AC 28TH NOVEMBER 2017 ITEM 06

CABINET – 16TH NOVEMBER 2017

Report of the Head of Finance & Property Services

Lead Member: Councillor Tom Barkley

Part A

ITEM TREASURY MANAGEMENT UPDATE – MID-YEAR REVIEW FOR THE 6 MONTHS ENDED 30TH SEPTEMBER 2017

Purpose of Report

This report reviews the Treasury Management Strategy and the Annual Investment Strategy, plus the various Prudential Borrowing and Treasury Indicators for the first six months of 2017/18.

Recommendations

1. That it be recommended to Council that the maximum limit of investments with a maturity of greater than one year be increased from £9m to £11m.

2. That it be otherwise recommended to Council to note this mid-year review of the Treasury Management Strategy Statement, Prudential Borrowing and Treasury Indicators plus the Annual Investment Strategy, as shown in Part B.

Reasons

1. To increase the investment opportunities available to the Council with a view to achieving higher rates of investment return.

2. To ensure that the Council's governance and management procedures for Treasury Management reflect best practice and comply with the Revised CIPFA Treasury Management in the Public Services Code of Practice, Guidance Notes and Treasury Management Policy Statement, that funding of capital expenditure is taken within the totality of the Council's financial position and that borrowing and investment is only carried out with proper regard to the Prudential Code for Capital Finance in Local Authorities.

Policy Justification and Previous Decisions

The Treasury Management Strategy Statement, Prudential & Treasury Indicators and Annual Investment Strategy must be approved by Council each year and reviewed half yearly. This review is set out in the attached report as Part B. The Strategy for the year was approved by Council on 27th February 2017 (minute ref: 77.2).

Implementation Timetable including Future Decisions and Scrutiny

This report will be available for Overview Scrutiny Group on 13th November 2017, should they wish to consider it, and for the Audit Committee on 28th November 2017.

Report Implications

The following implications have been identified for this report.

Financial Implications

There are no direct financial implications arising from this report.

Risk Management

Whilst there are no immediate risks arising from the recommendations in this report it should be noted that increasing the maximum limit of investments with a maturity of greater than one year from £9m to £11m would allow the Council to invest a greater proportion of funds in this type of investment as and when investment opportunities become available. In theory the greater returns available from this approach reflect both the 'time value' of money (in that longer term investment precludes alternative uses of funds in the short term) and also some limited element of increased risk. However, in the context of all possible investment opportunities, the envisaged investments are still considered low risk. This limited additional risk will be mitigated by the appointment of professional advisors to assist in the identification and assessment of alternative investments.

Other risks associated with the Treasury Policy in general are included in Part B.

Key Decision:	No
Background Papers:	None
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Part B

Treasury Management Update – Half Year Ended 30th September 2017

Background

1. The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the role of the treasury management operations is to ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

2. The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning, to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

3. Accordingly, treasury management is defined as:

   "The management of the local authority'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."

4. The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management recommends that members be updated on treasury management activities regularly. This report therefore ensures the Council is implementing best practice in accordance with the Code.

5. This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

   - An economic update for the first part of the 2017/18 financial year;
   - 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 2017/18;
   - A review of the Council's borrowing strategy for 2017/18;
   - A review of any debt rescheduling undertaken during 2017/18;
   - A review of compliance with Treasury and Prudential Limits for 2017/18.

6. This is a mid-year report therefore there are no proposed changes to the Capital strategy at this point.

Economic Background

7. UK

- After the UK economy surprised on the upside with strong growth in 2016, growth in 2017 has been disappointingly weak; quarter 1 came in at only +0.3% (+1.7% y/y) and quarter 2 was +0.3% (+1.5% y/y) which meant that growth in the first half of 2017 was the slowest for the first half of any year since 2012. . The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 75% of GDP, has seen weak growth as consumers cut back on their expenditure. However, more recently there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year. However, this sector only accounts for around 11% of GDP so expansion in this sector will have a much more muted effect on the average total GDP growth figure for the UK economy as a whole.

