

Report to Cabinet

Subject: Prudential Code Indicator Monitoring 2016/17 and Quarterly Treasury Activity Report for Quarter ended 30 September 2016

Date: 3 November 2016

Author: Deputy Chief Executive and Chief Financial Officer

Wards Affected

All

Purpose

To inform members of the performance monitoring of the 2016/17 Prudential Code Indicators, and to advise members of the quarterly treasury activity as required by the Treasury Management Strategy.

Key Decision

This is not a key decision.

Background

- 1.1 The Council is required by regulations issued under the Local Government Act 2003 to report on its Prudential Code indicators and treasury activity. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).
- 1.2 For 2016/17 the minimum reporting requirements are that the Full Council should receive the following reports:
 - An annual treasury strategy in advance of the year (the TMSS, considered by Cabinet on 18 February 2016 and subsequently approved by Full Council on 7 March 2016).
 - A mid-year treasury update report
 - An annual review following the end of the year describing the activity compared to the strategy.

In accordance with best practice, quarterly monitoring reports for treasury activity are provided to members, and this exceeds the minimum requirements.

- 1.3 The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report provides details of the position at 30 September 2016 and highlights compliance with the Council's policies.

Proposal

2.1 Economic update

UK GDP growth rates of 2.2% in 2013 and 2.9% in 2014 were the strongest of any G7 country. Growth in 2015 was disappointing at 1.8% but this remained one of the leading rates among the G7 countries. Growth improved in Q4 of 2015 from 0.4% to 0.7%, fell back again to 0.4% in Q1 of 2016 but bounced back to 0.7% in Q2. During most of 2015, the economy was challenging for exporters with the appreciation of sterling against the Euro, 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 delivered an immediate shock fall in confidence indicators and business surveys, indicating an impending sharp slowdown in the economy. However, subsequent surveys have shown a recovery in confidence, albeit that whilst it is generally expected that the economy will now avoid "flat-lining", growth will be weak through the second half of 2016 and during 2017.

The Bank of England meeting on 4 August addressed the expected slowdown in growth by a package of measures, including a cut in Bank Rate from 0.5% to 0.25%. The Bank of England Inflation Report included an unchanged forecast for growth in 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 provide the entire economic stimulus required, and suggested that the Government would 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 would be eased in the Autumn Statement on 23 November.

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 falls in the price of oil and food twelve months ago fall out of the calculation, and in addition the post-referendum drop of more than 10% in the value of

sterling is likely to result in a 3% increase in CPI over a period of 3-4 years. However, the Monetary Policy Committee (MPC) is expected to look beyond a one-off upward “blip” from this devaluation in order to support economic growth, especially if pay increases continue to remain subdued and pose little danger of stoking inflationary pressure in the UK economy.

The American economy experienced variable performance during 2015, with overall growth of 2.4%. Q1 of 2016 was disappointing at 0.8% whilst Q2 improved slightly to 1.4% and forward indicators suggest an improvement during the rest of the year. The Federal Reserve (Fed) embarked on its long anticipated first increase in rates in December 2015 and at that point, confidence was high that there would then be four more increases during 2016. Since then, downbeat international news and the Brexit vote has caused a delay in the timing of the second increase, which is now strongly expected in December.

In the Eurozone (EZ), the European Central Bank (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 programme was initially intended to run to September 2016, but in response to continuing weak growth was extended to March 2017. Furthermore the ECB has progressively cut both its deposit facility rate, which is now negative, and its refinancing rate. At its March meeting it also increased its monthly asset purchase to €80bn. These measures have struggled both to make a significant impact on boosting economic growth and on raising inflation from around zero towards the target of 2%. This has led to many forecasters to suggest that central banks around the world are running out of ammunition to stimulate economic growth and to boost inflation and they stress that governments will need to do more by way of structural reforms, fiscal measures and direct investment to support demand in their economies and economic growth.

Japan is facing very slow growth and is making little progress on fundamental reform of its economy. Chinese economic growth has been weakening and medium term risks have been increasing.

2.2 Interest rate forecasts

Capita Asset Services (CAS) undertook a quarterly review of its interest rate forecasts after the MPC meeting on 4 August cut Bank Rate to 0.25% and gave forward guidance that it expected to cut the rate again to near zero before the year-end. The CAS forecast below therefore includes a further cut to 0.1% in November 2016 and a first increase in May 2018 to 0.25%, but no further until a year later. The Governor of the Bank of England has repeatedly stated that increases in Bank Rate will be slow and gradual

when they do start, as 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 turn negative if, as expected, inflation rises during the next two years to exceed average pay increases.

