NOTTINGHAMSHIRE
Fire & Rescue Service
Creating Safer Communities

Nottinghamshire and City of Nottingham
Fire and Rescue Authority

TREASURY MANAGEMENT MID YEAR REVIEW 2016/17

Report of the Treasurer to the Fire Authority

Date: 16 December 2016

Purpose of Report:

To provide Members with an update on treasury management activity during the first half of the 2016/17 financial year.

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1. BACKGROUND

1.1. The Authority operates a balanced budget, which broadly means that cash raised during the year will meet its cash expenditure. Part of the treasury management operations is to ensure that this cash flow is adequately planned, with surplus balances being invested with low risk counterparties. The second main treasury management function is the funding of the Authority's capital plans. The capital programme provides a guide to the borrowing needs of the Authority, which is essentially the planning of longer term cash flows to ensure the Authority can meet its capital spending requirements. This management of longer term cash may involve arranging long or short-term loans, or using longer term cash flow surpluses.

Accordingly, treasury management is defined 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. "

1.2 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by the Fire Authority on 9 April 2010. The Code was updated in 2011.

1.3 The primary requirements of the Code are as follows:

1. The creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Authority's treasury management activities.

2. The creation and maintenance of Treasury Management Practices which set out the manner in which the Authority will seek to achieve those policies and objectives.

3. Receipt by the Fire Authority of an annual Treasury Management Strategy Statement for the year ahead, a mid-year review report and an annual report covering activities during the previous year.

4. Delegation by the Authority of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

5. Delegation by the Authority of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Authority the delegated body is the Finance and Resources Committee.

1.4 This mid-year report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- An economic update for the first part of the 2016/17 financial year;
- A review of the Treasury Management Strategy Statement;
- A review of the Authority's investment portfolio for 2016/17;
- A review of the Authority's borrowing strategy for 2016/17;
- A review of compliance with Treasury and Prudential Limits for 2016/17.

1.5 The Authority has appointed Capita Asset Services as its external treasury management adviser.

2. REPORT

2.1 Economic Update

UK GDP growth rates in 2013, 2014 and 2015 of 2.2%, 2.9% and 1.8% respectively have been some of the strongest amongst the G7 countries. The rates for the first three quarters of 2016 were +0.4%, +0.7% and +0.5%, and the latest Bank of England forecast for growth in 2016 as a whole is +2.2%.

2.2 The outcome of the EU referendum vote in June 2016 caused an immediate fall in confidence indicators and business surveys, which were interpreted by the Bank of England in its August Inflation Report as pointing to an impending sharp slowdown in the economy. This led to the implementation of a package of measures that included a cut in the Bank Rate from 0.5% to 0.25% and a renewal of quantitative easing. The Inflation Report also indicated that a further cut in the Bank Rate would be likely. However, the following monthly business surveys in September showed a sharp recovery in confidence, so that it is now generally expected that the economy will continue to grow reasonably strongly through the second half of 2016 and also in 2017, albeit at a slower pace than in the first half of 2016. As a result of this the Monetary Policy Committee (MPC) meeting on 3 November left the Bank Rate and other monetary policy measures unchanged.

2.3 The November MPC report included a forward view that Bank Rate could either go up or down, depending on how economic data evolves over coming months. The view of the Authority's external treasury management advisors is that the Bank Rate is likely to remain unchanged at 0.25% until quarter 2 of 2019 when it is expected to increase to 0.5%. However, forecasting as far ahead as 2019 is extremely difficult due to uncertainties over the terms of Brexit and political developments in the US and the EU.

2.4 After an initial sharp fall in the GfK consumer confidence index (GfK is a market research company) following the outcome of the EU referendum, there has been quite a strong recovery up to October. The signs are that UK consumers appear to be adopting a ‘business as usual’ approach until the actual impact of the UK’s withdrawal from the EU becomes clearer. This is clearly supporting growth, as it is consumer expenditure which underpins the services sector which comprises around 75% of UK GDP.

2.5 The Chancellor has said he will do ‘whatever is needed’ to promote growth; this could involve fiscal policy (e.g. cutting taxes, increasing investment allowances for businesses) and/or an increase in government spending on infrastructure and housing etc. This will mean that the Public Sector Borrowing Requirement (PSBR) deficit elimination timetable is likely to slip further into the future as promoting growth, and ultimately boosting tax revenues in the longer term, will be a more urgent priority.

2.6 The Bank of England’s November Inflation Report included an increase in the peak forecast for inflation from 2.3% to 2.7% during 2017. This increase is largely due to the sharp fall in the value of sterling since the referendum (16% down against the US dollar and 11% down against the Euro) creating an increase in the cost of imported goods and materials. The MPC has warned that if wage inflation were to rise significantly as a result of these cost pressures to consumers, then they would take action to raise the Bank Rate.

2.7 Gilt yields, and consequently Public Works Loan Board (PWLB) rates, have been very volatile during 2016. The year began with 10 year gilt yields at 1.88%, falling to a low point of 0.53% during August, and rates are currently at 1.46% (as at 14 November). The rebound since August is due to the sharp rise in growth expectations since the initial pessimistic forecasts which led to the decision to cut the Bank Rate. Inflation expectations also rose sharply as a result of the continuing fall in the value of sterling.

