Non-Executive Report of the: **Audit Committee** **21 July 2015**	TOWER HAMLETS
Report of: Chris Holme, Acting Corporate Director of Resources	**Classification:** Unrestricted
Treasury Management Quarter 3 Report – Year to 31 December 2014	

Originating Officer(s)	Bola Tobun, Investment & Treasury Manager
Wards affected	All wards

Summary

This report advises the Committee of the Council's borrowing and investment activities during 2014/15 to 31 December 2014. The Treasury Management Strategy Statement and the Treasury Prudential Indicators, for 2014/15 were approved by the Council on 26 February 2014 as required by the Local Government Act 2003.

The report also provides information on the economic conditions prevailing in the third quarter of 2014/15. The report also provides a summary of the prudential indicators, treasury management indicators and a summary of the credit criteria adopted by the Acting Corporate Director of Resources for the reporting year and the projected investment returns.

The Council earned an average return of 0.73% on its lending, outperforming the actual rolling average 7 day LIBID rate of 0.35%.

No long-term or short-term borrowing has been raised since the commencement of this financial year 2014/15 to reporting period.

Over the reporting period, all treasury management activities have been carried out in accordance with the approved limits and the prudential indicators set out in the Council's Treasury Management Strategy statement. The outturn report of the Treasury Management Strategy will be presented to the Council at its meeting of the 16 September 2015.

Recommendations:

Members are recommended to:

- note the contents of the treasury management activities and performance against targets for quarter ending 31 December 2014
- note the Council's outstanding investments as set out in Appendix 1. The balance outstanding as at 31 December 2014 was £297.6m which includes £35.8m, pension fund cash awaiting investment.

1. REASONS FOR THE DECISIONS

1.1 This report updates on both the borrowing and investment decisions made by the Director of Resources under delegated authority in the context of prevailing economic conditions and considers Treasury Management performance measured against the benchmark 7 day LIBID rate.

1.2 Treasury management is defined as “the management of the council’s investments and cash flows; its banking, money market and capital market transaction; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

1.3 Legislation requires that regular reports be submitted to Council/Committee detailing the council’s treasury management activities.

1.4 The regular reporting of treasury management activities should assist in ensuring that Members are able to scrutinise officer decisions and monitor progress on implementation of investment strategy as approved by Full Council.

2. ALTERNATIVE OPTIONS

2.1 The Council is bound by legislation to have regard to the Treasury Management (TM) Code. The Code requires that the Council or a sub-committee of the Council (Audit Committee) should receive regular monitoring reports on treasury management activities.

2.2 If the Council were to deviate from those requirements, there would need to be some good reason for doing so. It is not considered that there is any such reason, having regard to the need to ensure that Members are kept informed about treasury management activities and to ensure that these activities are in line with the investment strategy approved by the Council.

2.3 Within reason, the Council can vary its treasury management strategy having regard to its own views about its appetite for risk in relation to the financial returns required.

3. DETAILS OF REPORT

3.1 The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 require local authorities to have regard to the Treasury Management Code. The Treasury Management code requires that the Council or a sub-committee of the Council (Audit Committee) should receive regular monitoring reports on treasury management activities and risks.

3.2 These reports are in addition to mid-year and annual treasury management outturn reports that should be presented to the Council midway through the financial year and at year end respectively.

3.3 TREASURY MANAGEMENT STRATEGY 2014/15

3.3.1 The Council's Treasury Management Strategy was approved on 26 February 2014 by Full Council. The Strategy comprehensively outlines how the treasury function would operate throughout the financial year 2014/15 including the limits and criteria for selecting institutions to be used for the investment of surplus cash and the council's policy on long-term borrowing and limits on debt.

3.3.2 The Council complied with the strategy from the onset to reporting period, 31 December 2014. And all investments were made to counterparties within the Council's approved lending list.

3.3.3 The Pension Fund cash awaiting investment has been invested in accordance with Council's Treasury Management Strategy agreed by Full council on the 26 February 2014, under the delegated authority of the Corporate Director of Resources and is being managed in-line with the agreed parameters. The Pensions Committee is updated on Pension Fund investment activity on a quarterly basis.

3.4 ECONOMIC COMMENTARY

3.4.1 After strong UK GDP growth in 2013 at an annual rate 2.7%, and then in 2014 0.7% in Q1, 0.9% in Q2 2014 (annual rate 3.2% in Q2), Q3 has seen growth fall back to 0.7% in the quarter and to an annual rate of 2.6%. It therefore appears that growth has eased since the surge in the first half of 2014 leading to a downward revision of forecasts for 2015 and 2016, albeit that growth will still remain strong by UK standards. 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 than expected.

