TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY – MID YEAR REVIEW REPORT 2016/17

Meeting	**Governance and Audit Committee – 7 Dec 2016**
Report Author	**Tim Willis, Director of Corporate Resources & Section 151 Officer**
Portfolio Holder	**Councillor John Townend, Portfolio Holder for Financial Services and Estates**
Status	**For Decision**
Classification:	**Unrestricted**
Key Decision	**No**

Executive Summary:

This report summarises treasury management activity and prudential/treasury indicators for the first half of 2016/17.

Recommendation(s):

That the Governance and Audit Committee:

- Approves this report and the prudential and treasury indicators that are shown.
- Recommends this report to Cabinet.

CORPORATE IMPLICATIONS	
Financial and Value for Money	The financial implications are highlighted in this report.
Legal	Section 151 of the 1972 Local Government Act requires a suitably qualified named officer to keep control of the Council's finances. For this Council, this is the Director of Corporate Resources, Tim Willis, and this report is helping to carry out that function.
Corporate	Failure to undertake this process will impact on the Council's compliance with the Treasury Management Code of Practice.
Equalities Act 2010 & Public Sector Equality Duty	There are no equity and equalities implications arising directly from this report, but the Council needs to retain a strong focus and understanding on issues of diversity amongst the local community and ensure service delivery matches these.

	It is important to be aware of the Council's responsibility under the Public Sector Equality Duty (PSED) and show evidence that due consideration had been given to the equalities impact that may be brought upon communities by the decisions made by Council.

CORPORATE PRIORITIES (tick those relevant)✓	
A clean and welcoming Environment	
Promoting inward investment and job creation	
Supporting neighbourhoods	

CORPORATE VALUES (tick those relevant)✓	
Delivering value for money	✓
Supporting the Workforce	
Promoting open communications	

1 Introduction and Background

1.1 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

1.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

1.3 Accordingly 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."

1.4 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) was adopted by this Council on 24 April 2014.

1.5 The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the full Council of an annual Treasury Management Strategy Statement (including the Annual Investment Strategy and Minimum Revenue Provision Policy) for the year ahead, a **Mid-year Review Report** and an Annual Report (stewardship report) covering activities during the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Governance and Audit Committee.

1.6 This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first half of the 2016/17 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure (prudential indicators);
- A review of the Council's investment portfolio for 2016/17;
- A review of the Council's borrowing strategy for 2016/17;
- A review of any debt rescheduling undertaken during 2016/17;
- A review of compliance with Treasury and Prudential Limits for 2016/17.

1.7 There have not been any key changes to the Treasury and Capital Strategies during the first half of 2016/17.

2 Capita's Interest rate forecasts (issued by Capita on 5 October 2016)

2.1 The Council's treasury advisor, Capita Asset Services (Capita), has provided the following forecast:

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Bank rate	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.25%	0.25%	0.25%	0.25%	0.50%
5yr PWLB rate	1.00%	1.00%	1.10%	1.10%	1.10%	1.10%	1.20%	1.20%	1.20%	1.20%	1.30%
10yr PWLB rate	1.50%	1.50%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.70%	1.80%
25yr PWLB rate	2.30%	2.30%	2.40%	2.40%	2.40%	2.40%	2.50%	2.50%	2.50%	2.50%	2.60%
50yr PWLB rate	2.10%	2.10%	2.20%	2.20%	2.20%	2.20%	2.30%	2.30%	2.30%	2.30%	2.40%

2.2 Capita undertook a quarterly review of its interest rate forecasts after the MPC meeting of 4th August cut Bank Rate to 0.25% and gave forward guidance that it expected to cut Bank Rate again to near zero before the year end. The above forecast therefore includes a further cut to 0.10% in November this year and a first increase in May 2018, to 0.25%, but no further increase to 0.50% until a year later. Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual after they do start. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when the growth in average disposable income is still weak and could well turn negative when inflation rises during the next two years to exceed average pay increases.

