ISLE OF ANGLESEY COUNTY COUNCIL	
REPORT TO:	**AUDIT COMMITTEE**
DATE:	**7 NOVEMBER 2014**
SUBJECT:	**TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY: MID-YEAR REVIEW REPORT 2014/15**
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Nature and reason for reporting

To scrutinise the report to be consistent with professional guidance and to comply with the recommendations of the CIPFA Code of Practice on Treasury Management.

1. Background

1.1 Two of the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) are the receipt by the full council of a mid-year review report on treasury management activity and the delegation of the role of scrutiny of treasury management strategy and policies. This report will fulfill those requirements and covers the following:

- An economic update for the first six months, and looking forward to the second half, of 2014/15;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure (prudential indicators);
- A review of the Council's investment portfolio for 2014/15;
- A review of the Council's borrowing strategy for 2014/15;
- A review of any debt rescheduling undertaken during 2014/15;
- A summary of activity since quarter 2;
- A look ahead to next year; and
- A review of compliance with Treasury and Prudential Limits for 2014/15

2. Economic Update

2.1 The Council's treasury advisers provided a summary of the economic performance to date and outlook shortly after the end of the first quarter, and can be found in Appendix 1. They have also recently provided the following 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
5yr PWLB rate (%)	2.50	2.70	2.70	2.80	2.90	3.00	3.10
10yr PWLB rate (%)	3.20	3.40	3.50	3.60	3.70	3.80	3.90
25yr PWLB rate (%)	3.90	4.00	4.10	4.30	4.40	4.50	4.60
50yr PWLB rate (%)	3.90	4.00	4.10	4.30	4.40	4.50	4.60

2.2 The Council's treasury advisers recently provided a commentary alongside the interest rate forecast above. This commentary can be found in Appendix 2.

3. Treasury Management Strategy Statement and Annual Investment Strategy Update

3.1 The Treasury Management Strategy Statement (TMSS) for 2014/15 was approved by this Council on 27 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.

4. The Council's Capital Position (Prudential Indicators)

4.1 This part of the report is structured to update:-

- The Council'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; and
- Compliance with the limits in place for borrowing activity.
- HRA Reform

4.2 Prudential Indicator for Capital Expenditure

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

Capital Expenditure	2014/15 Original Estimate £m	Position as at 30 September 2014 £m	2014/15 Current Estimate £m
Council Fund	18,100	4,701	15,010
HRA	5,700	1,569	6,000
Total	23,800	6,270	21,010

4.2.1 The current estimate for capital expenditure is behind the original estimate mainly due to the exclusion of contingency items no longer being part of the capital strategy.

4.3 Changes to the Financing of the Capital Programme

4.3.1 There are no significant changes to the financing of the capital programme to report at this stage.

4.4 Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

4.4.1 The table below 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.

4.4.2 Prudential Indicator – Capital Financing Requirement

4.4.2.1 We are projected to be marginally ahead of the original forecast capital financing requirement.

4.4.2.2 The Borrowing figure for the External Debt/the Operational Boundary is based on the assumption that we continue to internalize our borrowing.

4.4.3 Prudential Indicator – External Debt/the Operational Boundary

	2014/15 Original Estimate £m	2014/15 Revised Estimate £m
Prudential Indicator – Capital Financing Requirement		
CFR – Council Fund	92,400	83,226
CFR – HRA	23,000	24,723
Total CFR	115,400	107,949
Net movement in CFR	5,057	1,534
Prudential Indicator – External Debt/the Operational Boundary		
Borrowing	120,000	89,583
Other long term liabilities	2,000	Nil
Total debt 31 March	122,000	89,583

4.5 Limits to Borrowing Activity

4.5.1 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 Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2014/15 Original Estimate £m	Position as at 30 September 2014 £m
Gross borrowing	115,400	89,587
Plus other long term liabilities	Nil	Nil
Gross borrowing	115,400	89,587
CFR (year end position)	115,400	n/a

4.5.2 By the end of the year the CFR is projected to be £108m, and there is a borrowing requirement of £18m as a result. The treasury management strategy statement (Section 3.4.1) states that a flexible approach will been adopted with regards to the choice between internal and external borrowing. This has been, and will continue to be, the case, with consideration to all the factors listed in that section. The decision to continue to internalize has been driven mainly due to 2 factors: (1) To limit the Authority's exposure to credit risk (2) to limit the cost of carry. These are set against the backdrop of PWLB and investment rates continuing to remain at historically low levels with only a steady increase forecast into the medium term. This current stance is in line with many other local authorities that have been asked in seminars and workshops attended by officers within the finance service. The appointed treasury advisors have also supported the decision to continue to internalize borrowing at this time. External borrowing at year end is therefore, expected to be £89.583m. Any changes to the current approach will be reported as appropriate.

