Cabinet

16 November 2016

Mid-Year Review Report on Treasury Management for the period to 30 September 2016

Report of Corporate Management Team
John Hewitt, Corporate Director Resources
Councillor Alan Napier, Cabinet Portfolio Holder for Finance

Purpose of the Report

1 The purpose of this report is to provide information on the treasury management mid-year position for 2016/17 and seek approval of a revision to:

(i) a Treasury Management Indicator for 2016/17; and
(ii) the Council's Investment Strategy for 2016/17.

Background

2 The Council operates a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

3 The second main function of the treasury management service is the funding of the Council's capital programme. The capital programme provides a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending requirements. The management of longer term cash may involve arranging long or short term loans, utilising longer term cash flow surpluses and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

4 Accordingly, 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'.

5 The Council adopts the latest CIPFA Code of Practice on Treasury Management (the Code) which is regarded as best practice in ensuring adequate monitoring of the Council's capital expenditure plans and its Prudential Indicators (PIs). This requires that Members agree the following reports, as a minimum:

(i) an annual Treasury Management Strategy in advance of the year (reported to the County Council on 24 February 2016);

(ii) an annual review following the end of the year describing the activity compared to the strategy (reported to the County Council on 21 September 2016), and

(iii) a mid-year Treasury Management Review Report (this report);

6 This mid-year report has been prepared in accordance with the Code and includes:

(i) an economic update for the first part of 2016/17;

(ii) a review of the Treasury Management Strategy Statement and Annual Investment Strategy;

(iii) a review of the Council's capital expenditure (prudential indicators);

(iv) a review of the Council's investment portfolio for 2016/17;

(v) a review of the Council's borrowing strategy for 2016/17;

(vi) a review of compliance with Treasury and Prudential Limits for 2016/17.

Treasury Management Statement and Investment Strategy Update

7 The Annual Treasury Management Statement for 2016/17 was approved by the Council on 24 February 2016.

8 It is recommended that revisions be made to the:

(i) Treasury Management Indicator for the upper limit on variable interest rate exposure as detailed in paragraphs 22 and 23; and

(ii) Investment Strategy. The proposed changes are detailed in paragraph 32 of this report and the rationale for these amendments is explained in paragraph 31.

Economic Update

9 Appendix 2 contains an economic update for the first part of 2016/17, as provided by the Council's Treasury Management advisers, Capita Asset Services.

Interest Rate Forecast

10 Capita Asset Services, has also provided an interest rate forecast up to June 2019, which is detailed in Appendix 3.

Capital Expenditure

11 The following table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed by Council.

Capital Expenditure by Service	2016/17 Estimate agreed by Council in Feb 2016 (£m)	2016/17 Approved Revisions (£m)	2016/17 Revised Estimate (£m)
Assistant Chief Executive	3.307	2.057	5.364
Children and Adults Services	23.105	6.306	29.411
Neighbourhoods	36.511	11.309	47.820
Regeneration and Economic Development	63.026	-23.041	39.985
Resources	9.026	3.469	12.495
Total Capital Expenditure	**134.975**	**0.100**	**135.075**

12 Taking into account re-profiling from the 2015/16 capital programme, additional approved expenditure funded from grants, capital receipts and reserves and re-profiling into future years, the revised capital expenditure budget for the General Fund is £135.075 million.

13 In addition to the capital expenditure, shown in the table above, a leasing budget of £6.019 million was agreed by full Council in February 2016, which will be revised to £4.791 million to reflect re-profiling from 2015/16 and into future years.

14 Further details on the capital programme can be found in the 16 November Cabinet report ‘Quarter 2 Forecast of Revenue and Capital Outturn 2016/17 for the General Fund – Period to 30 September 2016’.

Changes to the Financing of the Capital Programme

15 The following table 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. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR). This will be reduced in part by revenue charges for the repayment of debt which is known as the Minimum Revenue Provision (MRP).

