EAST HERTS COUNCIL

AUDIT COMMITTEE– 25 NOVEMBER 2015

REPORT BY EXECUTIVE MEMBER OF FINANCE

TREASURY MANAGEMENT STRATEGY – 2015/16 MID-YEAR REVIEW

WARD(S) AFFECTED: NONE SPECIFIC

Purpose/Summary of Report

- This report reviews the Council's treasury management activities for the 6 months to 30 September 2015.

RECOMMENDATIONS TO AUDIT COMMITTEE: **That:**	
(A)	**the loan and investment position as at 30 September 2015; and be noted;**
(B)	**the Prudential Indicator position as at 30 September 2015 be noted and that no changes to Prudential Indicators are proposed. (paragraph 2.8 and Essential Reference Paper "D")**
(C)	**the changes on credit rating methodology(paragraph 2.9) be noted.**

1.0 Background

1.1 The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management (the Code) recommends that Members be updated on treasury management activities regularly through the Treasury Management Strategy Statement (TMSS), Annual Investment Strategy (AIS) and mid and year end reports. This report, therefore, ensures this Council is implementing best practice in accordance with the Code.

1.2 The Council operates a balanced budget, which broadly means cash

raised during the year will meet its cash expenditure. Part of the treasury management operation ensures this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

1.3 The second main function of the treasury management function is to facilitate the funding of the Council's capital programme. The capital programme provides a guide to the borrowing need of the Council, essentially longer term cash flow planning to ensure the Council can meet its capital spending agreements. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses and, on occasions, any debt previously drawn may be restructured to meet Council risk or cost objectives.

1.4 Accordingly, treasury management is defined by the Code as: "The management of the local authority'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."

1.5 The Council has adopted the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (the Code).

1.6 This mid-year report has been prepared in compliance with the Code, and covers the following:

- A brief economic update for the first part of the 2015/16 financial year;
- A review of the Council's Treasury Management and Annual Investment Strategy;
- A review of the Council's capital expenditure (Prudential Indicators);
- A review of the Council's investment portfolio for 2015/16;
- A review of the Council's borrowing strategy;
- A review of any debt rescheduling undertaken during 2015/16;
- A review of compliance with Treasury and Prudential Limits for 2015/16.

1.7 The Council is supported in its treasury management activities by independent advisers – Capita Asset Services.

2.0 Report

2.1 Economic Update

2.1.1 An economic update has been provided by our independent advisors and is included in **Essential Reference Paper 'B'**. A summary of the impact on the Council is included in the following paragraphs.

2.1.2 The UK economy continues to grow and is expected to do so over the short to medium term however there are significant risks to the pace of this growth being achieved. The growth in the UK economy will be affected by the economic performance of other leading economies including the USA, China, Japan and the Eurozone. Should the UK exit the Eurozone following the referendum in 2017 the economic impact is unclear.

2.1.3 Interest rate forecasts are set out in **Essential Reference paper 'C'** although the earliest rate rise is not expected until the second quarter of 2016 at the earliest.

2.1.4 The impact on the Council of the economic forecast and interest rates predictions is discussed below.

2.2 Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2015/16, which includes the Annual Investment Strategy, was approved by the Council on 18 February 2015. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield

2.2.1 Investment rates available in the market have been broadly stable during the first half of the year and have continued at historically low levels as a result of the ultra-low Bank rate. The average level of funds available for investment purposes during the half year ending 30 September 2015 was £76m. The level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital

Programme.

2.2.2 The investment portfolio continues to maintain a relatively high degree of liquidity with the least liquid investments (in-house term deposits) generally rolled over for periods of 1 year.

2.2.3 Officers can confirm that the approved limit for NatWest Bank, a total of £20m, within the Annual Investment Strategy was breached on 6 occasions for a total of 17 days during the half year ended 30 September 2015. This was due to a limited number of available counterparties offering call facilities and the requirement to keep funds in excess of £20m on call to fund the Old River Lane purchase.