2.8 The result of the US presidential election in November is expected to lead to a strengthening of US growth if the President-elect’s election promise of a major increase in expenditure on infrastructure is implemented. This policy is also likely to strengthen inflationary pressures as the US economy is already working at near full capacity. In the first week since the US election, there has been a major shift in investor sentiment away from bonds to equities, especially in the US, and this has dragged UK gilt yields and EU bond yields higher. Some economists are of the opinion that this is the start of an expected unwinding of bond prices which were pushed to unrealistically high levels (and conversely yields pushed down) by the artificial and temporary power of quantitative easing. Other economists view it as an overreaction to the US election result which is likely to be reversed.

2.9 Eurozone GDP growth in the first three quarters of 2016 has been 0.5%, 0.3% and 0.3%. Forward indications are that economic growth in the EU is likely to continue at moderate levels. Economic growth in China has been slowing and this, in turn, has been denting economic growth in emerging market countries dependent on exporting raw materials to China.

2.10 Review of the Treasury Management Strategy

The Treasury Management Strategy approved by the Authority sets out the policies for managing investments and for giving priority to the security and liquidity of those investments. The risk appetite of this Authority is low in order to give priority to security of its investments. Accordingly the following types of low risk investments may be made:

- Deposits with the Debt Management Agency (Government)
- Term deposits with Banks and Building Societies
- Term Deposits with uncapped English and Welsh local authority bodies
- Triple-A rated Money Market Funds
- UK Treasury Bills
- Call deposits with Banks and Building Societies;
- Certificates of Deposit

2.11 The Authority will aim to limit its investment with any single counterparty to £2m although the strategy noted that this was sometimes difficult to achieve. No term deposits will be made for more than 1 year without the prior approval of the Treasurer and the Chair of Finance and Resources Committee. The selection of counterparties with a high level of creditworthiness will be achieved by selection of institutions down to a minimum durational band within Capita's weekly credit list of potential counterparties. The Authority will therefore use counterparties within the following durational bands:

- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 100 days

2.12 The Authority will avoid locking into longer term deals whilst investment rates are down at historically low levels unless exceptionally attractive rates are available which make longer term deals worthwhile.

2.13 In terms of cash resources, the strategy is to maintain a bank overdraft facility of £200,000, to continue to use cash flow forecasting to predict cash surpluses and shortfalls so that these can be managed and to invest small bank account balances in the Business Premium Account on a daily basis if the interest rate is favourable.

2.14 In the first half of the year, there were no instances of the bank account being overdrawn.

2.15 Review of the Investment Portfolio

During the first half of the year, a total of 5 investments were made (excluding the overnight sweep to the Business Premium Account). The maximum value placed in any single investment was £2m and the longest duration of 240 days was for a single investment of £50k. The investments were placed with banks and building societies meeting the credit rating criteria shown above. An analysis of investments as at 30 September 2016 revealed that the Authority had £6.050m invested with 4 different institutions at an average interest rate of 0.77%. Of the £6.050m, £4.050m was placed with UK institutions (as defined by the Bank of England Prudential Regulation Authority) and £2m was placed with overseas institutions which are authorised to accept deposits in the UK.

2.16 Investment income earned up to 30 September 2016 totalled £25k. The budgeted target of £76k therefore seems unlikely to be achieved at this stage. This is partly due to a decrease in interest rates following the cut in the Bank of England base rate in August, and partly due to lower than expected levels of cash balances as a result of a decision to delay long term borrowing for capital expenditure and instead rely on "internally borrowing" funds from the Authority's reserves.

2.17 Review of the Borrowing Strategy

The strategy for 2016/17 is to use a combination of capital receipts, borrowing and internal funds to finance capital expenditure.

2.18 In the Treasury Management Strategy for 2016/17, it was predicted that the Authority would need to borrow up to £13m to finance the capital programme and replace up to £6.5m of maturing loans. A £2m PWLB loan matured in September 2016 and three PWLB loans are due to mature during the next two financial years (£2m in 2017/18 and £1m and £1.5m in 2018/19). The £2m loan which matured in September was replaced by a £3m 49 year maturity loan which was taken in August at a rate of 1.95%. This rate compared very favourably to the 3.98% weighted average rate of the Authority's existing debt portfolio.

2.19 Forecasted PWLB interest rates have fallen during the year, with the forecasted rate for a 25 year maturity loan taken out in March 2017 reducing from 3.50% on 1 April 2016 to 2.90% on 18 November 2016. It is uncertain how long this downward trend will continue, especially given the high levels of uncertainty around the likely impact of the forthcoming Brexit negotiations.

