APPENDIX A

Mid-Year Treasury Management Report 2017/18

AC as at 24-10-17 - LT

1. Introduction and Background

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

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.

As a consequence 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."

The Council has adopted the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management.

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a **Mid-year Review Report** and an Annual Report (stewardship report) covering activities during the previous year.
4. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
5. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Scrutiny (Audit and Value for Money Council Services) Committee.

2. This Annual Treasury Report Covers

This mid-year report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- An economic update for 2017/18
- 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 during 2017/18
- A review of compliance with Treasury and Prudential Limits for 2017/18
- Update on the Icelandic Bank Defaults

3. Economic Update

3.1 **UK.** After the UK economy surprised on the upside with strong growth in 2016, growth in 2017 has been disappointingly weak; quarter 1 came in at only +0.3% (+1.7% y/y) and quarter 2 was +0.3% (+1.5% y/y) which meant that growth in the first half of 2017 was the slowest for the first half of any year since 2012. The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 75% of GDP, has seen weak growth as consumers cut back on their expenditure. However, more recently there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year. However, this sector only accounts for around 11% of GDP so expansion in this sector will have a much more muted effect on the average total GDP growth figure for the UK economy as a whole.

3.2 The Monetary Policy Committee (MPC) meeting of 14 September 2017 surprised markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that the Bank Rate will need to rise. The Bank of England Inflation Reports during 2017 have clearly flagged up that they expected CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years time. Inflation actually came in at 2.9% in August, (this data was released on 12 September), and so the Bank revised its forecast for the peak to over

3% at the 14 September meeting MPC. This marginal revision can hardly justify why the MPC became so aggressive with its wording; rather, the focus was on an emerging view that with unemployment falling to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that the amount of spare capacity in the economy was significantly diminishing towards a point at which they now needed to take action. In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of increasing globalisation. This effectively means that the UK labour faces competition from overseas labour e.g. in outsourcing work to third world countries, and this therefore depresses the negotiating power of UK labour. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a decrease in such globalisation pressures in the UK, and so would be inflationary over the next few years.

3.3 The MPC increased the Bank Rate to 0.5% in November. The big question is whether this will be a one off increase or the start of a slow, but regular, increase in the Bank Rate. As at the start of October, short sterling rates are indicating that financial markets do not expect a second increase until May 2018 with a third increase in November 2019. However, some forecasters are flagging up that they expect growth to improve significantly in 2017 and into 2018, as the fall in inflation will bring to an end the negative impact on consumer spending power while a strong export performance will compensate for weak services sector growth. If this scenario were to materialise, then the MPC would have added reason to embark on a series of slow but gradual increases in the Bank Rate during 2018. While there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two years will pan out.

3.4 **EU.** Economic growth in the EU, (the UK's biggest trading partner), has been lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of QE. However, growth picked up in 2016 and now looks to have gathered ongoing substantial strength and momentum thanks to this stimulus. GDP growth was 0.5% in quarter 1 (2.0% y/y) and 0.6% in quarter (2.3% y/y). However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in August inflation was 1.5%. It is therefore unlikely to start on an upswing in rates until possibly 2019.

3.5 **USA.** Growth in the American economy has been volatile in 2015 and 2016. 2017 is following that path again with quarter 1 coming in at only 1.2% but quarter 2

rebounding to 3.1%, resulting in an overall annualised figure of 2.1% for the first half year. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.4%, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on a gradual upswing in rates with three increases since December 2016; and there could be one more rate rise in 2017 which would then lift the central rate to 1.25 – 1.50%. There could then be another four more increases in 2018. At its June meeting, the Fed strongly hinted that it would soon begin to unwind its $4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

3.6 **Chinese economic growth** has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

3.7 **Japan** is struggling to stimulate consistent significant growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

3.8 Interest rate forecasts

The Council's treasury advisor, Capita Asset Services, have provided the interest rate forecasts and commentary, which is attached at **Annex 3**.

4. The Treasury Management Strategy and Annual Investment Strategy Update

4.1 <u>Background</u>

The Treasury Management Strategy Statement (TMSS) for 2017/18 was approved by this Council on 27th February 2017. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as follows:

- Security of capital
- Liquidity

The Council will also aim to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity.

