Report to Cabinet

Subject: Prudential Code Indicator Monitoring 2017/18 and Quarterly Treasury Activity Report for Quarter ended 30 June 2017

Date: 27 July 2017

Author: Deputy Chief Executive and Chief Financial Officer

Wards Affected

All

Purpose

To inform Members of the performance monitoring of the 2017/18 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 2017/18 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 16 February 2017 and subsequently approved by Full Council on 1 March 2017).
- 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 June 2017 and highlights compliance with the Council's policies.

Proposal

2.1 Economic update

The UK GDP growth rate for each of the years 2013 to 2016 were among the strongest of any G7 country, with 1.8% achieved in 2016. Performance in 2016 was notable, being a year in which the Bank of England (BOE) had forecast in August that growth would be near to zero in the second half of the year due to the economic shock expected from the Brexit referendum in June. In its February and May 2017 Inflation Reports the BOE upgraded its forecasts for growth to 1.9% in each of in 2017 and 2018, however over these years it also expects inflation to rise towards 3% as cost increases resulting from the fall in the value of sterling feed through into the economy. It anticipates inflation falling back to 2.2% in 2019, and provided cost pressures do not feed through into significantly higher domestically generated inflation in the UK, the Monetary Policy Committee (MPC) is expected to "look through" the one-off spike in the inflation rate as wage inflation is currently subdued. There is however a potential risk that the MPC may look to reverse the emergency 0.25% rate cut – before embarking on a progressive trend of rises in Bank Rate at a later date.

Growth in the US was highly volatile in 2016, but overall was an average of 1.6% for the year. Q1 of 2017 returned growth of 1.4% but current indications are that growth could rebound strongly in Q2. The disappointment so far has been a lack of progress with the promised fiscal stimulus package. The Federal Reserve (Fed) has therefore started to increase interest rates now that the economy is at or around full employment and inflationary pressures have been building to exceed its 2% target. Rates have risen four times so far, with a further two increases expected in 2017 and possibly four in 2018.

Growth in the EU improved to 1.7% in 2016 after the European Central Bank (ECB) cut rates to negative levels and embarked on massive quantitative easing during the year. The ECB is now forecasting growth of 1.9% in 2017, 1.8% in 2018, and 1.7% in 2019. It has committed to continuing major monthly quantitative easing purchases throughout 2017 in order to stimulate growth and get inflation up to its 2% target, however in April 2017 it reduced the rate from €80bn to €60bn per month.

There are major concerns about various stresses within the EU and these could have the potential to call the EU project itself into question. Dutch and French elections passed without making waves, and no significant fallout is anticipated from a national election in Germany in October. However, there is also an election due in Austria and one of the front running parties is strongly anti-immigration and anti-EU. There is also a risk of a snap election in Italy before May 2018, and a further major stress point is the unsustainable level of national debt in Greece – in the face of implacable opposition from Germany to any further bail-out. High levels of unemployment in some EU countries and the free movement of people within the EU, together with the EU's fraught relationship with Turkey in controlling such movement add to the stress level, and of course the EU now has to deal with Brexit negotiations with the UK.

China is expected to continue with reasonably strong growth of 6.5% in 2017; however medium term risks are increasing. Japan only achieved 1% growth in 2016 and is struggling to get inflation to move from around zero, despite massive fiscal stimulus and monetary policy action by the Bank of Japan.

2.2 Interest rate forecast

The MPC cut Bank Rate from 0.50% to 0.25% on 4th August 2016 to counteract a forecast sharp slowdown in growth during the second half of 2016. However, growth has been robust until dipping in quarter 1 of 2017 to 0.2%. CPI inflation has risen substantially as a result of the sharp fall in the value of sterling since the referendum and consequently, Bank Rate has not been cut again, and market concern has switched to whether the MPC could achieve a majority to reverse the August emergency 0.25% rate cut, before embarking on a progressive trend of increases in Bank Rate at a later date. There is much uncertainty about the slender Conservative majority, which is dependent on DUP support, and over what form Brexit will take and how difficult the EU could be in setting terms. There are, therefore, many unknowns at the current time, and the timing of Bank Rate rises is hard to call.

Accordingly, a first increase to 0.50% is not tentatively anticipated until Q2 of 2019, after the Brexit negotiations are due to have been concluded. However, if strong domestically generated inflation (such as that from wage increases) was to emerge, the pace and timing of increases in Bank Rate could be brought forward.

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

	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%

2.3 Investment strategy

The Treasury Management Strategy Statement (TMSS) for 2017/18 was approved by Council on 1 March 2017.

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 30 June 2017, significant use has been made of two Money Market Funds (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 0.2%, and whilst this is very low, it remains 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 30 June 2017 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 £11,535 was generated during the period from 1 April to 30 June 2017. This represents an equated rate of 0.44% and outperforms the benchmark 7 day LIBID rate, which averaged 0.20% for the same period. In cash terms this represents additional income to the General Fund of around £6,300 and was achieved by positive investment management. Performance in respect of the longer 3 month LIBID rate, which averaged 0.32%, still represents additional income of £3,100.

Rates in the market remain very low, and this is likely to continue following the UK's vote to leave the EU. As loans mature it is challenging 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 may fall further during the remainder of 2017/18. Interest rates are currently not expected to start rising until Q2 of 2019, and then only gradually, and not significantly.

It is currently anticipated that the outturn for investment interest for 2017/18 will be broadly in line with the current approved estimate of £35,000.

Credit ratings advice is 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 any UK counterparties subject to their individual credit ratings under the CAS methodology. It also permits the use of counterparties from other countries with a minimum sovereign rating of AA. For information, 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 June 2017.

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 2017/18, 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 30 June 2017.

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 1 March 2017.

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 June 2017 are shown at Appendix 3.

Prudential Indicators:

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 2017/18, and shows variances on some of the indicators, as described below:

i) Capital Expenditure

The latest projected outturn shows that capital expenditure is expected to be £5,752,000. This differs to the original estimate of £4,967,900 due to the inclusion of approved carry-forward requests from 2016/17 and to approved variations to the capital programme during 2017/18.

ii) Capital Financing Requirement (CFR)

The projected closing CFR for 2017/18 is £12,629,700. This is lower than the approved indicator of £13,160,400, due to savings on the 2016/17 capital programme, slippage of schemes to 2017/18, and additional capital receipts, all of which reduced the borrowing requirement in that year.

iii) Ratio of Financing Costs to Net Revenue Stream

The projected outturn of 11.82% shows an increase on the approved indicator of 11.00%. This is due to increased revenue contributions to capital expenditure, offset by a reduction in MRP arising from the savings and slippage on the capital programme in 2016/17.

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 2017/18 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 June 2017 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 2017/18 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 June 2017, 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 2017/18 for Quarter 1 (30 June 2017)
2. Definitions of LIBOR and LIBID
3. Prudential and Treasury Indicator Monitoring 2017/18 for Quarter 1 (30 June 2017).

Background Papers

None identified.

Recommendation

That:

Members note the report, together with the Treasury Activity Report 2017/18 for Quarter 1, at Appendix 1, and the Prudential and Treasury Indicator Monitoring 2017/18 for Quarter 1, 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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