NOTTINGHAMSHIRE
Fire & Rescue Service
Creating Safer Communities

Nottinghamshire and City of Nottingham
Fire and Rescue Authority

TREASURY MANAGEMENT MID YEAR REVIEW 2017/18

Report of the Interim Treasurer to the Fire Authority

Date: 15 December 2017

Purpose of Report:

To provide Members with an update on treasury management activity during the first half of the 2017/18 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 2017/18 financial year
- A review of the Treasury Management Strategy Statement
- A review of the Authority’s investment portfolio for 2017/18
- A review of the Authority’s borrowing strategy for 2017/18
- A review of compliance with Treasury and Prudential Limits for 2017/18

1.5 The Authority has appointed Link Asset Services (previously known as Capita Asset Services) as its external treasury management adviser. The sale of Capita Assets Services to the Link Group was completed on 3 November 2017. The services provided will not change under the new ownership.

2. REPORT

ECONOMIC UPDATE

2.1 After relatively strong growth in 2016, growth in 2017 has been fairly weak; quarter 1 and 2 were +0.3% and quarter 3 was +0.4%. Growth in the first half of 2017 was the slowest for the first half of any year since 2012. This slowdown has been largely attributed to the increase in inflation caused by the devaluation of sterling. This has pushed up the cost of imports and led to a reduction in consumer disposal income, which in turn has led to weak growth in the services sector of the economy as consumers cut back on expenditure. The devaluation of sterling has resulted in increased demand for exports which is resulting in strong growth in the manufacturing sector, however the manufacturing sector accounts for just 11% of GDP compared with 75% for the services sector.

2.2 At its meeting on 1 November the Monetary Policy Committee (MPC) voted to increase bank rate by 0.25 percentage points to 0.5% in an attempt to bring inflation back down to the 2% target. CPI inflation rose to 3% in September, and the MPC expects inflation to peak above 3% as the past depreciation of sterling and recent increases in energy prices continue to pass through to consumer prices. The minutes of the MPC meeting indicated that any future increases in bank rate are expected to be at a gradual pace and to a limited extent.

2.3 Economic growth in the EU is picking up and was +0.5% in quarter 1 and +0.6% in quarter 2. Despite providing massive monetary stimulus, the European Central Bank is struggling to get inflation up to its 2% target. It is therefore unlikely to start increasing rates until possibly 2019.

2.4 US growth has been fairly volatile, with quarter 1 at +1.2% and quarter 2 rebounding to 3.1%. Inflationary pressures are building in the American economy, and there could be one more rate rise in 2017. Further rates rises are also likely in 2018.

INTEREST RATE FORECASTS

2.5 The Authority's treasury advisor, Link Asset Services, has provided the following forecast:

	Dec 2017	Mar 2018	Jun 2018	Sep 2018	Dec 2018	Mar 2019	Jun 2019	Sep 2019	Dec 2019	Mar 2020	Mar 2021
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	0.75%	0.75%	0.75%	1.00%	1.25%
5yr PWLB	1.50%	1.60%	1.60%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.10%	2.30%
10yr PWLB	2.10%	2.20%	2.30%	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%	3.00%
25yr PWLB	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.60%
50yr PWLB	2.50%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%	3.40%

2.6 The overall balance of risks to economic recovery in the UK is currently to the downside, but there is huge uncertainty surrounding the Brexit negotiations.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- UK economic growth and increases in inflation being weaker than anticipated.
- Weak growth in the UK's main trading partners.
- Geopolitical risks in Europe, the Middle East and Asia, which could lead to increasing safe haven flows to the UK.
- A resurgence of the Eurozone sovereign debt crisis.
- Monetary policy action failing to stimulate sustainable growth.

Potential upside risks to current forecasts for UK gilt yields and PWLB rates (especially longer term PWLB rates) include:

- The pace and timing of increases in the Federal Funds Rate in the US could cause investors to reassess the relative risks of holding bonds as opposed to equities, leading to a major flight from bonds to equities.
- UK inflation returning to significantly high levels, causing an increase in the inflation premium inherent to gilt yields.

REVIEW OF THE TREASURY MANAGEMENT STRATEGY

2.7 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

2.8 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 Link'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

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

2.10 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.

