Midlothian

Midlothian Council
Tuesday 08 November 2016

Treasury Management Mid-Year Review Report 2016/17

Report by Gary Fairley, Head of Finance and Integrated Service Support

1 Purpose of Report

The purpose of this report is to inform members of the Treasury Management activity undertaken during the first half of 2016/17, the forecast activity for the second half of 2016/17, and update the Prudential Indicators for 2016/17.

2 Background

Council, on 08 March 2016, approved the Treasury Management and Annual Investment Strategy Statement for the financial year 2016/17.

3 Economic update for first half of 2016/17

The key points from economic activity in the first half of 2016/17 are as follows:-

- The referendum vote for Brexit in June has seen a reduction in borrowing rates whereby Public Works Loan Board (PWLB) long-term loan rates dropped to around the 2.00% mark during mid-summer;
- The bank of England, on 4th August 2016, cut the Bank of England Base Rate from 0.50% to 0.25% with both new fixed term and variable rate investment opportunities broadly reducing in line with this 25bps reduction;
- Borrowing rate forecasts over the short-medium term have been adjusted in light of the economic outlook and show a gradual rise from current levels, with projected longer-term interest rates forecast to rise to c. 2.50% for by June 2019;
- At the time of writing, current forecasts for Bank Base Rate include a further cut to 0.10% in November this year and a first increase from this level in May 2018, back to 0.25%;
- The forecast for Consumer Price Inflation shows a sharp rise to around 2.40% for 2018 and 2019.

An economic update for the first part of the 2016/17 financial year is included as Appendix 1. PWLB borrowing rates for the first half of the year are outlined in Appendix 2.

4. Treasury Activity during first half of 2016/17

The main points arising from treasury activity in the year to 07 October 2016 were:-

- Long-term borrowing of £20.000 million was sourced:-
    - £10.000 million maturity loan drawn on 04 July 2016 at an interest rate of 2.32% for a 49 year tenor; and
    - £10.000 million maturity loan drawn on 08 July 2016 at an interest rate of 2.28% for a 46.5 year tenor;

  The borrowing was sourced from PWLB, taking advantage of the Council's certainty rate discount of 0.20% from the standard PWLB rates and the historically low borrowing rate environment;
- Long term borrowing of £2.090 million matured, this being £2.000 million PWLB maturities, £0.061 million Salix maturities and £0.029 million PWLB Annuities;
- A £10.000 million deposit was placed with a German bank, Heleba[1], on 04 April 2016, for a fixed term of 1 year, at 0.94%, continuing the policy of cash backing reserves, whilst adding value to the portfolio with minimal risk.
- The average interest rate earned on external investments was 0.82%, exceeding the benchmark rate of 0.52%.

The Council's loan and investment portfolio as at 07 October 2016 is shown in tables 1 and 2 below (position at 31 March 2016 also shown for comparison):-

Table 1: Council's Loan Portfolio at 31 March 2016 and 07 October 2016

Loan Type	**31 March 2016**		**07 October 2016**	
	Principal Outstanding £000's	**Weighted Average Rate**	**Principal Outstanding £000's**	**Weighted Average Rate %**
PWLB Annuity	768	8.90%	754	8.90%
PWLB Maturity	179,224	4.01%	197,224	3.77%
LOBO	20,000	4.51%	20,000	4.51%
Temporary Market Loans	36,880	0.48%	35,000	0.25%
Other Loans	400	0.00%	357	0.00%
Total Loans	**237,272**	**3.51%**	**253,335**	**3.35%**
Underlying Borrowing Requirement*	**254,024**		**262,718**	
Internal Borrowing	**16,752**		**9,383**	

* *The Underlying Borrowing Requirement is the Capital Financing Requirement excluding the "Public Private Finance" (PPP) Contract Liabilities*

[1] Landesbank Hessen-Thueringen Girozentrale, domiciled in Germany

Table 2: Council's Investment Portfolio at 31 March 2016 and 07 October 2016

Investment Type	**31 March 2016**		**07 October 2016**	
	Principal Outstanding £000's	**Weighted Average Rate**	**Principal Outstanding £000's**	**Weighted Average Rate %**
Money Market Funds	13,355	0.50%	8,153	0.42%
Bank Notice Accounts	24,985	1.03%	24,985	0.78%
Bank Fixed Term Deposits	30,000	0.87%	50,000	0.84%
Total Investments	**68,340**	**0.86%**	**83,138**	**0.78%**

5. Expected Treasury Activity during second half of 2016/17

Borrowing

It is expected that further long-term borrowing will be undertaken in the latter half of 2016/17, given both (a) the historically low interest rate environment and (b) the capital expenditure forecasts for 2016/17 presented to Council elsewhere on today's agenda (and summarised in Section 6 below).

