COLCHESTER

Governance and Audit Committee

Item 9

28 November 2017

Report of	**Assistant Director Policy and Corporate**	**Author**	**Steve Heath** **☏ 282389**
Title	**Treasury Management Strategy Statement – Mid-Year Review Report 2017/18**		
Wards affected	Not applicable		

1 Executive Summary

1.1 This mid-year report considers treasury management activity for the first six months of 2017/18, and acts as a review of the 2017/18 Treasury Management Strategy Statement (TMSS) that was approved by Council on 22 February 2017. The report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of the 2017/18 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure (prudential indicators);
- A review of the Council's investment portfolio for 2017/18;
- A review of the Council's borrowing strategy for 2017/18;
- A review of any debt rescheduling undertaken during 2017/18;
- A review of compliance with Treasury and Prudential Limits for 2017/18.

2 Recommended Decision

2.1 To note the report and treasury activity, and to recommend approval to Cabinet of any changes to the Treasury Management Strategy Statement (TMSS) for the year, including Prudential Indicators, the investment criteria, and the credit methodology.

3 Reason for Recommended Decision

3.1 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.

4 Alternative Options

4.1 Alternative options regarding treasury management activities are considered on an ongoing basis in consultation with our Treasury adviser, Link Asset Services (formerly Capita Asset Services).

5 Introduction

5.1 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.

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. 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.

5.3 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."

5.4 The Council employ Link 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 and asset finance information.

6 Key changes to the Treasury Management Strategy Statement

6.1 There are no proposed changes to the strategy as a result of this review.

6.2 The table below compares our treasury adviser's latest interest rate forecasts with those that were included in the TMSS. The overall longer run trend is still for rates to rise gently, with the overall balance of risks remaining to the downside.

		Q3 2017	Q1 2018	Q1 2019	Q1 2020
Bank Rate	**TMSS**	0.25%	0.25%	0.25%	0.75%
	Now	0.50%	0.50%	0.75%	1.00%
PWLB 5 year	**TMSS**	1.60%	1.70%	1.80%	2.00%
	Now	1.50%	1.60%	1.80%	2.10%
PWLB 10 year	**TMSS**	2.30%	2.30%	2.50%	2.70%
	Now	2.10%	2.20%	2.50%	2.70%
PWLB 25 year	**TMSS**	3.00%	3.00%	3.20%	3.40%
	Now	2.80%	2.90%	3.10%	3.40%
PWLB 50 year	**TMSS**	2.80%	2.80%	3.00%	3.20%
	Now	2.50%	2.60%	2.90%	3.20%

7 Economic update

Performance to date

7.1 After the UK economy's surprising strong growth in 2016, growth in 2017 has been disappointingly weak, with the first half of 2017 being 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 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.

7.2 The Monetary Policy Committee (MPC) meeting of 14 September 2017 surprised markets and forecasters by switching to a much more aggressive tone in terms of its words around warnings that Bank Rate will need to rise. The focus was on an emerging view that with unemployment falling to the lowest level since 1975, and improvements in productivity being so weak, there was little spare capacity left in the economy, and they 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. 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.

7.3 It therefore looked very likely that the MPC would increase Bank Rate to 0.5% in November or, if not, in February 2018. The big question after that was whether this will be a one off increase or the start of a slow, but regular, increase in Bank Rate. 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.

Outlook

7.4 Link Asset Services undertook its last review of interest rate forecasts on 7 November after the MPC voted to increase Bank Rate to 0.5%, and gave forward guidance that they expected to increase Bank Rate only twice more in the next three years to reach 1.0% by 2020. This is in line with previous statements that Bank Rate would only go up gradually and to a limited extent. Link Asset Services' forecasts are in line with this subdued path for increases in Bank Rate, and is in line with market expectations. The overall longer run trend is also for gilt yields and PWLB rates to rise, albeit gently.

7.5 Economic forecasting remains difficult with so many external influences weighing on the UK. The forecasts will therefore be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year.

