FAREHAM
BOROUGH COUNCIL

Report to
Audit and Governance Committee

Date 23 November 2015

Report of: Director of Finance and Resources

Subject: TREASURY MANAGEMENT PROGRESS REPORTS

SUMMARY

In accordance with the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management Code of Practice, the Audit and Governance Committee is the responsible body to examine and assess the effectiveness of the Council's treasury management policy and strategy.

In accordance with this role, this report sets out the mid-year review of treasury management activity up to 30 September 2015.

RECOMMENDATION

The Audit and Governance Committee is asked to note the report.

BACKGROUND

1. 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".

2. 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.

3. 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.

INTRODUCTION

4. The purpose of this report is to satisfy the requirement contained within the CIPFA Treasury Management Code of Practice to have a nominated responsible body, being the Audit and Governance Committee, examine and assess the effectiveness of the Council's treasury management strategy and policies.

5. The current Treasury Management Strategy, in Appendix A, was submitted to the Executive on 2 March 2015 and was formally adopted by Full Council on 23 April 2015.

MID YEAR REVIEW

6. This mid-year review 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 2015/16;
   - A review of the Council's investment portfolio;
   - A review of the Council's borrowing activity;
   - A review of the Treasury Management Strategy 2015/16; and
   - A review of compliance with Treasury and Prudential Limits for 2015/16.

ECONOMIC UPDATE FROM TREASURY ADVISOR – CAPITA ASSET SERVICES

7. UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again, possibly being equal to that of the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a rebound in quarter 2 to +0.7% (+2.4% y/y). Growth is expected to weaken to about +0.5% in quarter 3 as the economy faces headwinds for exporters from the appreciation of Sterling against the Euro and weak growth in the EU, China and emerging markets, plus the dampening effect of the Government's continuing austerity programme.

8. Despite these headwinds, the Bank of England August Inflation Report had included a forecast for growth to remain around 2.4-2.8% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero over the last quarter.

9. The August Bank of England Inflation Report forecast was notably subdued in respect of inflation which was forecast to barely get back up to the 2% target within the 2-3 year time horizon. However, with the price of oil taking a fresh downward direction and Iran expected to soon rejoin the world oil market after the impending lifting of sanctions, there could be several more months of low inflation still to come, especially as world commodity prices have generally been depressed by the Chinese economic downturn.

10. There are therefore considerable risks around whether inflation will rise in the near future as strongly as had previously been expected; this will make it more difficult for the central banks of both the US and the UK to raise rates as soon as was being forecast until recently. Recent major concerns around the slowdown in Chinese growth, the knock on impact on the earnings of emerging countries from falling oil and commodity prices, and the volatility we have seen in equity and bond markets in 2015 so far, could all potentially spill over to impact the real economies rather than just financial markets.

11. On the other hand, there are also concerns around the fact that the central banks of the UK and US have few monetary policy options left to them given that central rates are near to zero and huge QE is already in place. There are therefore arguments that they need to raise rates sooner, rather than later, so as to have ammunition to use if there was a sudden second major financial crisis. But it is hardly likely that they would raise rates until they are sure that growth was securely embedded and ‘noflation’ was not a significant threat.

12. The forecast for the first increase in Bank Rate has therefore progressively been pushed back during 2015 from Q4 2015 to Q2 2016 and increases after that will be at a much slower pace, and to much lower levels than prevailed before 2008, as increases in Bank Rate will have a much bigger effect on heavily indebted consumers than they did before 2008.

13. The Government’s revised Budget in July eased the pace of cut backs from achieving a budget surplus in 2018/19 to achieving that in 2019/20.

INVESTMENT PORTFOLIO

14. 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.

15. In the current economic conditions, 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 0.5% 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, investment returns are likely to remain low.

16. The total of fixed term investments and call accounts, as at 30 September 2015 was £48.1 million, as summarised below. The activity during the year for fixed investments is

detailed in Appendix B.

Investments	**Externally Managed £m**	**Internally Managed £m**	**Call Accounts £m**	**Total £m**
At 1 April 2015	**10.0**	**13.0**	**20.1**	**43.1**
New	4.0	17.0	63.4	84.4
Repaid	4.0	11.0	64.4	79.4
At 30 Sept 2015	**10.0**	**19.0**	**19.1**	**48.1**

17. The £5 million increase in investments during the first half of the year was mainly due to the timing of precept payments, receipts of grants and progress on the capital programme.

Investment Structure

18. The structure of investments at 30 September is shown in the table below. Over the past few years, most investments have been held on short periods to mitigate the risks that have been seen during the recession.

Investment Structure	**Externally Managed £m**	**Internally Managed £m**	**Call £m**	**Total £m**
For periods of less than 1 month	1.0	1.0	15.1	17.1
For periods of 1 to 3 months	2.0	0	4.0	6.0
For periods of 3 to 6 months	0	0	0	0
For periods of 6 to 12 months	5.0	18.0	0	23.0
For periods of 1 to 2 years	2.0	0	0	2.0
Total Investments at 30 Sept 2015				
Investments for periods < 365 days	8.0	19.0	19.1	**46.1**
Investments for periods 365+ days	2.0	0	0	**2.0**

19. Throughout this period of uncertainty, officers have been taking advice from the Council's treasury advisor, Capita Asset Services, to ensure that decisions are taken in light of the latest facts at the time. This has given rise to lower interest rates being secured but this is the lowest priority consideration compared to the security of investments and the liquidity of cash flow.

