AUD174

REPORT TITLE: TREASURY MANAGEMENT MID YEAR REVIEW

AUDIT COMMITTEE

24 NOVEMBER 2016

PORTFOLIO HOLDER: Cllr Stephen Godfrey

REPORT OF HEAD OF FINANCE

Contact Officer: Simon Little Tel No: 01962 848224

Email slittle@winchester.gov.uk

WARD(S): ALL WARDS

PURPOSE

The purpose of this report is to inform the Audit Committee of the Treasury related activities over the first seven months of financial year and to make recommendations of any amendments to the Treasury Management Strategy to Full Council. This is to enable the efficient use of resources to maximise the return from investments within the risk appetite of the Council.

Due to increased levels of investments held, this paper recommends that the Council increase some of its counter-party investment levels from £5m to £7m to ensure there is a reasonable return to the Council on its investments and that it can manage counter-party risk. This paper also requests that the levels of longer term investments are increased to again enable a better rate of return in a historically low interest rate period and also, importantly, to reduce the risk that the Council has too much money held in short terms funds across a very large number of counterparties.

RECOMMENDATIONS:

That the Audit Committee:

1. Approves the Treasury Management Mid-Year Monitoring Report for 2016/17; and
2. Recommends to Full Council that the changes to the 2016/17 Treasury Management Strategy as detailed in section 15 of the report, be approved.

IMPLICATIONS:

1 COMMUNITY STRATEGY OUTCOME

1.1 Treasury management is part of being and Efficient and Effective Council.

2 FINANCIAL IMPLICATIONS

2.1 Effective treasury management ensures both the financial security and liquidity of the Council.

3 LEGAL AND PROCUREMENT IMPLICATIONS

3.1 None

4 WORKFORCE IMPLICATIONS

4.1 None

5 PROPERTY AND ASSET IMPLICATIONS

5.1 None

6 CONSULTATION AND EQUALITY IMPACT ASSESSMENT

6.1 None

7 RISK MANAGEMENT

Risk	**Mitigation**	**Opportunities**
Returns from investments are too low	A diversified strategy that attempts to manage the balance between liquidity risk, credit risk and yield within the Council's risk appetite.	
A counterparty fails	A diversified strategy that has relatively low levels of counter-party risk	

Cash is not available	A balanced portfolio of liquid and long term funds are held to ensure cash is available to utilise. The Council also mitigates this risk through cashflow forecasting	More accurate and immediate cashflow forecasting can help improve the return on investments through more active treasury management activity

8 SUPPORTING INFORMATION:

9 Introduction

9.1 The Treasury Management Strategy for 2016/17 is underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

9.2 The Code also recommends that members are informed of Treasury Management activities at least twice a year (a mid year and a year end report). This report therefore ensures that Winchester City Council (WCC) are embracing best practice in accordance with CIPFA's recommendations.

9.3 Treasury management is defined as: "the management of investments and cash flows, 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".

