Rother District Council **Agenda Item: 6.2**

Report to	-	Audit and Standards Committee
Date	-	27 September 2017
Report of the	-	Executive Director of Resources
Subject	-	Treasury Management Report - Mid Year Review

Recommendation: It be **RESOLVED**: That the report be noted.

Service Manager: Robin Vennard

Introduction

1. Cabinet approved the Council's 2017/18 Investment Strategy in February this year. The investment strategy requires regular reports to be presented to this Committee on the Council's treasury management activities. Members are also reminded that investment activity is also reported through the Members' Bulletin. In managing its treasury management activities, the Council follows the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011).

2. The primary requirements of the Code are as follows:

   i. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

   ii. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

   iii. Receipt by the full Council of an annual Treasury Management Strategy Statement (TMSS) – including the Annual Investment Strategy and Minimum Revenue Provision Policy – for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.

   iv. 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.

   v. 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 Audit and Standards Committee.

3. This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management.

Economic Update

4. Appendix 1 is our treasury advisors, Capita Asset Services' (CAS), view on the current economic environment and their outlook for the remainder of 2017/18. It details the impact this is likely to have on the Council's investment performance.

5. CAS undertook its last review of the main economic and market forecasts on 18 August 2017.

Treasury Management Strategy and Annual Investment Strategy review

6. The Council currently makes all its investments through the use of call and deposit accounts with the major financial UK institutions. In the last quarter they have additionally invested in a Local Authority. Capita's suggested duration in respect of Local Authorities is up to 5 years (colour code: yellow).

7. In addition the Council holds a Government Gilt valued at £1.121m which is a legacy of the previous arrangements with the external fund managers. The Council invested £2.25 million in the Churches, Charities, Local Authorities' (CCLA) Property Investment Fund in 2016/17. A further £2.75 million was invested at the end of April 2017. The current dividend yield as at July 2017 is 4.49%.

8. The Council is bringing forward proposals to invest in properties. A report on this has recently been considered by the Overview and Scrutiny Committee and the Treasury implications will be considered by this Committee in due course.

9. The following paragraphs describe the recent investment activity and the level of investment returns currently being generated.

Investment Portfolio 2017/18

10. 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. As set out in Appendix 1, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low with the Bank rate now at 0.25%. The Council's cash levels and cash flow profiles as well as restrictions on maximum deposit duration contribute to a low risk and short-term strategy. Given this risk averse environment, investment returns are likely to remain low.

11. The Council held £30m of investments as at 25 August 2016 and the investment portfolio yield to 30 June 2017 is £70,035. The average rate of return is 1.09%.

The following table shows the current investments:

Deposit with	Type of account	Maturity Date	Amount	Interest rate
Nat West	Deposit	10/05/2018	£2,000,000	0.48
Nat West	Deposit	10/07/2018	£2,000,000	0.46
Nat West	Deposit	09/08/2018	£1,000,000	0.42
Lloyds	Deposit	09/11/2017	£1,000,000	0.55
Lloyds	Deposit	08/09/2017	£2,000,000	0.6
Lloyds	Deposit	27/09/2017	£1,200,000	0.55
Bank of Scotland	Deposit	08/12/2017	£2,000,000	0.55
Bank of Scotland	Deposit	09/02/2018	£2,000,000	0.36
Santander	Deposit	17/11/2017	£2,700,000	0.7
Santander	Deposit	01/12/2017	£500,000	0.7
Santander	Deposit	19/12/2017	£1,790,000	0.7
Santander	31 Day Notice		£1,310	0.4
Barclays	Call Account		£788,786	0.25
Bank of Scotland	32 Day Notice		£2,400,000	0.32
Bank of Scotland	Call Account		£66	0.15
Lloyds - general	Call Account		£924,256	0.15
Local Authority - Telford & Wrekin Council	maturity	16/11/2017	£2,000,000	0.22
Local Authority Property Fund	1 month		£5,000,000	4.49
UK Gilt	maturity	22/07/2018	£1,100,000	1.25
TOTAL			**£30,404,418**	

12. The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first 5 months of 2017/18.

13. The Council's budgeted investment return for 2017/18 is £235,000, and the estimated outturn position is £300,000, a surplus of £65,000 which is mainly due to the additional investment in CCLA.

Investment Counterparty Criteria

14. The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

Capital Programme

15. A major part of the Council's Treasury Management Strategy concerns the Capital Programme, how it is funded and the impact this has on our taxpayers.

