COLCHESTER

Governance & Audit Committee

Item 12

22 November 2016

Report of	**Assistant Chief Executive**	**Author**	**Steve Heath** ☏ **282389**
Title	**Treasury Management Strategy Statement – Mid-Year Review Report 2016/17**		
Wards affected	Not applicable		

The Panel is invited to review treasury management activity during the first six months of 2016/17

1. Action required

1.1 To consider treasury management activity for the first six months of 2016/17.

1.2 To note the changes to the Treasury Management Strategy Statement (TMSS) for the year approved by Cabinet on 7 September 2016, as detailed in Section 4 of this report. They are:

- A revised interest rate forecast.
- Revisions to the borrowing and investment strategies to reflect the lower rates available.
- Changes to the Country limits to reflect ratings agency actions following the outcome of the EU referendum.
- Revised accounting treatment for an element of the Council's long term debt.
- A revision to the Council's MRP policy.

2. Reason for decision

2.1 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management was adopted by this Council on 17 February 2010. The primary requirements of the Code include the creation and maintenance of a Treasury Management Policy Statement and Practices, the production of an annual Treasury Management Strategy Statement for the year ahead, a **Mid-year Review Report** and an Annual Report covering activities during the previous year. This mid-year report has been prepared in compliance with CIPFA's Code of Practice on treasury Management.

3. Introduction

3.1 The Council operates a balanced budget, which broadly means that income raised during the year will meet its expenditure. Part of the treasury management operation ensures that the cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity before considering optimising investment returns.

3.2 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. 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.

3.3 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.”

3.4 The Council employ Capita Asset Services to provide a consultancy service in respect of treasury management, to include advice on both debt and investments. During the year they have provided advice on borrowing, investments, counterparty credit details and general capital accounting information.

4. Key changes to the Treasury Management Strategy Statement

4.1 This report proposes a number of changes to the 2016/17 TMSS that was approved by Council on 17 February 2016. These changes are as a result of changes to borrowing rates, credit ratings and interest rate forecasts following the outcome of the EU referendum on 23 June 2016, which includes the Monetary Policy Committee cutting the bank rate from 0.50% to 0.25% on 4 August. They are:

Interest rate forecast

4.2 The table below compares our treasury adviser’s latest interest rate forecasts with those that were included in the TMSS. Economic forecasting remains difficult, however the overall longer run trend is for rates to rise gently, albeit with the overall balance of risks remaining to the downside.

		Q3 2016	Q1 2017	Q1 2018	Q1 2019
Bank Rate	TMSS	0.75%	1.00%	1.75%	2.00%
	Now	0.25%	0.10%	0.10%	0.25%
PWLB 5 year	TMSS	2.70%	2.80%	3.30%	3.60%
	Now	1.00%	1.00%	1.10%	1.20%
PWLB 10 year	TMSS	3.20%	3.40%	3.80%	4.10%
	Now	1.50%	1.50%	1.60%	1.70%
PWLB 25 year	TMSS	3.90%	4.10%	4.30%	4.50%
	Now	2.30%	2.30%	2.40%	2.50%
PWLB 50 year	TMSS	3.80%	4.00%	4.20%	4.40%
	Now	2.10%	2.10%	2.20%	2.30%

4.3 Our treasury adviser’s latest advice is that as yields are at historic lows borrowing should be considered if appropriate to the strategy. As the outlook is uncertain, it is suggested that any borrowing is taken in tranches so as to benefit from the current rates, but also provide some flexibility if rates fall further.

Borrowing Strategy

4.4 The TMSS states that the Council is currently maintaining an under-borrowed position. This means that the capital borrowing need has not been fully funded with loan debt as cash supporting the Council’s reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is relatively high. This means that there would be a cost of carry to any new borrowing which causes an increase in investments, as this will incur a revenue loss between borrowing costs and investment returns.

