East Lothian Council

REPORT TO: Audit and Governance Committee

MEETING DATE: 28 November 2017

BY: Depute Chief Executive (Resources and Peoples Services)

SUBJECT: Treasury Management Strategy Statement and Annual Investment Strategy – Mid Year Review 2017/18

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1 PURPOSE

1.1 To update the Committee on Treasury Management activity during the first half of 2017/18.

2 RECOMMENDATIONS

2.1 The Committee are asked to note the content of the report.

3 BACKGROUND

3.1 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 potentially being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

3.2 A further important 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 obligations. 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.

3.3 Accordingly, treasury management can be 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."

3.4 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) has been adopted by the Council.

3.5 The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. Receipt by the full council of an annual Treasury Management Strategy Statement - including the annual Investment Strategy for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.
4. Delegation by the Council of responsibilities to the Chief Finance Officer (Head of Council Resources) for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
5. 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 Audit and Governance Committee:

3.6 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 part of the 2017/18 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 2017/18;
- A review of the Council's borrowing strategy for 2017/18;
- A review of any debt rescheduling undertaken during 2017/18;
- A review of compliance with Treasury and Prudential Limits for 2017/18.

Economics and interest rates update (provided directly by the Council's appointed Treasury Advisors, Capita Asset Services)

3.7 After the UK economy surprised on the upside with strong growth in 2016, growth in 2017 has been disappointingly weak; quarter 1 came in at only +0.3% (+1.7% y/y) and quarter 2 was +0.3% (+1.5% y/y) which meant that growth in the first half of 2017 was the slowest for the first half of any year since 2012. The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 75% of GDP, has seen weak growth as consumers cut back on their expenditure. However, more recently there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly 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, this sector only accounts for around 11% of GDP so expansion in this sector will have a much more muted effect on the average total GDP growth figure for the UK economy as a whole.

3.8 The Monetary Policy Committee (MPC) meeting of 14 September 2017 surprised markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise. The Bank of England Inflation Reports during 2017 have clearly flagged up that they expect CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years' time. Inflation actually came in at 2.9% in August, (this data was released on 12 September), and so the Bank revised its forecast for the peak to over 3% at the 14 September meeting MPC.

3.9 On the 2nd November the MPC increased the Bank Rate to 0.5%. The big question now is whether this will be a one off increase or the start of a slow, but regular, increase in Bank Rate. While there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two years will pan out.

3.10 Following the increase in Bank Rate the Council's treasury advisor, Capita Asset Services, provided the following updated forecast:

Table 3.1

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	0.75%	0.75%	0.75%	1.00%
5yr PWLB rate	1.50%	1.60%	1.60%	1.70%	1.80%	1.80%	1.90%	1.90%	1.50%	1.50%
10yr PWLB rate	2.10%	2.20%	2.30%	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%
25yr PWLB rate	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%
50yr PWLB rate	2.50%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%

Treasury Management Strategy Statement and Annual Investment Strategy update:

3.11 The Treasury Management Strategy Statement (TMSS) for 2017/18 was approved by this Council on 28th March 2017.

3.12 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.

Table 3.2

Prudential Indicator 2017/18	***Approved £m***	***Current Estimated Prudential Indicator £m***
Authorised Limit	£478	£468
Operational Boundary	£447	£438
Capital Financing Requirement	£407	£398

The Council's Capital Position (Prudential Indicators)

3.13 This part of the report provides an update on:

- 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.

Prudential Indicator for Capital Expenditure

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

Table 3.3

Capital Expenditure by Service	**2017/18 Approved Limits £m**	**2017/18 Revised Estimate £m**
General Services	£48	£39*
HRA	£23	£23
Total capital expenditure	**£71**	**£62**

**Re-profiled General Services Capital Budget presented to Cabinet 14th November 17.*

Changes to the Financing of the Capital Programme

3.15 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. This external borrowing need may also have additional increases due to maturing debt and other treasury requirements.

