Medway COUNCIL
Serving You

CABINET

26 SEPTEMBER 2017

TREASURY MANAGEMENT STRATEGY MID-YEAR REVIEW REPORT 2017/2018

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 2017/18 alongside the Capital and Revenue Budgets on the 23 February 2017. 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 2017/18.

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 28 September 2017 and full Council on 12 October 2017.

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 2017/18
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- 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. REVIEW OF ECONOMIC CONDITIONS APRIL TO AUGUST 2017

This section has been prepared by the Authority's Treasury Advisors, Capita.

3.1 ECONOMIC PERFORMANCE TO DATE 2017/18

3.1.1 The first half of 2017/18 has seen UK economic growth moderate to just below 2% and the Bank of England's Quarterly Inflation Report, released in August, suggests that growth will perform within a range of 1.6% to 1.7% through to the end of 2018. This is broadly similar to the Bank's overall assessment in May.

3.1.2 Having said that, some Monetary Policy Committee (MPC) members have expressed concerns about inflation threatening price stability, particularly with the £ significantly weaker since the June 2016 EU Referendum. However, with the Consumer Price Index (CPI) measure of inflation currently running at 2.6% (below its recent peak) and producer price input inflation falling back quickly (now 6.5% y/y having been close to 20%) there is no longer a strong argument for Bank Rate to rise in the near-term, or at least not significantly. Indeed, the MPC voted 6-2 in August to keep Bank Rate on hold at 0.25%.

3.1.3 With regard to unemployment, on the Independent Labour Organisation measure this is now at a 42 year low of 4.4%, and with full-time jobs continuing to be created and vacancy rates also increasing, there is some concern that there will be a squeeze upwards in pay inflation. Currently this is running at 2.1%, but views are divided as to whether this number will move up strongly in the second half of 2017 and in 2018, given the headwinds of: the uncertainties surrounding Brexit talks; a flat-lining housing market; and the household savings ratio having hit an all-time low.

3.1.4 This last point should not be under-estimated, as it suggests that consumers – the mainstay of the UK's economic performance to date – are struggling to cope with rising prices and negative real earnings. It will be important to monitor consumer confidence over the coming months and for the MPC to be careful not to undermine the current levels of growth by pre-emptively increasing Bank Rate. Furthermore, business sentiment surveys, such as the Purchasing Managers Index collated by Markit, suggest the UK will enjoy no more than tepid growth over the coming months.

3.1.5 In addition to the prevailing very loose monetary policy, the MPC has confirmed that the Term Funding Scheme, which provides cheap finance to banks, will end in February 2018, although, due to strong demand from banks, the size of the facility will be increased from £100bn to £115bn to encourage banks to make more cheap funding available to borrowers. Conversely, however, the Financial Policy Committee (FPC) has started to <u>tighten</u> banks' capital requirements as it is particularly concerned about unsecured consumer credit.

3.1.6 With regard to the US, the Fed is expected to embark on further quarterly increases in the Fed Funds interest rates in 2018 (currently 1% to 1.25%) and this should ensure that the dollar strengthens after a relative bout of weakness, i.e. the value of sterling against the dollar is likely to fall back again over the next couple of years from the current level of $1.28. However, we do not see this as being sufficiently negative news for the UK from an inflation perspective for the MPC to increase Bank Rate, particularly when the rise in inflation is eating into consumers' disposable income and spending power and business investment could disappoint in the face of Brexit. On a positive note, we do believe UK exports should do better during the second half of 2017, but this still leaves in question whether this will be sufficient to compensate for the decline in consumer expenditure, in supporting GDP growth.

4. Treasury Management Strategy Statement and Annual Investment Strategy update

4.1 Full Council approved the 2017/18 Treasury Management Annual Investment Strategy on the 23 February 2017.

4.2 On the 28 July 2017 the Leader, exercising his urgency powers, approved the removal of the limit on property fund investments previously included within Treasury Management Practice 1 (decision no. 77/2017). The removal was necessary to permit investment of a further £20m in such funds. £15m of the planned £20m has been invested to date and officers are working to place the remaining £5m. Details of the Leader's urgent decision, including the revised Treasury Management Practice 1, were provided to all Members on 28 July 2017 and can be found here: https://democracy.medway.gov.uk/ieListDocuments.aspx?CId=115&MId=3911&Ver=4

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.

	2017/18 Original Estimate £000	**Current Position 4 Sept 2017 £000**
Gross borrowing	200,535	202,378
Plus other long term liabilities*	243	298
Less investments	(18,000)	(52,001)
Net borrowing	182,778	150,675
CFR (year end position)	262,733	255,440

* 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 2016/17 Statement of Accounts.

4.3.3 Gross borrowing at 4 September is broadly in line with the level anticipated for 31 March 2018 when the Strategy was formulated. Since that date a decision has been taken to invest a further £20m property funds. So far £15m of this amount has been invested. In consequence the Council now has less cash and borrowing will be increased by the year end to maintain liquidity.