4.5 At 31 March 2016 the Council’s Capital Financing Requirement was £153.5m and, net of finance lease liabilities, the underlying borrowing requirement was £150.3m. The Council’s external borrowing totalled £136.1m, which meant under-borrowing was £14.2m.

4.6 On the basis of the above forecasts, if the Council borrowed to its current CFR for 50 years the annual cost of carry would be approximately £260k. This is not currently budgeted for, so should be considered as a cost pressure.

4.7 Against the above, the long term saving resulting from borrowing at very low rates should be considered. Assuming current rates increase in accordance with the above forecast, delaying borrowing until the beginning of 2019 this would lead to the cost of borrowing being significantly higher over the life of a 50 year loan.

Country Limits

4.8 The TMSS states that the Council will only use approved counterparties from countries with a minimum sovereign credit rating of AA-, based on the lowest available rating. Subsequent to the EU referendum decision, the following action has been taken by the ratings agencies regarding the UK sovereign rating:

Fitch

- Sovereign rating downgraded by one notch, from AA+ to AA.
- Outlook lowered to Negative, from Stable.

Moody's

- Sovereign rating affirmed, at Aa1 (equivalent to AA+ from Fitch / S&P).
- Outlook lowered to Negative, from Stable.

Standard & Poor's (S&P)

- Sovereign rating downgraded by two notches, from AAA to AA.
- Remains on Negative Outlook.

4.9 It is proposed that whilst our minimum sovereign debt limit is now in line with Capita's recommendation, this section should be amended to state that this policy excludes the UK. This will take account of any further deterioration in the UK's credit rating.

Investment Strategy

4.10 The Investment Strategy in the TMSS assumed that the Bank Rate would remain unchanged at 0.5% before starting to rise from quarter 2 of 2016. On this basis the suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during the year was 0.90%.

4.11 The current forecast suggests that budgeted investment earnings for 2016/17 should be amended to 0.25%. This is likely to have an adverse impact on the Central Loans and Investment Account.

LOBO Loans

4.12 Unrelated to the referendum outcome, Barclays Bank contacted the Council on 20 June 2016 to state that they had decided to waive their right to change the applicable interest rate of the Council's two Lender Option/Borrower Option (LOBO) loans in the future. As a result the two loans, which total £9 million, effectively become fixed rate loans at their current investment rates with their stated maturities.

4.13 The Council's LOBO loans are subject to six monthly calls, and the maturity profile is shown as the next call date, and as such they are accounted for as short-term loans. The financial impact of the change is that these loans will in future periods be shown as long-term market debt, which will have an impact on prudential indicators relating to the maturity profile of debt. This change is reflected in the table below:

Maturity Structure	Original Estimate	Revised Estimate
Under 12 months	15%	15%
12 months to 2 years	15%	15%
2 years to 5 years	15%	15%
5 years to 10 years	15%	15%
10 years to 20 years	30%	30%
20 years to 30 years	30%	30%
30 years to 40 years	40%	40%
40 years to 50 years	40%	40%
Over 50 years		10%

MRP Policy

4.14 For capital expenditure incurred before 1 April 2008, the MRP policy currently follows the existing practice outlined in former CLG regulations (option 1), which provides for an approximate 4% reduction in the borrowing need (CFR) each year on a reducing balance basis.

4.15 It is now the view of the Council's external Auditors (Ernst & Young) that there is no obligation to repay on this basis. Instead this historic element of MRP can now be paid on an equal instalment basis over a period of 50 years. This change would have the benefits of reducing the amount payable by the Council over the next 17 years, introducing a consistent level of charge, and ensuring that this element is eventually completely repaid.

4.16 In 16/17 this change of approach would reduce this element of the MRP charge from £186,684 to a standard amount of £93,342.

5. Economic update

Performance to date

5.1 UK growth rates in 2013 and 2014 were strong but 2015 was disappointing, though it still remained one of the leading rates among the G7 countries. Growth improved in quarter 4 of 2015 but fell back in quarter 1 of 2016 before bouncing back again 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.

5.2 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 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 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.