Table 3.4

Capital Expenditure	**2017/18 Original Estimate £m**	**Current Position £m**
Total capital expenditure	**£71**	**£62***
Financed by:		
Capital receipts	£26	£17
Capital grants	£15	£16
Capital reserves		
Revenue	£2	£3
Total financing	**£43**	**£36**
Borrowing requirement	**£28**	**£26**

**Re-profiled General Services Capital Budget presented to Cabinet 14th November 17.*

<u>Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary</u>

3.16 The table below 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.

Table 3.5

	2017/18 Approved Limits £m	**2017/18 Revised Estimate £m**
Prudential Indicator – Capital Financing Requirement		
CFR – non housing	£223	£219
CFR – housing	£184	£179
Total CFR	£407	£398
Net movement in CFR	**£13**	£11
Prudential Indicator – the Operational Boundary for external debt		
Borrowing	£407	£398
Other long term liabilities*	£40	£40
Total debt (yearend position)	**£447**	£438

** On balance sheet PFI/PPP schemes and finance leases etc.*

Limits to Borrowing Activity

3.17 The first key control 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 CFR in the preceding year plus the estimates of any additional CFR for 2017/18 and next two financial years. This allows some flexibility for limited early borrowing for future years.

Table 3.6

	2017/18 Original Estimate £m	**2017/18 Revised Estimate £m**
Borrowing	£367	£362
Other long term liabilities*	£40	£40
Total external debt	£407	£402
CFR* (year end position)	£447	£438

** Includes on balance sheet PFI/PPP schemes and finance leases etc.*

3.18 The Head of Council Resources reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

3.19 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 in Scotland Act 2003.

Table 3.7

Authorised limit for external debt	**2017/18 Approved Limit £m**	**Current Position £m**
Borrowing	438	428
Other long term liabilities*	40	40
Total	478	468

** Includes on balance sheet PFI/PPP schemes and finance leases etc.*

Investment Portfolio 2017/18

3.20 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 shown by forecasts in section

3.2, 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, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

3.21 Investment decisions during the first 6 months of 2017/18 were taken in accordance with the approved strategy. There were no new investments during the period and surplus cash balances were held in the Council's bank account, East Lothian Council Common Good funds and Charitable Trust funds are managed in two separate portfolios by an external investment management company, Investec. At 30th September 2017, the East Lothian Charitable Trust portfolio was valued at £3.361m, which represents an increase of £0.072m over the 6 month period. The Common Good portfolio was valued at £3.445m which represents an increase of £0.082m over the 6 month period.

