CABINET

Agenda Item: 12

Ward: **All**

Portfolio: **All**

FROM: Corporate Finance

Date: 5 December 2016

SUBJECT: Treasury Management Strategy Statement – Mid-Year Review 2016/2017

Report Sign off	**Seen by:**	**Name**	**Date**
	Chief Executive/ Deputy Chief Executive(s)	Stuart Brown	15 November 2016
	Legal	N/A	
	Finance	Duncan Moss	15 November 2016
	Group Manager	Paul Deal	15 November 2016
	Portfolio Holder	Cllr Parham	15 November 2016
	Ward Member(s)	ALL	
Summary:	This report reviews the treasury performance for the first 6 months of 2016/17		
Recommendation:	**Cabinet is recommended to note:** • **the half-yearly performance against 2016/17 investment strategy,** • **the current treasury activity and the midyear report.**		
Direct and/or indirect impact on service delivery to our customers and communities:	None as a direct result of this report.		
Contribution to Corporate Priorities:	The strategy has the potential to directly impact on all delivery of the corporate priorities through the capital programme		
Legal Implications:	None as a direct result of this report.		
Financial Implications:	The Strategy will impact on the financing of the Capital programme and the interest income achievable will be reflected in the revenue budgets. The aim is for the best financial return for the minimum exposure to risk.		
Impact on Service Plans:	The strategy has the potential to indirectly impact on all service plans through the capital programme		
Crime and Disorder Implications:	None as a direct result of this report.		

Equalities Implications:	None as a direct result of this report.
Risk Assessment and Adverse Impact on Corporate Actions:	Treasury Management performance is influenced by global and national economic conditions. Restrictions set out in the manager's contract limit the institutions in which investments can be made, limit the Fund's exposure to the gilts market and control market risk.

1. BACKGROUND

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.

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.

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."

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 on 25th February 2016.

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 (MRP) Policy – for the year ahead, a Mid-year Review Report (this report) and an Annual Report (stewardship 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 the Cabinet.

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 2016/17 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 2016/17;
- A review of the Council's borrowing strategy for 2016/17;
- A review of any debt rescheduling undertaken during 2016/17;
- A review of compliance with Treasury and Prudential Limits for 2016/17.

3. ECONOMIC PERFORMANCE TO DATE

UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were strong but 2015 was disappointing at 1.8%, though it still remained one of the leading rates among the G7 countries. Growth improved in quarter 4 of 2015 from +0.4% to 0.7% but fell back to +0.4% (2.0% y/y) in quarter 1 of 2016 before bouncing back again to +0.7% (2.1% y/y) in quarter 2. During most of 2015, the economy had faced headwinds for exporters from the appreciation during the year of sterling against the Euro, and weak growth in the EU, China and emerging markets, plus the dampening effect of the Government's continuing austerity programme. The referendum vote for Brexit in June this year delivered an immediate shock fall in confidence indicators and business surveys, pointing to an impending sharp slowdown in the economy. However, subsequent surveys have shown a sharp recovery in confidence and business surveys, though it is generally expected that although the economy will now avoid flat lining, growth will be weak through the second half of 2016 and in 2017.

The Bank of England meeting on August 4th addressed this expected slowdown in growth by a package of measures including a cut in Bank Rate from 0.50% to 0.25%. The Inflation Report included an unchanged forecast for growth for 2016 of 2.0% but cut the forecast for 2017 from 2.3% to just 0.8%. The Governor of the Bank of England, Mark Carney, had warned that a vote for Brexit would be likely to cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the UK would have continuing full access, (i.e. without tariffs), to the EU single market. He also warned that the Bank could not do all the heavy lifting and suggested that the Government will need to help growth by increasing investment expenditure and possibly by using fiscal policy tools (taxation). The new Chancellor Phillip Hammond announced after the referendum result, that the target of achieving a budget surplus in 2020 will be eased in the Autumn Statement on November 23.

