Agenda Item	**18(b)**
Report No	**RES/ 88/16**

The Highland Council

Resources Committee – 23 November 2016

Treasury Management Mid-year Review Report 2016/17

Report by the Director of Finance

Summary

This Treasury Management Mid-year Review Report 2016/17 is submitted to the Committee for Members' scrutiny and in compliance with CIPFA's Code of Practice on Treasury Management in Local Authorities.

This report also recommends an increase in individual counterparty limits from £15m to £20m with the exception of the Royal Bank and Clydesdale which will remain at £25m and £10m respectively.

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 2016/17, 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 2016/17;
- A review of the Council's borrowing strategy for 2016/17;
- A review of any debt rescheduling undertaken during 2016/17;
- A review of compliance with Treasury and Prudential Limits for 2016/17.

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 quarterly review of its interest rate forecasts after the MPC meeting of 4 August cut Bank Rate to 0.25% and gave forward guidance that it expected to cut Bank Rate again to near zero before the year end. The forecast below therefore includes a further cut to 0.10% in November this year and a first increase in May 2018, to 0.25%, but no further increase to 0.50% until a year later.

	Dec 16	**Mar 17**	**Jun 17**	**Sep 17**	**Dec 17**	**Mar 18**	**Jun 18**	**Sep 18**	**Dec 18**	**Mar 19**
BANK RATE	0.10	0.10	0.10	0.10	0.10	0.10	0.25	0.25	0.25	0.25
5yr PWLB	1.00	1.00	1.10	1.10	1.10	1.10	1.20	1.20	1.20	1.30
10yr PWLB	1.50	1.50	1.60	1.60	1.60	1.60	1.70	1.70	1.70	1.80
25yr PWLB	2.30	2.30	2.40	2.40	2.40	2.40	2.50	2.50	2.50	2.50
50yr PWLB	2.10	2.10	2.20	2.20	2.20	2.20	2.30	2.30	2.30	2.40

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 2016/17 was approved by Council on 10 March 2016. 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 the Council will avoid locking into longer term deals while investment rates are down at historically low levels unless 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 2016/17 financial year as a result of the aftermath of the Brexit vote, and the Council benefits from the PWLB certainty rate discount of 0.20% 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 10 March 2016 is still fit for purpose in the current economic climate.

4. Investment Portfolio 2016/17

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 0.59% against a benchmark (7 Day London Inter-bank Offer Rate – LIBID average) of 0.28%. During October 2016, the Council placed a £10m deposit with DZ bank to cover cash flow requirements in March 2017 and in July a fixed term deposit of £5m was placed with Commonwealth Bank of Australia.

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 2016/17 was £80.6m (2015/16 £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.

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 have reduced further following cut to the bank rate.

4.5 The most recent Treasury Management Strategy Statement & Investments Strategy (approved 24 February 2016) set out the individual counterparty limits as £15m with the exception of the Royal Bank limit which is £25m due to Government support, and the Clydesdale bank limit is £10m.

4.6 In order to increase counterparty capacity and access better rates, it is proposed that all individual counterparty limits are increased from £15m to £20m with the exception of RBS and Clydesdale which will remain at £25m and £10m respectively. Whilst this would increase the exposure of the Council to potential losses of £20m rather than £15m if any individual counterparty were to collapse it is felt that the benefits from this move would outweigh any increased risks. As outlined in 4.4 any deposits will only be placed with appropriate counterparties.

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.

