Northumberland County Council

AUDIT COMMITTEE

22 NOVEMBER 2017

Treasury Management Mid-Year Review Report for Period 01 April to 30 September 2017

Report of Alison Elsdon, Director of Corporate Resources

Cabinet Member: Councillor Nicholas Oliver – Portfolio Holder for Corporate Services

Purpose of the Report

This report provides a mid-year review of the activities of the Treasury Management function for the period 1 April 2017 to 30 September 2017, and performance against the Treasury Management Strategy Statement (TMSS) 2017-2018 - as approved by the County Council on 22 February 2017. The report provides a review of borrowing and investment performance for the period set in the context of the general economic conditions prevailing so far during the year. It also reviews specific Treasury Management prudential indicators defined by the (CIPFA) Treasury Management Code of Practice and CIPFA Prudential Code for Capital Finance in Local Authorities, (the Prudential Code), and approved by the Authority in the TMSS.

Recommendations

- Members receive the report and note the performance of the Treasury Management function from 01 April to 30 September 2017.
- Members recommend the report to County Council.

Link to the Corporate Plan

This report supports the Developing the Organisation (Innovation and Partnership) priority included in NCC's Corporate Plan 2013-2017.

Key Issues

The Local Government Act 2003 (the Act) and supporting Regulations require the Council to produce a mid-year review of treasury management activities and actual performance against prudential and treasury indicators. This report meets the requirements of both the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management Code of Practice, (the Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities, (the Prudential Code).

The report provides a review of the Treasury Management activities for the six month period from 1 April to 30 September 2017, and sets out performance against the Treasury Management Strategy Statement for 2017-18.

TREASURY MANAGEMENT MID-YEAR REVIEW REPORT FOR PERIOD 01 APRIL TO 30 SEPTEMBER 2017

1. INTRODUCTION

1.1. Background

This Treasury Management Mid-Year Report provides a review of the activities of the Treasury Management function for the period 1 April 2017 to 30 September 2017, and performance against the Treasury Management Strategy Statement (TMSS) for 2017-18. Its production and submission to Council is a requirement of the CIPFA Code of Practice on Treasury Management.

Treasury management is defined as:

"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

1.2. Statutory and Regulatory Requirements

The Local Government Act 2003 (the Act) and supporting Regulations requires the Council to produce an annual review of treasury management activities and the actual performance against prudential and treasury indicators. This report meets the requirements of both the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management Code of Practice, (the Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities, (the Prudential Code).

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is therefore, important as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

1.3. Basis and Content of Treasury Management Mid-Year Review Report for 2017-18

The report covers:

- Overview of the Treasury Management Strategy for the financial year 2017-18;
- Economic conditions and interest rates for period 1 April 2017 to 30 September 2017;
- Overview of the treasury position at 30 September 2017;
- Borrowing activity;
- Investment activity;
- Treasury management limits and prudential indicators position.

2. BACKGROUND - TREASURY MANAGEMENT STRATEGY FOR 2017-18

2.1. Overview of the 2017-18 Strategy

The expectation for interest rates within the Treasury Management Strategy Statement for 2017-18 was for UK Bank Rate (often referred to as Base Rate) to remain at 0.25%, and for only minimal increases in medium and longer term fixed borrowing rates in the latter half of the year. It was anticipated that throughout the period variable or short-term would be the cheapest form of borrowing, and that investment returns would remain very low and well below borrowing rates.

In these circumstances, the proposed strategy for 2017-18 was to postpone borrowing and wherever possible to use investment balances to repay maturing debt and fund capital expenditure; resulting in the Council operating an under-borrowing position. This practice would in turn avoid the cost of holding higher levels of investments and reduce counterparty risk.

Added to this, it was envisaged that a mixture of short term and long term loans would be taken to fund the remaining external borrowing requirement.

2.2. Compliance

The Section 151 Officer confirms that, throughout the period, all treasury activities have been conducted within the parameters and limits of the TMSS 2017-18, alongside best practice suggested by the CIPFA Treasury Management Code and Central Government.