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

REVIEW OF THE INVESTMENT PORTFOLIO

2.12 During the first half of the year, two investments were made (excluding the overnight sweep to the Business Premium Account). Both investments were call deposits with Barclays Bank: £3.5m in a 95 day notice account and £5m in a 32 day notice account. Ordinarily the Authority would avoid placing such a large amount with a single counterparty, however Officers had difficulty finding suitable alternative counterparties with which to invest the pension top-up grant. £2.5m has already been withdrawn from the 32 day account, and notice has been given to withdraw the remaining £2.5m. An analysis of investments as at 30 September 2017 revealed that the Authority had £14.050m invested with 5 different institutions at an average interest rate of 0.45%. All of the £14.050m was placed with UK institutions (as defined by the Bank of England Prudential Regulation Authority.

2.13 Investment income earned up to 30 September 2017 totalled £22k. The budgeted target of £66k 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.

REVIEW OF THE BORROWING STRATEGY

2.14 The strategy for 2017/18 is to use a combination of capital receipts, borrowing and internal funds to finance capital expenditure.

2.15 In the Treasury Management Strategy it was predicted that the Authority would need to borrow up to £8m during the 3 year period from 2017/18 to finance the capital programme and replace up to £4.5m of maturing loans. A £2m PWLB loan matured in September 2017 and two PWLB loans totalling £2.5m are due to mature in 2018/19.

2.16 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 3.00% on 3 April 2017 to 2.90% on 14 November 2017. 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.

2.17 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 £2.5m by March 2018. 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.

2.18 The Authority has taken out three short term loans during the period from April to November 2017. £2.5m was borrowed from the London Borough of Newham, and two loans of £250k and £1.2m have been taken from Nottinghamshire County Council. All of these loans have been repaid.

Officers opted for short term rather than long term borrowing on these occasions in order to avoid unnecessary carrying costs, as outlined in paragraph 2.17.

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

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

REVIEW OF COMPLIANCE WITH TREASURY AND PRUDENTIAL LIMITS

2.21 The following indicators were approved by Members for the 2017/18 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 2017/18	Actual as at 30/09/17
Estimate of Ratio of Financing Costs to Net Revenue Stream	6.0%	Not available until year end
Estimate of the Incremental Impact of the New Capital Investment Decisions on the Council Tax (Band D)	£0.40	Not available until year end
Estimate of Total Capital Expenditure to be Incurred (including slippage)	£5,113,000	£4,120,000
Estimate of Capital Financing Requirement	£28,407,000	Not exceeded
Operational Boundary	£27,726,000	Not exceeded
Authorised Limit	£30,538,000	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 (including LOBO)	Upper 20% Lower 0%	23.50%
Under 12 months (excluding LOBO)	Upper 20% Lower 0%	5.80%
12 months to 5 years	Upper 30% Lower 0%	15.70%
5 years to 10 years	Upper 75% Lower 0%	14.30%
10 years to 20 years	Upper 100% Lower 0%	0.00%
Over 20 years	Upper 100% Lower 30%	46.60%
Upper Limit for Principal Sums Invested for Periods Longer than 364 Days	£2,000,000	Not applicable

2.22 The table above shows that a breach of the < 12 months 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 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 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 category, the proportion of loans maturing during this time reduces from 23.50% to 5.80%, which is well within the limit set.

REVISED CIPFA CODES

2.23 The Chartered Institute of Public Finance and Accountancy (CIPFA) is currently conducting an exercise to consult local authorities on revising the Treasury Management Code and Cross Sectoral Guidance Notes, and the Prudential Code. CIPFA is aiming to issue the revised codes during November. The 2018/19 Treasury Management Strategy and the 2018/19 Prudential Code for Capital Finance will reflect the revised Codes when they are reported to Members in February 2018.

MIFID II

2.24 The Markets in Financial Instruments Directive ("MIFID I") came into force in 2007. "MIFID II" refers to a revision of the Directive which will be effective from 3 January 2018. Under the revised regulations, Local Authorities will be categorised as "retail clients". Such a categorisation will limit both the financial instruments and providers available to the Authority for treasury management purposes. However, authorities can opt up to become "elective professional clients" if certain criteria are satisfied. Officers have been advised that this Authority will be eligible to opt up, and preparations are being made to do so.

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 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 from this report.

7. LEGAL IMPLICATIONS

There are no legal implications arising 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. COLLABORATION IMPLICATIONS

There are no collaboration implications arising from this report.

10. RECOMMENDATIONS

That Members note the contents of this report.

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

None.

Theresa Channell
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