Full Council

12 December 2017

Report of: Service Director - Finance

Title: Treasury Management Mid-Year Report 2017/18

Ward: Citywide

Member Presenting Report: Deputy Mayor – Finance, Governance and Performance

Recommendation

That the Mid-Year Treasury Management report for 2017/18 is noted.

Summary

This report meets the treasury management regulatory requirement that the Council receive a Mid-Year Treasury review report. It also incorporates the needs of the Prudential Code to ensure adequate monitoring of the capital expenditure plans.

The significant issues in the report are:

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. The authority has identified a medium term borrowing requirement of £360m and is planning on borrowing £100m to support the delivery of the Capital Programme.

Policy

1. There are no policy implications as a direct result of this report.

Consultation

2. **Internal**
   Strategic & Service Directors, Audit Committee and Deputy Mayor – Finance, Governance & Performance.

3. **External**
   The Council's Treasury Management advisers

Purpose / Context of the report:

4. This report meets the treasury management regulatory requirement that the Council receive a mid-year treasury review report. It also incorporates the needs of the Prudential Code to ensure adequate monitoring of the capital expenditure plans and the Council's prudential indicators (PIs).

5. That the mid-year report is structured to highlight:
   - The economic outlook;
   - The actual and proposed treasury management activity (borrowing and investment);
   - The key changes to the Council's capital activity (the prudential indicators {PIs}).

Background

6. 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."

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

8. 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.

Introduction

9. The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised in 2011) has been adopted by this Council. The primary requirements of the Code are:

   - Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities;

- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives;

- 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;

- 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;

- 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 bodies are Overview and Scrutiny Management Board and Audit Committee.

10. 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 2017/18 financial year to 30 September 2017;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- A review of the Council's investment portfolio for 2017/18;
- A review of the Council's borrowing strategy for 2017/18;
- A review of any debt rescheduling undertaken or planned during 2017/18;
- The Council's capital expenditure and (prudential indicators);
- A review of compliance with Treasury and Prudential Limits for 2017/18.

Key Changes to the Treasury and Capital Strategies

11. 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.

12. The 2017–2020 Treasury Strategy (approved 21st February 2017) identified a medium term net borrowing requirement of £360m to support the existing and future Capital Programme with the debt servicing costs met from revenue savings from capital investment and the economic development fund. The Council's agreed policy is to defer borrowing while it has cash balances (£84m at September 2017, £40m estimated for March 2018). The authority is planning on borrowing £100m towards the end of the financial year from the PWLB / alternative market providers based on forecasts within the period 6 Finance Monitoring report, with the net financing costs contained within the existing capital financing budget. No further borrowing is anticipated in the current financial year, unless:

    - short term investments fall at a higher pace than expected increasing the liquidity risk of the authority and or;

    - there is a significant change in markets (debt financing costs continue to be at historic low levels) and long term borrowing is deemed advantageous the authority will borrow over

periods determined as the most appropriate to reduce the authorities exposure to interest rate risk.

Analysis of Debt and Investments

13. A summary of the of the Council's debt and Investment position as at 30th September 2017 (including forecast at 31st March 2018) compared with 31st March 2017 is shown in the table below:

Debt & Investments	31st March 2017		31st September 2017		31st March 2018	
	Actual		Actual		Forecast	
	£m	Rate%*b	£m	Rate%*b	£m	Rate%*b
Long Term Debt – PWLB	311	5.09	311	4.91	411	4.75
Long Term Debt – Market – LOBO*a	100	4.11	100	4.11	100	4.11
Long Term Debt – Market – Fixed	23	4.24	20	3.85	20	3.85
Short Term Borrowing	-	-	-	-	-	-
Total Debt	**434**	**4.81**	**431**	**4.68**	**531**	**4.58**
Investment	70	0.57	84	0.44	40	0.50
Net Borrowing Position	**364**		**347**		**491**	

*a Lender option Borrower option, *b reflects the average rate for the year taking account of new loans and repayments.

