North Somerset Council

REPORT TO THE AUDIT COMMITTEE

DATE OF MEETING: 1ST OF DECEMBER 2016

SUBJECT OF REPORT: MID-YEAR TREASURY MANAGEMENT STRATEGY 2016/17

TOWN OR PARISH: ALL

OFFICER/MEMBER PRESENTING: MALCOLM COE, HEAD OF FINANCE & PROPERTY

KEY DECISION: NO

RECOMMENDATIONS

That the Audit Committee;

1. To note the mid-year balances of £109m for investments and £119m for PWLB borrowing held as at the end of September and the activities that have occurred during the first half of the year.

2. To note the operational flexibilities within the current strategy and the associated financial implications.

3. To support the proposed changes to the council investment strategy for 2017/18, which include new investments in multi asset pooled funds and options to restructure long-term borrowing.

1. SUMMARY OF REPORT

The purpose of this report is to update Members on the council's treasury management activities in the current financial year, together with the associated financial implications and also to advise on draft proposals which will be included within the Treasury Management Strategy for the 2017/18 financial year. It is recommended that some changes are made to the future Strategy which will provide greater flexibility, allowing the council to both reduce risk whilst maintaining a similar level of returns on its portfolio of investments.

The purpose of the report is to recommend changes to the investment strategy in response to changes in the economic outlook and to improve the credit risk of the council's portfolio.

These planned changes will also help counter the additional MTFP savings of £200k added to the interest receivable budget in 2017/18 and changes to investment yields following the reduction in the Bank of England base rate

2. POLICY

The council's budget process should ensure that all resources are planned, aligned and managed effectively to achieve the corporate aims and objectives of the authority. It is also essential to integrate treasury strategies into revenue and capital budget planning processes in order to optimise financial opportunities and minimise any risks which may be present.

3. DETAILS

3.1 2016/17 current position – Borrowing & Investments

Investment balances are currently £109m with 30% in building societies, 28% in UK banks, 5% in the CCLA, 5% with other local authorities, 6% in money market fund and 6% in European banks with the remainder in banks located outside of the EU. With forecast receipts of £1.086m against a budget of £1.2m.

The Council currently also has Borrowing totalling £119m with the Public Works Loan Board (PWLB) and incurs annual interest charges of £5.4m.

3.2 2016/17 treasury activities

As at the end of quarter two 47 deposits had been placed in 2016/17 with £8m currently in the Netherlands, £8m in Singapore, £5m in Canada and £8m in Australia all with a minimum –AA rating. With remainder of the portfolio invested in UK banks, building societies and pooled funds. The council's portfolio has an average credit rating of –A.

During the year to date there has been no additional borrowing and there are no plans to do so until the next financial year.

3.3 Benchmarking

North Somerset Council have contracted with consultants Arlingclose for specialist treasury management services and advice. This service includes regular credit information as well as benchmarking reports on investments. This allows the council to compare and contrast performance and credit risk against like for like institutions with a view to making improvements.

The results of a recent benchmarking survey highlighted an above average return being generated on the council's internal investments in comparison with other unitary authorities. However, the councils risk rating was shown to be below the average in terms of credit risk.

Investment Benchmarking

31 March 2016

	North Somerset	22 English Unitaries Average
Internal Investments	£85.5m	£52.7m
External Funds	£4.7m	£8.2m
TOTAL INVESTMENTS	**£90.2m**	**£61.0m**
Security		
Average Credit Rating	A-	AA-
Average Credit Rating (time weighted)	BBB+	AA-
Number of Counterparties / Funds	19	22
Proportion Exposed to Bail-in	85%	65% *
Liquidity		
Proportion Available within 7 days	6%	41%
Proportion Available within 100 days	49%	63%
Average Days to Maturity	147	119
Yield		
Internal Investment Return	1.06%	0.64% **
External Funds - Income Return	4.67%	3.87%
External Funds - Capital Gains/Losses	-6.49%	0.78% ***
External Funds - Total Return	-1.81%	4.65% ***
Total Investments - Income Return	1.25%	1.24%
Total Investments - Total Return	**0.92%**	**1.41%**

This table highlights the following issues:

* North Somerset Council has a higher exposure to the EU bail in
** North Somerset Council has achieved higher investment yields than the average
*** North Somerset Council has significantly higher exposure to capital losses than the group average (6.49% to 0.78%).

3.4 Responding to the challenges in the current year

In response to the previous benchmarking results the Section 151 Officer requested that changes be made to the operational limits of the current investment strategy in order to increase our average investment credits ratings and also reduce exposure to the EU Bail in. Therefore in line with recommendations from Arlingclose, investments with unrated Building Societies have been scaled back, with durations limited to between 3 and 6 months. Longer duration investments, i.e. 9 and 12 month deposits, have now been replaced with 'A' rated UK banks deposits and with 'AA' rated overseas banks.