Financing of the Capital Programme

16. The table below draws together the main strategy elements of the capital expenditure plans, highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements

of this capital expenditure. Any borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). Any direct borrowing need may also be supplemented by maturing debt and other treasury requirements. Currently there are no plans to incur borrowing.

Rother District Council
Capital Programme Summary

	2017/18 Budget £ (000)	2018/19 Budget £ (000)	2019/20 Budget £ (000)
Total	4,945	226	13
Funded By:			
Capital Receipts	1,085	0	0
Grants and contributions	2,935	0	0
Capital Expenditure Charged to Revenue	925	226	13
Borrowing	NIL	NIL	NIL
Total Funding	4,945	226	13

Capital Financing Requirement and Borrowing

17. The Council's CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the Public Works Loan Board (PWLB) or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The CFR will increase each year by the amount of capital expenditure yet to be financed and is reduced by the amount that the Council sets aside for the repayment of borrowing.

18. The CFR balance of £1.091 million represents an "Item A" adjustment dating back to 2004: this is the agreed historic amount on which it is not necessary to provide the annual Minimum Revenue Provision (MRP) for repayment of debt. MRP would be payable for any capital expenditure financed from loan in the future.

19. Due to the limited scope of the current Capital Programme it is expected that the Council's CFR projections will be the same for the foreseeable future as shown in the table below:

£m	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000
Total CFR	1,091	1,091	1,091
Movement in CFR	Nil	Nil	Nil

Limits to Borrowing Activity

20. To ensure the Council acts reasonably when entering into borrowing, the first key control over the treasury activity is a Prudential Indicator (PI) to ensure that

over the medium-term, net borrowing (borrowings less investments) will only be for a capital purpose. Net external borrowing should not, except in the short-term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2017/18 and next 2 financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

21. The Service Manager - Finance and Welfare reports that no difficulties are envisaged for the current or future years in complying with this PI.

22. A further PI controls the overall level of borrowing. This is the Authorised Limit (AL) which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short-term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under Section 3 (1) of the Local Government Act 2003.

23. The Operational Boundary links directly to the Council's estimates of the CFR and estimates of other cash flow requirements. This indicator is based on the same estimates as the AL reflecting the most likely but not worst case scenario but without the additional headroom included in the AL.

Borrowing Limits	2016-2017 £m	2017-2018 £m	2018-2019 £m	2019-2020 £m
Authorised Limit	17	17	17	17
Operational Boundary	15	15	15	15

24. The maximum cash outflow in a month, plus potential short-term borrowing is estimated to be around £15m and this leads to the Operational Boundary quoted above.

25. Appendix 2 shows the latest approved list of countries for investments.

Conclusion

26. The Council's current treasury management and investment strategies remain robust in managing the Council's cash funds. The economic outlook remains difficult for a net investor such as the Council and supports the Council's financial strategy to reduce reliance on investment returns.

Malcolm Johnston
Executive Director of Resources

Risk Assessment Statement
There are no direct risks arising from this report. Failure to follow the Council's investment strategy could increase the risk of financial loss.

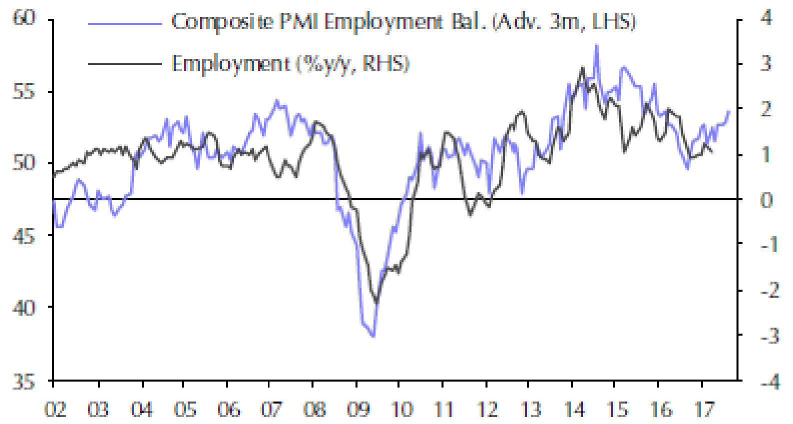
Appendix 1

Capita Asset Services – Economic Commentary

Despite relatively sluggish GDP growth in the first half of 2017, jobs growth has maintained a solid pace, with the unemployment rate having now fallen below the Monetary Policy Committee's (MPC) estimate of its "equilibrium" rate. Accordingly, with limited slack left in the labour market, for how much longer can the improvement in the jobs market continue?

