Annex 1

CITY OF YORK COUNCIL

Agenda Item

Executive **15 November 2017**

Report of the Deputy Chief Executive and Director of Customer & Corporate Services

Treasury Management Mid Year Review and Prudential Indicators 2017/18

Summary

1. The Council is required through legislation to provide members with a mid year update on treasury management activities. This report provides an update on activity for the period 1 April 2017 to 30 September 2017.

Recommendations

2. Members are required, in accordance with the Local Government Act 2003 (revised), to:
   - Note the Treasury Management activities to date in 2017/18
   - Note the Prudential Indicators set out at Annex A and note the compliance with all indicators.

Reason: to ensure the continued performance of the Council's Treasury Management function.

Background

3. The Treasury Management function is responsible for the effective management of the Council's investments, cash flows, banking, and money market transactions. It also considers the effective control of the risks associated with those activities and ensures optimum performance within those risk parameters.

4. This mid year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management and covers the following:
   - An economic update for the first part of the 2017/18 financial year;
   - A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
   - The prudential indicators;
   - A review of the Council's investment portfolio;

- A review of the Council's borrowing strategy;
- A review of compliance with the Treasury and Prudential Limits.

Economic Background and Analysis

5. After the UK economy surprised on the upside with strong growth in 2016, growth in 2017 has been disappointingly weak; quarter 1 came in at only +0.3% (+1.7% y/y) and quarter 2 was +0.3% (+1.5% y/y) which meant that growth in the first half of 2017 was the slowest for the first half of any year since 2012. The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 75% of GDP, has seen weak growth as consumers cut back on their expenditure. However, more recently there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year. However, this sector only accounts for around 11% of GDP so expansion in this sector will have a much more muted effect on the average total GDP growth figure for the UK economy as a whole.

6. The Monetary Policy Committee (MPC) meeting of 14 September 2017 surprised markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise. The Bank of England Inflation Reports during 2017 have clearly flagged up that they expected CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years time. Inflation actually came in at 2.9% in August, (this data was released on 12 September), and so the Bank revised its forecast for the peak to over 3% at the 14 September meeting MPC. This marginal revision can hardly justify why the MPC became so aggressive with its wording; rather, the focus was on an emerging view that with unemployment falling to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that the amount of spare capacity in the economy was significantly diminishing towards a point at which they now needed to take action. In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of increasing globalisation. This effectively means that the UK labour faces competition from overseas labour e.g. in outsourcing work to third world countries, and this therefore depresses the negotiating power of UK labour. However, the Bank was also concerned that the withdrawal of the UK from the EU

would effectively lead to a decrease in such globalisation pressures in the UK, and so would be inflationary over the next few years.

7. The MPC increased Bank Rate to 0.5% in November. The big question now is whether this will be a one off increase or the start of a slow, but regular, increase in Bank Rate. As at the start of October, short sterling rates were indicating that financial markets do not expect a second increase until May 2018 with a third increase in November 2019. However, some forecasters are flagging up that they expect growth to improve significantly in 2017 and into 2018, as the fall in inflation will bring to an end the negative impact on consumer spending power while a strong export performance will compensate for weak services sector growth. If this scenario were to materialise, then the MPC would have added reason to embark on a series of slow but gradual increases in Bank Rate during 2018. While there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two years will pan out.

Interest Rate Forecast

8. Capita Asset Services undertook its last review of interest rate forecasts on 9 August after the quarterly Bank of England Inflation Report. There was no change in MPC policy at that meeting. However, the MPC meeting of 14 September revealed a sharp change in sentiment whereby a majority of MPC members said they would be voting for an increase in Bank Rate “over the coming months”. At the time of writing the November MPC meeting has just agreed an increase in Bank Rate to 0.5%. The question now is whether the MPC will stop at just withdrawing the emergency Bank Rate cut of 0.25% in August 2016, after the result of the EU withdrawal referendum, or whether they will embark on a series of further increases in Bank Rate during 2018.

9. Table 1 is Capita’s Asset Services Interest Rate forecast for both the bank rate and long term Public Works Loans Board borrowing rates (note all figures are percentages):

	Dec 17	**Mar 18**	**Jun 18**	**Sep 18**	**Dec 18**	**Mar 19**	**Jun 19**	**Sep 19**	**Dec 19**	**Mar 20**
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50

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5 Yr PWLB rate	1.50	1.60	1.70	1.70	1.80	1.80	1.90	1.90	2.00	2.00
10 Yr PWLB rate	2.20	2.30	2.30	2.40	2.40	2.50	2.50	2.60	2.60	2.70
25 Yr PWLB rate	2.90	2.90	3.00	3.00	3.10	3.10	3.20	3.20	3.30	3.30
50 Yr PWLB rate	2.70	2.70	2.80	2.80	2.90	2.90	3.00	3.00	3.10	3.10

Table 1: Capita Asset Services Interest Rate Forecast (%)

Annual Investment Strategy Update

10. The Treasury Management Strategy Statement (TMSS) for 2017/18 was approved by Council on 23 February 2017. There are no policy changes to the TMSS and the details in this report do not amend the TMSS.

