Template: Semi-Annual Treasury Report 2010/11

1. Introduction

The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires that authorities report on the performance of the treasury management function at least twice yearly (mid-year and at year end).

The Authority's Treasury Management Strategy for 2014/15 was approved by audit committee on 30 January 2014 and by full council, as part of the council's budget strategy, on 26 February 2014, which can be accessed on http://www.iwight.com/documentlibrary/view/treasury-management-strategy-2012-13

The Authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. This report covers treasury activity and the associated monitoring and control of risk.

2. External Context

Growth and Inflation: The recent strong performance of the UK economy continued with output growing at 0.8% in Q1 2014 and at 0.9% in Q2. The services sector once again grew strongly. On the back of strong consumption growth, business investment appeared to be recovering quickly, albeit from a low base. The annual CPI inflation rate fell to 1.5% year-on-year in August.

Revisions to the GDP methodology, now compliant with the European System of Accounting 2010, mean that growth is now estimated to be 2.7% above its pre-recession peak in Q1 2008 rather than just 0.2% higher, the general theme being that the recession was not as deep and the recovery was earlier than initially estimated. In anticipation of these revisions, the MPC has forecast growth at 3.4% in 2014.

Unemployment: The labour market continued to improve, with strong employment gains and the headline unemployment rate falling to 6.2%. However, earnings growth remained very weak, rising just 0.6% for the three months May-July 2014 when compared to the same period a year earlier. The growth in employment was masked by a large number of zero-hour contracts and involuntary part-time working.

UK Monetary Policy: The MPC made no change to the Bank Rate of 0.5% and maintained asset purchases at £375bn. However, there was a marked shift in tone from the Bank of England's Governor and other MPC members. In his Mansion House speech in June Governor Mark Carney warned that interest rates might rise sooner than financial markets were expecting. Following some mixed messages from Governor Carney later in the summer, the minutes of the August and September MPC meetings revealed a split vote with regards to the Bank Rate. Ian McCafferty and Martin Weale voted to increase Bank Rate by 0.25%, arguing economic circumstances were sufficient to justify an immediate rise. The MPC emphasised that when Bank Rate did begin to rise, it was expected to do so only gradually and would likely remain below average historical levels for some time to come.

In the Bank of England's August Inflation Report the Bank forecast growth to be around 3½% in 2014, easing back thereafter to around its pre-crisis historical average rate. Inflation was forecast to remain at, or slightly below, 2% before reaching the target at the end of the 2-year forecast period.

The Bank's Financial Policy Committee also announced a range of measures to cool the UK's housing market to avert the potential of spiralling house prices derailing a sustainable economic recovery. Key recommendations included lenders stress-testing mortgage applicants can cope with a 3% rise in interest rates; putting a 15% cap on the number of mortgages at more than 4.5 times the borrower's income; and a separate Treasury pledge banning anyone applying for a loan through the Help to Buy scheme borrowing more than 4.5 times their income. The Prudential Regulation Authority also announced that it intends to consult on capital requirements for mortgages.

The result of the Scottish referendum in the end was close, but not as close as many believed it might be. However, the political upheaval set in motion (the Prime Minister's linking of a more devolved Scotland to giving greater powers to English MPs over English-only legislation, the prospect of Scotland's potential freedom to raise taxes not being replicated elsewhere in the UK) is arguably likely to be just as problematic in the run-up to and beyond next year's general election.

Eurozone inflation continued to fall towards zero (HICP inflation registered just 0.3% in September), and there was mounting evidence that the already feeble recovery was losing pace. The unemployment rate remained stubbornly high at 11.5%. The European Central Bank lowered its official benchmark interest rate from 0.15% to 0.05%. The rate it pays on commercial bank balances held with it was also cut further into negative territory from -0.1% to -0.2% and the Marginal Lending Facility rate cut further to 0.3%. The ECB also announced a programme of acquiring Asset Backed Securities (ABS) from banks in an effort to encourage lending which was viewed as being one step away from full blown Quantitative Easing (QE) adopted by the US, UK and Japanese central banks. The minutes of the Bank of England's MPC meeting in September noted that "*weakness in the euro area had been the most significant development during the month"* and that, if it led once again to uncertainty about the sustainability of euro-area public and external debt, it could damage confidence and disrupt financial markets

There was no change from the US Federal Reserve as the central bank kept policy on its current track with a reduction in asset purchases by $10 billion per month. Asset purchases are expected to end by October 2014, expectations therefore turned towards the timing of rate increases. The US economy rebounded strongly in Q2 with annualised growth of 4.6%.