We are currently achieving a return of 0.44% on our investments for the period to 30th September 2017. The return for the year is anticipated to rise following the recent change in base rate to 0.50% on the 2nd of November with investment rates gradually rising in line with this change. The authority's advisors are also forecasting the next rise in base rate to 0.75% around the turn of the following calendar year (December 2018). Long term interest rates are expected to remain at or around 2.75% (for 25 year term) for the remainder of the year.

Economic Update

14. **UK** – The Uk surprised with strong growth in 2016 but growth in 2017 has been weak; quarter 1 +0.3% (+1.7% y/y) and quarter 2 +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, increasing the cost of imports. This has resulted in 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. 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. 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.

15. The Monetary Policy Committee (MPC) meeting of 14 September 2017 surprised markets and forecasters by suddenly switching to a 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 its target rate of 2% in two years' time. Inflation was 2.9% in August, so the Bank revised its forecast for the peak to over 3%. This marginal revision does not justify why the MPC became more 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 was originally anticipated that the next likely rise in base rate to 0.50% would either be November 2017 or February 2018, with the first rate rise in 10 years being November 2017. The big question will be whether this will be a one off increase or the start of a slow, but regular, increase in Bank Rate. The governor of the bank of England has indicated two more rates rises over the next two years to reach 1.0% by 2020.

At the start of November, short sterling rates are indicating that financial markets do not expect a second increase until September 2018 with a third increase in September 2019. However, some forecasters are expecting 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 start a series of slow but gradual increases in Bank Rate during 2018. While there is 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 materialise.

16. **USA**. The American economy has been volatile in 2015 and 2016. 2017 is following a similar path with quarter 1 1.2% and 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 increasing. The Federal Reserve has started gradually lifting rates with three increases since December 2016; and there could possibly be one more rise in 2017 which would lift the central rate to 1.25 – 1.50%, with a possibility of another four increases in 2018. At its June meeting, the Federal Reserve 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.

17. **Europe**. Economic growth in the EU, (the UK's biggest trading partner), has faltered for several years since the financial crisis despite the European Central Bank eventually cutting its main rate to -0.4% along with a significant Quantitative Easing programme. Growth picked up in 2016 and now looks to have gathered strength and momentum as a result of this stimulus. GDP growth was 0.5% in quarter 1 (2.0% y/y) and 0.6% in quarter (2.3% y/y). However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its

2% target and in August inflation was 1.5%. It is therefore unlikely to start on an upswing in rates until possibly 2019.

Interest rate forecasts

18. The Council's treasury advisor, 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
BANK RATE	0.50	0.50	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00
3 month LIBID	0.40	0.40	0.40	0.40	0.40	0.60	0.60	0.60	0.70	0.90	0.90
6 month LIBID	0.45	0.50	0.50	0.50	0.60	0.80	0.80	0.80	0.90	1.00	1.00
12 month LIBID	0.65	0.70	0.80	0.80	0.90	1.00	1.00	1.10	1.10	1.30	1.30
5 yr PWLB	1.50	1.50	1.60	1.60	1.70	1.80	1.80	1.90	1.90	2.00	2.10
10 yr PWLB	2.10	2.10	2.20	2.30	2.40	2.40	2.50	2.60	2.60	2.70	2.70
25 yr PWLB	2.70	2.80	2.90	3.00	3.00	3.10	3.10	3.20	3.20	3.30	3.40
50 yr PWLB	2.40	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.00	3.10	3.20

19. Capita Asset Services undertook its last review of interest rate forecasts on 7th November after the Bank of England Meeting where bank rate was increased to 0.50% and indicated a further rises to 1.0% by 2020.

20. The overall trend is for gilt yields and PWLB rates to rise 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.

21. The overall balance of risks to economic recovery in the UK is currently to the downside but large variables over the coming few years exist including what the final form Brexit will take and when.

    The 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
    - 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.

22. 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 within the UK economy, which then requires a later rapid series of increases in Bank Rate faster than we currently expect.

- UK inflation returning to significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

- The pace and timing of increases in the Federal Reserve funds rate causing a reassessment by investors of the risks of holding bonds as opposed to equities and leading to a major move from bonds to equities.

Investment Portfolio 2017/18

23. 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 the "Economic Update" 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 0.50% 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.

