

Treasury Management Mid-year Report 2013/14**1 Purpose**

- 1.1 This report outlines the treasury management activities during the year to date for noting.

2 Contextual information

- 2.1 Hampshire Fire & Rescue Authority (HFRA) fully complies with the requirements of the revised Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice for Treasury Management in the Public Services (2009). This report continues to ensure that HFRA is following best practice in accordance with CIPFA's recommendations to report on treasury management activities.
- 2.2 Treasury management in the context of this report is defined as:

“The management of the organisation’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.” (CIPFA Code of Practice).

3 Economic background

- 3.1 The following paragraphs outline major macro economic themes in the domestic and global economy, which explain the background against which treasury management decisions have been made.
- 3.2 Growth - the UK economy showed some improvement, with consumer spending boosting growth. Gross Domestic Product (GDP) for the first quarter of 2013 was +0.3% and for the second quarter was +0.7%. Recent data suggests a similar rate in quarter three. Some positive signs for household spending emerged. The deterioration in real earnings growth (i.e. earnings less inflation) slowed, which implied a slower erosion of purchasing power. Consumer confidence improved. Household savings rates remained high, which is unsurprising given the uncertain economic outlook, but appear to be on a downward track, suggesting spending was being driven by borrowing or lower savings. This raises questions about the sustainability of the recovery at these rates of growth.
- 3.3 Inflation - annual CPI for August was 2.7% and is expected to remain close to this level throughout the autumn. Further out, inflation should fall back towards the 2% target as external price pressures fade and a revival in productivity growth curbs domestic cost pressures.
- 3.4 Monetary Policy - there was no change to UK monetary policy with official interest rates and asset purchases maintained at 0.5% and

£375bn respectively. The main development for UK monetary policy was the start of Mark Carney's tenure as Governor of the Bank of England and the implementation of forward guidance. Within the September Inflation Report, the Bank stated its forward guidance, the main element of which is to defer monetary tightening (an increase in interest rates) until the International Labour Organisation (ILO) Unemployment Rate falls below 7% (among a raft of caveats). The Bank projected that the probability of this happening would remain below 50% until 2016.

- 3.5 Global Economy - Whilst the outlook for the global economy appeared to have improved over the first half of calendar 2013/14, significant economic risks remain, particularly in China and the Eurozone. The Chinese banking system is facing tighter liquidity conditions as officials seek to slow down rampant credit growth, and, despite the time gained by the ECB to allow individual members and the Eurozone as a whole to reform their economies, the Eurozone debt crisis has not gone away. The region appears to be dragging itself out of recession and September's German general election passed with little incident but political uncertainties, particularly in Italy, could derail any progress towards a more balanced and stable regional economy.
- 3.6 The US recovery appeared to be in train, but a lack of agreement on the federal budget by the end of September caused a partial government shutdown at the start of October, which could have an effect on GDP growth. Political risks also remain regarding the debt ceiling.

4 Investments

- 4.1 HFRA has an investment portfolio consisting of reserves and short-term cash flows. The authority is currently investing according to a low risk, high quality lending list as outlined in its Treasury Management Strategy. In compliance with this Strategy, lending is restricted to approved banks and building societies, AAA-rated money market funds, other local authorities and the Government's Debt Management Office. Any residual balances are invested with Hampshire County Council, earning interest at Bank of England's base rate.
- 4.2 HFRA's investment holding was £39.4m at 30 September 2013, which was placed with the following counterparties:

Counterparty	£m	£m
Barclays	5.0	
Close Brothers	5.5	
HSBC	5.0	
Lloyds TSB	4.9	
Nationwide	5.0	
NatWest	5.0	
Santander	2.5	
Standard Chartered	2.0	
Banks and Building Societies sub-total (less than 1 year)		34.9
UK Local authorities (less than 1 year)		2.3
UK Local authorities (from 1 to 3 years)		1.7
Hampshire County Council		0.5
Total		39.4

- 4.3 The level of cash balances has increased significantly from £21.5m at the beginning of the financial year, but is expected to reduce by the end of this financial year as a result of falling short-term cashflows. The major reason for the uneven profile of HFRA's cash balance is that most of its Central Government funding is received at the beginning of the financial year, in particular the Pension Grant of £6.8m, which is paid in a single instalment each July, and then paid out gradually by HFRA throughout the year.
- 4.4 The average interest rate earned on these investments at 30 September 2013 was 0.78%, which should be considered within the context of an unchanged UK Base Rate of 0.5% since March 2009 and very low short-term money market rates.
- 4.5 The Guidance on Local Government Investments in England gives priority to security and liquidity and HFRA's aim is to achieve a yield commensurate with these principles. This has been maintained by following HFRA's counterparty policy as set out in its Treasury Management Strategy for 2013/14.
- 4.6 Counterparty credit quality is assessed and monitored with reference to a range of factors, including but not limited to, the ratings of the major ratings agencies. During the six months to the end of September 2013 investment counterparties and the duration of new investments have been monitored and amended where necessary based on this assessment. For example based on the assessment that a 'good bank' and 'bad bank' split for RBS was being favoured by the Chancellor as a potential plan for the government to sell its stake in RBS, the credit ratings agency Moody's placed RBS's rating on review for downgrade

on 5 July 2013. Although the probability of losses remains low as a precautionary measure HFRA has reduced its maximum duration on RBS (including NatWest) investments to overnight.

