Report to:	**Executive**
Date:	**01 December 2016**
Title:	**Treasury Management Mid-Year Review**
Portfolio Area:	**Support Services – Cllr S Wright**
Wards Affected:	**ALL**
Relevant Scrutiny Committee:	

Urgent Decision:	**N**	Approval and clearance obtained:	**Y**

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Recommendations:

1. That the report is noted.

1. Executive summary

In the first six months of 2016/17, the Council has outperformed the industry benchmark for the returns on its investments by 0.18%. The Council has achieved a rate of return of 0.46%, against the 7 day LIBID bid rate (LIBID) of 0.28%.

The Council is forecasting a shortfall in investment income of £10,000 against its budgeted income target of £148,000, following the cut in the Bank Base Rate from 0.5% to 0.25% on 4 August 2016. It is possible that there will be a further reduction in the Bank Base Rate to 0.1% by the end of 2016 and this is predicted to rise back to 0.5% by 2019. A cost pressure of £25,000 has been included within the Medium Term Financial Strategy for 2017/18 for a reduction in treasury management income. The Council is investigating alternative investment vehicles in order to be able to reduce this cost pressure.

2. 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. The Council is currently debt-free.

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's Finance Procedure Rules require that a report be taken to the Executive three times a year on Treasury Management. The specific reporting requirements are:

an annual treasury strategy in advance of the year (Executive 10/03/16 - E71-15)
a mid-year treasury update report (this report)
an annual review following the end of the year describing the activity compared to the strategy (15/09/16 - E23/16)

The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management recommends that Members be updated on treasury management activities regularly (i.e. Treasury Management Strategy Statement (TMSS), annual and midyear reports). This report therefore ensures this Council is implementing best practice in accordance with the Code.

Economic Background

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 through 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.

Interest Rate Forecast

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.

Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2016/17, which includes the Annual Investment Strategy, was approved by the Council on 19/05/16 – minute 20/16 (and Executive 10/03/16 - E71-15). It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield.

The Council will also aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with highly credit rated financial institutions, using our suggested creditworthiness approach, including a minimum sovereign credit rating, and Credit Default Swap (CDS) overlay information.

Treasury Position at 30 September 2016

	As at 31/03/2016		As at 30/09/2016	
	Principal £	**Interest %**	**Principal £**	**Interest %**
Investment Type				
Short Fixed	15,000,000	0.73	13,501,514	0.56
Money Market Funds	2,850,000	0.49	12,450,000	0.32
Heritable Bank	22,483	-	22,483	-
Total	**17,872,483**	**0.71**	**25,973,997**	**0.46**

The Council's Investments mid way through the year are always higher than at the end of the year (at 31st March) due to the cashflow advantage that the Council benefits from part way through the year.

This is, in part, due to the timing differences between the Council collecting council tax income and paying this over to major precepting authorities such as Devon County Council, the Police and the Fire Authority.

The following is a list of the Council's fixed investments at 30 September 2016:

Counterparty	Fixed to	£	Interest Rate
Barclays Bank plc	17/03/2017	3,500,000	0.41%
Nationwide BS	06/10/2016	5,000,000	0.42%
Lloyds TSB Bank Plc	04/01/2017	5,001,514	0.85%

Icelandic Bank

The Council placed a deposit of £1,250,000 on 25th September 2008 with the Heritable Bank which is a subsidiary of Landsbanki, one of the Icelandic Banks that was affected by the world economic crisis. Of this amount £1,227,517 (98%) has already been repaid to the Council by the Administrators. At the 30 September 2016, the Council had £22,483 frozen in the Heritable Bank.

At the time the deposit was placed, the risk rating of Heritable was 'A' (long term deposits) and F1 (short term deposits). Both ratings indicated low risk and were within the deposit policy approved by the Council. Heritable Bank is registered in Scotland with an address in Edinburgh. Heritable Bank Plc is authorised and regulated by the Financial Services Authority and is on the FSA Register. The bank's shares are owned by Icelandic bank, Landsbanki.

Administrators have kept the bank trading and are winding down the business over a period of years. The Administrators have paid fifteen dividends amounting to 98% of the original deposit. The administrators estimate that the return to all unsecured creditors is now between 98-100 pence in the pound.

Performance Assessment

Industry performance is judged and monitored by reference to a standard benchmark; this is the 7 day London Interbank Bid Rate (LIBID). The average weighted LIBID rate at the end of September was 0.28% which is 0.18% lower than the Council's average return of 0.46% @30/09/16. The reason the Council is exceeding this benchmark is due to the use of fixed term investments that where made before the Bank of England dropped the base rate so when they are renewed the return will be lower.