24. The Council held £84m of investments as at 30 September 2017 (£70m at 31 March 2017) with an average maturity of 75 days. These investments are predominately with UK banks, local authorities and money market funds. The investment portfolio yield for the first six months of the year is 0.44%. The standard comparator for investment performance is the benchmark 7 day rate (LIBID)[1,] which for the period was 0.11%. The benchmark for 3 month deposits was 0.18%.
1LIBID – London Interbank Bid rate is a recognised reference rate to benchmark short-term investment interest rates.

25. The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2017/18.

Borrowing

26. The Capital Financing Requirement (CFR) denotes the Council's underlying need to borrow for capital purposes. The Council's CFR at 31 March 2018 is estimated to be £876m. 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).

27. The balance of borrowing between external and internal is generally driven by market conditions and forecasts of future cash flows and interest rates. At the 31st March 2017 the Council had external borrowings of £580m and has utilised £253m of internal cash in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate but will require on-going monitoring in the event that upside risk to gilt yields prevails.

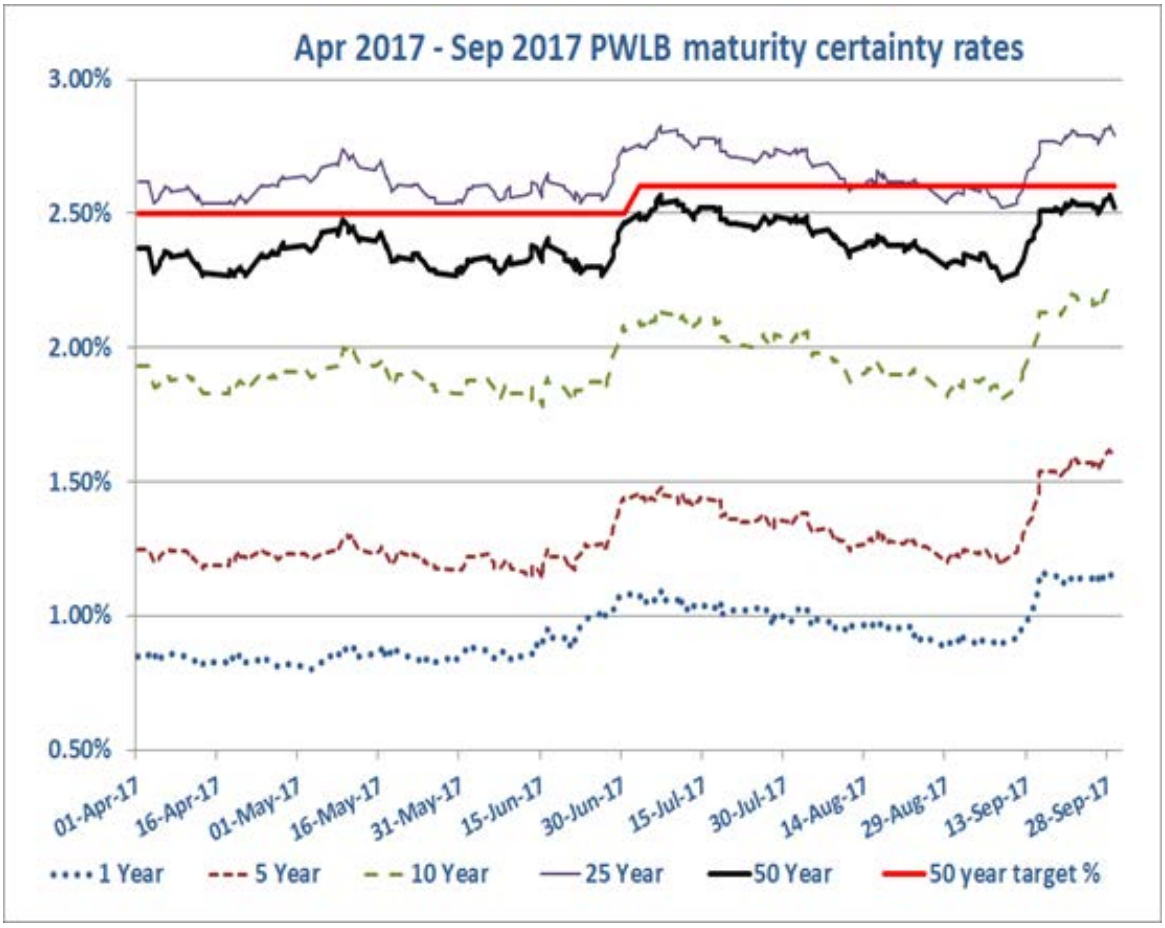
28. However, internal borrowing is a temporary measure that takes advantage of low interest rates and will ultimately be replaced by more expensive external borrowing as the cash used is