The latest Inflation Report also included a sharp rise in the forecast for inflation to around 2.4% in 2018 and 2019. CPI has started rising during 2016 as the falls in the price of oil and food twelve months ago fall out of the calculation during the year and, in addition, the post referendum 10% fall in the value of sterling on a trade weighted basis is likely to result in a 3% increase in CPI over a time period of 3-4 years. However, the MPC is expected to look to support economic growth through this one off upward blip from this devaluation of sterling in order, especially if pay increases continue to remain subdued and therefore pose little danger of stoking core inflationary price pressures within the UK economy.

The American economy had a patchy 2015 with sharp swings in the growth rate leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 disappointed at +0.8% on an annualised basis while quarter 2 improved, but only to a lacklustre +1.4%. However, forward indicators are pointing towards a pickup in growth in the rest of 2016. The Fed. embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene and then the Brexit vote, have caused a delay in the timing of the second increase which is now strongly expected in December this year.

In the Eurozone, the ECB commenced in March 2015 its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month; this was intended to run initially to September 2016 but was extended to March 2017 at its December 2015 meeting. At its December and March meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise from around zero towards the target of 2%. GDP growth rose by 0.6% in quarter 1 2016 (1.7% y/y) but slowed to +0.3% (+1.6% y/y) in quarter 2. This has added to comments from many forecasters that central banks around the world are running out of ammunition to stimulate economic growth and to boost inflation. They stress that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand in the their economies and economic growth.

Japan is still bogged down in anaemic growth and making little progress on fundamental reform of the economy while Chinese economic growth has been weakening and medium term risks have been increasing.

4. INTEREST RATE FORECAST

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

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Bank rate	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.25%	0.25%	0.25%	0.25%	0.50%
5yr PWLB rate	1.00%	1.00%	1.10%	1.10%	1.10%	1.10%	1.20%	1.20%	1.20%	1.20%	1.30%
10yr PWLB rate	1.50%	1.50%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.70%	1.80%
25yr PWLB rate	2.30%	2.30%	2.40%	2.40%	2.40%	2.40%	2.50%	2.50%	2.50%	2.50%	2.60%
50yr PWLB rate	2.10%	2.10%	2.20%	2.20%	2.20%	2.20%	2.30%	2.30%	2.30%	2.30%	2.40%

Capita Asset Services undertook a quarterly review of its interest rate forecasts after the MPC meeting of 4th August cut Bank Rate to 0.25% and gave forward guidance that it expected to cut Bank Rate again to near zero before the year end. The above forecast therefore includes a further cut to 0.10% in November this year and a first increase in May 2018, to 0.25%, but no further increase to 0.50% until a year later. Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual after they do start. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when the growth in average disposable income is still weak and could well turn negative when inflation rises during the next two years to exceed average pay increases.

The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. An eventual world economic recovery may also see investors switching from the safe haven of bonds to equities. However, we have been experiencing exceptional levels of volatility in financial markets which have caused significant swings in PWLB rates. Our PWLB rate forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

The overall balance of risks to economic recovery in the UK remains to the downside. Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Monetary policy action reaching its limit of effectiveness and failing to stimulate significant sustainable growth, combat the threat of deflation and reduce high levels of debt in some major developed economies, combined with a lack of adequate action from national governments to promote growth through structural reforms, fiscal policy and investment expenditure.
- Weak capitalisation of some European banks.
- A resurgence of the Eurozone sovereign debt crisis.
- Geopolitical risks in Europe, the Middle East and Asia, increasing safe haven flows.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or Fed. rate increases, causing a further flight to safe havens (bonds).
- 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.