Market reaction: Gilt yields have continued to decline and hit a financial year low at the end of August, before ticking upwards in the run up to the Scottish referendum. What has driven yields lower is a combination of factors but the primary drivers have been the escalation of geo-political risk within the Middle East and Ukraine alongside the slide towards deflation within the Eurozone (EZ).

Local Context

At 31/3/2014 the Authority's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £227.5m, while usable reserves and working capital which are the underlying resources available for investment were £73.3m.

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At 31/3/2014, the Authority had £154.5m of borrowing (including accrued interest payable) and £2.7m of investments. The Authority's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.

The Authority has an increasing CFR over the next 3 years, primarily due to the financing of the Highways PFI project, but minimal investments and will therefore be required to borrow up to £35m over the forecast period.

Borrowing Strategy

At 30/9/2014 the Authority held £151.9m of loans, (a decrease of £1m on 31/3/2014), as part of its strategy for funding previous years' capital programmes.

The Authority expects to borrow up to £27m in 2014/15. This will be borrowed on a short term (less than 364 days duration) basis, primarily to replace maturing short term borrowing.

The Authority's chief objective when borrowing continues to be striking an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective.

Affordability and the "cost of carry" remained important influences on the Authority's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained, and are likely to remain at least over the forthcoming two years, lower than long-term rates, the Authority determined it was more cost effective in the short-term to borrow short-term loans instead.

The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the Authority with this 'cost of carry' and breakeven analysis.

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Borrowing Activity in 2014/15

	Balance on 01/04/2014 £m	Maturing Debt £m	Debt Prematurely Repaid £m	New Borrowing £m	Balance on 30/09/2014 £m	Avg Rate % and Avg Life (yrs)
CFR	227.5					
Short Term Borrowing[1]	31.0	(1.0)	0.0	0.0	30.0	0.60% 0.23 years
Long Term Borrowing	121.9	(0.0)	0.0	0.0	121.9	4.96% 9.32 years
TOTAL BORROWING	152.9	(1.0)	0.0	0.0	151.9	4.10% 8.38 years
Other Long Term Liabilities	28.5				53.7	n/a
TOTAL EXTERNAL DEBT	181.4				205.6	n/a
Increase/ (Decrease) in Borrowing £m					(1.0)	

PWLB Certainty Rate and Project Rate Update: The Authority qualifies for borrowing at the 'Certainty Rate' (0.20% below the PWLB standard rate) for a 12 month period from 01/11/2013. In April the Authority submitted its application to the CLG along with the 2014/15 Capital Estimates Return to access this reduced rate for a further 12 month period from 01/11/2014.

LOBOs: The Authority holds £5m of LOBO (Lender's Option Borrower's Option) loans (1 loan) where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. £5m of these LOBOS had options during the half year to 30 September, none of which were exercised by the lender. As this loan has a further option during 2014/15, the Authority acknowledges there is an element of refinancing risk even though in the current interest rate environment lenders are unlikely to exercise their options.

Debt Rescheduling:
The premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Authority's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence.

Investment Activity

The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. Cashflow forecasts indicated that during 2014/15 the Authority's investment balances would range between £0 and £28 million.

The Guidance on Local Government Investments in England gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles.

[1] Loans with maturities less than 1 year.

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Investment Activity in 2014/15