CAS have provided the following forecast:

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Bank rate	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.25%	0.25%	0.25%	0.25%	0.50%
5yr PWLB rate	1.00%	1.00%	1.10%	1.10%	1.10%	1.10%	1.20%	1.20%	1.20%	1.20%	1.30%
10yr PWLB rate	1.50%	1.50%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.70%	1.80%
25yr PWLB rate	2.30%	2.30%	2.40%	2.40%	2.40%	2.40%	2.50%	2.50%	2.50%	2.50%	2.60%
50yr PWLB rate	2.10%	2.10%	2.20%	2.20%	2.20%	2.20%	2.30%	2.30%	2.30%	2.30%	2.40%

2.3 Investment strategy

The Treasury Management Strategy Statement (TMSS) for 2016/17 was approved by Council on 7 March 2016.

The Council's investment priorities remain the security of capital and good liquidity. Whilst the Council will always seek to obtain the optimum return (yield) on its investments, this will at all times be commensurate with proper levels of security and liquidity. In the current economic climate and with heightened credit concerns, it is considered appropriate either to keep investments short term to cover cash flow requirements, or to extend the period up to one year with selected government backed counterparties.

During the period from 1 April to 30 September 2016, significant use has been made of a Money Market Fund (MMF) currently achieving a return of around 0.3%. This fund is an AAA rated investment vehicle which allows the pooling of many billions of pounds worth of funds into a highly diversified fund. Whilst the rate of return remains quite low, it is still well in excess of overnight treasury deposit rates. Given the added security gained from the diversification of MMFs it is intended that at least one further Fund will be opened in the near future.

The Treasury Activity Report for the quarter ended 30 September 2016 is attached at Appendix 1, in accordance with the Treasury Management Strategy. For reference, definitions of LIBOR and LIBID are given at Appendix 2.

Members will note that investment interest of £44,681 was generated during the period from 1 April to 30 September 2016. This represents an equated rate of 0.73% and outperforms the benchmark 7 day LIBID rate, which averaged 0.28% for the same period. In cash terms this represents additional income to the General Fund of around £27,500 and was achieved by positive investment management. Performance in respect of the longer 3 month LIBID rate, which averaged 0.38%, still represents additional income of £21,400.

Rates in the market are exceptionally low, having fallen further since the cut in interest rates in August, which followed the UK's vote to leave the EU. As loans mature it is challenging to replace them, since security and liquidity will always be the overriding factors in the Council's treasury management. Interest rates are currently expected to fall to near zero, and are not expected to start rising again until at May 2018, and then only gradually, and not significantly.

It is currently anticipated that the outturn for investment interest will be broadly in line with the current approved estimate of £77,800 however this will be kept under ongoing review should interest rates fall further.

Credit ratings advice continues to be taken from CAS and the Chief Financial Officer has adopted the CAS credit rating methodology for the selection of investment counterparties. This employs a sophisticated modelling approach utilising credit ratings from all three of the main rating agencies to give a suggested maximum duration for investments. Accordingly it does not give undue preponderance to one agency's ratings.

The methodology subsequently applies an "overlay" to take account of positive and negative credit watches and/or credit outlook information, which may increase or decrease the suggested duration of investments. It then applies a second overlay based on the credit default swap spreads for institutions, the monitoring of which has been shown to give an early warning of likely changes in credit ratings. It also incorporates sovereign ratings to ensure selection of counterparties from only the most creditworthy countries. The current treasury strategy permits the use of counterparties with a rating of AA- and better. Following recent downgrades, the UK currently has a rating of AA.

The CAS modelling approach combines all the various factors in a weighted scoring system and results in a series of colour coded bands which indicate the creditworthiness of counterparties. The colour bandings are as follows:

- Yellow 5 years (UK Government debt or its equivalent)
- Purple 2 years

- Blue 1 year (nationalised or semi nationalised UK banks only)
- Orange 1 year
- Red 6 months
- Green 100 days
- No colour not to be used

All credit ratings are monitored weekly and the Council is also alerted to interim changes via its use of the CAS creditworthiness service, however ratings under the methodology, including sovereign ratings, will not necessarily be the sole determinant of the quality of an institution. Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

The ultimate decision on what is prudent and manageable for the Council will be taken by the Chief Financial Officer under the approved scheme of delegation.

2.4 New borrowing

No new long-term borrowing was undertaken during the quarter ended 30 September 2016.

The Council's Capital Financing Requirement (CFR) represents its "underlying" need to borrow to finance capital investment. Due to favourable interest rates, borrowing in advance of need is sometimes desirable, with the result that the CFR can differ to the actual borrowing planned in the year.