3.4.2 The MPC is now focusing on how quickly slack in the economy is being used up. It is also particularly concerned that the squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back significantly 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. Unemployment is expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in wage growth 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.

3.4.3 Also encouraging has been the sharp fall in inflation (CPI), reaching 1.0% in November, the lowest rate since September 2002. Forward indications are that inflation is likely to remain around or under 1% for the best part of a year. The return to strong growth has helped lower forecasts for the increase in Government debt over the last year but monthly public sector deficit figures during 2014 have disappointed until November. The autumn statement, therefore, had to revise the speed with which the deficit is forecast to be eliminated.

3.4.4 The U.S. Federal Reserve ended its monthly asset purchases in October 2014. GDP growth rates (annualised) for Q2 and Q3 of 4.6% and 5.0% have been stunning and hold great promise for strong growth going forward. It is therefore confidently predicted that the first increase in the Fed. rate will occur by the middle of 2015.

3.4.5 The Eurozone is facing an increasing threat from deflation. In November the inflation rate fell to 0.3%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the ECB did take some rather limited action in June and September to loosen monetary policy in order to promote growth and is currently expected to embark on quantitative easing early in 2015 to counter this threat of deflation and to stimulate growth.

3.5 INTEREST RATE FORECAST

3.5.1 The Council's treasury advisor, Capita Asset Services, has provided the following forecast:

	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank rate	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	1.75%	2.00%
5yr PWLB rate	2.20%	2.20%	2.30%	2.50%	2.60%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.60%
10yr PWLB rate	2.80%	2.80%	3.00%	3.20%	3.30%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
50yr PWLB rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%

3.5.2 Capita Asset Services undertook a review of its interest rate forecasts on 5 January 2015 after a proliferation of fears in financial markets around the plunge in the price of oil had caused a flight from equities into bonds and from exposure to the debt and equities of emerging market oil producing countries to safe havens in western countries. These flows were compounded by further fears that Greece could be heading towards an exit from the Euro after the general election on January 25 and financial flows generated by the increasing likelihood that the ECB would soon be starting on full blown quantitative easing (QE) purchase of Eurozone government debt. In addition, there has been a sharp increase in confidence that the US will start increasing the Fed. rate by the middle of 2015 due to the stunning surge in GDP growth in quarters 2 and 3 of 2014. This indicated that the US is now headed towards making a full recovery from the financial crisis of 2008.

3.5.3 The result of the combination of the above factors is that we have seen bond yields plunging to phenomenally low levels, especially in long term yields. These falls are unsustainable in the longer term but just how quickly these falls will unwind is hard to predict. In addition, positive or negative developments on the world political scene could have a major impact in either keeping yields low or prompting them to recover back up again. We also have a UK general election coming up in May 2015; it is very hard to predict what its likely result will be and the consequent impact on the UK economy, and how financial markets will react to those developments.

3.5.4 This latest forecast includes a move in the timing of the first increase in Bank Rate from quarter 2 of 2015 to quarter 4 of 2015 as a result of the sharp fall in inflation due to the fall in the price of oil and the cooling of the rate of GDP growth in the UK, albeit, that growth will remain strong by UK standards, but not as strong as was previously forecast. The Governor of the Bank of England, Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when average disposable income is only currently increasing marginally as a result of wage inflation now running slightly above the depressed rate of CPI inflation, though some consumers will not have seen that benefit come through for them. In addition, whatever party or coalition wins power in the next general election, will be faced with having to implement further major cuts in expenditure and / or increases in taxation in order to eradicate the annual public sector net borrowing deficit.

3.6 INVESTMENT STRATEGY

3.6.1 The Treasury Management Strategy Statement (TMSS) for 2014/15, which includes the Annual Investment Strategy, it outlines the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield.

3.6.2 The Council aims to achieve the optimum return (yield) on investments equivalent with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with highly credit rated financial institutions.

3.6.3 The approved limits within the Annual Investment Strategy were not breached during the period ended 31st December 2014.

