Report of	Meeting	Date
Chief Executive	Governance Committee	14 January 2015

TREASURY STRATEGY AND PRUDENTIAL INDICATORS 2014/15 - MID TERM REVIEW

PURPOSE OF REPORT

1. To report on performance and compliance with Prudential Indicators in financial year 2014/15 to the end of November.

RECOMMENDATION(S)

2. That the report be noted.

3. That an updated list of financial institutions and investment criteria should be prepared and presented to Council for approval with the annual Investment Strategy for 2015/16.

EXECUTIVE SUMMARY OF REPORT

4. The report takes into account changes to revenue and capital budgets reported to Executive Cabinet during 2014/15. Prudential Indicators have been updated to reflect rephasing of capital expenditure and changes to financing.

5. The Capital Financing Requirement (CFR) has been recalculated to reflect rephasing of capital expenditure to be financed by borrowing from 2013/14, and from 2014/15 to later years. Net borrowing – gross borrowing and other long-term liabilities less surplus cash invested – is expected to be much lower than the CFR in 2014/15.

6. Average interest earned is 0.64% to the end of November. However, cash balances have been used as a source of internal borrowing to minimise external borrowing at higher rates of interest, thereby achieving revenue budget savings.

7. The report reviews a number of issues arising in the UK banking sector. While no immediate change to investment counterparties is required, regulatory changes may have an impact on ratings given to UK banks. The list of counterparties will be reviewed and be presented for approval with the Investment Strategy for 2015/16.

Confidential report Please bold as appropriate	Yes	**No**

CORPORATE PRIORITIES

8. This report relates to the following Strategic Objectives:

Involving residents in improving their local area and equality of access for all		A strong local economy	
Clean, safe and healthy communities		An ambitious council that does more to meet the needs of residents and the local area	

BACKGROUND

9. Special Council of 25 February 2014 approved the Prudential Indicators for 2014/15 to 2016/17; the Treasury Management Strategy and Treasury Indicators for 2014/15; and the Annual Investment Strategy 2014/15. The Annual Minimum Revenue Provision (MRP) Policy for 2014/15 was approved by Council on 11 November 2013, when the purchase of Market Walk was agreed.

10. The Treasury Management Annual Report for 2013/14 was presented to Governance Committee of 25 June 2014. Changes to total capital expenditure in 2013/14, and the financing of it by borrowing (external and internal), have an impact on Prudential Indicators in 2014/15. See Table 1 and Table 3 below.

11. This report reflects rephasing of capital expenditure, and other changes to the capital programme and revenue budgets, reported to Executive Cabinet during 2014/15.

12. The Code of Practice for Treasury Management requires Councils to review their treasury strategies and activities half yearly. This report satisfies that requirement.

PRUDENTIAL INDICATORS

Capital Expenditure 2014/15

13. The Prudential Indicator reported on 25 February 2014 took account of estimated capital expenditure and sources of financing from 2013/14 to 2016/17. The Capital Expenditure prudential indicator for 2014/15 has been updated to include expenditure rephased from 2013/14 to 2014/15, and from 2014/15 to later years, as shown in the table below.

Table 1 - Capital Expenditure	**2014/15 Estimate £'000**	**Net Changes £'000**	**2014/15 Revised £'000**
Capital expenditure incurred directly by the Council	11,924	(6,157)	5,767
Less Capital resources - Capital Receipts/grants & contributions/revenue financing	(4,019)	(498)	(4,517)
Unfinanced amount (affects CFR)	**7,905**	**(6,655)**	**1,250**

14. The unfinanced total represents the expenditure that would be financed by Prudential Borrowing, whether external or use of internal balances. The largest variance is the

rephasing of £6.65m in respect of the Chorley East Health Centre, because the project is now expected to commence during 2015/16 and continue into 2016/17.

15. The Council's treasury advisors Capita Asset Services have provided the following interest rates forecast. Public Works Loan Board (PWLB) interest rates in Table 2 below include the certainty rate adjustment. Compared to the rates forecast presented to Council in February 2014, PWLB rates are currently lower than expected and are not considered likely to increase as much as previously suggested. On the other hand, an increase in Bank rate was not expected until the June quarter of 2016, whereas now it is considered that the first increase could be a year earlier. The Bank of England issued an inflation report in November 2014, in which it suggested that the interest rate could remain at 0.5% until later in 2015, because of a possible reduction in inflation below 1% early in 2015.

