

# Treasury Management Review up to 30 September 2017

## 1.1 Background

The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties, providing adequate liquidity initially before considering investment return.

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. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

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.”

## 1.2 Introduction

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

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. 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 covering activities during the previous year.
4. 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.
5. 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 Governance and Audit Committee:

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

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- 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 borrowing strategy for 2017/18;
  - A review of any debt rescheduling undertaken during 2017/18;
  - A review of the Council's investment portfolio, Treasury and Prudential Limits for 2017/18;
  - Treasury Policies /Issues
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## 2. Economics and interest rates

### 2.1 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.

The MPC raised rates on the 2<sup>nd</sup> November 2017. The big question is 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

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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 Quantitative Easing. 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 (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.

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## 2.2 Interest rate forecasts

The Council's treasury advisor, Link Asset Services (formerly Capita Asset Services), has provided the following forecast:

	NOW	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
<b>BANK RATE</b>	0.50	0.50	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.25	1.25	1.25
<b>3 month LIBID</b>	0.40	0.40	0.40	0.40	0.40	0.60	0.60	0.60	0.70	0.90	0.90	1.00	1.20	1.20	1.20
<b>6 month LIBID</b>	0.45	0.50	0.50	0.50	0.60	0.80	0.80	0.80	0.90	1.00	1.00	1.10	1.30	1.30	1.40
<b>12 month LIBID</b>	0.65	0.70	0.80	0.80	0.90	1.00	1.00	1.10	1.10	1.30	1.30	1.40	1.50	1.50	1.60
<b>5 yr PWLB</b>	1.50	1.50	1.60	1.60	1.70	1.80	1.80	1.90	1.90	2.00	2.10	2.10	2.20	2.30	2.30
<b>10 yr PWLB</b>	2.10	2.10	2.20	2.30	2.40	2.40	2.50	2.60	2.60	2.70	2.70	2.80	2.90	2.90	3.00
<b>25 yr PWLB</b>	2.70	2.80	2.90	3.00	3.00	3.10	3.10	3.20	3.20	3.30	3.40	3.50	3.50	3.60	3.60
<b>50 yr PWLB</b>	2.40	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.00	3.10	3.20	3.30	3.30	3.40	3.40

Link Asset Services undertook its last review of interest rate forecasts on the 7<sup>th</sup> November after the Monetary Committee change rates on the 2<sup>nd</sup> November from 0.25% to 0.50%. The question now is 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.

### **2.3 Treasury Management Strategy Statement and Annual Investment Strategy update**

The Treasury Management Strategy Statement (TMSS) for 2017/18 was approved by this Council on 18<sup>th</sup> July 2017. There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

### **2.4 The Council's Capital Position (Prudential Indicators)**

This part of the report is structured to update:

- The Council's capital expenditure plans;
- Limits to Borrowing Activity,
- Borrowing
- Compliance with the limits in place for borrowing activity.

#### **2.4.1 Prudential Indicator for Capital Expenditure**

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

<b>Capital Expenditure by Service</b>	<b>2017/18 Original Estimate £m</b>	<b>Current Position £m</b>	<b>2017/18 Revised Estimate £m</b>
Total Capital Expenditure	£124m	£34.8m	£104.8m

#### **2.4.2 Limits to Borrowing Activity**

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 Capital Finance Requirement (CFR) in the preceding year plus the estimates of any additional CFR for 2017/18 and next two financial years. This allows some flexibility for limited early borrowing for future years.

The Strategic Director Corporate Services reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

Below is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

<b>Authorised limit for external debt</b>	<b>2017/18 Original Indicator £m</b>	<b>Current Position</b>
Borrowing	440	336
Other long term liabilities	240	186
<b>Total</b>	<b>680</b>	<b>522</b>

Given the current historically low interest rates, the reduction in the Council's cash balance and the need to finance the commitments in the capital investment plan it is expected that the Council will need to consider additional borrowing before the end of this financial year.

### **2.4.3 Borrowing**

The Council's capital financing requirement (CFR) for 2017/18 is expected to be slightly above the original forecast of £675m, due to changes in the profiling of spend in a number of capital schemes. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. The Council has borrowings of £336m and last year a decision was made in December to take advantage of low interest rates to borrow against loans maturing in March 2017. Loans to the value of £25.9m was taken out.

It is anticipated that further borrowing be undertaken during this financial year to refinance a loan of £10m maturing in February 2018 and commitments in the capital investment plan.

