 financial year to 30 September 2013
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- A review of the Council's investment portfolio for 2013/14

3. Economic Update – as provided by the Council's Treasury Management Advisors (Capita Asset Services)

3.1 Economic performance to date

During 2013/14 economic indicators suggested that the economy is recovering, albeit from a low level. After avoiding recession in the first quarter of 2013, with a 0.3% quarterly expansion the economy then grew by 0.7% in Q2. There have been signs of renewed vigour in household spending in the summer, with a further pick-up in retail sales, mortgages, house prices and new car registrations.

The strengthening in economic growth appears to have supported the labour market, with employment rising at a modest pace and strong enough to reduce the level of unemployment further. Pay growth also rebounded strongly in April, though this was mostly driven by high earners delaying bonuses until after April's cut in the top rate of income tax. Excluding bonuses, earnings rose by just 1.0% year on year, well below the rate of inflation at 2.7% in August, causing continuing pressure on households' disposable income.

The Bank of England extended its Funding for Lending Scheme (FLS) into 2015 and sharpened the incentives for banks to extend more business funding, particularly to small and medium size enterprises. To date, the mortgage market still appears to have been the biggest beneficiary from the scheme, with mortgage interest rates falling further to new lows. Together with the Government's Help to Buy scheme, which provides equity loans to credit-constrained borrowers, this is helping to boost demand in the housing market. Mortgage approvals by high street banks have risen as have house prices, although they are still well down from the boom years pre 2008.

Turning to the fiscal situation, the public borrowing figures continued to be distorted by a number of one-off factors. On an underlying basis, borrowing in Q2 started to come down, but only slowly, as Government expenditure cuts took effect and economic growth started to show through in a small increase in tax receipts. The 2013 Spending Review, covering only 2015/16, made no changes to the headline Government spending plan, and monetary policy was unchanged in advance of the new Bank of England Governor, Mark Carney, arriving. Bank Rate remained at 0.5% and quantitative easing also stayed at £375bn. In August, the MPC provided forward guidance that Bank Rate is unlikely to change until unemployment first falls to 7%, which was not expected until mid 2016. However, 7% is only a point at which the MPC will review Bank Rate, not necessarily take action to change it. The three month to July average rate was 7.7%.

CPI inflation (MPC target of 2.0%), fell marginally from a peak of 2.9% in June to 2.7% in August. The Bank of England expects inflation to fall back to 2.0% in 2015.

Tensions in the Eurozone eased over the second quarter, but there remained a number of triggers for a renewed flare-up. Economic survey data improved consistently over the first half of the year, pointing to a return to growth in Q2, so ending six quarters of Eurozone recession.

3.2 Outlook for the next six months of 2013/14

Economic forecasting remains difficult with so many external influences weighing on the UK. 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. Downside risks to UK gilt yields and PWLB rates include:

- A return to weak economic growth in the US, UK and China causing major disappointment to investor and market expectations
- 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.
- The Italian political situation is frail and unstable: the coalition government fell on 29 September.
- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Weak growth or recession in the UK's main trading partners - the EU and US, depressing economic recovery in the UK.
- Geopolitical risks e.g. Syria, Iran, North Korea, could trigger safe haven flows back into bonds

Upside risks to UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- Increased investor confidence that sustainable robust world economic growth is firmly expected, together with a reduction or end of QE operations in the US, causing a further flow of funds out of bonds into equities.
- A reversal of Sterling's safe-haven status on a sustainable improvement in financial stresses in the Eurozone.
- In the longer term - a reversal of QE in the UK; this could initially be implemented by allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held.
- 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 sustained recovery of economic growth, causing the ratio of total Government debt to GDP to rise to levels that provoke major concern.