4.2 There are no policy changes to the TMSS being proposed; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

4.3 <u>Overview</u>

The Council held £28m of investments as at 30 September 2017 (£25m at 30 September 2016) and the investment portfolio yield for the first six months of the year is 0.43% (0.54% 2016/17). A breakdown of the Council's investment portfolio is shown at **Annex 2** of this report.

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.

It continues to be a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low. The continuing potential for a re-emergence of a eurozone sovereign debt crisis, and its impact on banks, prompts a relatively low risk and short-medium term strategy. Given this risk environment and the fact that increases in the 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.

The current investment counterparty criteria selection approved in the Treasury Management Strategy Statement is meeting the requirements of the treasury function.

5. Investment Portfolio

5.1 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.

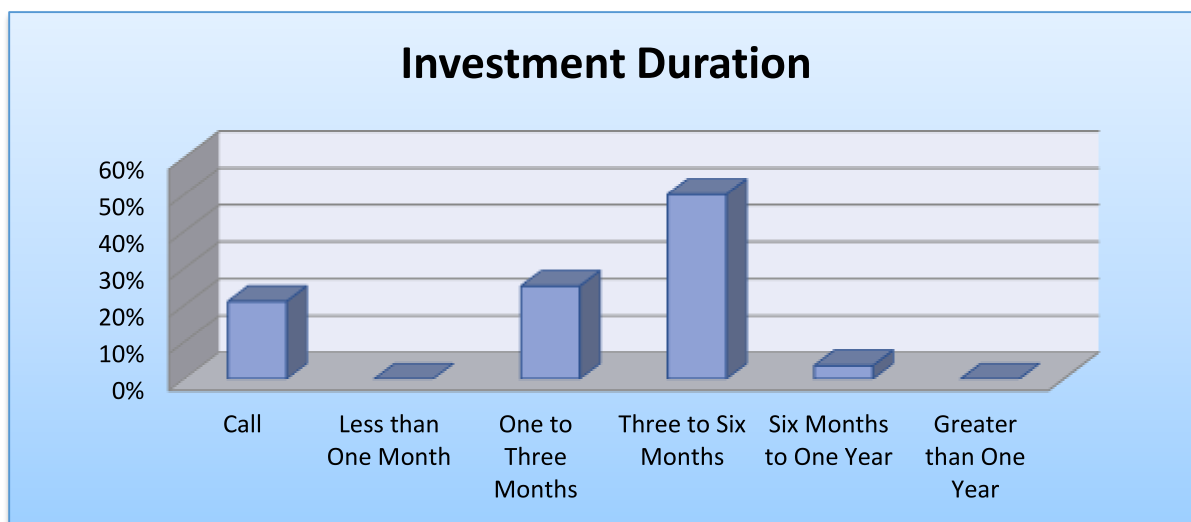
5.2 The investment portfolio yield for the first six months of the year is 0.43%.

