The Highland Council

Resources Committee – 25 November 2015

Agenda Item	**14(b)**
Report No	**RES/ 105/15**

Treasury Management Mid-year Review Report 2015/16

Report by the Director of Finance

Summary

This Treasury Management Mid-year Review Report 2015/16 is submitted to the Committee for Members' scrutiny. In compliance with CIPFA's Code of Practice on Treasury Management in Local Authorities, the report will also be submitted to the Council in December 2015 for approval.

1. Background

1.1 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."

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

1.2 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 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 the Resources Committee.

1.3 This Mid-year Review Report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- An economic update for the first six months of 2015/16, 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 2015/16;
- A review of the Council's borrowing strategy for 2015/16;
- A review of any debt rescheduling undertaken during 2015/16;
- A review of compliance with Treasury and Prudential Limits for 2015/16.

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

2.1 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.

2.2 Capita Asset Services undertook a review of its interest rate forecasts on 11 August. 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. 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.

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

The above Capita forecasts for PWLB rates incorporate the **PWLB certainty rate** which reduces PWLB borrowing rates by 0.20% for most local authorities. Highland is eligible for this rate reduction.

3. Treasury Management Strategy Statement and Annual Investment Strategy update

3.1 The Treasury Management Strategy Statement (TMSS) for 2015/16 was approved by Council on 12 March 2015. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as security of capital and liquidity.

3.2 There have been no policy changes to the TMSS since it was agreed in March.

3.3 The Council will also aim to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity. In the current economic climate longer term deals will only be entered into when attractive rates are available with counterparties of high creditworthiness which make longer term deals worthwhile and within the risk parameters set by this Council. The Council will only invest with highly credit rated financial institutions, using Capita's suggested creditworthiness approach, including sovereign credit rating and credit default swap (CDS) overlay information provided by Capita.

3.4 Borrowing rates continued to be historically low during the first six months of the 2015/16 financial year, and the Council benefits from the PWLB certainty rate discount 20bps off normal PWLB rates.

3.5 As outlined in the commentary at **Appendix 2**, there is still considerable uncertainty and volatility in the financial and banking market, both globally and in the UK. In this context, it is considered that the strategy approved on 12 March 2015 is still fit for purpose in the current economic climate.

4. Investment Portfolio 2015/16

4.1 In line with the requirements of the Code, any cash deposits placed by the Council are described as investments. 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.

4.2 The investment portfolio yield for the first six months of the year is an average rate of 0.56% against a benchmark (7 Day London Inter-bank Offer Rate – LIBID average) of 0.36%.

4.3 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 2015/16 was £84.9m. 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. The Council has £5m invested with RBS for 365 days at a rate of 0.88% which is within the £20m limit that can be invested for longer than 364 days, as set out in the TMSS.

4.4 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 remain low. To avoid use of the HM treasury debt management office, as a counterparty of last resort, given the low returns available, the Council continues to use 2 Money Market Funds (MMFs), which are AAA rated, and permitted in the Council's investment strategy.

4.5 From August 2014 onwards, the Council placed certificates of deposits with Standard Chartered and Royal Bank of Scotland which are both UK registered banks. Certificates of deposit are a permitted investment in the TMSS and are similar to fixed term deposits but can be traded before the maturity date (the Council has no intention to trade before maturity). The use of certificates of deposit enables the Council to access counterparties which would not deal directly with the Council due to the low level of deposit amounts.

4.6 At its meeting on 12 March 2015, the Council approved a change to the Highland Council's list of counterparties to include non-UK Banks with high credit worthiness and based within countries with an AAA or AA+ rating. Following this approval, the Council started using Svenska Handelsbanken as a counter party.

5. New External Borrowing

5.1 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.

5.2 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.

5.3 The table below shows the estimated CFR at 31/03/16 and how it is expected to be funded by short term borrowing. All borrowing to date has been been on a short-term basis, or through internal borrowing. This has largely been driven by market conditions, favourably low short-term rates, and cash flows in the early part of the year.