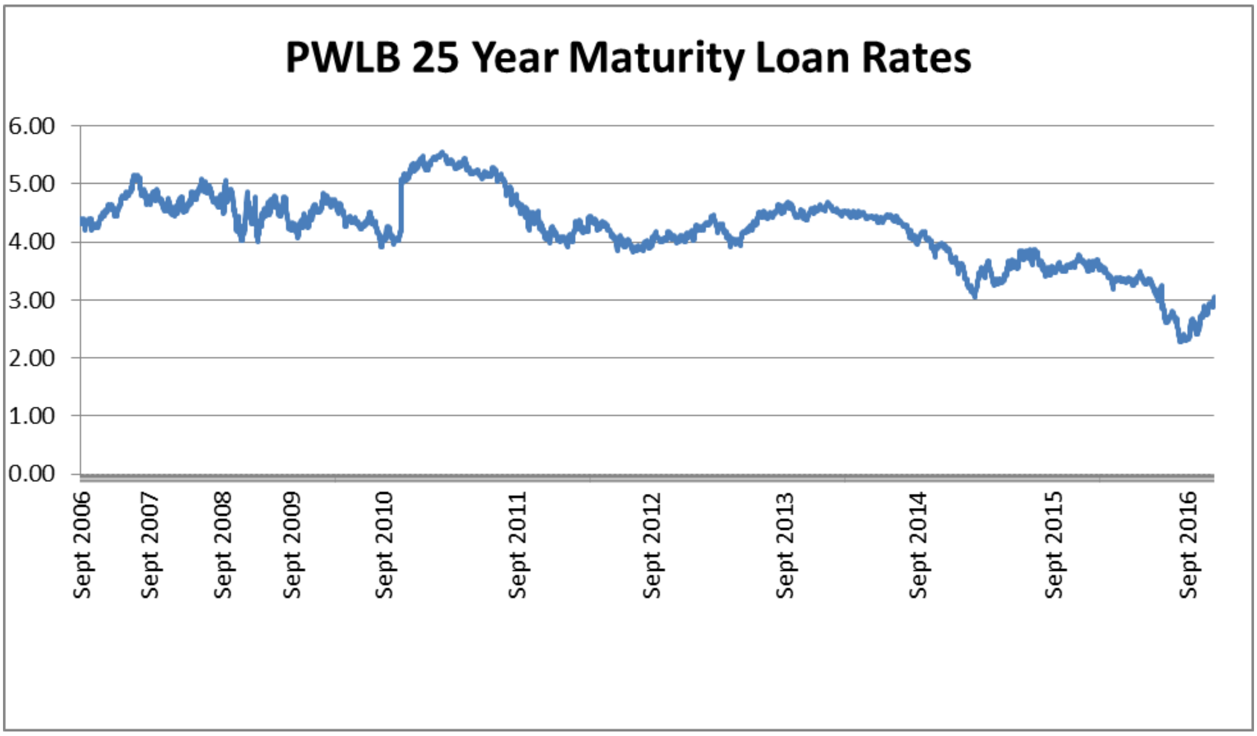
10 Economic Background

10.1 The following section outlines the key economic themes currently in the UK against which investment and borrowing decisions have been made in the year to date.

10.2 The preliminary estimate of Quarter 3 2016 GDP showed growth as the economy grew 0.5% quarter-on-quarter, and 2.3% year-on-year. However the UK economic outlook changed significantly on 23 June 2016. The surprise result of the referendum on EU membership prompted forecasters to rip up previous projections and dust off worst-case scenarios. Growth forecasts had already been downgraded as 2016 progressed, as the very existence of the referendum dampened business investment, but the crystallisation of these downside risks and the subsequent political turmoil prompted a sharp decline in household, business and investor sentiment.

10.3 The repercussions of this plunge in sentiment on economic growth were judged by the Bank of England to be severe, prompting the Monetary Policy Committee (MPC) to initiate substantial monetary policy easing at its August meeting to mitigate the worst of the downside risks. This included a cut in Bank Rate to 0.25%, further gilt and corporate bond purchases (quantitative easing (QE)) and cheap funding for banks to maintain the supply of credit to the economy. The minutes of the August meeting also suggested that many members of the Committee supported a further cut in Bank Rate to near-zero levels (the Bank, however, does not appear keen to follow peers into negative rate territory) and more QE should the economic decline worsen.

10.4 In response to the Bank of England's policy announcement, money market rates and bond yields declined to new record lows. Banks are being heavily encouraged to pass on the reduction in rates to customers since the onset of the financial crisis over eight years ago, the Council's Treasury Management Adviser's (Arlingclose Ltd) rate outlook has progressed from 'lower for longer' to 'even lower for even longer' to, now, 'even lower for the indeterminable future'. Arlingclose's central forecast case for Bank Base Rate is currently 0.25%, but there is a strong possibility that the rate is cut further towards zero. The macro-economic picture has also had a significant impact on the PWLB (Public Works Loans Board) rates at which the Council can borrow, with 25 year money at very low levels in recent months.



10.5 Meanwhile, inflation is expected to pick up due to a rise in import prices, dampening wage growth and real investment returns. The August Quarterly Inflation Report from the Bank of England forecast a rise in CPI to 0.9% by the end of calendar 2016 and thereafter a rise closer to the Bank's 2% target over the coming year, as previous rises in commodity prices and the sharp depreciation in sterling begin to drive up imported material costs for companies.

11 Investment Activity

11.1 WCC holds invested funds representing income received in advance of expenditure plus balances and reserves held. WCC is currently investing according to a low risk, high quality lending list as outlined in its Treasury Management Strategy.

11.2 The transposition of European Union directives into UK legislation places the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors through potential bail-in of unsecured bank deposits. (The outcome of the EU referendum does not alter the UK's legislated bail-in resolution regime.)

11.3 Given the increasing risk and continued low returns from short-term unsecured bank investments, it is WCC's aim to further diversify into more secure and/or higher yielding asset classes. The majority of WCC's surplus cash was previously invested in short-term unsecured bank deposits, certificates of deposit and money market funds.

