Report to Cabinet

Subject: Prudential Code Indicator Monitoring 2017/18 and Quarterly Treasury Activity Report for Quarter ended 31 December 2017

Date: 1 February 2018

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 31 December 2017 and highlights compliance with the Council's policies.

Proposal

2.1 Economic update

UK - The UK economy grew strongly in 2016, however growth in 2017 has been disappointingly weak with quarters 1 and 2 returning only +0.3% each, meaning that growth in the first half of 2017 has been the slowest for the first half of any year since 2012. 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. Growth picked up in Q3 to 0.4% and there have been encouraging statistics from the manufacturing sector which is seeing strong growth as a result of increased demand for exports. 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. Growth in Q4 is again expected to be around 0.4%, making annual growth for 2017 approximately 1.7% to 1.8%.

The Monetary Policy Committee (MPC) meeting of 14 September 2017 surprised markets and forecasters by switching to a much more aggressive tone in its words, warning that Bank Rate will need to rise. Recent Bank of England Inflation Reports have flagged up that they expected CPI inflation to peak at just over 3% in late 2017, before falling back to near to its target rate of 2% in two years' time. Inflation actually came in at 3.1% in November. The reason why the MPC became so aggressive with its wording in September and November around increasing Bank Rate was due to an emerging view that with unemployment falling to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that the amount of spare capacity in the economy was significantly diminishing towards a point at which they now needed to take action. In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of increasing globalisation. This effectively means that the UK labour faces competition from overseas labour e.g. in outsourcing work to third world countries, 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 was therefore unsurprising that the MPC increased Bank Rate by 0.25% to 0.5% in November, however their forward guidance of two more increases of 0.25% by 2020 was viewed as being more “dovish” than markets had expected. Some forecasters are flagging up that they expect growth to improve significantly in 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 weaker services sector growth. If this scenario were to materialise, then the MPC would have added reason to embark on more than one increase in Bank Rate during 2018. While there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is too early to be confident about how the next two years will pan out.

EU - Economic growth in the EU, (the UK’s biggest trading partner), had been slow for several years after the financial crisis despite the European Central Bank (ECB) eventually cutting its main rate to -0.4% and embarking on a massive programme of quantitative easing (QE). However, growth picked up in 2016 and now looks to have gathered ongoing momentum thanks to this stimulus. GDP growth was 0.6% in Q1, 0.7% in Q2 and 0.6% in Q3. However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in November inflation was only 1.2%. It is therefore unlikely that rates will start to rise until towards the end of 2019.

USA - Growth in the American economy was volatile in 2015 and 2016 and 2017 has followed that path again, with Q1 coming in at only 1.2%, Q2 rebounding to 3.1% and Q3 coming in at 3.2%, the first time since 2014 that two successive quarters have been over 3%. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.1% in November, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started increasing rates, with four rises since December 2016 to lift the central rate to 1.50% and there could be four further increases in 2018. In October, the Fed became the first major western central bank to make a start on unwinding QE by phasing in a start to a gradual reduction of reinvesting maturing debt.

China - Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus and 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 - GDP growth has been gradually improving during 2017 to reach an annual figure of 2.1% in Q3. However, it is still struggling to get inflation anywhere near 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, Link Asset Services (formerly Capita), undertook its last review of interest rate forecasts on 7 November after the quarterly Bank of England Inflation Report and MPC meeting. As expected the MPC raised Bank Rate by 0.25% to 0.5% in November, and gave forward guidance that it expected only two further rises of 0.25% each over the next two years, to reach 1% by 2020. This is in line with previous guidance that Bank Rate would rise only gradually, and to a limited extent.

The overall balance of risk to economic recovery in the UK is currently to the downside due to uncertainties around Brexit, however those very uncertainties lead to a diversity of possible outcomes for economic growth and inflation, and correspondingly to the rate of increase in Bank Rate.

Link Asset Services (LAS) have provided the following forecast:

Link Asset Services Interest Rate View													
	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate	0.50%	0.50%	0.50%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%
5yr PWLB rate	1.60%	1.60%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%
10yr PWLB rate	2.20%	2.30%	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%
25yr PWLB rate	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%

2.3 Investment strategy

The Treasury Management Strategy Statement (TMSS) for 2017/18 was approved by Council on 1 March 2017. At Cabinet on 2 November, Members agreed an amendment to Appendix 3 of the 2017/18 TMSS to add the use of Property Funds to the list of approved investment instruments, and referred the amendment to Full Council for approval as required by the regulations. The change was subsequently approved by Full Council on 15 November 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 LAS creditworthiness methodology (see below) which includes consideration of sovereign ratings.

The investment counterparty limit for 2017/18 is generally £3m per counterparty as set out in the TMSS, however the CFO has delegated authority to vary this as appropriate and report the change to Cabinet as part of the next quarterly report. The £3m limit was exceeded by £90k on a single occasion during Q3 for operational reasons, and no change to the limit is needed.

During the period from 1 April to 31 December 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. Following the interest rate rise in November, the current rate of return on these funds is around 0.34%, and whilst this remains very low, it is generally higher than overnight treasury deposit rates and of the rate obtainable from the Debt Management Office (DMO).