	Average Rate Year to 30/09/17
ESBC	0.43%
LIBID – 6 month	0.32%
Base Rate	0.25%

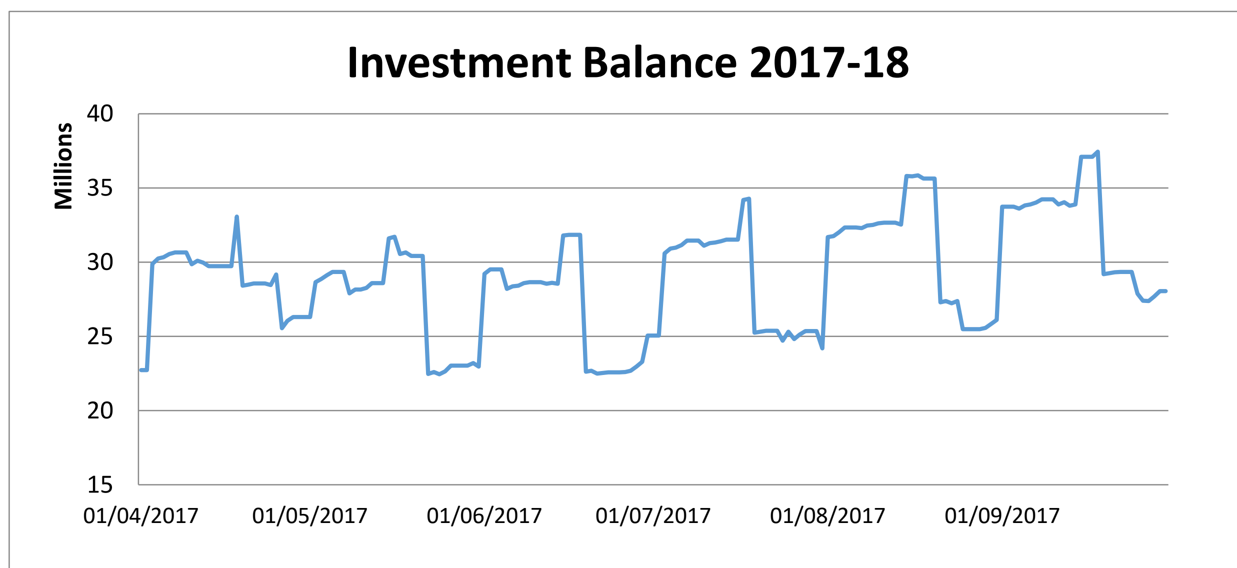
Investment rates available in the market are at a historical low point. Despite this, the above table demonstrates that the authority has outperformed the benchmarks. The Council's budgeted investment return for 2017/18 is 0.33%, performance is currently forecast to be slightly above the budget.

5.3 A full list of investments held as at 30th September 2017, totalling £28m is shown in **Annex 2**. The graph below demonstrates the maturity profile of investments. Call account rates have continued to dip over the last 12 months, as a direct result the investment listing includes certificates of deposits, as well as fixed deposits.

These instruments offer significant counterparty strength and rates preferable to those available with call account and money market fund deposits.



5.4 Average cash balances in the first six months of 2017/18 were £29m. The graph below demonstrates how these balances have fluctuated so far this year.



5.5 Property Funds

The treasury strategy for 2017/18 was updated to include scope to diversify our investment portfolio, with the option to invest in property funds. Property funds offer enhanced rates over the long term, but are more volatile in the short term. This was subject to appropriate due diligence being carried out before any investment of this type was undertaken and any such investment being subject to approval by the Chair of Audit Committee, the Deputy Leader with responsibility for Finance and the Chief Finance Officer.

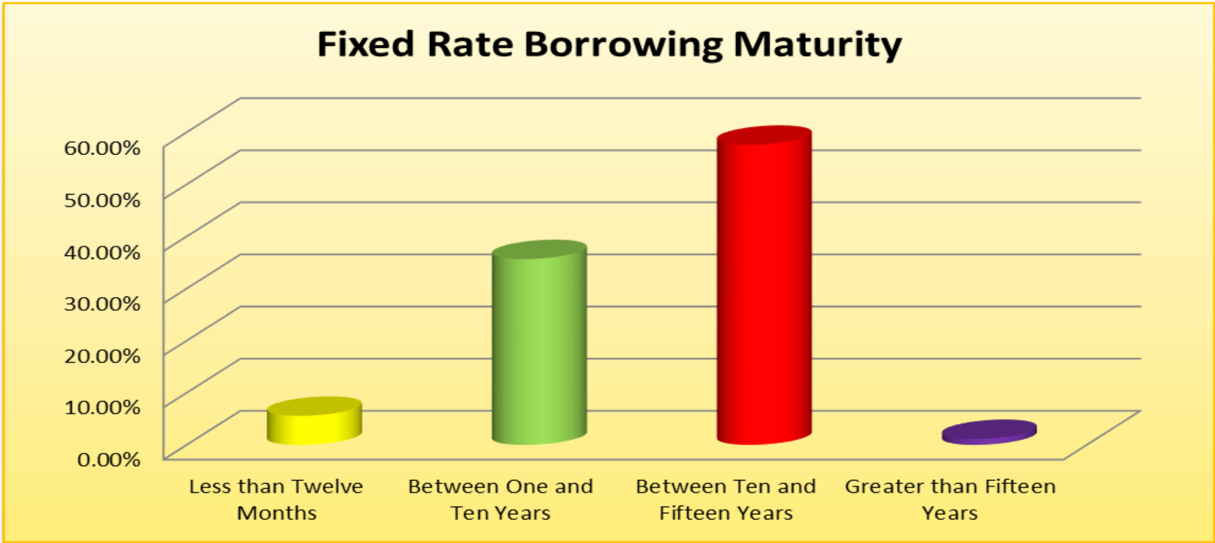
Following discussions with the Leader, as Finance Portfolio holder, it has been decided to defer for the time being any investment of this type. This is due to a combination of uncertainty around proposed accounting changes for investments such as this and the potential impact of Brexit on the economy and potentially on property values. These issues will be monitored closely and the position reviewed periodically.