11. The Council's Annual Investment Strategy, which is incorporated in the Strategy, outlines the Council's investment priorities as follows:
    - security of capital
    - liquidity
    - yield

12. The Council continues to aim to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity and the Councils risk appetite.

Investment Portfolio

13. The average level of cash balances available for investment purposes in the first 6 months of 2017/18 was £114.243m (£106.306m for the same 6 month period in 16/17). The level of cash balances available is largely dependent on the timing of the Council's cash flow as a result of precept payments, receipt of grants, receipt of developers contributions, borrowing for capital purposes, payments to its suppliers of goods and services and spend progress on the Capital Programme. These funds are therefore only available on a temporary basis depending on cash flow movement.

14. The average level of cash balances has increased compared to a year ago due to a number of factors. These include the receipt of grant

funding in advance of the associated profiled spend and delays to a number of capital schemes.

15. This allows the Council to continue to use cash balances instead of taking long term debt to finance the Councils capital programme. This strategy remains a prudent one as investment rates continue to be lower than borrowing rates when viewed on a short term projection but the potential to secure long term funding is kept under review to ensure this remains the most effective use of cash balances, given long term rates are currently at attractive levels.

16. Investment return (calculated as the amount of interest earned against the average cash balance for the period) during the first six months of 2017/18 is shown in table 2:

	2016/17 (full year)	**2017/18 (part year to date)**
Average CYC Rate of Return	0.49	0.38
Benchmarks		
Bank of England Base Rate	0.25	0.25
Average 7 Day LIBID	0.20	0.11
Average 1 Month LIBID	0.32	0.13

Table 2: CYCs investment rate of return performance vs. benchmarks

17. The average rate of return achieved to date in 2017/18 has fallen compared to the average seen in 2016/17. The reason for this is a combination of continuing falling interest yields across all types of investment accounts the Council makes use of on a short term basis, such as instant access Money Market Funds and notice accounts, and the maturity of several fixed term investments that the Council held which were yielding a higher than current average interest rate. Where new fixed term investments have been entered into the yield is reflective of current market rates.

18. However, as set out earlier in this report, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates continue to be very low. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this

risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

19. Figure 1 shows the interest rates available on the market based on LIBID rates between 7 days and 1 year and also the rate of return that the Council has achieved for the first six months of 2017/18. It shows that favourable / competitive interest rates have been obtained for investments whilst ensuring the required liquidity and security of funds for the Council.