11.4 WCC's investment holding was £62.7m at 31 October 2016, which was £12.1m (23.9%) higher than the same time last year, The investment balances have increased due to a number of reasons, the main ones being the receipt of a large grant from the HCA towards the delivery of a housing build project, the continued slippage in the delivery of other non-housing projects and the Council's continued push to transform the organisation which has led to savings being made ahead of the curve of the cuts in central government support.

11.5 The balances were placed into the following investment types:

Table 1 – Investments at 31 October 2016

Duration to maturity	Overnight £m	< 1 year £m	>1 year £m	Total £m	Average rate/yield %	Average life (years)
Subject to bail-in risk						
Bank call accounts	3.0	-		3.0	0.75	0.00
Bank notice accounts	-	6.0		6.0	0.90	0.23
Bank certificates of deposit[1]	-	6.0		6.0	0.49	0.25
	3.0	12.0	-	15.0	0.70	0.19
Exempt from bail-in risk						
Covered floating rate notes	-	3.5	7.0	10.5	0.68	1.12
Covered fixed bonds	-	1.5	1.0	2.5	1.08	0.59
Supranational bonds	-	1.0	-	1.0	0.61	0.10
Government bonds	-	3.0	-	3.0	0.71	0.12
Corporate fixed bonds	-	3.0	-	3.0	0.53	0.34
Money market funds	8.4	-	-	8.4	0.39	0.00
Local authorities	-	16.0	-	16.0	0.66	0.43
Pooled property funds	-	-	2.0	2.0	4.88	n/a
Registered provider	-	1.3	-	1.3	0.59	0.16
	8.4	29.3	10.0	47.7	0.80	0.48
Total	**11.4**	**41.3**	**10.0**	**62.7**	**0.78**	**0.41**

11.6 The Council is currently holding a £3m balance in a bank call account, and £6m within bank notice accounts. Although these are investments that are subject to bail-in risk, they provide reasonable liquidity, and they are currently earning rates of interest which compensate for the level of risk.

11.7 Counterparty credit quality was assessed and monitored with reference to credit ratings (WCC's minimum long-term counterparty rating for institutions defined as having "high credit quality" is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

11.8 The average interest rate earned on these investments at 31 October 2016 was 0.78%, which should be considered within the context of a recently lowered UK Base Rate of 0.25%, following a period of over 7 years of unchanged UK Base Rate at 0.50%, and very low short-term money market rates. This rate reflects interest rates available prior to the Base Rate cut, and is likely to fall in the coming months.

[1] Certificates of deposit have fixed terms but have greater liquidity as they can be sold on the secondary market.

11.9 The Guidance on Local Government Investments in England gives priority to security and liquidity and WCC's aim is to achieve a yield commensurate with these principles. This has been maintained by following WCC's counterparty policy as set out in its Treasury Management Strategy for 2016/17.

12 Borrowing Strategy

12.1 The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) at 31 March 2016 was £163m. Affordability and the "cost of carry" remained important influences on WCC's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing.

12.2 For the Council the use of internal resources in lieu of borrowing has, therefore, continued to be the most cost effective means of funding capital expenditure. No new long-term borrowing has taken place to date in 2016/17, or is planned for the remainder of the year. This has lowered overall treasury risk by reducing both external debt and temporary investments.

12.3 As at 31 October 2016 the Council held £156.7m of loans, (which has not changed since the last report at 31/3/2016), as part of its strategy for funding previous years' Housing Revenue Account programmes.

12.4 The premia that applies to the premature repayment of the Council's Public Works Loan Board loans is still relatively expensive for the loans in the portfolio and therefore unattractive for debt rescheduling. As a consequence, no rescheduling activity has taken place. However, consideration will continue to be given to any advantageous opportunity for the Council to reduce or restructure its debt portfolio.

13 Compliance with Prudential Indicators

13.1 During the financial year to date, the Council operated within the Prudential Indicators for 2016/17, which were set in February 2016 as part of the Council's Treasury Management Strategy Statement.

Authorised Limit and Operational Boundary for External Debt

13.2 CIPFA's Code of Practice requires authorities to set an authorised limit for external debt, defined as the sum of external borrowing and other long-term liabilities. The annual strategy report agreed by WCC in February 2016 set an authorised limit for external debt of £201.7m.

