Cheltenham Borough Council

Cabinet – 5th December 2017

Council – 11th December 2017

Treasury Mid-Term Report 2017/18

Accountable member	**Finance, Rowena Hay**
Accountable officer	**Section 151 Officer, Paul Jones**
Accountable scrutiny	**Treasury Management Panel**
Ward(s) affected	**None**
Key Decision	**Yes**
Executive summary	The Treasury Management Strategy for 2017/18 has been determined by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009 (revised 2011), which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year. The Code also recommends that members are informed of Treasury Management activities at least twice a year. This report therefore ensures this authority has adopted the code and complies with its requirements.
Consultation	The Treasury Management Panel has considered this report on 20th November 2017.
Recommendations	**Treasury Management Panel approves the following recommendation to Cabinet/Council:** **1. Note the contents of the summary report of the treasury management activity during the first six months of 2017/18.**

Financial implications	All financial implications are detailed throughout the report **Contact officer: Andrew Sherbourne, andrew.sherbourne@cheltenham.gov.uk, 01242 264337**
Legal implications	None specific arising from the report recommendations. **Contact officer: Peter Lewis, peter.lewis@tewkesbury.gov.uk, 01242 264216**

HR implications (including learning and organisational development)	No direct HR implications arising from this report **Contact officer: Julie McCarthy, julie.mccarthy@cheltenham.gov.uk. 01242 264355**
Key risks	see appendix 2
Corporate and community plan Implications	None
Environmental and climate change implications	None

1. Background

1.1 The Treasury Management Strategy for 2017/18 has been developed by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009 (revised 2011), which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year. The Code also recommends that members are informed of Treasury Management activities at least twice a year. This report therefore ensures this authority has adopted the code and complies with its requirements, one of which is the provision of a Mid-year report to Members.

1.2 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. 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.

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."

2. Economic update for the first six months

2.1 The following key points have been provided by the councils Treasury Advisors, Capita Treasury Solutions.

2.2 After the UK economy showed strong growth in 2016, growth in 2017 has been disappointingly weak; quarter 1 came in at +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.

2.3 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 expected 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. This marginal revision can hardly justify why the MPC became so aggressive with its wording; rather, the focus was on 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.

2.4 At the time of this report being written the MPC took the decision on 2nd November 2017 to increase Bank Rate to 0.5%. The big question after that will be whether this will be a one off increase or the start of a slow, but regular, increase in Bank Rate. As at the start of October, short sterling rates are indicating that financial markets do not expect a second increase until May 2018 with a third increase in November 2019. However, some forecasters are flagging up that they expect growth to improve significantly in 2017 and into 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 weak services sector growth. If this scenario were to materialise, then the MPC would have added reason to embark on a series of slow but gradual increases 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 far too early to be confident about how the next two years will pan out.

2.5 Economic growth in the EU, (the UK's biggest trading partner), has been lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of QE. However, growth picked up in 2016 and now looks to have gathered ongoing substantial strength and momentum thanks to this stimulus. GDP growth was 0.5% in quarter 1 (2.0% y/y) and 0.6% in quarter (2.3% y/y). However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in August inflation was 1.5%. It is therefore unlikely to start on an upswing in rates until possibly 2019.

2.6 Growth in the American economy has been volatile in 2015 and 2016. 2017 is following that path again with quarter 1 coming in at only 1.2% but quarter 2 rebounding to 3.1%, resulting in an overall annualised figure of 2.1% for the first half year. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.4%, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on a gradual upswing in rates with three increases since December 2016; and there could be one more rate rise in 2017 which would then lift the central rate to 1.25 – 1.50%. There could then be another four more increases in 2018. At its June meeting, the Fed strongly hinted that it would soon begin to unwind its $4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

3. Portfolio position 1/4/2017 to 30/9/2017

Movements in the Council's borrowing during the first six months of 2017/18 financial year can be seen in the table below. Long term loans are deemed to be those repayable over a period of more than one year.