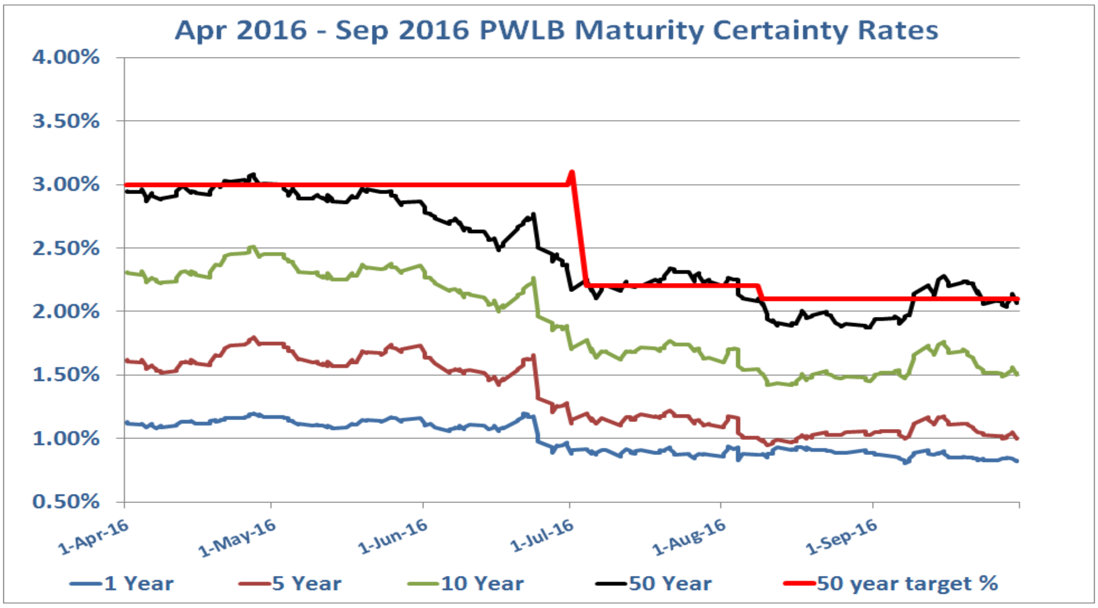
5.2 The balance of external and internal borrowing is generally driven by market conditions, and the need to take a balanced view of savings available from short term and internal borrowing, versus the mitigation of re-financing risk which can be achieved from longer-term borrowing, but at potentially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

5.3 The table below shows the estimated CFR at 31/03/17 and how it is expected to be funded by long and short term borrowing. This approach has largely been driven by market conditions, favourably low short-term rates, and cash flows in the early part of the year. In June 2016, £25m of long term PWLB borrowing was undertaken to replace debt that matured in March 2016.

Estimated Capital Financing Requirement (CFR) at 31/03/17 See appendix 1 – indicator 2	£1,031.9m
Less PPP	-£118.2m
Estimated CFR 31/03/17	**£913.7m**
Opening Long Term Debt 01/04/16	£729.5m
New fixed rate market borrowing for periods of 5 years or less replacing short term borrowing	£28.0m
PWLB borrowing (21/06/16) to replace PWLB loan (£20m	£25.0m

repaid 31/03/16)	
Long term maturities (£20m PWLB maturing 31/03/17, £0.75m mortgages)	-£20.7m
Estimated Long Term Debt 31/03/17	**£761.8m**
Opening short term borrowing 01/04/16	£89.0m
Short term borrowing replaced with new longer term borrowing	-£53.0m
Add estimated net borrowing for new capital expenditure in 2016/17	£47.3m
Add Borrowing to replace maturing loans (£20m PWLB maturing 31/03/17, £0.75m mortgages)	£20.7m
Estimated Short Term Debt at 31/03/17	**£104.0m**
Estimated total long term and short term debt 31/03/17	**£865.8m**
Difference between CFR and borrowing = Funding from internal balances and cash flow	£47.9m

5.4 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 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	0.81%	0.95%	1.42%	2.08%	1.87%
Date	07/09/16	10/08/16	10/08/16	12/08/16	30/08/16
High	1.20%	1.80%	2.51%	3.28%	3.08%
Date	27/04/16	27/04/16	27/04/16	27/04/16	27/04/16
Average	0.99%	1.33%	1.92%	2.69%	2.46%

5.5 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.

5.6 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.

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 2016/17 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 2016.

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 borrowing undertaken at favourable interest rates, as detailed above, is forecast to result in an underspend in the loans charges budget of £0.5m. This figure depends on the level of capital expenditure undertaken and will be reviewed during the course of the year.

8.2 The recommendation to increase the counterparty limit from £15m to £20m has Risk implications for the Council as it would increase the exposure of the Council to potential losses of £20m rather than £15m if any individual counterparty was to collapse.

8.3 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.

8.4 There are no Legal; Equalities; Climate Change/Carbon Clever; Gaelic or Rural implications relating to this report.

Recommendation

Members are invited to scrutinise this Treasury Management Mid-year Review Report 2016/17.