4.5.3 It is not envisaged that there will be any difficulties for the current year in complying with this prudential indicator.

4.5.4 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 (£m)	Position as at 30 September 2014 (£m)
Borrowing	125,000	89,587
Other long term liabilities	2,000	Nil
Total	127,000	89,587

4.6 HRA Reform

4.6.1 The proposed reform of the HRA subsidy arrangements is expected to take place on 31 March 2015. This will involve the Council paying funds to the Welsh Government which will remove the Council from the HRA subsidy system. The estimated payment is £23.9m. This will impact on the capital structure of the Council, (as the HRA Capital Financing Requirement will rise by the size of the Welsh Government payment), and the treasury management service will need to consider the funding implications for borrowing

5. Investment Portfolio 2014/15

5.1 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 2, 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.

5.2 The Council held £18.6m of investments as at 30 September 2014 (£9.2m at 31 March 2014) and the investment portfolio yield for the first six months of the year was 0.39%. A full list of investments as at 30th September 2014 can be found in Appendix 4. A summary of the investments and rates can be found in Appendix 3.

5.3 The approved limits within the Annual Investment Strategy were not breached during the first six months of 2014/15.

5.4 The Council's budgeted investment return for 2014/15 is £0.3m. As indicated in the strategy, some borrowing has been internalised and so, during the year, the projected investment returns are below those budgeted for. However, there have been corresponding savings on loan interest and the forecast net outturn is within budget.

5.5 Investment Counterparty criteria

5.5.1 The current investment counterparty criteria selection approved in the TMSS is meeting the requirements of the treasury management function, although it is continuing to be challenging to place funds as the credit quality of counterparties continues at a reduced level.

6. Borrowing

6.1 The projected capital financing requirement (CFR) for 2014/15 is £1.5m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive, the Council 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 Council has projected year end borrowings of £89.6m and will have used £18m of cash flow funds in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

6.2 A summary of investments held can be found in Appendix 3.

7. Debt Rescheduling

7.1 No debt rescheduling was undertaken during the first six months of 2014/15.

8. Activity Since Quarter Two

8.1 There has been no change since Quarter 2

9. Plans for next year

9.1 At its next meeting in February, this Committee will consider the plans for borrowing and investment for the next financial year. The initial plans, according to the current strategy are:

- to use the available general supported borrowing allocation of £3.502m (£2.193m in 2014/15) plus any unused allocation brought forward from this year;
- to borrow, on an unsupported basis, to fund capital investment priorities, linking in to the transformation objectives.

10. Recommendation

10.1 To consider the content of the report and to pass the report onto the next meeting of the County Council together with any comments.

RICHARD MICKLEWRIGHT
INTERIM HEAD OF FUNCTION (RESOURCES) &
SECTION 151 OFFICER **31 OCTOBER 2014**

ATODIAD / APPENDIX 1

Perfformiad Economaidd hyd yma a'r rhagolygiad/ Economic performance to date and outlook

1.1 U.K.

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 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 (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.

1.2 U.S.

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 are expected to stop on 29th 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 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.

1.3 Eurozone

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).

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.

1.4 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% q/q 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.

ATODIAD / APPENDIX 2

Sylwadau ar y rhagolygon diweddaraf ar raddfeydd llog/Commentary on the latest interest rates forecasts

The Council's treasury advisers 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.

Our 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 Eurozone 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 Eurozone 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 Eurozone 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 competiveness are also urgently required to lift the economy out of stagnation.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone 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 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.

