North Somerset Council

REPORT TO THE AUDIT COMMITTEE

DATE OF MEETING: **1ST DECEMBER 2015**

SUBJECT OF REPORT: **TREASURY MANAGEMENT MID-YEAR REPORT**

TOWN OR PARISH: **ALL**

OFFICER PRESENTING: **MALCOLM COE, HEAD OF FINANCE & PROPERTY**

KEY DECISION: **NO**

RECOMMENDATION

The Audit Committee notes the report and considers any comments to make to the Executive at its 8th December Meeting.

1. SUMMARY OF REPORT

The report is a mid-year performance update and the Executive will receive this report formally at its 8th December meeting as part of its governance role. The Audit Committee - as part of its overview role on financial governance - is asked to consider the report and provide comments as necessary.

The report details –

- Treasury Management activities during the first seven months of 2015/16 and confirms that the activities undertaken during the year have complied with both the requirements of the Accountability and Responsibility Framework and also the approved Treasury Management Strategy approved by Council in February 2015.
- Prudential Indicators for 2015/16, as required by CIPFA's Prudential Code for Capital Finance in Local Authorities.

2. POLICY

Part 1 (7) of the Financial Regulations, sets out the councils' policy framework with regards to treasury management activities.

Following the council's adoption of the 2011 edition of the CIPFA *Treasury Management in the Public Services: Code of Practice*, Members are required to approve an annual treasury management strategy before the start of each financial year and then to receive an in-year report and also an annual report after the end of each financial year. This in-year report covers the period 1 April to 31 October 2015.

In addition, the Communities and Local Government *Guidance on Local Government Investments* recommends that a local authority review and potentially amend its investment strategy in the light of changing internal or external circumstances. This report therefore meets the requirements of both sets of guidance.

3. DETAILS

3.1 External context provided by Arlingclose Ltd (treasury advisers)

World economy - As the financial year began, economic data was largely overshadowed by events in Greece. Markets' attention centred on the never-ending Greek issue which stumbled from turmoil to crisis, running the serious risk of a disorderly exit from the Euro which heightened when Greece failed to make a scheduled repayment to the IMF on 30th June. On 12th July, following a weekend European Union Summit, it was announced that the terms for a third bailout of Greece had been reached although the European Central Bank froze liquidity assistance provided to Greek banks and capital controls within the country severely restricted individuals' and corporates' access to cash.

The summer then saw attention shift towards China as the Shanghai composite index (representing China's main stock market), dropped by 43% in less than three months with a reported $3.2 trillion loss to investors, on the back of concerns over growth and after regulators clamped down on margin lending activity in an effort to stop investors borrowing to invest and feeding the stock market bubble. On 24th August, Chinese stocks suffered their steepest one-day fall on record, driving down other equity markets around the world and soon becoming known as another 'Black Monday'. Chinese stocks have recovered marginally since and are trading around the same level as the start of the year. Concerns however remain about slowing growth and potential deflationary effects on this area and also the impact across other world markets.

UK economy - The economy has remained resilient over the last six months. Although economic growth slowed in Q1 2015 the year on year growth to March 2015 was a relatively healthy 2.7%. GDP has now increased for ten consecutive quarters, breaking a pattern of slow and erratic growth from 2009. The annual rate for consumer price inflation (CPI) briefly turned negative in April, before fluctuating between 0.0% and 0.1% over the next few months. In the August Quarterly Inflation Report, the Bank of England projected that GDP growth will continue around its average rate since 2013. The Bank of England's projections for inflation remained largely unchanged from the May report with them expecting inflation to gradually increase to around 2% over the next 18 months and then remain there in the near future.

3.2 Investment activity

The Guidance on Local Government Investments in England gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles. The following table summarises the council's external investments at 31 October 2015, and compares to the balances held at 31 March 2015. This sum includes monies managed by the council's in-house team, as well as £30m, which is currently managed by the council's external fund manager.

Summary of External Investments as at 31 October 2015 (principal sums)				
	In-House Cash Deposits	In-House Market Funds	Tradition UK	**TOTAL**
	£m	£m	£m	**£m**
< 1 Year	75.00	5.00	21.00	**101.00**
> 1 Year	4.00	0.00	9.00	**13.00**
Total - 31 October 2015	79.00	5.00	30.00	**114.00**
Total - 31 March 2015	52.00	0.00	30.00	**82.00**

As can be seen above, the council is currently holding approximately £32m more cash in October than it did at the end of March. However it should be noted that this profile is very similar to recent years and the increase in balances is not reflective of additional resources, but merely represents a timing issue at this point in the financial year whereby income is received in advance of associated expenditure. It is projected that these balances will reduce in the coming months as the council's expenditure commitments are fulfilled and cash receipts become less.