5 Borrowing

- 5.1 HFRA's underlying need to borrow as measured by the Capital Financing Requirement (CFR) at 31 March 2013 was £14.8m. Affordability and the "cost of carry" remained important influences on HFRA'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.
- 5.2 For HFRA the use of internal resources in lieu of borrowing has, therefore, continued to be the most cost effective means of funding capital expenditure. No new long-term borrowing has taken place in the six months to September 2013, or is planned for the remainder of the financial year. This has lowered overall treasury risk by reducing both external debt and temporary investments.
- 5.3 As at 30 September 2013 HFRA had £8.35m of outstanding Public Works Loan Board (PWLB) borrowing at an average interest rate of 4.71% and an average outstanding term remaining of 16 years. These loans were taken out between 1998 and 2010, when HFRA's cash balances were considerably lower than they are today.
- 5.4 There is no financial benefit to HFRA in using any of its current reserves to repay loans. The premium that is added by the PWLB to any loans that are repaid is still relatively expensive for the loans in HFRA's portfolio in comparison to the returns available from continuing to invest reserves. As a consequence no rescheduling activity has taken place. However, consideration will continue to be given to any advantageous opportunity for HFRA to reduce or restructure its debt portfolio in the future.

6 Compliance with prudential indicators

- 6.1 During the first six months of 2013/14, HFRA operated within the treasury management indicators set out in the Treasury Management Strategy, with the exception of the indicator for the exposure of investments to variable interest rates, which is explained in section 6.10 below.

Authorised limit for external debt

- 6.2 CIPFA's Code of Practice requires authorities to set an authorised limit for external debt, defined as the sum of external borrowing and other long-term liabilities. The annual strategy report agreed by the HFRA on 14 February 2013 set an authorised limit for external debt of £19.6m.

- 6.3 This limit is based on the estimated CFR in order to enable it to be financed entirely from external borrowing should HFRA's internal reserves become depleted. The limit also includes an allowance for temporary borrowing to cover normal revenue cash flow requirements and unexpected outflows or delays in receiving cash.
- 6.4 During the six month period to 30 September 2013 borrowing remained well within the authorised limit of £19.6m and no new long term borrowing has been taken out. Total external debt, including finance leases, reached a maximum of £9.3m.

Operational boundary for external debt

- 6.5 HFRA has set an operational boundary for external debt. This should reflect the most likely scenario and be consistent with HFRA's capital plans and Treasury Management Strategy. Temporary breaches of the operational boundary can take place for cash flow reasons, but any sustained breach will lead to further investigation. HFRA approved an operational boundary for 2013/14 of £17.2m.
- 6.6 As outlined above HFRA's maximum total external debt of £9.3m in the period from April to September 2013, was within the operational boundary.

Upper limit on fixed and variable interest rate exposure

- 6.7 HFRA has to set an upper limit on its fixed interest rate exposure for both total investments and total external debt. HFRA approved an upper limit on fixed and variable interest rate exposure for external debt for 2013/14 of £17.2m, which is based on the operational boundary and has been set to give HFRA maximum policy flexibility. The limit enables the potential for refinancing e.g. from variable to fixed rate borrowing.
- 6.8 The vast majority of HFRA's long-term debt portfolio (PWLB loans and finance leases) are fixed interest loans, which were £9.2m in the six month period to 30 September 2013, within the £17.2m limit. There was a very small amount of variable rate borrowing, £70,000 made up of an energy efficiency Government loan and money owed to Hampshire County Council.
- 6.9 HFRA also has to set upper limits on its interest rate exposure for fixed and variable rate investments, which are £24.2m and £18.2m respectively. In the period from April to September 2013 HFRA had a maximum of £16m of investments at fixed rates and £22m at variable rates, therefore the exposure of investments to variable interest rates has exceeded the indicator that was set.
- 6.10 The indicator has been exceeded as a result of the increase in HFRA's cash balances, which have increased by 83% from £21.5m at 31 March 2013, not any change in the investment strategy. Given the significant

increase in HFRA's cash balances it is recommended to increase the limit for the exposure of investments to both fixed and variable interest rates to £32m and £29m respectively.

Upper and lower percentage limits on the maturity structure of long-term fixed-rate borrowing outstanding in 2013/14

6.11 The Code also requires HFRA to set upper and lower percentage limits on the maturity structure of its long-term fixed rate borrowing during 2013/14. The following table shows the limits approved by HFRA. These have been set in order to allow maximum flexibility in managing the debt portfolio and are consistent with the existing portfolio.

	Upper limit (%)	Lower limit (%)	Actual (%)
Under 12 months	50	0	0
12 to 24 months	50	0	0
24 months to 5 years	50	0	0
5 years to 10 years	75	0	29
10 years and within 20 years	75	0	29
20 years and within 30 years	75	0	42
30 years and above	100	0	0

Upper limits on investments with maturities longer than one year

6.12 Investments for periods in excess of a year are currently limited only to UK Local Authorities, up to a maximum of three years, with an upper limit of £5m and the maximum investment being placed with a single institution restricted to £1m.

6.13 At 30 September 2013 HFRA had £1.75m of investments over 364 days up to a maximum of three years with other UK local authorities, with a further £1m of investments agreed with Local Authority counterparties but due to begin in the coming months.

7 Recommendation

7.1 That the mid-year review of treasury management activities be noted.

7.2 To increase the prudential indicator limit for the exposure of investments to both fixed and variable interest rates to £32m and £29m respectively, following the significant increase in HFRA's cash balances.