Agenda item No: 9

Bristol City Council
Audit Committee
27 November 2015

Title: Treasury Management Mid-Year Report 2015/16

Ward(s) affected by this report: Citywide

Strategic Director: **Section 151 Officer**

Report author: **Peter Gillett – Service Director - Finance**

Contact telephone no. **Jon Clayton - 0117 922424**
& e-mail address: **jon.clayton@bristol.gov.uk**

RECOMMENDATION

The Audit Committee note, and comment as appropriate, on the Treasury Management Mid-Year Report 2015/16.

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 and the Council's prudential indicators (PIs).

Policy

None affected by this report.

Consultation

Internal: None.

External: None.

1 Introduction

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 2015/16 financial year to 30 September 2015;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- A review of the Council's investment portfolio for 2015/16;
- A review of the Council's borrowing strategy for 2015/16;
- A review of any debt rescheduling undertaken or planned during 2015/16;
- The Council's capital expenditure and (prudential indicators);
- A review of compliance with Treasury and Prudential Limits for 2015/16.

Other options considered

Not applicable.

Risk Assessment

As set out in the report.

Equalities Impact Assessment

There are no issues arising from this report.

Legal and Resource Implications

As set out in the report

Appendices:

Appendix 1: report to Cabinet meeting 24 November 2015 - Treasury Management Mid-Year Report 2015/16

LOCAL GOVERNMENT (ACCESS TO INFORMATION) ACT 1985

Background Papers: None

Appendix 1

CABINET – 24th November 2015 EXECUTIVE SUMMARY OF AGENDA ITEM X

Report title: Treasury Management Mid-Year Report 2015/16
Wards affected: Citywide
Strategic Director: Section 151 Officer
Report Author: Peter Gillett, Service Director - Finance

RECOMMENDATION for the Mayor's approval

1. That the Mayor recommends the report to Full Council.

2. That the Mid-Year Treasury Management report for 2015/16 is noted.

Key background / detail:

3. During the first half of 2015/16 the Council has complied with its legislative and regulatory requirements.

4. The current financial year continues the challenging environment of the previous year's namely low investment returns and heightened levels of counterparty risk.

5. There are no policy changes to the Treasury Management Strategy Statement (TMSS); the details in this report update the position in the light of the updated economic position and budgetary changes.

6. The 2015–2018 Treasury Strategy (approved 17th February 2015) identified a medium term borrowing requirement of £150m 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 significant levels of cash balances (£247m at September 2015, £140m estimated for March 2016). No change to this policy is proposed and no borrowing anticipated in the current financial year.

7. However, if 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.

Agenda Item No

BRISTOL CITY COUNCIL
CABINET
24th November 2015

REPORT TITLE: Treasury Management Mid-Year Report 2015/16

Ward(s) affected by this report: Citywide

Strategic Director:	**Section 151 Officer**
Report author:	**Peter Gillett – Service Director - Finance**
Contact telephone no. & e-mail address:	**Jon Clayton - 0117 922424 jon.clayton@bristol.gov.uk**

RECOMMENDATION for Mayor approval:

1. That the Mayor recommends the report to Full Council.

2. That the Mid-Year Treasury Management report for 2015/16 is noted

Purpose of the report:

3. 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).

4. 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

5. 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."

6. 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.

7. 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

8. 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 body is Audit Committee.

9. 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 2015/16 financial year to 30 September 2015;
   - A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
   - A review of the Council's investment portfolio for 2015/16;
   - A review of the Council's borrowing strategy for 2015/16;
   - A review of any debt rescheduling undertaken or planned during 2015/16;
   - The Council's capital expenditure and (prudential indicators);
   - A review of compliance with Treasury and Prudential Limits for 2015/16

Key Changes to the Treasury and Capital Strategies

10. 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.

11. The 2015–2018 Treasury Strategy (approved 17th February 2015) identified a medium term borrowing requirement of £150m 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 significant levels of cash balances (£247m at September 2015, £140m estimated for March 2016). No change to this policy is proposed and no borrowing anticipated in the current financial year.

