JOINT INDEPENDENT AUDIT COMMITTEE 12 SEPTEMBER 2016

TREASURY MANAGEMENT MID-YEAR REPORT 2016/17

REPORT OF THE JOINT CHIEF FINANCE OFFICER

1. Purpose of the Report

1.1 The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management recommends that those charged with governance and scrutiny receive regular updates on treasury management activities. This report presents the performance up to and including 31 August 2016 for scrutiny.

2. Background

2.1 In previous years we have reported the performance to 30 September at the December meeting of the Committee. We have brought forward the date of this report so that the Committee has more timely information to consider.

2.2 The mid-year performance of the Treasury Management Service is reported in line with CIPFA's Code of Practice on Treasury Management and the Treasury Policy Statement and Strategy.

2.3 The report is attached.

3. Financial Considerations

3.1 Financial implications are considered throughout this report.

4. Legal Considerations

4.1 Relevant legislation and guidance has been complied with in the delivery of the Treasury Management activities.

5. Equality Considerations

5.1 There are no equality implications arising from the contents of this report.

6. Risk Management Considerations

6.1 Associated risks have been considered and adequate control measures implemented. All Treasury Management activity during the year is carried out in accordance with the approved Treasury Management Policy Statement and Strategy, which has the underlying aim of minimising risk to ensure the Commissioner's principal sums are safeguarded. Maximising income is considered secondary to this main aim.

7. Recommendation

7.1 The Committee is asked to note the Treasury Management mid-year report for the five months to 31 August 2016.

Treasury Management Performance to 31 August 2016

1 Purpose of the Report

1.1 The purpose of this report is to summarise Treasury Management performance for the five months to 31 August 2016.

2 Background

2.1 The mid-year performance of the Treasury Management Service is reported in line with CIPFA's Code of Practice on Treasury Management and the Treasury Policy Statement and Strategy 2016/17 to 2019/20.

2.2 The PCC operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations 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.

2.3 The second main function of the treasury management service is the funding of the PCC's capital plans. These capital plans provide a guide to the borrowing need of the PCC, essentially the longer term cash flow planning to ensure the PCC can meet its capital spending operations.

2.4 Accordingly, treasury management is defined as:

"The management of the PCC'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."

3 Borrowing

3.1 The total borrowing as at 31 August 2016 was £81.464m, which was within the operational borrowing limit of £160m. This borrowing is made up of £66.475m PWLB long term loans and £15m short term market loans. Loan details are shown in Appendix 1.

3.2 During this financial year the Commissioner had entered into £32m short term borrowing which has all now been repaid when the Pension top up grant of £60m was received in July. To date this year there has been no new long term borrowing. This was in line with the current strategy to defer long term borrowing and use cash balances and short term borrowing until capital receipts generated from the estates rationalisation programme are received.

3.3 Following consultation with our treasury advisers CAPITA we are also looking at the longer term savings that we could generate by fixing into longer term borrowing now that Public Works Loan Board (PWLB) rates are at historic lows. Longer term loans do attract a higher rate of interest than short term loans. Options are being considered at the moment which need to carefully consider the short-term additional cost of borrowing now against the longer-term savings which can be achieved by potentially borrowing at current PWLB rates.

3.5 As at quarter 1 Treasury Management budgets were forecast to underspend by £0.500m. This resulted primarily because the interest rate assumptions at the time the budget was set were very different to now. The average rate anticipated for all new borrowing was expected to be an average of 2% (Short term rates were 0.5% and long term 3.5%).

3.6 The forecast for quarter 2 will be prepared in October and will take into account the latest interest rates, capital receipts and decisions agreed regarding longer term borrowing. Further net savings are expected.

4 Investment Performance

4.1 The latest projection of investment income for 2016/17, based on interest earned to date and expected interest to March 2017, is £0.080m compared to the original estimate of £0.103m. The £0.023m underachievement is a result of the Bank of England's decision to reduce Bank rate from 0.50% to 0.25%, the first rate cut since 2009.

4.2 The average rate of return is monitored for each investment type that the Commissioner enters into and these are used to calculate an average rate of return for the year to date. The current rate of return is 0.52%, which is a slight overachievement against the estimate of 0.50%. This current rate of return will be expected to decrease throughout the year as the impact of the Bank Rate cut is felt across future deposits made.

4.3 As a means of benchmarking, the average rate of return for the month and year to date is compared to the equivalent 7 day London Inter Bank Bid Rate (LIBID), which is the rate that banks are willing to borrow money from each other. The monthly return of 0.04% exceeds the LIBID 7 day rate equivalent of 0.01%. The Commissioner's average rate of return of 0.52% is well in excess of the equivalent LIBID 7 day rate of 0.31%.