On the face of it, the current pace of employment growth should continue for at least another few months. In fact, the employment balance of the all sector PMI actually points to an acceleration in annual employment growth from about 1% in June, to around 2%. Technically speaking, the balance is backward-looking, asking firms whether or not the level of employment has increased over the past month. But it appears to be a fairly good leading indicator, with changes in the official data tending to lag it by around three months. (See Chart 1.)

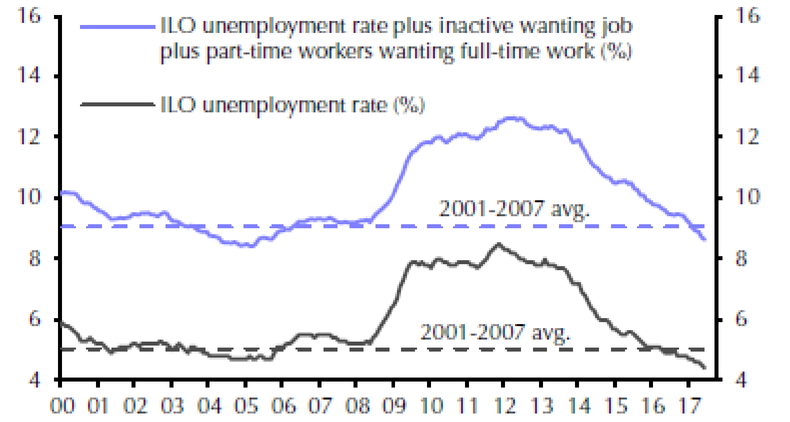
Chart 1: PMI Employment Balance & ONS Employment



Sources – Markit, Thomson Reuters

Moreover, other survey measures of hiring intentions, paint a similarly upbeat picture, with most pointing to annual employment growth of between 1-2%.level of 4.4%, to around 3.8% in a year's time. And, if this trend was maintained through 2019 too, the unemployment rate could fall to as low as 3%. It's worth putting into context how much the labour market has tightened already. Indeed, the unemployment rate is already well below its pre-crisis average of 5%. And even a broader measure of the unemployment rate, which includes workers who are classified as inactive (i.e. not seeking work) but would like a job, and part-time workers who would actually prefer to work full-time, has dropped below its pre-crisis average in recent months. (See Chart 2.)

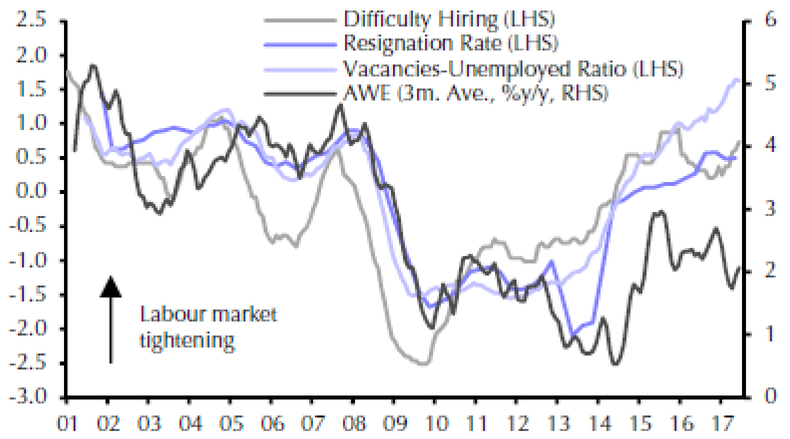
CHART 2: MEASURES OF UNEMPLOYMENT (%)



Sources – Thomson Reuters, Capital Economics

There are a number of factors which have helped to push down the equilibrium rate of unemployment over recent years, including increasing participation among older generations and women, more flexible working arrangements, and government policies which have seen a switch from out-of-work to in work welfare incentives. These factors could continue to exert downward pressure on the equilibrium rate over the coming year, but we are sceptical that unemployment can fall quite so much further in the near term. As Chart 3 overleaf shows, there have been clearer signs recently that firms are finding it more difficult to recruit workers, suggesting that there may be skills mismatches preventing the unemployment rate from falling much further. Note too that the vacancy ratio – i.e. the number of job openings per unemployed person, has risen to its highest level since comparable records began in 2001. (See Chart 3 again.)