Investments	Balance on 01/04/2014 £m	Investments Made £m	Maturities/ Investments Sold £m	Balance on 30/09/2014 £m	Avg Rate/Yield (%) and Avg Life (years)
Short term Investments (call accounts, deposits) - Banks and Building Societies with ratings of A- or higher	1.3	86.3	(66.2)	21.4	0.55% 0.03 years
- Local Authorities	1.4	20.2	(19.7)	1.9	0.27% 0.01 years
Long term Investments - Banks and Building Societies with ratings of A+ or higher	0.0	0.0	(0.0)	0.0	n/a
- Local Authorities	0.0	0.0	(0.0)	0.0	n/a
UK Government: - DMADF	0.0	50.3	(50.3)	0.0	n/a
- Treasury Bills	0.0	0.0	(0.0)	0.0	n/a
- Gilts	0.0	0.0	(0.0)	0.0	n/a
Money Market Funds	0.0	4.9	(2.9)	2.0	0.48% Call
Other Pooled Funds	0.0	0.0	(0.0)	0.0	n/a
Investments with Registered Providers of Social Housing rated BBB- or higher	0.0	0.0	(0.0)	0.0	n/a
- Bonds issued by Multilateral Development Banks - Corporate Bonds	0.0	0.0	(0.0)	0.0	n/a
Building societies without credit ratings	0.0	0.0	(0.0)	0.0	n/a
Other organisations (e.g. loans to small businesses)	0.0	0.0	(0.0)	0.0	n/a
Funds Managed Externally	0.0	0.0	(0.0)	0.0	n/a
TOTAL INVESTMENTS	2.7	161.7	(139.1)	25.3	0.52% 0.03 years
Increase/ (Decrease) in Investments £m				22.6	

Security of capital has remained the Authority's main investment objective. This has been maintained by following the Authority's counterparty policy as set out in its Treasury Management Strategy Statement for 2014/15.

Counterparty credit quality was assessed and monitored with reference to credit ratings (the Authority's minimum long-term counterparty rating is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

Credit Risk
Counterparty credit quality as measured by credit ratings is summarised below:

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating
31/03/2014	A+	4.52	A+	5.00
30/06/2014	A+	5.05	A+	5.19
30/09/2014	A+	4.94	A+	4.70

Scoring:
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-AAA = highest credit quality = 1
- D = lowest credit quality = 26
-Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

On advice from Arlingclose, the council has diversified its short term investment portfolio to include a wider variety of counterparties. The council has invested surplus funds to match future expenditure requirements, with no investment being longer than 183 days during the period.

Counterparty Update

The European Parliament approved the EU Bank Recovery and Resolution Directive (BRRD) on April 15, 2014. Taking the view that potential extraordinary government support available to banks' senior unsecured bondholders will likely diminish within its two-year rating horizon for investment-grade entities, in April Standard & Poor's revised the Outlook of Barclays, Deutsche Bank, Credit Suisse and ING Bank from Stable to Negative (note, this is not the same as a rating review negative). In May, Moody's also changed the outlook from stable to negative for 82 European banks and from positive to stable for two European banks. The institutions affected on the Authority's lending list are Nationwide Building Society and Svenska Handelsbanken.

In August Moody's changed its outlook for the UK banking system from stable to negative, citing the reduction of government support for systemic banks as the reason. Although the agency believes that the stand-alone financial strength of UK institutions is improving they believed that this is more than offset by the potential bail-in risk now faced by investors. Similarly, in August S&P revised the outlooks for major Canadian banks to negative following the government's announcement of a potential bail-in policy framework.

There was strong likelihood that the UK, alongside Germany and Austria, would accelerate the adoption of the BRRD and that the implementation of bail-in resolutions would be fast-tracked in these countries to 1st January 2015, a full year ahead of other EU nations.

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Banks in the UK and EU face banks face stress tests this autumn, which may result in some institutions having to additionally bolster their capital buffers. The extent to which this might be required and the form they will have to take casts uncertainty over capital requirements in the system.

Budgeted Income and Outturn

The average cash balances were £9.4m during the half year to September. The UK Bank Rate has been maintained at 0.5% since March 2009. Short-term money market rates have remained at relatively low levels (see Table 1 in Appendix 1). New deposits were made at an average rate of 0.45%. Investments in Money Market Funds generated an average rate of 0.44%

The Authority's budgeted investment income for the year is estimated at £0.16m. The Authority anticipates an investment outturn of £0.1 million for the whole year.

Compliance with Prudential Indicators

The Authority confirms compliance with its Prudential Indicators for 2014/15, which were set in January 2014 as part of the Authority's Treasury Management Strategy Statement.