The overall balance of risks to economic recovery in the UK is now 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, and it remains exposed to vulnerabilities in a number of key areas. 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. Near-term, there is some residual risk of further QE if there is a dip in strong growth or if the MPC were to decide to take action to combat the market's expectations of an early first increase in Bank Rate. If the MPC does take 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, such action could cause gilt yields and PWLB rates over the next year or two to significantly undershoot

the forecasts in the table below. The tension in the US over passing a Federal budget for the new financial year starting on 1 October and raising the debt ceiling in mid October could also see bond yields temporarily dip until agreement is reached between the opposing Republican and Democrat sides. Conversely, the eventual start of tapering by the US Federal Reserve will cause bond yields to rise.

3.3 Capita Asset Services' Interest Rate Forecast (as at 23/09/13)

Bank Rate														
Sep 2013	Dec 2013	Mar 2014	Jun 2014	Sep 2014	Dec 2014	Mar 2015	Jun 2015	Sep 2015	Dec 2015	Mar 2016	Jun 2016	Sep 2016	Dec 2016	Mar 2017
0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%

Expectations for the first change in Bank Rate in the UK are now dependent on how to forecast when unemployment is likely to fall to 7%. Financial markets have taken a very contrary view to the MPC and have aggressively raised short term interest rates and gilt yields due to their view that the strength of economic recovery is now so rapid that unemployment will fall much faster than the Bank of England forecasts. Financial markets therefore expect the first increase in Bank Rate to be in quarter 4 of 2014. There is much latitude to disagree with this view as the economic downturn since 2008 was remarkable for the way in which unemployment did not rise to anywhere near the extent likely, unlike in previous recessions. This meant that labour was retained, productivity fell and now, as the MPC expects, there is major potential for unemployment to fall only slowly as existing labour levels are worked more intensively and productivity rises back up again. The size of the work force is also expected to increase relatively rapidly and there are many currently self employed or part time employed workers who are seeking full time employment. Capita Asset Services take the view that the unemployment rate is not likely to come down as quickly as the financial markets are currently expecting and that the MPC view is more realistic. The prospects for any increase in Bank Rate before 2016 are therefore seen as being limited. However, some forecasters are forecasting that even the Bank of England forecast is too optimistic as to when the 7% level will be reached and so do not expect the first increase in Bank Rate until spring 2017.

4. Treasury Management Strategy Statement and Annual Investment Strategy Update

The Treasury Management Strategy Statement (TMSS) for 2013/14 was approved by Full Council on 27 February 2013. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as follows:

- Security of Capital
- Liquidity

The Council 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 investments short term, and only invest with highly credit rated financial institutions using the Capita Asset Services suggested creditworthiness matrices, including Credit Default Swap (CDS) overlay information where this is available. Currently investments are only being made with U.K. financial institutions.

Investments during the first six months of the 2013/14 financial year have been in line with the strategy, and there have been no deviations from the strategy.

As outlined in Section 3 above, there is still considerable uncertainty and volatility in the financial and banking market, both globally and in the UK. In this context, it is considered that the strategy approved on 27 February 2013 is still fit for purpose in the current economic climate.

5. Investment Portfolio 2013/14

In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As set out in Section 3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. Indeed, the introduction of the Government's 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.

The Council held £8.85m of investments as at 30 September 2013 (£4.9m at 31 March 2013). Funds available for investment purposes can vary between £4m and £14m due to the large fluctuations in cash inflows and outflows during each month. Large cash inflows include council tax & business rate direct debits and the Housing Benefit subsidy from the Department for Work and Pensions. Large cash outflows include payment of the precepts to Staffordshire County Council, the Fire Authority and the Police, payment of salaries and payment of business rates to Central Government and the Staffordshire Business Rate pool.

The investment portfolio yield for the first six months of the year is 0.73% against a target of 0.90%. The Council's budgeted investment return for 2013/14 is £100,000. As at the end of the first 2 quarters of 2013/14 £47,190 of interest has been earned. Interest earned is below budget to date due to Banks and Building Societies being able to obtain cheap funding from the Government's Funding for Lending scheme (FLS). This has resulted in a significant drop in the rates being offered for investing in the market and led to a reduction in the interest rates being paid on all our instant access and 30 day notice accounts.