- The Monetary Policy Committee (MPC) meeting of 14 September 2017 surprised markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise. The Bank of England Inflation Reports during 2017 have clearly flagged up that they expected CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years time. Inflation actually came in at 2.9% in August, (this data was released on 12 September), and so the Bank revised its forecast for the peak to over 3% at the 14 September meeting MPC. This marginal revision can hardly justify why the MPC became so aggressive with its wording; rather, the focus was on an emerging view that with unemployment falling to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that the amount of spare capacity in the economy was significantly diminishing towards a point at which they now needed to take action. In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of increasing globalisation. This effectively means that the UK labour faces competition from overseas labour e.g. in outsourcing work to third world countries, and this therefore depresses the negotiating power of UK labour. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a decrease in such globalisation pressures in the UK, and so would be inflationary over the next few years.

- It therefore looks very likely that the MPC will increase Bank Rate to 0.5% in November or, if not, in February 2018. The big question after that will be whether this will be a one off increase or the start of a slow, but regular, increase in Bank Rate. As at the start of October, short sterling rates are indicating that financial markets do not expect a second increase until May 2018 with a third increase in November 2019. However, some forecasters are flagging up that they expect growth to improve significantly in 2017 and into 2018, as the fall in inflation will bring to an end the negative impact on consumer spending power while a strong export performance will compensate for weak services sector growth. If this scenario were to materialise, then the MPC would have added reason to embark on a series of slow but gradual increases in Bank Rate during 2018. While there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two years will pan out.

8. EU

- Economic growth in the EU, (the UK's biggest trading partner), has been lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of QE. However, growth picked up in 2016 and now looks to have gathered ongoing substantial strength and momentum thanks to this stimulus. GDP growth was 0.5% in quarter 1 (2.0% y/y) and 0.6% in quarter (2.3% y/y). However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in August inflation was 1.5%. It is therefore unlikely to start on an upswing in rates until possibly 2019.

Interest Rate Forecast

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

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.50%	1.60%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%
50yr PWLB rate	2.70%	2.70%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%

10. Capita Asset Services undertook its last review of interest rate forecasts on 9 August after the quarterly Bank of England Inflation Report. There was no change in MPC policy at that meeting. However, the MPC meeting of 14 September revealed a sharp change in sentiment whereby a majority of MPC members said they would be voting for an increase in Bank Rate "over the coming months". It is therefore possible that there will be an increase to 0.5% at the November MPC meeting. If that happens, the question will then be as to whether the MPC will stop at just withdrawing the emergency Bank Rate cut of 0.25% in August 2016, after the result of the EU withdrawal referendum, or whether they will embark on a series of further increases in Bank Rate during 2018.

11. The overall balance of risks to economic recovery in the UK is currently to the downside but huge variables over the coming few years include just what final form Brexit will take, when finally agreed with the EU, and when. Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

    - UK economic growth and increases in inflation are weaker than we currently anticipate.
    - Weak growth or recession in the UK's main trading partners - the EU and US.
    - Geopolitical risks in Europe, the Middle East and Asia, which could lead to increasing safe haven flows.
    - A resurgence of the Eurozone sovereign debt crisis.
    - Weak capitalisation of some European banks.
    - Monetary policy action failing to stimulate sustainable growth and to get inflation up consistently to around monetary policy target levels.

12. The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

    - The pace and timing of increases in the Fed. Funds Rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
    - UK inflation returning to significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

<u>Treasury Management Strategy Statement and Annual Investment Strategy update</u>

13. The Treasury Management Strategy Statement (TMSS) for 2017/18, which includes the Annual Investment Strategy, was approved by Council on 28th February 2017. It sets out the Council's investment priorities as being:

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

14. In line with the Treasury Management Policy, the approved limits have been reviewed and Officers are proposing to amend these at the next appropriate Council meeting to reflect available investment monies and market conditions. The amendment is an increase to the maximum limit of investments of over a year from £9m to £11m. This is to allow potential investments in property funds up to the value of £5m subject to an assessment process. This increase in the scope of investment options will significantly enhance the Council's ability to achieve greater returns with limited additional risk. The identification and assessment of potential property fund investments will be supported by our external treasury advisors.

15. The details in this report update the position in the light of the updated economic position and budgetary changes already approved.