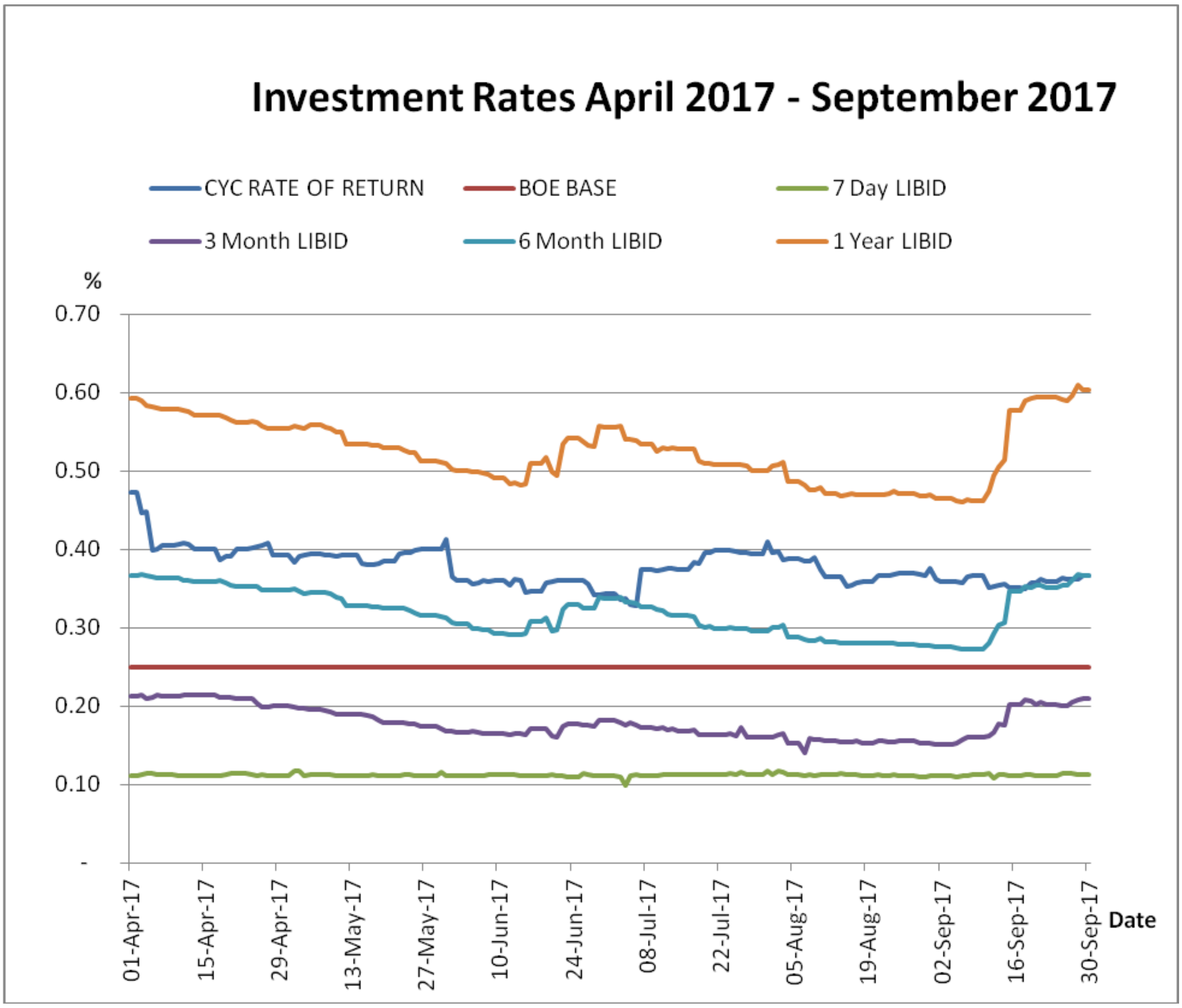

Figure 1 CYC Investments vs Money Market Rates up *to 30th September 2017*

20. Figure 2 shows the investments portfolio split by deposits in short term call accounts, fixed term investments and money market funds (MMFs).

21. All of the money market funds have an AAA credit rating, the notice call accounts are all AA or A+ rated and the fixed terms investments are A+ or A rated.

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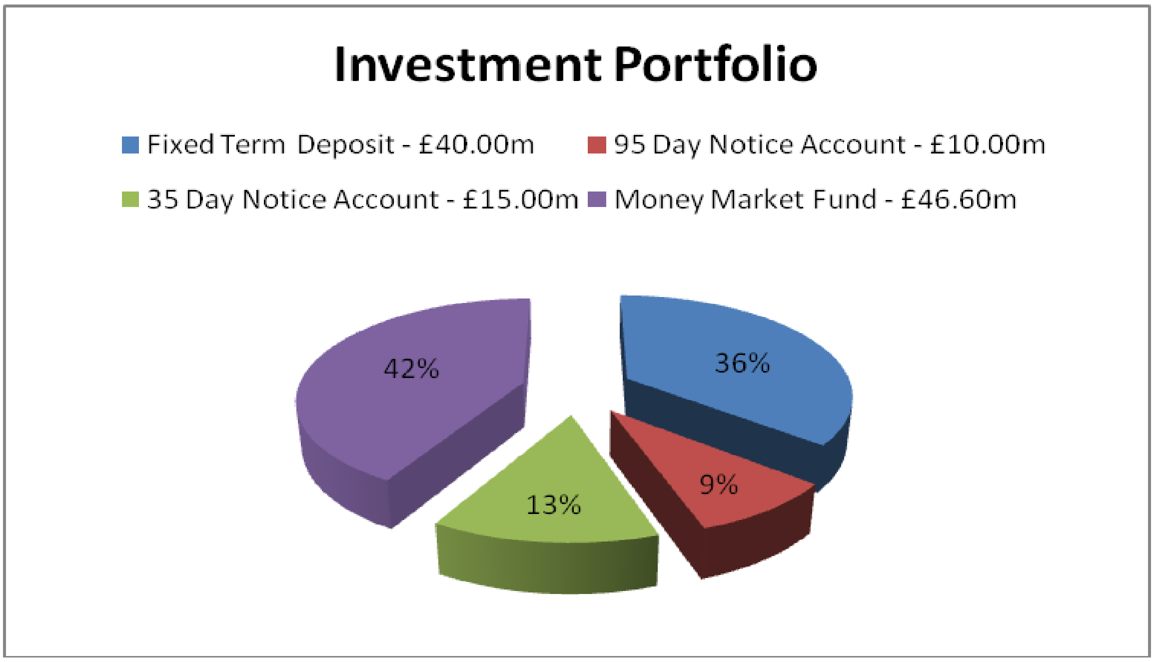