7.6 The overall balance of risks to economic recovery in the UK is currently to the downside, particularly with the current level of uncertainty over the final terms of Brexit. The latest Link Asset Services interest rate forecast is shown below.

	Dec 2017	Mar 2018	Jun 2018	Sep 2018	Dec 2018	Mar 2019	Jun 2019	Sep 2019	Dec 2019	Mar 2020
Bank Rate	0.50	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00
5yr PWLB Rate	1.50	1.60	1.60	1.70	1.80	1.80	1.90	1.90	2.00	2.10
10yr PWLB Rate	2.10	2.20	2.30	2.40	2.40	2.50	2.60	2.60	2.70	2.70
25yr PWLB Rate	2.80	2.90	3.00	3.00	3.10	3.10	3.20	3.20	3.30	3.40
50yr PWLB Rate	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.00	3.10	3.20

8 Treasury Management Strategy Statement 2017/18

8.1 The Council's Treasury Management Strategy Statement (TMSS) for 2017/18 was approved by full Council on 22 February 2017. The strategy was as follows:

- The UK bank rate was cut from 0.50% to 0.25% in August 2016, having been at the previous historical low since March 2009. The view from the Council's treasury advisers was that the Bank Rate was expected to remain unchanged until quarter 2 of 2019.

- 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. However, against this, the long term saving resulting from borrowing at very low rates should be considered. Consequently this approach will be kept under review 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. However, this policy excludes UK counterparties.
    - The suggested budgeted return on investments placed for periods up to 100 days during the year is 0.25%.
- The Council's Prudential and Treasury Indicators for 2017/18 through to 2019/20 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 2017/18 stated that the historic debt liability will continue to be repaid on an equal instalment basis over a period of 50 years, 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.

8.2 The details in this report update the position in the light of the latest economic position.

9 The Council's Capital Position (Prudential Indicators)

9.1 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.

9.2 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 2017/18	Original Estimate £'000	Current Position £'000	Revised Estimate £'000
Total Spend	22,262	6,594	26,897
Total Financing	20,238	6,594	24,873
Borrowing Need	2,024	0	2,024

9.3 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 2017/18.

		Original Estimate	Current Position	Revised Estimate
		£'000	£'000	£'000
Capital Financing Requirement				
	CFR - non housing	23,342	26,664	26,664
	CFR - housing	130,993	129,957	129,957
Total CFR (year end position)		154,335	156,621	156,621
Net movement in CFR		(262)	2,024	2,024
The Operational Boundary				
	Borrowing	139,154	141,094	143,118
	Other long term liabilities	1,383	1,295	1,295
Total		**140,537**	**142,389**	**144,413**
The Authorised Limit				
	Borrowing	168,252	170,826	170,826
	Other long term liabilities	1,383	1,295	1,295
Total		**169,635**	**172,121**	**172,121**

9.4 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 2017/18 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	Current Position	Revised Estimate
	£'000	£'000	£'000
External Borrowing	139,154	141,094	143,118
Plus other long term liabilities	1,383	1,295	1,295
Gross Borrowing	140,537	142,389	144,413
CFR (year end position)	154,335	156,621	156,621
Under / (over) borrowing	**13,798**	**14,232**	**12,208**