Capital Expenditure	2016/17 Original Estimate (£m)	2016/17 Revised Estimate (£m)
Capital expenditure	134.975	135.075
Leasing	6.019	4.791
Financed by:		
Capital receipts	15.883	18.253
Capital grants	40.452	45.106
Revenue and Reserves	0.072	1.859
Total Financing	56.407	65.218
Borrowing Need	**84.587**	**74.648**

16 Following approval of the 2016/17 capital programme in February 2016, additional capital grants have been received and additional earmarked capital receipts and revenue and reserves have been allocated to finance the capital programme.

17 As a result of the changes to the capital budget the underlying borrowing requirement has been revised downwards by £9.939 million to £74.648 million.

Changes to the Prudential Indicators for the Capital Financing Requirement, External Debt and Operational Boundary

Capital Financing Requirement

18 The following table shows the capital financing requirement (CFR). It also shows the Operational Boundary, which is the limit that external borrowing is not normally expected to exceed.

	2016/17 Original Estimate (£ million)	2016/17 Revised Estimate (£ million)
CFR – Non Housing CFR – Housing	498.063 0.000	467.493 0.000
Total CFR (PI 2)	**498.063**	**467.493**
Net movement in CFR	**87.656**	**57.086**
Operational Boundary (PI 5)		
Borrowing	447.000	417.000
Other long term liabilities*	52.000	50.000
Total debt (yearend position)	**499.000**	**467.000**

* PFI schemes and finance leases on balance sheet

Limits to Borrowing Activity

19 The first key control over the treasury activity is a PI to ensure that over the medium term, net borrowing (i.e. borrowings less investments) will only be for a capital purpose. Gross 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 2016/17 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has an approved policy for borrowing in advance of need which will be utilised if considered prudent.

20 The Corporate Director Resources reports that no difficulties are envisaged for the current or future years in complying with this PI.

21 A further PI controls the overall level of borrowing. This is the Authorised Limit 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.

Authorised limit for external debt (PI 6)	2016/17 Original Estimate (£m)	2016/17 Revised Estimate (£m)
Borrowing	497.000	467.000
Other long term liabilities*	55.000	53.000
Total debt	**552.000**	**520.000**
CFR (yearend position)	**498.063**	**467.493**

* PFI schemes and finance leases on balance sheet

Changes to the Treasury Management Indicators

22 There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. The indicators are:

(i) Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments
(ii) Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
(iii) Maturity structure of borrowing. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

23 The Council is asked to approve an increase to the upper limit on variable rate loans as a percentage of net debt for 2016/17 to 70% from 30%, as set out in the following table. Net debt is total borrowing less total investments. The revision is necessary due to the high level of investments held by the Council, which reduces the net debt position and in turn increases the percentage of loans to net debt.

Interest rate Exposures	2016/17 Original	2016/17 Revised
Limits on fixed interest rates based on net debt	100%	100%
Limits on variable interest rates based on net debt	30%	70%

Borrowing Strategy

24 The CFR indicates the requirement for the Council to borrow to support its capital activities. This borrowing can be in the form of external sources (e.g. PWLB) or internal resources (e.g. use of reserves and working capital).

25 The Corporate Director Resources, under delegated powers, will adopt the most appropriate form of borrowing depending on the prevailing interest rates at the time.

26 Due to the overall financial position of the Council, no new borrowing has been raised during the first six months of 2016/17.

27 The overall borrowing position at 30 September 2016 was £246 million.

Debt Rescheduling

28 Debt rescheduling opportunities are very limited in the current economic climate given the consequent structure of interest rates and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. Therefore no debt rescheduling has been undertaken this year.

Investment Portfolio

29 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 3, it is a very difficult investment market in terms of earning the level of interest rate commonly seen in previous decades as rates are very low and in line with the current 0.25% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, together with other risks which could impact on the creditworthiness of banks, prompts a low risk strategy. Given this risk environment, investment returns are likely to remain low.

30 The approved limits for investments as previously agreed within the Annual Investment Strategy no longer meet the requirements of the treasury management function.

31 The main reasons for the need to amend the strategy are:

(i) to facilitate a more balanced approach to investing by diversifying the Council's investment portfolio, spreading the investment risk and maximising investment returns (whilst having regard to security and liquidity);

(ii) due to the re-categorisation of the loan with Durham County Cricket Club into equity;

(iii) to invest in businesses within County Durham in order to encourage regeneration and economic development in the area.