2.3 The overall longer run trend is for gilt yields and Public Works Loan Board (PWLB) rates to rise, albeit gently. An eventual world economic recovery may also see investors switching from the safe haven of bonds to equities. However, we have been experiencing exceptional levels of volatility in financial markets which have caused significant swings in PWLB rates. Our PWLB rate forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

2.4 The overall balance of risks to economic recovery in the UK remains to the downside. Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Monetary policy action reaching its limit of effectiveness and failing to stimulate significant sustainable growth, combat the threat of deflation and reduce high levels of debt in some major developed economies, combined with a lack of adequate action from national governments to promote growth through structural reforms, fiscal policy and investment expenditure.
- Weak capitalisation of some European banks.
- A resurgence of the Eurozone sovereign debt crisis.
- Geopolitical risks in Europe, the Middle East and Asia, increasing safe haven flows.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or Fed. rate increases, causing a further flight to safe havens (bonds).
- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.

2.5 The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include:

- The pace and timing of increases in the Fed. funds rate 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 than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

3 Treasury Management Strategy Statement and Annual Investment Strategy Update

3.1 The Treasury Management Strategy Statement (TMSS) for 2016/17, which includes the Annual Investment Strategy, was approved by the Council on 4 February 2016. There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

3.2 The Section 151 Officer can confirm that the approved limits within the Annual Investment Strategy were not breached during the six months ended 30th September 2016.

4 The Council's Capital Position (Prudential Indicators)

4.1 This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

4.2 Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

The revised estimate includes carry-forward from the previous year of £8.941m General Fund and £11.640m HRA.

Capital Expenditure	2016/17 Original Estimate £m	Current Position – Actual at 30/09/16 £m	2016/17 Revised Estimate £m
General Fund	4.332	2.238	12.311
HRA	11.450	1.498	22.177
Total	**15.782**	**3.736**	**34.488**

4.3 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	2016/17 Original Estimate £m Total	Current Position – Actual at 30/9/16 £m	2016/17 Revised Estimate £m GF	2016/17 Revised Estimate £m HRA	2016/17 Revised Estimate £m Total
Total spend	15.782	3.736	12.311	22.177	34.488
Financed by:					
Capital receipts	1.995		3.356	0.736	4.092
Capital grants	2.012		5.691	3.297	8.988
Capital reserves	4.739		0.081	8.717	8.798
Revenue	1.522		0.143	2.191	2.334
Total financing	10.268		9.271	14.941	24.212
Borrowing need	**5.514**		**3.040**	**7.236**	**10.276**

4.4 Changes to the Prudential Indicators for the Capital Financing Requirement, External Debt and the Operational Boundary

The table shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period, which is termed the Operational Boundary.

Prudential Indicator – Capital Financing Requirement

We are on target to achieve the forecast Capital Financing Requirement.

Prudential Indicator – the Operational Boundary for external debt

	2016/17 Original Estimate £m	Current Position – Actual at 30/9/16 £m	2016/17 Revised Estimate £m
Prudential Indicator – Capital Financing Requirement			
CFR – non housing	28.856		29.189
CFR – housing	27.282		27.477
Total CFR	56.138		56.666
Net movement in CFR	**8.831**		**9.358**
Prudential Indicator – the Operational Boundary for external debt			
Borrowing	46.000	31.980	46.000
Other long term liabilities*	12.000	3.485	12.000
Total debt	**58.000**	**35.465**	**58.000**

** On balance sheet PFI schemes and finance leases etc (including the leisure centre deferred credit). Excludes the amount owed to KCC for the Westwood spine road construction as classified as a current liability.*

4.5 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, borrowing will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2016/17 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2016/17 Original Estimate £m	Current Position – Actual at 30/09/16 £m	2016/17 Revised Estimate £m
Gross borrowing	40.602	31.980	40.434
Plus other long term liabilities*	3.579	3.485	3.315
Total gross borrowing	44.181	35.465	43.749
CFR (year end position)	56.138		56.666