3. ECONOMIC CONDITIONS AND INTEREST RATES FOR PERIOD 1 APRIL TO 30 SEPTEMBER 2017

3.1. Economy - At 5 October 2017

After unexpectedly strong growth in 2016, UK gross domestic product (GDP) has been disappointing low in 2017 at +0.3% for quarter 1 (+1.7% year-on-year) and again in quarter 2 (+1.5% year-on-year) – the slowest first half year growth since 2012. The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling following the EU referendum, feeding increases in the cost of imports. This has in turn caused a reduction in disposable income and led to a cut back in consumer spending.

Concerns over climbing inflation, and the impact this is having on consumer spending, has led the Bank of England's Monetary Policy Committee (MPC) to recently suggest that Bank Rate may need to rise sooner than previously thought. As a result it looks increasing likely that the MPC may raise bank rate to 0.5% in November 2017 or, if not, February 2018.

Further afield, economic growth in the EU now looks to have gathered strength, with EU GDP increasing by +0.6% (2.3% year-on-year) in quarter 2. In the USA growth has been volatile but rebounded in quarter 2 to an annualised figure of 2.1%, and its central bank, the Fed, is expected to continue with the interest rate increases it started in December 2016. The Fed's central rate is currently 1.25 – 1.5%.

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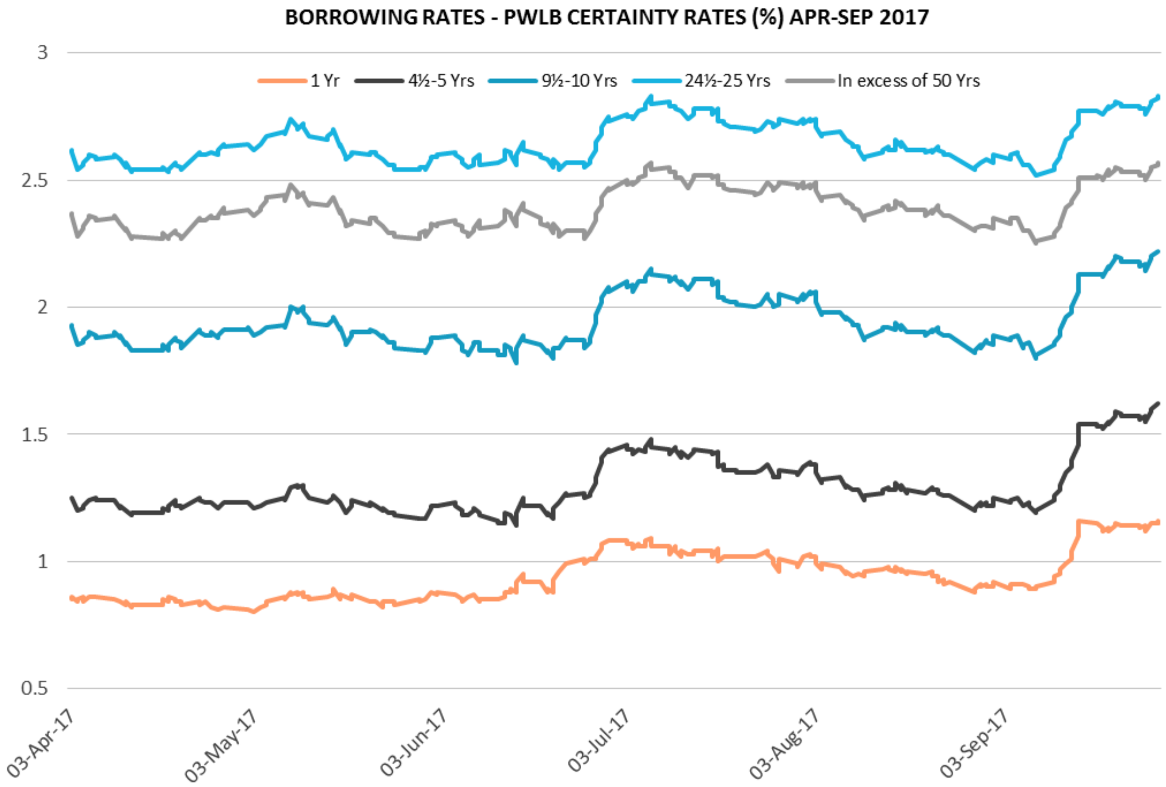
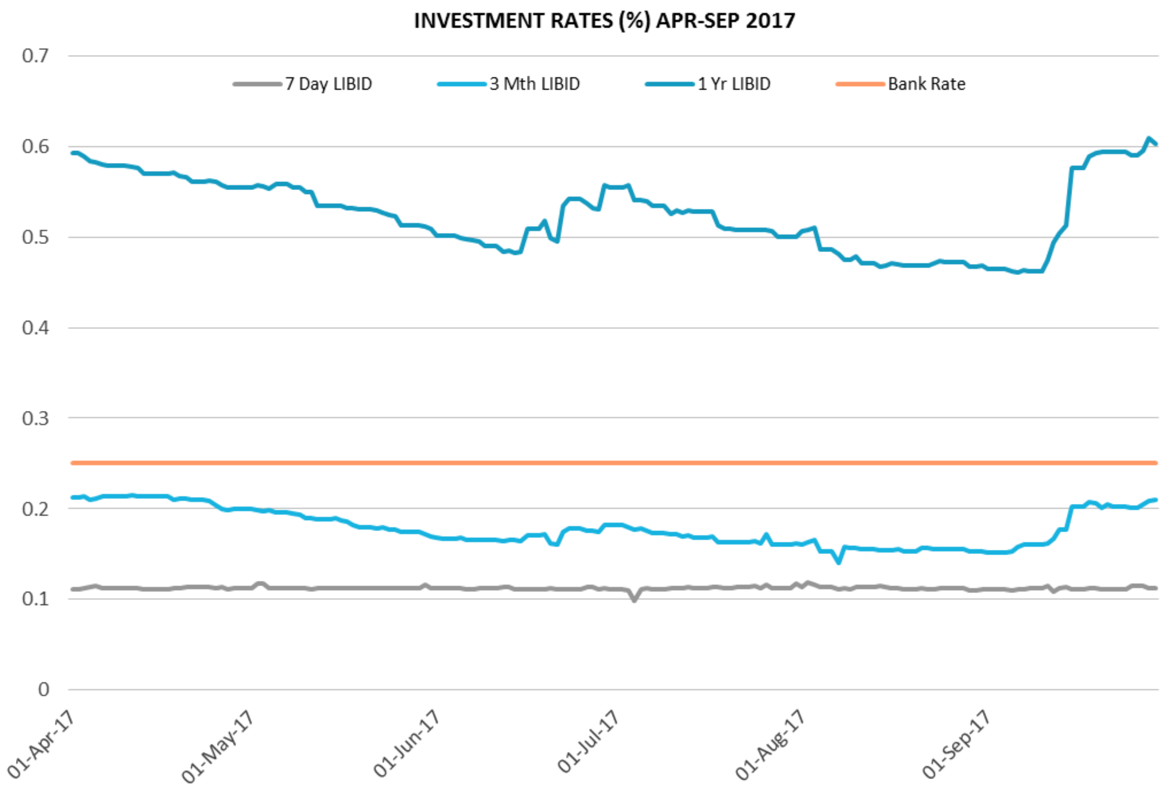
3.2. Actual Interest Rates 01 April to 30 September 2017

The following graphs show interest rate movements over the period, for various terms of borrowing and investment.





3.3. Forecast Interest Rates

The Council's treasury advisor, Capita Asset Services, interest forecast is shown below. It should however be noted that Capita last updated their forecast on 9 August (following the quarterly BoE inflation report) - i.e. before the last MPC meeting on 14 September when there appeared to be a change in sentiment and a suggestion of earlier increases in bank rate.