The Council is forecasting a shortfall in investment income of £10,000 against its budgeted income target of £148,000, following the cut in the Bank Base Rate from 0.5% to 0.25% on 4 August 2016. It is possible that there will be a further reduction in the Bank Base Rate to 0.1% by the end of 2016 and this is predicted to rise back to 0.5% by 2019. A cost pressure of £25,000 has been included within the Medium Term Financial Strategy for 2017/18 for a reduction in treasury management income. The Council is investigating alternative investment vehicles in order to be able to reduce this cost pressure. A discussion with Members of the different options available will be part of the agenda for the forthcoming Financial Principles workshop with Members on 8 December 2016.

The current Treasury Management Strategy is risk averse with no investments allowed for a period of more than a year and very high credit rating are required together with a limit of £6m per counterparty. This has resulted in only a small number of institutions in which the Council can invest (see Appendix A).

Compliance with Treasury Limits and Prudential Indicators

During the financial year the Council has operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Policy Statement and annual Treasury Strategy Statement. The Council's Prudential Indicators for 2016/17 are detailed and shown in Appendix B.

3. Outcomes/outputs

In the last 18 months the interest achieved has been above the industry benchmark due to better use of fixed term investments. Now that rates have dropped not risen the Council is forecasting a shortfall in 2016/17.

4. Implications

Implications	Relevant to proposals Y/N	Details and proposed measures to address
Legal/Governance	Y	Statutory powers are provided by the Local Government Act 1972 Section 151 and the Local Government Act 2003
Financial	Y	In the first six months of 2016/17, the Council has outperformed the industry benchmark for the returns on its investments by 0.18%. The Council has achieved a rate of return of 0.46%, against the 7 day LIBID bid rate (LIBID) of 0.28%. The Council is forecasting a shortfall in investment income of £10,000 against its budgeted income target of £148,000, following the cut in the Bank Base Rate from 0.5% to 0.25% on 4 August 2016. It is possible that there will be a further reduction in the Bank Base Rate to 0.1% by the end of 2016 and this is predicted to rise back to 0.5% by 2019. A cost pressure of £25,000 has been included within the Medium Term Financial Strategy for 2017/18 for a reduction in treasury management income. The Council is investigating alternative investment vehicles in order to be able to reduce the cost pressure for 2017/18. A discussion with Members of the different options available will be part of the agenda for the forthcoming Financial Principles workshop with Members on 8 December 2016. Consideration of the Annual Treasury Report forms an essential component of the Council's systems for public accountability. It also provides a platform for future investment planning.

Risk	Y	The security risk is the risk of failure of a counterparty. The liquidity risk is that there are liquidity constraints that affect the interest rate performance. The yield risk is regarding the volatility of interest rates/inflation. The Council has adopted the CIPFA Code Of Practice for Treasury Management and produces an Annual Treasury Management Strategy and Investment Strategy in accordance with CIPFA guidelines. The Council engages a Treasury Management advisor and a prudent view is always taken regarding future interest rate movements. Investment interest income is reported quarterly to SLT and the Executive.
Comprehensive Impact Assessment Implications		
Equality and Diversity	N	N/A
Safeguarding	N	N/A
Community Safety, Crime and Disorder	N	N/A
Health, Safety and Wellbeing	N	N/A
Other implications	N	None

<u>Supporting Information</u>

Appendices:

Appendix A – Lending list as at 31 March 2016
Appendix B – Prudential and Treasury Indicators 2016/17

Background Papers:

Annual treasury strategy in advance of the year (Executive 10/03/16 - E71-15)
Annual review following the end of the year describing the activity compared to the strategy (15/09/16 - E23/16)
Budget Monitoring Report for 2016/17 – Executive 20 October 2016

Approval and clearance of report

Process checklist	**Completed**
Portfolio Holder briefed	**Yes**
SLT Rep briefed	**Yes**
Relevant Exec Director sign off (draft)	**Yes**
Data protection issues considered	**Yes**
If exempt information, public (part 1) report also drafted. (Cabinet/Scrutiny)	**N/A**

APPENDIX A

South Hams District Council lending list as at 30 September 2016.

Barclays Bank Plc
HSBC Bank plc
Lloyds Banking Group Plc: • Bank of Scotland plc • Lloyds Bank plc
Nationwide Building Society
Royal Bank of Scotland Group Plc: • The Royal Bank of Scotland plc • National Westminster Bank plc
Government UK Debt Management Facility
Local Authorities (as defined under Section 23 of the Local Government Act 2003)
AAA rated Money Market Funds

APPENDIX B

PRUDENTIAL INDICATORS

THE CAPITAL PRUDENTIAL INDICATORS

The Council's capital expenditure plans are the key driver of treasury management activity. The outputs of the capital expenditure plans are reflected in prudential indicators, which are designed to assist members to overview and confirm capital expenditure plans.

Capital Expenditure.

This prudential Indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle.

Capital Expenditure	2014/15	2015/16	2016/17	2017/18	2018/19
	Actual £000	Actual £000	Estimate £000	Estimate £000	Estimate £000
Total	**3,554**	**4,357**	**1,765**	**TBA**	**TBA**

The table below summarises the above capital expenditure plans and how these plans are being financed. Any shortfall of resources results in a funding need (borrowing).