It is also recommended that the Committee approve that the individual counterparty limit is increased from £15m to £20m with the exception of the Royal Bank and Clydesdale which will remain at £25m and £10m respectively.

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Date:	8 November 2016
Background Papers:	Treasury Live Reports, Excel Loans Fund files and Integra Ledger prints

Appendix 1

Prudential and Treasury Indicators

The original Prudential Indicators were agreed within the TMSS March 2016.

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		2016/17 Original (Est March 16)	2016/17 Revised Estimate	Explanation of Indicator
1.	**Capital Expenditure**			
	Estimates of Capital Expenditure (Gross)			
	General Fund including PPP	£86.0m	£115.5m	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	£26.4m	£38.8m	
		£112.4m	**£154.4m**	
	Income			
	General Fund	-£38.5m	-£53.2m	
	Housing Revenue Account	-£10.8m	-£16.6m	
		£49.3m	**-£69.8m**	
	Net Capital Expenditure			
	General Fund including PPP	£47.5m	£62.3m	Net capital expenditure is the borrowing or funding requirement for new capital investment in each year.
	Housing Revenue Account	£15.6m	£22.2m	
	Total Net Capital Expenditure	**£63.1m**	**£84.5m**	

Prudential Indicator		2016/17 Original (Est March 16)	2016/17 Revised Estimate	Explanation of Indicator
	Instalments			
	General Fund including PPP	-£24.0m	-£28.6m	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	-£9.4m	-£8.6m	
		£33.4m	**-£37.2m**	
	External Long Term Borrowing requirement for new capital expenditure			
	General Fund including PPP	£23.5m	£33.7m	
	Housing Revenue Account	£6.2m	£13.6m	
		£29.7m	**£47.3m**	
2.	**Capital Financing Requirement (CFR) as at 31/03/17**			
	General Fund excluding PPP	£623.4m	£643.0m	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	£118.2m	£118.2m	
		£741.6m	**£761.2m**	
	Housing Revenue Account	£240.1m	£249.0m	
		£981.7m	**£1,010.2m**	
	Joint Boards	£21.1m	£21.2m	
	Total (incl Joint Boards)	**£1,002.8m**	**£1,031.4m**	

Prudential Indicator		2016/17 Original (Est March 16)	2016/17 Revised Estimate	Explanation of Indicator
3.	**Treasury Position as at 31/03/17**			This indicator shows the expected borrowing position, net of investments.
	Borrowing (long term)	£872.4m	£761.8m	
	Borrowing (short term)	-	£104.0m	
	Total borrowing	**£872.4m**	**£865.8m**	
	Other Long Term Liabilities	£118.2m	£118.2m	
	Total Debt	**£990.6m**	**£984.0m**	
	Investments	-£50.0m	-£50.0m	
	Net Borrowing	**£940.6m**	**£934.0m**	
4	**Authorised Limit for Borrowing**			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.
	Borrowing	£963.6m	£963.6m	
	Other Long Term Liabilities	£118.2m	£118.2m	
	Total	**£1,081.8m**	**£1,081.8m**	
5.	**Operational Boundary for Borrowing**			
	Borrowing	£947.6m	£947.6m	
	Other Long Term Liabilities	£118.2m	£118.2m	
	Total	**£1,065.8m**	**£1,065.8m**	

Prudential Indicator		2016/17 Original (Est March 16)	2016/17 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	11.5%	11.5%	
	Housing Revenue Account	39.9%	39.9%	
7.	**Estimates of the Incremental impact of capital investment** decisions on the B and D Council tax	-£42.51	£6.62	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).	£163.29 (£3.40)	£77.26 (£1.61)	
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)	£884.7m	£884.7m	
	Upper Limit (Variable)	£309.6m	£309.6m	

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 strong but 2015 was disappointing at 1.8%, though it still remained one of the leading rates among the G7 countries. Growth improved in quarter 4 of 2015 from +0.4% to 0.7% but fell back to +0.4% (2.0% y/y) in quarter 1 of 2016 before bouncing back again to +0.7% (2.1% y/y) in quarter 2. During most of 2015, the economy had faced headwinds for exporters from the appreciation during the year 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. The referendum vote for Brexit in June this year delivered an immediate shock fall in confidence indicators and business surveys, pointing to an impending sharp slowdown in the economy. However, subsequent surveys have shown a sharp recovery in confidence and business surveys, though it is generally expected that although the economy will now avoid flat lining, growth will be weak through the second half of 2016 and in 2017.