13.3 This limit is based on the estimated CFR in order to enable it to be financed entirely from external borrowing should WCC's internal reserves become depleted. The limit also includes an allowance for temporary borrowing to cover normal revenue cash flow requirements and unexpected outflows or delays in receiving cash.

13.4 The Council has set an operational boundary for external debt reflecting the more likely scenario and consistent with WCC's capital plans and Treasury Management Strategy. Temporary breaches of 2016/17 operational boundary can take place for cash flow reasons, but any sustained breach will lead to further investigation. WCC approved an operational boundary for 2016/17 of £194.2m.

Table 2 – Authorised Limit and Operational Boundary for External Debt

	Authorised Limit £m	Operational Boundary £m	2016/17 Actual £m
Borrowing	200.7	193.4	156.7
Other long-term liabilities	1.0	0.8	0.8
Total debt	**201.7**	**194.2**	**157.5**

13.5 During the period to 31 October 2016, borrowing remained well within the authorised limit and operational boundary, and no new long-term borrowing has been taken out.

14 Treasury Management Indicators

14.1 The Council measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

14.2 The Council has to set an upper limit on its fixed and variable interest rate exposures for both total investments and total external debt. This indicator is set to control WCC's exposure to interest rate risk. WCC approved the following upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed or invested. None of the limits have been exceeded.

Table 3 – Interest Rate Exposures

	2016/17 limit	Maximum to 31 October 2016
Upper limit on fixed interest rate investment exposure	£15.0m	£3.0m
Upper limit on variable interest rate investment exposure	£80.0m	£69.6m
Upper limit on fixed interest rate borrowing exposure	£201.7m	£156.7m
Upper limit on variable interest rate borrowing exposure	£201.7m	-

14.3 The limit for borrowing rate exposures has been set to enable maximum policy flexibility for the potential for refinancing e.g. from variable to fixed rate borrowing. WCC's entire long-term debt portfolio is currently made up of fixed interest loans.

14.4 The upper limit for investment exposure rates is based on an extreme case of the total investment balances, and to allow for all of this to be held at variable rates (investments with a maturity of less than one year) if necessary.

Maturity Structure of Borrowing

14.5 The Code also requires the Council to set upper and lower percentage limits on the maturity structure of its long-term fixed rate borrowing during 2016/17. The following table shows the limits approved by WCC. These have been set to allow maximum flexibility in managing the debt portfolio and are consistent with the existing portfolio.

Table 4 – Maturity Structure of Borrowing

	Upper	**Lower**	**Actual**
Under 12 months	25%	0%	0%
12 months and within 24 months	25%	0%	0%
24 months and within 5 years	25%	0%	0%
5 years and within 10 years	25%	0%	13%
10 years and within 20 years	50%	0%	38%
20 years and within 30 years	50%	0%	13%
30 years and within 40 years	75%	0%	13%
40 years and within 50 years	100%	0%	23%

Principal Sums Invested for Periods Longer than 364 days

14.6 The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. For 2016/17 WCC restricted investments for periods of over a year to a maximum of £15m. At 31 October 2016 WCC held £10m of investments with over 364 days to their maturity, and £12m at its maximum.

15 Changes to the 2016/17 Treasury Management Strategy

15.1 Hampshire County Council has managed WCC's Treasury Management function for two years, and within this time WCC's investment balances have risen significantly from £39m to £72m at its highest point this financial year. The investment balances have increased due to a number of reasons, the main ones being the receipt of a large grant from the HCA towards the delivery of a housing build project, the continued slippage in the delivery of other non-housing projects and the Council's continued push to transform the organisation which has led to savings being made ahead of the curve of the cuts in central government support. The diversification of those balances has been managed initially between 22 counterparties which have now grown to 37 counterparties.

15.2 Investment balances are higher than predicted when the current Treasury Management Strategy was approved, which has resulted in reduced flexibility. The priority of capital security through diversification remains the same, so in order to create greater diversification and maintain the same flexibility with higher balances it would be helpful to make some changes to the 2016/17 Treasury Management Strategy.

Investment Limits

15.3 Increasing the investment and counterparty limits will maintain the previous level of flexibility but with higher cash balances.

15.4 As approved in the 2016/17 Treasury Management Strategy, a group of banks under the same ownership will be treated as a single organisation for limit purposes. Maximum limits will also be placed on fund managers and industry sectors as below:

Table 5 – Investment Limits

	Cash Limit	
	Current	Revised
Any single organisation, except the UK Central Government	£5m each	£7m each
UK Central Government	Unlimited	Unchanged
Any group of organisations under the same ownership	£5m per group	£7m per group
Any group of pooled funds under the same management	£5m per manager	£7m per manager
Registered Providers	£6m in total	Unchanged
Money Market Funds	50% in total	Unchanged

15.5 WCC may invest its surplus funds with any of the counterparty types in Table 6, subject to the cash limits (per counterparty) and the duration limits shown.