20. The Council's fixed term investments are partly managed externally by Tradition UK Ltd. The role of the broker is to determine the most appropriate investment option within criteria set by the Council. All cash transfers are made by Council officers and Executive approval has been given for the allocation of up to £13 million to the externally managed portfolio. This retains sufficient funds within the direct management of officers, while still ensuring that maximum yield is achieved from the longer term investments.

21. The investment structure is sufficient to meet the capital programme and other large cash outflows.

22. To increase the liquidity of the Council's investments, call accounts with Nat West,

Santander, HSBC and Svenska Handelsbanken are being used. These accounts offer quick access to funds, however, they do attract a lower rate of interest than some of the fixed term investments shown in the table above.

23. The balance within each call/notice account as at 30 September 2015 is set out in the following table:

Call Accounts	£m
NatWest	5.1
Santander – 95 Day Notice	4.0
Svenska Handelsbanken	4.0
HSBC	6.0
Total	**19.1**

BORROWING ACTIVITY

24. The Council's external long term debt amounted to £40.2 million as at 1 April 2015. This is as a result of the Housing Revenue Account (HRA) reforms (£40m) and the Hampshire County Council interest free loan for Portchester Community Centre (£0.2m).

25. For the HRA reforms, the Council has taken out ten £4 million loans from the Public Works Loan Board (PWLB) with duration of between 40 and 50 years at an average interest rate of 3.50% as detailed in the table below:-

Repayment Date	Loan Amount	Interest Rate
30/09/2052	£4m	3.52%
30/09/2053	£4m	3.51%
30/09/2054	£4m	3.51%
30/09/2055	£4m	3.51%
30/09/2056	£4m	3.50%
30/09/2057	£4m	3.50%
30/09/2058	£4m	3.50%
30/09/2059	£4m	3.49%
30/09/2060	£4m	3.49%
30/09/2061	£4m	3.48%
Total	**£40m**	**3.50% average**

26. Interest payable for 2015/16 is budgeted at **£1,851,700** and will be met by the HRA. £1,400,400 relates to the PWLB loans and £451,300 for interest on internal borrowing between the General Fund and the HRA.

INTEREST RATE FORECAST

27. The Council's treasury advisor, Capital Asset Services, has provided the following forecast:

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%
5yr PWLB rate	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%
10yr PWLB rate	3.00%	3.20%	3.30%	3.40%	3.50%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%
50yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%

28. Capita Asset Services undertook its last review of interest rate forecasts on 11 August shortly after the quarterly Bank of England Inflation Report. Later in August, fears around the slowdown in China and Japan caused major volatility in equities and bonds and sparked a flight from equities into safe havens like gilts and so caused PWLB rates to fall below the above forecasts for quarter 4 2015.

29. However, there is much volatility in rates as news ebbs and flows in negative or positive ways and news in September in respect of Volkswagen, and other corporates, has compounded downward pressure on equity prices. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2016.

STRATEGY COMPLIANCE

30. The Council's Treasury Management Strategy Statement for 2015/16 in Appendix A, which includes the Annual Investment Strategy 2015/16, was approved by the Council on 2 March 2015. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield

31. The Council will also aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs but also to seek out value available in higher rates in periods up to 2 years with highly credit rated financial institutions.

32. The compliance with the various elements of the strategy are set out in the following table:-

Compliance on Individual Elements	Yes/No	Notes
Borrowing only up to "supported" level	Yes	No borrowing this quarter.
All investments with approved institutions	Yes	Treasury management advisors provide updated list of approved institutions weekly.
All individual investments within prescribed financial limits	Yes	There are currently 6 institutions where the total investment is at the maximum level. They are Lloyds, Barclays and HSBC, (£6m limit), Skipton BS, West Brom BS and Principality BS (£2m limit).

33. No changes to the Council's Treasury Management Strategy Statement and Annual Investment Strategy 2015/16 are considered necessary at this time as the rules currently being applied to investments are much tighter than those approved within the Treasury Management Strategy.

COMPLIANCE WITH TREASURY AND PRUDENTIAL LIMITS

34. It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. The Council's approved Treasury and Prudential Indicators (affordable limits) were approved by the Executive at its meeting on 2 March 2015.

35. Performance for the first half of the year is shown in Appendix C and the purpose of each indicator is explained in more detail in Appendix D. During the financial year to date the Council has operated within the treasury limits and the Prudential Indicators.

RISK ASSESSMENT

36. In the current economic climate, there are risks that financial institutions holding Council investments could default and be unable to fulfil their commitments to repay the sums invested with them.

37. To help mitigate this risk, the Council maintains a list of approved institutions based on a grading system operated by the Council's treasury management advisers. Maximum limits are also set for investments with individual institutions.

Background Papers: None

Reference Papers: 2 March 2015 Executive Report - Treasury Management Policy and Strategy 2015/16

Appendices:
Appendix A - Treasury Management Strategy 2015/16
Annex A - Summary of Prudential and Treasury Indicators
Appendix B - Total investment activity to 30 September 2015 with each approved institution
Appendix C - 2015/16 Prudential Indicators - Half-Yearly Performance
Appendix D - Details of Prudential Indicators

Enquiries:

For further information on this report please contact Caroline Hancock. (Ext 4589)