**AUDIT COMMITTEE – 22 NOVEMBER 2016**

**PART I – DELEGATED**

**11. TREASURY MANAGEMENT – 2016/17 MID YEAR REVIEW**

(DoF)

1. **Summary**

1.1 This report gives details of the 2016/17 Mid Year Review of the Treasury Management function.

2. **Details**

2.1 The Chartered Institute of Public Finance and Accountancy (CIPFA) defines treasury management 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”.

2.2 The Council’s 2016/17 Treasury Management Strategy (TMS) as approved by Council on 23 February 2016 (Minute No. CL68/13) is designed to ensure that cash flows are adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity before considering optimising investment return.

2.3 This report considers the UK economy and updates members with the progress on whether the Council is meeting the TMS and the policies contained therein for the first 6 months of 2016/17.

2.4 The UK Economy for the first 6 months of 2016/17 (1/4/16 – 30/9/16)by Capita Asset Services Treasury Solutions (the Council’s treasury advisors)

*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 4 August 2016 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.*

2.5 The Council’s treasury advisor, Capita Asset Services Treasury Solutions, has provided the following forecast:

*Interest rate forecasts*

|  |  |
| --- | --- |
| **Month & Year** | **Bank**  **Rate %** |
| Dec 2016 | 0.10 |
| Mar 2017 | 0.10 |
| Jun 2017 | 0.10 |
| Sep 2017 | 0.10 |
| Dec 2017 | 0.10 |
| Mar 2018 | 0.10 |
| Jun 2018 | 0.25 |
| Sep 2018 | 0.25 |
| Dec 2018 | 0.25 |
| Mar 2019 | 0.25 |
| Jun 2019 | 0.50 |

Capita Asset Services Treasury Solutions 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.

Downside risks 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.

2.6 *The Council’s Capital Position (Prudential Indicators)*

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

The capital expenditure plans are financed in full by capital receipts, grants or capital reserves. Over the next three years there are no planned shortfalls of resources which would result in a funding need (borrowing). The Council is currently debt free; however a major project in South Oxhey is in the planning stage and may require significant funding and involve borrowing funds.

2.7 *Capital Financing Requirement (CFR), External Debt and Operational Boundary*

The CFR and Operational Boundary estimates are shown below:

|  |  |  |  |
| --- | --- | --- | --- |
| **Prudential Indicator** | **2016/17**  **Original**  **Estimate** | **Current Borrowing Position** | **2016/17**  **Revised**  **Estimate** |
| **Capital Financing Requirement** | £0m | £0m | £0m |
| **External Debt / the Operational Boundary** | | | |
|  |  |  |  |
| Borrowing | £10m | £10m | £10m |

2.8 *Limits to Borrowing Activity*

The first key control over the treasury activity is a Performance Indicator (PI) 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 of need which will be adhered to if this proves prudent.

2.9 *The Authorised Limit*

This PI, which is required to be set and revised by Members, controls the overall level of borrowing and represents the limit beyond which borrowing is prohibited. 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 undersection 3 (1) of the Local Government Act 2003.

|  |  |  |  |
| --- | --- | --- | --- |
| **Authorised Limit For**  **External Debt** | **2016/17**  **Original**  **Indicator** | **Current**  **Borrowing Position** | **2016/17**  **Revised**  **Indicator** |
| Borrowing | £9m | £0m | £9m |

2.10 *Investment Portfolio* *2016/17*

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 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 0.5% Bank Rate. Indeed, the Funding for Lending scheme has reduced market investment rates even further. The potential for a prolonging of the Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment, investment returns are likely to remain low.

