ITEM NO. 7.1

Report of:	**Head of Finance**
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Portfolio Leader:	**Leader of the Council**
Key Decision:	**No**
Report Track:	**Audit & Governance C'ttee: 05/12/17**

AUDIT & GOVERNANCE COMMITTEE

5 DECEMBER 2017

TREASURY MANAGEMENT MID-YEAR REPORT 2017/18

1 Purpose of Report

1.1 To update Members on treasury management activity and performance during the first half of the 2017/18 financial year.

2 Recommendations

2.1 That the Committee notes the Report, treasury activity and the prudential indicators for 2017/18.

3 Key Issues and Reasons for Recommendation

3.1 To report the treasury management activity and performance during the first half of the 2017/18 financial year.

4 Relationship to Corporate Priorities

4.1 Treasury management and investment activity links in with all of the Council's priorities and their spending plans.

5 Report Detail

Background

5.1 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 ensures this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

5.2 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. 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.

5.3 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

5.4 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) was adopted by this Council on 29th February 2012.

5.5 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 the Cabinet.

5.6 The 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 2017/8 financial year to 30 September 2017;
- 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 compliance with Treasury and Prudential limits for 2017/18.

Economic Update

5.7 **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.

5.8 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.

5.9 The MPC increased the Bank Rate to 0.5% in November and now the big question after this 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.

5.10 **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.

5.11 **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 Federal Reserve System (often referred to as The Fed – the central bank of the United States) 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.

5.12 **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.

5.13 **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.

Interest rate forecasts

5.14 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	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate	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%
5yr PWLB Rate	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%
10yr PWLB View	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%
25yr PWLB View	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%
50yr PWLB Rate	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%

5.15 As expected, the Monetary Policy Committee (MPC) delivered a 0.25% increase in Bank Rate at its meeting on 2 November. This removed the emergency cut in August 2016 after the EU referendum. The MPC also gave forward guidance that they expected to increase Bank rate only twice more by 0.25% by 2020 to end at 1.00%. The Link Asset Services forecast as above includes increases in Bank Rate of 0.25% in November 2018, November 2019 and August 2020.

5.16 The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. It has long been expected, that at some point, there would be a more protracted move from bonds to equities after a historic long-term trend, over about the last 25 years, of falling bond yields. The action of central banks since the financial crash of 2008, in implementing substantial Quantitative Easing, added further impetus to this downward trend in bond yields and rising bond prices. Quantitative Easing has also directly led to a rise in equity values as investors searched for higher returns and took on riskier assets. The sharp rise in bond yields since the US Presidential election in November 2016 has called into question whether the previous trend may go into reverse, especially now the Fed. has taken the lead in reversing monetary policy by starting, in October 2017, a policy of not fully reinvesting proceeds from bonds that it holds when they mature.

5.17 Until 2015, monetary policy was focused on providing stimulus to economic growth but has since started to refocus on countering the threat of rising inflationary pressures as stronger economic growth becomes more firmly established. The Fed. has started raising interest rates and this trend is expected to continue during 2018 and 2019. These increases will make holding US bonds much less attractive and cause their prices to fall, and therefore bond yields to rise. Rising bond yields in the US are likely to exert some upward pressure on bond yields in the UK and other developed economies. However, the degree of that upward pressure is likely to be dampened by how strong or weak the prospects for economic growth and rising inflation are in each country, and on the degree of progress towards the reversal of monetary policy away from quantitative easing and other credit stimulus measures. From time to time, gilt yields - and therefore PWLB rates - can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis and emerging market developments. Such volatility could occur at any time during the forecast period.

5.18 Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK. The above forecasts (and MPC decisions) will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments, especially in the EU, could also have a major impact. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments

5.19 The overall balance of risks to economic recovery in the UK is probably to the downside, particularly with the current level of uncertainty over the final terms of Brexit.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:-

- Bank of England monetary policy takes action too quickly over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate;
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows;
- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system;
- Weak capitalisation of some European banks;
- The result of the October 2017 Austrian general election is likely to result in a strongly anti-immigrant coalition government. In addition, the new Czech prime minister is expected to be Andrej Babis who is strongly against EU migrant quotas and refugee policies. Both developments could provide major impetus to other, particularly former Communist bloc countries, to coalesce to create a major block to progress on EU integration and centralisation of EU policy. This, in turn, could spill over into impacting the Euro, EU financial policy and financial markets;
- Rising protectionism under President Trump;
- A sharp Chinese downturn and its impact on emerging market countries.

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

- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect;
- UK inflation returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields;
- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of Quantitative Easing, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.

Treasury Management Strategy Statement and Annual Investment Strategy Update

5.21 The Treasury Management Strategy Statement (TMSS) for 2017/18 was approved by this Council on 8 February 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.

The Council's Capital Position (Prudential Indicators)

5.22 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.

Prudential Indicators for Capital Expenditure

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

Capital Expenditure by Portfolio	2017/18 Original Estimate £m	2017/18 Revised Estimate £m
Housing Revenue Account	10,195	12,570
Housing General Fund	328	1,129
Economic Dev & Planning		76
Environment	1,156	282
Culture and Sport	27	1,769
Town Centre Regeneration	45	209
Corporate Improvement		450
Total	**11,751**	**16,485**

Changes to the Financing of the Capital Programme

5.24 The following table draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	2017/18 Original Estimate £m	2017/18 Revised Estimate £m
Supported	11,751	16,485
Unsupported	-	-
Total Spend		
Financed by:		
Capital Receipts	667	1,449
Major Repairs Allowance	3,301	3,280
Capital Grants/contributions	1,142	1,843
Revenue	3,619	6,891
Total Financing	**8,729**	**13,463**
Borrowing Need	**3,022**	**3,022**

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

5.25 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.

