Cabinet – Supplementary agenda No.1

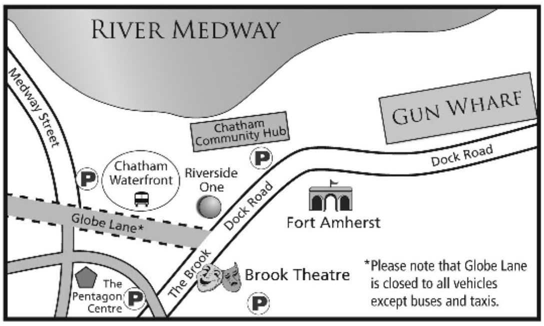
A meeting of the Cabinet will be held on:

Date:	27 September 2016
Time:	3.00pm
Venue:	Meeting Room 2 - Level 3, Gun Wharf, Dock Road, Chatham ME4 4TR

Items

For further information please contact Wayne Hemingway/Alex Saul, Democratic Services Officers on Telephone: 01634 332509/332008 or Email: democratic.services@medway.gov.uk

Date: 22 September 2016



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CABINET

27 SEPTEMBER 2016

TREASURY MANAGEMENT STRATEGY MID-YEAR REVIEW REPORT 2016/2017

Portfolio Holder: Councillor Alan Jarrett, Leader

Report from: Phil Watts, Chief Finance Officer

Author: Jonathan Lloyd, Principal Accountant

Summary

Full Council approved the Treasury Management Strategy for 2016/17 alongside the Capital and Revenue Budgets on the 25 February 2016. In accordance with the Chartered Institute of Public Finance Accountancy's (CIPFA) Code of Practice for Treasury Management, there should be a review of that strategy at least half yearly. This report represents the mid year review of the Treasury Management Strategy 2016/17.

1. Budget and Policy Framework

1.1 Audit Committee is responsible for the scrutiny of the Council's Treasury Management, Investment Strategy and Minimum Revenue Provision Policy Statement along with Treasury Management Practices and associated Schedules.

1.2 There needs to be, as a minimum, a mid-year review of treasury management strategy and performance. This is intended to highlight any areas of concern that have arisen since the original strategy was approved.

1.3 This report is also scheduled for consideration by the Audit Committee on 29 September 2016 and Full Council on 13 October 2016.

1.4 This report has been added to the Cabinet agenda in accordance with the provisions of section 11 (cases of special urgency) of the Local Authorities (Executive Arrangements)(Meetings and Access to Information)(England) Regulations 2012 and Rule 17 (special urgency) of the Council's Access to Information Rules, as set out in the Constitution. The Chairman of the Business Support Overview and Scrutiny Committee has agreed that consideration of this report is urgent and cannot be reasonably deferred to enable the Cabinet's views on the mid-year review to be submitted to Full Council on 13 October 2016. The next Cabinet meeting takes places on 25 October 2016, the consequence of which would have been to cause an unacceptable delay in submission of the mid-year review to Full Council (26 January 2017).

1.5 The Cabinet is asked to accept this report as an urgent item to enable its views to be submitted to Full Council on 13 October 2016.

1.6 In addition, a report will be submitted to Full Council on 13 October setting out the use of the special urgency provisions, in accordance with paragraph 18.3 of the Access to Information Rules.

2. Background

2.1 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 ensures this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially, before looking to maximise investment return.

2.2 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 requirements of the Council, essentially the longer-term cash flow planning to ensure the Council can meet its capital spending liabilities. This management of longer-term cash may involve arranging long or short-term loans, or using long-term cash flow surpluses, and on occasion, debt previously incurred may be restructured to meet Council risk or cost objectives.

2.3 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. "

2.4 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) was adopted by this Council on 24 January 2013.

2.5 The principal requirements of the Code are as follows:

(i) Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities

(ii) Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives

(iii) Receipt by 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 undertaken during the previous year

(iv) 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

(v) Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific committee. For this Council the delegated body is the Audit Committee.