4.4 Capita Asset Services produces a quarterly Investment Benchmarking report that assesses both the rate of return and the risk of the counterparty to calculate a weighted average rate of return, which is used for comparison across other similar Authorities. In the most recent report that covers the period up to June 2016, the Commissioner achieved a weighted average rate of return of 0.50% on investments. This is at the higher end of the risk adjusted expectations as defined in the benchmarking report of between (0.42%) and (0.52%). This reflects the receipt of the Pension Top Up Grant in July whereby investment balances are at their highest and deposits can be placed with longer maturity dates and higher yields.

4.5 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 and in line with the current 0.25% Bank Rate. 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, investment returns are likely to remain lower for the remainder of the year.

4.6 Details of Capita Asset Services, the PCC's treasury adviser's latest interest rate forecast as of the 8th August can be seen in Appendix 2.

5 Heritable Bank

5.1 When Heritable Bank entered administration in October 2008 the Commissioner had £5.238m invested which was due to mature with interest by the end of 2008/09; the total value including accrued interest was £5.300m.

5.2 It has been previously reported dividends totalling £5.194m (98.00p in the £) have been received. This is an overachievement against the estimated return of 90p in the £. As the original investment was impaired in 2010/11 to reflect the expected return, all additional income above 90p in the £ is revenue income and this equates to £0.540m.

5.3 The balance of the investment outstanding is therefore £0.106m.

5.4 The most recent update from the administrators, Ernst and Young, in March 2016, provided detail of all dividends received to date and advised that no further dividend is expected at the current time until the current administration period closes on the 6 October 2016.

6 Treasury Management Policy and Strategy Update.

6.1 The Treasury Management Policy and Strategy Statement approved by the PCC on the 10 March 2016 required revision in the light of economic developments following the BREXIT vote. The report as approved by the PCC on 7 July 2016 sets out the changes and is attached at Appendix 3. The revised Policy and Strategy can be found on the PCC website here.

7 Summary of Mid-year Performance

7.1 The unexpected reduction in interest rates and the use of lower cost short term and internal borrowing is resulting in further savings against the original budget.

7.2 The current approach of borrowing internally provides benefits in terms of reduced credit risk, as the PCC has less cash invested than if it had gone to the markets and borrowed externally. This means that cash balances are lower than projected and investment returns are lower than budgeted, but this loss of income significantly outweighs the savings from actual and potential reduced borrowing costs and reduced credit risk.Internal borrowing does have an element of interest rate risk on the overall treasury management positions, if interest rates were suddenly to rise but this is being taken into account when discussing potential borrowing options with our treasury management advisers, CAPITA.

7.3 As at quarter 1 net savings of £0.500m were forecast. The forecast for quarter 2 will be prepared in October and will take into account the latest interest rates, capital receipts and decisions agreed regarding longer term borrowing. Further net savings are expected.

7.4 Prudential indicators are set annually to ensure that borrowing is prudent, sustainable and affordable. Performance is monitored against these indicators throughout the year and reported in the quarterly capital monitoring reports. The outturn against the prudential indicators at the mid-year point confirms that all indicators were operating within agreed limits with no breaches

throughout in the year to date. For completeness a copy of the prudential indicators is attached as Appendix 4.

Appendix 1

PWLB Loans

PWLB REF	Principal	START DATE	Maturity	RATE %	Years to Maturity
459137	£4,579,637	03/04/1986	21/11/2017	9.125%	1.28
465087	£915,928	16/08/1988	05/07/2018	9.375%	1.90
479387	£3,663,710	21/05/1997	21/05/2057	7.125%	40.78
479687	£3,663,710	17/07/1997	05/07/2057	7.000%	40.90
479976	£454,300	06/10/1997	05/09/2057	6.625%	41.07
479977	£696,105	06/10/1997	05/09/2057	6.625%	41.07
480186	£659,468	22/10/1997	05/09/2057	6.500%	41.07
480880	£1,831,855	23/04/1998	23/04/2058	5.625%	41.70
496086	£5,000,000	13/10/2009	05/09/2024	3.910%	8.07
496528	£10,000,000	21/01/2010	05/01/2017	3.660%	0.41
497288	£5,000,000	25/05/2010	23/04/2060	4.290%	43.70
498781	£5,000,000	20/07/2011	20/07/2018	3.480%	1.94
499079	£5,000,000	31/10/2011	31/10/2022	3.730%	6.23
510249	£5,000,000	14/05/2012	14/11/2019	2.440%	2.76
502361	£5,000,000	02/05/2013	02/05/2023	2.520%	6.73
503622	£5,000,000	09/01/2015	09/01/2050	3.160%	33.42
503623	£5,000,000	09/01/2015	09/01/2030	2.790%	13.42
Total	**£66,464,713**				