	Qtr 3 17-18 (Q/E Dec 2017)	Qtr 4 17-18 (Q/E Mar 2018)	Qtr 1 18-19 (Q/E Jun 2018)	Qtr 2 18-19 (Q/E Sep 2018)
Bank Rate	0.25%	0.25%	0.25%	0.25%
5yr PWLB	1.50%	1.60%	1.70%	1.70%
10yr PWLB	2.20%	2.30%	2.30%	2.40%
25yr PWLB	2.90%	2.90%	3.00%	3.00%
50yr PWLB	2.70%	2.70%	2.80%	2.80%

This was accompanied with the following comments:

"Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. A world economic recovery will likely see investors switching from the safe haven of bonds to equities.

We have pointed out consistently that the Fed. Rate is likely to go up more quickly and more strongly than Bank Rate in the UK. While there is normally a high degree of correlation between the two yields, we would expect to see a growing decoupling of yields between the two i.e. we would expect US yields to go up faster than UK yields. We will need to monitor this area closely and the resulting effect on PWLB rates.

The overall balance of risks to economic recovery in the UK remains to the downside, particularly with the current uncertainty over the final terms of Brexit.

The balance of risks to increases in Bank Rate and shorter term PWLB rates are to the upside and are dependent on how quickly inflation pressures rise and how high the peak will be.

Our forecasts are predicated on an assumption that there is no break-up of the Eurozone or EU, (apart from the departure of the UK), within our forecasting time period, despite the major challenges that are looming up, and that there are no major *ructions in international relations, especially between the US and China / North Korea, which have a major impact on international trade and world GDP growth."*

4. THE PORTFOLIO POSITION AT 31 MARCH 2017

4.1. Current Borrowing

The Council's debt at the beginning of the year and at 30 September 2017 is shown below:

TABLE 1: BORROWING	Total Principal 1 Apr 2017 £m	Weighted Average Rate %	Total Principal 30 Sep 2017 £m	Weighted Average Rate %
Public Works Loan Board Loans	268.92	3.43	269.66	3.40
LOBOs	189.50	4.06	209.50	3.90
Market / Local Authority (>1yr)*	248.10	1.78	312.10	1.60
Market / Local Authority (<1yr)*	55.00	0.49	35.00	0.51
Salix	0.09	0.00	0.08	0.00
TOTAL EXTERNAL BORROWING	**761.61**	**2.84**	**826.34**	**2.72**

* Note: above figures are based on the term of loans at their inception

4.2. Current Investments

The table below summarises the investment position at 30 September 2017:

TABLE 2: INVESTMENTS	Total Outstanding 1 Apr 2017 £m	Weighted Average Rate %	Total Outstanding 30 Sep 2017 £m	Weighted Average Rate %
Fixed Term Investments – Long Term (>1yr)*	103.25	2.60	33.25	3.24
Fixed Term Investments – Short Term (<1yr)*	0.00	0.00	148.00	0.37
Money Market Funds and Call Accounts	28.80	0.31	46.20	0.31
TOTAL INVESTMENTS (excl Cash)	**132.05**	**2.10**	**227.45**	**0.80**

* Note: above figures are based on the term of investments at their inception

5. BORROWING ACTIVITY 2017-18

As mentioned above, the Strategy for 2017-18 proposed maximising the use of the internal borrowing by wherever possible using investment balances to fund new capital expenditure or repay maturing debt. Despite this however, it still forecasts an increase in the external borrowing requirement over the next three years in excess of £675.00 million (including around £211.00 million for 2017-18) net of maturities -

based on the capital approved programme at that time. It was envisaged that new borrowing would be met by a mixture of short term and long term loans.

As shown in the above table, total external borrowing has increased by £64.37 million over the last 6 months, from £761.61 million at the start of year to £826.34 million at 30 September 2017. This is as a result of repaying maturing loans of £49.27 million and new / replacement borrowing of £114.00 million.