2.6 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 2016/17
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- 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 Economic update

3.1 Economic performance to date and outlook: UK

3.1.1 UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country. However, the 2015 growth rate finally came in at a disappointing 1.8%, though it still remained one of the leading rates among the G7 countries. Growth was +0.4% in quarter 1 and +0.6% in quarter 2, (first estimate), but forward looking indicators point to a sharp slowdown in the second half of 2016 as a result of the Brexit vote. 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 and uncertainty created by the Brexit referendum. However, since the peak in November 2015, sterling has fallen in value, especially after the referendum result, which will help to make British goods and services much more competitive and will increase the value of overseas earnings by multinational companies based in the UK. In addition, the Chancellor has announced that the target of achieving a budget surplus in 2020 will have to be eased in order to help the economy recover from the expected slowing of growth during the second half of 2016. He has also said he will do 'whatever is needed' to stimulate growth which could mean fiscal policy action e.g. cutting taxes, increasing investment allowances for businesses etc and / or increasing government expenditure on infrastructure, housing etc.

3.1.2 The Bank of England August Inflation Report included a sharp reduction in forecasts for growth for 2017 @ +0.8% and for 2018 @ 1.8%, though 2016 was kept at 2.0%. While this does not indicate the economy could go into recession in the second half of 2016, growth is expected to be minimal during that period.

3.1.3 The August Bank of England Inflation Report forecast also included a sharp upward revision to the forecasts for inflation rising up above the MPC's 2% target in 2018 to about 2.3% due to the recent fall in the value of sterling etc. However, the MPC is likely to look through that and take a longer term view in order to give time for economic growth to recover.

3.2 Economic performance to date and outlook: US

3.2.1 The American economy had a patchy 2015 – quarter 1 0.6% (annualised), 3.9% quarter 2, 2.0% quarter 3 and 1.4% in quarter 4, leaving growth in 2015 as a whole at 2.4%. Quarter 1 of 2016 came in at a weak 0.8% (annualised) and quarter 2 at 1.2% (first estimate). While these overall figures were disappointing, they were depressed by a significant run down in inventories which masked an underlying strength in consumer demand; forward indicators are therefore pointing towards a pickup in growth for the rest of 2016. The Fed embarked on its long anticipated first increase in rates at its December 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, caused a re-emergence of caution over the timing and pace of further increases. However, in recent weeks, increases in non-farm payroll figures have again boosted confidence that the economy is on a strong upward trend and have renewed expectations of at least one increase in the Fed. rate in 2016.

3.3 Economic performance to date and outlook: Eurozone

3.3.1 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. In response to a continuation of weak growth, at the ECB's December meeting, this programme was extended to March 2017 but was not increased in terms of the amount of monthly purchases. 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. This programme of monetary easing has had a limited positive effect in helping a recovery in consumer and business confidence and an initial start to some improvement in economic growth. GDP growth rose by 0.6% in quarter 1 2016 (1.7% y/y) but disappointed in quarter 2 with a reversal to only 0.3% (1.6% y/y). The ECB is also struggling to get inflation up from near zero towards its target of 2%.

3.4 Economic performance to date and outlook: China and Japan

3.4.1 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.

3.5 Interest rate forecasts

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

	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Bank rate	0.25%	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%	1.00%	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%	1.50%	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%	2.30%	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%	2.10%	2.20%	2.20%	2.20%	2.20%	2.30%	2.30%	2.30%	2.30%	2.40%

3.5.2 Capita Asset Services undertook its last review of interest rate forecasts on 8 August shortly after the quarterly Bank of England Inflation Report and the MPC cutting Bank Rate from 0.50% to 0.25% and launching various quantitative easing measures. This action was prompted by concerns that the UK economy would slow down sharply as a result of the Brexit vote. It is widely expected that the MPC could cut Bank Rate further to nearly zero, probably at the November quarterly inflation report meeting. Since the Brexit vote on 23 June, gilt yields and PWLB rates have fallen sharply. Investment rates also fell after the cut in Bank Rate.

3.5.3 The above forecast includes a very tentative first increase in Bank Rate in June 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.

3.5.4 There are also concerns that weak growth in the UK, EZ, China and Japan is only being achieved by monetary policy being highly aggressive. While such policies undoubtedly help to stimulate growth, there is substantial doubt that without additional aggressive fiscal action by national governments to stimulate growth and inflation, (and also fundamental economic and political reforms in some countries), then many countries are likely to have a prolonged struggle to return to both strong growth, and inflation rising to around 2%, within the next few years.