Figure 2 Investment Portfolio by type at 30th September 2017

Borrowing Portfolio

22. The Council undertakes long term borrowing in accordance with the investment requirements of the capital programme and all borrowing is therefore secured for the purpose of its asset base.

23. The level of borrowing taken by the Council is determined by the Capital Financing Requirement (the Councils underlying need to borrow for capital expenditure purposes). Borrowing needs to be affordable, sustainable and prudent.

24. Under regulation, the Council can borrow in advance of need and Markets are therefore constantly monitored and analysed to ensure that advantage is taken of favourable rates and the increased borrowing requirement is not as dependant on interest rates in any one year.

25. On the reverse side, the Council’s level of borrowing can also be below the Capital Financing Requirement. This would mean that instead of increasing the Council’s level of borrowing, surplus funds held for investment purposes would be utilised. In the current interest rate environment, where investment rates on holding investments are significantly below borrowing rates, consideration is given to the value of taking borrowing or whether it is better for the council to keep investment balances lower.

26. Throughout 2017/18 the finance team continues to closely monitor the opportunities that arise and receive daily updates from Capita Asset

Services in respect of borrowing timings and amounts. One new loan has been taken during 2017/18 on 1st September 2017 for £618,598.00 from West Yorkshire Combined Authority at 0% interest, repayable on the 28th February 2027. No repayments are due during the term of the loan. The purpose of the loan is to help to fund York Central infrastructure projects. Members are reminded that this is a further instalment of a total £2.55m loan agreed by Executive on the 14th July 2016.

27. The Councils long-term borrowing started the year at a level of £261.3m. On 1st September 2017 a £0.619m WYCA loan was taken taking the Council's long-term borrowing figure to £261.9m. On 10th September 2017 a £3m PWLB loan was repaid taking the Councils long-term borrowing figure to £258.9m. The Housing Revenue Account settlement debt amounts is 47% of the borrowing portfolio (£121.5m) and the General Fund debt is 53% (£137.4m). On 5th November 2017 a £2.00m PWLB loan will be repaid taking the Councils long-term borrowing figure to £256.9m.

28. Figure 3 illustrates the 2017/18 maturity profile of the Council's debt portfolio at 30th September 2017. The maturity profile shows that there is no large concentration of loan maturity in any one year, thereby spreading the interest rate risk dependency.