Consideration will also continue to be given as to whether borrowing now (for capital expenditure in 2017/18 or beyond) to secure historically low PWLB rates offers value compared with forward interest rate projections. Equally, consideration will continue to be given as to whether any forward borrowing opportunities offer value (this would allow the Council to secure loans now at an agreed rate, to be drawn down at later dates when interest rates are forecast to be significantly higher. This would eliminate the majority of the cost of carry).

Appendix 3 provides forecasts for interest rates from the Council's Treasury Management advisor, Capita.

As with all long-term borrowing decisions, an option appraisal will be undertaken prior to executing any loan transaction, to ensure that any loans taken offer best value to the Council.

Investments

As noted in Section 3 and detailed in Appendix 1, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the current 0.25% Bank Rate, with a further cut in Bank Base Rate to 0.10% in November expected to reduce investment returns further. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis together with other risks which could impact on the creditworthiness of banks prompts a low risk strategy. Given this risk environment, investment returns are likely to remain low.

£40.000 million of the Council's investments are held in fixed term deposits which mature in late March / early April 2017 and £24.985 million in bank notice accounts (with the notice period equating to broadly 6 months). Given the current low interest rate environment and the expected further reduction in Bank Base Rate, it is proposed that Council officers, in conjunction with Capita Asset Services, continue to review the range of investment options available to the Council within its stated investment policy in order to select only the most creditworthy counterparties to ensure the security of Council funds, and from that list select the range of investment products that offer best value to the Council's investment portfolio.

Expected Loan & Investment Portfolio at 31 March 2017

Taking all of the above into account, the expected loan and investment portfolio at 31 March 2017 is shown in Tables 7 and 8 below:-

Table 7: Council's forecast Loan Portfolio at 31 March 2017

Loan Type	**31 March 2017**	
	Principal Outstanding £000's	**Weighted Average Rate**
PWLB Annuity	739	8.90%
PWLB Maturity	208,482	3.70%
LOBO	20,000	4.51%
Temporary Market Loans	40,170	0.25%
Other Loans	337	0.00%
Total Loans	**269,728**	**3.26%**
Underlying Borrowing Requirement	**287,493**	
Internal Borrowing	**17,765**	

Table 8: Council's forecast Investment Portfolio at 31 March 2017

Investment Type	**31 March 2017**	
	Principal Outstanding £000's	**Weighted Average Rate**
Money Market Funds	5,000	0.25%
Bank Notice Accounts	24,985	0.63%
Bank Fixed Term Deposits	40,000	0.69%
Total Investments	**69,985**	**0.64%**

6. Prudential Indicators 2016/17

The following prudential indicators have been refreshed from those reported to Council on 08 March 2016 in the original Treasury Management and Annual Investment Strategy Statement 2016/17, based on the actual outturn for 2015/16 and the Council's Capital Plans for 2016/17 to 2021/22, and are shown in Table 9 and in graphical form below (see also Appendix 4):-

Table 9: Prudential Indicators 2016/17 – Mid Year Update

Indicator	**2016/17 Original Estimate £000's**	**2016/17 Current Position £000's**	**2016/17 Revised Estimate £000's**
2016/17 Capital Expenditure	72,501	18,145	59,118
2016/17 Required Borrowing	59,341	12,060	40,714
2016/17 Underlying Borrowing Requirement*	310,697	262,718	287,493
2016/17 Gross External Borrowing	285,736	253,335	269,728
Operational Boundary – Borrowing	310,727	275,854	301,868
Authorised Limit – Borrowing	334,260	384,844	384,844
2016/17 Capital Financing Requirement**	365,699	318,340	342,495

** Excludes "On balance sheet" PPP schemes.*
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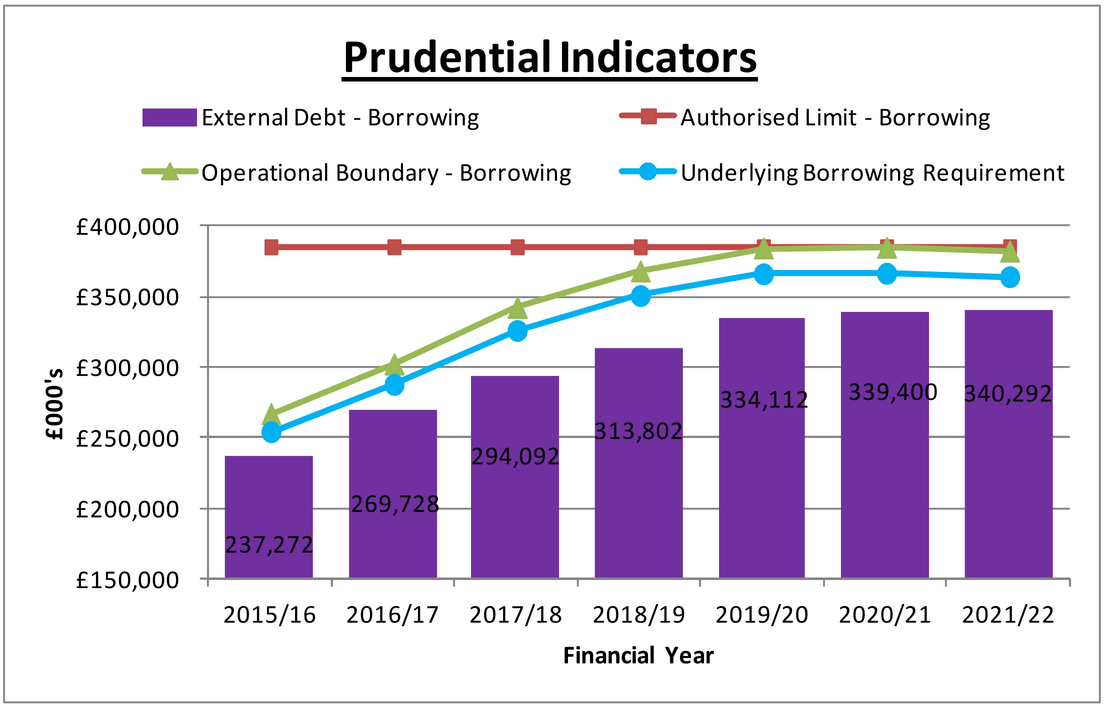