CHART 3: MEASURES OF LABOUR MARKET TIGHTNESS & AVERAGE WEEKLY EARNINGS



Sources – REC/KPMG, Thomson Reuters, Capital Economics

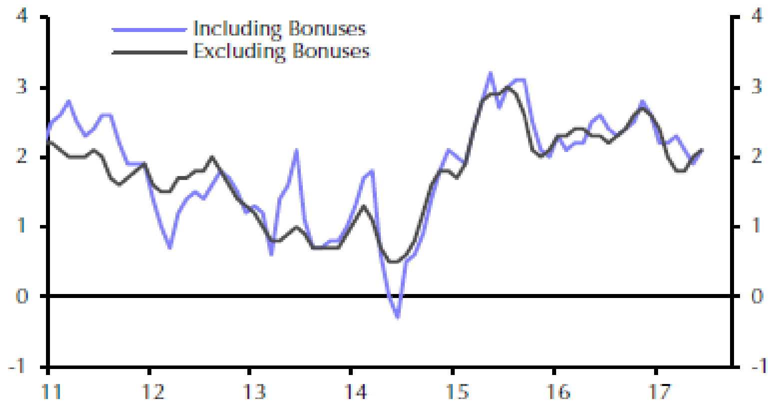
Labour market slack is not evenly concentrated across sectors either. Chart 4 shows the vacancy ratio broken down by industry, standardised to account for the fact that some industries typically have a higher or lower vacancy ratio than average. There is an extremely high number of unfilled vacancies relative to the number unemployed workers in sectors such as accommodation and food, and construction by historical standards. And in the longer term, these two sectors are areas that could be hit particularly hard by any new immigration system post-Brexit that stemmed the flow of low-skilled migration to the UK.

CHART 4: RATIO OF VACANCIES TO UNEMPLOYED BY INDUSTRY (STD DEV. FROM 2001-07 AVERAGE)

Sources – ONS, Capital Economics

Nonetheless, we think that there is probably a bit of scope for the unemployment rate to fall further. Our forecasts see it dropping to about 4.2% around the turn of the year. That all said, while the amount of slack in the labour market is a key judgement that the MPC makes when forming its policy decision, the Committee is really concerned with how this impacts wage growth and therefore inflation. Accordingly, even if the unemployment rate does fall further (compared to the MPC's forecasts of remaining broadly unchanged in the near term), this is likely to only prompt the MPC to raise interest rates if there are clearer signs that wage growth is strengthening in response, relative to productivity. June's labour market figures provided some tentative signs that wage growth may be starting to flicker back to life. Headline growth in regular pay (i.e. excluding the volatile bonuses component), which the MPC places more weight on, has picked up for two consecutive months now. (See Chart 5.)

CHART 5: HEADLINE AVERAGE WEEKLY EARNINGS (3M AVE. %Y/Y)



Source – Thomson Reuters

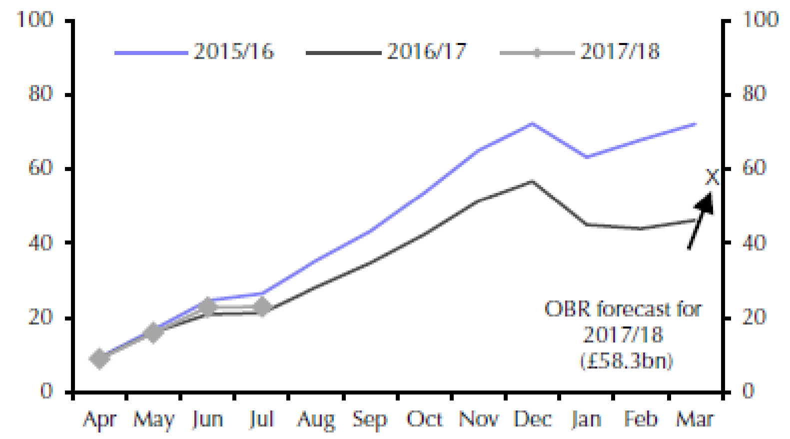
But this will need to be sustained over the coming months for an imminent interest rate hike to come back on to the table. If we are right in thinking that unemployment will fall a bit further though, and that this will cause wage growth (and unit labour costs) to pick up a bit faster than the MPC expects over the next year or so, then interest rates are likely to rise sooner, and somewhat faster, than investors currently anticipate.

