HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Audit Committee
Date:	01 December 2016
Title:	Treasury Management Monitoring Report 2016/17
Reference:	7918
Report From:	Director of Corporate Resources – Corporate Services

Contact name: Gemma Farley

Tel: 01962 847540 **Email:** gemma.farley@hants.gov.uk

1. Purpose

1.1. The Treasury Management Strategy for 2016/17 is underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

1.2. The Code also recommends that members are informed of Treasury Management activities at least twice a year (a mid year and a year end report). This report therefore ensures that the County Council is embracing best practice in accordance with CIPFA's recommendations.

1.3. Treasury Management is defined as: "the management of investments and cash flows, 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".

2. Economic Background

2.1. The following section outlines the key economic themes currently in the UK against which investment and borrowing decisions have been made in the year to date.

2.2. The preliminary estimate of Quarter 2 2016 GDP showed strong growth as the economy grew 0.7% quarter-on-quarter, as compared to 0.4% in Quarter 1 and year/year growth running at a healthy pace of 2.2%. However the UK economic outlook changed significantly on 23 June 2016. The surprise result of the referendum on EU membership prompted forecasters to rip up previous projections and dust off worst-case scenarios. Growth forecasts had already been downgraded as 2016 progressed, as the very existence of the referendum dampened business investment, but the crystallisation of these downside risks and the subsequent political turmoil prompted a sharp decline in household, business and investor sentiment.

2.3. The repercussions of this plunge in sentiment on economic growth were judged by the Bank of England to be severe, prompting the Monetary Policy Committee (MPC) to initiate substantial monetary policy easing at its August meeting to mitigate the worst of the downside risks. This included a cut in Bank Rate to 0.25%, further gilt and corporate bond purchases (quantitative easing (QE)) and cheap funding for banks to maintain the supply of credit to the economy. The minutes of the August meeting also suggested that many members of the Committee supported a further cut in Bank Rate to near-zero levels (the Bank, however, does not appear keen to follow peers into negative rate territory) and more QE should the economic outlook worsen.

2.4. In response to the Bank of England's policy announcement, money market rates and bond yields declined to new record lows. Banks are being heavily encouraged to pass on the reduction in rates to customers – great for borrowers, although the outlook for savers is now rather more downbeat. Since the onset of the financial crisis over eight years ago, Arlingclose's rate outlook has progressed from 'lower for longer' to 'even lower for even longer' to, now, 'even lower for the indeterminable future'. Arlingclose's central forecast case for Bank Base Rate is currently 0.25%, but there is a strong possibility that the rate is cut further towards zero.

2.5. Meanwhile, inflation is expected to pick up due to a rise in import prices, dampening wage growth and real investment returns. The August Quarterly Inflation Report from the Bank of England forecast a rise in CPI to 0.9% by the end of calendar 2016 and thereafter a rise closer to the Bank's 2% target over the coming year, as previous rises in commodity prices and the sharp depreciation in sterling begin to drive up imported material costs for companies.

3. Investment Activity

3.1. The County Council holds invested funds representing income received in advance of expenditure plus balances and reserves held. The County Council is currently investing according to a low risk, high quality lending list as outlined in its Treasury Management Strategy.

3.2. The transposition of European Union directives into UK legislation places the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors through potential bail-in of unsecured bank deposits. (The outcome of the EU referendum does not alter the UK's legislated bail-in resolution regime.)

3.3. Given the increasing risk and continued low returns from short-term unsecured bank investments, it is the County Council's aim to further diversify into more secure and/or higher yielding asset classes. The majority of the County Council's surplus cash was previously invested in short-term unsecured bank deposits, certificates of deposit and money market funds.

3.4. The County Council's investment holding was £546m at 30 September 2016, which was £4m (0.7%) lower than the same time last year, and was placed into the following investment types:

Table 1 Investments at 30 September 2016

Duration to maturity	Overnight £m	<1 year £m	>1 year £m	Total £m	Average rate/yield %	Average life (years)
Subject to bail-in risk						
Bank notice accounts	-	28	-	28	0.84	0.20
Bank certificates of deposit[1]	-	30	-	30	0.55	0.25
	-	58	-	58	0.69	0.23
Exempt from bail-in risk						
Covered floating rate notes	-	33	70	103	0.76	1.46
Covered fixed bonds	-	10	15	25	1.16	0.96
Supranational bonds	-	9	-	9	0.60	0.19
Government bonds	-	27	-	27	0.68	0.19
Corporate fixed bonds	-	6	-	6	0.62	0.24
Corporate floating rate notes	-	10	-	10	0.67	0.35
Money market funds	5	-	-	5	0.38	0.00
Local authorities	-	98	122	220	1.21	1.38
	5	193	207	405	1.01	1.12
Targeting higher yields						
Local authorities	-	-	30	30	3.90	17.40
Pooled property funds	-	-	35	35	4.69	n/a
Pooled equity funds[2]	-	-	13	13	0.77	n/a
Registered provider	-	-	5	5	3.40	2.58
	0	0	83	83	3.70	n/a
Total	5	251	290	546	1.46	