2.2.4 Direct deposit and call facility arrangements have now been set up with a number of additional approved counterparties, including UK building societies. This will significantly reduce, if not eliminate, the number of days exceeding the maximum limit for NatWest.

2.2.5 In the current economic climate it is a very challenging investment market in terms of earning the level of interest commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. The table below illustrates that the Council outperformed the benchmark by 93 basis points (bps). The Council's budgeted investment return for 2015/16 is £867k, and performance for the year to date is £167k below budget, even though investment returns were above the national benchmarks. This is due to a delay in property fund investments being placed and the purchase of Old River Lane resulting in a reduction in the level of balances available to invest. Any variance will be met from the Interest Equalisation Reserve, as agreed by Council, at year end. The balance on the reserve is £1.503m as at 31 March 2015.

Investment performance for the financial year to date as at 30 September 2015

Benchmark	Benchmark Return	Council Performance	Investment Interest Earned £
7 day	0.36%	0.38%	37,315
1 Month	0.38%	0.43%	17,247

3 Month	0.45%	0.59%	22,617
6 Month	0.60%	0.70%	20,085
12 Month	0.90%	1.52%	113,075

Note: The above table does not include Investec or property fund investments.

2.3 Investec Asset Management

2.3.1 In May 2015 the following statement was received from Investec Asset Management:

"*As a growing global business, Investec Asset Management (IAM) is constantly reviewing the services it provides to its clients, together with its efficiency at providing those services. IAM's core business is investment management but historically the firm offered a wider range of services including the provision of custody. Further to changes to the UK Financial Conduct Authority's rules around how custody services must be operated which are highly technical in nature, relating amongst other things to reporting, record-keeping and reconciliations, we have made the strategic decision to exit the custody markets from the end of June 2015."*

2.3.2 Following this announcement of their withdrawal from the market funds totalling £22m were drawn down on maturity, with the final balance received on 30 June 2015.

2.4 Property Funds

2.4.1 After the procurement of external advice, an amendment to the TMSS and AIS 2014/15 was agreed at Council on 30 July 2014 to include the use of Property Fund Investments. Investment in Property Funds is limited to an initial investment of £20m in a maximum of two funds at any one time. There are large entry and exit fees associated with Property Fund investments, which cover costs such as stamp duty land tax, so these are typically viewed as long term investments over a term of 5 years or more.

2.4.2 There are long waiting lists for entry into these funds with the first opportunity not arising until June of this year. £10m was placed with Lothbury Property Trust on 4 June 2015, which purchased units with a value after fees of £9.5m. These units have grown in value at an average rate of £90k (0.90%) per calendar month. If this rate of growth continues at the same level the units should

start to exceed their original investment value in December 2015. Please note unit values can fall as well as rise.

2.4.3 In addition to the capital gain the units are producing average quarterly interest/rental returns of £80k. This equates to a return on investment of 3.20%.

2.5 Old River Lane

2.5.1 Purchase of the Old River Lane site in Bishop's Stortford, completed on 13 October 2015. It was treated as an investment decision, representing good value for money in delivering a return on investment in excess of 5% from rental income.

2.5.2 This increase in our investment property portfolio has reduced investment balances by £22m which will impact on the investment interest received.

2.5.3 The full report on the Bishop's Quarter site purchase will be presented to the Executive on 1 December 2015.

2.6 New Borrowing

2.6.1 As outlined below, the general trend in Public Works Loan Board (PWLB) rates has been an increase in interest rates during the first quarter but then a fall during the second quarter. The 50 year PWLB target (certainty) rate for new long term borrowing, for the quarter ending 30 September 2015, fell slightly from 3.60% to 3.40% after the August Bank of England Inflation report.