This action has resulted in a more diverse portfolio of investments and reduced the exposure to the EU Bail-and any fallout from the BREXIT by providing global diversification. This has improved the risk profile of the council's investment portfolio with 71% of investments now held in counterparties with a rating of A- or higher.

However these actions, along with uncontrollable market conditions such as the cut in interest rates following the BREXIT decision, are likely to impact upon returns achievable, which are forecast to drop below the current yield of 1.06%. The rates being quoted on new deposits since the interest rate cut are around 30% lower than before.

3.5 Looking ahead

Credit outlook: Markets have expressed concern over the financial viability of a number of European banks recently. Sluggish economies and continuing fines for pre-crisis behaviour have weighed on bank profits, and any future slowdown will exacerbate concerns in this regard.

Bail-in legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future, has now been fully implemented in the European Union, Switzerland and USA, while Australia and Canada are progressing with their own plans. The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Authority; returns from cash deposits however continue to fall.

Interest rate forecast: The Authority's treasury adviser Arlingclose's central case is for UK Bank Rate to remain at 0.25% during 2017/18. The Bank of England has, however, highlighted that excessive levels of inflation will not be tolerated for sustained periods. Given this view and the current inflation outlook, further falls in the Bank Rate look less likely. Negative Bank Rate is currently perceived by some policymakers to be counterproductive but, although a low probability, cannot be entirely ruled out in the medium term, particularly if the UK enters recession as a result of concerns over leaving the European Union.

Gilt yields have risen sharply, but remain at low levels. The Arlingclose central case is for yields to decline when the government triggers Article 50. Long-term economic fundamentals remain weak, and the quantitative easing (QE) stimulus provided by central banks globally has only delayed the fallout from the build-up of public and private sector debt. The Bank of England has defended QE as a monetary policy tool, and further QE in support of the UK economy in 2017/18 remains a distinct possibility, to keep long-term interest rates low.

For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 0.50%, and that new long-term loans will be borrowed at an average rate of 2.0% well below the Councils current average of 4.5%

The fall in interest rates together with the additional £0.2m MTFP saving in 2017/18 and uncertain economic conditions make for challenging conditions in the next budget cycle.

3.6 Proposed changes to the Treasury Management Strategy

3.6.1 Increasing investment returns by diversifying into Pooled Funds

In response to the changes in the economic outlook and to the benchmarking report the following changes to the strategy are proposed to strengthen the portfolios credit score and mitigate against any reduction in yield.

The council is currently generating returns of 5% from the CCLA property fund with forecast income of £250k in 2016/17. This fund has helped generate above average returns whilst providing diversification. However a capital loss on the fund has been reported on the funds value in the balance sheet.

This loss is partly due to the spread built into the fund between the bid and offer prices to ensure investors are locked into the fund for long periods, i.e. 3 to 5 years. It is envisaged that over this time frame any capital losses will be recovered. However this should be monitored and a stop loss introduced to try and limit any future unforeseen large capital losses. With this in mind it is proposed that members are consulted should any capital loss exceed 10% or £500k.

Additionally it is proposed that the council makes an additional investment into pooled funds to allow diversification away from Banks and Building Society investments and to provide an alternative revenue stream in a low interest rate environment. Whilst the CCLA property fund has provided positive returns it is recommended that any future investments are in a different asset class to provide further diversification limiting volatility in returns and reducing the likelihood of capital losses occurring all at once in any one year.

It is proposed that a limit of £5m is placed on each fund with a similar limit for each class of assets, i.e. bond funds, multi asset funds, equity funds and property funds. With a view to making a future investment in a multi asset fund. This change will also help to mitigate against EU bail-in risk.

3.6.2 Early repayment of borrowing

The size of premiums repayable to the PWLB on early repayment (£33.6m) make the opportunity to realise any gains above those from reducing cash balances limited. With interest rates falling the opportunity to repay PWLB will become even more limited in the future.

One option would be to repay two loans totalling £5.5m. This would incur a premium of £990k, which would be paid back over the life of the loans at around £132k per annum. There would also be lost income from using cash balances in the region of 1% or £64k per annum. However this would save £272k per annum in interest payable, giving a net benefit of £76k per annum.

Rescheduling debt and the transfer of the council's share of the long-term debt held by Bristol City Council is also currently been considered. However, this is unlikely to generate any additional savings, for the same reasons above, but will give the Council more control over future borrowing decisions.

In 2014/15 the council invested £50k to help establish the Municipal Bond Fund. It was envisaged that the creation of such an organisation could potentially enable LA's to secure borrowing costs below those offered by the PWLB, which has been the optimum choice for the public sector over many years. In order to take advantage of any potential future borrowing which may be offered at advantageous rates the council has included the UK Municipal Bond Agency within its strategy as an authorised lender.

3.6.3 Annual Policy for Minimum Repayment of Principal (MRP)

When the council funds capital expenditure by long-term borrowing, the costs are charged to the council tax payer in future years, reflecting the long-term use of the assets procured. There are two elements to this cost – the interest on borrowing is charged in the year it is payable, and the principal (or capital) element is charged as a “minimum revenue provision” (MRP).