** On balance sheet PFI schemes and finance leases etc (including the leisure centre deferred credit). Excludes the amount owed to KCC for the Westwood spine road construction as classified as a current liability.*

The Section 151 Officer reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Authorised limit for external debt	2016/17 Original Indicator £m	Current Position – Actual at 30/09/16 £m	2016/17 Revised Indicator £m
Borrowing	51.000	31.980	51.000
Other long term liabilities*	15.000	3.485	15.000
Total	66.000	35.465	66.000

** On balance sheet PFI schemes and finance leases etc (including the leisure centre deferred credit). Excludes the amount owed to KCC for the Westwood spine road construction as classified as a current liability.*

5 Investment Portfolio 2015/16

5.1 In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As set out in Section 3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the current 0.25% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, together with other risks which could impact on the creditworthiness of banks, prompts a low risk strategy. Given this risk environment, investment returns are likely to remain low.

5.2 The Council held £43.782m of investments as at 30 September 2016 (£28.612m at 31 March 2016) and the investment portfolio yield for the first six months of the year is 0.59% against a benchmark (average 7-day LIBID rate) of 0.28%. The constituent investments are:

Sector	Country	Up to 1 year £m	1 year – 370 days £m	Total £m
Banks	UK	13.758	0.000	13.758
Banks	Sweden	3.976	0.000	3.976
Money Market Funds	UK	26.048	0.000	26.048
Total		**43.782**	**0.000**	**43.782**

5.3 The Section 151 Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2016/17.

5.4 The Council's budgeted investment return for 2016/17 is £0.165m and performance for the first half of the financial year is above budget at £0.117m.

5.5 Investment Risk Benchmarking

Investment risk benchmarks were set in the 2016/17 Treasury Management Strategy Statement (TMSS) for security, liquidity and yield. The mid-year position against these benchmarks is given below.

5.5.1 Security

The Council's maximum security risk benchmark for the current portfolio, when compared to historic default tables, is:

- 0.05% historic risk of default when compared to the whole portfolio.

The security benchmark for each individual period is:

	370 days	2 years	3 years	4 years	5 years
Maximum	**0.05%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**

Note: This benchmark is an average risk of default measure, and would not constitute an expectation of loss against a particular investment.

The Section 151 Officer can report that the investment portfolio was maintained within this overall benchmark for the first half of this financial year.

5.5.2 Liquidity

In respect of this area the Council seeks to maintain:

- Bank overdraft - £0.5m
- Liquid short term deposits of at least £10m available with a week's notice.
- Weighted Average Life benchmark is expected to be 0.5 years, with a maximum of 1.0 year.

The Section 151 Officer can report that liquidity arrangements were adequate for the first half of this financial year.

This authority does not currently place investments for more than 370 days due to the credit, security and counterparty risks of placing such investments.

5.5.3 Yield

Local measures of yield benchmarks are:

- Investments – Internal returns above the 7 day LIBID rate

The Section 151 Officer can report that the yield on deposits for the first half of the financial year is 0.59% against a benchmark (average 7-day LIBID rate) of 0.28%.

5.6 Investment Counterparty criteria

The current investment counterparty criteria selection approved in the revised TMSS is meeting the requirement of the treasury management function.

6 Borrowing

6.1 The Council's capital financing requirement (CFR) original estimate for 2016/17 is £56.138m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. The Council has borrowings of £31.980m (table 4.5) and has utilised an estimated £24.158m of cash flow funds in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

6.2 Due to the overall financial position and the underlying need to borrow for capital purposes (the capital financing requirement – CFR), new external borrowing of £3.000m was undertaken from the PWLB during the first half of the financial year, as below.