The new borrowing in the period was taken out in the early part of the year, when interest rates were low, to meet some of the identified new borrowing requirement for the year - as set out in the original capital programme and accompanying Treasury Management Strategy Statement. This comprised of 13 loans over a range of maturities - ranging from 2.5 to 55 years - with a combined weighted average term of 19.03 years and overall average interest rate of 1.48%. Three 'forward starting' loans, totalling £20 million, have also been agreed for later in the year / early 2018.

The overall weighted average rate of interest on all outstanding loans at 30 September 2017 was 2.72% - a reduction of 0.12% compared to start of the year average of 2.84%.

In light of the on-going review of the capital programme and potential reduction in levels of capital spend going forward, it may not be necessary to borrow again during the remainder of 2017-18.

It is projected there will be an overall saving of around £1.27 million against the original interest payable budget for 2017-18 of £23.66 million. This is primarily due to the forecast reduction in capital spending following the review of the capital programme, and therefore the borrowing need, for the year. The original budget was also based on a 'prudent' view of interest rates, allowing for rate increase risk, as well as an assumption that more of the borrowing would be taken over longer terms (and therefore at higher interest rates).

6. INVESTMENT ACTIVITY 2017-18

The Council's investment policy (as set out in the Treasury Management Strategy Statement for 2016-2017) is governed by the Communities and Local Government's Guidance on Local Government Investments ("the Guidance") and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies (Moody's, Fitch Group and Standard and Poor's), supplemented by additional market data, (such as rating outlooks, credit default swaps, bank share prices etc.).

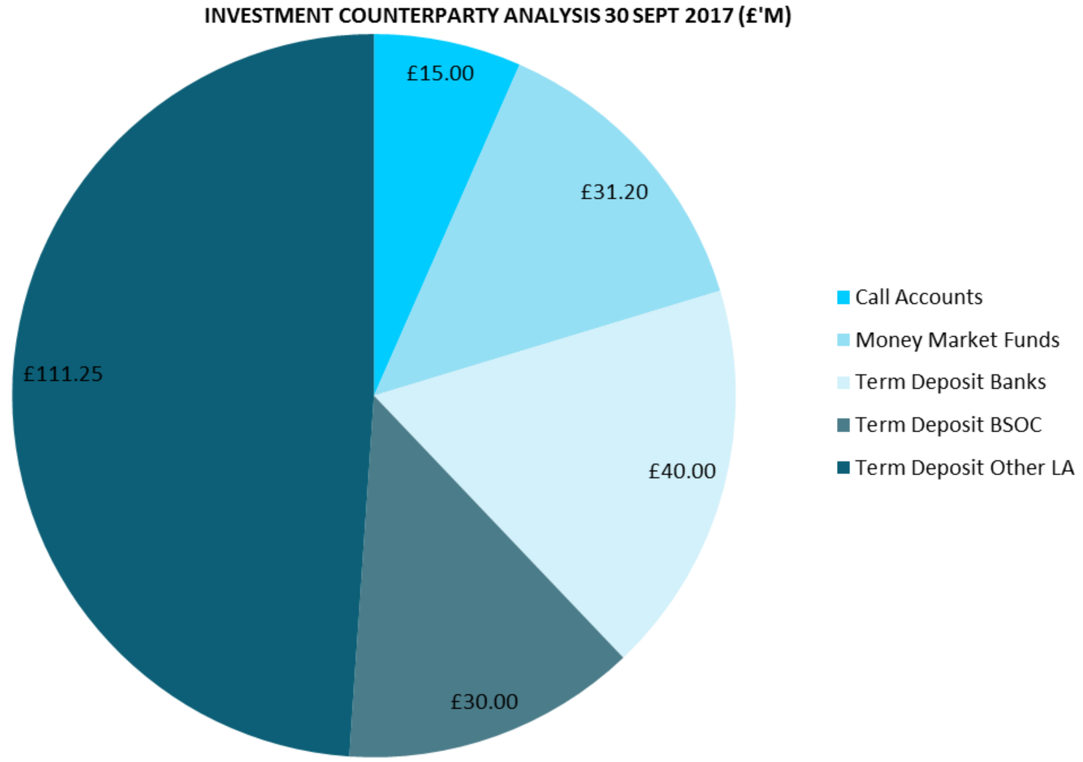
All investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

As identified above, the current policy is to use a significant proportion of available investment balances as 'internal borrowing' to support the financing of the Capital Financing Requirement (CFR).