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 than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

5. THE COUNCIL'S CAPITAL POSITION (PRUDENTIAL INDICATORS)

This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;

- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

The Council's Capital Investment Programme

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

Capital Expenditure 2016/17	2016/17 Original Budget	Spend as at 30th Sept	2016/17 Revised Estimate
	£000s	£000s	£000s
BIS - Website	14	-	14
Car Park lighting	26	-	26
Car Park Surfacing	40	-	40
Car Park Ticket Machine Replacement	100	1	100
Civica Legal Case Management System	29	23	29
Desktop/Laptop replacement	183	-4	-
Disabled Facilities Grant	694	208	985
Environmental Health - eNgage	23	-	-
Frome Library Foot Bridge	26	-	26
New & Replacement Wheeled Bins	120	-	91
Planning Printer / Scanner	13	19	19
Shepton Cemetery Tree felling	15	-	-
Shepton Mallet Cemetery burial project – additional space	45	-	-
Shepton Mallet Cemetery Wall £17k p/a	45	7	65
SQL licence upgrade	10	-	10
Wells Hospital Cemetery Wall £17k p/a	45	15	45
Frome Recreation & Open Ground Supporters (FROGS)	-	4	-
Total	**1,426**	**272**	**1,449**

Prudential Indicator for Capital Expenditure

The table below summarises the financing of the capital expenditure. Any shortfall of resources results in a funding need (borrowing).

Financing of Capital Expenditure	2016/17 Original Estimate £000s	2016/17 Revised Estimate £000s
Capital Receipts	-	-
Capital Grants	410	701
Direct Revenue Contribution	25	47
	435	**747**

Internal borrowing	**992**	**701**
Total	**1,426**	**1,449**

The main change in the figures above is due to the additional grant funding made available through the Disabled Facilities Grant.

Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

The table shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period. This is termed the Operational Boundary. We are on target to achieve the original forecast Capital Financing Requirement.

	2016/17 Original Estimate £000s	**2016/17 Revised Estimate £000s**
Prudential Indicator – Capital Financing Requirement		
Total CFR	3,203	2,912
Net movement in CFR	1,949	1,658
Prudential Indicator – External debt / the Operational Boundary		
Borrowing limit	10,000	10,000
Other long term liabilities	-	-
Total Council Debt 30 Sept 2016	**0**	**0**

The reduction in the CFR is mainly due to the identification of alternative sources of funding being identified in relation to the planned ICT refresh cost of the IT Refresh.

6. AFFORDABILITY PRUDENTIAL INDICATORS

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances.

Actual and estimates of the ratio of financing costs to net revenue stream

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

Ratio of Financing Costs to Net Revenue Stream	**2016/17 Original Estimate %**	**2016/17 Revised Estimate %**
Total	**(0.85)**	**(0.94)**

The estimates of financing costs include current commitments and the proposals in the budget.

Estimates of the incremental impact of capital investment decisions on Council Tax.

This indicator identifies the revenue costs associated with proposed changes to the three year capital programme compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three year period.

Incremental Impact of Capital Investment Decisions on the Band D Council Tax	2016/17 Original Estimate £	2016/17 Revised Estimate £
Total	**5.80**	**5.80**

The Authorised Limit for external debt

A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.

Authorised limit for external debt	2016/17 Original Indicator £000s	2016/17 Current Indicator £000s	2016/17 Revised Indicator £000s
Borrowing	10,000	10,000	10,000
Other long term liabilities	0	0	0
Total	**10,000**	**10,000**	**10,000**

7. INVESTMENT PORTFOLIO 2016/17

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. As set out in Section 3, 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 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 £20,345,875 of investments as at 30 September 2016 (£16,262,074 of investments as at 30 September 2015). A full list of investments held as at 30th September 2016 is:

Investments / Lending Summary as at:			30th September 2016		
Borrower	**Amount Invested**	**Limit**	**Length of deposit**	**Terms**	**Rate %**
UK Government Gilt	£1,610,000	£5,000,000	N/A	Call	1.25%
Lloyds	£2,000,000	£5,000,000	6 months	Fixed	0.80%
Lloyds	£2,000,000		6 months	Fixed	0.65%
Lloyds	£1,000,000		9 months	Fixed	0.90%
United Overseas Bank	£3,000,000	£5,000,000	6 months	Fixed	0.66%
Barclays	£1,000,000	£5,000,000	4 months	Fixed	0.43%
Barclays	£2,000,000		7 months	Fixed	0.71%
Bank of Scotland	£3,000,000	£5,000,000	4 months	Fixed	0.65%
Bank of Scotland	£94		NA	Call	0.15%
Bank of New York Mellon	£2,300,998	£5,000,000	NA	1 day not.	0.80%
Santander	£9,129	£5,000,000	N/A	Call	0.15%
Santander	£1,200,000		N/A	95 day not.	0.65%
Natwest	£1,225,654	£5,000,000	N/A	Call	0.25%
Total	**£20,345,875**				

The Corporate Financial Advisor (S151 Officer) confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2016/17. The Council's revised estimate investment return for 2016/17 is £92,000.