32 The proposed changes are to:

(i) extend the list of investment instruments categorised as non-specified to enable the Council to invest in other entities locally;
(ii) increase the monetary limit for equity shareholdings up to:
  (a) £20 million in total (from £10 million) and
  (b) £11 million in an individual business;
(iii) allow investment in property funds of not more than £10 million in total and £5 million in an individual fund.

33 Any new investments will only be agreed after significant due diligence checks have been carried out.

34 A revised list of investments which the Council will be permitted to use, if Members are in agreement, is attached as Appendix 4.

35 Members are recommended to approve the aforementioned revisions to the Investment Strategy for 2016/17.

36 The following table details the Council's equity shareholdings as at 30 September 2016 and the anticipated holdings at 31 March 2017.

Company	**30 Sep 2016**	**31 Mar 2017**
	£ million	**£ million**
Newcastle International Airport Ltd	10.558	10.558
Chapter Homes	1.410	1.410
Polyphotonix	0.300	0.300
Forrest Park	1.000	1.000
Atom Bank	0.152	0.152
Durham County Cricket Club	0	3.740
Total	**13.420**	**17.160**

37 The original budgeted investment return for investment income 2016/17 was £1.641 million, however it is now expected that this will be exceeded by around £0.399 million. This is in the main due to higher than anticipated cash balances.

Investment Risk Benchmarking

38 All of the Council's investment activity has remained within the benchmarks for managing investment risk which were included in the Annual Treasury Management Strategy.

39 The following table compares the actual position for the first six months of 2016/17 against the previously agreed benchmarks.

Investment Risk	Measured by	Benchmark	Actual position Apr to Sep 2016
Security	% of historic risk of default	0.08%	0.017%
Liquidity	Weighted average life to maturity	6 months (183 days) average 9 months (274 days) maximum	219 days average
Yield	Internal returns above the 7 day LIBID rate	0.28%	0.77%

Investment Counterparty criteria

40 The current investment counterparty criteria selection as approved in the Annual Treasury Management Strategy is meeting the requirements of the treasury management function.

41 At 30 September 2016 the Council held investments, with a maturity of no longer than one year, totalling £187 million. The following table provides a breakdown of the type of financial institution within which these investments were held at 30 September 2016, split by the maturity period.

Sector	Country	0-3 months	3-6 months	6-12 months
		£m	**£m**	**£m**
Banks 1 higher quality	UK	22.090	22.540	0
Banks 1 medium quality	UK	0	0	31.556
Banks 1 lower quality	UK	0	0	0
Banks 2 - part nationalised	UK	0	0	72.129
Council Bank Account	UK	0.167	0	0
Building Societies	UK	0	0	22.540
Central Government	UK	0.901	0	0
Local Authorities	UK	0	0	0
Money Market Funds	UK	15.305	0	0
TOTAL		**38.463**	**22.540**	**126.225**

Icelandic Bank Deposits

42 Prior to Local Government Review, one former District Council had £7 million deposited across the Icelandic banks Glitnir Bank hf (£4 million), Landsbanki (£2 million) and Kaupthing Singer and Friedlander Ltd (£1 million), which all

collapsed financially in October 2008. The County Council inherited this position in April 2009.

43 The only outstanding balance as at 31 March 2016 is in relation to the investment with Kaupthing Singer and Friedlander Ltd (KSF). All monies with KSF are currently subject to the respective administration and receivership processes. As at 30 September 2016, 83.75% of the outstanding balance has been repaid to the Council; 85.5%-86.5% recovery is ultimately anticipated.

Recommendations and Reasons

44 It is recommended that Members:

(a) approve the proposed changes to the Treasury Management Strategy for 2016/17;

(b) note the contents of the mid-year review report and agree to report further to Full Council.

Background papers

(a) 24 February 2016 – County Council – Appendix 12: Durham County Council Annual Treasury Management Strategy of the Medium Term Financial Plan, 2016/17 – 2018/19 and Revenue and Capital Budget 2016/17.

