

Treasury solutions

## Treasury Management Strategy Statement and Annual Investment Strategy

Mid-year Review Report 2017/18

English Authorities

## 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 9th February 2017.

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 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.

## 3 Economics and interest rates

### 3.1 Economics update

**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.

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 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.

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

**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 (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.

**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.

**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.

**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.

### 3.2 Interest rate forecasts

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

	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 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 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.

## 4 Treasury Management Strategy Statement and Annual Investment Strategy update

The Treasury Management Strategy Statement (TMSS) for 2017/18 was approved by this Council on 9th February 2017.

- 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	2017/18 Original Estimate £	Current Position £	2017/18 Revised Estimate £
Advances & Cash Incentives	548,000	0	548,000
Asset Management	850,000	3,504,259	6,127,500
CCTV	60,000	0	60,000
Community Services	340,000	44,919	318,200
Computer Software & Equipment	366,000	52,802	259,700
Corporate Items	0	0	10,600
Growth Fund Project	652,000	0	0
Leisure Facilities	688,000	1,981,439	2,731,800
Museum & Arts	0	87,692	148,600
Parking	415,000	930	529,300
Renovation & Reinstatement Grant Expenditure	805,000	147,597	805,000
Town Centre Enhancement	141,000	0	0
Waste Collection	3,600,000	0	3,600,000
<b>Total capital expenditure</b>	<b>8,465,000</b>	<b>5,819,638</b>	<b>15,138,700</b>

### 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 financing arrangements of this capital expenditure.



Capital Expenditure	2017/18 Original Estimate £	Current Position £	2017/18 Revised Estimate £
<b>Total capital expenditure</b>	<b>8,465,000</b>	<b>5,819,638</b>	<b>15,138,700</b>
Financed by:			
Capital receipts	1,291,300	1,166,338	2,406,400
Government grants	1,396,800	144,776	745,000
Other Capital Contributions	163,000	0	0
Revenue Contributions	0	0	0
S106 Funding	341,300	272,538	564,760
<b>Total financing</b>	<b>3,192,400</b>	<b>1,583,652</b>	<b>3,716,160</b>
<b>Net Financing Need</b>	<b>5,272,600</b>	<b>4,235,986</b>	<b>11,422,540</b>

### 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.

	2017/18 Original Estimate £	2016/17 Year End £	2017/18 Revised Estimate £
<b>Prudential Indicator – Capital Financing Requirement</b>			
Total CFR	-2,286,000	-16,633,719	-5,211,179
<b>Net movement in CFR</b>	<b>0</b>	<b>-14,347,719</b>	<b>11,422,540</b>

#### Prudential Indicator – the Operational Boundary for external debt

	2017/18 Original Estimate £	2017/18 Current Position £	2017/18 Revised Estimate £
<b>Prudential Indicator – the Operational Boundary for external debt</b>			
Operational Boundary	4,000,000	4,000,000	4,000,000
Borrowing			
PWLB	480,455	466,179	455,732
LOBO	0	0	0
<b>Total debt</b>	<b>480,455</b>	<b>466,179</b>	<b>455,732</b>
<b>Within Operational Boundary</b>	<b>3,519,545</b>	<b>3,533,821</b>	<b>3,544,268</b>

#### 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 2017/18 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need but this will not be required in 2017/18.

The Head of Finance, Performance and Asset Management 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	6,000,000	6,000,000	6,000,000
Borrowing	480,455	466,179	455,732

## 6 Investment Portfolio 2017/18

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 shown by forecasts in section 3.2, 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, and its impact on banks, prompts a low risk 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.

The Council held £39.1m of investments as at 30 September 2017 (£36.0m at 31 March 2017). The average level of funds available for investment purposes in house during the 2<sup>nd</sup> quarter was £13.7M. 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). The investment portfolio yield for the first six months of the year including in-house deals is 0.8%.