Market Loans

Lender	Principal	START DATE	Maturity	RATE %	Years to Maturity
PCC West Yorkshire	£5,000,000	02/04/2016	03/10/2016	1.050%	0.15
Wakefield	£5,000,000	02/04/2016	03/10/2016	0.750%	0.15
Barclays LOBO	£5,000,000	01/06/2010	01/06/2040	3.520%	23.81
Total	**£15,000,000**				

Capita Interest Rate Forecast Appendix 2

	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Bank rate	0.25%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.25%	0.25%	0.25%	0.25%	0.50%
5yr PWLB rate	1.00%	1.00%	1.00%	1.10%	1.10%	1.10%	1.10%	1.20%	1.20%	1.20%	1.20%	1.30%
10yr PWLB rate	1.50%	1.50%	1.50%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.70%	1.80%
25yr PWLB rate	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.40%	2.50%	2.50%	2.50%	2.50%	2.60%
50yr PWLB rate	2.10%	2.10%	2.10%	2.20%	2.20%	2.20%	2.20%	2.30%	2.30%	2.30%	2.30%	2.40%

These rates to be discounted by 0.20% for Northumbria Police and Crime Commissioner

Capita Asset Services undertook its last review of interest rate forecasts on 8 August shortly after the quarterly Bank of England Inflation Report and the MPC cutting Bank Rate from 0.50% to 0.25% and launching various quantitative easing measures. This action was prompted by concerns that the UK economy would slow down sharply as a result of the Brexit vote. It is widely expected that the MPC could cut Bank Rate further to nearly zero, probably at the November quarterly inflation report meeting. Since the Brexit vote on 23 June, gilt yields and PWLB rates have fallen sharply. Investment rates also fell after the cut in Bank Rate.

The above forecast includes a very tentative first increase in Bank Rate in June 2018. The overall balance of risks to economic recovery in the UK is currently to the downside but huge variables over the coming few years include just what final form Brexit will take, when finally agreed with the EU, and when.

There are also concerns that weak growth in the UK, EZ, China and Japan is only being achieved by monetary policy being highly aggressive. While such policies undoubtedly help to stimulate growth, there is substantial doubt that without additional aggressive fiscal action by national governments to stimulate growth and inflation, (and also fundamental economic and political reforms in some countries), then many countries are likely to have a prolonged struggle to return to both strong growth, and inflation rising to around 2%, within the next few years.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or Fed. rate increases, causing a further flight to safe havens (bonds).
- Geopolitical risks in Europe, the Middle East and Asia, increasing safe haven flows.
- 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.
- A resurgence of the Eurozone sovereign debt crisis.
- Weak capitalisation of some European banks.

- Monetary policy action failing to stimulate sustainable growth and combat the threat of deflation in western economies, especially the Eurozone and Japan.

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 3

JOINT BUSINESS MEETING **07 JULY 2016**

Report Title: CHANGE TO TREASURY POLICY AND STRATEGY 2016/17 to 2019/20

Report of: Joint Chief Finance Officer

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1. PURPOSE OF REPORT

1.1. To explain the reason for amending the Treasury Strategy 2016/17 to 2019/20 to exclude the United Kingdom's (UK) sovereign credit rating criteria.

2. RECOMMENDATIONS

2.1. To remove the UK sovereign credit rating criteria from the Treasury Policy and Strategy 2016/17 to 2019/20 and approve the revised strategy.

3. BACKGROUND

3.1. It is the Commissioner's responsibility under the Code to approve a treasury policy statement. The 2016/17 to 2019/20 Treasury Policy and Strategy was adopted Key Decision 220/2016 31.03.2016.

3.2. The Commissioner delegates the review of the policy, monitoring of the performance of the treasury management function and the scrutiny of treasury management strategy and policies to the Joint Independent Audit Committee, and the execution and administration of treasury management decisions to the Chief Finance Officer. Any proposals to approve, adopt or amend policy require the consent of the Commissioner and are matters for the Commissioner to determine.

4. UK SOVEREIGN CREDIT RATING

4.1. The Treasury Strategy and Policy 2016/17 to 2019/20 covers the specific activities proposed in relation to both borrowing and investments and ensures a wide range of advice is taken to maintain and preserve all principal sums, whilst obtaining a reasonable rate of return, and that the most appropriate borrowing is undertaken. The primary objective of the investment strategy is to maintain the security of investments at all times.

