Report to Cabinet

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

Date: 2 November 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 Mid-Year position at 30 September 2017 and highlights compliance with the Council's policies.

Proposal

2.1 Economic update

The UK economy grew strongly in 2016, however 2017 has so far been disappointing, with each of Q1 and Q2 at only +0.3%. The main reason has been the sharp increase in inflation, caused by the devaluation of sterling after the EU referendum, which has fed increases in the cost of imports into the economy. This in turn has caused a reduction in consumer disposable income, so the services sector, which accounts for around 75% of GDP, has seen weak growth as consumers cut back their spending. There have been encouraging statistics from the manufacturing sector which is seeing strong growth as a result of increased demand for exports, and it has helped that growth in the EU, our main trading partner, has improved significantly over the last year. However, manufacturing only accounts for around 11% of GDP so expansion in this sector will have a muted effect on the average total GDP growth for the UK economy as a whole.

The Monetary Policy Committee (MPC) meeting on 14 September 2017 surprised markets and forecasters by switching to a more aggressive tone around its warning that Bank Rate will need to rise. The Bank of England Inflation Reports during 2017 have clearly flagged that CPI inflation is expected to peak at just under 3% in 2017, before falling back to near to the target rate of 2% in two years' time. Inflation was 2.9% in August and the Bank revised its forecast for the peak to over 3% at the 14 September MPC meeting. This marginal revision hardly justified the MPC's change of tone, rather the focus was on an emerging view that with unemployment falling to only 4.3%, the lowest level since 1975, and improvements in productivity being weak, that the amount of spare capacity in the economy was significantly diminishing towards a point at which it now needed to take action. The MPC also took a more tolerant view of low wage inflation, as this now seems a common factor in nearly all western economies as a result of increasing globalisation. This effectively means that the UK labour force faces competition from overseas labour eg. in outsourcing work to developing economies, and this therefore depresses the negotiating power of UK labour. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a decrease in such globalisation pressures in the UK, and so would be inflationary over the next few years.

It therefore looks likely that the MPC will increase Bank Rate to 0.5% in November 2017 or in February 2018, and it remains to be seen whether this will be a one off increase, or the start of a series of slow but regular increases. As at the start of October, short sterling rates indicate that financial markets do not expect a second increase until May 2018, with a third increase in November 2019. However, some forecasts are for growth to improve significantly in 2017, and into 2018, as the fall in inflation will bring to an end the negative impact on consumer spending power, while a strong export performance will compensate for weak services sector growth. If this scenario was to materialise, then the MPC would have added reason to embark on a series of slow but gradual increases in Bank Rate during 2018. With so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is considered by most forecasters to be too early to be confident about how the next two years will pan out.

Economic growth in the EU, (the UK's biggest trading partner), was disappointing for several years following the financial crisis, despite the European Central Bank (ECB) cutting its main rate to -0.4% and embarking on a massive programme of Quantitative Easing. However, growth picked up in 2016 and looks to have gathered ongoing momentum thanks to this stimulus. GDP growth in 2017 has been 0.5% in Q1 and 0.6% in Q2. However, despite massive monetary stimulus, the ECB is still struggling to get inflation up to its 2% target and in August inflation was 1.5%. It is therefore unlikely that interest rates will start to rise until around 2019.

Growth in the American economy was volatile in 2015 and 2016, and 2017 is following a similar pattern with Q1 at only 1.2% but Q2 rebounding to 3.1%. Unemployment in the US has also fallen to the lowest level for many years while wage inflation pressures, and inflationary pressures in general, have been building. The Federal Reserve (Fed) has started on a gradual rise in rates with three increases since December 2016 and the possibility of one more rate rise in 2017, which would then lift the central rate to around 1.50%, and there could potentially be four more increases in 2018. At its June meeting, the Fed strongly hinted that it would soon begin to unwind its $4.5 trillion balance sheet holding of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

Chinese economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems. Japan is struggling to stimulate consistent significant growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

2.2 Interest rate forecast

The Council's treasury advisers, Capita Asset Services, undertook its last review of interest rate forecasts on 9 August after the quarterly Bank of England Inflation Report. There was no change in MPC policy at that meeting. However, the MPC meeting of 14 September revealed a sharp change in sentiment whereby a majority of MPC members said they would be voting for an increase in Bank Rate "over the coming months". It is therefore possible that there will be an increase to 0.5% at the November MPC meeting. If that happens, the question will then be whether the MPC stops at just withdrawing the emergency Bank Rate cut of 0.25% (made in August 2016 after the result of the EU referendum), or whether they will embark on a series of further increases in Bank Rate during 2018.

The overall balance of risk to economic recovery in the UK is currently to the downside, however significant variables remain over the coming few years, including what form Brexit will take when it is agreed with the EU.

