Appendix B

Treasury Management Mid-Year Report 2016/17

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 Hampshire Fire and Rescue Authority 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 Recommendation

2.1 That the mid-year review of treasury management activities be noted.

3 Economic Background

3.1 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.

3.2 The preliminary estimate of Quarter 3 2016 GDP showed growth as the economy grew 0.5% quarter-on-quarter, and 2.3% year on year. 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.

3.3 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 decline worsen.

3.4 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, the Fire and Rescue Authority's Treasury Management Adviser's (Arlingclose Ltd) 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.

3.5 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.

4 Investment Activity

4.1 The Fire & Rescue Authority has an investment portfolio consisting of reserves and short-term cash flows. The Fire & Rescue Authority is currently investing according to a low risk, high quality lending list as outlined in its Treasury Management Strategy.

4.2 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.)

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

4.4 The Fire & Rescue Authority's investment holding was £35.3m at 31 October 2016, which was £4.3m (10.9%) lower than the same time last year, and was placed into the following investment types:

Table 1 – Investments at 31 October 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 call accounts	0.1	-	-	0.1	0.40	0.00
Bank notice accounts	-	3.0	-	3.0	0.75	0.20
Bank certificates of deposit[1]	-	1.0	-	1.0	0.42	0.31
	0.1	4.0	-	4.1	0.66	0.23
Exempt from bail-in risk						
Covered floating rate notes	-	2.4	5.0	7.4	0.75	1.60
Covered fixed bonds	-	1.5	1.0	2.5	1.08	0.59
Supranational bonds	-	1.0	-	1.0	0.61	0.10
Corporate floating rate notes	-	0.5	-	0.5	0.67	0.27
Corporate fixed bonds	-	0.5	-	0.5	0.68	0.10
Government bonds	-	4.3	-	4.3	0.72	0.12
Money market funds	1.0	-	-	1.0	0.35	0.00
Local authorities	-	10.5	-	10.5	0.58	0.39
Pooled equity funds	-	-	1.5	1.5	0.78[2]	n/a
Pooled property fund	-	-	2.0	2.0	4.88	n/a
	1.0	20.7	9.5	31.2	0.96	0.66
Total	1.1	24.7	9.5	35.3	0.93	0.60

4.5 The Fire & Rescue Authority is currently holding £3m within bank notice accounts. Although this type of investment is subject to bail-risk, these notice accounts provide reasonable liquidity, and are currently earning rates of interest which compensate for the level of risk.

4.6 Counterparty credit quality was assessed and monitored with reference to credit ratings (the Fire & Rescue Authority's minimum long-term counterparty rating for institutions defined as having "high credit quality" is A- 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.

4.7 The average interest rate earned on these investments at 31 October 2016 was 0.93%, 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 market rates. This rate reflects interest rates available prior to the Base Rate cut, and is likely to fall in the coming months.

4.8 The Guidance on Local Government Investments in England gives priority to security and liquidity and the Fire & Rescue Authority's aim is to achieve a yield commensurate with these principles. This has been

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[1] Certificates of deposit have fixed terms but have greater liquidity as they can be sold on the secondary market.

[2] The return on the pooled equity funds represents the income return achieved for the three months invested.

maintained by following the Fire & Rescue Authority's counterparty policy as set out in its Treasury Management Strategy for 2016/17.

5 Borrowing

5.1 The Fire & Rescue Authority's underlying need to borrow as measured by the Capital Financing Requirement (CFR) at 31 March 2016 was £12.8m. Affordability and the "cost of carry" remained important influences on the Fire & Rescue Authority'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 as rates of interest significantly lower than the cost of borrowing.

5.2 For the Fire & Rescue Authority 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.

5.3 As at 31 October 2016 the Fire & Rescue Authority held £8.4m of loans, (which has not changed since last reported on 31 March 2016), made up of Public Works Loans Board (PWLB) loans, as part of its strategy for funding previous years' capital programmes.

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

6 Compliance with Prudential Indicators

6.1 During the period to date of 2016/17, the Fire & Rescue Authority operated within the Prudential Indicators for 2016/17, which were set in February 2016 as part of the Fire & Rescue Authority's Treasury Management Strategy Statement.

Authorised Limit and Operational Boundary for External Debt

6.2 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 Fire and Rescue Authority in February 2016 set an authorised limit for external debt of £18.3m.

6.3 This limit is based on the estimated CFR in order to enable it to be financed entirely from external borrowing should the Fire & Rescue Authority'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.

6.4 The Fire & Rescue Authority has set an operational boundary for external debt reflecting the more likely scenario and consistent with the Fire & Rescue Authority'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 Fire & Rescue Authority approved an operational boundary for 2016/17 of £15.2m.

Table 2 – Authorised Limit and Operational Boundary for External Debt

	Authorised Limit £m	Operational Boundary £m	2016/17 Actual £m
Borrowing	18.3	15.2	8.4
Total Debt	**18.3**	**15.2**	**8.4**

6.5 During the period to 31 October 2016, borrowing remained well within the authorised limit and operational boundary, and no new long term borrowing has been taken out. There has been no temporary borrowing, so the maximum external debt in the period has remained at the total long-term borrowing amount, which is now £8.4m.

7 Treasury Management Indicators

7.1 The Fire & Rescue Authority measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

7.2 The Fire & Rescue Authority 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 Fire & Rescue Authority's exposure to interest rate risk. The Fire & Rescue Authority 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 31 October 2016**
Upper limit on fixed interest rate investment exposure	£18.0m	£1.0m
Upper limit on variable interest rate investment exposure	£50.0m	£41.8m
Upper limit on fixed interest rate borrowing exposure	£15.2m	£8.4m
Upper limit on variable interest rate borrowing exposure	£15.2m	-

7.3 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 Fire & Rescue Authority's entire long-term debt portfolio is currently made up of fixed interest loans.

7.4 The upper limits for investments exposure 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 than one year) if necessary.

Maturity Structure of Borrowing

7.5 The Code also requires the Fire & Rescue Authority 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 Fire & Rescue Authority. 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%	0%
12 months and within 24 months	50%	0%	0%
24 months and within 5 years	50%	0%	15%
5 years and within 10 years	75%	0%	23%
10 years and within 20 years	75%	0%	52%
20 years and above	100%	0%	10%

Principal Sums Invested for Periods Longer than 364 days

7.6 The purpose of this indicator is to control the Fire & Rescue Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. For 2016/17 the Fire & Rescue Authority restricted investments for periods of over a year to a maximum of £18.0m. At 31 October 2016 the Fire & Rescue Authority had £9.5m of investments with over 364 days to their maturity, which is also the maximum held to date this financial year.