The Bank of England meeting on August 4th addressed this expected slowdown in growth by a package of measures including a cut in Bank Rate from 0.50% to 0.25%. The Inflation Report included an unchanged forecast for growth for 2016 of 2.0% but cut the forecast for 2017 from 2.3% to just 0.8%. The Governor of the Bank of England, Mark Carney, had warned that a vote for Brexit would be likely to cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the UK would have continuing full access, (i.e. without tariffs), to the EU single market. He also warned that the Bank could not do all the heavy lifting and suggested that the Government will need to help growth by increasing investment expenditure and possibly by using fiscal policy tools (taxation). The new Chancellor Phillip Hammond announced after the referendum result, that the target of achieving a budget surplus in 2020 will be eased in the Autumn Statement on November 23.

The Inflation Report also included a sharp rise in the forecast for inflation to around 2.4% in 2018 and 2019. CPI has started rising during 2016 as the falls in the price of oil and food twelve months ago fall out of the calculation during the year and, in addition, the post referendum 10% fall in the value of sterling on a trade weighted basis is likely to result in a 3% increase in CPI over a time period of 3-4 years. However, the MPC is expected to look thorough a one off upward blip from this devaluation of sterling in order to support economic growth, especially if pay increases continue to remain subdued and therefore pose little danger of stoking core inflationary price pressures within the UK economy.

U.S. The American economy had a patchy 2015 with sharp swings in the growth rate leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 disappointed at +0.8% on an annualised basis while quarter 2 improved, but only to a lacklustre +1.4%. However, forward indicators are pointing towards a pickup in growth in the rest of 2016. The Fed. embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene and then the Brexit vote, have caused a delay in the timing of the second increase which is now strongly expected in December this year.

Eurozone In the Eurozone, the ECB commenced in March 2015 its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month; this was intended to run initially to September 2016 but was extended to March 2017 at its December 2015 meeting. At its December and March meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise from around zero towards the target of 2%. GDP growth rose by 0.6% in quarter 1 2016 (1.7% y/y) but slowed to +0.3% (+1.6% y/y) in quarter 2. This has added to comments from many forecasters that central banks around the world are running out of ammunition to stimulate economic growth and to boost inflation. They stress that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand in the their economies and economic growth.

China and Japan Japan is still bogged down in anaemic growth and making little progress on fundamental reform of the economy while Chinese economic growth has been weakening and medium term risks have been increasing.

Capita's view for the next six months of 2016/17

Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. An eventual world economic recovery may also see investors switching from the safe haven of bonds to equities.

We have pointed out consistently that the Fed. rate is likely to go up more quickly and more strongly than Bank Rate in the UK and recent events have not changed that view, just that the timing of such increases may well have been deferred somewhat. While there is normally a high degree of correlation between the two yields, we would expect to see a growing decoupling of yields between the two i.e. we would expect US yields to go up faster than UK yields. We will need to monitor this area closely and the resulting effect on PWLB rates.

The overall balance of risks to economic recovery in the UK remains to the downside. We would, as always, remind clients of the view that we have expressed in our previous interest rate revision newsflashes of just how unpredictable PWLB rates and bond yields are at present. We are experiencing exceptional levels of volatility which are highly correlated to emerging market, geo-political and sovereign debt crisis developments. Our revised forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

Apart from the uncertainties already explained above, downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Monetary policy action reaching its limit of effectiveness and failing to stimulate significant sustainable growth, combat the threat of deflation and reduce high levels of debt in some major developed economies, combined with a lack of adequate action from national governments to promote growth through structural reforms, fiscal policy and investment expenditure.
- Weak capitalisation of some European banks.
- A resurgence of the Eurozone sovereign debt crisis.
- Geopolitical risks in Europe, the Middle East and Asia, increasing safe haven flows.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or Fed. rate increases, causing a further flight to safe havens (bonds).
- 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.

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

- The pace and timing of increases in the Fed. funds rate 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