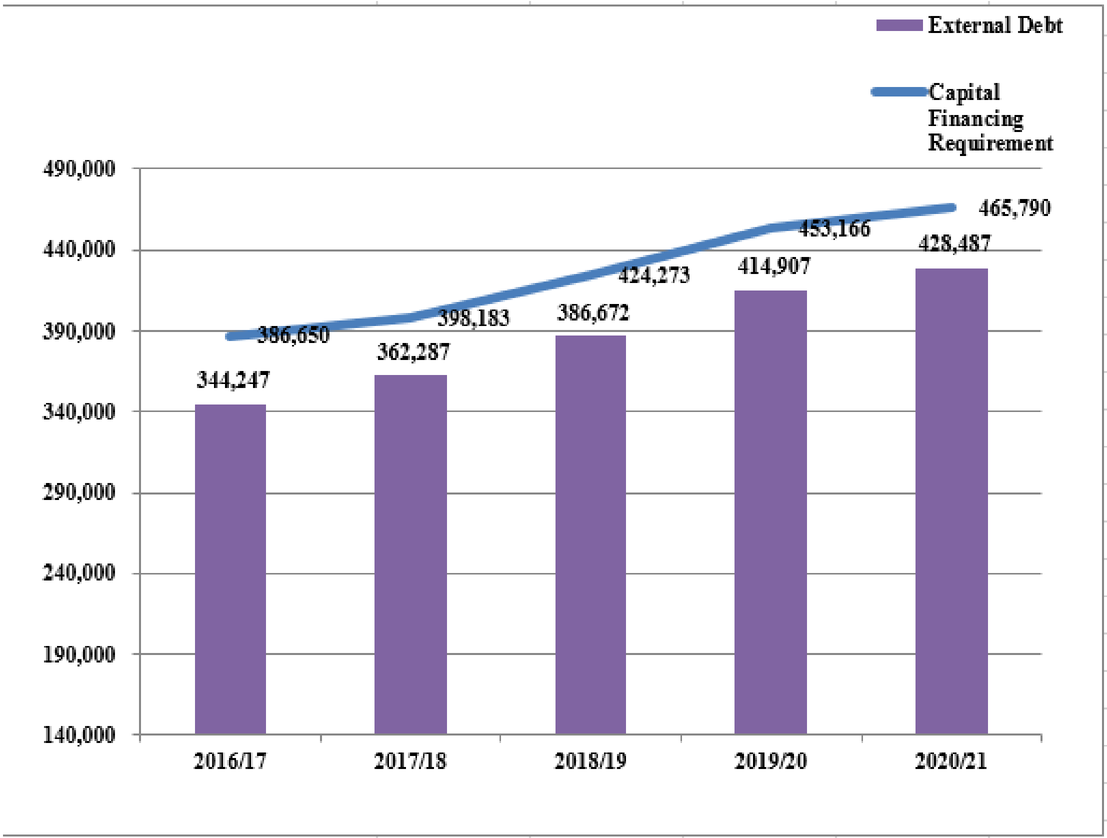
Investment Counterparty criteria

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

Borrowing

3.23 The Council's capital financing requirement (CFR) for 2017/18 is projected to be £398m. 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. Table 3.6 shows the Council expects to have borrowings of £362m and to utilise £36m 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.

Comparison of Capital Financing Requirement to actual/estimated external borrowing



Graph 3.1

3.24 Due to the overall financial position and the underlying need to borrow for capital purposes (the capital financing requirement - CFR), new external borrowing of £26m is estimated to be undertaken during the second half of this financial year.

