

Agenda Item No:

Report to: Cabinet

Date of Meeting: 7 November 2016

Report Title: **Treasury Management - Mid Year Report 2016-17**

Report By: Peter Grace
Assistant Director – Financial Services and Revenues

Purpose of Report

This report advises the Cabinet of the Treasury Management activities and performance during the current year. It provides the opportunity to review the Treasury Management Strategy and make appropriate recommendations to Council to take account of any issues or concerns that have arisen since approving it in February 2016.

Recommendation(s)

- 1. Cabinet ask the Audit Committee to explore investment opportunities in property funds and the treasury management implications for the Council of making larger investments in, for example, commercial property, housing, and energy as part of the Council's income generation strategy.**
- 2. The Audit Committee to consider the substantial implications and risks to the Council at its meeting in January 2017 when considering the proposed Treasury Management Strategy for 2017/18, with a view to making recommendations to the meetings of Cabinet and Council in February 2017.**

Reasons for Recommendations

The Code of Practice on Treasury Management requires, 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 (February 2016). It is a requirement of the Code of Practice that the Mid-year review is considered by Cabinet and full Council.

The Council is seeking to increase its levels of income generation and this will entail new borrowing over potentially long periods, with consequent risks in terms of asset valuations, credit worthiness, cash and reserve fund availability. Such risks cannot be considered in isolation of all the issues facing the Council now and potentially in the future.

Background

1. The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure in combination with funding from reserves. 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.
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 needs 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.
3. 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.”

Introduction

4. The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) was adopted by this Council In February 2015.
5. The primary requirements of the Code are as follows:
 - Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
 - Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
 - 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.
 - 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.
 - 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 the Audit Committee.

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 the 2016/17 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 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.
7. The Committee will need to determine whether there are any issues that require the amendment of the Council's Treasury Management Strategy or Investment Policy and that they therefore wish to draw to the attention of Council. The Audit Committee will consider a similar report at their meeting in January 2017. At the meeting in September 2016 no changes to the 2016/17 strategy were proposed when reviewing the effectiveness of the strategy for 2015/16.

Economic Update

8. Following on from Brexit and with renewed global macro-economic uncertainty surrounding another possible US rate hike at year end, market participants are hedging their bets against all possible outcomes.
9. 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. In 2016 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.
10. During most of 2015 the economy had been difficult for exporters due to the strong pound, 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.
11. The Bank of England August Inflation Report included a sharp reduction in forecasts for growth for 2017 at +0.8% and for 2018 at 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.

12. The American economy had growth in 2015 of 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 affected 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.
13. Volatility has also returned in the oil market as production cuts emerge from the Organisation of the Petroleum Exporting Countries (OPEC), as Iran agrees to follow suit but Iraq has not – at least at the time of writing. Prices are currently just over \$50 per barrel.
14. The British Bankers Association's (BBA) Mortgage approval rates for the UK show a fall in approvals for the month of August to its lowest level since January 2015. British Banks approved 36,997 housing mortgages in August, down from 37,672 in July as activity in the sector continues to slow.
15. In the UK and the Eurozone release of the latest consumer confidence figures revealed better than expected results. British consumer morale rocketed back to pre-Brexit levels in September. The latest figures portray British consumers as having shrugged off Brexit fears about the economy as wages continue to grow faster than prices and low interest rates encourage people to spend.
16. Britain's dominant services sector grew more than anticipated in July, thus providing further confirmation that the economy did not slow sharply after the shock of the country's Brexit vote in June. Consumer demand remained the largest driver of growth in the economy as spending by households grew by 0.9 percent from the first quarter, even as their disposable income grew more slowly. The data will help the BoE to decide whether it needs to cut interest rates again at its next meeting in November. In a separate release, British House prices rose more slowly in September than in August, adding to signs of a cooling in the housing market. In monthly terms, house prices rose by 0.3 percent, also slowing from a rise of 0.6 percent in August.
17. For the Euro currency bloc, the seasonally adjusted unemployment rate registered a reading of 10.1 percent in August, stable compared to July 2016, but still down from 10.7 percent in August 2015. This still remains the lowest rate recorded in the euro area since July 2011. This closely monitored figure indicates that the unprecedented monetary stimulus from the ECB seems to be encouraging a glacial-like recovery in the labour market. Though, the rate has come down, it still suggests that a structural shift is needed in European policy to specifically tackle the unemployment problem.