12. However, if there is a significant change in markets 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 2015 (including forecast at 31st March 2016) compared with 31st March 2015 is shown in the table below:

Debt & Investments	31st March 2015		31st September 2015		31st March 2016	
	£	Rate	£	Rate	£	Rate
Long Term Debt - PWLB	£291m	5.09%	£291m	5.09%	£291m	5.09%
Long Term Debt – Market	£123m	4.14%	£123m	4.14%	£123m	4.14%
Short Term Borrowing	-	-	-	-	-	-
Total Debt	**£414m**	**4.81%**	**£414m**	**4.81%**	**£414m**	**4.81%**
Investment	£191m	0.69%	£247m	0.60%	£140m	0.60%
Net Borrowing Position	**£223m**		**£167m**		**£274m**	

14. We are currently achieving a return of 0.60% on our investments, with long term interest rates expected to remain at or around 3.50% (for 25 year term).

Economic Update to review

15. **UK** - UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again, possibly being equal to that of the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a rebound in quarter 2 to +0.7% (+2.4% y/y). Growth is expected to weaken marginally to about +0.5% in quarter 3 as the economy faces headwinds for exporters from the appreciation 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, although the pace of reductions was

eased in the May Budget.

16. Despite these headwinds, the Bank of England is forecasting growth to remain around 2.4 – 2.8% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero over the last quarter. Investment expenditure is also expected to support growth.

17. The August Bank of England Inflation Report forecast was notably subdued with inflation barely getting back up to the 2% target within the 2-3 year time horizon. However, with the price of oil taking a fresh downward direction and Iran expected to soon rejoin the world oil market after the impending lifting of sanctions, there could be several more months of low inflation still to come, especially as world commodity prices have generally been depressed by the Chinese economic downturn.

18. There are therefore considerable risks around whether inflation will rise in the near future as strongly as previously expected; this will make it more difficult for the central banks of both the US and the UK to raise rates as soon as had previously been expected, especially given the recent major concerns around the slowdown in Chinese growth, the knock on impact on the earnings of emerging countries from falling oil and commodity prices, and the volatility we have seen in equity and bond markets in 2015 so far, which could potentially impact the real economies rather than just financial markets.

19. **USA**. The American economy has made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015. While there had been confident expectations during the summer that the Fed. could start increasing rates at its meeting on 17 September, or if not by the end of 2015, the recent downbeat news about Chinese and Japanese growth and the knock on impact on emerging countries that are major suppliers of commodities, was cited as the main reason for the Fed's decision to pull back from making that start. This has led to a reappraisal of the likelihood of any increase occurring in 2015 with early 2016 now being widely regarded as being more likely.

20. **EZ**. In the Eurozone, the ECB in January 2015 released a €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This already appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to a significant improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and looks as if it may maintain this pace in quarter 3. However, the recent downbeat Chinese and Japanese news has raised questions as to whether the ECB will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

Interest rate forecasts

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

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%
5yr PWLB rate	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%
10yr PWLB rate	3.00%	3.20%	3.30%	3.40%	3.50%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%
50yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%

22. Capita Asset Services undertook its last review of interest rate forecasts on 11 August shortly after the quarterly Bank of England Inflation Report. Later in August, fears around the slowdown in China and Japan caused major volatility in equities and bonds and sparked a flight from equities into safe havens like gilts and so caused PWLB rates to fall below the above forecasts for quarter 4 2015. However, there is much volatility in rates following negative or positive news. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2016.

23. Despite market turbulence since late August causing a sharp downturn in PWLB rates, the overall trend in the longer term will be for gilt yields and PWLB rates to rise when economic recovery is firmly established accompanied by rising inflation and consequent increases in Bank Rate, and the eventual unwinding of QE. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

24. The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

25. The disappointing US nonfarm payrolls figures and UK PMI services figures at the beginning of October have served to reinforce a trend of increasing concerns that growth is likely to be weaker than had previously been expected. This, therefore, has markedly increased concerns, both in the US and UK, that growth is only being achieved by monetary policy being highly aggressive with central rates at near zero and QE in place. In turn, this is also causing an increasing debate as to how realistic it will be for central banks to start on reversing such aggressive monetary policy until such time as strong growth rates are more firmly established and confidence increases that inflation is going to get back to around 2% within a 2-3 year time horizon. Market expectations in October for the first Bank Rate increase have therefore shifted back sharply into the second half of 2016.