Investment performance for financial year to date @ 31st December 2014

Benchmark	Benchmark Return	LBTH Performance	Over/(Under) Performance
Full Year 2013/2014	0.35%	0.82%	0.47%
Quarter 1	0.34%	0.69%	0.35%
Quarter 2	0.35%	0.73%	0.38%
Quarter 3	0.35%	0.77%	0.42%
Year to Period	0.35%	0.73%	0.38%

3.6.4 As illustrated above, the Council outperformed the benchmark by **38bps** for financial year to date. The Council's budgeted investment return for 2014/15 is **£1.6m,** and performance for the year to date is **£0.4m** above budget.

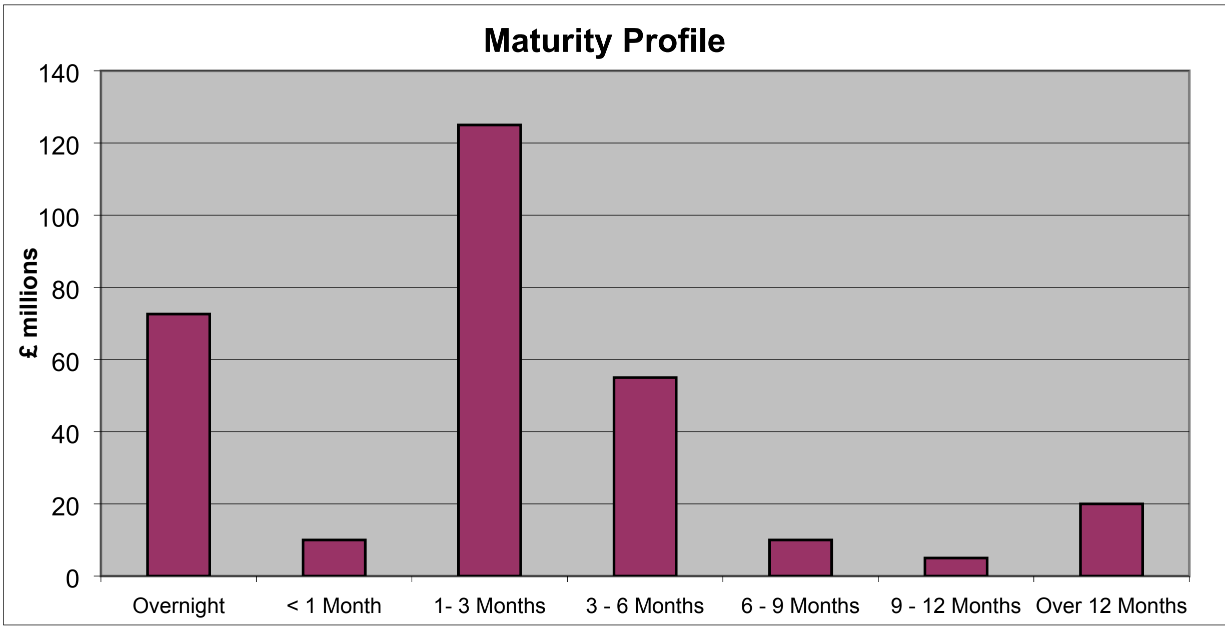
3.6.5 Investment rates available in the market have been broadly stable during the period and have continued at historically low levels as a result of the ultra-low Bank Rate and other extraordinary measures such as the Funding for Lending Scheme. The average level of funds available for investment purposes during the reporting period was **£324.2m**. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme.

3.7 Investments Outstanding & Maturity Structure

- At the end of December, we have 29% of outstanding investments of £297.6m as overnight money and 46% maturing within 3months, 8% maturing within 3-6 months, 4% maturing within 6-9 months, just 2% maturing within 9-12 months and about 8% to mature after 12months.