Table 2 - Interest Rate Forecast	**Dec 2014 %**	**Mar 2015 %**	**Jun 2015 %**	**Sep 2015 %**	**Dec 2015 %**	**Mar 2016 %**	**Jun 2016 %**
Bank rate	0.50	0.50	0.75	0.75	1.00	1.00	1.25
5 yr PWLB	2.50	2.70	2.70	2.80	2.90	3.00	3.10
10 yr PWLB	3.20	3.40	3.50	3.60	3.70	3.80	3.90
25 yr PWLB	3.90	4.00	4.10	4.30	4.40	4.50	4.60
50 yr PWLB	3.90	4.00	4.10	4.30	4.40	4.50	4.60

Any increase in the cost of new external borrowing to finance capital expenditure would need to be reflected in the revenue budget.

Capital Financing Requirement (CFR) 2014/15

16. The CFR measures the indebtedness resulting from the Council's Capital Programme. It increases when the Council incurs unfinanced capital expenditure or leasing liabilities. The CFR is used to calculate the charge to the revenue account for debt repayment known as the Minimum Revenue Provision or MRP.

17. The CFR for the current year has been recalculated to take account of the rephasing of capital expenditure from 2013/14 to 2014/15, and from 2014/15 to later years. The largest variance is the rephasing of Chorley East Health Centre from 2014/15 to 2015/16 to 2016/17. Of the £32.865m CFR as at 1 April 2014, £23,341m is in respect of Market Walk.

Table 3 - Capital Financing Requirement (CFR)	**2014/15 Estimate £'000**	**Net Changes £'000**	**2014/15 Revised £'000**
Estimated CFR at start of year	32,518	347	32,865
Reasons for change in estimated CFR			
Unfinanced Capital Expenditure	7,905	(6,655)	1,250
Annual Revenue Charge (MRP)	(471)	11	(460)
Estimated CFR at end of year	**39,952**	**(6,297)**	**33,655**

The CFR and Borrowing 2014/15

18. The Prudential Code requires that borrowing net of investments should not exceed the CFR for the preceding year plus any anticipated increase in the current and next two years. This is in order to ensure that Councils borrow only for capital investment purposes. As at 31 March 2014, net borrowing as reported in the Treasury Management Annual Report 2013/14 was £18.739m and therefore was well below the CFR. Net borrowing will not exceed the CFR in 2014/15, and the actual year-end figure will be confirmed in the Treasury Management Annual Report for the financial year.

19. As there is a large margin between net borrowing and the CFR, the Council could take additional external borrowing should it need to top-up cash balances. However, there would be a "carrying cost" of additional borrowing, because the interest rates payable would exceed the interest rates receivable on the cash balances. As indicated in Table 4 below, the average rate of interest earned this year to November is 0.64%, whereas interest payable on new PWLB loans would be 2.5% to 3.9% (see Table 2 above).

Operational Boundary for External Debt 2014/15

20. The Operational Boundary for external debt should reflect the most likely, but not worst case, scenario consistent with the Council's approved budgets. Gross borrowing and other long-term liabilities should not exceed the Operational Boundary. The figure approved on 25 February 2014 was £35.647m, being the forecast gross borrowing and other long-term liabilities as at 31 March 2015. Actual borrowing at that date is expected to be lower, firstly because of the rephasing of the Chorley East Health Centre scheme to later years; and secondly because as much as possible of the CFR is matched by internal rather than external borrowing. Use for internal borrowing is the most effective use of the Council's cash balances while available. The Operational Boundary was set at a value based on the CFR to allow additional external borrowing should cash balances be depleted, without breaching the Prudential Indicator.

Authorised Limit 2014/15

21. The Authorised Limit should allow headroom above the Operational Boundary to accommodate the fluctuations that can occur in cash flows. The figure approved for 2014/15 was £37.647m, and there is no reason to amend this at present.