Overall external investments (excluding cash) increased during the first 6 months of the year from £132.05 to £227.45 million. This is largely because the new borrowing taken to support capital spend will not be utilised until later in the year (and is therefore being invested in the meantime); with the balance relating to other cash flow variances (i.e. the timing differences between income coming in and expenditure being incurred).

Based on the forecast revised capital spend for the year following the review of the capital programme (contained in 7.1 below), investment balances are anticipated to reduce to around £80-90 million by 31 March 2018.

An analysis of the mid-year investment balance (excluding cash) by counterparty is shown in the following chart:



The internally managed funds earned an overall average rate of return of 1.04% during the first 6 months of 2017-18. This is largely due to the (longer term) investments with other LA's, but nonetheless compares favourably against the average London Interbank Bid Rate (LIBID) benchmark indicators of:

- 7 Day - 0.11%
- 3 Month - 0.18%
- 1 Year – 0.52%

The Council's budgeted investment return for 2017-18 is £1.65 million (excluding interest of loans to thirds parties). Based on the current position and forecasts for the remainder of the year, the year-end performance is estimated to be around £0.28 million ahead of budget - at £1.93 million.

The improved performance is mainly due to the higher than estimated level of balances – see earlier comments.

The above figures are exclusive of interest received on loans to third parties, such as the facilities to Arch and Northumbria Healthcare Trust etc. These loans are made for policy / service reasons, as opposed to day-to-day treasury undertakings in relation to the investment of cash flows, and as a result are not technically classed as a treasury management activity.

7. PRUDENTIAL INDICATORS AND TREASURY LIMITS 2017-18

The Prudential Code has been developed by CIPFA. The Code has a central role in capital finance decisions, including borrowing for capital investment. Its key objectives are to provide a framework for local authority finance that will ensure individual authorities' capital expenditure plans are affordable; all external borrowing is within prudent and sustainable levels; and, that treasury management decisions are taken in accordance with good professional practice.

Performance against the approved prudential indicators, as set out in the 2017-18 Treasury Management Strategy Statement, is outlined below. None of the indicators have been exceeded during the year to 30 September 2017.

7.1. Capital Expenditure

This table shows the original approved capital programme (as agreed as part of the MTFP), current expenditure and forecast outturn for the year.

Capital Expenditure	2017-18 Original Estimate £m	Position 30 Sept 2017 £m	2017-18 Forecast Outturn £m
Arch	12.92	4.50	4.49
Finance (Corporate Resources)	160.95	13.88	25.95
IT	8.28	1.16	5.05
Leisure Services / Active Northumberland	12.34	0.04	0.60
Regeneration	1.58	0.26	1.33
Property Services	3.56	0.35	1.05
Strategic Estates	21.38	1.10	2.26
Renewable Energy	7.26	0.37	1.69
Fire and Rescue	1.52	0.14	0.86
Neighbourhood Services	6.54	1.32	3.27
Technical Services (Local Services)	72.72	20.69	43.15
Housing – GF	0.01	0.00	0.39
Housing – HRA	10.39	2.49	9.40
Planning and Development	7.60	0.00	0.25

Capital Expenditure	2017-18 Original Estimate £m	Position 30 Sept 2017 £m	2017-18 Forecast Outturn £m
Adult Services	2.22	0.89	2.37
Schools	52.20	9.42	17.35
TOTAL EXPENDITURE	**381.47**	**56.61**	**119.46**

7.2. Authorised Limit and Operational Boundary

The authorised limit - is the “affordable borrowing limit” required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level.

The operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

The table below demonstrates that during 2017-18 the Council has maintained gross borrowing within its authorised limit.

	Authorised Limit for External Debt £m	Operational Boundary for External Debt £m	Actual 30 September 2017 £m
Borrowing	1,348.68	1,123.90	826.34
Other Long Term Liabilities (PFI)	84.78	70.65	75.36
TOTAL EXTERNAL DEBT	**1,433.46**	**1,194.55**	**901.70**

7.3. Limits to Borrowing Activity

One of the key controls over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of Capital Financing Requirement (“CFR”) [i.e. the underlying need to borrow] in the preceding year plus the estimates of any additional CFR for 2017-18 and next two financial years.

CFR vs Borrowing	2017-18 Original Estimate £m	Position 30 Sept 2017 £m	2017-18 Forecast Outturn £m
Borrowing	947.06	826.34	742.06
Other Long Term Liabilities (PFI)	70.65	75.36	72.20
TOTAL EXTERNAL DEBT	**1,017.71**	**901.70**	**814.26**
CFR	**1,085.52**	**N/A**	**943.56**

The Director of Corporate Resources reports that no difficulties are envisaged for the current or future years in complying with this indicator.

The purpose of following limit is to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates.

Interest Rate Exposure	Limit for 2017-2018	Actual ?30 Sep 2017
Fixed Rate Exposure	0% - 100%	86.49%
Variable Rate Exposure	0% - 50%	13.51%

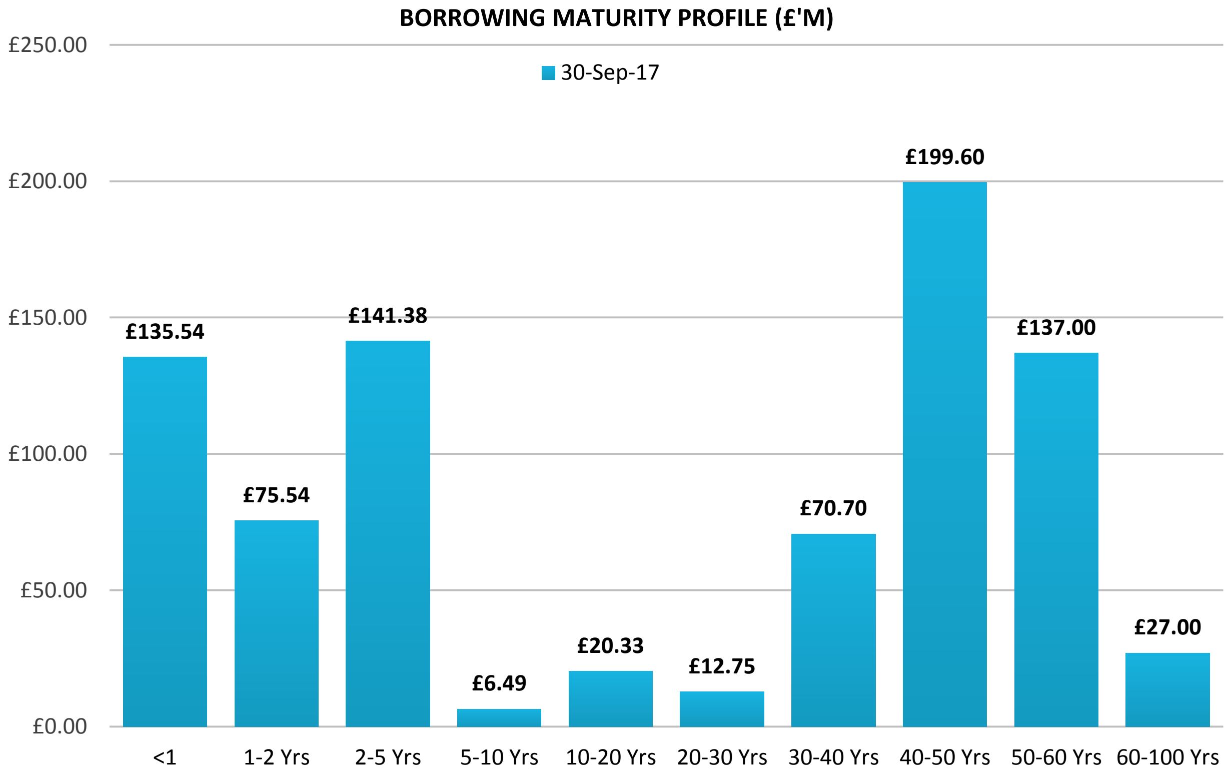
Lender option, borrower option loans (LOBOs) callable within 12 months are classed as variable; if the rate is fixed for a longer period they are classed as fixed. At 30 September 2017 the total of variable rate loans was £110.00 million and is within the set limit.