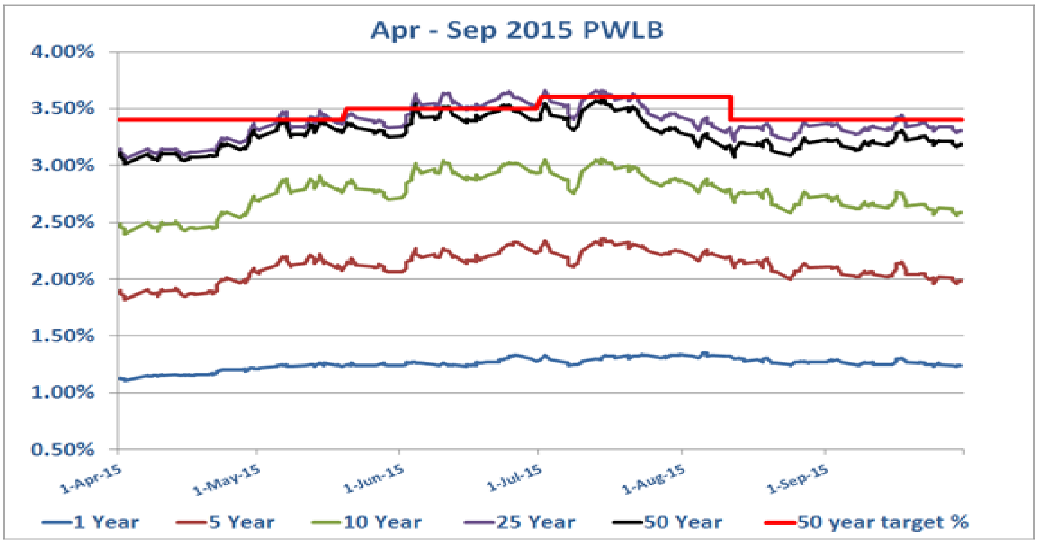
Estimated Capital Financing Requirement (CFR) at 31/03/16 See appendix 1 – indicator 2	£1,014.2m
Less PPP	-£122.0m
Estimated CFR 31/03/16	**£892.2m**
Long Term Debt 01/04/15	£746.2m
NHT borrowing 2015/16	£3.7m
Less repaid during 2015/16	-£21.7m
Long Term Debt 31/03/16	**£728.8m**
2015/16 capital expenditure will be funded by short term borrowing	
Add estimated net borrowing for new capital expenditure in 2014/15	£107.1m
Add Borrowing to replace maturing loans*	£20.7m
Short Term Debt at 31/03/16	**£127.8m**
Total long term and short term debt 31/03/15	**£856.6m**
Difference between CFR and borrowing = Funding from	£35.6m

internal balances and cash flow	

* Will not replace market loan for £1m that matured in August 2015.

5.4 Long Term borrowing rates have remained below Capita's central target rate for new external long term borrowing which was used for the loan charge budget.

5.5 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 decrease in interest rates for PWLB loans greater than 10 years and overall increase for shorter dated borrowing during the six months.



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.11%	1.82%	2.40%	3.06%	3.01%
Date	02/04/15	02/04/15	02/04/15	02/04/15	02/04/15
High	1.35%	2.35%	3.06%	3.66%	3.58%
Date	05/08/15	14/07/15	14/07/15	02/07/15	14/07/15
Average	1.26%	2.12%	2.76%	3.39%	3.29%

5.6 It is anticipated that over the remainder of the financial year, new long-term borrowing will be only undertaken if rates are advantageous. However, markets remain volatile, and favourable short-term borrowing opportunities are likely to be available to the Council, and will be considered where appropriate. 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.

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

6. Debt Rescheduling

6.1 No debt rescheduling was undertaken during the first six months of 2015/16 due to breakage costs.

7. Compliance with Treasury and Prudential Limits

7.1 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 March 2015.

7.2 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.

8. Implications

8.1 The resource implications are covered in the attached tables. There are no specific legal, risk, equality, climate change/Carbon Clever, Gaelic or rural implications relating to this report.

9. Recommendations

Members are invited to scrutinise this Treasury Management Mid-year Review Report 2015/16.

Members are asked to note that, in compliance with CIPFA's Code of Practice on Treasury Management in Local Authorities, this report will also be submitted to Council for approval in December 2015.

Designation:	Director of Finance
Author:	Catriona Stachan, Accountant
Date:	12 November 2015
Background Papers:	Logotech Reports, Excel Loans Fund files and Oracle Ledger prints

Appendix 1

Prudential and Treasury Indicators

The original Prudential Indicators were agreed within the TMSS March 2015.

The Estimates of Capital Expenditure below in indicator 3 and 4 include expenditure in relation the National Housing Trust which is self-financing, due to recovery of interest costs and under-writing of capital and interest guarantees by the Scottish Government.