3.25 The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date:

PWLB certainty rates 1 April 2017 to 30 September 2017

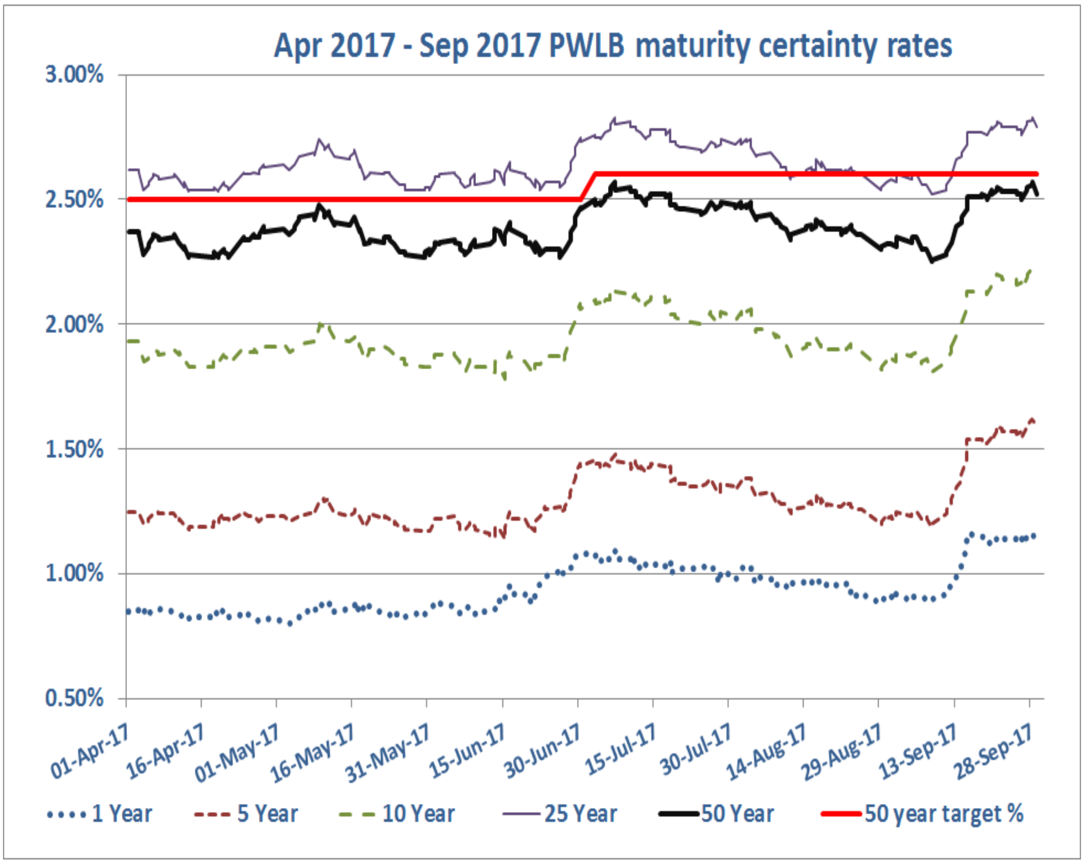


Table 3.8

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.8	1.14	1.78	2.52	2.25
Date	03/05/2017	15/06/2017	15/06/2017	08/09/2017	08/09/2017
High	1.16	1.62	2.22	2.83	2.57
Date	15/09/2017	28/09/2017	28/09/2017	07/07/2017	07/07/2017
Average	0.9408	1.2981	1.9470	2.6475	2.3917

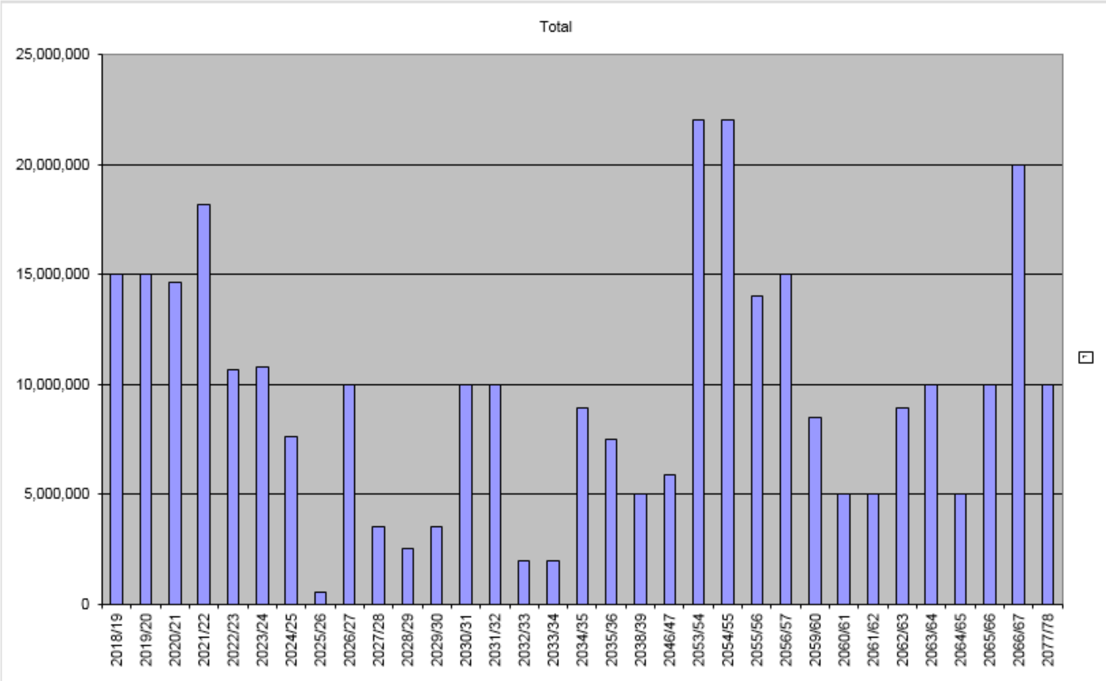
3.26 Two PWLB loans matured during the first six months and were repaid:

Table 3.9

Date repaid	Principal	Maturity	Interest rate
21/04/17	£0.662m	22 years	8.5%
24/09/17	£5m	8 years	4.02%

There were no short term loans taken or repaid

Current Maturity Profile



Debt Rescheduling

3.27 Debt rescheduling opportunities have been very limited in the current economic climate given the 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.

3.28 No debt rescheduling has therefore been undertaken to date in the current financial year.

Other Matters

a) Revised CIPFA Codes

3.29 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 2017.

3.30 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 much higher level than can be attained by treasury investments. 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.

b) MIFID II

3.31 The EU has now set a deadline of 3 January 2018 for the introduction of regulations under MIFID II. These regulations will govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. This will have little effect on this authority apart from having to fill in forms sent by each institution dealing with this authority and for each type of investment instrument we use apart from for cash deposits with banks and building societies

4 POLICY IMPLICATIONS

4.1 There are no direct policy implications associated with this report however the Council's treasury management activity is determined by the policy framework set out in the approved Treasury Management Strategy.

