Agenda Item	13 (b)
Report No	RES/62/17

HIGHLAND COUNCIL

Committee: Corporate Resources Committee

Date: 15 November 2017

Report Title: Treasury Management Mid-Year Review 2017/18

Report By: Director of Corporate Resources

1. Purpose/Executive Summary

1.1 This report is the mid-year treasury management review for the financial year 2017/18 and is prepared in compliance with the Chartered Institute of Public Finance and Accountancy's (CIPFA) revised Code of Practice on Treasury Management in Local Authorities.

1.2 The report highlights the Council's treasury management activities undertaken, provides a commentary on the year to 30 September and compares activity to the expected activities contained in the annual Treasury Strategy Statement and Investment Statement which was approved by Corporate Resources Committee on 8 February 2017.

1.3 This Treasury Management Mid-Year Review - 2017/18 is submitted to the Committee for consideration. The Report will then be submitted to Council for approval in December 2017.

1.4 The Prudential Code also requires the Council to report the actual prudential indicators after the financial year end and these are shown in **Appendix 1.**

2. Recommendations

2.1 Members are asked to:

i. Consider the Treasury Management Mid-Year Review 2017/18;

ii. Note the pending reclassification of the Council to "retail" status under the Markets in Financial Instrument Directive 2014/65 MiFID II; and

iii. Agree the Council will complete the required documentation to "opt up" to "professional" status in order to ensure it can continue to implement an effective investment strategy.

3. Background

3.1 Treasury Management is defined as: "*The management of the local authority's 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*".

3.2 The Chartered Institute of Public Finance and Accountant's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by the Council on 4 March 2010. The Code was further updated in November 2011.

3.3 The primary requirements of the Code are the:

- 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 Council of an Annual Strategy Report for the year ahead, a mid–year report and an **Annual Review Report** of 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 policies to a specific named body, which in this Council is the Corporate Resources Committee.

3.4 The Treasury Management Mid-Year Review 2017/18 has been prepared in compliance with CIPFA's Code of Practice and covers the following:

- An economic update for the first six months of 2017/18, provided by the Council's Treasury Advisers, Capita;
- 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.

4. Economic update (provided by Capita, Treasury Advisers to the Council)

4.1 The Council has appointed Capita as treasury adviser to the Council and part of their service is to assist the Council to formulate a view on interest rates. **Appendix 2** provides an economic update from Capita.

4.2 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". There was an increase to 0.5% at the November MPC meeting.

	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%

4.3 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.

5. Treasury Management Strategy Statement and Annual Investment Strategy update

5.1 The Treasury Management Strategy Statement (TMSS) for 2017/18 was approved by Corporate Resources Committee on 8 February 2017. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as security of capital and liquidity.

5.2 There have been no policy changes to the TMSS since it was agreed in February 2017.

6. Investment portfolio 2017/18

6.1 Cash deposits placed by the Council are described as investments. In accordance with the Code the key considerations when investing are security of capital, liquidity and to obtain a level of return consistent with the Council's risk appetite.

6.2 The investment portfolio yield for the first six months of the year is an average rate of 0.55% against a benchmark (7 Day London Inter-bank Offer Rate – LIBID average) of 0.24%.

6.3 As illustrated in the economic update, investment rates available in the market are at a historical low point. The average level of funds available for investment purposes in the first six months of 2017/18 was £87.3m (2016/17 £80.6m). These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of Council Tax payments, receipt of grants and progress on the capital programme.

6.4 In line with the investment strategy, the Council will only place deposits with counter-parties with a high-creditworthiness. The availability of such counter-parties remains a challenge, and the returns and terms available in the market, mean that short-term investment returns have reduced further following cut to the bank rate.