Downside risks to current forecasts include:

- Weaker than anticipated UK economic growth and increases in inflation.
- Weak growth or recession in the UK's main trading partners - the EU and US.
- Geopolitical risks in Europe, the Middle East and Asia
- A resurgence of the Eurozone sovereign debt crisis.
- Weak capitalisation of some European banks.
- Monetary policy action failing to stimulate sustainable growth and to get inflation up consistently to around monetary policy target levels.

The potential for upside risks to current forecasts include:

- The pace and timing of rate increases by the US Fed causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities, and leading to a major flight from bonds to equities.
- UK inflation returning to significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

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

	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%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.50%	1.60%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%
50yr PWLB rate	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 September 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. The current rate of return on these funds is around 0.15%, and whilst this is very low, it remains higher than overnight treasury deposit rates and of the rate obtainable from the Debt Management Office (DMO).

The Treasury Activity Report for the quarter ended 30 September 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 £23,576 was generated from MMF activity and term deposits with banks and building societies during the period from 1 April to 30 September 2017. This represents an overall equated rate for the Council of 0.43% and outperforms the benchmark 7 day LIBID rate, which averaged 0.11% for the same period. In cash terms this represents additional income to the General Fund of around £17,500 and was achieved by positive investment management. Performance in respect of the longer 3 month LIBID rate, which averaged 0.18%, still represents additional income of £13,700.

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 will be £45,000, an increase of £10,000 on the original estimate of £35,000 for 2017/18, mainly due to the effect of loans arranged in 2016/17 and to ongoing positive investment management. The impact of this increase is included in the Q2 revenue budget monitoring report elsewhere on this agenda.

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 place undue reliance on any 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 September 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 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.

It is currently anticipated that the outturn for PWLB interest payable will be £277,200, a reduction of £29,000 on the original estimate of £306,200 for 2017/18, and this is due to planned borrowing at the end of 2016/17 not taking place. The impact of this reduction is included in the Q2 revenue budget monitoring report elsewhere on this agenda.

The Council is embarking upon a commercialisation programme aimed at the generation of funding to replace central government support, which is scheduled to be withdrawn by 2020. Significant additional borrowing may be required to support this commercial programme, which will be supported by individual business case assessments to demonstrate that each project generates a return sufficient to cover any borrowing costs. 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 remain historically low, investment rates too are very poor, 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 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 September 2017 are shown at Appendix 3.

a) 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 £5,290,500. 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 £12,456,200. 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 11.11% shows an increase on the approved indicator of 11.00%. This is due to increased revenue contributions to capital expenditure, offset by reductions in MRP arising from the savings and slippage on the capital programme in 2016/17, and in PWLB interest as the planned new borrowing in 2016/17 was not undertaken.

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 September 2017 was £6.812m which was well within the approved indicator.

b) 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 September 2017, and demonstrates that all activities are contained within the currently approved limits.

2.7 Other Issues

i) Amendment to the approved Treasury Management Strategy Statement

Appendix 3 to the Treasury Management Strategy Statement (TMSS) for 2017/18, approved by Full Council on 7 March 2017, sets out the investment instruments permitted for use by the Council. The TMSS states that the risk appetite of the Council with regard to its investments is very low, and this is demonstrated by the currently approved investment priorities of:

1. Security of capital
2. Liquidity
3. Rate of return

Further evidence is provided by the current policy of using only highly rated counterparties, for a maximum of 6 months, and then only up to tightly controlled maximum limits. Returns on such products remain at historically low levels and are not expected to rise significantly in the near future.

Consideration is being given to the use of a Property Fund, which would allow the Council to introduce a property element into its investment portfolio without the direct purchase of assets, however investment in such an instrument is **not** currently permitted by the TMSS, and the approval of Full Council to a variation is required **before** any investment is made.

The Local Authority Property Fund is a local government investment scheme approved by the Treasury under the Trustee Investments Act 1961 (section 11). Dividends are currently averaging around 4.5% per annum and are treated as revenue income, however the General Fund is protected from fluctuations in the unit price. Whilst the acquisition of share capital, including units in unregulated collective investment schemes, normally counts as capital expenditure, investments in the LAPF would fall

as long term investments. The proposed amendment to the TMSS will **only** allow the use of property funds that are so categorised.

Property Funds are not rated, due to their diverse portfolios and structures therefore, should Members approve their use, it is recommended that a selection process should be undertaken before any long-term investment is made. The Council's treasury advisers, Capita Asset Services, would be available to assist with this process, and they have recommended for example that consideration be given to funds which are diversified in terms of geographical regions and also diversified in terms of property types.