6. External Borrowing

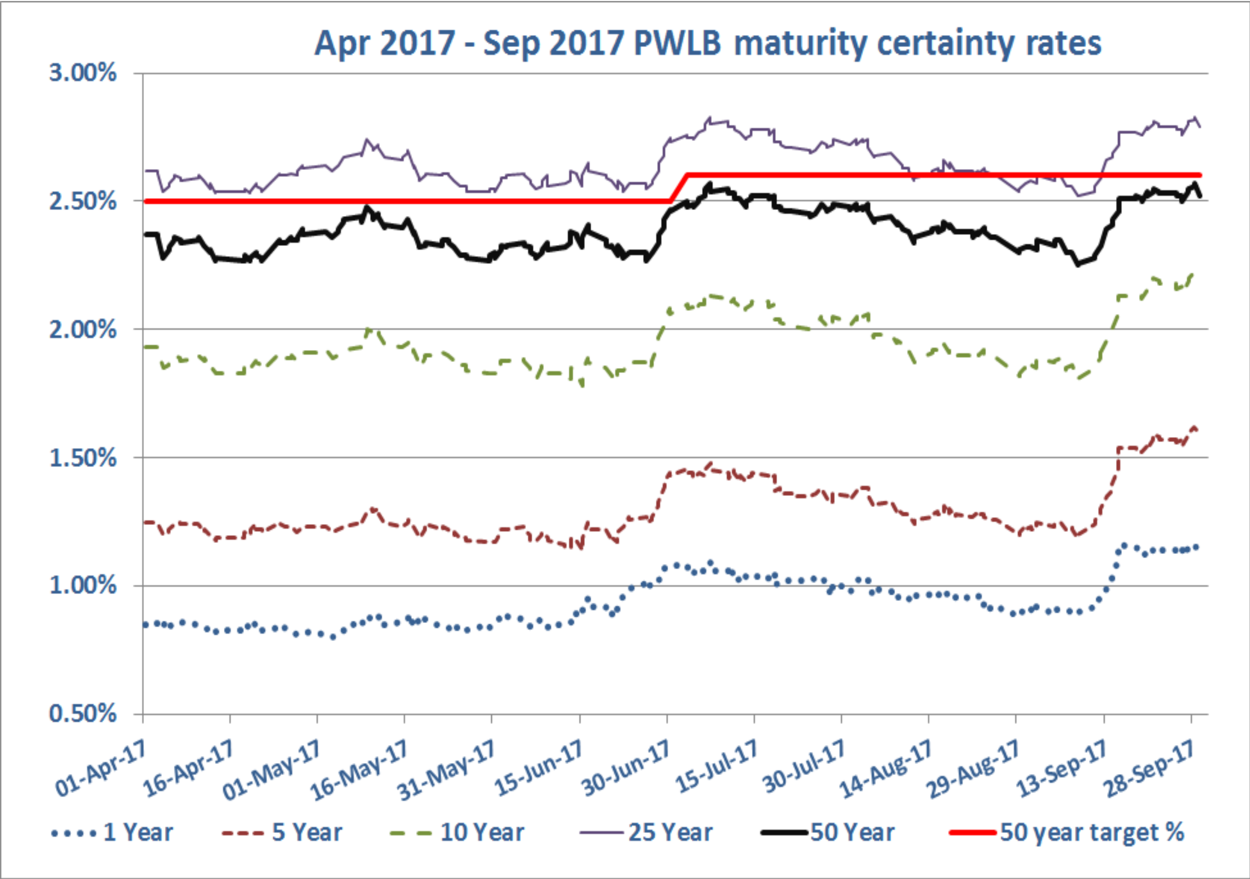
The Council's capital financing requirement (CFR) as at 31st March 2018 is estimated to be £16.9m (£18.6m as at 31st March 2017). Excluding finance leases, the CFR is estimated to be £15.6m as at 31st March 2018 (£16.7m at 31st March 2017). This reduction largely reflects the decision to make a voluntary repayment of debt amounting to £0.7m from windfall New Homes Bonus (which has generated ongoing revenue savings of £30k), together with the Statutory repayment of £0.4m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions.