Interest rate forecasts

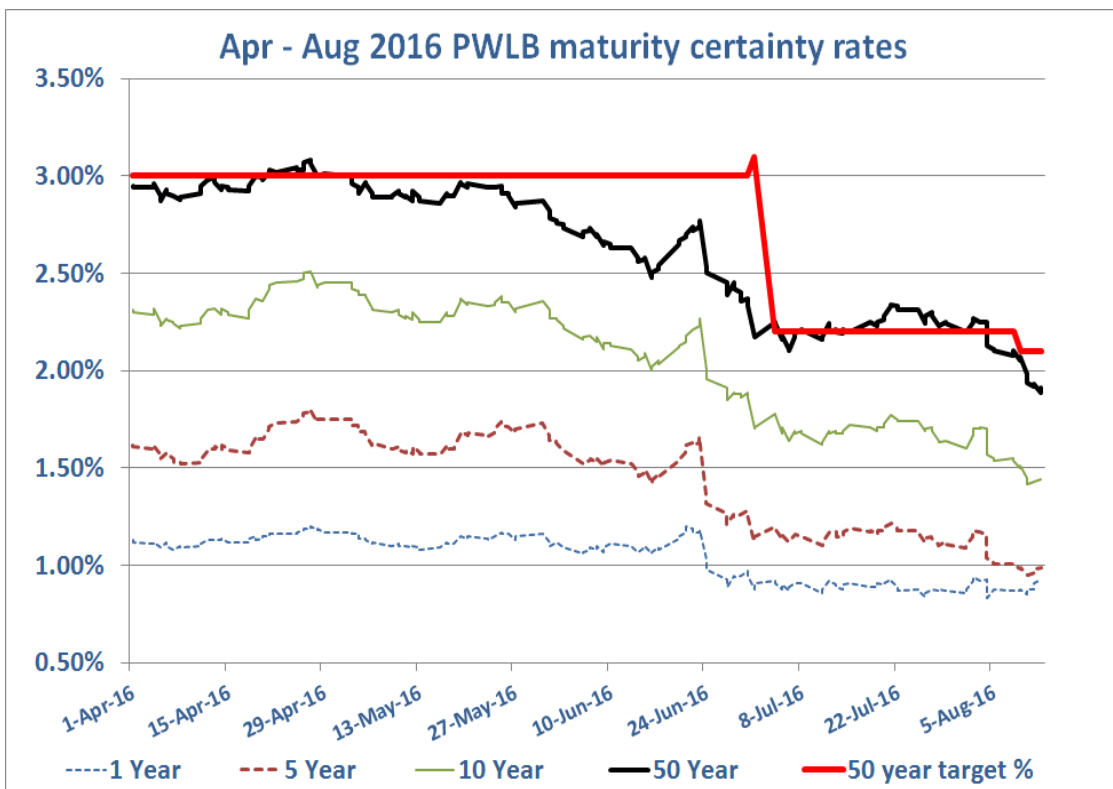
18. The Council's treasury advisor, Capita Asset Services, has provided the following forecast (forecasts below are for PWLB certainty rates).

Interest rate Forecasts – September 2016 to June 2019

	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%

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%	1.19%	1.34%	1.57%
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%



The Council's Treasury Position – 30 September 2016

Borrowing

19. The Council's debt and investment position at the 30 September 2016 was as follows:

Table 1 - Borrowing

Debt	1 April 2016 Principal	Rate	Maturity	30 September 2016 Principal	Rate
PWLB Loan 1	£7,500,000	4.80%	2033	£7,500,000	4.80%
PWLB Loan 2	£1,000,000	2.02%	2016	£1,000,000	2.02%
PWLB Loan 3	£1,000,000	1.63%	2018	£1,000,000	1.63%
PWLB Loan 4	£2,000,000	0.56% (Variable Rate)	2019	£2,000,000	0.40% (Variable Rate)
PWLB Loan 5	£909,027	3.78%	2044	£909,027	3.78%
PWLB Loan 6	£1,788,235	3.78%	2044	£1,788,235	3.78%
PWLB Loan 7 (Annuity)	£300,000	1.66%	2026	£286,149	1.66%
PWLB Loan 8			2056	£1,000,000	2.92%
PWLB Loan 9			2046	£1,000,000	3.08%
PWLB Loan 10			2036	£1,000,000	3.01%
PWLB Loan 11			2026	£1,000,000	2.30%
PWLB Loan 12			2054	£2,000,000	2.80%
PWLB Loan 13			2028	£1,000,000	2.42%
Total Debt	£14,497,262	3.55%		£21,483,411	3.28%

20. At the 30 September 2016 the Council had debt amounting to £21.5m (PWLB debt).

21. The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's debt position. The CFR results from the capital activity of the Council and what resources have been used to pay for the capital spend.