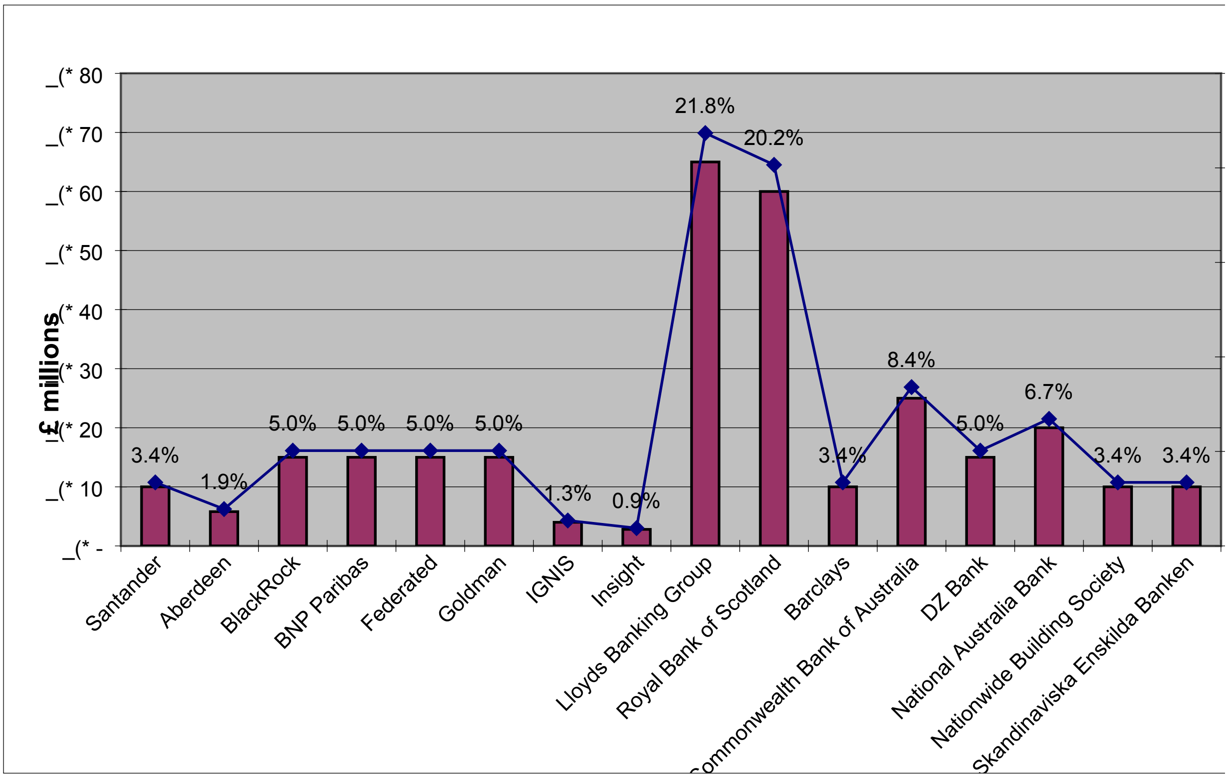
- The chart below illustrates the maturity structure of deposits as at 31 December 2014, we had £72.6m as overnight deposits, and this is predominantly Money Market Funds.

Maturity of Investment Portfolio as at 31 December 2014



- The Weighted Average Maturity for outstanding investment portfolio is 119 days. This is the average number of outstanding days to maturity of each deal from 31st December 2014.

<u>Counterparty Exposure as at 31 December 2014</u>



- The chart above shows the deposits outstanding with authorised counterparties as at 31 December 2014, of which 42% were with part-nationalised banks (Lloyds and RBS Groups).

3.8 DEBT PORTFOLIO

3.8.1 The Council's Treasury Management Strategy Report approved in February 2014 outlined the Council's long term borrowing strategy for the year.

3.8.2 The table below sets out the Council's debt as at the beginning of the financial year and as at 31 December 2014. The overall debt fell by £0.035m from £89.564 at the start of the year. Total debt outstanding, stands at £89.529m, against estimated CFR of £245.513m for 2014/15, resulting in an under-borrowing of £155.984m