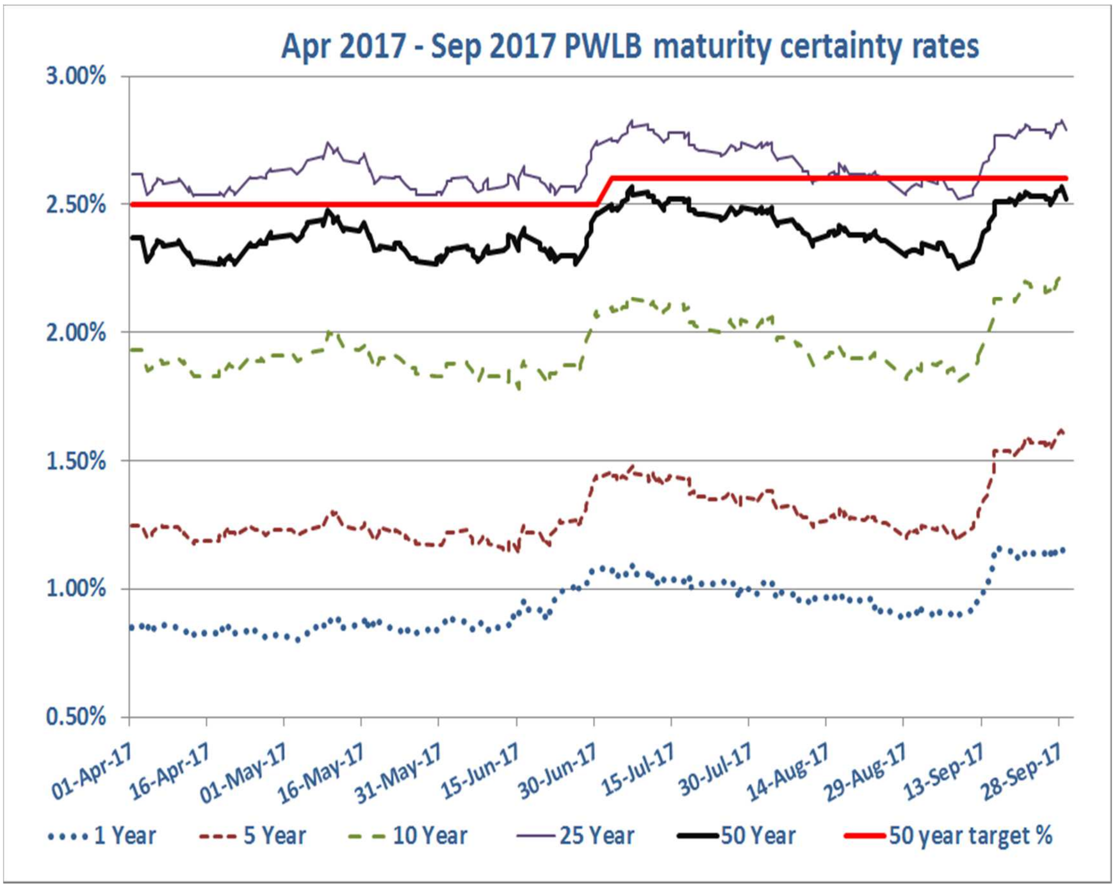
10 Borrowing

10.1 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 £141m and has utilised £14m 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.

10.2 Due to the overall financial position and the underlying need to borrow for capital purposes, new external borrowing of £5m has been undertaken from the PWLB and other Local Authorities. It is currently anticipated that further borrowing will not be undertaken during this financial year.

Source	Amount (£'000)	Duration (Years)	Rate (%)
Local Authority	2,000	4.5	1.02
PWLB	3,000	50.0	2.29

10.3 The graph below shows the movement in PWLB certainty rates for the first six months of the financial year:



10.4 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.

11 Investments

11.1 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 Bank Rate. The continuing potential for a re-emergence of the 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.

11.2 The Council held £56.9m of investments as at 30 September 2017 (£45.2m at 31 March 2017) and the investment portfolio yield for the first six months of the year is 0.40% against a six-month benchmark of 0.32%. A full list of investments held as at 30 September 2017 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.

11.3 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 2017/18.

11.4 The Council's budgeted investment return for 2017/18 is £170k, and performance for the year to date is currently expected to be above this figure despite the low rates available. This is due to levels of cash balances being higher than expected, which is partly as a result of the borrowing activity during the summer.

12 Strategic Plan references

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

13 Publicity considerations

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

14 Financial implications

14.1 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.

14.2 The outturn position for the CLIA is currently projected to be in line with the budget. The main factors affecting the forecast are the combined impact of the additional investment income detailed above, and the interest cost of the new borrowing undertaken during the year. The position will continue to be reviewed as part of the regular budget monitoring reports.

15 Risk Management implications

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

15.2 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

16 Other Standard References

16.1 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.

Appendices
Appendix A: Outstanding Temporary Investments 2017/18 (**confidential**)

Background Paper
None