Following approval for the use of Property Funds (see above), an investment of £1m was made in the CCLA Local Authority Property Fund (LAPF) on 1 December 2017. The LAPF 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. This investment has allowed the Council to introduce a property element into its investment portfolio without the risks associated with the direct purchase of assets. The main risk around Property Funds is the preservation of the capital sum, however evidence from recent years shows that over time the property market has been a positive long-term investment. It is accordingly anticipated that this investment will be held for at least five years to minimise any risk.

The property fund investment purchased a number of units, determined by the unit price on the entry date. This valued the initial investment of £1m at £936,000, setting the entry fee at £64,000, or 6.4%. As indicated above, the property fund investment is for the long-term, and it is expected that this will be recovered as the fund grows. The sum of £64,000 is included in the Q3 revenue budget monitoring report elsewhere on this agenda.

The Treasury Activity Report for the quarter ended 31 December 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 £37,228 was generated from MMF activity and term deposits with banks and building societies during the period from 1 April to 31 December 2017. This represents an overall equated rate for the Council of 0.42% and outperforms the benchmark 7 day LIBID rate, which averaged 0.16% for the same period. In cash terms

this represents additional income to the General Fund of around £23,000 and was achieved by positive investment management. Performance in respect of the longer 3 month LIBID rate, which averaged 0.23%, still represents additional income of £16,800.

Rates in the market remain low, and this is likely to continue following the UK's vote to leave the EU. As loans mature every effort is made to replace them at favourable rates, however security and liquidity will always be the overriding factors in the Council's treasury management. It is anticipated that the LAPF property fund investment will allow the final equated rate for 2017/18 to rise from the current level, however general 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 £50,000, an increase of £10,000 on the current approved estimate of £40,000 for 2017/18. The impact of this increase is included in the Q3 revenue budget monitoring report elsewhere on this agenda.

Credit ratings advice is taken from LAS and the Chief Financial Officer has adopted the LAS 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 LAS 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 LAS 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

Credit ratings are monitored weekly and the Council is also alerted to interim changes by its use of the LAS 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 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. Borrowing in advance of need purely to profit from the investment of the extra sums borrowed is however unlawful.

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 in line with the currently approved budget for 2017/18.

The Council has embarked 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 LAS 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 are also 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 LAS. No debt rescheduling has been undertaken during the period from 1 April to 31 December 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 31 December 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 £5,566,000. 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 £12,133,200. 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 15.17% shows an increase on the approved indicator of 11.00%. This is due to increased revenue contributions to capital expenditure and the entrance fee for the property fund, offset by reductions in MRP arising from the savings and slippage on the capital programme in 2016/17, a saving in PWLB interest as the planned new borrowing in 2016/17 was not undertaken, and additional investment interest.

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 31 December 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 31 December 2017, and demonstrates that all activities are contained within the currently approved limits.

2.7 Other Issues

i) Code of Practice Consultations

Consultations by the Chartered Institute of Public Finance and Accountancy, (CIPFA), have now ended, and revised editions of the Prudential Code and the Treasury Management Code and Cross Sectoral Guidance Notes were published in December. Changes, whilst not wide-ranging, will be applicable from 2018/19.

The most significant change in the revised Prudential Code is the introduction of an explicit requirement for the preparation of a Capital Strategy, to set out the long term context in which capital expenditure and investment decisions are made. The strategy must give due consideration to both risks and rewards, as well as any impact on the achievement of priority outcomes. The Council already produces a Capital Programme and Capital Investment Strategy and the document will be reviewed to ensure that any additional requirements of the revised Code are incorporated.

The revised Codes seem to acknowledge the drive for financial returns and the use of "non-treasury" related investment instruments (eg. property) but reiterate the need for risk management and "proportionality", ie. how much of the Council's resources can be put at risk.

The Department for Communities and Local Government (CLG) has also consulted on overlapping issues around investment guidance and Minimum Revenue Provision (MRP), and the outcome of this is awaited.

Iii) MiFID II

The Markets in Financial Instruments Directive (MiFID II) regulations came into effect on 3 January 2018 and will govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. Local authorities are now classed as "retail clients" unless they opt up to "professional status", done by the completion of a form for each individual institution (investment counterparties and advisers etc) 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.

As most of Gedling's investment instruments are straightforward cash deposits with banks and building societies, which are not 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. Most Money Market Funds and Property Funds **are** however covered by the new regulations and the CFO has completed the opt-up procedure to be recognised as a professional client where appropriate. Opt-ups have also been made to maintain current relationships with the Council's treasury advisers (LAS) 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).

Financial Implications

No specific financial implications are attributable to this report.

Appendices

1. Treasury Activity Report 2017/18 for Quarter 3 (31 December 2017)
2. Definitions of LIBOR and LIBID
3. Prudential and Treasury Indicator Monitoring 2017/18 for Quarter 3 (31 December 2017).

Background Papers

None identified.

Recommendation

That:

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

Reasons for Recommendation

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

For more information, please contact:

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