22. Part of the Council's treasury activities is to address the funding requirements for the Council's borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

23. The Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to reduce the CFR. This is

effectively a repayment of the borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

24. The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

25. The Council's 2016/17 MRP Policy was approved as part of the Treasury Management Strategy Report for 2016/17 by Council in February 2016.

26. The Council's CFR for the year is shown below, and represents a key prudential indicator. It includes leasing schemes on the balance sheet, which increase the Council's borrowing need. No borrowing is actually required against this scheme.

Table 2 CFR: General Fund	2015/16 Actual £000's	2016/17 Estimate £000's	2017/18 Estimate £000's
Opening balance	18,572	18,352	24,669
Add unfinanced capital expenditure	300	6,845	709
Less MRP	-511	-519	-893
Less finance lease arrangements	-9	-9	-9
Closing balance	18,352	24,669	24,476

27. Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

28. The Council's long term borrowing must only be for a capital purpose. This essentially means that the Council is not borrowing to support revenue expenditure. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2016/17 plus the expected changes to the CFR over 2016/17 and 2017/18 from financing the capital programme. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2016/17.

Table 3 Internal Borrowing	2015/16 Actual £000's	2016/17 Estimate £000's	2017/18 Estimate £000's
Capital Financing Requirement	18,352	24,669	24,476
External Borrowing	14,497	21,486	22,195
Net Internal Borrowing	3,855	3,183	2,281

29. The table above highlights the Council's gross borrowing position against the CFR, which provides an indication of affordability for the Council. The Council has complied with this prudential indicator.

Investments in 2016-17

30. The table below provides a snapshot of the investments and deposits held on 30 September 2016. The level of investments can fluctuate significantly on a day to day basis, given the level of funding received, precept payments, grants payable and receivable, salaries and wages, etc.

Table 4 – Investments and deposits

Counterparty	Rate/ Return (%)	Start Date	End Date	Principal £	Term
NATWEST	0.250	15/06/2011		68,370	Call
LLOYDS - LAMS	4.450	05/01/2012	10/01/2017	1,000,000	Fixed
LLOYDS - LAMS	1.970	26/03/2013	23/03/2018	1,000,000	Fixed
NATWEST BANK	0.350	21/08/2013		5,000,021	Call 95 day
LLOYDS BANK	1.050	11/05/2016	10/05/2017	5,000,000	Fixed
NATIONAL AUSTRALIA BANK	0.760	03/06/2016	05/06/2017	3,000,000	Fixed
NATIONAL AUSTRALIA BANK	0.580	03/06/2016	05/12/2016	2,000,000	Fixed
TORONTO	0.550	16/08/2016	16/05/2017	5,000,000	Fixed
SUMITOMO	0.390	08/09/2016	08/12/2016	3,000,000	Fixed
NORDEA	0.430	30/09/2016	30/06/2017	5,000,000	Fixed
BARCLAYS BANK	0.400	25/04/2012		2,000,090	Call
SANTANDER	0.740	01/04/2011		5	Call
SANTANDER	0.740	01/01/1900		415,534	Call
			Total	32,484,020	

31. As at 30 September 2016 four longer term loans are outstanding to other organisations.

Table 5 – Loans to Other Organisations

3rd Party Organisations	Rate/ Return (%)	Start Date	End Date	Principal £	Term
AMICUS	3.780	04/09/2014	02/09/2044	1,788,235	Fixed
The Foreshore Trust	1.660	21/03/2016	20/03/2026	286,149	Annuity
The Source	2.430	17/12/2015	16/12/2024	25,000	Annuity
The Foreshore Trust	1.820	21/03/2016	21/03/2026	127,000	Annuity
			Total	2,226,384	

32. Borrowing from the PWLB was taken to fund the Amicus Horizon loan (£1,788,235- Maturity loan) and one of the loans to the Foreshore Trust (£300,000 originally borrowed – Annuity loan); these correspond to PWLB loans 6 & 7 respectively in Table 1 above.