Members must fully understand the potential risks associated with Property Fund investments, should capital values fluctuate in the years ahead, since past dividend performance is no guarantee of future returns, and there is inevitably some risk to the capital sum. This would be a departure from the current policy. Members must also understand that property fund investments should be made with a time horizon of a **minimum** five years, to accommodate any potential reduction in property values in the short to medium term.

The main risk around Property Funds is the preservation of the capital sum. Evidence from recent years shows that over time the property market has been a positive long-term investment, however the market undeniably goes in cycles, and investing for short periods, ie. anything less than five years, may pose a significant risk, especially in the face of uncertainty around Brexit, government stability and the general performance of the UK economy.

The timing of an investment represents some degree of risk both in terms of the dividend and the capital sum. The key unknown is the future performance relative to the risk. If an investment is made at or near the bottom of a cycle, significant benefits might accrue from any subsequent upturn with rising dividends and increasing capital value. Conversely, should the cycle turn downwards for a significant proportion of the investment period, dividends might be lower than would be acceptable to Members - given the additional risks taken, and that the capital sum returned might be **less** than that invested.

Property is not a liquid asset and it can take time to realise an investment. Whilst Property Funds must hold a proportion of their assets as cash, in practice there may be a delay whilst the fund sells assets to realise cash with which to make a redemption payment. For this reason any investment in a Property Fund should be from core cash that is not likely to be required for at least five years, and even then not "on demand". Current projections in the medium term plan already assume the running down of cash balances, and careful consideration would therefore need to be given

to all property fund investments to ensure the Council retained sufficient liquidity within its overall investment portfolio to meet its financial requirements.

Members' approval is sought to add the use of Property Funds to the schedule of approved investments included in the TMSS for 2017/18. Investment in Property Funds would be made only at such times as the Chief Financial Officer, in conjunction with the Council's treasury advisers, considered it to be appropriate.

ii) Code of Practice Consultations

The Chartered Institute of Public Finance and Accountancy, (CIPFA), is currently conducting an exercise to consult local authorities on revising the Treasury Management Code and Cross Sectoral Guidance Notes, and the Prudential Code. CIPFA is aiming to issue the revised codes during November.

A particular focus of this exercise is how to deal with local authority investments which are not treasury type investments e.g. by investing in purchasing property in order to generate income for the authority at a higher level than can be attained by treasury investments (see 2.7(i) above). One recommendation is that local authorities should produce a new report to Members to give a high level summary of the overall capital strategy and to enable Members to see how the cash resources of the authority have been apportioned between treasury and non-treasury investments. Officers are monitoring developments and will report to Members when the new codes have been agreed and issued and on the likely impact on this authority.

Iii) MiFID II

The EU has now set a deadline of 3 January 2018 for the introduction of regulations under the Markets in Financial Instruments Directive (MiFID II). These regulations will govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. Local authorities will be classed as "retail clients" unless they opt up to "professional status", which may be done by the completion of a form for each individual institution (investment counterparties and advisers) to confirm that a minimum investment portfolio of £10m is held at the opt-up date, and that **either** a minimum number of transactions are conducted with that institution in a year, **or** that the authority (effectively the CFO) has at least one year's experience in a professional position in financial markets which require knowledge of the transactions or services envisaged. Because opting up assumes a higher level of expertise the protections afforded by the institutions with regard to,

for example, the simplicity and frequency of communication, and the timescales for the reporting of information, are a little lower than for retail clients.

Remaining as a retail client may mean that certain investment instruments are no longer available for use. As most of Gedling's investment instruments are straightforward cash deposits with banks and building societies, which are not expected to be affected, it is not anticipated that MiFID II will have a major impact on the Council, since remaining a retail client in these circumstances should cause no difficulty.

Money Market Funds **are** however covered by the new regulations and the CFO will complete the opt-up procedure if it is deemed prudent to continue with their use. Should Members approve the use of Property Funds, these too would be covered by the regulations and would necessitate an opt-up to be completed. Opt-ups will also be required to maintain the current relationships with the Council's treasury advisers (CAS) and brokers for the arrangement of temporary borrowing (ICAP).

Alternative Options

There are no alternative options in that this report is a requirement of the Council's Treasury Management Strategy Statement (TMSS). The Council does however have the option not to use Property Funds, and instead accept minimal returns on its investments.

Financial Implications

No specific financial implications are attributable to this report.

Appendices

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

Background Papers

None identified.

Recommendations

That:

1. Members note the report, together with the Treasury Activity Report 2017/18 for Quarter 2, at Appendix 1, and the Prudential and Treasury Indicator Monitoring 2017/18 for Quarter 2, at Appendix 3.

2. Members approve the amendment to the Treasury Management Strategy Statement (TMSS) for 2017/18, to add the use of Property Funds to the list of approved investment instruments referred to at 2.7(i) above, and refer the amendment to Full Council for approval as required by the regulations.

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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