Source of Loan **Temporary Borrowing**	**Balance at 1 April 2017 £**	**Raised during Apr-Sept £**	**Repaid during Apr-Sept £**	**Balance at 30 Sept 2017 £**
Local Authority	0	6,000,000	6,000,000	0
Temporary Investment	21,000	0	0	21,000
Total Short Term Borrowing	**21,000**	**6,000,000**	**6,000,000**	**21,000**
Long Term Borrowing				
- Public Works Loan Board	48,929,794	0	270,123	48,659,671
- Market Loans	15,900,000	0	0	15,900,000
Long Term Borrowing	**64,829,794**	**0**	**270,123**	**64,559,671**
Total External Borrowing	**64,850,794**	**6,000,000**	**6,270,123**	**64,580,671**

3.1 In February 2017 the Council's borrowing costs for 2017/18 was budgeted to be £2,477,900 and this is expected to come in at £2,494,060, an overspend of £16,160. The small increase estimated is in respect of what the General Fund needs to pay the HRA for the reserves and balances held within the council investment balances. These balances are expected to come in higher than what was estimated in February 2017 due mainly to the higher rate of return on investments which ultimately affects the interest paid on the HRA balances.

3.2 The Public Works Loan Board (PWLB) remains an attractive source of borrowing for the Council as it offers flexibility and control. No long term borrowing has occurred as of yet, however some borrowing is expected to take place before the 31st March 2018 in respect of the new Crematorium. Further analysis is required to decide on what is to be funded from the PWLB and the level of internal resources that is required. Members will be updated as soon as any new borrowing is untaken.

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

4. Investments

The DCLG's Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy for 2017/18 approved by Council on the 10th February 2017. This restricted new investment to the following:-

Investment	Max Sum per institution/group	Maximum period
Debt Management Agency Deposit Facility* (DMADF) • this facility is at present available for investments up to 6 months	UNLIMITED	6 months
UK Government Gilts/ Bonds	£2m	2 years
UK Government Treasury Bills	UNLIMITED	1 year
Term deposits with the UK government or with UK local authorities (i.e. local authorities as defined under Section 23 of the 2003 Act) with maturities up to 1 year	£7m	Unlimited
Term deposits with credit-rated deposit takers (banks and building societies), including callable deposits (UK & Non-UK)	£7m	2 years

Investment	Max Sum per institution/group	Maximum period
Repos/Reverse Repo through custodian King & Shaxson	£5m	1 year
Money Market Funds with UK/Ireland/Luxembourg domiciled	£2m per fund	Liquid
Enhanced Money Market funds UK/Ireland/Luxembourg domiciled	£2m per fund	Liquid - 3months - 5 years
Corporate Bonds held in a broker's nominee account (King & Shaxson Ltd)	£2m	2 years to maturity
T-Bills issued by the DMO (Government)	UNLIMITED	1 year
Repo/reverse repo – fixed term deposits with banks and other financial institutions	£7m	1 year
Property Funds	Unspecified	Unlimited
Equities – One off for an App investment	£50k	Unlimited
Other Money Market and Collective Investment Schemes	£2m	Unlimited
Certificates of deposit (CD's) issued by banks and building societies covered by UK Government (explicit) guarantee	£7m	2 years

This Council applies the creditworthiness service provided by Capita. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard and Poor's. The credit ratings of counterparties are supplemented with the following overlays:

- Credit watches and credit outlooks from credit rating agencies;
- CDS spreads to give early warning of likely changes in credit ratings;
- Sovereign ratings to select counterparties from only the most creditworthy countries.

4.1 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 0.25% 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.

4.2 Investments - Movements in the Council's investment portfolio during the first six months of 2017/18 can be seen in the table below.