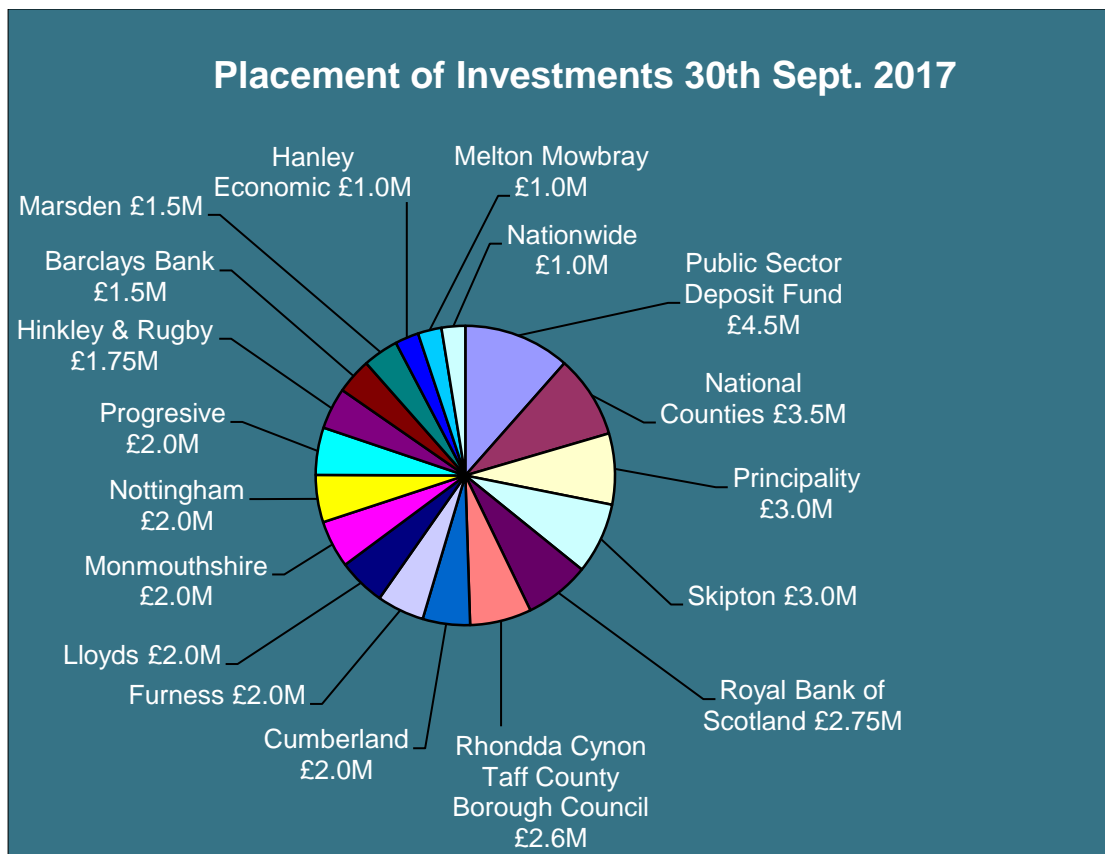
## Investments as at 30 September 2017

	Amount £	Average Interest Rate %
<b>Managed By NHDC</b>		
Banks	3,500,000	0.66
Local Authorities	2,600,000	0.30
Money Market Fund	4,500,000	0.28
<b>NHDC To Total</b>	<b>10,600,000</b>	<b>0.50</b>
<b>Managed by Tradition</b>		
Banks	2,750,000	0.58
Building Societies	25,750,000	1.09
<b>Tradition Total</b>	<b>28,500,000</b>	<b>1.05</b>
<b>TOTAL</b>	<b>39,100,000</b>	<b>1.00</b>