7. New External Borrowing

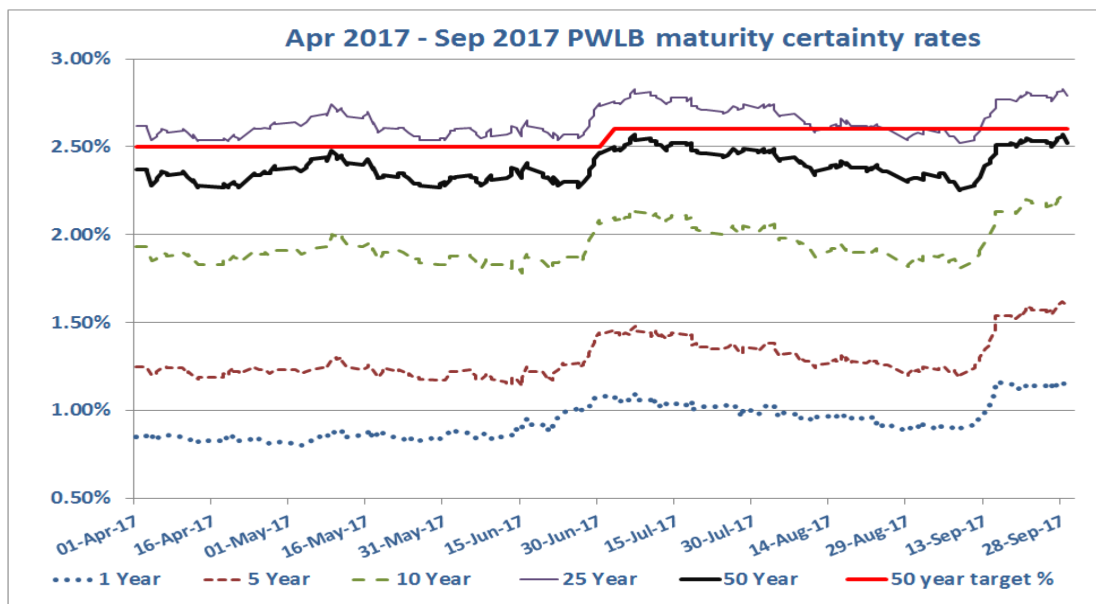
7.1 The Capital Financing Requirement (CFR) represents the accumulated net capital expenditure which the Council requires to fund by way of long term debt until the capital projects, comprising the CFR, are fully written off by way of annual loan charges to revenue accounts.

7.2 The balance of external and internal borrowing is generally driven by market conditions, and the need to take a balanced view of savings available from short term and internal borrowing, versus the mitigation of re-financing risk which can be achieved from longer-term borrowing, but at potentially higher cost.

7.3 The graph below shows the estimated CFR at 31/03/18 and how it is expected to be funded by short term borrowing and historic long term borrowing.

Estimated Capital Financing Requirement (CFR) at 31/03/18 See appendix 1 – indicator 2	£1,113.2m
Less PPP/NPD	-£165.6m
Estimated CFR 31/03/18	**£947.6m**
Opening Long Term Debt 01/04/17	£767.9m
Long term maturities (PWLB	-£22.5m
Estimated Long Term Debt 31/03/18	£745.4m
Opening short term borrowing 01/04/17	£115.0m
Add estimated net borrowing for new capital expenditure in 2017/18	£40.3m
Add Borrowing to replace maturing loans (PWLB maturing 31/03/17)	£22.5m
Estimated Short Term Debt at 31/03/18	£177.8m
Estimated total long term and short term debt 31/03/18	£923.2m
Difference between CFR and borrowing = Funding from internal balances and cash flow	£24.4m

7.4 The graph and table below shows the movement in PWLB rates for the first six months of the year incorporating the certainty rate. The general trend has been an overall increase in interest rates for PWLB loans though rates remain volatile.



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.80%	1.14%	1.78%	2.52%	2.25%
Date	03/05/17	15/06/17	15/06/17	08/09/17	08/09/17
High	1.16%	1.62%	2.22%	2.83%	2.57%
Date	15/09/17	28/09/17	28/09/17	07/07/17	07/07/17
Average	0.94%	1.29%	1.94%	2.64%	2.39%

7.5 It is anticipated that over the remainder of the financial year, no new long-term borrowing will be undertaken. Markets remain volatile, and favourable short-term borrowing opportunities are likely to be available to the Council. However, the strategy remains flexible and will give consideration to borrowing based on prevailing market conditions.