PWLB certainty rates for the financial year to 30 September 2015

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.11%	1.82%	2.40%	3.06%	3.01%
Date	02/04/2015	02/04/2015	02/04/2015	02/04/2015	02/04/2015
High	1.35%	2.35%	3.06%	3.66%	3.58%
Date	05/08/2015	14/07/2015	14/07/2015	02/07/2015	14/07/2015
Average	1.26%	2.12%	2.76%	3.39%	3.29%

2.6.2 No borrowing was undertaken during the half year ended 30 September 2015. It is anticipated that borrowing will not be undertaken during this financial year.

2.6.3 This Council has not borrowed in advance of need during the half year which ended on 30 September 2015 and has not borrowed in advance at all during the 2015/16 financial year.

2.7 Debt Rescheduling

2.7.1 Debt rescheduling opportunities have been limited in the current economic climate and, following the increase in the margin added to gilt yields, PWLB new borrowing rates have been impacted since October 2010. No debt rescheduling was undertaken during the half year which ended on 30 September 2015.

2.8 Compliance with Treasury and Prudential Limits

2.8.1 The Council has a statutory duty to determine and keep under review its affordable borrowing limits. The Council's approved Treasury and Prudential Indicators (affordability limits) are included in the approved TMSS.

2.8.2 During the financial year to date the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices. The prudential and treasury Indicators are shown in **Essential Reference Paper 'D'**.

2.8.3 Capital programme budgets and forecast outturn form part of the monthly Healthcheck report. The Council resolved to fund the capital programme internally rather than from external borrowing. Given the current economic climate it is not proposed that this approach be changed.

2.8.4 The capital outturn presented in the September Healthcheck report shows that the forecast capital outturn will be £165k less than budget. There is, therefore, no risk that the 2015/16 capital programme will become unaffordable to the Council.

2.8.5 There has been no change to the Council's outstanding loans and therefore there is no risk that any of the prudential indicators

relating to borrowing will be breached or require reconsideration this financial year.

2.9 Changes in credit rating methodology

2.9.1 The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. Commencing in 2015, in response to the evolving regulatory regime, all three agencies have begun removing these "uplifts" with the timing of the process determined by the regulatory progress at the national level. The process has been part of a wider reassessment of methodologies by each of the rating agencies.

2.9.2 In addition to the removal of implied support, new methodologies are now taking into account additional factors, such as regulatory capital levels. In some cases, these factors have "netted" each other off, to leave underlying ratings either unchanged or little changed. A consequence of these new methodologies is that they have also lowered the importance of the (Fitch) Support and Viability ratings and have seen the (Moody's) Financial Strength rating withdrawn by the agency.

2.9.3 In keeping with the agencies' new methodologies, the credit element of our own credit assessment process now focuses solely upon the Short and Long Term ratings of an institution. While this is the same process that has always been used by Standard & Poor's, this has been a change to the use of Fitch and Moody's ratings. It is important to stress that the other key elements to our process, namely the assessment of Rating Watch and Outlook information as well as the Credit Default Swap (CDS) overlay, have not been changed.

2.9.4 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. Where, through the crisis, clients typically assigned the highest sovereign rating to their criteria, the new regulatory environment is attempting to break the link between sovereign support and domestic financial institutions. 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.

2.9.5 It is important to stress that these rating agency changes do not reflect any changes in the underlying status or credit quality of the institution, and are merely a reassessment of their methodologies in light of enacted and future expected changes to the regulatory environment in which financial institutions operate.

2.9.6 While some banks have received lower credit ratings as a result of these changes, this does not mean that they are suddenly less credit worthy than they were formerly. Rather, in the majority of cases, this mainly reflects the fact that implied sovereign government support has effectively been withdrawn from banks. The banks are now expected to have sufficiently strong balance sheets to be able to withstand foreseeable adverse financial circumstances without government support. In fact, in many cases, the balance sheets of banks are now much more robust than they were before the 2008 financial crisis when they had higher ratings than now. However, this is not universally applicable, leaving some entities with modestly lower ratings than they had through much of the "support" phase of the financial crisis.

3.0 Implications/Consultations

3.1 Information on any corporate issues and consultation associated with this report can be found within **Essential Reference Paper 'A'**.

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