Consistent with the strategy, no new borrowing has been undertaken during the first half of 2017/18. The current borrowing levels and maturity profile are set out in the table and graph below.

Debt Type	Principal Outstanding (£)	Average Rate
Total Fixed Debt		
PWLB Maturity	5,700,000	4.650%
PWLB Annuity	726,794	8.210%
Total Variable Debt		
Market	4,500,000	5.914%
GBSLEP Loan	375,000	0%
Total External Debt	**11,301,794**	**5.390%**



The table below shows the movement in PWLB certainty rates for the first six months of the year to date:



As set out in the Treasury Management Strategy Statement for 2017/18, the Council is operating a under-borrowed position, which is favourable in the current market conditions. It is not currently anticipated that any external borrowing will

be undertaken in the remainder of the year. Nevertheless, the Financial Management Unit will continue to monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances and any decisions will be reported to the appropriate decision making body at the next available opportunity.

7. Debt Re-Scheduling

Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. As a consequence there has not been any re-scheduling undertaken.

8. Compliance with Treasury and Prudential Limits

It is a statutory duty for the Council to determine and keep under review the “Affordable Borrowing Limits”. Council’s approved Treasury and Prudential Indicators (affordability limits) are outlined in the approved TMSS.

During the financial year to date the Council has operated within the treasury limits and Prudential Indicators set out in the Council’s Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators are shown in **Annex 1**.

9. Icelandic Bank Defaults

This authority currently has £0.297m investments frozen in the Icelandic bank (KSF). We anticipate further dividend repayments from the administration process, the next anticipated to be in November and Members will be informed in the normal manner.

10. Other Matters

MIFID II

10.1 The EU has now set a deadline of 3 January 2018 for the introduction of regulations under MIFID II. These regulations will govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. This will have little effect on this authority apart from a requirement to complete forms sent by each institution dealing with this authority and for each type of investment instrument we use, with the exception of cash deposits with banks and building societies.

Annex 1: Prudential and Treasury Indicators

PRUDENTIAL INDICATOR	2016/17	2017/18	2017/18
	Outturn	Estimate	Probable
	£'000	£'000	£'000
Capital Expenditure	1,999	1,117	**2,133**
Ratio of financing costs to net revenue stream	12.97%	13.83%	**13.56%**
Capital Financing Requirement (excluding finance leases)	16,706	15,284	**15,570**
Capital Financing Requirement as at 31 March (including finance leases)*	18,595	16,683	**16,957**
External Debt* (including finance leases)	13,349	12,427	**12,790**
Incremental impact of capital investment decisions	£ p	£ p	£ p
Increase in Council Tax (Band D) per annum	0.08	0.01	**0.12**

**this includes finance leases and estimate accrued interest at year end (as per accounting requirements)*

Maturity structure of new fixed rate borrowing during 2017/18	upper limit	lower limit
under 12 months	85%	0%
12 months and within 24 months	85%	0%
24 months and within 5 years	85%	0%
5 years and within 10 years	90%	0%
10 years and above	90%	0%

Annex 1: Prudential and Treasury Indicators

PRUDENTIAL INDICATOR	2016/17	2017/18	2017/18	2018/19	2019/20
(2). TREASURY MANAGEMENT PRUDENTIAL INDICATORS	Outturn	Estimate	Probable	Estimate	Estimate
Authorised Limit for external debt					
borrowing	21,500	18,500	18,500	18,000	17,500
other long term liabilities	2,000	3,000	3,000	3,000	3,000
TOTAL	**23,500**	**21,500**	**21,500**	**21,000**	**20,500**
Operational Boundary for external debt -					
borrowing	19,500	16,500	16,500	16,000	15,500
other long term liabilities	2,000	2,000	2,000	2,000	2,000
TOTAL	**21,500**	**18,500**	**18,500**	**18,000**	**17,500**
Upper limit on fixed interest rate exposure	9,000	9,000	**9,000**	**9,000**	**9,000**
Upper limit for variable rate exposure	4,000	4,000	**4,000**	**4,000**	**4,000**
Upper limit for total principal sums invested for over 1 year	3,000	3,000	**5,000**	**5,000**	**5,000**