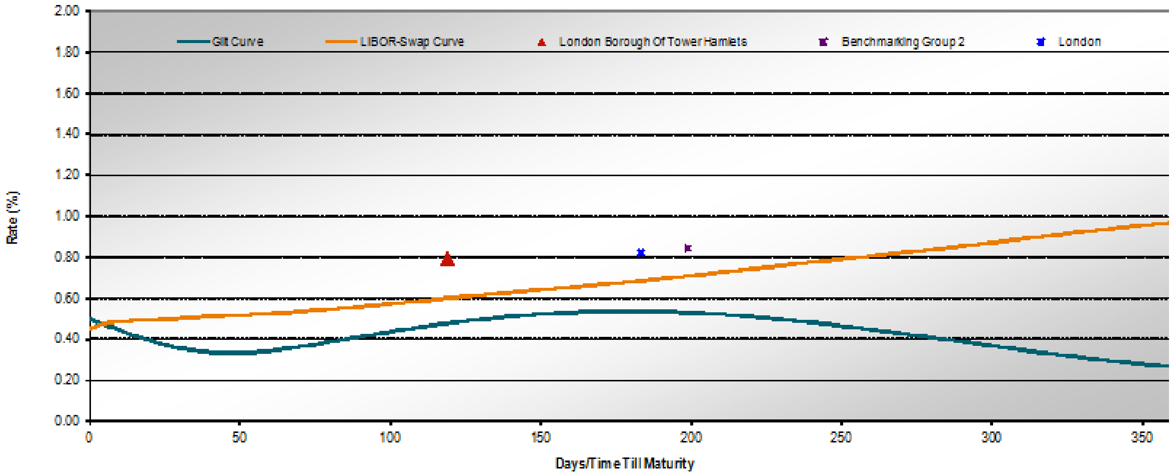
	31 March 2014 Principal	Loans raised	Loans repaid	31 December 2014 Principal
	£'000	£'000	£'000	£'000
Fixed Rate Funding:				
-PWLB	12,064	-	0.035	12,029
-Market	13,000	-	-	13,000
Total Fixed Rate Funding	25,064		0.035	25,029
Variable Rate Funding:				
-PWLB	-	-		-
-Market	64,500	-	-	64,500
Total Variable Rate Funding	64,500	-	-	64,500
Total Debt	***89,564***	***-***	***0.035***	***89,529***
CFR	***220,720***	***-***	***-***	***245,513***
Over/ (under) borrowing	***(131,156)***	***-***	***-***	***(155,984)***

3.8.3 No borrowing has been undertaken in this financial year to date. Also no debt rescheduling opportunities have arisen during this financial year to reporting period as the cost of premiums outweighs savings that could be made from the lower PWLB borrowing rates.

3.9 INVESTMENT BENCHMARKING CLUB

3.9.1 LBTH participates in a benchmarking club to enable officers to compare the Council's treasury management /investment returns against those of similar authorities. The model below shows the performance of benchmark club members given the various levels of risks taken as at 31 December 2014. The model takes into account a combination of credit, duration and returns achieved over the duration, and it includes data from 20 local authorities. Tower Hamlets lies close to the expected return given the council's portfolio risk profile, which is placing deposits with institutions with the sovereign rate of AAA.

Returns Comparable Against the Risk-Free Rate and LIBOR Curve

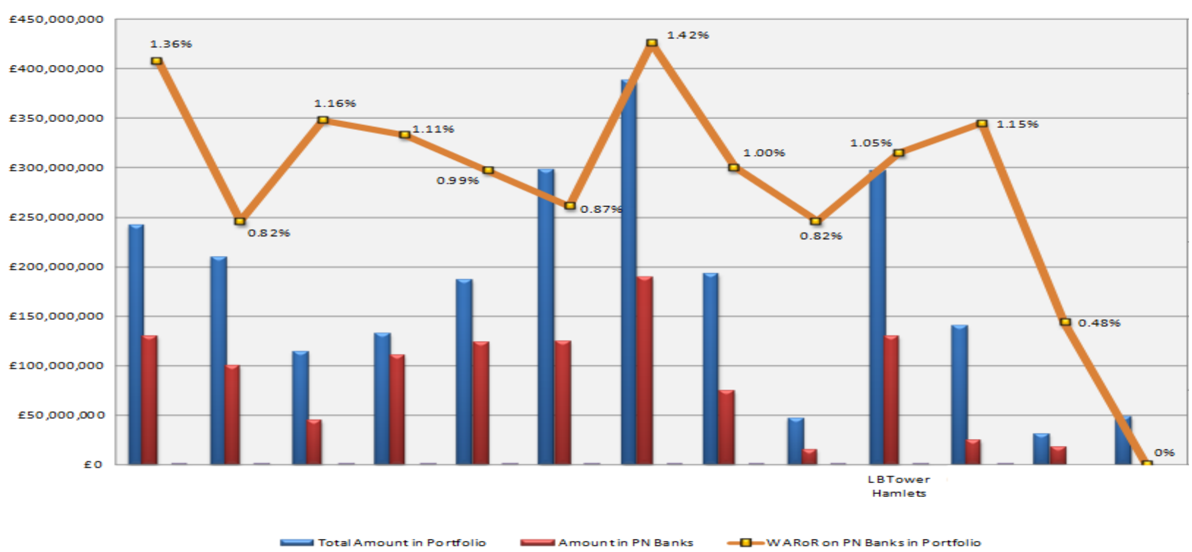


							Difference		Model	
	WARoR	WAM	WATT	WARisk	Gilt	LIBOR-Swap	Gilt	LIBOR-Swap	Bands	Perf
London Borough Of Tower Hamlets	0.80%	119	272	3.0	0.48%	0.60%	0.32%	0.19%	0.70% - 0.83%	
Benchmarking Group 2	0.85%	199	356	3.0	0.53%	0.71%	0.32%	0.14%	0.73% - 0.86%	
London	0.83%	183	343	2.8	0.54%	0.69%	0.29%	0.14%	0.73% - 0.86%	