5.3 The 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 thorough a one off upward blip from this devaluation of sterling in order to support economic growth, especially if pay increases continue to remain subdued and therefore pose little danger of stoking core inflationary price pressures within the UK economy.

Outlook

5.4 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.

5.5 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.

5.6 The overall balance of risks to economic recovery in the UK remains to the downside. The latest Capita Asset Services interest rate forecast is shown below.

	Dec 2016	Mar 2017	Jun 2017	Sep 2017	Dec 2017	Mar 2018	Jun 2018	Sep 2018	Dec 2018	Mar 2019	Jun 2019
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

6. Treasury Management Strategy Statement 2016/17

6.1 The Council's Treasury Management Strategy Statement (TMSS) for 2016/17 was approved by full Council on 17 February 2016. The strategy was as follows:

- The UK bank rate has been unchanged from a historically low 0.5% since March 2009. The view from the Council's treasury advisers was that the Bank Rate is expected to remain unchanged until quarter 2 of 2016.
- The Council is currently maintaining an under-borrowed position. The borrowing strategy is to reduce the difference between gross and net debt by continuing to 'borrow internally', which is primarily due to investment rates on offer being lower than long term borrowing rates. This has the advantages of maximising short-term savings and reducing the Council's exposure to interest rate and credit risk. This approach is intended to be maintained during the year.
- The investment policy reflects the Council's low appetite for risk, emphasising the priorities of security and liquidity over that of yield. The main features of the policy are as follows:

- The Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties, which also enables diversification and avoidance of concentration risk.
  - The Council applies the creditworthiness service provided by Capita Asset Services, which combines data from credit rating agencies with credit default swaps and sovereign ratings.
  - The Council will only use approved counterparties from countries with a minimum credit rating of 'AA-', based on the lowest available rating.
  - The suggested budgeted return on investments placed for periods up to 100 days during the year is 0.90%.
- The Council's Prudential and Treasury Indicators for 2016/17 through to 2018/19 were produced to support capital expenditure and treasury management decision making, and are designed to inform whether planned borrowing and the resultant revenue costs are affordable and within sustainable limits. They take into account all the economic forecasts and proposed borrowing and investment activity detailed in the TMSS.
- The Minimum Revenue Provision (MRP) Policy Statement for 2016/17 stated that the historic debt liability will continue to be charged at 4%, with the charge for more recent capital expenditure being based on the useful life of the asset and charged using the equal annual instalment method.

6.2 The details in this report update the position in the light of the latest economic performance. The approved changes to the TMSS for 2016/17 are detailed in Section 4 of this report.

7. The Council's Capital Position (Prudential Indicators)

7.1 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.

7.2 The table below shows the original estimates for capital expenditure when the Prudential Indicators were agreed, along with the latest forecast. 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 2016/17	**Original Estimate £'000**	**Current Position £'000**	**Revised Estimate £'000**
Total Spend	19,120	8,165	26,566
Total Financing	17,104	8,165	25,550
Borrowing Need	2,016	0	1,016

7.3 The following table shows the CFR, which is the underlying need to incur external borrowing for capital purposes. It also shows two further prudential indicators relating to the level of borrowing. The **Operational Boundary** reflects the Council's expected debt position during the year, whilst the **Authorised Limit** controls the overall level beyond which borrowing is prohibited. This is the statutory limit determined by section 3 (1) of the Local Government Act 2003, and reflects a level of borrowing that could be afforded in the short-term, but is not sustainable in the longer term. The table demonstrates that the Council has maintained gross borrowing within its authorised limit during the first six months of 2016/17.