A full list of investments held as at 30 September 2013 is shown in Annex A.

6. Borrowing Position 2013/14

It is not currently intended to borrow to finance capital investment in 2013/14. The only borrowing envisaged by the 2013/14 Treasury Management Strategy is temporary borrowing to cover short-term cash flow deficits. In fact no borrowing has taken place for the first half of the financial year.

7. Prudential Indicators 2013/14

Treasury management activity during the first half year has been carried out within the parameters set by the prudential indicators contained in the approved 2013/14 Treasury Management Strategy. Consequently, there is no intention to revise any of the indicators for the remainder of the year.

Annex A

			INVESTMENTS OUTSTANDING As at 30/09/13			
ACK NO.	**BROKER**	**INT. RATE**	**DATE INVESTED**	**NAME OF BORROWER**	**PRINCIPAL**	**DATE MATURING**
5211	N/A	0.70%	07/08/2013	HALIFAX BANK OF SCOTLAND	500,000	07/11/2013
5214	N/A	0.70%	11/09/2013	HALIFAX BANK OF SCOTLAND	1,500,000	11/12/2013
					£ 2,000,000	
				ROYAL BANK OF SCOTLAND 30 DAY NOTICE ACCOUNT (Rate of Interest 0.80%)	**£ 6,500,000**	
				ROYAL BANK OF SCOTLAND DEPOSIT ACCOUNT (Rate of Interest 0.70%)	**£ 350,000**	
				TOTAL INVESTMENTS	**£ 8,850,000**	
				HERITABLE BANK INVESTMENT		
5092	TRAD	6.10%	15/09/2008	**HERITABLE BANK *(Landsbanki)***	£ 142,309	14/09/2009

Payments of £403,250, £317,649, £155,396, £157,437, £103,815, £118,358, £156,863, £101,810, £104,919, £83,407, £95,089, £71,528, £68,207, £419,963 were received from the Heritable Bank administrators on 30th July 2009, 18th December 2009, 30th March 2010, 16th July 2010, 18th October 2010, 14th January 2011, 19th April 2011, 15th July 2011, 20th October 2011, 23rd January 2012, 20th April 2012, 20th July 2012, 17th January 2013 & 23rd August 2013 respectively.

Annex B

Treasury Management – Glossary of Terms

- **CDS –** 'Credit Default Swap' is an additional assessment of credit worthiness by providing a risk analysis of changes in credit quality as perceived by the market.

- **CIPFA –** the Chartered Institute of Public Finance and Accountancy, is the professional body for accountants working in Local Government and other public sector organisations.

- **CPI Inflation –** a measure that examines the weighted average of prices of a basket of consumer goods and services. The CPI is calculated by taking price changes for each item in the predetermined basket of goods/services and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

- **Credit Rating –** is an opinion on the credit-worthiness of an institution, based on judgements about the future status of that institution. The main rating agencies are Fitch. Standard and Poor's and Moody's.

- **GILTS –** the name given to bonds issued by the UK Government. Gilts are issued bearing interest at a specified rate, however, they are traded on the markets like shares and their value rises of falls accordingly. The 'yield' on a gilt is the interest paid divided by the market value of that gilt.

- **Gross Domestic Product (GDP) –** is the market value of all officially recognised final goods and services produced within a country in a given period of time.

- **Liquidity –** relates to the amount of readily available or short term investment money which can be used for either day to day or unforeseen expenses. For example Call Accounts allow instant daily access to invested funds.

- **Monetary Policy Committee (MPC) –** The MPC is a committee of the Bank of England who meet each month to set the official bank base rate.

- **PWLB –** the Public Works Loan Board is a statutory board that is run within the UK Debt Management Office (DMO), it's function is to lend money to Local Authorities and other prescribed bodies.

- **Quantitative Easing –** a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.