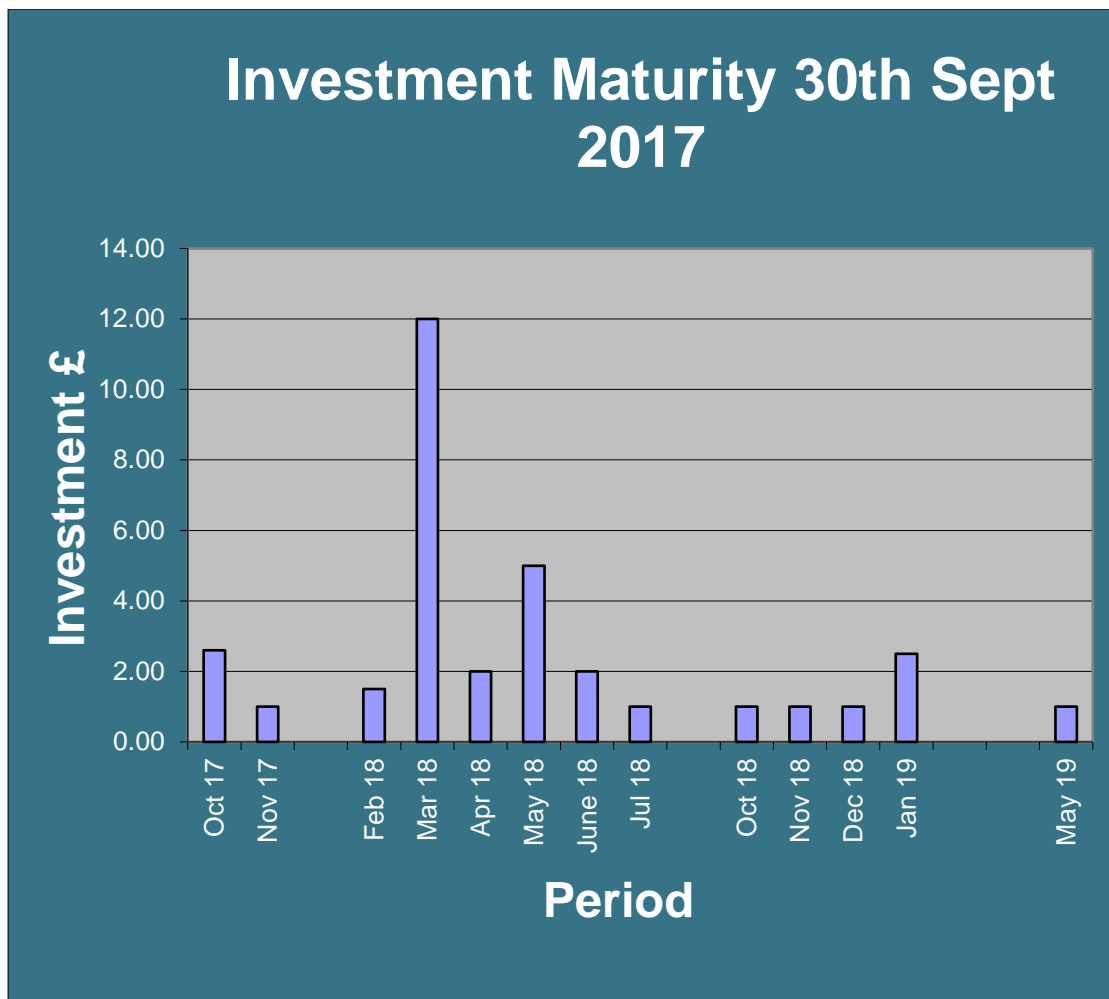
In percentage terms, this equates to:

	Percentage
Local Authorities	6.65
Money Market Funds	11.51
Banks	15.98
Building Societies	65.86

The pie chart below shows the spread of investment balances as at 30 September 2017. This is a snapshot in time that demonstrates the diversification of investments.

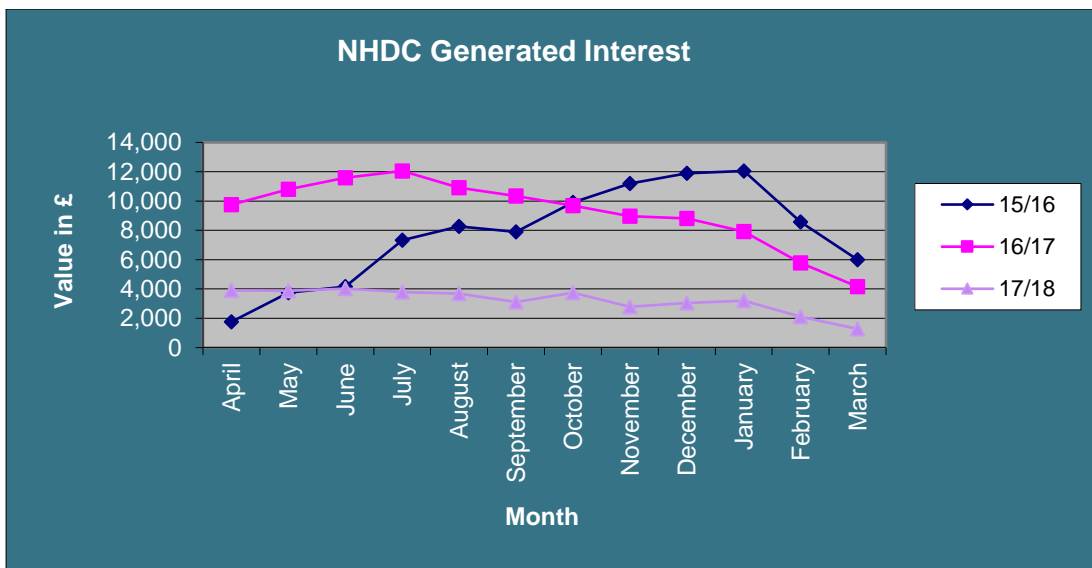


The chart below shows the Council's investment maturity profile. (This does not include the £4.5M held in the Public Sector Deposit Fund Money Market account or £1.0M held in the Lloyds current account which can be called back on any day). Tradition placed five new deals in the second quarter, two of which were for longer than a year (£1M at 1.0% for 18 months and £1M at 0.85% for a year). The other three 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 2017/18 was £0.267M. The projection at the first quarter was £0.327M which was an increase of approximately £0.060M. The projection at the second quarter is slightly lower at £0.320M.