The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date:

#### **PWLB certainty rates 1 April 2017 to 30 September 2017**

	<b>1 Year</b>	<b>5 Year</b>	<b>10 Year</b>	<b>25 Year</b>	<b>50 Year</b>
Low	0.8	1.14	1.78	2.52	2.25
Date	03/05/17	15/06/17	15/06/17	08/09/17	08/09/17
High	1.16	1.62	2.22	2.83	2.57
Date	15/09/17	28/09/17	28/09/17	07/07/17	07/07/17

#### **2.4.4 Debt Rescheduling**

Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

#### **2.5 Investment Portfolio, Treasury and Prudential Limits 2017/18**

In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. It is 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 current 0.25% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment, investment returns are likely to remain low.

The Council held £45m of investments as at 30<sup>th</sup> September 2017 (£49.8m at 31 March 2017) and the investment portfolio yield for the first 6 months of the year is 0.37% against a benchmark of 0.25 %. £8.3m in Euro's is also held in our Euro account in connection with the Waste Disposal Contract.

The Strategic Director Corporate Services confirms that the approved limits within the Annual Investment Strategy and prudential limits were not breached in 2017/18, apart from on the cash investments, where school individual balances for both Lloyds and Barclays were over the set limits.

#### **2.6 Treasury Policies /Issues**

##### **2.6.1 Revised CIPFA and DCLG Codes**

The Chartered Institute of Public Finance and Accountancy, (CIPFA), and the Department for Communities and Local Government, (DCLG), are currently conducting an exercise to consult local authorities on

i) CIPFA revising the Treasury Management and Cross Sectoral Guidance Notes, and the Prudential code.

ii) DCLG revising the Strategic Framework for the Prudential System.

Both CIPFA and DCLG are aiming to issue new guidance in the new year.

A particular focus of this exercise is how to deal with local authority investments which are not treasury type investments e.g. by investing in purchasing property in order to generate income for the authority at a much higher level than can be attained by treasury investments. One recommendation is that local authorities should produce a new report to members to give a high level summary of the overall capital strategy and to enable members to see how the cash resources of the authority have been apportioned between treasury and non treasury investments. Officers are monitoring developments and will report to members when the new codes have been agreed and issued and on the likely impact on this authority.

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## 2.6.2 MIFID II

The EU has now set a deadline of 3 January 2018 for the introduction of regulations under MIFID II. These regulations will govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. This will have little effect on this authority apart from having to fill in forms sent by each institution dealing with this authority and for each type of investment instrument we use apart from for cash deposits with banks and building societies. It will opt the Council up to be classed as a professional investor rather than a retail investor.

## 3. Other considerations

None

## 4. Financial and Resources Appraisal

The financial implications are set out in section 2 of this report

## 5. Risk Management and Governance Issues

The principal risks associated with treasury management are:

Risk: Loss of investments as a result of failure of counterparties

Mitigation: Limiting the types of investment instruments used, setting lending criteria for counterparties, and limiting the extent of exposure to individual counterparties

Risk: Increase in the net financing costs of the authority due to borrowing at high rates of interest.

Mitigation: Planning and undertaking borrowing and lending in light of assessments of future interest rate movements, and by undertaking mostly long term borrowing at fixed rates of interest (to reduce the volatility of capital financing costs).

## 6. Legal Appraisal

Any relevant legal considerations are set out in the report

## 7. Other Implications

7.1 Equality & Diversity – no direct implications

7.2 Sustainability implications – no direct implications

7.3 Green house Gas Emissions Impact – no direct implications

7.4 Community safety implications – no direct implications

7.5 Human Rights Act – no direct implications

7.6 Trade Unions – no direct implications

7.7 Ward Implications – no direct implications

8. Not for publications documents – none

9. Options

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## 10. Recommendations

10.1. That the revised report which includes further information on the new regulation on the CIPFA and DCLG codes out for consultation be adopted.

## 11. Appendices

Prudential and Treasury Indicators as at 30th September 2017

## 12. Background Documents

Treasury Management Schedules

Treasury Management Practices

Treasury Policy

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

Treasury Indicators	2017/18 Budget £m	(Apr - Sept) Actual £m
Authorised limit for external debt	£680m	£680m
Operational boundary for external debt	£620m	£620m
Gross external debt	£528m	£522m
Upper limit for principal sums invested over 365 days	£20m	£0m

Maturity structure of fixed rate borrowing -	Upper Limit	(Apr-March) Actual
Under 12 months	20%	3%
12 months to 2 years	20%	3%
2 years to 5 years	50%	8%
5 years to 10 years	50%	18%
10 years and above	90%	68%

Prudential Indicators	2017/18 Budget £m	(Apr - Sept) Actual £m
Capital expenditure	£124m	£34m
Capital Financing Requirement (CFR)	£675m	£678m
Ratio of financing costs to net revenue stream	16.2%	16.1%
Incremental impact of capital investment decisions:- a) Increase in council tax (band change) per annum.	0.00	0.00