required elsewhere. The timing and amount of new external borrowing is therefore dependent on capital spending decisions, future cash flows and forecasts of interest rates.

29. The Council are planning on borrowing £100m at the end of the financial year from the PWLB or Capital markets to fund the Capital Programmes. The net financing costs of such borrowing will be contained within the existing capital financing budget.

30. Should debt financing costs continue to historic low levels, and with a significant capital programme predominately financed by borrowing the Council will consider further borrowing if rates continue to fall or are anticipated to rise at a higher pace than expected. This will enable the authority to take advantage of a low interest rate environment and reduce the interest rate risk of the authority.

31. The trend in interest rates was a rise during the first six months of the year, across all maturity bands. The graph below show the movement in PWLB (certainty) rates for the first six months of the year to 30th September 2017:



Debt Rescheduling

32. Debt rescheduling opportunities have been limited in the current economic climate given the consequent structure of interest rates. The authorities debt portfolio is made up of long dated loans (PWLB £311m, Market Debt (LOBOS) £100m and Market Debt (Fixed) £20m) averaging 34

years. The estimated penalty to repay the PWLB loans early is £223m, taking the total cost to £534m. In respect of the market loans, where indicative prices have been provided, a similar level of penalty has been quoted.

The total life cycle cost of rescheduling loans on a discounted cash-flow basis has been reviewed with no loans providing a positive cash-flow benefit to the authority. This would in part be due to large early repayment penalties that the authority will incur.

For these reasons no debt rescheduling has been undertaken during the first six months of the year and none is anticipated for the remainder of the year.

Ethical Policy

33. An Ethical Investment Policy is incorporated within the Treasury Management Practice Statements (TMPS). The City Council currently invest surplus funds with Banks and Building Societies either directly or via the Money Markets in the form of instant access cash deposit accounts, money market funds or on fixed term deposit and with other local authorities. The City Council's ethical investment policy is based on the premise that the City Council's choice of where to invest should reflect the ethical values it supports in public life. The City Council will not knowingly invest in organisations whose activities include practices which directly pose a risk of serious harm to individuals or groups, or whose activities are inconsistent with the mission and values of the City Council.

Other

34. **Revised CIPFA Codes**

The Chartered Institute of Public Finance and Accountancy, (CIPFA), is currently consulting local authorities on revising the Treasury Management Code and the Prudential Code, with a view to issuing revised codes late autumn.

A particular focus of this is how to deal with local authority investments which are not treasury type investments such as investing in commercial property investments that historically over time tend to generate higher level income streams than typical 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.

35. **MIFID II (Markets in Financial Instruments Directive)**

The European Union 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 the completion on annual forms sent by each institution dealing with this authority and for each type of investment instrument that we currently use apart from standard cash deposits with banks and building societies.

The Council's Capital Position (Prudential Indicators)

36. 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 Indicator for Capital Expenditure

37. This table shows the latest estimates for capital expenditure:

Capital Expenditure by Service	2017/18 Original Estimate £m	2017/18 Period 6 Forecast £m
Non-HRA	173	150
HRA	41	34
Total	**214**	**184**

38. The latest capital monitoring report for the end of September 2017 sets out a capital forecast of £184m as detailed within the period 6 monitoring report also presented to Cabinet on the 12th December 2017.

Financing of the Capital Programme

39. The table below draws together the capital expenditure plan 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 Period 6 Forecast £m
Total spend	**214**	**184**
Financed by:		
Capital receipts	3	2
Capital grants	39	40
Revenue / Reserves	17	20
HRA – Self Financing	25	25
Prudential Borrowing – Increase in Capital Financing Requirement	130	97
Total financing	**214**	**184**

Capital Financing Requirement (CFR) & Operational Boundary

40. The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose and it also shows the expected debt position over the period. This is termed the Operational Boundary.