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

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.

- UK economic growth turns significantly weaker than we currently anticipate.

- Weak growth or recession in the UK's main trading partners - the EU, US and China.

- A resurgence of the Eurozone sovereign debt crisis.

- Recapitalisation of European banks requiring more government financial support.

- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or the start of Fed. rate increases, causing a flight to safe havens

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

- Uncertainty around the risk of a UK exit from the EU.

- The ECB severely disappointing financial markets with a programme of asset purchases which proves insufficient to significantly stimulate growth in the EZ.

- The commencement by the US Federal Reserve 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 change 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.

Investment Portfolio 2015/16

28. 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 0.5% 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.

29. The Council held £247m of investments as at 30 September 2015 (£191m at 31 March 2015) with an average maturity of 140 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 0.60%. The standard comparator for investment performance is the benchmark 7 day rate, which for the period was 0.36%. The benchmark for 6 month deposits was 0.60%.

30. The Chief Financial Officer confirms that the approved limits within the Annual

Investment Strategy were not breached during the first six months of 2015/16.

Borrowing

31. The Capital Financing Requirement (CFR) denotes the Council's underlying need to borrow for capital purposes. The Council's CFR at 31 March 2016 is estimated to be £807m. 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).

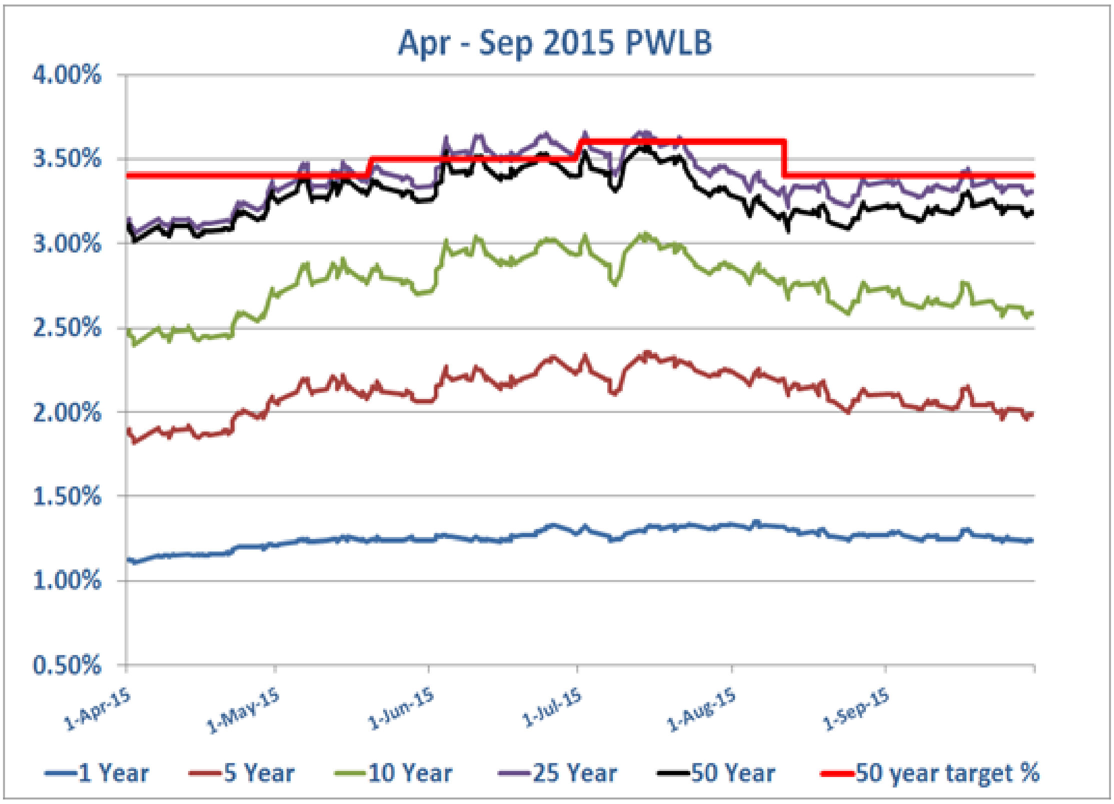
32. The balance of borrowing between external and internal is generally driven by market conditions and forecasts of future cash flows and interest rates. At the 31st March 2015 the Council had external borrowings of £577m and has utilised £138m of internal cash in lieu of borrowing. This is a prudent 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.