Prudential Indicator – Capital Financing Requirement

5.26 We are on target to achieve the original forecast Capital Financing Requirement.

Prudential Indicator – External Debt / the Operational Boundary

	2017/18 Original Estimate £m	2017/18 Revised Estimate £m
Prudential Indicator – Capital Financing Requirement		
Housing CFR	83,990	83,990
General Fund CFR	13,866	13,866
Total CFR	**97,856**	**97,856**
Prudential Indicator – the Operational Boundary for external debt (compared with actual debt)		
Operational boundary	97,856	97,856
Total PWLB Debt 31 March	**89,302**	**89,302**

Limits to Borrowing Activity

5.27 The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowing 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 allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

Borrowing compared with Capital Financing Requirement (CFR)	2017/18 Original Estimate £m	2017/18 Revised Estimate £m
External Debt		
Gross PWLB Borrowing	89,302	89,302
Plus Other Long Term Liabilities		
Gross Borrowing	**89,302**	**89,302**
CFR (year end position)	**97,856**	**97,586**

5.28 The Head of Finance reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

5.29 A further prudential indicator controls the overall level of borrowing. This 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.

	2017/18 Original Estimate £m	**2017/18 Revised Estimate £m**
Authorised limit for external debt	109,356	109,356

Investment Portfolio 2017/18

5.30 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 earlier in this report, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in the previous decades as rates are very low and in line with the 0.5% Bank Rate (0.25% until 2 November 2017). 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 and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

5.31 The Council held £19,076m of investments as at 30 September 2017 and the investment portfolio yield for the first six months of the year is 0.34% which compares favourably against a benchmark of the 3 month LIBID rate of 0.21%.

5.32 A full list of investments held as at 30 September 2017 is in **APPENDIX 1**.

5.33 The Council's budgeted investment return for 2017/18 is £90,000 (excluding pension prepayment) and performance to date is in line with budget.

5.34 The Head of Finance confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2017/18.

Borrowing

5.35 The Council's Capital Financing Requirement (CFR) for 2017/18 is £xx.xm. 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 £85m and has therefore utilised £12m of cash flow funds in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

5.36 Due to the overall financial position and the underlying need to borrow for capital purposes (the Capital Financing Requirement – CFR); no new external borrowing has been undertaken during the first half of the year.

5.37 As outlined below, the general trend has been an increase in interest rates during the first quarter but then a fall during the second quarter.

5.38 It is not currently anticipated that further borrowing will be undertaken during this financial year.

5.39 A summary of the PWLB certainty rates is set out below:

	1 Year	5 Year	10 Year	25 Year	50 Year
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
Average	0.9408%	1.2981%	1.9470%	2.6475%	2.3917%

Debt Rescheduling

5.40 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.

MIFID11 (Markets in Financial Instruments Directive)

5.41 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.

Revised CIPFA Codes

5.42 The Chartered Institute of Public Finance and Accountancy is currently reviewing the various Treasury Management Codes and Guidance Notes. 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 Council.

Money Market Fund Regulation

5.43 The new regulation comes into force on 21July 2018 in relation to existing funds but impacts immediately on any new funds created. For any existing funds they will have to be compliant, by no later than 21 January 2019. The Officers will review the impact of these changes and report back when further details are known.

6 Implications

6.1 **Financial**

The financial implications have been referred to throughout the report.

6.2 **Legal**

The legal implications have been referred to throughout the report.

6.3 **Human Resources**

There are no human resource implications arising from this report.

6.4 **Section 17 (Crime Prevention)**

There are no implications arising from this report.

6.5 **Human Rights Act**

There are no identified implications in respect of the Human Rights Act 1998 arising from this report.

6.6 **Data Protection**

There are no implications arising from this report.

6.7 **Risk Management**

The risk management implications have been referred to throughout the report.

6.8 **Equality & Diversity**

There are no identified implications arising form this report.

6.9 **Best Value**

The strategy ensures that best value is provided to the Council.

7 Appendices to the Report

Appendix 1: Current Investment List at 30 September 2017

Previous Consideration

None.

Background Papers

Available in Financial Services

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APPENDIX 1

Current Investment List at 30 September 2017

Borrower	Principal (£)	Interest Rate	Start Date	Maturity Date
MMF Standard Life (Ignis)	6,000,000	0.2028%		MMF*
MMF Federated Investors	800,000	0.1586%		MMF*
Santander UK plc	3,000,000	0.40%		Call95**
Svenska Handelsbanken	2,000,000	0.15%		Call***
Barclays Bank PLC	500,000	0.05%		Call***
Bank of Scotland plc	2,276,000	0.36%	13/09/17	14/03/18
The Royal Bank of Scotland	2,000,000	0.56%	11/09/17	10/09/18
Helaba	2,500,000	0.67%	16/11/16	16/11/17
Total Investments	**19,076,000**	**0.34%**		

*MMF - Money Market Fund (instant access)
**Call95 - 95 day notice account
*** Call - Instant access account