4.3.4 The Chief Finance Officer reports that no difficulties are envisaged for the current or future years in ensuring that borrowing does not exceed 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 2017/18 is £439.620 million and it will not exceed this limit.

5. Investment Portfolio 2017/18

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. Given the risk environment, investment returns are likely to remain low.

5.2 The Council held £52m of investments as at 4 September 2017 inclusive of property funds (£24.6m at 31 March 2017) and the investment portfolio yield on cash investments for the first three months of the year was 1.02%. A full list of in house investments held as at 4 September 2017 is shown below:

Investments	**Principal 4 Sept 2017 £**	**Interest %**
<u>Core Investments (Local Authorities)</u>		
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%
CCLA Property Fund (cost)	8,000,000	n/a
Rockspring Hannover Property UT (cost)	4,999,365	n/a
Lothbury Property Trust (cost)	5,000,000	n/a
Total Core Investments	**32,999,365**	
Liquid Investments		
Svenska Handelsbanken	150	0.15%
Lloyds	16,000,000	0.20%
Barclays	1,591	0.25%
Santander	3,000,000	0.40%
Total Liquid Investment	**19,001,741**	
Total In house Investments	**52,001,106**	

5.3 The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the period from 1 April 2017 to 4 September 2017.

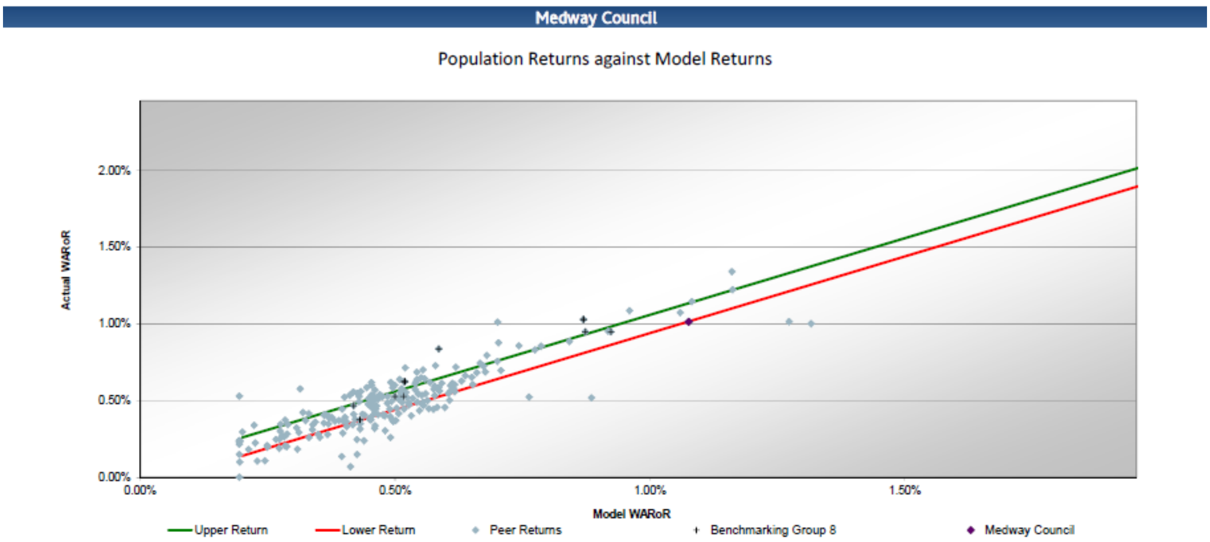
5.4 The Council's budgeted net interest payments for 2017/18 is £5.263m however the deterioration in cash flow and delays in placing funds in property trusts have resulted in a revised prediction of around £5.645m.

5.5 Investment Counterparty Criteria

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

5.6 Benchmarking

5.6.1 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	1.02%	1.08%	-0.06%	1.02%	1.14%	Below

5.6.2 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 fell slightly below that expected for our level of risk. However the data includes only at cash deposits and excludes property funds which currently yield dividends in excess of 4%.

5.6.3 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.

5.6.4 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.

Comparison of risk and returns

	Model Weighted Average Rate of Return	Risks			Weighted Average Rate of Return
		Weighted Average Maturity (Days)	Weighted Average Total Time (Days)	Weighted Average Credit Risk	
Medway	**1.08%**	**220**	**685**	**3.13**	**1.02%**
Average English Unitaries (20)	0.55%	120	247	3.11	0.56%
Average Total Population (224)		100	189	3.49	0.50%
Average Local Benchmarking Group (11)		166	340	3.99	0.72%
Brighton & Hove CC	0.42%	165	253	3.80	0.62%
East Sussex CC	0.52%	104	121	3.96	0.47%
Sevenoaks DC	0.43%	67	120	3.49	0.38%
Tonbridge and Malling BC	0.52%	133	201	4.27	0.52%

6. Borrowing

6.1 The Council's capital financing requirement (CFR) for 2017/18 is £255.480 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 4.3.1 shows the Council has gross external borrowings of £202.378 million against a CFR of £255.480 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. Further short term borrowing is expected to be needed due to the use of cash balances for property fund investment. However, as specified within the strategy, in the event that it is deemed advantageous to borrow for longer 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 Forecasts by our advisors, Capita, assume that there is no cancellation of the emergency cut in Bank Rate in August 2016 from 0.50% to 0.25% nor a stop to the £435bn Quantitative Easing (QE) programme in the shorter-term. There is, nonetheless, a potential risk, and there has probably been some increase in this risk, that the MPC could muster a majority to simply reverse both and then pause for a further period before reaching a time when there is a progression to a sustained trend of gentle increases in Bank Rate. But that is not their central view.