The security of capital has previously been the authority's main investment objective and this is under-pinned by the authority's choice of investment products and counter-party policies which were contained within the TM Strategy approved in February 2015. Members will be aware that the February Strategy allowed new investments to be placed in the following types of investment:

- Other Local Authorities;
- AAA-rated Money Market Funds;
- Call Accounts;
- Term Deposits with approved financial institutions;
- DMADF (Government Debt Management Office);
- Gilts and Treasury Bills; Bonds issued by Multilateral Development Banks, such as the European Investment Bank; Certificates of Deposit (CD's)

The table below shows further analysis of the investments held at 31 March and 31 October 2015 which adhered to this Strategy.

Analysis of External Investments (principal sums)			
	31/10/2015	31/03/2015	Movement
	£m	£m	£m
UK Banks	26.00	24.00	2.00
Overseas Banks	7.00	0.00	7.00
UK Building Societies	66.00	48.00	18.00
Money Market Funds	5.00	0.00	5.00
Debt Management Office	5.00	5.00	0.00
Local Authorities	5.00	5.00	0.00
Totals	**114.00**	**82.00**	**32.00**

However since that time the Strategy has been reviewed by the Section 151 Officer who believes that the current investment approach needs to be revised in order to establish a more balanced portfolio allowing for an element of funds to be invested for a longer-term to generate higher returns than those currently available within the traditional cash markets.

In October the Section 151 Officer approved an amendment to the current Strategy in order to allow investments to be made in property funds. Such funds are pooled investment products and are accessed on a traded share basis rather than a fixed cash deposit sum. This does mean that such investments are classified as 'available for sale' assets rather than a receivable investment and will require a revaluation at the end of each financial year and so whilst unlikely, the council will now be exposed to the risk of capital losses as a result.

It is the councils' intention to place an investment of £5m with the Local Authorities Property Fund, (managed by the CCLA) towards the end of November. The CCLA provide a range of pooled money market funds, some of which are created specifically for the public sector and cover asset classes such as Equities, Bond, Property or Cash. The council's investment will be placed into the property related asset class which has achieved a rate of return of approximately 7-8% over recent years.

Members will be assured that although the CCLA does not have any form of rating or financial support criteria awarded to it, something which is currently required for all other investments, the organisation was established in 1958 and has a strong approach to stewardship and ethics.

The council's treasury advisers, Arlingclose Ltd are entirely comfortable with, and recommend, the CCLA property fund and currently have 43 other clients who invest with the organisation. They suggest that this investment should be viewed as a long-term term investment on a 5-year rolling horizon and recommend that Members focus upon the potential income return and not be distracted by the capital fluctuations in the share values. The advisers have also confirmed that such an investment would offer some accounting advantages compared with other property investments and because it represents a way of diversifying the investment portfolio away from focusing entirely upon bank credit risk.

Based upon current share prices an investment of £5m placed in November 2015 would have an equivalent share price of £4.655m when valued at the end of the financial year. This capital loss will be reflected within the Available for Sale reserve at the year-end and would only crystallise should the asset be sold before the fund had increased in value at some point in the future.

3.3 Investment interest budgets

Current projections of current and potential future investments indicate that the council will have a surplus of £0.206m in interest compared to budgeted levels.

Summary of External Investments as at 31 October 2015 (principal sums)				
	In-House Cash Deposits	In-House Market Funds	Tradition UK	**TOTAL**
	£000	£000	£000	**£000**
Projected Out-turn	704	21	445	**1,170**
Budget	509	20	435	**964**
Variance	195	1	10	**206**

There are a significant number of factors which influence the council's ability to generate investment returns on its balances, some of which being;- the official Bank Rate, money market activity, counter-party limits, credit ratings, levels and timing of surplus cash balances available as well as economic and political factors, with the majority of these being external and beyond the council's control.

The UK Bank Rate has been maintained at 0.5% since March 2009 with latest estimates indicating that this is still not expected to rise significantly until the latter part of 2016. Short-term money market rates have continued to follow this trend and have remained at very low levels for some time providing limited investment opportunities.