33. The interest receivable for 2016/17 on these loans amounts to £75,312, albeit the smaller Foreshore Trust loan (£127,000) will terminate on the completion of a land swap – subject to receiving Charity Commission approval.
34. The overall investment performance for the first 6 months of 2016/17 provided an average return of 0.80% (2015/16 0.88%) including the Local Authority Mortgage Scheme (LAMS) and 0.61% (2015/16 0.68%) excluding LAMS. These figures exclude the interest receivable in respect of loans to other organisations.
35. The total interest receivable for the first 6 months is £110,000 (2015/16 £93,000) including the Local Authority Mortgage Scheme and £78,000 (2015/16 £61,000) excluding LAMS.
36. These figures exclude the interest receivable in respect of loans to other organisations.

Borrowing Strategy

37. The Council purchased Aquila House for £4.4m (including stamp duty) at the start of this financial year. In addition there are two large schemes in the capital programme being the construction of a new industrial unit (BD Foods - £1,400,000) and a further grant to Amicus Horizon (Phase 2 of the Coastal Space project - £875,000).
38. Prior to the referendum vote in the summer interest rates look set to increase. The opportunity was taken to take new borrowing to finance Aquila House in particular and lock in the savings that were achieved by purchasing the property rather than renting it. In addition, given the low historical rates of interest, the level of internal borrowing was also reduced. In total some £7m of new borrowing from the PWLB has been taken to date this financial year.
39. The Council now has some £21.5m of PWLB debt, and could potentially borrow up to a level of £24.6m. This figure does not take account of any new capital spending in 2016/17 which could potentially be funded by new borrowing. It should be noted that a £1m PWLB loan is due to be repaid in December 2016. This loan was taken out to fund the first tranche of the Local Authority Mortgage scheme and is matched with a deposit of £1m with Lloyds Bank at an interest rate of 4.45% (which should be repaid to the Council in January 2017).
40. The interest rate forecasts from the Council's treasury advisers identify further reductions in base rates by December 2016. Whilst the borrowing rates are attractive on a historical basis the difference between the return on investment and the cost of borrowing remains – the additional revenue cost falling on the Council taxpayer. There is however still a case for taking new borrowing before rates increase again or restrictions are placed on the amount and levels of borrowing that authorities can undertake (particularly from the PWLB) and a balanced view will be taken. The plans for income generation, which would require substantial new borrowing by the Council in the future, play a part in the consideration as to when to borrow and the level of internal borrowing. Given the historically low interest rates and the ability of the Council to look at other investment opportunities which are providing higher returns than the cost of borrowing e.g. property funds, there is a much stronger case for reducing the level of internal funding now in order to ensure a lower level of borrowing risk in the future.

41. The Council also keeps under review the potential for making premature debt repayments in order to reduce borrowing costs as well as reducing counterparty risk by reducing investment balances. However, the cost of the early repayment premiums that would be incurred and the increase in risk exposure to significantly higher interest rates for new borrowing, continue to make this option unattractive. When last reviewed the early repayment cost of the £7.5m PWLB loan, maturing in 2033, would amount to some £3m. No debt rescheduling is being contemplated at present.

Investment Strategy

42. Priority is given to security and liquidity of investments in order to reduce counterparty risk to the maximum possible extent.

43. The Council has a limit of £5m with any one institution (rated A or above, supported by Government, and given a blue (12month) rating by Capita Asset Services). This generally represents a level of up to 15% of the investment portfolio with any one institution or group at any one time. It is also necessary, at times, to invest sums of this size in order to attract the larger institutions which have the higher credit ratings.

44. The Eurozone and Brexit have led to a number of downgrades to banks' credit ratings, making it increasingly difficult to spread investments across a number of institutions. The Chief Finance Officer has the authority to amend the limits if necessary to ensure that monies can be placed with appropriate institutions.

45. The net cost to the Council of borrowing, investment interest and fees will be reviewed as part of the budget setting process.

46. The net interest on the deposits in respect of the LAM scheme for the year will be transferred into the mortgage reserve in order to meet potential defaults (none at present). If at the end of the five year periods of the two schemes there are no defaults and arrears exceeding 3 months the Council will receive its deposit back in full and would then be able to consider the use of the reserve monies. Such considerations will be included in future budget reports.