Annex 2: Investments as at 30th September 2017

Borrower	Principal (£)	Interest Rate	Start Date	Maturity Date
Call Accounts and Money Market Funds				
RBS SIBA	435,221	0.01%		Call
Standard Life MMF	1,420,000	0.16%		Call
Insight Money Market Fund	4,000,000	0.20%		Call
Santander	1,500,000	0.40%		95 day notice
Fixed Deposits / T Bills / Certificates of Deposit				
Barclays	3,405,616	0.30%	22/08/2017	22/02/2018
Bank of Scotland	1,500,000	0.36%	29/09/2017	29/03/2018
Bank of Scotland	500,000	0.55%	04/05/2017	06/11/2017
Bank of Scotland	500,000	0.55%	06/04/2017	06/10/2017
Santander	1,000,000	0.45%	26/09/2017	26/03/2018
Lloyds TSB	1,500,000	0.55%	04/04/2017	04/10/2017
Lloyds TSB	1,000,000	0.55%	01/06/2017	01/12/2017
Nationwide CD	2,000,000	0.37%	04/04/2017	04/10/2017
Nationwide CD	1,000,000	0.30%	18/08/2017	16/02/2018
Nordea CD	1,500,000	0.31%	13/04/2017	13/10/2017
UBS AG CD	1,000,000	0.55%	04/04/2017	16/01/2018
Toronto Dominion CD	1,500,000	0.49%	13/04/2017	29/03/2018
RBS CD	3,000,000	0.73%	03/04/2017	27/03/2018
RBS CD	1,000,000	0.60%	04/09/2017	03/09/2018

Borrower - Icelandic Exposure	Principal (£)	Interest Rate	Start Date	Maturity Date
Singer	297,000	5.41%		08/10/2008

Investments rate of interest as at 30th September 2017	Principal (£)	Interest Rate
Total Investments	**28,057,837**	
Total Investments - Excluding Icelandic Exposure	**27,760,837**	**0.40%**
Total Investments - Icelandic Exposure Only	**297,000**	**5.41%**

Average rate of interest for the year to date	Principal (£)	Interest Rate
Total Investments	**28,868,880**	
Total Investments - Excluding Icelandic Exposure	**28,571,880**	**0.43%**
Total Investments - Icelandic Exposure Only	**297,000**	**5.41%**

Annex 3: Interest Rate Forecasts

The Council's treasury advisor, Capita Asset Services, has provided the following forecast *(Pre. November 2017 MPC Decision to increase Bank Rate)*

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.50%	1.60%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%
50yr PWLB rate	2.70%	2.70%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%

Capita Asset Services undertook its last review of interest rate forecasts on 9 August after the quarterly Bank of England Inflation Report. There was no change in MPC policy at that meeting. However, the MPC meeting of 14 September revealed a sharp change in sentiment whereby a majority of MPC members said they would be voting for an increase in the Bank Rate "over the coming months". It is therefore possible that there will be an increase to 0.5% at the November MPC meeting. If that happens, the question will then be as to whether the MPC will stop at just withdrawing the emergency Bank Rate cut of 0.25% in August 2016, after the result of the EU withdrawal referendum, or whether they will embark on a series of further increases in the Bank Rate during 2018.

The overall balance of risks to economic recovery in the UK is currently to the downside but huge variables over the coming few years include just what final form Brexit will take, when finally agreed with the EU, and when.

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

- UK economic growth and increases in inflation are 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.
- Monetary policy action failing to stimulate sustainable growth and to get inflation up consistently to around monetary policy target levels.

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

- The pace and timing 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 major flight from bonds to equities.
- UK inflation returning to significantly higher levels causing an increase in the inflation premium inherent to gilt yields.