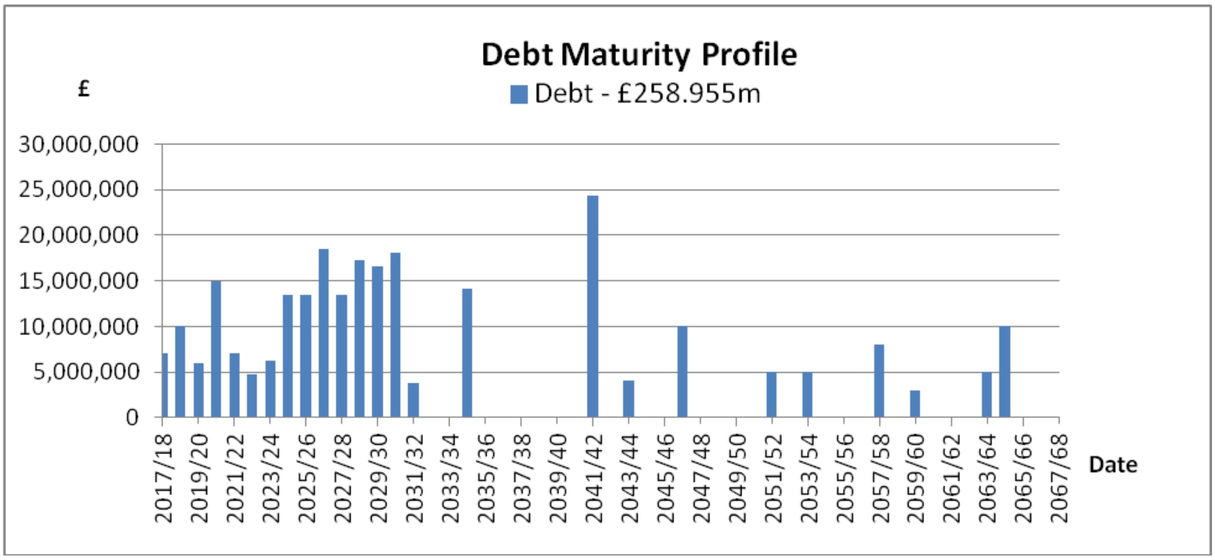

Figure 3 – Debt Maturity Profile 16/17 up to 30th September 2017

29. Table 3 shows PWLB Certainty borrowing rates available for selected loan durations. There have been fluctuations in the rates with an average trend upwards to 30th September 2017.

	PWLB Certainty borrowing rates by duration of loan				
	1 Year	**5 Year**	**10 Year**	**25 Year**	**50 Year**
Yr High	1.41%	1.89%	2.47%	3.03%	2.77%
Yr Low	1.02%	1.40%	2.04 %	2.72%	2.45%
Yr Avg	1.16%	1.57%	2.20%	2.85%	2.59%
Spread	0.39%	0.49%	0.43%	0.31%	0.32%

Table 3 – PWLB Borrowing Rates (%) – to 30th September 2017

Compliance with Prudential Indicators

30. The Prudential Indicators for 2017/18 included in the Treasury Management Strategy Statement are based on the requirements of the Council's capital programme and approved at Budget Council on 23 February 2017.

31. It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits" included in the Prudential Indicators. The monitoring of the Prudential Indicators is attached at Annex A. During the financial year 2017/18 to date the Council has operated within the treasury limits and Prudential Indicators set out.

Revised CIPFA codes

32. The Chartered Institute of Public Finance and Accountancy (CIPFA) is currently conducting an exercise to consult local authorities on revising the Treasury Management Code and Cross Sectoral Guidance Notes, and the Prudential Code. CIPFA is aiming to issue the revised codes during November.

33. A particular focus of this exercise is how to deal with local authority investments which are not treasury type investments e.g. by investing in purchasing property in order to generate income for the authority at a much higher level than can be attained by treasury investments. One recommendation is that local authorities should produce a new report to members to give a high level summary of the overall capital strategy and to enable members to see how the cash resources of the authority have been apportioned between treasury and non treasury investments.

Officers are monitoring developments and will report to members when the new codes have been agreed and issued and on the likely impact on the Council.

MIFID II

34. The EU has now set a deadline of 3 January 2018 for the introduction of regulations under MIFID II. These regulations will govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. This will have little effect on this authority apart from having to fill in forms sent by each institution dealing with this authority and for each type of investment instrument we use apart from for cash deposits with banks and building societies.

Consultation and Options

35. The report shows the six month position of the treasury management portfolio in 2017/18. The treasury management budget was set in light of the council's expenditure plans and the wider economic market conditions, based on advice from Capita Asset Services. It is a statutory requirement to provide the information detailed in the report.

Council Plan

36. The treasury management function aims to achieve the optimum return on investments commensurate with the proper levels of security, and to minimise the interest payable by the Council on its debt structure. It thereby contributes to all Council Plan priorities.

Financial implications

37. The financial implications are in the body of the report.

Legal Implications

38. Treasury Management activities have to conform to the Local Government Act 2003, the Local Authorities (Capital; Finance and Accounting) (England) Regulations 2003 (SI 2003/3146), which specifies that the Council is required to have regard to the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice and also the Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 (SI 2008/414), which clarifies the requirements of the Minimum Revenue Provision guidance.

Other Implications

39. There are no crime and disorder, information technology, property, equalities, human resources or other implications as a result of this report.

Risk Management

40. The Treasury Management function is a high-risk area because of the level of large money transactions that take place. As a result of this there are procedures set out for day to day treasury management operations that aim to reduce the risk associated with high volume high value transactions. These are detailed in the Treasury Management Strategy Statement at the start of each financial year.

Contact Details

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<tr><td colspan="5">Wards Affected: All</td><td></td></tr>
<tr><td colspan="6">For further information please contact the author of the report</td></tr>
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Specialist Implications**:**
Legal – Not Applicable
Property – Not Applicable
Information Technology – Not Applicable

Annexes
Annex A – Prudential Indicators 2017/18