CAPITA

Asset Services

Treasury solutions

Strategy Statement and Annual Investment Strategy

Mid-year Review Report 2016-17

North Hertfordshire District Council

Contents

1 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 optimising 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. This council does not currently have borrowing requirements due to the capital receipts previously classed as "set-aside".

Accordingly, 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."

2 Introduction

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) was adopted by this Council on 11 February 2016.

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 Finance, Audit and Risk Committee

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 first part of the 2016/17 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 2016/17;

- A review of the Council's borrowing strategy for 2016/17;
- A review of any debt rescheduling undertaken during 2016/17;
- A review of compliance with Treasury and Prudential Limits for 2016/17.

3 Economics and interest rates

3.1 Economics update

UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were strong but 2015 was disappointing at 1.8%, though it still remained one of the leading rates among the G7 countries. Growth improved in quarter 4 of 2015 from +0.4% to 0.7% but fell back to +0.4% (2.0% y/y) in quarter 1 of 2016 before bouncing back again to +0.7% (2.1% y/y) 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.

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 of 2.0% 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, (i.e. without tariffs), 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.

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.

The American economy had a patchy 2015 with sharp swings in the growth rate leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 disappointed at +0.8% on an annualised basis while quarter 2 improved, but only to a lacklustre +1.4%. However, forward indicators are pointing towards a pickup in growth in the rest of 2016. The Fed. embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene and then the Brexit vote, have caused a delay in the timing of the second increase which is now strongly expected in December this year.

In the Eurozone, the ECB commenced in March 2015 its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month; this was intended to run initially to September 2016 but was extended to March 2017 at its December 2015 meeting. At its December and March meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise from around zero towards the target of 2%. GDP growth rose by 0.6% in quarter 1 2016 (1.7% y/y) but slowed to +0.3% (+1.6% y/y) in quarter 2. This has added to comments from many forecasters that central banks around the world are running out of ammunition to stimulate economic growth and to boost inflation. They stress that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand in the their economies and economic growth.

Japan is still bogged down in anaemic growth and making little progress on fundamental reform of the economy while Chinese economic growth has been weakening and medium term risks have been increasing.

3.2 Interest rate forecasts

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

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
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%

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.

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. Our PWLB rate forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

The overall balance of risks to economic recovery in the UK remains to the downside. Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Monetary policy action reaching its limit of effectiveness and failing to stimulate significant sustainable growth, combat the threat of deflation and reduce high levels of debt in some major developed economies, combined with a lack of adequate action

from national governments to promote growth through structural reforms, fiscal policy and investment expenditure.
- Weak capitalisation of some European banks.
- A resurgence of the Eurozone sovereign debt crisis.
- Geopolitical risks in Europe, the Middle East and Asia, increasing safe haven flows.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or Fed. rate increases, causing a further flight to safe havens (bonds).
- 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.

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 than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

4 Treasury Management Strategy Statement and Annual Investment Strategy update

The Treasury Management Strategy Statement (TMSS) for 2016/17 was approved by this Council on 11 February 2016.
- 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 already approved.

5 The Council's Capital Position (Prudential Indicators)

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.

5.1 Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure as approved in the first quarter Capital Budget Monitoring Report.

Capital Expenditure by Service	2016/17 Original Estimate £	Current Position £	2016/17 Revised Estimate £
Advances & Cash Incentives	548,000	0	0
Asset Management	4,138,200	569,307	7,449,900
Building Control	53,000	0	53,000
CCTV	0	0	12,300
Community Services	250,000	278,075	765,500
Computer Software & Equipment	52,000	34,972	449,000
Corporate Items	0	2,501	2,512,700
Growth Fund Project	126,000	0	672,500
Leisure Facilities	1,677,400	638,101	4,847,300
Museum & Arts	0	487,760	868,500
Parking	709,400	53,159	1,097,300
Renovation & Reinstatement Grant Expenditure	805,000	94,834	805,000
Town Centre Enhancement	0	0	141,200
Waste Collection	260,000	0	35,000
Total capital expenditure	**8,619,000**	**2,158,709**	**19,709,200**

5.2 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), and the expected finance arrangements of this capital expenditure.

Capital Expenditure	2016/17 Original Estimate £	Current Position £	2016/17 Revised Estimate £
Total capital expenditure	**8,619,000**	**2,158,709**	**19,709,200**
Financed by:			
Capital receipts	2,404,200	532,334	4,774,200
Capital grants	381,000	84,914	1,417,500
Other Capital Contributions	473,000	445,390	1,005,700
Revenue Contributions	88,000	0	4,300
S106 Funding	290,900	249,616	509,700
Total financing	**3,637,100**	**1,312,254**	**7,711,400**
Net Financing Need	**4,981,900**	**846,455**	**11,997,800**

5.3 Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

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

Prudential Indicator – Capital Financing Requirement

The Capital Financing Requirement will remain negative during the year.