3.9.2 The weighted average rate of return (WARoR) for Tower Hamlets is 0.80% compared to 0.85% for the group. The return on LBTH investment is commensurate with the Council's risk appetite as set out in the Investment Strategy.

3.9.3 The below chart compares exposure to Part-Nationalised Banks (PNB) between club members as the Council currently has a significant amount of investment with PNBs. The chart shows that the Council's allocation to and returns from investment with PNBs is in line with other London boroughs as at 31 December 2014.

LB Tower Hamlets Exposure to Part-Nationalised Banks- end of Dec 2014



3.10 INVESTMENT STRATEGY UPDATE

3.10.1 Full Council approved the Investment Strategy on 26 February 2014. Officers continue to look for ways to maximise returns on cash balances within the constraints of the Investment Strategy. The Investment Strategy was developed based on an improving outlook in the money markets.

3.10.2 Wholly or partly owned government banks offer significantly higher rates than the DMO, but have similar levels of security based on government guarantee of their credit quality. The Council already relies on this guarantee and invests with these banks, and the current strategy is to have £70m money limit for each group with an aggregate of 40% of the overall investment portfolio. This should ensure that the Council continues to receive good returns on its cash balances and that the investment strategy is optimised to support the Council's efficiency programme.

3.10.3 There has been reports that the Government will start divesting from these banks, but the Council treasury adviser assured the officers that this report has no bearing on their current views of the banks and they will continue to keep clients informed of developments on this front and any related updates to their views on both Lloyds Banking Group and Royal Bank of Scotland Group.

4. COMMENTS OF THE CHIEF FINANCE OFFICER

4.1 The comments of the Acting Corporate Director Resources are incorporated in the report.

5. LEGAL COMMENTS

5.1 Treasury management activities cover the management of the Council's investments and cash flows, its banking, money market and capital market transactions, the effective control of risks associated with those activities and the pursuit of optimum performance consistent with those risks. The Local Government Act 2003 provides a framework for the capital finance of local authorities. It provides a power to borrow and imposes a duty on local authorities to determine an affordable borrowing limit. It provides a power to invest. Fundamental to the operation of the scheme is an understanding that authorities will have regard to proper accounting practices recommended by the Chartered Institute of Public Finance and Accountancy (CIPFA) in carrying out capital finance functions.

5.2 The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 require the Council to have regard to the CIPFA publication "Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes" ("the Treasury Management Code") in carrying out capital finance functions under the Local Government Act 2003. If after having regard to the Treasury Management Code the Council wished not to follow it, there would need to be some good reason for such deviation.

5.3 The Treasury Management Code requires as a minimum that there be a practice of regular reporting on treasury management activities and risks to the responsible committee and that these should be scrutinised by that committee. Under the Council's Constitution, the audit committee has the functions of monitoring the Council's risk management arrangements and making arrangements for the proper administration of the Council's affairs.

6. ONE TOWER HAMLETS CONSIDERATIONS

6.1 Interest on the Council's cash flow has historically contributed significantly towards the budget.

7. BEST VALUE (BV) IMPLICATIONS

7.1 Assessment of value for money is achieved through:

- Monitoring against benchmarks
- Operating within budget

7.2 For example, investment returns exceeded the LIBID benchmark up to December 2014 and the treasury function operated within budget in Q3 of 2014/15.

8. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

8.1 There are no Sustainable Actions for A Greener Environment implications.

9. RISK MANAGEMENT IMPLICATIONS

9.1 Any form of investment inevitably involves a degree of risk. To minimise risk the investment strategy has restricted exposure of council cash balances to UK backed banks or institutions with the highest short term rating or strong long term rating.

10. CRIME AND DISORDER REDUCTION IMPLICATIONS

10.1 There are no crime and disorder reduction implications arising from this report.

Linked Reports, Appendices and Background Documents

Linked Report

- NONE

Appendices

- Appendix 1 - Investments Outstanding as at 31st December 14.