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

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

- Monetary policy action failing to stimulate sustainable growth and combat the threat of deflation in western economies, especially the Eurozone and Japan.

3.5.6 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

4.1 Full Council approved the 2016/17 Treasury Management Annual Investment Strategy on the 25 February 2016.

4.2 There are no policy changes to the strategy.

4.3 Limits to Borrowing Activity

4.3.1 The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowing less investments) will only be for a capital purpose. Net external borrowing should not, except in the short term, exceed the total of Capital Financing Requirement (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.

	2016/17 Original Estimate £000	**Current Position 7 Sept 2016 £000**
Gross borrowing	164,678	190,378
Plus other long term liabilities*	541	497
Less investments	(11,000)	(27,961)
Net borrowing	154,219	162,914
CFR (year end position)	234,256	257,978

* Embedded Leases (on balance sheet)

4.3.2 The change in CFR between the current position and the original estimate is due to revisions to the balance sheet value of long term asset identified during the audit of the 2015/16 Statement of Accounts.

4.3.3 The increase in gross borrowing is due largely to the necessity to undertake short term borrowing to support cash flow following a rescheduling of in-year government grant payments.

4.3.4 The Chief Finance Officer reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator for maintaining net borrowing to CFR.

4.3.5 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 longer-term scenario. It is a forecast of maximum borrowing requirement with some capacity for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Council's authorised borrowing limit for 2016/17 is £409.396 million and it will not exceed this limit.

5 Investment Portfolio 2016/17

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. 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, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment, investment returns are likely to remain low.

5.2 The Council held £46.1m of investments as at 7 September 2016 inclusive of CCLA Property Fund (£24.0m at 31 March 2016) and the investment portfolio yield on cash investments for the first six months of the year is 1.24%.

5.3 A full list of in house investments held as at 7 September 2016 is shown below:

Investments	**Principal 7 Sept 2016 £**	**Interest %**
Core Investments (Local Authorities)		
City of Newcastle Upon Tyne	5,000,000	2.35%
Lancashire County	5,000,000	2.00%
Doncaster Metropolitan Borough	5,000,000	2.32%
Newport City	4,475,000	1.50%
CCLA Property Fund (cost)	3,000,000	n/a
Total Core Investments	**22,475,000**	
Liquid Investments		
Svenska Handelsbanken	4,002,275	0.15%
Lloyds	19,713,303	0.4% (0.2% from 4/10/16)
Total In house Investments	46,190,578	

5.4 The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the period from 1 April 2015 to 8 September 2016.

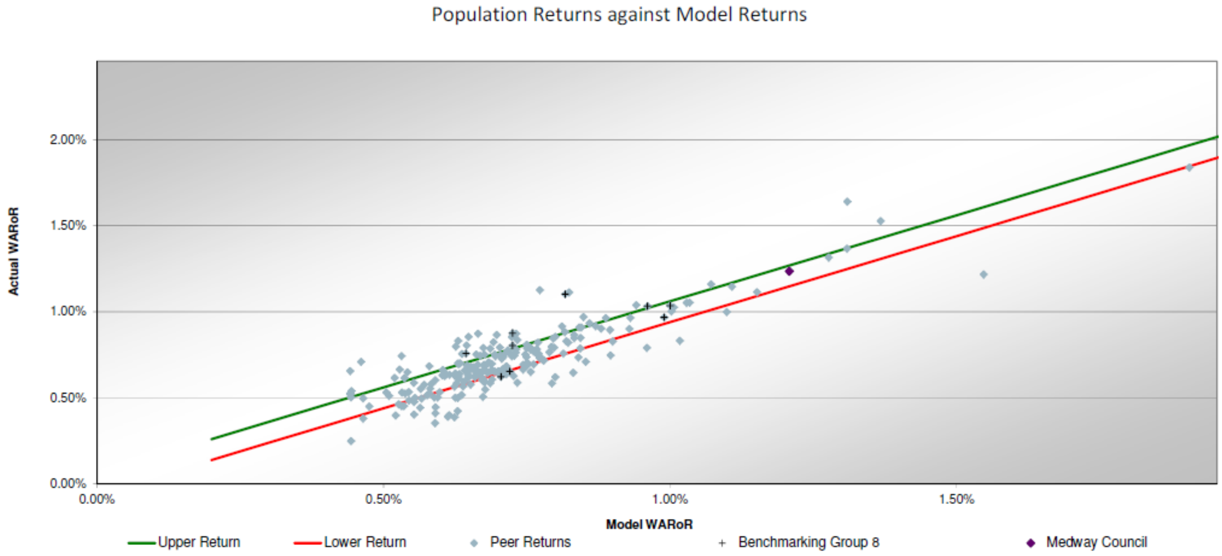
5.5 The Council’s budgeted investment interest for 2016/17 is £515,000, however the deterioration in cash flow and falling interest rates have resulted in a revised prediction of around £500,000 net of the cost of temporary borrowing.