The amount of MRP to be charged was previously determined by regulation, although the council is also allowed to make an additional “voluntary” charge to the revenue account. However these regulations have recently changed and instead the council is required to determine its own MRP policy on an annual basis. There are stipulations when approving this policy, as the council has to give due regard to the principles of prudence rather than just things such as affordability and in addition, the policy must be linked to the underlying asset for which the capital expenditure has been borrowed for.

Officers are currently reviewing the technical details of the MRP policy for 2017/18 with a view to potentially extending the life over which the borrowing is calculated, changes to the policy will impact on the budget, if the life is extended then revenue budget savings could be achieved, if the lives are shortened then the annual costs will increase. Full details will be provided as part of the council’s MTFP budget process.

4. CONSULTATION / RESEARCH

Information has been collated from a variety of sources and considered to form the recommendations within this report. This includes advice from Arlingclose on counter-party limits, benchmarking results and pooled investment limits.

5. FINANCIAL IMPLICATIONS

The proposed changes in this report will help mitigate against a reduction in returns from following the recommendations of the council’s treasury advisors whilst contributing to reducing risk. The financial implications of the recommendations in this report and alternatives are discussed below.

Option 1 – Do Nothing

The drop in interest rates to 0.25% will impact adversely upon the interest receivable from investments. This is forecast to drop to a total of £750k in 2017/18 once investments placed prior to the interest rate cut mature, providing a shortfall of up to £700k next year.

Strict adherence to the recommendations of the council’s treasury advisors with no alterations to the Investment Strategy will also impact upon the council’s revenue budget. The full year impact of the changes is likely to lead to a further reduction in returns of £117k.

Option 2 – Pooled Fund Investment

It is estimated that a multi-asset pooled fund would achieve a return of 2% to 4% with less volatility and risk than property funds. This equates to around £100k to £200k per annum on a proposed £5m investment.

Option 3 – Early repayment of PWLB

The early repayment of £5.5m in PWLB debt will result in a net benefit of £76k per annum. The scale of premiums repayable on the remainder of the portfolio limits the opportunity to further reduce overall borrowing.

Financial Summary

Option	Forecast £'000	Current Budget £'000	MTFP Saving 2017/18 £'000	Projected (Shortfall)/ Surplus £'000
1. Do Nothing	750	1,175	200	-625
2. Additional pooled fund investment	900	1,175	200	-475
3. Restructure debt (*)	-	-	0	76
4. Review MRP policy	TBA	-	0	TBA
All the above	**1,085**	**1,175**		**-399**

* To be confirmed when the MTFP is approved in February 2017.

6. RISK MANAGEMENT

Top 5 current risks	Detail	Proposed mitigation measure	Mitigated RAG rating
1. Credit Risk	Risk of insolvency resulting in an inability to repay capital investment	More diverse portfolio of investments	Amber
2. EU Bail-in	Counterparties no longer supported by national governments during times of financial hardship	Diversification into pooled funds	Amber
3. Liquidity	Lack of access to funds to pay bills	Mixture of maturity durations matched to cashflow needs and access to temporary borrowing and longer term PWLB	Amber
4. Interest Rates	Reduction in interest receivable from investments as a result of base rate changes	Additional investments in pooled funds will limit exposure to interest rate movements.	Amber
5. Capital Losses	Risk of capital losses not being recovered or becoming a revenue expense following changes to accounting practice	Limit losses to 10% or £500k, whichever is greater, before consulting on withdrawing the investment	Amber

6. EQUALITY IMPLICATIONS

NA

7. CORPORATE IMPLICATIONS

None apart from the financial implications on the corporate budget as discussed above.

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BACKGROUND PAPERS

None

Appendix A

Post Brexit Economy from Arlingclose

Following the results of the EU referendum to leave the European Union the UK economy has become more volatile. With Sterling suffering its largest fall since 1985 and the downgrading of the UK's credit rating to AA. Uncertainty remains with Article 50 yet to be triggered and the re negotiation of trade deals still to be completed.

To counteract the fall in business sentiment and economic growth the Bank of England dropped interest rates to 0.25% in August and indications are an additional cut to 0.10% could follow.

The BREXIT result has not had the same impact upon the credit ratings of UK financial institutions as much as the credit crunch of 2008. More stringent capital requirements for UK banks has improved liquidity and prevented a repeat collapse of the financial markets. And although the UK's sovereign rating has been downgraded to AA, reflecting the uncertain economic position and weaker growth outlook, there have been no major changes to ratings.

Advice on counterparty lending limits and durations is sought externally from Arlingclose. The only major change to its advice has been to that of unrated building societies with recommendations to restrict lending durations to 100 days. This prudent stance reflects the softening in the housing market and the lack of other forward looking indicators of performance.