Prudential Indicator – the Operational Boundary for external debt

	2016/17 Original Estimate £	2016/17 Current Position £	2016/17 Revised Estimate £
Prudential Indicator – Capital Financing Requirement			
Total CFR	-18,826,766	-18,826,766	-18,826,766
Net movement in CFR	**0**	**0**	**0**
Prudential Indicator – the Operational Boundary for external debt			
Operational Boundary	5,000,000	5,000,000	5,000,000
Borrowing			
PWLB	515,357	497,213	480,455
LOBO	1,000,000	1,000,000	0
Total debt	**1,515,357**	**1,497,213**	**480,455**
Within Operational Boundary	**3,484,643**	**3,502,787**	**4,519,545**

5.4 Limits to Borrowing Activity

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 but this will not be required in 2016/17.

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

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	2016/17 Original Indicator £m	2016/17 Current Position £m	2016/17 Revised Indicator £m
Authorised Limit	7,000,000	7,000,000	7,000,000
Borrowing	1,515,357	1,497,213	480,455

6 Investment Portfolio

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 Section 3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the current 0.25% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis together with other risks which could impact on the creditworthiness of banks, prompts a low risk strategy. Given this risk environment, investment returns are likely to remain low.

The Council held £28.5m of investments as at 30 September 2016 (£28.5m at 31 March 2016) and the investment portfolio yield for the first six months of the year including in-house deals is

0.9%.

The average level of funds available for investment purposes in house during the quarter was £19.3M. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme. At the 30 September the Council held £28.5M core cash balances for investment purposes (i.e. funds available for more than one year). and the investment portfolio yield for the first six months of the year including in-house deals is 0.9%.