5.6 <u>Investment Counterparty Criteria</u>

5.6.1 The current investment counterparty criteria selection approved in the Treasury Strategy is meeting the requirement of the treasury management function.

5.7 <u>Benchmarking</u>

5.7.1 The in-house Treasury team, contribute to the Capita Asset Services benchmarking club which produces quarterly reports. Shown below is a graph showing Medway’s performance to June.



	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
Medway Council	1.24%	1.21%	0.03%	1.15%	1.27%	Inline

5.7.2 The “x” axis of the graph shows the “Model Weighted Average Rate of Return”, this is easiest interpreted as the level of return we should expect for the level of risk that we are taking with our investment portfolio. This is then plotted against the “Actual Weighted Average Rate of Return” on the “y” scale, running diagonally upwards across the graph are two parallel lines, if a Council performance falls between these lines then they are deemed to be receiving a return as would be expected for their level of risk, below these two lines and performance is considered below that expected and above then the return being received is above that expected. As can be seen Medway’s return is at that expected for our level of risk.

5.7.3 In assessing the risk inherent in an Investment Portfolio for the benchmarking, three factors are taken into account,

(i) The number of days to maturity of an investment. With a larger the number of days left to maturity the greater the risk that an adverse event could occur
(ii) The total number of days that the investment was originally invested for, again the longer an authority is comfortable to invest for the greater the risk it is willing to take.
(iii) The creditworthiness of the counterparties that the authority invests with.

5.7.4 The table below shows some detail from the benchmarking data comparing Medway in-house performance against all participants of the benchmarking group; Unitaries and other local councils.

<u>Comparison of risk and returns</u>

		Risks			
	Model Weighted Average Rate of Return	Weighted Average Maturity (Days)	Weighted Average Total Time (Days)	Weighted Average Credit Risk	Weighted Average Rate of Return
Medway	**1.21%**	**423**	**760**	**3.5**	**1.24%**
Average English Unitaries (22)	0.86%	160	336	3.5	0.89%
Average Total Population (228)		99	187	3.9	0.72%
Average Local Benchmarking Group (10)		197	343	4.4	0.92%
Brighton & Hove CC	0.73%	151	228	4.5	0.88%
East Sussex CC	0.64%	101	122	4.8	0.76%
Sevenoaks DC	0.82%	71	164	4.1	0.65%
Tonbridge and Malling BC	0.73%	117	195	4.6	0.80%