Ratio of Financing Costs to the Revenue Stream 2014/15

22. The Ratio of Financing Costs to the Revenue Stream shows the percentage of the Council's income from Government grants and council tax that has been used to meet interest costs and debt repayment. The actual figure for 2014/15 will be presented in the Treasury Management Annual Report 2014/15 in June 2015.

Incremental Impact of Capital Investment Decisions 2014/15

23. The Incremental Impact of Capital Investment Decisions measures the cumulative impact of capital expenditure on the revenue budget. It is not possible to make a meaningful comparison against this indicator other than when it is restated in the annual Treasury Strategy, which will be presented to Council in February 2015.

TREASURY ACTIVITY

24. Investment activity up to the end of November 2014 is summarised in the following table.

Table 4 - Investment Activity	Average Daily Investment £'000	Earnings to 30/11/14 £	Average Rate %
Fixed Term Deposits	2,000	12,563	0.98
Call Accounts	3,614	12,549	0.53
Money Market Funds	600	1,363	0.37
Total	**6,214**	**26,475**	**0.64**

A full list of current investments is shown at Appendix A. The current list of Financial Institutions and Investment Criteria is attached as Appendix B.

25. The average interest earned of 0.64% exceeds the benchmark of 0.35% (being the average LIBID 7 day rate).

26. No changes to counterparties are proposed at present, though Capita Asset Services have recommended that their clients should change their credit methodologies to reflect changes by main rating agencies (Fitch, Moody's, and Standard & Poor's). See Appendix C for further explanation. A revised list of financial institutions and investment criteria will be prepared and presented to Council for approval with the annual Investment Strategy for 2015/16.

27. Capita Asset Services provided an update on the regulatory framework for Money Market Funds (MMFs). They advise that they "continue to believe that Money Market Funds are an appropriate investment option for clients to consider, both now and in the future. They currently offer levels of security, liquidity and diversification that many other investment types cannot".

28. Our treasury consultants and CIPFA advise that local authorities should base investment decisions on multiple sources of intelligence, rather than relying on one source of information. Capita Asset Services provide weekly summaries of the ratings produced by the main agencies. However, the Shared Financial Services' Financial Accountancy team has registered directly with Fitch, Moody's, and Standard & Poor's, so that up-to-date ratings can be checked on each agency's web site. Other sources of intelligence are being investigated. Daily e-mail alerts are received from the financial press. Company watch alerts have been set up for all appropriate UK banks, and copies of financial statements obtained.

TREASURY CONSULTANTS' ADVICE

29. Appendix C presents the advice of Capita Asset Services in respect of credit criteria, Money Market Funds regulatory update, economic performance to date and outlook, including interest rate forecasts.

30. Further advice has been received to assist in the preparation of the 2015/16 Investment Strategy. Our treasury consultants have considered the implications of European Union Directives on Bank Recovery and Resolution (BRRD) and Deposit Guarantee Schemes (DGSD), which will be implemented during 2015 with the objective of making the financial system sounder. The new measures are part of a complete overhaul of financial market and institution-level regulatory changes, which are aimed at making financial markets safer, thus

promoting investor confidence. However, the reaction of rating agencies could have consequences for councils' Investment Strategies.

31. Should action by rating agencies reduce the number of suitable counterparties, local authorities should have alternative options available, and Capital Asset Services continue to recommend use of Money Market Funds as an alternative to banks and building societies.

REVIEW OF UK BANKING SECTOR ISSUES

32. The need to monitor counterparty market stress indicators is emphasised by the fact that banks have rarely been out of the news headlines since the financial crisis of 2008. On 12 November 2014, for example, news media reported the significant fines imposed by US, UK and Swiss regulators on five banks, following a global probe into allegations of rate-rigging in the foreign exchange markets. This is referred to in the news media as the "forex scandal" or "forex probe". The UK's Financial Conduct Authority (FCA) levied fines totalling £1.115 billion on Citibank, HSBC Bank, JPMorgan Chase Bank, The Royal Bank of Scotland, and UBS AG. The FCA is continuing an investigation in respect of Barclays Bank's foreign exchange business area. US regulators also fined the Bank of America. The Bank of England's chief currency trader was dismissed for 'serious misconduct' following an internal review by the Bank.