7.6 Overall, it is considered probable that the year-end out-turn will reflect borrowings achieved at rates lower than had been originally anticipated when budgets were set, and current revenue budget monitoring reflects a forecast underspend on the loan charge budget.

7.7 In consultation with Capita, the market situation is constantly monitored and borrowing strategies reviewed on a regular basis.

8. Debt rescheduling

8.1 No debt rescheduling was undertaken during the first six months of 2017/18.

9. Compliance with Treasury and Prudential Limits

9.1 It is a statutory duty for the Council to determine and keep under review the “Affordable Capital Expenditure Limits”. The Council’s approved Treasury and Prudential Indicators (affordability limits) are outlined in the approved Treasury Management Strategy Statement (TMSS) agreed in February 2017.

9.2 During the financial year to date the Council has operated within the treasury limits and Prudential Indicators set out in the Council’s TMSS and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators are shown in **Appendix 1**, comparing the initial limits agreed for the year, and updated year-end forecasts.

10. Markets in Financial Instrument Directive (MiFID II)

10.1 The EU has 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.

10.2 It is a MiFID II requirement for local authorities (currently treated as professional investors) to be classified as “retail” clients by default. Under such a classification, local authorities investing in regulated products such as such as Certificates of Deposit, Gilts, Corporate Bonds and investment funds, including Money Market Funds would be affected.

10.3 Local authorities can “opt up” to be an Elected Professional Client in order to access regulated products. The Council plans to “opt up” which requires demonstrating that we meet both the quantitative (portfolio size £10m and transaction volume of 10 per quarter over the previous year) and qualitative requirements.

10.4 The qualitative requirements are that the Person authorised to carry out transactions on behalf of the client works, or has worked in the financial sector for at least one year in a professional position which requires knowledge of the provision of services envisaged.

10.5 Officers are comfortable that The Highland Council Treasury team have the requisite knowledge and experience to meet the criteria required to gain professional investor status.

11. Implications

11.1 Resource – borrowing undertaken at favourable interest rates, the use of the capital reserve receipt in 2016/17 which has reduced the debt instalments for 2017/18, and a different asset profile than was forecast, has contributed to a forecast under-spend in the loans charge budget of £3.1m. This figure depends on the level of capital expenditure undertaken during the rest of the financial year and will continue to be monitored.

11.2 There are Risk implications associated with a strategy of short term borrowing that rates increase and the Council is exposed to refinancing a large portfolio of short term debt at higher interest rates and missing the opportunity to secure favourable rates for longer term borrowing.

11.3 There are no Legal, Community (Equality, Poverty and Rural), Climate Change/Carbon Clever or Gaelic implications relating to this report.

Designation:	Director of Corporate Resources
Date:	6 November 2017
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Background Papers:	Treasury system and financial ledger reports TMSS 2017/18