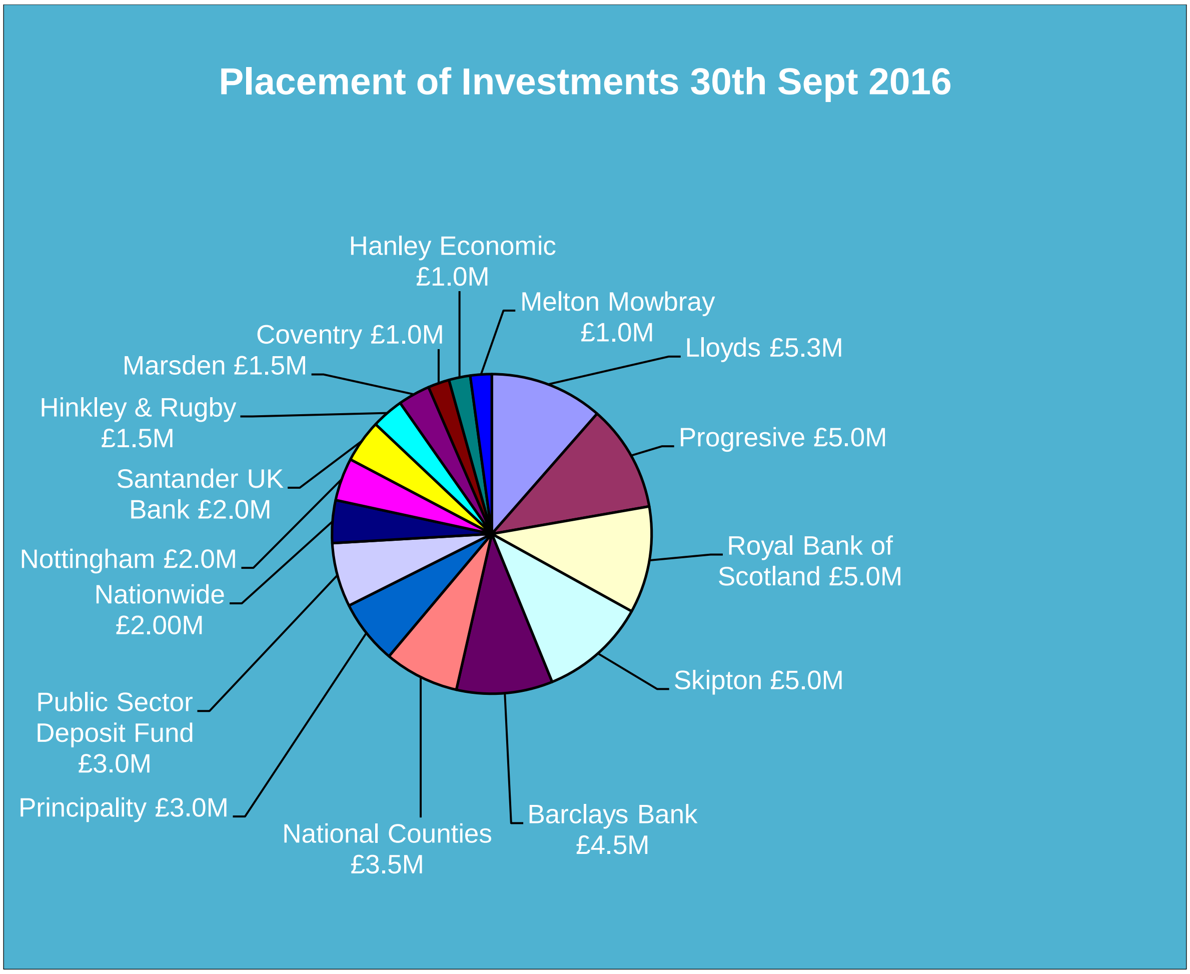
Investments as at 30 September 2016

	Amount £	Average Interest Rate %
Managed By NHDC		
Banks	8,800,000	0.79
Building Societies	6,000,000	0.62
Money Market Fund	3,000,000	0.39
NHDC To Total	**17,800,000**	**0.72**
Managed by Tradition		
Banks	8,000,000	1.32
Building Societies	20,500,000	1.25
Tradition Total	**28,500,000**	**1.26**
TOTAL	**46,300,000**	**1.18**

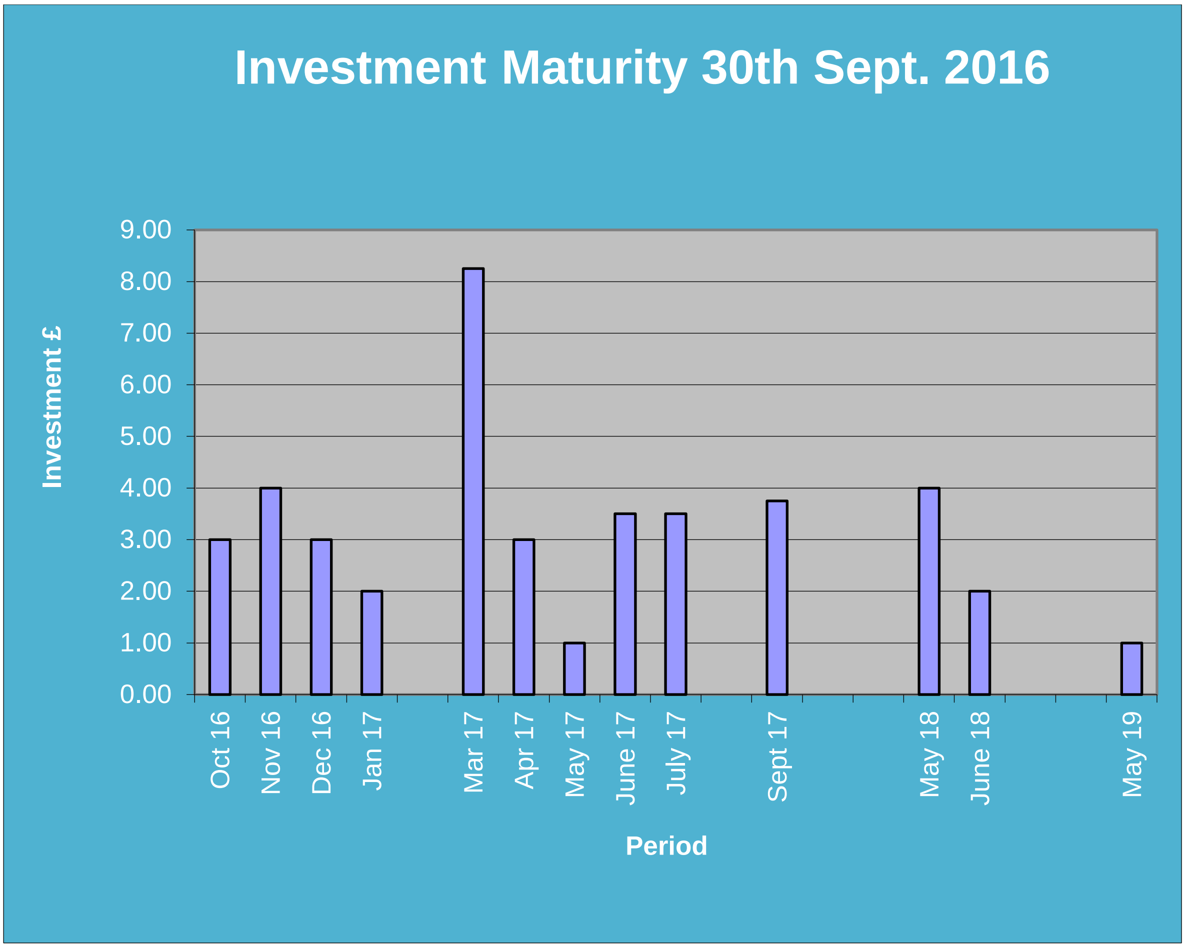
In percentage terms, this equates to:

	Percentage
Money Market Funds	6.48
Banks	36.28
Building Societies	57.24

The pie chart below shows the spread of investment balances as at 30 September 2016. This is a snapshot in time that demonstrates the diversification of investments.

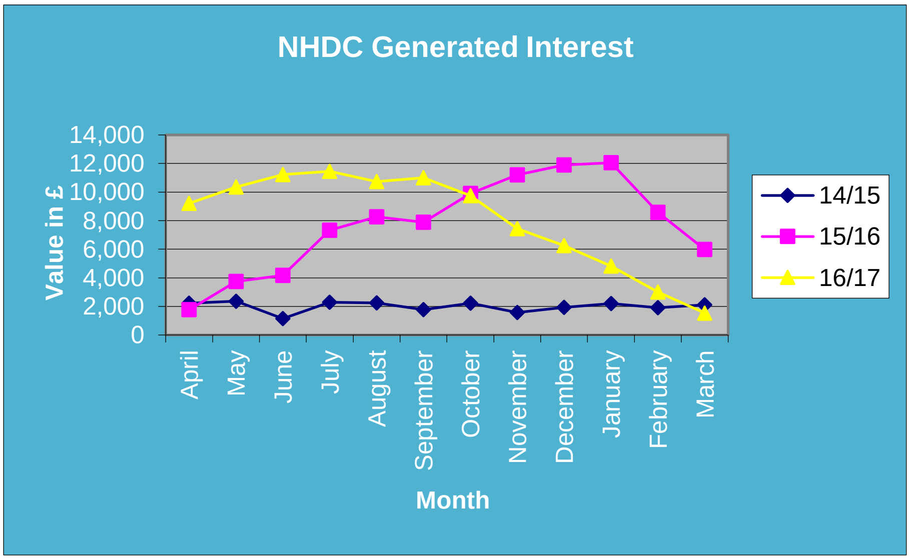


The chart below shows the Council's investment maturity profile. (This does not include the £3.0M held in the Public Sector Deposit Fund Money Market account or £1.3M held in the Lloyds current account which can be called back on any day). Tradition placed four new deals in the second quarter, two of which were for a year (£1M at 1.0% and £1M at 1.05%). The other two deals were asked to be kept short to ensure enough funds will be available to fund the capital programme.



The Council's Original budgeted investment return for 2016/17 was £0.372M. The projection at the first quarter was £0.427M which was an increase of approximately £0.055M. The projection at the second quarter remains at £0.427M.

The graph below shows the level of interest expected to be generated from the cash available in-house over the year which is maintained to ensure adequate cash flow. Cash balances have historically reduced over January to March each year as there are fewer Council tax receipts in February and March.