Local Government Act, 1972 Section 100D (As amended)

List of "Background Papers" used in the preparation of this report
List any background documents not already in the public domain including officer contact information.

- Capita December 2014 Investment Portfolio Analysis Report

Officer contact details for documents:

- Bola Tobun   Ext. 4733
- Mulberry Place, 3rd Floor.

Appendix 1
Investments Outstanding as at 31st December 14

Time to Maturity	Counterparty	From	Maturity	Amount £m	Rate
Overnight	IGNIS		**MMF**	4.00	0.47%
	Aberdeen		**MMF**	5.80	0.41%
	Blackrock		**MMF**	15.00	0.39%
	BNP Paribas		**MMF**	15.00	0.46%
	Federated		**MMF**	15.00	0.46%
	Goldman		**MMF**	15.00	0.41%
	Insight		**MMF**	2.80	0.44%
	SUB TOTAL			**72.60**	
< 1 Month	Royal Bank of Scotland	09/07/2013	09/01/2015	5.00	0.95%
	Royal Bank of Scotland	27/01/2012	27/01/2015	5.00	3.35%
1 - 3 Months	Santander		Call - 95N	10.00	0.45%
	Lloyds Banking Group	04/02/2014	04/02/2015	5.00	0.95%
	Lloyds Banking Group	13/02/2014	13/02/2015	5.00	0.95%
	Commonwealth Bank of Australia	15/08/2014	13/02/2015	5.00	0.48%
	DZ Bank	26/08/2014	26/02/2015	5.00	0.71%
	Skandinaviska Enskilda Banken	29/08/2014	27/02/2015	5.00	0.64%
	Lloyds Banking Group	04/09/2014	04/03/2015	5.00	0.70%
	Lloyds Banking Group	05/03/2014	05/03/2015	10.00	0.95%
	Barclays	05/09/2014	05/03/2015	10.00	0.61%
	Commonwealth Bank of Australia	15/09/2014	16/03/2015	5.00	0.53%
	Lloyds Banking Group	07/10/2014	07/04/2015	5.00	0.70%
	Lloyds Banking Group	11/04/2014	10/04/2015	5.00	0.95%
	Lloyds Banking Group	11/07/2014	13/04/2015	10.00	0.80%
	Nationwide Building Society	13/10/2014	13/04/2015	5.00	0.66%
	Lloyds Banking Group	15/04/2014	15/04/2015	5.00	0.95%
	Royal Bank of Scotland	16/04/2013	16/04/2015	5.00	0.88%
	Royal Bank of Scotland	16/04/2014	16/04/2015	5.00	0.67%
	Nationwide Building Society	16/10/2014	16/04/2015	5.00	0.66%
	Lloyds Banking Group	17/07//2014	17/04/2015	5.00	0.80%
	Skandinaviska Enskilda Banken	29/04/2014	29/04/2015	5.00	0.71%
	Lloyds Banking Group	29/10/2014	29/04/2015	5.00	0.70%
3 - 6 Months	National Australia Bank	06/11/2014	06/05/2015	5.00	0.55%
	National Australia Bank	14/05/2014	14/05/2015	10.00	0.63%
	DZ Bank	26/08/2014	26/05/2015	5.00	0.86%
	National Australia Bank	07/07/2014	07/07/2015	5.00	0.64%
	Royal Bank of Scotland	15/07/2014	15/07/2015	20.00	0.97%
	Commonwealth Bank of Australia	15/07/2014	15/07/2015	5.00	0.83%
	Commonwealth Bank of Australia	17/07/2014	17/07/2015	5.00	0.82%
6 - 9 Months	Commonwealth Bank of Australia	12/08/2014	12/08/2015	5.00	0.81%
	DZ Bank	26/08/2014	26/08/2015	5.00	0.98%
9 - 12 Months	Lloyds Banking Group	04/12/2014	04/12/2015	5.00	1.00%
> 12 Months	Royal Bank of Scotland	27/02/2013	26/02/2016	10.00	1.15%
	Royal Bank of Scotland	20/03/2014	20/03/2016	5.00	1.25%
	Royal Bank of Scotland	10/01/2014	09/01/2017	5.00	1.74% *
	SUB TOTAL			**225.00**	
	TOTAL			**297.60**	

* This is a structured deal, the terms of which could change during its tenor.