16. The Council will aim to achieve the optimum return (yield) on investments commensurate 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, using the Council's creditworthiness approach including sovereign credit rating and Credit Default Swap (CDS) overlay information. In addition, the Annual Investment Strategy allows the Council to invest in property funds and with other Local Authorities for a maximum of 2 years.

17. Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the six months ended 30th September 2017.

18. It is currently 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 0.25% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis together with other risks, which could impact on the creditworthiness of banks, prompts a low risk strategy. Given this risk environment, investment returns are likely to remain low.

19. The average level of funds available for investment purposes during the half year was £46.65m. The majority of 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.

20. During the six months to 30th September 2017, the Council's interest rate earned was 0.49% against a benchmark of 3 month London Interbank Bid Rate (LIBID) of 0.18%. This measure is used as a comparator because it allows comparisons

with our benchmarking group and matches the weighted average time period of our current investments. Although the return rate is low, our performance can still be considered to be good as we exceeded the target rate by 0.31%. The actual interest received to 30th September 2017 was £110k, against an annual budget of £30k so we performed above target in both percentage and actual returns for the six months. It is proposed to review the investment income budget as part of 2018/19 budget setting in light of the higher than budgeted returns being achieved.

New Borrowing

21. No new borrowing was undertaken during the half year and neither has the council borrowed in advance of need during the six months ended 30th September 2017. Similarly, no debt rescheduling was undertaken during the half year.

Compliance with Treasury and Prudential Limits

22. It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. The Council's approved Treasury and Prudential Indicators (affordability limits) are included in the approved TMSS.

23. During the financial year to date, the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices. The prudential and treasury Indicators are shown in Appendix 1.

Appendices

Appendix 1: Prudential and Treasury Indicators as at 30th September 2017

Appendix 2: Investment Portfolio – Investments held as at 30th September 2017

APPENDIX 1:

Prudential and Treasury Indicators as at 30th September 2017

Treasury Indicators	2017-18 Budget £'000	30/09/17 Actual £'000
Authorised limit for external debt	96,000	81,190
Operational boundary for external debt	81,190	81,190
Gross external debt	81,190	81,190
Investments	30,103	48,350
Net borrowing	51,087	32,840
Maturity structure of fixed rate borrowing - upper and lower limits	**Upper Limits**	**Actual**
Under 12 months	5%	0%
12 months to 2 years	10%	0%
2 years to 5 years	20%	0%
5 years to 10 years	30%	11%
10 years to 20 years	35%	33%
20 years to 30 years	50%	38%
30 years to 40 years	15%	12%
40 years and above	20%	6%

Prudential Indicators	2017/18 Budget £'000	30/09/17 Actual £'000
Capital expenditure – General Fund	4,909	1,767
Capital expenditure – HRA	7,512	1,132
Capital Financing Requirement (CFR) – GF	-484	-484
Capital Financing Requirement (CFR) – HRA	81,820	81,820
Annual change in CFR	0	0
In year external borrowing requirement	0	0
Ratio of financing costs to net revenue stream - GF	1.33%	1.33%
Ratio of financing costs to net revenue stream - HRA	12.43%	12.43%
Incremental impact of capital investment decisions:-		
Increase in council tax (band change) per annum.	0%	0%
Increase in average housing rent per week	0%	0%

APPENDIX 2:

Investment Portfolio

Investments held as at 30th September 2017

Institution	Maturity Date	Interest Rate %	Principal £'000
Warrington Borough Council	23/02/2018	0.90	2,000
Liverpool City Council	25/01/2019	0.70	2,000
Bournemouth Borough Council	27/09/2019	0.72	2,000
Nationwide Building Society	14/11/2017	0.37	1,000
Nationwide Building Society	14/02/2018	0.30	2,000
Goldman Sachs International Bank	09/03/2018	0.575	3,000
Santander	180 Day Notice	0.55	8,000
Goldman Sachs International Bank	180 Day Notice	0.67	5,000
Bank of Scotland	175 Day Notice	0.65	4,000
Barclays Bank Plc	95 Day Notice	0.45	6,000
Federated ECF	2 Day Notice	0.44	7,000
Federated MMF	1 Day Notice	0.21	6,350
Total			48,350