2.20 As borrowing rates are currently higher than investment rates the Authority can avoid carrying costs by not borrowing too far in advance of expenditure; however, a balance needs to be struck between avoiding unnecessary carrying costs and managing the interest rate risk which arises from delaying borrowing while interest rates are at relatively low levels. The Authority is currently maintaining an under-borrowed position, which means that the capital financing requirement is being partly funded by the Authority's reserves and balances rather than by loan debt. This strategy, known as "internal borrowing" is prudent at the moment as investment returns are low and counterparty risk is relatively high. However, this strategy is not sustainable in the longer term and borrowing will have to be taken at some point in the future to ensure that reserves and balances are "cash-backed" to an appropriate level. The timing of this borrowing will very much depend on prevailing economic conditions and the Authority's ability to ensure the security of funds and demonstrate value for money in its investment returns. Current cash flow forecasts show that the Authority is likely to require further borrowing of £1.5m by March 2017. Officers will work with treasury advisors to decide if this borrowing should be short or long term, and if it is appropriate to borrow more than this amount in order to reduce the Authority's under-borrowed position.

2.21 A short-term loan of £4m was taken from Cumbria County Council at the beginning of May. The interest rate was 0.48%, and the loan was repaid in August.

2.22 No rescheduling of debt has taken place to date, as the interest rate climate has not resulted in an advantageous environment for rescheduling.

2.23 Following a period of consultation, the government has announced that it intends to abolish the Public Works Loan Board and transfer its functions for lending local authorities to the Treasury, with operational responsibility delegated to the Debt Management Office. This is not expected to have a tangible impact on the Authority's ability to borrow from the government at preferential rates.

2.24 All other aspects of the borrowing strategy remain in place at this mid-point in the year.

2.25 Review of compliance with treasury and prudential limits

The following indicators were approved by Members for the 2016/17 financial year. As at 30 September, the actual performance was as shown in the final column of the table below.

Treasury or Prudential Indicator or Limit	**Approved for 2016/17**	**Actual as at 30/09/16**
Estimate of Ratio of Financing Costs to Net Revenue Stream	5.6%	Not available until year end
Estimate of the Incremental Impact of the New Capital Investment Decisions on the Council Tax (Band D)	£0.55	Not available until year end
Estimate of Total Capital Expenditure to be Incurred (including slippage)	£4,505,000	£3,308,000
Estimate of Capital Financing Requirement	£29,190,000	Not exceeded
Operational Boundary	£28,026,000	Not exceeded
Authorised Limit	£30,829,000	Not exceeded

Upper limit for fixed rate interest exposures	100%	100%
Upper limit for variable rate interest exposures	30%	0%
Loan Maturity:	Limits:	
Under 12 months	Upper 20% Lower 0%	9.40%
12 months to 5 years	Upper 30% Lower 0%	38.20%
5 years to 10 years	Upper 75% Lower 0%	15.30%
10 years to 20 years	Upper 100% Lower 0%	0.00%
Over 20 years	Upper 100% Lower 30%	37.10%
Upper Limit for Principal Sums Invested for Periods Longer than 364 Days	£2,000,000	Not applicable

2.26 The table above shows that a breach of the 12 months to 5 years limit has occurred in the first half of the year. However, this is due to the inclusion of a £4m “Lender Option Borrower Option” LOBO loan in the 12 months to 5 years category. The terms of the LOBO loan state that the lender may revise the rate every five years, and at that point the Authority may choose to repay the loan without penalty if the amended rate is not advantageous. The next opportunity for revision is 7 March 2018, which is why the loan is shown in the 12 months to 5 years category. Unless the Authority chooses to repay the loan early due to an unfavourable interest rate change, the loan will mature in 2078. As the risk of the loan maturing in 2018 is low due to medium term interest rate forecasts, the re-financing risk arising from the loan maturing within 5 years is low. Therefore this breach of the loan maturity indicators is considered acceptable. If the LOBO loan is excluded from the 12 months to 5 years category, the proportion of loans maturing during this time reduces from 38.2% to 19.4%, which is well within the limit set.

3. FINANCIAL IMPLICATIONS

The financial implications of this report are set out in full within the body of the report.

4. HUMAN RESOURCES AND LEARNING AND DEVELOPMENT IMPLICATIONS

There are no human resources or learning and development implications arising directly from this report.

5. EQUALITIES IMPLICATIONS

An Equality Impact Assessment has not been undertaken because this report details a review of activities rather than a new policy.

6. CRIME AND DISORDER IMPLICATIONS

There are no crime and disorder implications arising directly from this report.

7. LEGAL IMPLICATIONS

There are no legal implications arising directly from this report, other than the requirement to act within the Authority's powers when undertaking treasury management borrowings and investments.

8. RISK MANAGEMENT IMPLICATIONS

The investment of local authority funds cannot be achieved without some element of risk. Careful choice of borrowers using creditworthiness indices will minimise this risk. This prudent approach will undoubtedly result in some interest rate loss but the principles of security and liquidity are paramount.

9. RECOMMENDATIONS

It is recommended that Members note the contents of this report.

10. BACKGROUND PAPERS FOR INSPECTION (OTHER THAN PUBLISHED DOCUMENTS)

None.

NEIL TIMMS
TREASURER TO THE FIRE AUTHORITY