	Original Estimate £'000	Current Position £'000	Revised Estimate £'000
Capital Financing Requirement			
CFR - non housing	24,342	25,630	25,630
CFR - housing	130,548	127,933	128,949
Total CFR (year end position)	154,890	153,563	154,579
Net movement in CFR	1,327	0	1,016
The Operational Boundary			
Borrowing	141,522	136,094	137,110
Other long term liabilities	2,008	2,074	2,074
Total	**143,530**	**138,168**	**139,184**
The Authorised Limit			
Borrowing	168,182	166,589	167,805
Other long term liabilities	2,008	2,074	2,074
Total	**170,190**	**168,663**	**169,879**

7.4 One 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 2015/16 and the next two financial years. This allows some flexibility for limited early borrowing for future years. No difficulties are envisaged for the current or future years in complying with this prudential indicator.

	Original Estimate £'000	Current Position £'000	Revised Estimate £'000
External Borrowing	141,522	136,094	137,110
Plus other long term liabilities	2,008	2,074	2,074
Gross Borrowing	143,530	138,168	139,184
CFR (year end position)	154,890	153,563	154,579
Under / (over) borrowing	**11,360**	**15,395**	**15,395**

8. Borrowing

8.1 When 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 £136.1m and has utilised £14.2m 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 the upside risk to gilt yields prevails.

8.2 No new long-term or temporary borrowing has been undertaken so far this financial year in accordance with the TMSS. The general trend in PWLB interest rates has been a sharp fall in interest rates during the first half of this financial year.

8.3 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 during the first six months of 2016/17.

9. Investments

9.1 In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. It is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.25% Bank Rate. The continuing potential for a re-emergence of the Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk strategy. Given this risk environment, investment returns are likely to remain low.

9.2 The Council held £47.7m of investments as at 30 September 2016 (£37.4m at 31 March 2016) and the investment portfolio yield for the first six months of the year is 0.51% against the three-month LIBID benchmark of 0.38%. A full list of investments held as at 30 September 2016 is shown in **Appendix B**. It should be noted that the level of investments held, and therefore the total returns available, are expected to reduce during the remainder of the year as a result of cash flow fluctuations and the continuing strategy of internal borrowing.

9.3 With the exception of the changes in Section 4 of this report, the current investment counterparty criteria selection approved in the TMSS is meeting the requirements of the treasury management function. Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2016/17.

9.4 The Council's budgeted investment return for 2016/17 is £225k, and performance for the year to date is currently expected to be slightly below the budget.

10. Strategic Plan references

10.1 Prudent treasury management underpins the budget required to deliver all Strategic Plan priorities.

11. Publicity considerations

11.1 **Appendix A** to this report is confidential.

12. Financial implications

12.1 The Central Loans and Investment Account (CLIA) comprises the Council's borrowing costs and investment income. The CLIA is difficult to predict and can be affected by several factors. The majority of the Council's debt is on fixed rates reflecting the longer-term nature of the borrowing decisions. Investments are generally made for shorter periods, making returns more variable. This mix is generally more beneficial when interest rates are high or increasing. It is important to add that the exposure to interest rate movements is regularly monitored to minimise risks to changes in returns.

12.2 The outturn position for the CLIA is currently projected to be an adverse variance of £30k. The main factors affecting the forecast are a lower recharge to the HRA due to a reduction in the level of HRA borrowing required this year, and the low interest rates currently available on cash balances. With the growing prospect of short term interest rates reducing following the EU referendum result, there is potential for a further pressure on achieving investment income targets. The position will continue to be reviewed as part of the regular budget monitoring reports.

13. Risk Management implications

13.1 Risk Management is essential to effective treasury management. The Council's Treasury Management Policy Statement contains a section on treasury Risk Management (TMP1).

13.2 TMP1 covers the following areas of risk all of which are considered as part of our treasury management activities:

- Credit and counterparty risk
- Liquidity risk
- Interest rate risk
- Exchange rate risk
- Refinancing risk
- Legal and regulatory risk
- Fraud, error and corruption, and contingency management
- Market risk

14. Other Standard References

14.1 Having considered consultation, equality, diversity and human rights, health and safety and community safety implications, there are none which are significant to the matters in this report.

Background Papers
Appendix A: Outstanding Temporary Investments 2016/17 (**confidential)**