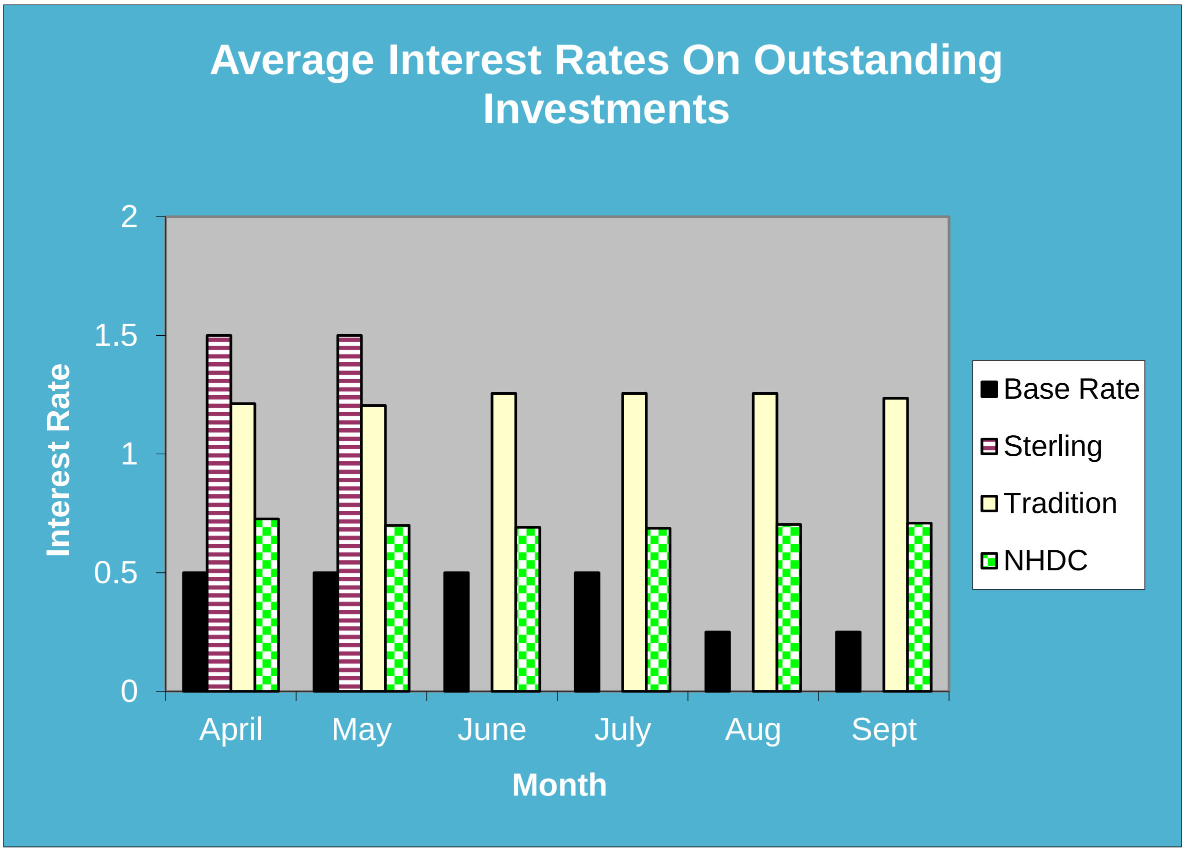


The table below shows the average rates achieved on investments made during the second quarter.

	Ave Interest Rate on Deals made in the 2nd Qrt
NHDC	0.65%
Tradition	0.79%

Base rate started the year at 0.5% and remained constant until 4th August when it reduced to 0.25%.

The graph below shows the average rate of interest on outstanding investments at 30th September.



As can be seen from the graph, the average rate of interest on outstanding investments for NHDC (cash managed internally) is consistently lower than that of the Cash Managers. This is because the investments made by NHDC during the year are to meet cash flow requirements and are therefore made for short periods. At present, rates in the shorter periods are lower than the longer periods. The Cash Managers have more long term investments and the turnover of investments is small in comparison to NHDC.

The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2016/17.

Investment Counterparty criteria

The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function but will be reviewed when setting next year's TMSS

7 Borrowing

The Council's capital financing requirement (CFR) for 2016/17 is -£18.8M. 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 CFR is negative as the Council has more cash investments than borrowing. The balance of external and internal borrowing is generally driven by market conditions.

Loans Outstanding at 30 September 2016

	Amount	Average Interest Rate	Cumulative Rate
	£	%	%
Public Works Loans Board	479,213	9.324	8.85
Lender Option Borrower Option	1,000,000	10.125	10.10
	1,479,213	9.8590	8.5584

It is anticipated that long term borrowing will not be undertaken during this financial year.

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

PWLB certainty rates 1 April 2016 to 30TH September 2016

	1 Year	5 Year	10 Year	25 Year	50 Year
1/4/16	1.13%	1.62%	2.31%	3.14%	2.95%
30/9/16	0.83%	1.01%	1.52%	2.27%	2.10%
Low	0.81%	0.95%	1.42%	2.08%	1.87%
Date	07/09/2016	10/08/2016	10/08/2016	12/08/2016	30/08/2016
High	1.20%	1.80%	2.51%	3.28%	3.08%
Date	27/04/2016	27/04/2016	27/04/2016	27/04/2016	27/04/2016
Average	0.99%	1.33%	1.92%	2.69%	2.46%

8 Debt Rescheduling

No debt rescheduling was undertaken during the first six months of 2016/17.