Treasury Management Mid-Year Report 2017/18

Wards affected: **All**

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Proposed Decision

That the treasury management mid-year report for 2017/18, covering the period 1 April 2017 to 30 September 2017 be considered and noted.

Corporate implications

To promote effective financial management and comply with the Local Authorities (Capital Finance and Accounting) Regulations 2003 and other relevant guidance. Treasury management activity plays a significant part in supporting the delivery of all the Council's corporate priorities

Background

1. The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations 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 likely borrowing needs of the Council. Essentially the purpose of longer term cash flow planning is to ensure the Council can meet its capital spending operations. The 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."

Introduction

4. The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) has been adopted by this Council.

5. The primary requirements of the Code are as follows:
    a. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
    b. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
    c. Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.
    d. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
    e. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is The Audit Committee.

6. The purpose of this report is specifically to meet one of the above requirements, namely the mid-year report of Treasury Management activities. The report details progress during the year against the Strategy approved by Council on 23 February 2017 and covers the following:
    - Treasury position as at 30 September 2017 (paragraphs 07-08);
    - A review of the Council's Investment (paragraphs 09-14) and Borrowing strategy for 2017/18 (paragraphs 15 to 16);
    - A review of compliance with Prudential Indicators (paragraphs 17 to 23); and
    - An economic update (Appendix A) provided by Capita Asset Services.

Treasury Position as at 30 September 2017

7. As at 30 September 2017, the Council did not have any external borrowing and the treasury investments were £90.6m earning an average rate of return at 0.64%. The Treasury position is summarised in the table below:-

	As at 30 September 2017		As at 31 March 2017	
	Principal £m	Average Rate %	Principal £m	Average Rate %
Total Investments	90.6	0.64%	74.6	0.67%
Total Borrowing	0.0		0.0	

8. On one occasion the Council exceeded its £4m limit with its own banking services provider Natwest Plc. The excess balance position arose due to unexpected cash being received late in the day and treasury staff not being able to place the funds with another suitable counterparty due to the financial markets being closed. On this occasion investments with Natwest Plc were brought within the approved limit at the first available opportunity. Aside from

this one occasion, the Council has complied with its approved investment strategy.

Review of Investment Strategy

9. The Council remains cautious by placing security and liquidity considerations ahead of income generation. With Bank Rate at its low at 0.25% it is impossible, at comparable risk levels, to invest at interest rates commonly seen in previous decades. Yields available in the short term during the period are outlined in the table below:

Deposit Rates	30th September 2017
Overnight rates	0.20
One month	0.20
Three months	0.25
One year	0.60

10. The Council held £90.6m of investments as at 30 September 2017 compared with £74.627m at 31 March 2017. The investment portfolio yield for the first six months of the year is 0.64% against the three months LIBOR of 0.23%. The increase in investments is primarily due to the timing difference between the collection of Council Tax and Business Rates and the payments to major preceptors.

11. The Treasury strategy approved by the Council in February 2017 allows Council to invest in indirect property funds. However, it did not allow for investment directly in property for Treasury purposes. The Council on 9th October 2017 approved the use of property investments, direct and indirect, to achieve improvements in Treasury Yields, up to a maximum investment value of £15.000m.

12. Council is considering an investment of £7.500m in the CCLA Property Fund during the next quarter. The forecast yield for the CCLA Local Authorities Property Fund is in estimated to be around 4.00%.

13. Council will also consider any direct property investments opportunities which would generate better yields.

14. The table below sets out the treasury position as at 30 September

	As at September 2017		As at March 2017	
	£m	**%**	**£m**	**%**
Specified Investments				
Banks & Building Socities	38.6	43%	32.6	44%
Locals	7.0	8%	9.0	12%
Money Market Funds	27.0	30%	22.0	30%
Non-Specified Investments				
Banks & Building Socities	13.0	14%	6	8%
Gilt	5.0	6%	5	7%
Total	**90.6**	**100%**	**74.6**	**100%**

Review of Borrowing Strategy

15. The Council does not have any external borrowing and none has been taken out during the six month period to 30 September 2017.

16. With low interest rates and counter party risks, the Council's strategy continues to utilise internal borrowing to support the capital programme. However, the Council, at its meeting on 9 October 2017, approved borrowing up to the agreed ceiling. External borrowing will therefore be considered if appropriate schemes become available and it is cost effective to pursue such borrowing.

Compliance with Prudential Indicators

Prudential Indicator - Capital Expenditure

17. The Council's capital programme is the key driver of Treasury Management activity. The output of the capital programme is reflected in the statutory prudential indicators. The table below summarises the capital expenditure and funding for the current financial year.

	Original Estimate	Revised Estimate	Forecast Outturn
	£m	£m	£m
Capital expenditure	16.985	19.705	16.202
Financed by:			
Capital receipts	2.099	0.000	0.000
Capital grants	0.500	0.972	0.800
CIL & Section106	4.951	5.796	5.071
Revenue	9.435	12.937	10.331
Total financing	16.985	19.705	16.202

18. The above table shows revised capital programme for the year of £19.705m. However, as at 30 September 2017, £16.202m was forecast to be spent in the current financial year with the remainder being deferred to future years.

Prudential Indicator - Capital Financing Requirement

19. The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). It represents the cumulative 2017/18 and previous years' net capital expenditure which has not yet been funded by revenue nor other resources, but has been paid for by borrowing from internal existing cash balances.

Capital Financing Requirement	Estimate	Forecast
	£m	£m
Opening Balance	6.352	6.864
Less MRP (Waste Contract leases)	(0.918)	(0.918)
Closing Balance	**5.434**	**5.946**

Prudential Indicator – Operational Boundary and Authorised Limits

20. 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 2017/18 and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. The table below highlights the Council's gross borrowing position against the CFR.

	Estimate	Forecast
Gross borrowing	£18.00m	£2.388m
CFR	£5.434m	£5.946m
Authorised Limit	£19.000m	£19.000m
Operational Boundary	£18.000m	£18.000m

21. The Council has complied with this prudential indicator. The Head of Finance and Commercial reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

22. **The authorised limit** - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level.

23. **The operational boundary** – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

Background papers: Appendix A - Treasury Management strategy approved by Council in February 2017

Appendix A - Economics and interest rates

Economics update

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.

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.

USA. Growth in the American economy has been volatile in 2015 and 2016. 2017 is following that path again with quarter 1 coming in at only 1.2% but quarter 2 rebounding to 3.1%, resulting in an overall annualised figure of 2.1% for the first half year. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.4%, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on a gradual upswing in rates with three increases since December 2016; and there could be one more rate rise in 2017 which would then lift the central rate to 1.25 – 1.50%. There could then be another four more increases in 2018. At its June meeting, the Fed strongly hinted that it would soon begin to unwind its $4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

Chinese economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

Japan is struggling to stimulate consistent significant growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

3.2 Interest rate forecasts

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%

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.

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.

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.