33. On 22 December, the Chancellor confirmed that the government would extend the legislation originally put in place to regulate Libor to cover seven further financial benchmarks, including the main foreign exchange ("forex") benchmark. Those found guilty of manipulating the benchmarks would face up to seven years imprisonment. Policing of the benchmarks would be the responsibility of the FCA, which regulates financial firms providing services to consumers, and maintains the integrity of the UK's financial markets. The government published a number of recommendations on 17 December to ensure that the way the financial regulators, the FCA and the Prudential Regulation Authority, make enforcement decisions continues to be fair, transparent, and efficient, following a review.

34. The "forex scandal" followed the "Libor scandal", a series of fraudulent actions connected to the Libor (London Interbank Offered Rate), of 2012 to 2014. In that period, UK and US regulators fined a number of banks, including Barclays Bank, UBS, The Royal Bank of Scotland, Deutsche Bank, JPMorgan, Lloyds Bank and Bank of Scotland.

35. On 10 November 2014, it was reported that the Financial Stability Board (FSB), a global regulator, has proposed new rules to prevent banks that are "too big to fail" from being bailed out by taxpayers. FSB Chairman and governor of the Bank of England Mark Carney explained that the new system would ensure that bank shareholders, and lenders to banks such as bondholders, would become the first in line to bear the brunt of future losses if banks could not pay out of their own resources. The proposed new rules are subject to consultation, and should take effect in 2019. Global systemically important banks would need to hold a minimum amount of cash to ensure that they would be able to survive big losses without turning to governments for help. The FSB has proposed that the cash set aside should be worth 15-20% of the bank's assets, which is a far bigger cushion against losses than is required by current banking rules. The ratings agencies are removing the previous ratings "uplift" given due to implied levels of sovereign support in response to the evolving regulatory regime.

36. The Chancellor on 17 December set out the next stage in the government's plan to return Lloyds Banking Group to private ownership, by announcing the sale of part of the government's remaining shareholding in the firm through a trading plan. Previous share sales raised £7.4 billion, reducing the government's stake in the bank from around 40% to just under 25%. The trading plan will be in place for approximately six months, and involves selling shares gradually in the market in an orderly and measured way. Shares will not be

sold below the average price that the previous government paid for them. The number of shares sold under the trading plan will depend on market conditions, among other factors.

37. The Bank of England's "stress test" that assessed major UK banks' ability to withstand another financial crisis was published on 16 December. Media reports concentrated on the Co-operative Bank having failed the test. Lloyds Banking Group and the Royal Bank of Scotland, both currently investment counterparties, passed the test but were found to be at risk in the event of a "severe economic downturn". The Bank of England emphasised that the "stress test" scenario of economic downturn was "extreme" and not likely to materialise; and the Bank will submit UK banks to an annual stress test from now onwards. Capita Asset Services focused on the positive news in the report, in particular expectation of continued asset quality improvements, and therefore did not advise of any urgent need to change investment limits for the Lloyds and RBS groups.

38. At the end of December 2014, Mervyn King, former Governor of the Bank of England, was quoted in the news media as saying that the banking system is now safer, but not yet at the point where it has been made completely safe.

39. On 2 January 2015, RBS shares fell by 1.2% after media reports that it could face fines of £5 billion over sales of mortgage-backed securities in the US.

IMPLICATIONS OF REPORT

40. This report has implications in the following areas and the relevant Directors' comments are included:

Finance	✓	Customer Services	
Human Resources		Equality and Diversity	
Legal		Integrated Impact Assessment required?	
No significant implications in this area		Policy and Communications	

COMMENTS OF THE STATUTORY FINANCE OFFICER

41. This report complies with statutory requirements. Statistical content is consistent with the assumptions in the approved capital and revenue budgets for 2014/15, including changes approved during the year.

COMMENTS OF THE MONITORING OFFICER

42. The Monitoring Officer has no comments.

GARY HALL
CHIEF EXECUTIVE

There are no background papers to this report.

Report Author	Ext	Date	Doc ID
Michael Jackson	5490	2 January 2015	Treasury Strategy & Prudential Indicators 2014-15.docx