Source of Loan Short term Lending	Balance at 1 April 2017 £	Raised during Apr-Sept £	Repaid during Apr-Sept £	Balance at 30 Sept 2017 £
Bank – Term Deposits/CD'S	18,000,000	13,000,000	14,000,000	17,000,000
Local Authorities	1,000,000	0	0	1,000,000
Call A/C's	300,000	49,710,000	47,440,000	2,570,000
Glos Airport (Temp)	70,000	0	35,000	35,000
Glos Airport (Revolving Credit)	0	200,000	0	200,000
Money Market Funds	0	22,200,000	18,200,000	4,000,000
CCLA Property Fund	0	1,000,000	0	1,000,000
St. Margaret's Hall	0	50,000	0	50,000
Total Lending	**19,370,000**	**86,160,000**	**79,675,000**	**25,855,000**
Icelandic Banks in administration	**Balance at 1 April 2017 £**	**Raised during Apr-Sept £**	**Repaid during the year £**	**Balance at 30 Sept 2016 £**
- Kaupthing Singer & Friedlander	484,986	0	27,646	457,340
Total Icelandic Banks	**484,986**	**0**	**27,646**	**457,340**
Total External Investments	**19,854,986**	**86,160,000**	**79,702,646**	**26,312,340**

4.3 In February 2017 the Council's Investment income for 2017/18 was budgeted to be £385,700 which includes £290,600 from the interest payable in respect of the third party loans from CBH, Cheltenham Everyman Theatre and Glos. Airport Ltd. The average cash balances representing the council's reserves and working balances, was £23.440m during the period this report covers. The Council anticipates an investment outturn of £140,600 at a rate of return of 0.60% for this financial year plus the £290,600 from the third party loans. In total we are expecting a surplus of around £45,500 for the financial year. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2017/18.

4.4 Included within the investments of £26.312m as at 30th September 2017, the Council has £457k deposited in the collapsed Icelandic bank Kaupthing Singer & Friedlander (KSF). KSF administrators have made distributions of 85.15p in the pound to date. Administrators currently estimate a total return of 86.25p-87p in the pound, which is a small improvement from when last reported. The next dividend is due in December 2017.

5. Prudential Indicators

5.1 During the financial year to date the Council has operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Policy Statement and Annual Treasury Strategy Statement. Appendix 1 attached highlights the major indicators.

6. Outlook

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.50%	1.60%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%
50yr PWLB rate	2.70%	2.70%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%

6.1 Capita Asset Services undertook its last review of interest rate forecasts on 9 August after the quarterly Bank of England Inflation Report. There was no change in MPC policy at that meeting. However, the MPC meeting of 14 September revealed a sharp change in sentiment whereby a majority of MPC members said they would be voting for an increase in Bank Rate "over the coming months". It is therefore possible that there will be an increase to 0.5% at the November MPC meeting. If that happens, the question will then be as to whether the MPC will stop at just withdrawing the emergency Bank Rate cut of 0.25% in August 2016, after the result of the EU withdrawal referendum, or whether they will embark on a series of further increases in Bank Rate during 2018.

The overall balance of risks to economic recovery in the UK is currently to the downside but huge variables over the coming few years include just what final form Brexit will take, when finally agreed with the EU, and when.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

• 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.

• Geopolitical risks in Europe, the Middle East and Asia, which could lead to increasing safe haven flows.

• A resurgence of the Eurozone sovereign debt crisis.

• Weak capitalisation of some European banks.

• Monetary policy action failing to stimulate sustainable growth and to get inflation up consistently to around monetary policy target levels.

• UK inflation returning to significantly higher levels causing an increase in the inflation premium inherent to gilt yields

7. Performance management

7.1 In compliance with the requirements of the Treasury Management CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during the first six months of 2017/18. None of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

8. Other

8.1 Revised CIPFA Codes

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. 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.

8.2 MIFID II

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. This council will be opting up for 'professional' status where necessary.

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Appendices	Prudential Indicators Appendix 1 Risk Appendix 2
Background information	Treasury Management Strategy, Council 10th February 2017