Indicators for Affordability, Prudence and Capital Expenditure

Prudential Indicator		2015/16 Original (Est March 15)	2015/16 Revised Estimate	Explanation of Indicator
1.	**Capital Expenditure**			
	Estimates of Capital Expenditure (Gross)			
	General Fund including PPP	£113.3m	£133.5m	Expressed in absolute terms rather than as a ratio, these show the overall levels of capital investment irrespective of how they are being funded.
	Housing Revenue Account	£39.7m	£65.0m	
		£153.0m	**£201.9m**	
	Income			
	General Fund	-£42.9m	-£38.5m	
	Housing Revenue Account	-£20.5m	-£17.3m	
		£63.4m	**-£55.8m**	
	Net Capital Expenditure			
	General Fund including PPP	£70.4m	£95.0m	Net capital expenditure is the borrowing or funding requirement for new capital investment in each year.
	Housing Revenue Account	£19.2m	£47.7m	
	Total Net Capital Expenditure	**£89.6m**	**£142.7m**	

Prudential Indicator		2015/16 Original (Est March 15)	2015/16 Revised Estimate	Explanation of Indicator
	Instalments			
	General Fund including PPP	-£29.7m	-£28.2m	The loan charge instalment is the amount by which the debt outstanding is written off each year and is also called the repayment of principal. The amount depends on the period of write off for the loan and is calculated using an annuity factor.
	Housing Revenue Account	-£7.9m	-£7.4m	
		£37.6m	**£35.6m**	
	External Long Term Borrowing requirement for new capital expenditure			
	General Fund including PPP	£40.7m	£66.8m	
	Housing Revenue Account	£11.3m	£40.3m	
		£52.0m	**£107.1m**	
2.	**Capital Financing Requirement (CFR) as at 31/03/16**			
	General Fund excluding PPP	£611.0m	£624.5m	These indicators represent the level of the Council's underlying need to borrow or finance by other long-term liabilities for a capital purpose. This includes past and future borrowing or funding.
	PPP	£122.0m	£122.0m	
		£733.0m	**£746.5m**	
	Housing Revenue Account	£222.6m	£245.5m	
		£955.6m	**£992.0m**	
	Joint Boards	£22.2m	£22.2m	
	Total (incl Joint Boards)	**£977.8m**	**£1,014.2m**	

<table>
<tr><th colspan="2">Prudential Indicator</th><th>2015/16 Original (Est March 15)</th><th>2015/16 Revised Estimate</th><th>Explanation of Indicator</th></tr>
<tr><td>3.</td><td colspan="3">Treasury Position as at 31/03/16</td><td rowspan="8">This indicator shows the expected borrowing position, net of investments.</td></tr>
<tr><td></td><td>Borrowing (long term)</td><td>£821.1m</td><td>£748.9m</td></tr>
<tr><td></td><td>Borrowing (short term)</td><td></td><td>£107.1m</td></tr>
<tr><td></td><td>Total borrowing</td><td></td><td>£856.0m</td></tr>
<tr><td></td><td>Other Long Term Liabilities</td><td>£122.0m</td><td>£122.0m</td></tr>
<tr><td></td><td>Total Debt</td><td>£943.1m</td><td>£978.0m</td></tr>
<tr><td></td><td>Investments</td><td>-£50.0m</td><td>-£50.0m</td></tr>
<tr><td></td><td>Net Borrowing</td><td>£893.1m</td><td>£928.0m</td></tr>
<tr><td>4</td><td colspan="3">Authorised Limit for Borrowing</td><td rowspan="6">These indicators identify 2 limits in relation to the Council's total external debt. The Authorised Limit is the maximum level of external borrowing which should not be exceeded. The limit is linked to the estimated level of borrowing assumed in the Capital Programmes. An Operational Boundary is also required which represents the Director of Finance's estimate of the day to day limit for the Treasury Management activity based on the most likely i.e. prudent but not worst case scenario.</td></tr>
<tr><td></td><td>Borrowing</td><td>£924.3m</td><td>£924.3m</td></tr>
<tr><td></td><td>Other Long Term Liabilities</td><td>£122.0m</td><td>£122.0m</td></tr>
<tr><td>5.</td><td colspan="3">Operational Boundary for Borrowing</td></tr>
<tr><td></td><td>Borrowing</td><td>£907.1m</td><td>£907.1m</td></tr>
<tr><td></td><td>Other Long Term Liabilities</td><td>£122.0m</td><td>£122.0m</td></tr>
</table>