	2017/18 Original Estimate £m	2017/18 Revised Estimate £m
Capital Financing Requirement		
CFR – non housing	667	631
CFR – housing	245	245
Total CFR	**912**	**876**
External Debt (Operational Boundary)		
Borrowing	565	531
Other long term liabilities*	152	152
Total debt 31 March	**717**	**683**

** On balance sheet PFI schemes and finance leases etc.*

41. The revised Capital Financing Requirement is based on the actual CFR as at 31 March 2017 (£787m) increased by in-year capital expenditure financed by borrowing (£97m) and reduced by the minimum revenue provision (MRP) for repayment of debt (£8m).

Limits to Borrowing Activity

42. 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 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.

	2017/18 Original Estimate £m	2017/18 Revised Estimate £m
Gross borrowing	565	531
Plus other long term liabilities*	152	152
Gross borrowing & long term Liabilities	**717**	**683**
CFR* (year-end position)	912	876

** Includes on balance sheet PFI schemes and finance leases etc.*

43. The Chief Finance Officer reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

44. 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.

Authorised limit for external debt	**2017/18 Original Indicator**	**2017/18 Revised Indicator**
Total Borrowing	**930**	**900**

Proposal

45. That the Mid-Year Treasury Management report for 2017/18 is noted.

Other Options Considered

46. None

Risk Assessment

47. Borrowing and lending activity is reported to the Mayor.

The principal risks associated with treasury management are:

Risk	**Mitigation**
Loss of investments as a result of failure of counterparties	Limiting the types of investment instruments used, setting lending criteria for counterparties, and limiting the extent of exposure to individual counterparties
Increase in the net financing costs of the authority due to borrowing at high rates of interest / lending at low rates of interest	Planning and undertaking borrowing and lending in light of assessments of future interest rate movements, and by undertaking most long term borrowing at fixed rates of interest (to reduce the volatility of capital financing costs)

Public Sector Equality Duties

48. a) Before making a decision, section 149 Equality Act 2010 requires that each decision-maker considers the need to promote equality for persons with the following “protected characteristics”: age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, sex, sexual orientation. Each decision-maker must, therefore, have due regard to the need

to:

i) Eliminate discrimination, harassment, victimisation and any other conduct prohibited under the Equality Act 2010.

ii) Advance equality of opportunity between persons who share a relevant protected characteristic and those who do not share it. This involves having due regard, in particular, to the need to --

- remove or minimise disadvantage suffered by persons who share a relevant protected characteristic;

- take steps to meet the needs of persons who share a relevant protected characteristic that are different from the needs of people who do not share it (in relation to disabled people, this includes, in particular, steps to take account of disabled persons' disabilities);

- encourage persons who share a protected characteristic to participate in public life or in any other activity in which participation by such persons is disproportionately low.

iii) Foster good relations between persons who share a relevant protected characteristic and those who do not share it. This involves having due regard, in particular, to the need to –
- tackle prejudice; and
- promote understanding.

b) There are no proposals in this report, which require either a statement as to the relevance of public sector equality duties or an Equalities Impact Assessment.

Legal and Resource Implications

Legal

The Council is under a duty to manage its resources prudently and therefore due consideration must always be given to its borrowing and lending strategy. A wide range of local authority financial activities, including borrowing, lending, financial management, and the approval of types of investment vehicle are governed by legislation and various regulations. The Council is obliged to comply with these.

(Legal advice provided by Shahzia Daya - Service Director - Legal and Democratic Services)

Financial

(a) Revenue

The financing costs arising from planned borrowing are provided for in the revenue budget and medium term financial plan. Any additional operating costs will have to be contained within the revenue budget of the relevant department.

(Financial advice provided by Jon Clayton (Principal Accountant)

(b) Capital
Not applicable

Land
Not applicable

Personnel
Not applicable

Appendices:
None

LOCAL GOVERNMENT (ACCESS TO INFORMATION) ACT 1985
Background Papers:
None