Property Funds - The use of these instruments can be deemed capital expenditure, and as such will be an application (spending) of capital resources. This Authority will seek guidance on the status of any fund it may consider using. Appropriate due diligence will also be undertaken before investment of this type is undertaken.

8. BORROWING

As at 30th September 2016, the Council continued to have no treasury borrowing need.

9. RECOMMENDATION

To note the half-yearly performance against the approved investment strategy for 2016/17, the current treasury activity and the contents of the mid-year report.

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Background Papers

- The Prudential Code for Capital Finance in Local Authorities
- Prudential Code Interim Guidance
- Local Government Act 2003
- Prudential Indicators report to Council February 2016
- Treasury Management Strategy report to Council February 2016

10. GLOSSARY

Borrowing Requirement / Financing Need - The amount that the Council needs to borrow to finance capital expenditure and manage debt.

Call Account – A bank deposit account where funds can be withdrawn at any time.

Capital Financing Requirement (CFR) - The Capital Financing Requirement reflects the Council's underlying need to borrow for capital purposes. Thus, if new capital expenditure is incurred and not financed from sources other than by borrowing, the CFR will increase by the amount of that expenditure. Borrowing, up to the value of the CFR, may be either from internal cash balances or externally, such as from the PWLB.

CIPFA Code of Practice on Treasury Management - A code of practice issued by CIPFA detailing best practice for managing the treasury management function.

Consumer Price Index (CPI) – CPI is calculated by collecting and comparing prices of a set basket of goods and services as bought by a typical consumer, at regular intervals over time. The CPI covers some items that are not in the RPI, such as unit trusts and stockbrokers fees, university accommodation fees and foreign students university tuition fees.

European Central Bank (ECB) – Sets the central interest rates in the European Monetary Union (EMU) area. The ECB determines the targets itself for its interest rate setting policy; this is to keep inflation within a band of 0 to 2%. It does not accept that monetary policy is to be used to manage fluctuations in unemployment and growth caused by the business cycle.

Gilts - Also known as Gilt-edged Securities. Registered British Government securities giving the investor an absolute commitment from the government to honour the debt that those securities represent.

Limits for External Debt - A Prudential Indicator prescribed by the Prudential Code sets limits on the total amount of debt the Council could afford.

Liquidity - Access to cash that is readily available.

Minimum Revenue Provision (MRP) - The minimum amount, which must be charged to an authority's revenue account each year for the prudent repayment of debt.

Prudential Code for Capital Finance in Local Authorities - The capital finance system is based on the Prudential Code developed by CIPFA. The key feature of the system is that local authorities should determine the level of their capital investment and how much they borrow to finance that investment based on their own assessment of what they can afford.

Prudential Indicators - The key objectives of the Prudential Code are to ensure that the capital investment plans are affordable, sustainable and prudent. As part of this framework, the Prudential Code sets out several indicators that must be used to demonstrate this.

Public Works Loan Board (PWLB) - A central government agency which provides loans to local authorities and other prescribed institutions at interest rates slightly higher than those at which the Government itself can borrow.

Sovereign Debt Rating - Assessment of the international rating agencies of the likelihood that a particular country will default on its loans.

Yield - The rate of return on the current market value of an asset or liability, usually expressed as a percentage per annum. For example, today's yield to maturity of a bond measures the total return to an investor in the bond, reflecting both the interest income over the life of the bond and any capital gain (or loss) from today's market value to the redemption amount payable at maturity.