Report to Cabinet

Subject: Prudential Code Indicator Monitoring 2016/17 and Quarterly Treasury Activity Report for Quarter ended 31 December 2016

Date: 2 February 2017

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 31 December 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 in Q3 of 2016 was 0.6%, which confounded pessimistic forecasts by the Bank of England (BOE) and others, most of which expected to see near zero growth during 2016 after the referendum. Prior to the referendum, the UK economy was challenging for exporters, with the appreciation of sterling against the Euro, weak growth in the EU, China and emerging markets, and the dampening effect of the Government's continuing austerity programme. The referendum vote for Brexit in June this year delivered an immediate shock fall in confidence indicators and business surveys, pointing to an impending sharp slowdown in the economy, however there was then a sharp recovery in confidence and business surveys, and the fall in the value of sterling has had a positive effect in boosting manufacturing in the UK due to improved competitiveness in world markets.

The BOE meeting on 4 August addressed its forecast of a slowdown in growth by a package of measures including a cut in Bank Rate from 0.50% to 0.25%. The BOE Inflation Report cut the forecast for growth in 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. While the Monetary Policy Committee (MPC) was prepared to cut Bank Rate again by the end of 2016, Mr Carney 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 November 23, and he duly delivered this. In the light of robust growth of 0.6% in Q3, plus positive forward business surveys, the MPC did not cut rates further at its November meeting.

The November BOE Inflation Report included a forecast for inflation to rise to around 2.7% in 2018 and 2019, well above its 2% target, due to a sharp rise in the cost of imports as a result of the sharp fall in the value of sterling after the referendum. However, the MPC is expected to look through a one off upward "blip" resulting from this devaluation of sterling in order to support economic growth, especially if pay increases continue to remain subdued and therefore pose little danger of stoking inflationary pressure in the UK economy.

The American economy experienced variable performance during 2015 with overall growth for the year of 2.4%. Growth on an annualised basis of 0.8% and 1.4%, in Q1 and Q2 of 2016 respectively was disappointing, however Q3 was stronger at 3.5% and forward indicators point towards robust growth in 2017, especially if President Elect Trump's expansionary plans are put into effect.

The Federal Reserve (Fed) embarked on its long anticipated first increase in rates in December 2015 and further rises were then expected during 2016. Since then, downbeat international news and the Brexit vote has caused a delay in the timing of a second rise, and three or four further increases are now expected during 2017 and 2018.

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 was subsequently extended to March 2017. Furthermore, the ECB has progressively cut both its deposit facility rate, which is now negative, and its main refinancing rate. In March 2016 it also increased its monthly asset purchases to €80bn, and in December extended its QE programme. Monthly purchases at €80bn will continue to March 2017, and then continue at €60bn until December 2017. 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%. GDP growth rose by 0.6% in Q3 of 2016 and forward surveys are now positive about a modest upturn to growth, while inflation has also started to increase significantly. There have been many comments from forecasters that central banks around the world are running out of options to stimulate economic growth and to boost inflation. They stress that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand in the their economies and economic growth.

Japan has struggled for many years to boost economic growth, despite massive fiscal and monetary stimulus and Chinese economic growth has been weakening and medium term risks have been increasing.

2.2 Interest rate forecasts

The MPC cut Bank Rate from 0.5% to 0.25% on 4 August 2016 in order to counteract its forecast for a sharp slowdown in growth in the second half of 2016. It also indicated that it was likely to cut Bank Rate again by the end of the year. However, economic data since August has indicated much stronger growth in the second half of 2016 than was forecast, and inflation forecasts have also risen substantially as a result of a continuing sharp fall in the value of sterling. Consequently, Bank Rate was not cut again in November or December, and on current trends it now appears unlikely that there will be another cut – although this cannot be completely ruled out if there was a significant dip in economic growth. During the two-year period during which the UK is negotiating the terms for its withdrawal from the EU it is likely that the MPC will do nothing to dampen growth prospects, ie. by raising Bank Rate, which will already be adversely impacted by uncertainties around the form which Brexit will eventually take. Accordingly, a first increase to 0.5% is not now expected until Q2 of 2019, after Brexit negotiations have been concluded, although if strong domestically generated inflation was to emerge (eg. from UK wage increases), the pace and timing of increases in Bank Rate could be brought forward.

Capita Asset Services (CAS) have provided the following forecast:

	Mar-17	Jun-17	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%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%
50yr PWLB rate	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%

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 it is considered appropriate either to keep investments short term to cover cash

flow needs, or to extend the period up to six months with highly rated financial institutions, selected by the use of the Capita creditworthiness methodology (see below) which includes consideration of sovereign ratings.

During the period from 1 April to 31 December 2016, significant use has been made of two Money Market Fund (MMFs). These are AAA rated investment vehicles which allow the pooling of many billions of pounds into highly diversified funds, thus reducing risk. Current rates of return are around 0.27% and 0.24%, and whilst these are very low, they remain well in excess of overnight treasury deposit rates and of the rate obtainable from the Debt Management Office (DMO).

The Treasury Activity Report for the quarter ended 31 December 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 £64,372 was generated during the period from 1 April to 31 December 2016. This represents an equated rate of 0.65% and outperforms the benchmark 7 day LIBID rate, which averaged 0.23% for the same period. In cash terms this represents additional income to the General Fund of around £41,600 and was achieved by positive investment management. Performance in respect of the longer 3 month LIBID rate, which averaged 0.34%, still represents additional income of £30,700.

Rates in the market remain exceptionally low, and this is likely to continue following the UK's vote to leave the EU. As loans mature and the positive impact of rates agreed before the cut in Bank Rate fall out, it is generally impossible to replace them at similar rates since security and liquidity will always be the overriding factors in the Council's treasury management. Accordingly the equated rate is expected to fall further during the remainder of 2016/17 and more significantly in 2017/18. As discussed at 2.2 above, interest rates are currently not expected to start rising again until June 2019, and then only gradually, and not significantly.

It is currently anticipated that the outturn for investment interest for 2016/17 will be broadly in line with the current approved estimate of £77,800.

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 31 December 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 currently anticipated that £1m of new borrowing will be undertaken during the final quarter of 2016/17, at a point when interest rates are deemed most favourable by the Chief Financial Officer. Interest rates remain very 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 31 December 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 31 December 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) <u>Prudential Indicators:</u>

i) <u>Capital Expenditure</u>

The latest projected outturn shows that capital expenditure is expected to

be £4,154,600. 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, which include slippage of £1,458,800 in Q3.

ii) Capital Financing Requirement (CFR)

The projected closing CFR for 2016/17 is £12,684,700. 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 12.24% 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 31 December 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

This is the limit which external debt is not "normally" expected to exceed. In most cases, this would be a similar figure to the CFR, but it may be lower or higher depending on the levels of actual debt.

ii) Authorised limit for external debt

This limit represents a control on the "maximum" level of borrowing. It is the statutory limit determined under s3 (1) of the Local Government Act 2003 and represents the limit beyond which external debt is prohibited. The Authorised Limit must be set, and revised if necessary, by Full Council. It reflects a level of external debt which, while not desirable, could be afforded in the short term, but is not sustainable in the longer term. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised

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 31 December 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 3 (31 December 2016)
2. Definitions of LIBOR and LIBID
3. Prudential and Treasury Indicator Monitoring 2016/17 for Quarter 3 (31 December 2016).

Background Papers

None identified.

Recommendation

That:

Members note the report, together with the Treasury Activity Report 2016/17 for Quarter 3, at Appendix 1, and the Prudential and Treasury Indicator Monitoring 2016/17 for Quarter 3, 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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