Slight borrowing improvement due to one-off factors

The public finance figures may show that one-off factors helped to lower borrowing a little in July, relative to that seen in the same month a year ago. July is typically the second largest month for receipts in the financial year, due to firms paying the first of four corporation tax payments, oil and gas firms paying the first of three, and the second self-assessment payment for 2016-17 financial year. And July's figures will probably bring some better news after the weakness in June. Firstly, although the economy slowed in Q1, corporate profitability has remained strong. And second, there might be an annual boost to self-assessment receipts due to the July 31st deadline falling on a Monday this year, but Sunday last year – meaning that some receipts were probably accrued to August last year.

Accordingly, we have pencilled in borrowing of £0.2bn in July, a little smaller than last year's £0.4bn figure. But this would still leave borrowing 8% above the level for the first fourth months of 2016/17. (See Chart.)

CHART: CUMULATIVE PSNB EX (£BN)



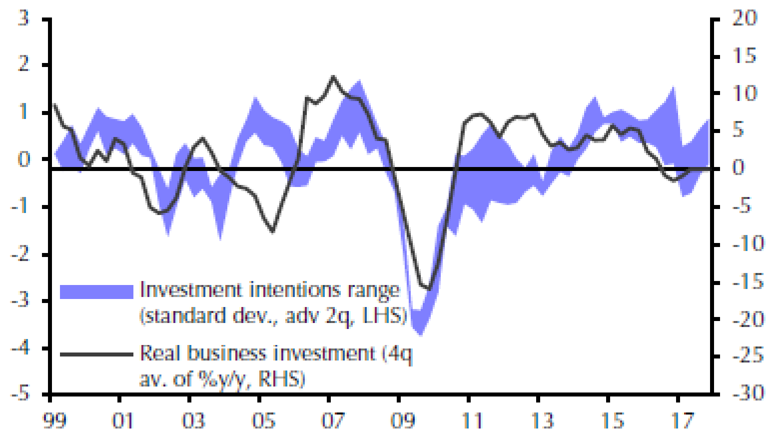
Sources – Thomson Reuters, OBR

Revision to Q2 GDP looks unlikely

The second estimate of GDP is likely to confirm that quarterly growth was sluggish in Q2. But at least growth should look a bit better balanced. As things stand, it seems unlikely that the 0.3% quarterly rise in GDP in Q2 will be revised. The latest production figures confirmed the 0.4% quarterly fall in Q2 included in the first GDP estimate. And while construction output dropped by 1.3% on the quarter, instead of the 0.9% decline that the ONS had previously assumed, this isn't enough to affect GDP to 1 decimal place. The main interest is therefore likely to lie in the breakdown of growth by expenditure components, and in particular, the resilience of household spending to the real pay squeeze. We already know that retail sales rose by a very solid 1.5% in Q2. But we suspect that this strength was offset somewhat by weaker growth off the high street. Meanwhile, the monthly trade data suggest that net trade made at least some positive contribution to growth, after providing a 0.8pp drag in

Q1. Surveys of firms' investment intentions point to a decent rise in business investment in Q2 too. (See Chart.)

Chart: Investment & Surveys of Investment Intentions



Sources – Thomson Reuters, BCC, BoE, Capital Economics

Interest rate forecasts

The Council's treasury advisor, CAS, has provided the following forecast:

Main Economic & Market Forecasts

%q/q(%y/y)unless stated	Latest	Q2 2017	Q3 2017	Q4 2017	2017	2018	2019
GDP	+0.3(+1.7)	+0.3(+1.7)	+0.5(+1.8)	+0.6(+1.8)	+1.8	+2.3	+2.0
Household spending	+0.4(+2.6)	+0.3(+2.1)	+0.4(+1.7)	+0.4(+1.4)	+2.0	+1.5	+2.0
CPI inflation (%)	(+2.6) (Jul)	+2.8	+2.8	+3.0	+2.9	+2.4	+2.0
ILO unemployment rate (%)	4.4 (Jun)	4.4	4.3	4.3	4.7	4.4	4.5
Bank rate, end period (%)	0.25	0.25	0.25	0.25	0.25	0.75	1.25
10 yr gilt, end period (%)	1.07	1.26	1.38	1.50	1.50	2.50	2.50
$/£, end period	1.29	1.30	1.31	1.30	1.30	1.35	1.40
Euro/£, end period	1.10	1.14	1.12	1.13	1.13	1.17	1.17

Approved countries for investments as at 30.06.2017

Since publication of the Treasury management Strategy and annual Investment Strategy in February 2017 the approved list of countries has changed as detailed below.

Based on lowest available rating

AAA

- Australia
- Canada
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France
- Hong Kong
- U.K.

AA-

- Belgium
- Qatar