Table 6 - Counterparty limits: Revised limits

Credit Rating	Banks Unsecured	Banks Secured	Government	Corporates	Registered Providers Unsecured	Registered Providers Secured
UK Govt	n/a	n/a	£ Unlimited 30 years	n/a	n/a	n/a
AAA	£3.5m 5 years	£7m 20 years	£7m 30 years	£3.5m 20 years	£3.5m 20 years	£3.5m 25 years
AA+	£3.5m 5 years	£7m 10 years	£7m 25 years	£3.5m 10 years	£3.5m 10 years	£3.5m 10 years
AA	£3.5m 4 years	£7m 5 years	£7m 15 years	£3.5m 5 years	£3.5m 10 years	£3.5m 10 years
AA-	£3.5m 3 years	£7m 4 years	£7m 10 years	£3.5m 4 years	£3.5m 10 years	£3.5m 10 years
A+	£3.5m 2 years	£7m 3 years	£3.5m 5 years	£3.5m 3 years	£3.5m 5 years	£3.5m 5 years
A	£3.5m 13 months	£7m 2 years	£3.5m 5 years	£3.5m 2 years	£3.5m 5 years	£3.5m 5 years
A-	£3.5m 6 months	£7m 13 months	£3.5m 5 years	£3.5m 13 months	£3.5m 5 years	£3.5m 5 years
BBB+	£1m 100 days	£3.5m 6 months	£3.5m 2 years	£1m 6 months	£3.5m 2 years	£3.5m 2 years
BBB	£1m next day only	£3.5m 100 days	n/a	n/a	n/a	n/a
None	£1m 6 months	n/a	£3.5m 25 years	n/a	£3.5m 5 years	£3.5m 25 years
Pooled funds	£7m per fund					

Principal Sums Invested for Periods longer than 364 days

15.6 As a result of the cash balances held by WCC being greater than expected, principal sums invested for periods longer than 364 days are now close to the limits set for 2017/18 and 2018/19 within the strategy.

15.7 For 2017/18 and 2018/19 WCC restricted investments for periods of over a year to a maximum of £5.0m. At 31 October 2016 WCC is at the maximum limit for 2017/18 as there are £3.0m of investments and a further £2.0m committed which have over 364 days to their maturity as at the end of 2017/18. Against the 2018/19 limit, WCC has £1.0m spare capacity as there are £2.0m of investments and a further £2.0m committed which have over 364 days to their maturity as at the end of 2018/19.

15.8 The profile of spend for the council, especially the delay in delivery of large capital projects means that the Council has continued to hold too much cash in less than 1 year investments, thereby reducing the potential return from that asset. With borrowing costs being at very low levels it is possible to place our resources into longer term vehicles which will improve the annual return; if the Council then requires the cash sooner than anticipated it can borrow short-term at very low rates pending the liquidation of some investments.

15.9 Therefore it would be prudent to increase these limits to £17.0m for 2017/18 and £18.0m for 2018/19 to allow for further excess funds to be invested over a longer period so as to maintain the previous level of flexibility and to also take advantage of greater interest rates than those that are available in the over-night cash options.

Table 7 – Limit on principal invested beyond 364 days

	2016/17	2017/18	2018/19
Limit on principal invested beyond 364 days	£15m	£17m	£18m

15.10 Increasing the principal sum invested for periods longer than 364 days requires other limits to also be increased so as to comply with the new limits. These new limits are shown in the table below.

Table 8: Interest Rate Exposures

	2016/17	2017/18	2018/19
Upper limit on fixed interest rate investment exposure	£15.0m	£17.0m	£18.0m
Upper limit on variable interest rate investment exposure	£80.0m	£80.0m	£80.0m
Upper limit on fixed interest rate borrowing exposure	£201.7m	£208.9m	£222.3m
Upper limit on variable interest rate borrowing exposure	£201.7m	£208.9m	£222.3m

BACKGROUND DOCUMENTS:-

Previous Committee Reports:-

CAB2766 - Treasury Management Strategy 2016/17 – 18 February 2016

Other Background Documents:-

None

APPENDICES:

None