As well as being influenced by the official Bank rate, the money markets are also affected by the quantities of surplus cash available at any given time, with interest rates decreasing further should more cash balances be offered within the markets. The markets have not changed significantly from previous years with short-term periods remaining highly liquid which has resulted in a reduction in rates and numbers of investors which the council can place funds with.

In summary, although the council has held surplus cash balances during the first half of the year, it has sought to continue extending the duration of investments where possible in order to increase returns as these usually offer increased yields sufficient compared to shorter periods. It is anticipated that the proposed investment in the CCLA property fund will also generate higher returns than the fixed-term cash deposit type investments during the remainder of the financial year, although these will be required to pay for the fees in the first instance.

3.4 Review of the investment strategy

Since the current Investment Strategy was approved in February, the outlook for credit (or counter-party) risk for the council has largely remained unchanged although the council is aware that credit ratings for institutions are relative, rather than absolute measures of credit risk. The council continues to monitor risks in this area, and would look to review and amend both its lending criteria and also timescales for those institutions which could have a negative out-look. Any such changes would represent additional process issues and would not affect the overall flexibility of the Strategy itself.

As mentioned above, the Section 151 Officer has utilised his delegated authority to amend the Strategy to enable investments of £5m to be placed in unrated property funds, a decision supported by the council's external advisers. At this time it is not proposed that any further changes be made to the current Strategy, although this will remain subject to monthly review, and Members will be advised should further action be required.

3.5 Long-term borrowing

Over recent years the PWLB has remained the most attractive source of borrowing for the authority as it has offered greater flexibility and control than the external funding markets where resource levels are often lower during times of weakened economic activity and rates offered are usually higher than those from the PWLB.

At the start of the year the council held long-term borrowing of £124.23m which is profiled for repayment between March 2016 and March 2052, with no more than £7.3m repayable in any one financial year. This is in accordance with the council's current borrowing policy and is structured in a way to reduce exposure to significant cash-flow movements and adverse interest rates at the time each loan matures. The council has 2 loans totalling £5.27m which are due to mature before the end of the financial year, both of which are held with the Public Works Loan Board.

Long-term debt profile as at 31 October 2015		
	Debt	Ave Rate
	£m	%
Less than 1 year	5.27	4.22
Between 1 and 2 years	3.40	3.81
Between 2 and 5 years	6.10	4.32
Between 5 and 10 years	13.34	4.93
Over 10 years	96.12	4.36

In addition the council also has long-term borrowing obligations of £15.65m in respect of the former Avon County Council, although these loans are currently administered by Bristol City Council meaning that the council's overall long-term debt stands at £139.88m.

At this time there has been no change to the overall debt total although as Members will recall a further borrowing requirement of £30.89m for 2015/16 was identified in the capital and treasury management report considered by the Executive at the meeting in February.

Given both the anticipated increase in capital expenditure and the reducing cash balances during the remainder of the year, it is anticipated that the council may begin to consider taking some of its borrowing requirement before the year-end although the timing of any such decisions will be reviewed to ensure that interest rates are at optimum levels and within the budget provision and that there are no opportunities available to re-finance existing debt structures.

Should rates rise during this period then the council will seek to defer borrowing decisions until the next financial year whilst advising of the associated impacts this would have on the councils' revenue budget.

Members will be aware that the PWLB offers various interest rate options for local authorities;

- Standard interest rates – both fixed and variable rates
- Certainty rate – which represents a discount of 0.2% from the standard rate should the authority provide information as required on their plans for long-term borrowing and associated capital spending
- Project rate – which represents a discount of 0.2% from the certainty rate (or 0.4% from the standard rate) for lending in respect of an infrastructure project nominated by a Local Enterprise Partnership (LEP)

The council was awarded access to the certainty rate for its 2015/16 borrowing requirement, and it is intended that proposed borrowing to be undertaken for the City-Region Deal investment projects will attract the project rate, these being the North Somerset Enterprise and Technology College (£3.7m) and the North-South Link road (£9m). It is essential that the council ensures all borrowing decisions are based upon sound and viable business cases and interest rates on loans taken are at optimum levels in order to reduce the impact on the council's revenue budget.

3.6 Treasury management indicators

The council measures its exposures to treasury management risks using the indicators approved in February 2015, and shown at Appendix 1. This report confirms that the council has complied with its prudential indicators for 2015/16, and the Executive are asked to note the following indicators as at 31 October 2015.