Treasury Management Indicators

The Authority measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures: This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed will be:

	2014/15	2015/16	2016/17
Upper limit on fixed interest rate exposure	100%	100%	100%
Actual	95.67%		
Upper limit on variable interest rate exposure	20%	20%	20%
Actual	4.33%		

Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

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Maturity Structure of Borrowing: This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	Upper	Lower	Actual
Under 12 months	30%	0%	21.4%
12 months and within 24 months	10%	0%	6.6%
24 months and within 5 years	20%	0%	11.2%
5 years and within 10 years	50%	0%	18.6%
10 years and above	95%	0%	42.3%

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than 364 days: The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

	2014/15	2015/16	2016/17
Limit on principal invested beyond year end	£15m	£25m	£30m
Actual	£0m		

Other prudential indicators will be reported to audit committee at year end.

Investment Training

On 14 July 2015, members of the audit committee and executive received a presentation from Arlingclose Limited on treasury management and the local and global context.

Outlook for Q3 and Q4 2014/15

The stronger economic growth seen in the UK over the past six months is likely to use up spare capacity more quickly than previously assumed. Arlingclose has brought forward the timing for the first rise in Bank Rate to Q3 2015.

In addition to two MPC members having voted for a rate rise in August and September, the rhetoric from Committee members has in general become more hawkish. However, the lack of inflationary pressure is expected to allow policymakers to hold off monetary tightening for longer than the market currently expects. The near-term risk is that the Bank Rate could rise sooner than anticipated, which is captured in the 'upside risk' range of our forecast table below.

The focus is now on the rate of increase and the medium-term peak and, in this respect, expectations are that rates will rise slowly and to a lower level than in the past.

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	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Official Bank Rate											
Upside risk	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	**0.50**	**0.50**	**0.50**	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**	**1.25**	**1.50**	**1.50**
Downside risk				0.25	0.25	0.50	0.50	0.75	0.75	1.00	1.00

Appendix 1

Money Market Data and PWLB Rates

The average, low and high rates correspond to the rates during the financial year rather than those in the tables below.

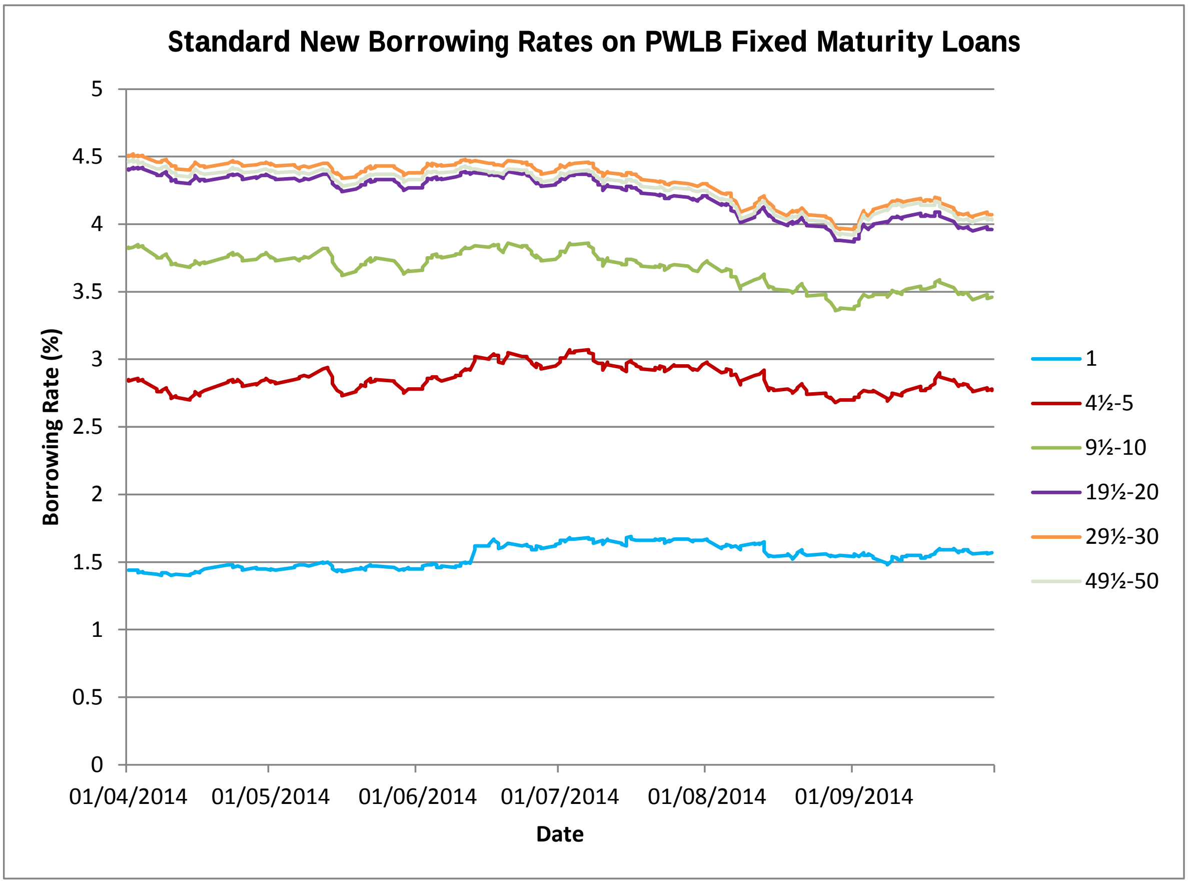
Please note that the PWLB rates below are Standard Rates. Authorities eligible for the Certainty Rate can borrow at a 0.20% reduction.