33. 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.

34. Should debt financing costs continue to historic low levels, and with a significant capital programme predominately financed by borrowing (£150m over the medium term) the Council will consider borrowing earlier than anticipated 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.

35. The general trend was a marginal increase in interest rates during the first six months of the year, across the shorter and longer dated maturity bands. The graph below show the movement in PWLB (certainty) rates for the first six months of the year to 30th September 2015:

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.11%	1.82%	2.40%	3.06%	3.01%
Date	02/04/2015	02/04/2015	02/04/2015	02/04/2015	02/04/2015
High	1.35%	2.35%	3.06%	3.66%	3.58%
Date	05/08/2015	14/07/2015	14/07/2015	02/07/2015	14/07/2015
Average	1.26%	2.12%	2.76%	3.39%	3.29%



Debt Rescheduling

36. Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. During the first six months of the year no debt rescheduling was undertaken, and none is anticipated for the remainder of the year.

Ethical Policy

37. 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. 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 espouses 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.

The Council's Capital Position (Prudential Indicators)

38. 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

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

Capital Expenditure by Service	2015/16 Original Estimate £m	2015/16 Revised Estimate £m
Non-HRA	155	229
HRA	54	54
Total	**209**	**283**

40. The latest capital monitoring report for the end of September 2015 includes re-profiling from the 2014/15 programme and additional schemes approved by Cabinet.

Financing of the Capital Programme

41. 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	2015/16 Original Estimate £m	2015/16 Revised Estimate £m
Total spend	**209**	**283**
Financed by:		
Capital receipts	10	16
Capital grants	55	85
Revenue / Reserves	16	35
HRA – Self Financing	31	37
Prudential Borrowing – Increase in Capital Financing Requirement	97	110
Total financing	**209**	**283**

Capital Financing Requirement (CFR) & Operational Boundary

42. 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.

	2015/16 Original Estimate £m	2015/16 Revised Estimate £m
Capital Financing Requirement		
CFR – non housing	533	562
CFR – housing	245	245
Total CFR	**778**	**807**
External Debt (Operational Boundary)		
Borrowing	489	414
Other long term liabilities*	162	162
Total debt 31 March	**651**	**576**

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

43. The revised Capital Financing Requirement is based on the actual CFR as at 31 March 2015 (£715m) increased by in-year capital expenditure financed by borrowing (£110m) and reduced by revenue provision for repayment of debt (£18m).

Limits to Borrowing Activity

44. 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 2016/17 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.

	2015/16 Original Estimate £m	2015/16 Revised Estimate £m
Gross borrowing	489	414
Plus other long term liabilities*	162	162
Gross borrowing & long term Liabilities	**651**	**576**
CFR* (year end position)	778	807

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

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

46. 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	2015/16 Original Indicator	2015/16 Revised Indicator
Total Borrowing	**810**	**810**

Consultation and scrutiny input

Internal consultation: Audit Committee will scrutinise the Treasury Management Report at their meeting on 27 November. Any comments will be incorporated within the final report for Full Council.

External consultation: The Council's Treasury Management advisers

Risk Assessment

Borrowing and lending activity is reported to the Mayor.

The principal risks associated with treasury management are:

- The risk of loss as a result of failure of counterparties.

- This is mitigated by limiting the types of investment instruments used, setting lending criteria for counterparties, and limiting the extent of exposure to individual counterparties;

- The risk of loss as a result of borrowing at high rates of interest/lending at low rates of interest.

This is mitigated by planning and undertaking borrowing and lending in the light of advisers' 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:

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.

Environmental checklist / eco impact assessment

Not applicable

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

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.

Advice given by Jon Clayton (Corporate Accountant) 21/10/2015

(b) Capital

None Sought

Land

None.

Personnel

None.

Appendices: None

Access to Information (Background Papers): None