Appendix 1

Estimated and Actual Treasury Position and Prudential Indicators

Figures are for financial year unless otherwise titled in italics

	2017/18 Original	2017/18 Revised Est	Reason for variance
1. Capital expenditure			
Gross capital expenditure			
General Fund	£106.0m	£99.8m	
Housing Revenue Account	£30.7m	£39.7m	
Total gross capital expenditure	**£136.7m**	**£139.5m**	
Income			
General Fund	(£40.7m)	(£43.2m)	
HRA	(£6.8m)	(£20.0m)	Council House and LIFT sales income revised.
Total income	**(£47.5m)**	**(£63.2m)**	
Net capital expenditure			
General Fund	£65.3m	£56.6m	
HRA	£23.9m	£19.7m	Less borrowing required due to above income
Total net capital expenditure	**£89.2m**	**£76.3m**	
Loan charge instalments			
General Fund	(£31.3m)	(£28.2m)	Loan charge instalments for 2016/17 capital expenditure are lower than forecast due to capital accounting adjustments and forecast was based on greater proportion of assets having shorter asset lives.
HRA	(£8.4m)	(£7.8m)	Loan charge instalments lower as based on higher level of capital expenditure.
Total instalments	**(£39.7m)**	**(£36.0m)**	
Net borrowing for new capital expenditure			
General Fund	£34.0m	£28.4m	
HRA	£15.5m	£11.9m	
Total net borrowing for new capital expenditure	**£49.5m**	**£40.3m**	
2. Capital Financing Requirement (CFR) at 31 March			
General Fund excluding PPP/NPD	£689.5m	£681.3m	
Housing Revenue Account	£259.5m	£246.2m	
Joint Boards	£20.0m	£20.1m	
Sub-total excluding PPP/NPD	**£969.0m**	**£947.6m**	
PPP/NPD	£165.6m	£165.6m	
Total	**£1,134.6m**	**£1,113.2m**	
Treasury Position at 31 March			
Borrowing	£916.6m	£923.2m	
Other Long Term Liabilities (PPP/NPD)	£165.6m	£165.6m	
Total Debt	**£1,082.2m**	**£1,088.8m**	
Investments	£50.0m	£50.0m	
Net Borrowing	**£1,032.2m**	**£1,038.8m**	

	2017/18 Original	2017/18 Revised Est	Reason for variance
3. Authorised Limit for Borrowing (against maximum position)	£1,055.7m	£915.0m (20/02/17)	
4. Operational Boundary for Borrowing	£937.4m	£915.0m (20/02/17)	
5. Ratio of financing costs to net revenue stream			
General Fund including PPP	13.0%	12.7%	
Housing Revenue Account	36.6%	34.2%	
6. Incremental impact of capital investment decisions on the Band D council tax	£68.39	£12.94	Instalment costs lower than forecast (see indicator 1)
Incremental impact of capital investment decisions on the housing rent levels (Weekly figures based on a 48 week year are shown in brackets).			
There is zero incremental impact on Council Tax and Rents shown as Council Tax and Housing Rents have already been already set for these years.	£135.04 (£2.81)	£44.93 (£0.93)	Annual outturn borrowing requirement lower than originally forecast
7. Interest rate exposures of debt net of investments			
Upper Limit (Fixed)	£969.0m	£921.5m (May 2017)	
Upper Limit (Variable)	£339.1m	£90.3m (June 2017)	
8. Maturity structure of fixed rate borrowing (against maximum position)			
Under 12 months	30.0%	21.4% (May 2017)	
12 months to 2 years	30.0%	6.2% (April 2017)	
2 years to 5 years	30.0%	10.7% (Sept 2017)	
5 years to 10 years	50.0%	14.5% (June 2017)	
10 years and above	100.0%	52.9% (June 2017)	
9. Upper limit for the maturing of investments made for periods longer than 364 days(against maximum position)	£20.0m	Nil	
10. Short term borrowing (net of investments) as a % of outstanding long term debt (maximum position)	25.0%	18.4% (May 2017)	
11. Variable interest debt (net of investments) as a % of outstanding long term debt (maximum position)	35.0%	14.3% (Aug 2017)	

In addition to the above the Council is required as a Prudential Indicator to:

- Adopt the CIPFA Code of Practice.
- Ensure that over the medium term borrowing will only be for a capital purpose (i.e. net external borrowing is less than the CFR).

The compliance for these indicators is highlighted in the body of the report.

Appendix 2

Economic update (provided by Capita, Treasury Advisers to the Council)

UK

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.

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.

It therefore looks very likely that the MPC will increase Bank Rate to 0.5% in November or, if not, in February 2018. 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.

EU
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.

USA
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.

China
Chinese economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

Japan is struggling to stimulate consistent significant growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.