Agenda Item 11

JOINT INDEPENDENT AUDIT COMMITTEE 18 SEPTEMBER 2017

TREASURY MANAGEMENT MID-YEAR REPORT 2017/18

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 2017 for scrutiny.

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.

2.2 The report is attached at Appendix A.

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 2017. .

Treasury Management Performance to 31 August 2017

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 2017.

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 2017/18 to 2020/21.

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 2017 was £76.465m, which was within the operational borrowing limit of £145m. This borrowing is made up of £71.465m PWLB long term loans and £5m short term market loans. Loan details are shown in Appendix 1.

3.2 During this financial year the Commissioner had entered into £30m short term borrowing which was repaid when the Pension top up grant of £60m was received in July. To date this year there has been £5m taken as new long term borrowing in the form of a PWLB loan. This was in line with the current strategy of maximising the use of 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 have also realised extended savings by fixing into longer term borrowing now that Public Works Loan Board (PWLB) rates are at historic lows.

3.4 As at 31 August 2017 Treasury Management budgets for borrowing costs were forecast to underspend by £0.144m. This underspend is primarily due to the interest rate assumptions for borrowing included in the 2017/18 budget being slightly higher than interest rates now. The average rate anticipated for all new borrowing was expected to be 1.50% (Short term rates were 0.6% and long term 3.0 %).

3.5 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.

4 Investment Performance

4.1 The latest projection of investment income for 2017/18, based on interest earned to 31 August 2017 and expected interest to March 2018, is £0.036m compared to the original estimate of £0.029m.

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 0.27%, which is a slight overachievement against the estimate of 0.25%. This current rate of return will be expected to decrease throughout the year due to the impact of UK economic uncertainty.

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 0.026% exceeds the LIBID 7 day rate equivalent of 0.009%. The Commissioner's average rate of return of 0.26% is well in excess of the equivalent LIBID 7 day rate of 0.111%.

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 2017, the Commissioner achieved a weighted average rate of return of 0.24% on investments. This is at the higher end of the risk adjusted expectations as defined in the benchmarking report of between (0.14%) and (0.26%). This does not reflect the receipt of the Pension Top Up Grant in July when investment balances are at their highest and deposits are able to 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. CAS indicates in its forecast that there is no expectation of a Bank Rate rise until Q2 2019 which reflects huge uncertainty following EU Referendum. Given this scenario investment returns are likely to remain relatively low 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 9th August can be seen in Appendix 2.

5 Heritable Bank

5.1 When Heritable Bank entered administration in October 2008 the former Police Authority had £5.238m invested which was due to mature with interest by the end of 2008/09. The majority of the investment has now been recovered; the current balance outstanding is £0.106m. The most recent update from the administrators, Ernst and Young, advised of a further extension of the administration for a year, to 6 October 2017, any final distribution will be made after this time.

6 Summary of Mid-year Performance

6.1 The use of lower cost short term and internal borrowing is resulting in savings against the original budget.

6.2 The projected net impact of investments and borrowing activity to the Commissioner in 2017/18 is an underspend of £0.151m to the budget.

6.3

	Estimate £m	Projected Outturn £m	Variance £m
Investments	(0.029)	(0.036)	0.007
Borrowing	3.129	2.985	0.144
Net Position	**3.100**	**2.949**	**(0.151)**

6.4 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 and investment returns are lower than in previous years resulting in reduced levels of income, which is significantly outweighed by the savings achieved from avoiding external borrowing. Internal borrowing does have an element of interest rate risk on the overall treasury management position i.e. if interest rates were suddenly to rise it may make external borrowing in the longer term more expensive. This is regularly monitored in considering potential borrowing options with our treasury management advisers, CAPITA.

6.5 As at quarter 1 net savings of £0.151m 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.

6.6 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 3.

PWLB Loans

Appendix 1

PWLB REF	Principal	START DATE	Maturity	RATE %	Years to Maturity
459137	£4,579,637.45	03/04/1986	21/11/2017	9.125%	0.22
465087	£ 915,927.54	16/08/1988	05/07/2018	9.375%	0.84
479387	£3,663,710.14	21/05/1997	21/05/2057	7.125%	39.75
479687	£3,663,710.14	17/07/1997	05/07/2057	7.000%	39.87
479976	£454,300.06	06/10/1997	05/09/2057	6.625%	40.04
479977	£696,104.92	06/10/1997	05/09/2057	6.625%	40.04
480186	£659,467.82	22/10/1997	05/09/2057	6.500%	40.04
480880	£1,831,855.07	23/04/1998	23/04/2058	5.625%	40.67
496086	£5,000,000.00	13/10/2009	05/09/2024	3.910%	7.02
497288	£5,000,000.00	25/05/2010	23/04/2060	4.290%	42.67
498781	£5,000,000.00	20/07/2011	20/07/2018	3.480%	0.88
499079	£5,000,000.00	31/10/2011	31/10/2022	3.730%	5.17
510249	£5,000,000.00	14/05/2012	14/11/2019	2.440%	2.20
502361	£5,000,000.00	02/05/2013	02/05/2023	2.520%	5.67
503622	£5,000,000.00	09/01/2015	09/01/2050	3.160%	32.38
503623	£5,000,000.00	09/01/2015	09/01/2030	2.790%	12.36
505904	£5,000,000.00	22/03/2017	22/03/2067	2.460%	49.59
505920	£5,000,000.00	27/03/2017	27/03/2066	2.370%	48.60
506307	£5,000,000.00	31/08/2017	31/08/2065	2.300%	48.00
Total	**£71,464,713.14**				