Table 1: Bank Rate, Money Market Rates

Date		Bank Rate		O/N LIBID	7-day LIBID	1-month LIBID	3-month LIBID	6-month LIBID	12-month LIBID	2-yr SWAP Bid	3-yr SWAP Bid	5-yr SWAP Bid
01/04/2014		0.50		0.36	0.39	0.42	0.46	0.56	0.84	1.05	1.44	2.03
30/04/2014		0.50		0.36	0.40	0.42	0.47	0.57	0.85	1.09	1.47	2.02
31/05/2014		0.50		0.35	0.40	0.43	0.48	0.67	0.87	1.11	1.46	1.98
30/06/2014		0.50		0.36	0.40	0.43	0.50	0.71	0.94	1.33	1.70	2.17
31/07/2014		0.50		0.37	0.41	0.43	0.50	0.72	0.97	1.34	1.71	2.17
31/08/2014		0.50		0.36	0.42	0.43	0.50	0.77	0.98	1.22	1.53	1.93
30/09/2014		0.50		0.43	0.45	0.43	0.51	0.66	1.00	1.25	1.57	1.99
Average		**0.50**		**0.37**	**0.41**	**0.43**	**0.49**	**0.67**	**0.92**	**1.21**	**1.57**	**2.06**
Maximum		**0.50**		**0.43**	**0.50**	**0.43**	**0.51**	**0.81**	**1.00**	**1.38**	**1.77**	**2.26**
Minimum		**0.50**		**0.24**	**0.36**	**0.42**	**0.46**	**0.56**	**0.84**	**1.00**	**1.36**	**1.91**
Spread		**--**		**0.19**	**0.14**	**0.01**	**0.05**	**0.25**	**0.16**	**0.38**	**0.41**	**0.35**

Table 2: PWLB Borrowing Rates – Fixed Rate, Maturity Loans

Change Date	Notice No	1 year	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
01/04/2014	127/14	1.44	2.85	3.83	4.41	4.51	4.49	4.47
30/04/2014	166/14	1.45	2.86	3.79	4.37	4.46	4.43	4.41
31/05/2014	206/14	1.45	2.78	3.65	4.27	4.38	4.35	4.33
30/06/2014	248/14	1.63	2.95	3.74	4.30	4.40	4.36	4.34
31/07/2014	294/14	1.66	2.96	3.70	4.21	4.30	4.27	4.25
31/08/2014	334/14	1.55	2.70	3.38	3.88	3.97	3.94	3.93
30/09/2014	378/14	1.57	2.77	3.46	3.96	4.07	4.05	4.03
	Low	1.40	2.68	3.36	3.87	3.96	3.94	3.92
	Average	1.55	2.86	3.67	4.22	4.32	4.29	4.27
	High	1.69	3.07	3.86	4.42	4.52	4.49	4.48


Standard New Borrowing Rates on PWLB Fixed Maturity Loans
Borrowing Rate (%)
5
4.5
4
3.5
3
2.5
2
1.5
1
0.5
0
01/04/2014
01/05/2014
01/06/2014
01/07/2014
01/08/2014
01/09/2014
Date
1
4½-5
9½-10
19½-20
29½-30
49½-50