4. CONSULTATION

The content of the reports has been consulted with the S151 Officer and relevant other officers.

5. FINANCIAL IMPLICATIONS

Contained within the report.

6. RISK MANAGEMENT

The council does face significant types and degrees of risk in this area, from both internal and external sources. However the council has implemented, and adheres to, strict policies and internal controls in order to mitigate such risks wherever possible.

The council's primary objectives for the management of its investments have always been to give priority to the security and liquidity of its funds before seeking the best rate of return although the need to increase returns on a proportion of cash balances has resulted in a slight change of approach in the current year with the proposed investment into a property fund where capital losses are possible. The majority of surplus cash remains held as short-term investments and in addition £30m is invested on behalf of the council by a professional fund manager, all of which helps the council to diversify its portfolio and reduce risk where possible.

The council's primary objective for the management of its debt is to ensure its long-term affordability. All of the council's current loans have been borrowed from the Public Works Loan Board at long-term fixed rates of interest thereby reducing the exposure of future interest rate rises which could potentially occur should variable or option loans be taken.

However it is noted that the continued combination of short duration investments and long duration debt could expose the council to the risk of falling investment income during periods of low interest rates. This risk is partially mitigated by the inclusion of some longer-term investments and retaining the option to prematurely repay some long-term loans should the financial assessment prove viable and offer best value to the tax paters.

The council measures its exposure to credit risk by monitoring the individual credit ratings of each investor within its portfolio on at least a monthly basis

7. EQUALITY IMPLICATIONS

NONE

8. CORPORATE IMPLICATIONS

NONE

9. OPTIONS CONSIDERED

None, this is an update report.

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BACKGROUND PAPERS

Capital & Treasury Management Strategy report – Executive, February 2015

APPENDIX 1 - TREASURY MANAGEMENT INDICATORS

The following Treasury Management prudential indicators were set for 2015/16 as part of the MTFP process. The limits are shown below together with the actual indicators for the first seven months of 2015/16.

Authorised Limit for External Debt

In respect of its external debt, the council approved the following authorised limit for its total external debt. This limit separately identifies borrowing from other long-term liabilities such as finance leases. The actual level of external debt is shown, and is well within the limits set at the start of the year.

Authorised Limit for External Debt		
	2015/16 Limit	2015/16 Actual
	£m	£m
Borrowing - NSC	200.00	124.23
Borrowing - Former Avon CC	16.00	15.65
Other Long Term Liabilities	39.00	2.59
Authority Total	**255.00**	**142.47**

Operational Boundary

The council also approved the following operational boundary for external debt for the same period, which was based on the same estimates as the authorised limit, but reflected estimates of the most likely, prudent, but not worst case scenario, without the additional headroom included within the authorised limit to allow for unusual cash movements. As can be seen below, the actual level of external debt is well within the operational boundary set at the start of the year.

Operational Boundary for External Debt		
	2015/16 Limit	2015/16 Actual
	£m	£m
Borrowing - NSC	191.00	124.23
Borrowing - Former Avon CC	16.00	15.65
Other Long Term Liabilities	37.00	2.59
Authority Total	**244.00**	**142.47**

Interest Rate Exposure

This indicator is set to control the council's exposure to interest rate risk, including both exposures to fixed and variable rate interest rates, expressed as an amount of net principal borrowed.

Interest Rate Limits		
	2015/16 Limit	2015/16 Actual
	£m	£m
Upper Limit on fixed rate exposures (net)	214.00	28.46
Upper Limit on variable rate exposures (net)	30.00	-5.00

Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year.

Maturity Structure of Borrowing

This indicator is set to control the council's exposure to refinancing risk. The maturity structure of fixed rate borrowing is shown below.

Maturity Structure of Borrowing			
	Upper Limit	Lower Limit	Actual
	%	%	%
Under 12 months	50%	0%	4%
12 months and within 24 months	30%	0%	3%
24 months and within 5 years	40%	0%	5%
5 years and within 10 years	50%	0%	11%
10 years and above	100%	0%	77%

Principal sums invested for periods longer than 364 days

The purpose of this indicator is to control the council's exposure to the risk of incurring losses by seeking early repayment of its investments. The total principal sums invested to final maturities beyond the period end are shown below.

Maturity Structure of Borrowing			
	2016/17	2017/18	2018/19
	£m	£m	£m
Upper limit of principal sums invested beyond the year-end	85	65	59
Actual principal sums invested beyond the year-er	26	2	0