- £2.000m loan for 22.5 years at a fixed interest rate of 3.09%, repayable at maturity.
- £1.000m loan for 7 years at a fixed interest rate of 1.28%, repayable by equal instalments of principal over the life of the loan.

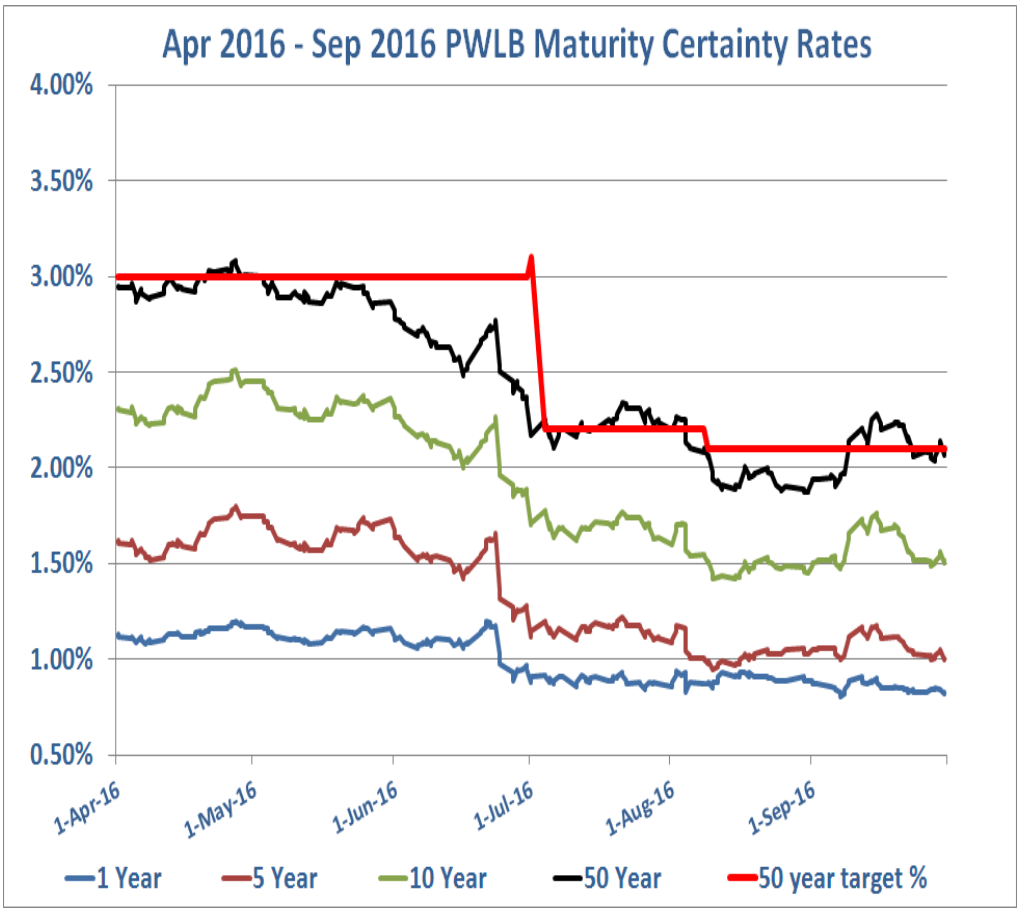
6.3 As shown in the graph below, the general trend to date has been a sharp fall in interest rates in the current financial year.

6.4 Borrowing may be undertaken during the second half of this financial year and options will be reviewed in due course in line with market conditions.

6.5 The graph and table below show the movement in PWLB certainty rates for the first six months of the year to 30 September 2016.