ATODIAD / APPENDIX 3

Crynodeb Benthyca a Buddsoddi – Chwarteroedd 1 a 2 2014/15
Borrowing and Investment Summary – Quarters 1 and 2 2014/15

	30 Medi / Sept 2014		30 Mehefin / June 2014	
	£m	**%**	**£m**	**%**
Benthyca – graddfa sefydlog Borrowing – fixed rate	89.6	5.72	89.6	5.72
Benthyca – graddfa amrywiol Borrowing – variable rate	Dim / Nil	d/b / n/a	Dim / Nil	d/b / n/a
Adneuon – galw hyd at 30 diwrnod Deposits – Call to 30 days	18.6	0.39	19.1	0.40
Adneuon – Tymor sefydlog < 1 bl. Deposits – Fixed Term < 1 year	0.0	nil	0.0	nil
Adneuon – Tymor sefydlog 1 bl. + Deposits – Fixed Term 1 year +	Dim / Nil	d/b / n/a	Dim / Nil	d/b / n/a
Cyfanswm Adneuon Total Deposits	18.6	0.39	19.1	0.40
Cyfartaledd Adneuon yn y Chwarter Average Deposits in the Quarter	21.2	0.43	20.3	0.50

Ni torwyd unrhyw un o’r dangosyddion trysorlys yn ystod hanner cyntaf y flwyddyn.
None of the treasury indicators were breached during the first half of the year.

ATODIAD / APPENDIX 4

Graddfeydd Credyd Gwrthbartion buddsoddi a'r adneuon a ddelir gyda phob un ar 30 Medi 2014*
Credit ratings of investment counterparties and deposits held with each as at 30 September 2014*

Grŵp Bancio/ Banking Group	Sefydliad/ Institution	Adneuon / Deposit £'000	Hyd (Galw tymor sefydlog) / Duration (Call / Fixed Term**)	Cyfnod (O/I)/ Period (From / To)	Graddfa Dychweliad/ Rate of Return %	Graddfa Tymor Hir Fitch Long Term Rating	Graddfa Tymor Byr Fitch Short Term Rating	Graddfa Tymor Hir Moody's Long Term Rating	Graddfa Tymor Byr Moody's Short Term Rating	Graddfa Tymor Hir Standard & Poor's (S&P) Long Term Rating	Graddfa Tymor Byr Standard & Poor's (S&P) Short Term Rating	Lliw Sector/Hyd Awgrymiedig/ Sector Colour / Suggested Duration
Lloyds Banking Group plc	Bank of Scotland plc	**9,950**	**Galw/ Call**	**n/a**	**0.40**	**A**	**F1**	**A1**	**P-1**	**A**	**A-1**	**Glas - 12 mis/ Blue - 12 months**
HSBC Holdings plc	HSBC Bank plc	**703**	**Galw/ Call**	**n/a**	**0.25**	**AA-**	**F1+**	**Aa3**	**P-1**	**AA-**	**A-1+**	**Oren – 12 mis / Orange – 12months**
Santander Group plc	Santander UK plc	**7,499**	**Galw/ Call**	**n/a**	**0.40**	**A**	**F1**	**A2**	**P-1**	**A**	**A-1**	**Coch – 6 mis/ Red - 6 months**
The Royal Bank of Scotland Group plc	The Royal Bank of Scotland plc	**470**	**Galw/ Call**	**n/a**	**0.25**	**A**	**F1**	**Baa1**	**P-2**	**A-**	**A-2**	**Glas - 12 mis / Blue - 12 months**

* Ceir y Rhestr Benthyca Cymeradwyedig yn Atodiad 6 o'r Datganiad Strategaeth Rheoli Trysorlys 2014/15/Strategaeth Buddsoddi Blynyddol/ The Approved Lending List can be found at Appendix 6 of the 2014/15 Treasury Management Strategy Statement / Annual Investment Strategy

** Sef tymor ar pwynt y buddsoddi/Being term at the point of investment.

- Yn Atodiad 5 ceir y graddfeydd credyd cyfatebol ar gyfer y 3 asiantaeth graddio y cyfeirir atynt uchod./The equivalent credit ratings for the 3 rating agencies referred to above can be found at Appendix 5.

ATODIAD / APPENDIX 5

Graddfeydd Credyd Cyfatebol/
Equivalent Credit Ratings (Fitch, Moodys, S&P)

Tymor Hir Fitch Long Term	**Tymor Hir Moodys Long Term**	**Tymor Hir S&P Long Term**
AAA	Aaa	AAA
AA+	Aa1	AA+
AA	Aa2	AA
AA-	Aa3	AA-
A+	A1	A+
A	A2	A
A-	A3	A-
BBB+	Baa1	BBB+
BBB	Baa2	BBB
BBB-	Baa3	BBB-
Tymor Byr Fitch Short Term	**Tymor Byr Moodys Short Term**	**Tymor Byr S&P Short Term**
F1+	d/b / n/a	A-1+
F1	P-1	A-1
F2	P-2	A-2
F3	P-3	A-3