5 EQUALITIES IMPACT ASSESSMENT

5.1 This report is not applicable to the well-being of equalities groups and Equality Impact Assessment is not required.

6 RESOURCE IMPLICATIONS

6.1 Financial - There are no direct financial implications associated with this report however the Council's Treasury Management activity clearly has a significant impact on the management of the Council's financial resources.

6.2 Personnel – None

6.3 Other – None

7 BACKGROUND PAPERS

7.1 Treasury Management Strategy 2017/18 to 2019/2020 – East Lothian Council 28 March 2017

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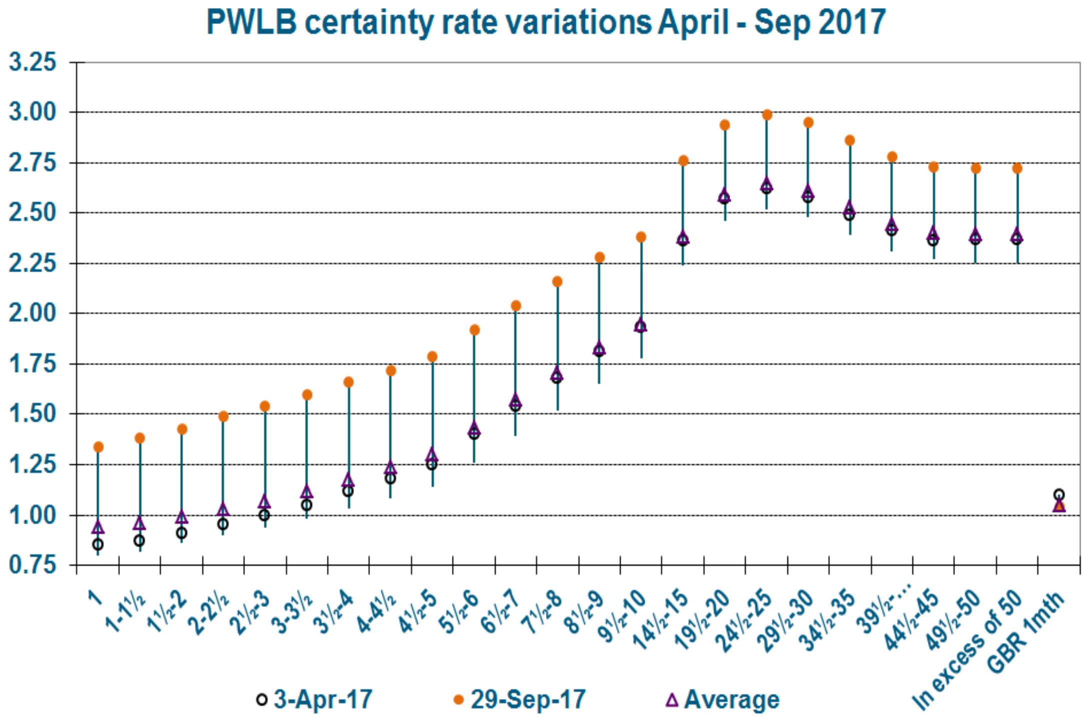
DATE	15th November 2017

APPENDIX 1: borrowing



Graph 3.4

APPENDIX 2: Investing

	Bank Rate	7 day	1 mth	3 mth	6 mth	12 mth
High	0.25	0.12	0.13	0.21	0.37	0.61
High Date	01/04/2017	02/08/2017	19/04/2017	11/04/2017	28/09/2017	28/09/2017
Low	0.25	0.10	0.12	0.14	0.27	0.46
Low Date	01/04/2017	04/07/2017	10/08/2017	07/08/2017	07/09/2017	06/09/2017
Average	0.25	0.11	0.13	0.18	0.32	0.53
Spread	0.00	0.02	0.01	0.08	0.09	0.15

APPENDIX 3: Approved countries for investments

Based on lowest available rating

AAA

- Australia
- Canada
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Finland
- Hong Kong
- U.S.A.

AA

- Abu Dhabi (UAE)
- France
- U.K.

AA-

- Belgium
- Qatar

THIS PAGE IS CORRECT AS AT 30.9.17