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.

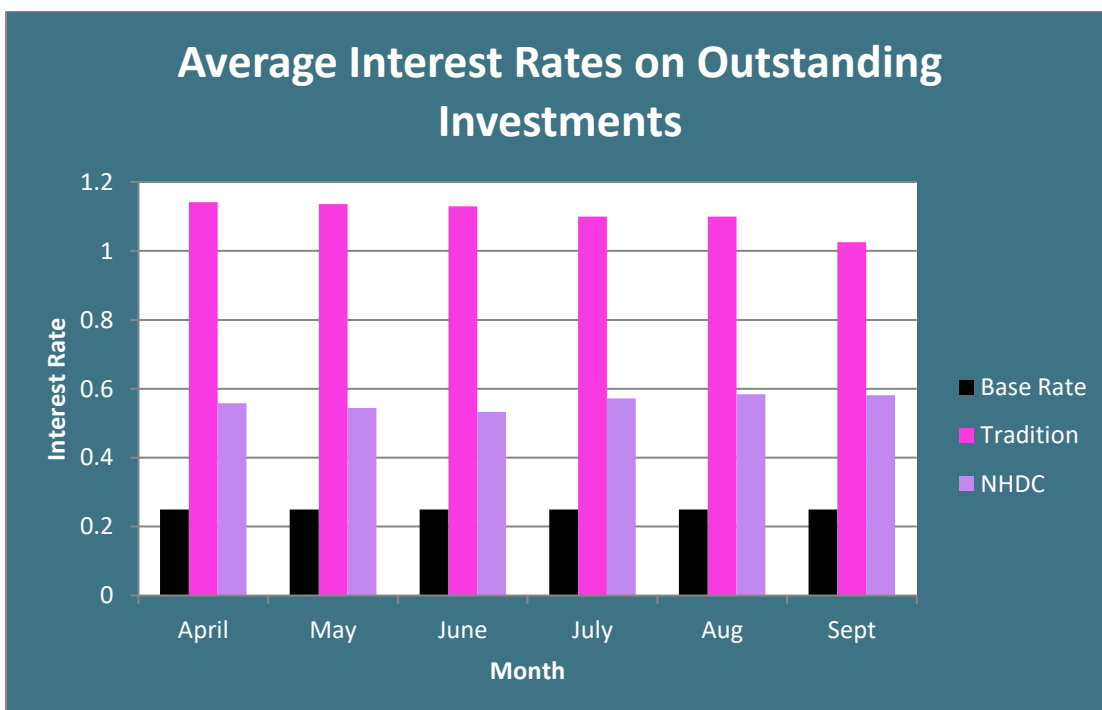


The table below shows the average rates achieved on investments made during the second quarter.

Ave Interest Rate on Deals made in the 2nd Qrt	
NHDC	0.30%
Tradition	0.76%

Base rate started the year at 0.25% and remained constant during the two quarters.

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 2017/18.

#### 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 2017/18 is -£5.2M. 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 2017

	Amount	Average Interest Rate	Cumulative Rate
	£	%	%
Public Works Loans Board	466,179	9.526	8.85
	466,179	9.526	8.85

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

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

#### PWLB certainty rates 1 April 2017 to 30 September 2017

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.8	1.14	1.78	2.52	2.25
Date	03/05/2017	15/06/2017	15/06/2017	08/09/2017	08/09/2017
High	1.16	1.62	2.22	2.83	2.57
Date	15/09/2017	28/09/2017	28/09/2017	07/07/2017	07/07/2017
Average	0.9408	1.2981	1.9470	2.6475	2.3917

## 8 Debt Rescheduling

No debt rescheduling was undertaken during the first six months of 2017/18.

## 9 Other

### ***Revised CIPFA Codes***

The Chartered Institute of Public Finance and Accountancy, (CIPFA), is currently conducting an exercise to revising the Treasury Management Code and Cross Sectoral Guidance Notes, and the Prudential Code. CIPFA is aiming to issue the revised codes during November.

A particular focus of this exercise is how to deal with local authority investments which are not treasury type investments e.g. by investing in purchasing property in order to generate income for the authority at a much higher level than can be attained by treasury investments. One recommendation is that local authorities should produce a new report to members to give a high level summary of the overall capital strategy and to enable members to see how the cash resources of the authority have been apportioned between treasury and non treasury investments. Officers are monitoring developments and will report to members when the new codes have been agreed and issued and on the likely impact on this authority.

### **MIFID II (Markets in Financial Instruments Directive)**

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 having to fill in forms sent by each institution dealing with this authority and for each type of investment instrument we use apart from for cash deposits with banks and building societies.