6 Borrowing

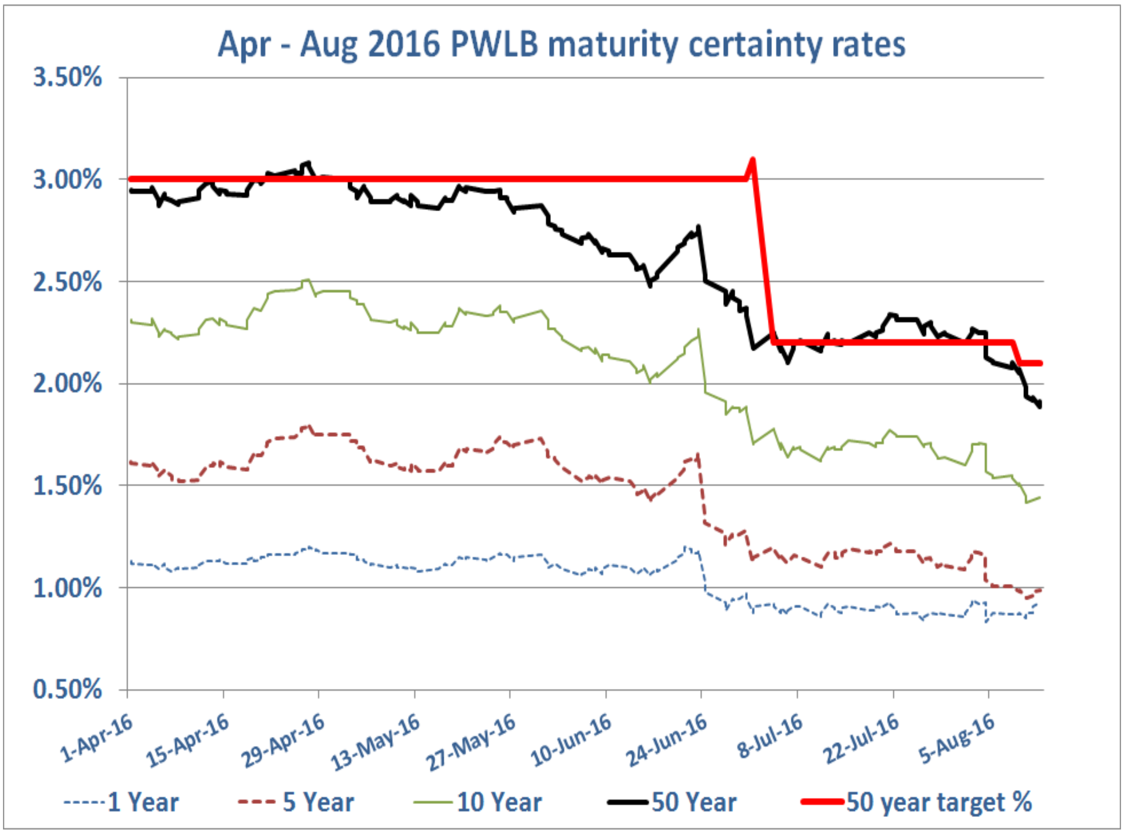
6.1 The Council's capital financing requirement (CFR) for 2016/17 is £257.978 million. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. The table in section 4.2.1 shows the Council has external borrowings of £190.378 million against a CFR of £257.978 million.

6.2 The current borrowing strategy is to postpone new long term borrowing and use short term borrowing when necessary. This policy has been adhered to for the first six months of this financial year. However, as specified within the strategy, in the event that it is deemed advantageous to borrow then we will evaluate the economic and market factors to form a view on future interest rates so as to determine the manner and timing of decisions to borrow.

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

PWLB certainty rates 1 April 2016 to mid-August 2016

	1 Year	5 Year	10 Year	25 Year	50 Year
1/4/16	1.13%	1.62%	2.31%	3.14%	2.95%
15/8/16	0.92%	0.98%	1.44%	2.11%	1.91%
Low	0.83%	0.95%	1.42%	2.08%	1.89%
Date	04/08/2016	10/08/2016	10/08/2016	12/08/2016	12/08/2016
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	1.04%	1.43%	2.05%	2.84%	2.61%



6.4 It is anticipated that no external borrowing will be undertaken during this financial year, unless it is found to be advantageous as mentioned in paragraph 6.2

6.5 One of the important risks inherent within Treasury management is "Interest rate risk". This risk is high where a large proportion of an organisation's borrowing portfolio reach termination point at the same time. The organisation has then to re-finance a large proportion of their portfolio at a set point of time whereby they run the risk that interest rates may not be beneficial to the organisation.