7.4. Maturity Structure of Borrowing

Measuring maturity structure of borrowing ensures a reasonable spread of maturing debt as a safety mechanism to ensure significant amounts of debt do not mature at a time when interest rates for refinancing the debt may be high.

Maturity Structure	Upper Limit for 2017-2018	Actual 30 Sep 2017
Under 12 months	25%	16%
1 year - 2 years	40%	26%
2 years within 5 years	60%	43%
5 years within 10 years	80%	43%
10 years and above	100%	100%

The following graph shows maturity of loans by monetary value. LOBOs are shown as held to maturity. In the current climate it is not envisaged that loans would be called for repayment within the next 12 months, as rates are so low.



7.5. Investments for periods longer than 365 days

These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

	Limit 2017-2018 £m	Actual Highest £m	Actual 30 Sept 2017 £m
Principal sums invested > 364 days	120.00	33.25	33.25

Implications

Policy	The report provides a half-year review of the Treasury Management activities for 2017-18, and sets out performance against the Treasury Management Strategy Statement for 2017-18. It is consistent with the priorities in the Corporate Plan 2013-2017: Developing the Organisation (Innovation and Partnership).
Finance and value for money	The financial implications of the 2017-18 investment and borrowing transactions have been taken into account within the revenue budget for 2017-18. Northumberland County Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving best value in treasury management within the context of effective risk management, and to employing suitable performance measurement techniques, for example comparison with other members of the CIPFA and Capita benchmarking clubs.
Legal	Under Section 1 of the Local Government Act 2003 (the Act) the Council may borrow money for any purpose relevant to its functions under any enactment, or for the purpose of the prudent management of its financial affairs. The Act and supporting regulations also requires the Council to 'have regard to' the Chartered Institute of Public Finance and Accountancy (CIPFA) Prudential Code and the CIPFA Treasury Management Code of Practice (which were adopted by Northumberland County Council in February 2010).
Procurement	There are no direct procurement implications for the County Council.
Human Resources	There are no direct staffing implications for the County Council.
Property	There are no direct property implications for the County Council.
Equalities (Impact Assessment attached) Yes ☐ No ☐ N/A ☐	Not applicable for the County Council.

Risk Assessment	The report highlights the principal financial risks within the Treasury Management function. The identification, monitoring and control of risk are the prime criteria by which the effectiveness of the County Council's Treasury Management activities will be measured. Accordingly, the analysis and reporting of Treasury Management activities will focus on their risk implications for the Council. The investment priority is security and liquidity rather than yield, which is a secondary aim.
Crime & Disorder	There are no Crime and Disorder implications for the County Council.
Customer Consideration	There are no Customer Considerations for the County Council.
Carbon reduction	None.
Wards	All divisions.

Background Papers:

Treasury Management Strategy Statement for 2017-2018.
CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance notes (revised 2011).
CIPFA Prudential Code for Capital Finance in Local Authorities.
Guidance on Local Government Investments The Local Government Act 2003.
Local Authorities (Capital Finance and Accounting) Regulations 2012 (S.I.2012/265).

Report sign off:

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Portfolio Holder	Nicholas Oliver

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