3.5. Counterparty credit quality was assessed and monitored with reference to credit ratings (the County Council's minimum long-term counterparty rating for institutions defined as having "high credit quality" is BBB across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

3.6. The average interest rate earned on these investments at 30 September 2016 was 1.46%, which should be considered within the context of a recently lowered UK Base Rate of 0.25%, following a period of over 7 years of unchanged UK Base Rate at 0.50%, and very low short-term money

[1] Certificates of deposit have fixed terms but have greater liquidity as they can be sold on the secondary market.
[2] The average rate/yield listed for pooled equity funds is the total income return for the partial year that the County Council has been invested in these funds.

market rates. This rate reflects interest rates available prior to the Base Rate cut, and is likely to fall in the coming months.

3.7. The Guidance on Local Government Investments in England gives priority to security and liquidity and the County Council's aim is to achieve a yield commensurate with these principles. This has been maintained by following the County Council's counterparty policy as set out in its Treasury Management Strategy for 2016/17.

Investments targeting a higher yield

3.8. As part of the 2014/15 Strategy the County Council decided to earmark £90m of its cash balances for investments appropriately targeting a higher yield. This was in addition to the £15m of long term investments that had been made for the Street Lighting PFI scheme. Higher yields can be accessed through long-term cash investments (although this is currently less the case as yields have declined) and investments in other assets than cash, such as pooled property, equities and bonds. Non-cash pooled investments must be viewed as long-term investments in order that monies are not withdrawn in the event of a fall in capital values to avoid crystallising a capital loss.

3.9. As shown in Table 1 the County Council has invested £83m of the £105m allocation, and a further £7m has been committed. The County Council is continuing to work with its advisors, Arlingclose, to identify additional opportunities for this allocation. Without this allocation the weighted average return of the Council's cash investments would have been 0.97%, the allocation to higher yielding investments has added 0.49% (£2.7m based on the cash balance at 30 September) to the average interest rate earned by the remainder of the portfolio.

3.10. Given the stability of the County Council's cash balances there is the opportunity to add to this allocation, which would increase the overall rate of return and the income contributed to the revenue budget. It is recommended to increase the allocation targeting higher yields to £200m. This amount represents half of the County Council's forecast minimum cash balance and is therefore an amount that can be managed appropriately as a long-term investment.

4. Borrowing Strategy

4.1. The County Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) at 31 March 2016 was £753m. Affordability and the "cost of carry" remained important influences on the County Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing.

4.2. For the County Council the use of internal resources in lieu of borrowing has, therefore, continued to be the most cost effective means of funding capital expenditure. No new long-term borrowing has taken place to date in 2016/17, or is planned for the remainder of the year. This has lowered overall treasury risk by reducing both external debt and temporary investments.

4.3. As at 30 September 2016 the County Council held £340m of loans, (a decrease of £6m on 31/3/2016), made up of Public Works Loans Board (PWLB) loans and Lender's Option Borrower's Option (LOBO) loans, as part of its strategy for funding previous years' capital programmes.

4.4. The premia that applies to the premature repayment of the County Council's PWLB loans is still relatively expensive for the loans in the portfolio, and therefore unattractive for debt rescheduling. As a consequence, no debt rescheduling has taken place. However, consideration will continue to be given to an advantageous opportunity for the County Council to reduce or restructure its debt portfolio.

4.5. The County Council holds £60m of LOBO loans (down from £73m due to the conversion of Barclays LOBO loans, which is further explained in paragraph 5.6) where the lender has the option to propose an increase in the interest rate at set dates, following which the County Council has the option to either accept the new rate or to repay the loan at no additional cost. None of the LOBO loan options were exercised by the lender in the year to date.

4.6. In June Barclays Bank informed the County Council of its decision to cancel all the embedded options within standard LOBO loans. This effectively converts £13m of the County Council's Barclays LOBO loans to fixed rate loans removing the uncertainty on both interest cost and maturity date. This waiver has been done by 'deed poll'; it is irreversible and transferable by Barclays to any new lender.

5. Compliance with Prudential Indicators

5.1. During the period to date of 2016/17, the County Council operated within the Prudential Indicators for 2016/17, which were set in February 2016 as part of the County Council's Treasury Management Strategy Statement.

Authorised Limit and Operational Boundary for External Debt

5.2. CIPFA's Code of Practice requires authorities to set an authorised limit for external debt, defined as the sum of external borrowing and other long-term liabilities. The annual strategy report agreed by the County Council in February 2016 set an authorised limit for external debt of £850m.

5.3. This limit is based on the estimated CFR in order to enable it to be financed entirely from external borrowing should the County Council's internal reserves become depleted. The limit also includes an allowance for temporary borrowing to cover normal revenue cash flow requirements and unexpected outflows or delays in receiving cash.