47. It is recommended that the option for diversification of some of the investments into a property fund be explored, given the higher returns being achieved in some parts of the country. The investments would be in respect of the Council's reserves that are not required for a period of at least 5 years in order that any fall in values and entry costs into such funds can be covered. Before any recommendations are put before Council, the Audit Committee and Cabinet will need to consider the risk implications. To this end the Council's Treasury advisers will be asked to identify options for investments into property funds for consideration within the Treasury Management Strategy report that will be considered by the Audit Committee in January 2017 and subsequently by the Cabinet in February 2017.

48. The income generation proposals that the Council is looking at will require substantial investments to be made by the Council and will necessitate new borrowing. The levels of new borrowing that the Council can afford to take on board for new commercial property purchases and development, housing and energy schemes, etc, will be dependent upon the individual proposals and credit worthiness of the counterparties involved. Due to the timescales within which some property purchasing and disposal

decisions have to be made the Council's existing governance arrangements and delegated authorities may need to be reviewed.

49. The additional risks that the Council will consider taking on will need to be considered in the context of the totality of risk that the Council faces e.g. Pier claim, rates revaluation, robustness of income streams, economic downturns, etc. Where there is more risk and volatility in income streams the Council will need to ensure that it maintains sufficient reserves to ensure the Council's ability to deliver key services is not jeopardised.

Compliance with Treasury Limits

50. During the financial year to date there have again been a few occasions where it has not been possible to find institutions to take the Council's money given the strict criteria in place. In these circumstances the Council will place money in its existing call accounts and this can thus result in the investments exceeding general limits. Where such an occasion looks likely to arise the approval of Chief Finance officer is required in compliance with the Council's Treasury Management Practices. The Prudential Indicators have been complied with - reproduced in Appendix 1 for reference.

Financial Implications

51. The Council's 2016/17 budget estimated a 0.70% return on investments. Based on current market conditions this is difficult to achieve given the lower interest rates currently available. However savings from the reduction in new borrowing rates should help to ensure overall budget projections are achieved.

Risk Management

52. The Council spreads its risk on investments by limiting the amount of monies with any one institution or group and limiting the timeframe of the exposure. In determining the level of the investment and period the Council considers formal credit ratings (Fitch) along with its own advisers (Capita Asset Services) ratings advice.
53. The security of the principal sum remains of paramount importance to the Council.

Wards Affected

Ashdown, Baird, Braybrooke, Castle, Central St. Leonards, Conquest, Gensing, Hollington, Maze Hill, Old Hastings, Ore, Silverhill, St. Helens, Tressell, West St. Leonards, Wishing Tree

Area(s) Affected

Central Hastings, East Hastings, North St. Leonards, South St. Leonards

Policy Implications

Please identify if this report contains any implications for the following:

Equalities and Community Cohesiveness	No
Crime and Fear of Crime (Section 17)	No
Risk Management	Yes
Environmental Issues	No
Economic/Financial Implications	Yes
Human Rights Act	No
Organisational Consequences	No
Local People's Views	No
Anti-Poverty	No

Appendices – Appendix 1: Prudential Indicators

Officer to Contact

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APPENDIX 1

PRUDENTIAL INDICATOR	2015/16	2016/17	2017/18	2018/19	2019/20
(2). TREASURY MANAGEMENT PRUDENTIAL INDICATORS	£'000	£'000	£'000	£'000	£'000
Authorised Limit for external debt - borrowing	£25,000	£30,000	£30,000	£30,000	£30,000
other long term liabilities	£10,000	£10,000	£10,000	£10,000	£10,000
TOTAL	£35,000	£40,000	£40,000	£40,000	£40,000
Operational Boundary for external debt - borrowing	£25,000	£30,000	£30,000	£30,000	£30,000
other long term liabilities	£10,000	£10,000	£10,000	£10,000	£10,000
TOTAL	£35,000	£40,000	£40,000	£40,000	£40,000
Upper limit for fixed interest rate exposure					
Net principal re fixed rate borrowing / investments OR:-	100%	100%	100%	100%	100%
Upper limit for variable rate exposure					
Net principal re variable rate borrowing / investments OR:-	100%	100%	100%	100%	100%
Upper limit for total principal sums invested for over 364 days – LAMS Scheme and Coastal Space	£6,000	£6,000	£6,000	£6,000	£6,000
Maturity structure of fixed rate borrowing during 2015/16	upper limit	lower limit			
under 12 months	100%	0%			
12 months and within 24 months	100%	0%			
24 months and within 5 years	100%	0%			
5 years and within 10 years	100%	0%			
10 years and above	100%	0%			