The Council held £26m of investments as at 30 September 2016 (see table below). This information is reported in the monthly Members Information Bulletin

|  |  |
| --- | --- |
| **Institution** | **Principal (£)** |
|
| Lloyds Bank plc | 5,500,000 |
| *Total Banks* | *5,500,000* |
|  |  |
|  |  |
| Nationwide Building Society | 4,000,000 |
| Principality Building Society | 8,000,000 |
| Skipton Building Society | 8,500,000 |
| *Total Building Societies* | *20,500,000* |
| *Total* | *26,000,000* |

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

2.11 *Security*

The Council’s maximum security risk benchmark for the current portfolio was set as 0.01% risk of default when compared to the whole portfolio. The benchmarks are an average risk of default measure, and would not constitute an expectation of loss against a particular investment. The benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members. As this data is collated, trends and analysis will be collected and reported. Where counterparty is not credit rated a proxy rating will be applied.

In line with the TMS, the Council has managed to invest with those institutions who offered the best rate and the investment portfolio is above the overall benchmark during the year to date.

2.12 *Liquidity*

The Council set liquidity facilities/benchmarks to maintain:

* Bank overdraft - £0m.
* The benefit of instant access to its funds on the general account with Lloyds.

The liquidity arrangements were adequate during the year to date.

2.13 *Yield*

The budget for interest earned on investments for 2016/17 is £283,000; interest received and accrued up to the end of September was **£104,000**. Due to the recent drop interest rates and the low returns available, it is expected that the forecast outturn will be in the region of £165,000.

The approved benchmark measure of yield is a return of 0.12% above the average bank rate of 0.50% (until 03 August 2016, after which the bank rate was reduced to 0.25%). The returns up to 30 September 2016 averaged 0.74%, against a benchmark rate of 0.62% (until 03 August 2016).

The average yield return was higher than the benchmark for the year to date.

Table of Monthly Interest Rates to Date:

|  |  |
| --- | --- |
| **Month** | **Rate Achieved** |
| April | 0.76% |
| May | 0.72% |
| June | 0.78% |
| July | 0.75% |
| August | 0.73% |
| September | 0.71% |

The Council keeps all investments short term. There are no sums invested for greater than 364 days. Counterparties have been downgraded over the past few years; most investments have been limited to a 6 months period. This has resulted in lower interest rates being achieved.

The current investment counterparty criteria selection approved in the TMS is being met.

2.14 *Credit Ratings*

Fitch and Moody provide the Council with credit ratings for financial institutions,

The credit rating of counterparties is monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Capita Asset Services Treasury Solutions as and when ratings change, and counterparties are checked promptly. The Council considers minimum short term ratings as key criteria in the choice of creditworthy investment counterparties. F1+, P-1 and A-1+ are the highest short term credit ratings of Fitch, Moody's and Standard and Poor's respectively. Minimum Short Term Ratings, where given, these must be met, for all categories.

3. **Options/Reasons for Recommendation**

3.1 The recommendation allows members to note the contents ofthe 2016/17 Mid Year Review of the Treasury Management function.

4. **Policy/Budget Implications**

4.1 The recommendations in this report are within the Council’s agreed policy and budgets.

5. **Financial Implications**

5.1 As contained in the body of the report.

6. **Legal Implications**

6.1 There is no requirement to make any amendments to the Treasury Management Strategy at this stage.

7. **Equal Opportunities, Staffing, Environmental, Community Safety, Customer Services Centre Implications and Website Implications**

7.1 None specific.

8. **Risk Management Implications**

8.1 There are no risks associated with the decision Members are being asked to make, i.e. to note this report.

9**. Recommendation**

* 1. That Members note the contents of the 2016/17 Mid Year Review of the Treasury Management function.

**Background Papers:**

Treasury Management Strategy 2016/17;

UK Economic Forecasts provided by Capita Asset Services Treasury Solutions;

**Report prepared by:** Sunjiv Seetul (Finance Manager) and Loretta Manhertz (Finance Officer)

**Data source:** Logotech Treasury Management system

**Data checked by:** Bob Watson (Head of Finance)

Data rating

|  |  |  |
| --- | --- | --- |
| 1 Data rating: 1 | Poor |  |
| 2 | Sufficient |  |
| 3 | High | **✓** |