6.4 Capita's central view is for Bank Rate to not have to increase until the middle of 2019 and for gilt yields, and therefore PWLB Certainty Rate, to only gently increase over the next three years from their current levels as illustrated in the table below.

	Sep-17	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%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.40%	1.50%	1.60%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.10%	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%
50yr PWLB rate	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%

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.

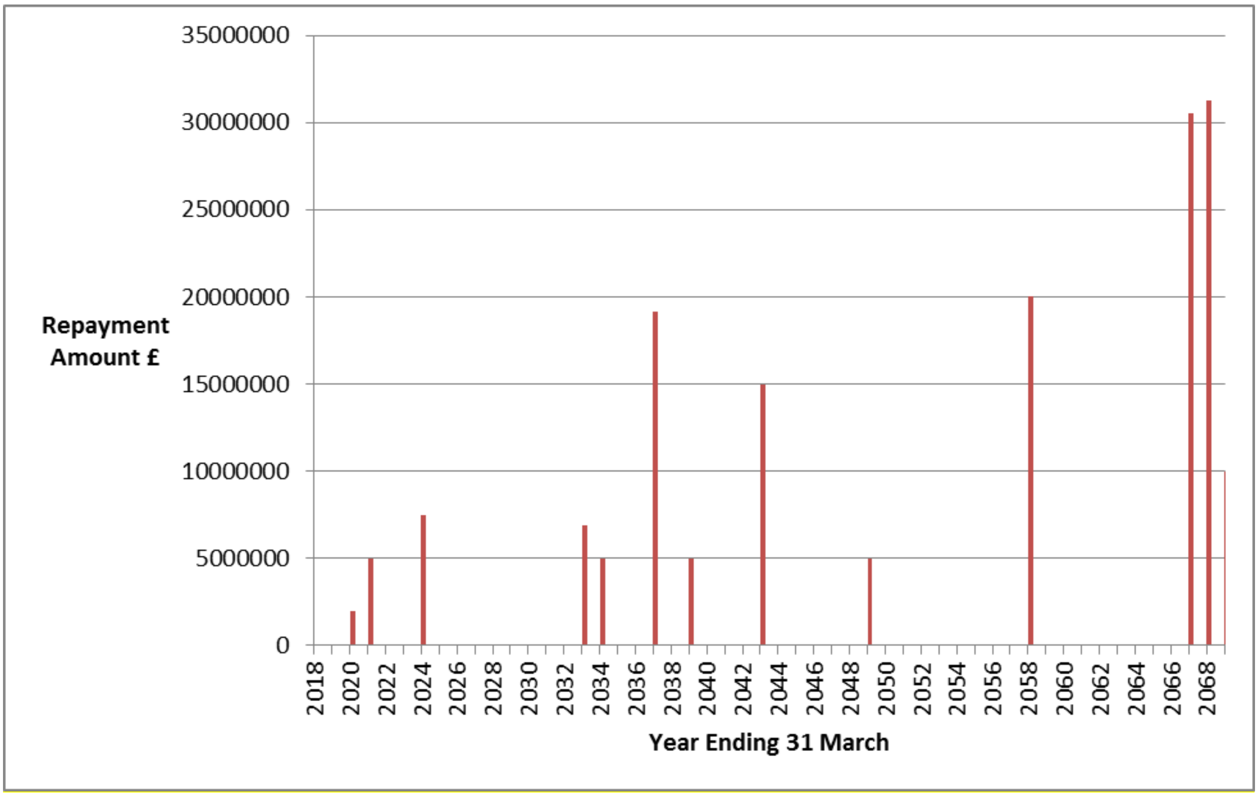
6.6 In order to protect against this risk it is prudent to spread repayment dates over a number of years thereby reducing the risk of a large proportion of the portfolio being affected by adverse interest rates.

6.7 The graph in paragraph 6.10 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 4 September 2017 the Council owed some £50m in short term borrowing. These loans are planned to be replaced as they mature at various dates between 17 November 2017 and 20 February 2018. Additional short term borrowing will also be required before the year end.

6.10 Long term debts in the table below are all 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. Recommendations

11.1 The Cabinet is requested to consider this report, note its contents and pass any comments on this report to the Audit Committee.

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.

Lead officer contact

Jonathan Lloyd, Principal Technical Accountant
Telephone No: 01634 332787 Email: jonathan.lloyd@medway.gov.uk

Appendices
None

Background papers
Leader – urgent decision 28 July 2017
https://democracy.medway.gov.uk/ieListDocuments.aspx?CId=115&MId=3911&Ver=4