(b) County Council – 23 September 2015 – Treasury Management Outturn 2015/16.

(c) Capita Treasury Solutions –Strategy Statement and Annual Investment Strategy – Mid Year Review Report 2016/17 – English Authorities.

Contact:	**Jeff Garfoot**	**Tel:**	**03000 261946**

Appendix 1: Implications

Finance -

Details of the overall financing of the Council's anticipated capital expenditure, along with forecast borrowing and investment income returns are provided in the report.

Staffing –

None

Risk –

None

Equality and Diversity / Public Sector Equality Duty –

None

Accommodation -

None

Crime and Disorder -

None

Human Rights -

None

Consultation -

None

Procurement -

None

Disability issues -

None

Legal Implications –

None

Appendix 2: Economic Update provided by Capita

1. Capita Asset Services, the Council's treasury adviser, has provided the following economic update:

2. 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.

3. 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.

4. 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.

5. 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.

6. 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.

7. 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.

Appendix 3: Interest rate forecasts provided by Capita

1. Capita Asset Services, has provided the following interest rate forecast up to June 2019:

Rate	Dec 2016	Mar 2017	Jun 2017	Sep 2017	Dec 2017	Mar 2018	Jun 2018	Sep 2018	Dec 2018	Mar 2019	Jun 2019
	%	%	%	%	%	%	%	%	%	%	%
Bank	0.10	0.10	0.10	0.10	0.10	0.10	0.25	0.25	0.25	0.25	0.50
5 yr PWLB	1.00	1.00	1.10	1.10	1.10	1.10	1.20	1.20	1.20	1.20	1.30
10 yr PWLB	1.50	1.50	1.60	1.60	1.60	1.60	1.70	1.70	1.70	1.70	1.80
25 yr PWLB	2.30	2.30	2.40	2.40	2.40	2.40	2.50	2.50	2.50	2.50	2.60
50 yr PWLB	2.10	2.10	2.20	2.20	2.20	2.20	2.30	2.30	2.30	2.30	2.40

2. Capita Asset Services undertook a quarterly review of its interest rate forecasts after the Monetary Policy Committee (MPC) meeting of 4th 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 above forecast 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. Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual after they do start. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when the growth in average disposable income is still weak and could well turn negative when inflation rises during the next two years to exceed average pay increases.

3. 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. However, we have been experiencing exceptional levels of volatility in financial markets which have caused significant swings in PWLB rates. Our PWLB rate forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

4. The overall balance of risks to economic recovery in the UK remains to the downside. 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.

5. 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.

Appendix 4: Revised List of Investment Instruments for use in 2016/17

Specified Investments

These investments are sterling investments of not more than one year maturity, or those which could be for a longer period but where the Council has the right to be repaid within 12 months if it wishes. These are considered low risk assets where the possibility of loss of principal or investment income is small. These would include sterling investments which would not be defined as capital expenditure with:

- The UK Government (such as the Debt Management Account deposit facility);
- UK treasury bills or a gilt with less than one year to maturity;
- Term deposits with UK banks and building societies;
- A local authority, parish council or community council;
- Certificates of Deposit;
- Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency.

Non-specified Investments

These are investments which do not meet the specified criteria outlined above. The Council is required to examine non-specified investments in more detail. The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below.

Non-specified investments would include any sterling investments in the following:

- Gilt edged securities with a maturity of greater than one year.
  These are Government bonds and so provide the highest security of interest and the repayment of principal on maturity.
- The Council's own banker if it fails to meet the basic credit criteria.
  In this instance balances will be minimised as far as is possible.
- Equity shareholding in businesses of not more than £20 million in total, and £11 million in any one company.
  This will be after undertaking significant due diligence checks only. It will facilitate a more balanced approach to investing by diversifying the investment portfolio and reducing concentration risk.
- Local businesses, in order to encourage regeneration and economic development in the area.
  Any new investments will only be agreed after significant due diligence checks have been carried out.
- Property funds of not more than £10 million in total and £5 million in an individual fund.