The Council is currently debt-free and the approved Capital Programme for 2016/17 will be financed from capital receipts, capital grants and reserves. The Council is not currently undertaking any new borrowing to fund its Capital Programme from 2016/17 onwards. Therefore the Council currently has a nil borrowing requirement.

Capital Expenditure	2014/15	2015/16	2016/17	2017/18	2018/19
	Actual £000	Actual £000	Estimate £000	Estimate £000	Estimate £000
Total	**3,554**	**4,357**	**1,765**	**TBA**	**TBA**
Financed by:					
Capital receipts	542	1,087	300	**TBA**	**TBA**
Capital grants	1,604	764	366	**TBA**	**TBA**
Revenue Reserves (including New Homes Bonus Reserve)	1,408	2,506	1,099	**TBA**	**TBA**
Net financing need for the year	**Nil**	**Nil**	**Nil**	**Nil**	**Nil**

Note: Please note that the estimate for 2016-17 represents the approved capital programme for that year. However, actual capital spend includes not only expenditure on projects within that capital programme, but also expenditure on schemes carried forward from previous capital programmes.

The Council's Borrowing Need (the Capital Financing Requirement)

The second prudential indicator is the Council's Capital Financing Requirement (CFR). It is essentially a measure of the Council's underlying need to borrow if the figure is greater than zero. The negative figure reflects the fact that the Council is debt-free and has a nil borrowing requirement. The Council is not currently undertaking any borrowing to fund its Capital Programme from 2016/17 onwards.

In July 2016 (Minute 33/16), the Council agreed to undertake prudential borrowing of £6.337 million for the new leisure contract. The Treasury Management Strategy for 2017/18 onwards will reflect this borrowing and the financial year in which the borrowing will occur, in line with the scheduled programme of works.

	2014/15	2015/16	2016/17	2017/18	2018/19
	Actual £000	Actual £000	Actual £000	Estimate £000	Estimate £000
Capital Financing Requirement (CFR)					
Total CFR	-98	-98	-98	TBA	TBA
Movement in CFR	Nil	Nil	Nil	TBA	TBA
Net borrowing requirement (the Council is debt free)	Nil	Nil	Nil	TBA	TBA

AFFORDABILITY PRUDENTIAL INDICATORS

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances.

Ratio of financing costs to net revenue stream

This indicator identifies the trend in the receipt of net investment income against the net revenue stream. It is calculated by dividing investment income and interest received by the Council's Net Budget.

	2014/15	2015/16	2016/17	2017/18	2018/19
	Actual	Actual	Estimate	Estimate	Estimate
Ratio of net investment income to net revenue stream. (Surplus)	1.5%	1.8%	1.7%	2.2%	2.6%

Estimates of the incremental impact of capital investment decisions on council tax

This indicator calculates the notional cost of the impact of lost investment income on the Council Tax, from spending capital resources. The Council is not undertaking any borrowing to fund its Capital Programme at present.

Incremental impact of capital investment decisions on the band D council tax (Notional cost as explained above)

	2014/15	2015/16	2016/17	2017/18	2018/19
	Actual	Actual	Estimate	Estimate	Estimate
	£	£	£	£	£
Future incremental impact of capital investment decisions on the band D Council tax (Notional cost)	0.21	0.30	0.11	TBA	TBA

TREASURY INDICATORS: LIMITS TO BORROWING ACTIVITY

The Operational Boundary – This is the limit beyond which external debt is not normally expected to exceed. This is the maximum level of external debt for cash flow purposes.

In July 2016 (Minute 33/16), the Council agreed to undertake prudential borrowing of £6.337 million for the new leisure contract. The Treasury Management Strategy for 2017/18 onwards will reflect this borrowing and the financial year in which the borrowing will occur, in line with the scheduled programme of works. Therefore higher Operational Boundary limits will be proposed as part of the Treasury Management Strategy for 2017/18 onwards.

Operational Boundary	2015/16	2016/17	2017/18	2018/19
	£	£	£	£
Borrowing	2,000,000	2,000,000	TBA	TBA
Other long term liabilities	-	-	-	-
Total	2,000,000	2,000,000	TBA	TBA

The Authorised Limit for External Debt – A further key prudential indicator represents a control on the overall level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by Full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

This provides headroom over and above the operational boundary for unusual cash movements. This is the maximum amount of money that the Council could afford to borrow.

This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although no control has yet been exercised.

As above, higher Authorised limits will be proposed as part of the Treasury Management Strategy for 2017/18 onwards, to reflect the prudential borrowing for the new leisure contract.

Authorised limit	2015/16	2016/17	2017/18	2018/19
	£	£	£	£
Borrowing	7,000,000	7,000,000	TBA	TBA
Other long term liabilities	-	-	-	-
Total	7,000,000	7,000,000	TBA	TBA