4.2. Credit ratings are one of the controls required by the strategy.

4.3. The result of the EU referendum held on 23 June 2016 has resulted in a downgrading of the UK Sovereign credit rating by two of the three credit reference agencies that we use.

- Fitch – AA+ to AA
- Standard and Poor – AAA to AA
- Moody's reaffirmed at AA1 (Equivalent to AA+)

4.4. Our treasury advisers Capita Asset Services, Treasury Solutions have noted that many of their clients including Northumbria will be impacted by this change if they have an investment risk requirement for UK banks that also includes a UK sovereign AA+ credit rating. Paragraph 6.12 of our strategy states:

6.12 The evolving regulatory environment, in tandem with the rating agencies' new methodologies also means that sovereign ratings are now of lesser importance in the assessment process. While this authority understands the changes that have taken place, it will continue to specify a minimum sovereign rating of AA+. This is in relation to the fact that the underlying domestic and where appropriate, international, economic and wider political and social background, will still have an influence on the ratings of a financial institution.

4.5. Capita Asset Services, Treasury Solutions has advised that the "Sovereign Rating" is no longer relevant to the UK banks ratings because they are no longer underwritten by the government as they are all independently funded and subject to their own credit ratings. They advise that we can safely remove the UK sovereign rating requirement from our strategy.

4.6. They also state:

"We would also stress that while there are negative implications for the UK, its economy and financial institutions as a result of Brexit, financial markets and the operators therein are materially stronger, in terms of capital and liquidity than they were ahead of the financial crisis. Mark Carney, Governor of the Bank of England stated on Friday, in the immediate aftermath of the vote that "…the capital requirements of our largest banks are now ten times higher than before the crisis. The Bank of England has stress tested them against scenarios more severe than the country currently faces. As a result of these actions, UK banks have raised over £130bn of capital, and now have more than £600bn of high quality liquid assets."

5. IMPLICATIONS

5.1. Capita Asset Services, Treasury Solutions advise that we can safely remove the UK sovereign credit rating requirement from our strategy and rely on the separate credit ratings of banks.

5.2. At this time because one out of the three credit rating agencies (Moody's) UK rating is AA+ we are able to fully utilise deposits with UK banks within the strategy. However, should that rating subsequently reduce we would:

- Not be able to deposit with UK banks.
- Be able to continue to utilise Money Market Funds (MMFS) for overnight deposits as they are AAA rated.
- We could also deposit with foreign banks that meet our criteria but only if we deposit for 3 months or longer.
- Invest with the UK Debt Management Office a rate of 0.25%

5.3. So unless we change the policy we will only be able to deposit the surplus with the UK DMO @ 0.25% (about half the rate of a bank deposit).

6. REVISED POLICY AND STRATEGY

6.1. The changes incorporated into the revised Policy and Strategy attached are as follows:

Appendix 1 Policy – No Changes

Appendix 2 – Paragraph 6.12 replaced the 2nd sentence with "The requirement for a UK sovereign rating of AA+ has now been removed."

Appendix 8 - Approved countries for investments: Removed "AA+ UK"

IMcC
06.07.2016

Appendix 4

Prudential Indicators 2016/17

Authorised Limit for External Debt	
	2016/17 **£000** **Reported Indicator**
Borrowing	185,000
Other Long Term Liabilities	0
Total	**185,000**
Maximum YTD £117,656	

Operational Boundary for External Debt	
	2016/17 **£000** **Reported Indicator**
Borrowing	160,000
Other Long Term Liabilities	0
Total	**160,000**
Maximum YTD £117,656	

Limit on Fixed and Variable Interest Rates Exposures		
Range	**2016/17** **£000** **Reported Indicator**	**2016/17** **£000** **Outturn**
Fixed Rate	147,188 (4,956)	Actual 71,121 *max 117,656* *min 50,683*
Variable	6.000 (45.000)	12,200 *max 0,000* *min (-14,000)*
No breaches to report		

Upper / Lower Limits for Maturity Structure of Fixed Rate Borrowing				
	2016/17 Reported Indicator		**2016/17 Outturn**	
	Upper Limit	**Lower Limit**	**Actual Percentage**	**Maximum YTD**
< 1yr	65%	0%	24.55%	51.40%
1 -2 yrs	50%	0%	12.88%	12.88%
2 – 5 yrs	50%	0%	6.14%	10.93%
5 – 10yrs	60%	0%	18.41%	21.87%
10 yrs >	75%	0%	38.02%	38.02%
All within agreed limits				

Upper Limit on amounts invested beyond 364 days			
	2016/17 £000 Reported Indicator	**2016/17 £000 Outturn**	**2016/17 £000 Maximum YTD**
Investments	**15,000**	**0**	**0**