Prudential Indicator		2015/16 Original (Est March 15)	2015/16 Revised Estimate	Explanation of Indicator
6.	**Ratio of financing costs to net revenue stream**			These indicators show the capital financing costs (interest charges, the provision for the repayment of debt and the financing of PPP outstanding capital investment liability) as a percentage of government grant (revenue), Council Tax, Rents and other income. This allows the authority to track how much of its annual income is needed to pay for its capital investment plans and outstanding funding liabilities compared to its day to day running costs. For this mid-year report no significant variance from original estimates is assumed.
	General Fund including PPP	13.0%	12.2%	
	Housing Revenue Account	33.8%	35.0%	
7.	**Estimates of the Incremental impact of capital investment** decisions on the B and D Council tax	£56.32	£27.66	These indicators demonstrate the **notional** impact of varying new capital investment expressed as a cost on the Band D Council Tax and Rents. These are notional rather than actual increases in Council Tax and rent, as the Council has or will utilise savings and other measures to fund its capital plans, to minimise the impact on tax and rent levels. For this mid-year report no significant variance from original estimates is assumed.
8.	**Estimates of the Incremental impact of capital investment** decisions on the housing rent levels (Weekly figures based on a 48 week year are shown in brackets).	£114.03 (£2.38)	£79.20 (£1.65)	
9.	**Interest rate exposures of debt net of investments**			Interest rate exposures of debt net of investments are required to be set in compliance with the Code. This limits the Council's exposure to both fixed and variable interest rate movements as part of the overall risk management strategy for Treasury Management activities. It promotes a prudent strategy aimed to avoid the adverse effects of fluctuating interest rates. The limits are based on estimates of net capital advances outstanding.
	Upper Limit (Fixed)	£865.1m	£865.1m	
	Upper Limit (Variable)	£302.8m	£302.8m	

In addition to the above the Council is required as a Prudential Indicator to comply with the following which is in the body of the report:

- 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).

Appendix 2

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

Global economy

U.K.

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 marginally 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, although the pace of reductions was eased in the May Budget.

Despite these headwinds, the Bank of England is forecasting 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. Investment expenditure is also expected to support growth.

The August Bank of England Inflation Report forecast was notably subdued with inflation barely getting 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.

There are therefore considerable risks around whether inflation will rise in the near future as strongly as previously expected; this will make it more difficult for the central banks of both the US and the UK to raise rates as soon as had previously been expected, especially given the 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, which could potentially spill over to impact the real economies rather than just financial markets.

U.S.

The American economy has made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015. While there had been confident expectations during the summer that the Fed. could start increasing rates at its meeting on 17 September, or if not by the end of 2015, the recent downbeat news about Chinese and Japanese growth and the knock on impact on emerging countries that are major suppliers of commodities, was cited as the main reason for the Fed's decision to pull back from making that start. This has led to a reappraisal of the likelihood of any increase occurring in 2015 with early 2016 now being widely regarded as being more likely.

Eurozone

In the Eurozone, the ECB fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This already appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to a significant improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and looks as if it may maintain this pace in quarter 3. However, the recent downbeat Chinese and Japanese news has raised questions as to whether the ECB will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

China and Japan

Japan is causing considerable concern as the increase in sales tax in April 2014 has suppressed consumer expenditure and growth. In Q2 2015 growth was -1.6% (annualised) after a short burst of strong growth of 4.5% in Q1. During 2015, Japan has been hit hard by the downturn in China. This does not bode well for Japan as the Abe government has already fired its first two arrows to try to stimulate recovery and a rise in inflation from near zero, but has dithered about firing the third, deregulation of protected and inefficient areas of the economy, due to political lobbies which have traditionally been supporters of Abe's party.

As for China, the Government has been very active during 2015 in implementing several stimulus measures to try to ensure the economy hits the growth target of 7% for the current year and to bring some stability after the major fall in the onshore Chinese stock market. Many commentators are concerned that recent growth figures around that figure, could have been massaged to hide a downturn to a lower growth figure. There are also major concerns as to the creditworthiness of much bank lending to corporates and local government during the post 2008 credit expansion period and whether the bursting of a bubble in housing prices is drawing nearer. Overall, China is still expected to achieve a growth figure that the EU would be envious of. However, concerns about whether the Chinese cooling of the economy could be heading for a hard landing, and the volatility of the Chinese stock market, have caused major volatility in financial markets in August and September such that confidence is, at best, fragile

Capita's view for the next six months of 2015/16

The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

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

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth turns significantly weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Monetary policy action failing to stimulate sustainable growth and to combat the threat of deflation in western economies, especially the Eurozone and Japan.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or the start of Fed. rate increases, causing a flight to safe havens

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

- Uncertainty around the risk of a UK exit from the EU.
- The ECB severely disappointing financial markets with a programme of asset purchases which proves insufficient to significantly stimulate growth in the EZ.
- The commencement by the US Federal Reserve of increases in the Fed. funds rate in 2015, 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.