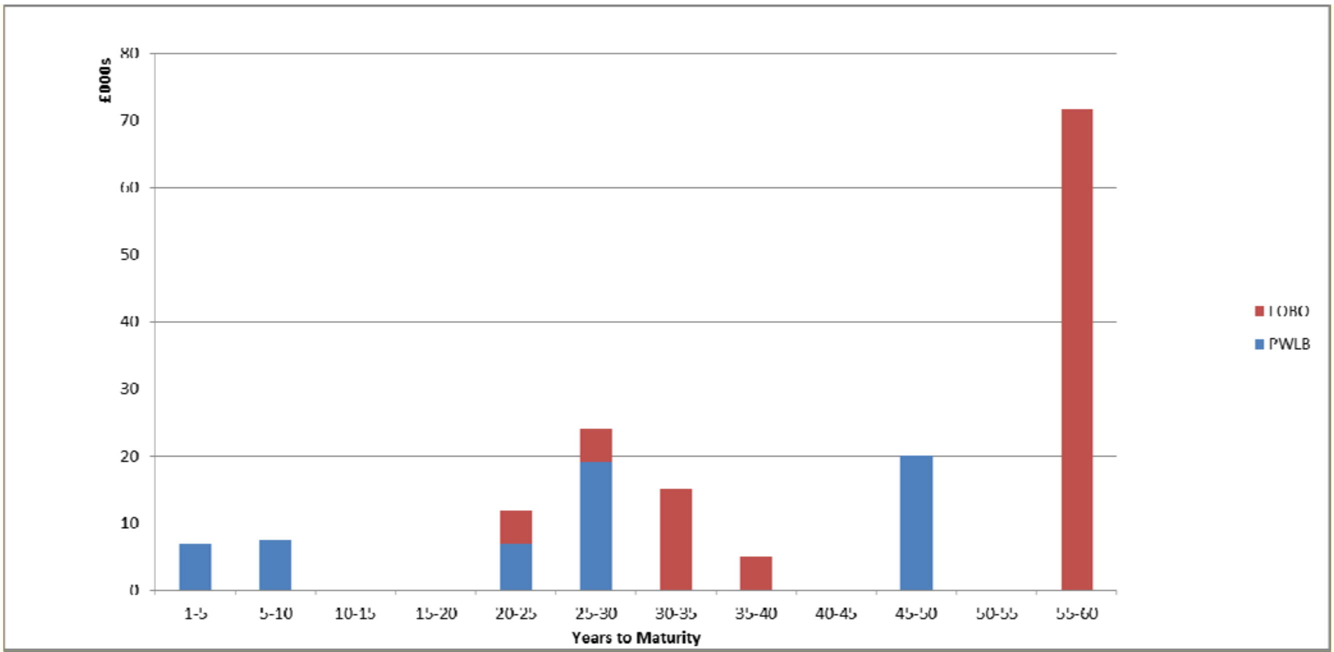
6.6 In order to protect against this risk it is prudent to spread repayment dates over a number of years thereby reducing the risk of a large proportion of the portfolio being affected by adverse interest rates.

6.7 The graph below shows the long term debt portfolio repayment profile as at 1 April 2016. It can be seen that the debt repayments are reasonably spread over the forthcoming decades, thereby reducing any impact of interest rate risk.

6.8 The earliest repayments of long term debt are due in November 2019, £2m, November 2020, £5m and November 2023, £7.5m.

6.9 As at 7 September 2016 the Council owed some £20m in short term borrowing. These loans are planned to be replaced by short term borrowing upon maturity on 22 September 2016.

6.10 All debts are being shown as repayable at term, although the LOBO's (Lender Option Borrower Option) have a variety of "call" periods of between 6 months and every 5 years. The risk of a call occurring is currently low and therefore these have been shown as running full term.



7 Debt Rescheduling

7.1 Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. During the first six months of the year, no debt rescheduling was undertaken and it is not envisaged that any will occur before the end of the financial year. However, officers and the council's financial advisers 'Capita Asset Services' will continue to monitor the situation and opportunities will be carefully considered.

8 Compliance with Treasury and Prudential Limits

8.1 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.

8.2 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.

9 Risk management

9.1 Risk and the management thereof is a feature throughout the strategy and in detail within the Treasury Management Practices 1.

10 Financial and legal implications

10.1 The finance and legal implications are highlighted throughout this report. The Council has delegated responsibility for the execution and administration of treasury management decisions to the Chief Finance Officer, who will act in accordance with the Council's policy statement and Treasury Management Practices.

11 Recommendation

11.1 The Cabinet is requested to consider this report, note its contents and submit any comments to Full Council on 13 October 2016.

12. Suggested reasons for decision

12.1 In accordance with the Chartered Institute of Public Finance Accountancy's (CIPFA) Code of Practice for Treasury Management, there should be a review of the strategy at least half yearly.

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Appendices
None

Background Papers
None