It is not currently anticipated that any new borrowing will be undertaken during 2016/17.

Interest rates do however remain low, and the PWLB certainty rate, available to all authorities providing relevant information to CLG, allows the Council to take advantage of a discount of 20 basis points. Advice will be taken from CAS with regard to the amount and timing of any additional borrowing, and should conditions become advantageous, some borrowing in advance of need will also be considered by the Chief Financial Officer. Whilst borrowing rates may be historically low, so too are investment rates and serious consideration must be given to the cost of carrying any additional borrowing during the period prior to it being required for the financing of capital expenditure.

2.5 Debt rescheduling

Debt rescheduling opportunities are limited in the current economic climate, and due to the structure of interest rates. Advice in this regard will continue to be taken from CAS. No debt rescheduling has been undertaken during the period from 1 April to 30 September 2016.

2.6 Compliance with Prudential and treasury indicators

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limit. The Council's approved Prudential and Treasury Indicators (affordability limits) are included in the Treasury Management Strategy Statement (TMSS) approved by Full Council on 7 March 2016.

During the financial year to date the Council has at all times operated within the treasury limits and Prudential Indicators set out in the council's TMSS, and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators as at 30 September 2016 are shown at Appendix 3.

These indicators are based on estimates of expected outcomes, and are key indicators of "affordability". They are monitored on a quarterly basis, and Appendix 3 compares the approved indicators with the projected outturn for 2016/17, and shows variances on some of the indicators, as described below:

a) Prudential Indicators:

i) Capital Expenditure

The latest projected outturn shows that capital expenditure is expected to be £5,527,000. This differs to the original estimate of £4,366,900 due to the inclusion of approved carry-forward requests from 2015/16 and to approved variations to the capital programme during 2016/17.

ii) Capital Financing Requirement (CFR)

The projected closing CFR for 2016/17 is £12,769,500. This is lower than the approved indicator of £13,030,300, mainly due to slippage and savings on the 2015/16 capital programme which reduced the borrowing requirement in that year, and to variations to the 2016/17 programme.

iii) Ratio of Financing Costs to Net Revenue Stream

The projected outturn of 12.70% shows an increase on the approved indicator of 9.75%. This is due to a reduction in anticipated investment

interest due to continuing uncertainty and poor rates in the market, and an increased revenue contribution to capital expenditure. These increases are offset by reductions in MRP, as a result of slippage and savings on the capital programme in 2015/16, and in serviced debt interest, due to the full redemption of the debt on 31 March 2016.

iv) Maximum gross debt

The Council must ensure that its gross debt does not, except in the short term, exceed the opening capital financing requirement, plus estimates of any additional CFR for 2016/17 and the following two financial years. This allows flexibility for early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes. The Council's gross debt at 30 September 2016 was £6.812m which was well within the approved indicator.

Treasury Management Indicators:

These indicators are based on limits, beyond which activities should not pass without management action. They include two key indicators of affordability and four key indicators of prudence.

Affordability

- i) Operational boundary for external debt.
- ii) Authorised limit for external debt.

Prudence

- iii) Upper limit for fixed interest exposure – represented by the maximum permitted net outstanding principal sum borrowed at fixed rates. Please note that a negative indicator represents a position of net investment.
- iv) Upper limit for variable interest rate exposure – represented by the maximum permitted net outstanding principal sum borrowed at variable rates. Please note that a negative indicator represents a position of net investment.
- v) Maximum new principal sums to be invested during 2016/17 for periods in excess of 364 days - such investments are classified as a “non-specified”. This indicator is subject to the overall limit for non-specified investments set in the TMSS.
- vi) Upper limits for the maturity structure of borrowing - set to reduce the Council's exposure to large fixed rate sums falling due for refinancing.

Appendix 3 shows the actual position as at 30 September 2016, and demonstrates that all activities are contained within the currently approved limits

Alternative Options

There are no alternative options, this report being a requirement of the Council's Treasury Management Strategy Statement (TMSS).

Financial Implications

No specific financial implications are attributable to this report.

Appendices

1. Treasury Activity Report 2016/17 for quarter ended 30 September 2016.
2. Definitions of LIBOR and LIBID
3. Prudential and Treasury Indicators for 2016/17 as at 30 September 2016.

Background Papers

None identified.

Recommendation

That:

Members note the report, together with the Treasury Activity Report for Quarter 2 at Appendix 1, and the Prudential and Treasury Indicator Monitoring for Quarter 2 at Appendix 3.

Reasons for Recommendations

To comply with the requirements of the Council's Treasury Management Strategy Statement.

For more information, please contact:

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