Market Loans

Lender	Principal	START DATE	Maturity	RATE %	Years to Maturity
Barclays	£5,000,000	01/06/2010	01/06/2040	3.520%	22.76
Total	**£5,000,000**				

Capita Interest Rate Forecast **Appendix 2**

	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.40%	1.50%	1.60%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.10%	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%
50yr PWLB rate	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%

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

Capita Asset Services undertook its latest review of interest rate forecasts on 9th August, shortly after the release of the quarterly Bank of England Inflation Report. The latest forecasts assume that there is no cancellation of the emergency cut in Bank Rate in August 2016 from 0.50% to 0.25% and/or a stop to the Quantitative Easing (QE) programme in the shorter-term. Nevertheless, there remains a potential risk, and there has probably been some increase in this risk, that the MPC could muster a majority to simply reverse both and then pause for a further period before reaching a time when there is a progression to a sustained trend of gentle increases in Bank Rate. Capita Asset Services' forecasts for both Bank Rate and PWLB rates would then need revision if both were to occur.

The overall balance of risks to economic recovery in the UK remains to the downside, particularly with the current uncertainty over the final terms of Brexit. The balance of risks to increases in Bank Rate and shorter term PWLB rates are to the upside and are dependent on how quickly inflation pressures rise and how high the peak will be. Capita Asset Services' forecasts are predicated on an assumption that there is no break-up of the Eurozone or EU, (apart from the departure of the UK), within the forecasting time period, despite the major challenges that are looming up. Furthermore, that there are no major ructions in international relations, especially between the US and China / North Korea, which have a major impact on international trade and world GDP growth.

On the international front, economic growth in the EU, (the UK's biggest trading partner), has been lack lustre for several years after the financial crisis. This has come about despite the European Central bank (ECB) eventually cutting its main rate to -0.4% and embarking on a massive programme of QE. However, growth picked up in 2016 and now looks to have gathered ongoing substantial strength and momentum thanks to all this stimulus.

In the US, GDP growth in 2016 was highly erratic on a quarterly basis but came in at an average of 1.6% for the year. Quarter 1 growth at +1.4% on an annualised basis was mediocre, but growth has been highly erratic from quarter to quarter. It is widely expected that there will be at least one more rate rise in 2017, probably in December to lift the central rate to 1.25 – 1.50%, after 0.25% increases in March and June, followed by four more in 2018. At its June meeting, the Fed strongly hinted that it would soon begin to unwind its $4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

Meanwhile, in Asia, Japan is struggling to stimulate consistent significant growth to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. Chinese economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

One major uncertainty in the international arena is the degree to which there will be a major financial stimulus programme in the US. This will likely depend on the degree of agreement, or otherwise, between President Trump and Congress. It now looks more likely that any fiscal stimulus will be delayed to 2018 and to be more moderate than Trump was promising – if it occurs. The risk of a trade war between America and China appears to have evaporated as China has become a sought after partner to the US in curbing North Korea's nuclear ambitions. However, the continuing series of North Korean missile tests has increased tension and concerns as to the potential for American response.

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

- Geopolitical risks in Europe, the Middle East and Asia, which could lead to 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 to get inflation up consistently to around monetary policy target levels.

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 causing an increase in the inflation premium inherent to gilt yields.

Prudential Indicators 2017/18 **Appendix 3**

Authorised Limit for External Debt	
	2017/18 £000 Reported Indicator
Borrowing	170,000
Other Long Term Liabilities	0
Total	**170,000**
Maximum YTD £114,465	

Operational Boundary for External Debt	
	2017/18 £000 Reported Indicator
Borrowing	145,000
Other Long Term Liabilities	0
Total	**145,000**
Maximum YTD £114,465	

Limit on Fixed and Variable Interest Rates Exposures		
Range	**2017/18 £000 Reported Indicator**	**2017/18 £000 Position at 31 Aug 2017**
Fixed Rate	Max 129,465 Min (13,561)	Actual 62,918 *Max YTD 111,075* *Min YTD 38,963*
Variable	Max 9,446 Min (20,000)	Actual (6,000) *Max YTD 0,000* *Min YTD (10,000)*
No breaches to report		

Upper / Lower Limits for Maturity Structure of Fixed Rate Borrowing				
	2017/18 Reported Indicator		2017/18 Position at 31 Aug 2017	
	Upper Limit	Lower Limit	Actual Percentage	Maximum YTD
< 1yr	70%	0%	13.73%	41.57%
1 -2 yrs	60%	0%	6.54%	13.99%
2 – 5 yrs	60%	0%	0.00%	4.83%
5 – 10yrs	65%	0%	19.62%	20.99%
10 yrs >	80%	0%	60.12%	60.12%
All within agreed limits				

Upper Limit on amounts invested beyond 364 days			
	2017/18 £000 Reported Indicator	2017/18 £000 Position at 31 Aug 2017	2017/18 £000 Maximum YTD
Investments	**15,000**	**0**	**0**

Gross Debt and CFR		
	2017/18 £000 Reported Indicator	2017/18 £000 Forecast Position
Forecast Borrowing as at 31 March	101,885	101,649
Capital Financing Requirement at 31 March	102,244	101,879
Amount of borrowing (over) / under CFR	359	230