6.6 PWLB certainty rates, half year ended 30th September 2016

	1 Year	5 Year	10 Year	25 Year	50 Year
1/4/16	1.13%	1.62%	2.31%	3.14%	2.95%
30/9/16	0.83%	1.01%	1.52%	2.27%	2.10%
Low	0.81%	0.95%	1.42%	2.08%	1.87%
Date	07/09/2016	10/08/2016	10/08/2016	12/08/2016	30/08/2016
High	1.20%	1.80%	2.51%	3.28%	3.08%
Date	27/04/2016	27/04/2016	27/04/2016	27/04/2016	27/04/2016
Average	0.99%	1.33%	1.92%	2.69%	2.46%



6.7 Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. During the first six months of the year, no debt rescheduling was undertaken. The Council is currently under-borrowed to address investment counterparty risk and the differential between borrowing and investment interest rates. This position is carefully monitored.

6.8 The Council's budgeted debt interest payable for 2016/17 is £1.654m and performance for the first half of the financial year is below budget at £0.583m.

7 Treasury Management Indicators

7.1 Ratio of financing costs to net revenue stream

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

%	2016/17 Original Indicator	2016/17 Revised Indicator
Non-HRA	10.2%	6.9%
HRA	8.3%	8.3%

7.2 **Upper Limits on Variable Rate Exposure** – This identifies a maximum limit for variable interest rates based upon the debt position net of investments.

Upper Limits on Fixed Rate Exposure – Similar to the previous indicator, this covers a maximum limit on fixed interest rates.

Both of these are shown in the below table:

	2016/17 Original Indicator £m	Current Position – Actual at 30/09/16 £m	2016/17 Revised Indicator £m
Upper limits on fixed interest rates			
Debt only	66.000	31.980	66.000
Investments only	45.000	11.789	45.000
Upper limits on variable interest rates			
Debt only	66.000	0.000	66.000
Investments only	50.000	31.993	50.000

7.3 **Maturity Structures of Borrowing**

These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing.

	2016/17 Original Upper Limit	Current Position – Actual at 30/09/16	2016/17 Revised Upper Limit
Maturity structure of fixed rate borrowing			
Under 12 months	50%	16%	50%
1 year to under 2 years	50%	2%	50%
2 years to under 5 years	50%	32%	50%
5 years to under 10 years	55%	11%	55%
10 years to under 20 years	50%	21%	50%
20 years to under 30 years	50%	9%	50%
30 years to under 40 years	50%	6%	50%
40 years to under 50 years	50%	3%	50%
50 years and above	50%	0%	50%

The current position shows the actual percentage of fixed rate debt the authority has within each maturity span. None of the upper limits have been breached.

8 **Options**

8.1 The recommended option (to ensure regulatory compliance as set out in section 1 of this report) is that the Governance and Audit Committee:

- Approves this report and the prudential and treasury indicators that are shown.
- Recommends this report to Cabinet.

8.2 Alternatively, the Governance and Audit Committee may decide not to do this and advise the reason(s) why.

9 Next Steps

9.1 This report is to go to Cabinet and then Council for approval. The next Cabinet meeting is on 17 January 2017.

10 Disclaimer

10.1 This report (including annexes) is a technical document focussing on public sector investments and borrowings and, as such, readers should not use the information contained within the report to inform personal investment or borrowing decisions. Neither Thanet District Council nor any of its officers or employees makes any representation or warranty, express or implied, as to the accuracy or completeness of the information contained herein (such information being subject to change without notice) and shall not be in any way responsible or liable for the contents hereof and no reliance should be placed on the accuracy, fairness or completeness of the information contained in this document. Any opinions, forecasts or estimates herein constitute a judgement and there can be no assurance that they will be consistent with future results or events. No person accepts any liability whatsoever for any loss howsoever arising from any use of this document or its contents or otherwise in connection therewith.

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Annex List

Annex 1	Economic Update and Debt Maturity
Annex 2	Guidance on the Treasury Management Strategy Statement and Annual Investment Strategy – Mid Year Review Report 2016/17

Corporate Consultation Undertaken

Finance	Peter Timmins, Interim Head of Financial Services
Legal	Tim Howes, Director of Corporate Governance & Monitoring Officer