5.4. The County Council has set an operational boundary for external debt reflecting the more likely scenario and consistent with the County Council's capital plans and Treasury Management Strategy. Temporary breaches of 2016/17 operational boundary can take place for cash flow reasons, but any sustained breach will lead to further investigation. The County Council approved an operational boundary for 2016/17 of £780m.

Table 2 – Authorised Limit and Operational Boundary for External Debt

	Authorised Limit £m	Operational Boundary £m	2016/17 Actual £m
Borrowing	640	610	442
Other long-term liabilities	210	170	111
Total Debt	850	780	553

5.5. During the period to 30 September 2016, borrowing remained well within the authorised limit and operational boundary, and no new long-term borrowing has been taken out.

6. Treasury Management Indicators

6.1. The County Council measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

6.2. The County Council has to set an upper limit on its fixed and variable interest rate exposures for both total investments and total external debt. This indicator is set to control the County Council's exposure to interest rate risk. The County Council approved the following upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed or invested. None of the limits have been exceeded.

Table 3 – Interest Rate Exposures

	2016/17 limit	**Maximum to 30 September 2016**
Upper limit on fixed interest rate investment exposure	£285m	£172m
Upper limit on variable interest rate investment exposure	£700m	£473m
Upper limit on fixed interest rate borrowing exposure	£780m	£442m
Upper limit of variable interest rate borrowing exposure	£780m	£111m

6.3. The limit for borrowing rate exposures has been set to enable maximum policy flexibility for the potential for refinancing e.g. from variable to fixed rate borrowing. The County Council's entire long-term debt portfolio is currently made up of fixed interest loans.

6.4. The upper limit for exposures for investments rates is based on an extreme case of the total investment balances, and to allow for all of this to be held at variable rates (investments with a maturity of less then one year) if necessary.

Maturity Structure of Borrowing

6.5. The Code also requires the County Council to set upper and lower percentage limits on the maturity structure of its long-term fixed rate borrowing during 2016/17. The following table shows the limits approved by the County Council. These have been set to allow maximum flexibility in managing the debt portfolio and are consistent with the existing portfolio.

Table 4 – Maturity Structure of Borrowing

	Upper	Lower	Actual
Under 12 months	50%	0%	3%
12 months and within 24 months	50%	0%	4%
24 months and within 5 years	50%	0%	9%
5 years and within 10 years	75%	0%	12%
10 years and within 20 years	75%	0%	47%
20 years and within 30 years	75%	0%	23%
30 years and above	100%	0%	2%

Principal Sums Invested for Periods Longer than 364 days

6.6. The purpose of this indicator is to control the County Council's exposure to the risk of incurring losses by seeking early repayment of its investments. For 2016/17 the County Council restricted investments for periods of over a year to maximum of £285m. In July 2016 the County Council approved a new limit of £350m. At 30 September 2016 the County Council had £236m of investments with over 364 days to their maturity.

7. Recommendation

7.1. The Audit Committee are asked to note the following recommendations that are being reported to Cabinet and Full Council:

1. Based on the stability of the County Council's cash balances, it is recommended to increase the allocation targeting higher yields to £200m, to increase the overall rate of return and the income contributed to the revenue budget.
2. That the mid-year review of treasury management activities be noted.

CORPORATE OR LEGAL INFORMATION:

Links to the Corporate Strategy

This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision because the management of the County Council's cash balance needs to be decided.

Other Significant Links

Links to previous Member decisions:		
Title	Reference	Date
Direct links to specific legislation or Government Directives		
Title		Date

Section 100 D - Local Government Act 1972 - background documents **The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)** Document   Location None

IMPACT ASSESSMENTS:

1. Equality Duty

1.1. The County Council has a duty under Section 149 of the Equality Act 2010 ('the Act') to have due regard in the exercise of its functions to the need to:

- Eliminate discrimination, harassment and victimisation and any other conduct prohibited under the Act;
- Advance equality of opportunity between persons who share a relevant protected characteristic (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, gender and sexual orientation) and those who do not share it;
- Foster good relations between persons who share a relevant protected characteristic and persons who do not share it.

Due regard in this context involves having due regard in particular to:

a) The need to remove or minimise disadvantages suffered by persons sharing a relevant characteristic connected to that characteristic;

b) Take steps to meet the needs of persons sharing a relevant protected characteristic different from the needs of persons who do not share it;

c) Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity which participation by such persons is disproportionally low.

1.2. **Equalities Impact Assessment:**

1.3. Equality objectives are not considered to be adversely affected by the proposals in this report.

2. Impact on Crime and Disorder:

2.1. The proposals in this report are not considered to have any direct impact on the prevention of crime.

3. Climate Change:

a) How does what is being proposed impact on our carbon footprint / energy consumption?

No specific impact.

a) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.