The **Capital Financing Requirement (CFR)** denotes the Council's underlying need to borrow for capital purposes. The CFR includes borrowing arising as a result of the Council's Capital Plans, plus the long-term liability arising from the Council's two PPP contracts. The Underlying Borrowing Requirement strips out the latter of these (long-term liability arising from the two PPP contracts) from the CFR.

The **Authorised Limit for Borrowing** represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It is the expected maximum borrowing need with some headroom for unexpected movements. This was recommended to be £334.260 million in the Treasury Strategy report presented to Council on 08 March 2016 and subsequently agreed by Council.

Rather than restrict external borrowing in the remainder of 2016/17 to:-

- the expected Underlying Borrowing Requirement for this year (£287.493 million); or
- the Authorised Limit for Borrowing of £334.260 million approved by Council on 08 March 2016;

it is proposed that permission be granted to borrow up to the authorised limit for borrowing of £384.844 million (as shown in the table below), if market conditions supported this action. This would have the effect of securing lower costs for future years but care would be taken to ensure that the cost of carry from borrowing early is minimized and that the maturity structure of all debt is sufficiently robust to ensure that the CFR at 31 March 2022 remains achievable.

Table 10: Authorised Limit for Borrowing: Calculation

Indicator	**2016/17 Original Estimate £000's**	**2016/17 Revised Estimate £000's**
CFR – General Services (31 March 2021)	121,652	129,163
CFR – HRA (31 March 2021)	202,464	236,914
Unrealised Capital Receipts & Developer Contributions 2016/17	2,084	4,708
Forecast level of Capital Receipts & Developer Contributions 2016/17 to 2020/21	8,060	14,059
Proposed Authorised Limit	**334,260**	**384,844**

7 Report Implications

7.1 Resource

Expenditure from Treasury Management activity i.e. loan charges, is reported in quarterly financial positions to Council, with Quarter 2 monitoring reflected in the Financial Monitoring 2016/17 – General Fund Revenue report elsewhere on today's agenda.

7.2 Risk

As the Council follows the requirements of the CIPFA Code of Practice for Treasury Management, and the Prudential Code, there is a reduced level of risks involved in Treasury Management activities. Those risks that do exist are further controlled through written Treasury Management Practices which define the responsibilities of all staff involved and these have recently been reviewed and updated.

7.3 Single Midlothian Plan and Business Transformation

Themes addresses in this report:-

☐ Community safety
☐ Adult health, care and housing

- ☐ Getting it right for every Midlothian child
- ☐ Improving opportunities in Midlothian
- ☐ Sustainable growth
- ☒ Business transformation and Best Value
- ☐ None of the above

7.4 Impact on Performance and Outcomes

The strategies adopted are an integral part of the corporate aim to achieve Best Value as they seek to minimise the cost of borrowing by exercising prudent debt management and investment. This in turn helps to ensure that the Council's capital expenditure is sustainable in revenue terms.

7.5 Adopting a Preventative Approach

The proposals in this report do not directly impact on the adoption of a preventative approach.

7.6 Involving Communities and Other Stakeholders

Although no external consultation has taken place, cognisance has been taken of professional advice obtained from Capita Asset Services, the Council's appointed Treasury Consultants.

7.7 Ensuring Equalities

There are no equality issues arising from this report.

7.8 Supporting Sustainable Development

There are no sustainability issues arising from this report.

7.9 Digital Issues

There are no Digital Services implications arising from this report.

8 Summary

Treasury Management activity during the year to 07 October 2016 has been effective in minimising borrowing costs and maximising investment income within the parameters set by the strategy for the year.

Further long-term borrowing is forecast for the remainder of 2016/17, reflective of the General Services and HRA capital plans reported elsewhere on today's agenda.

The investment climate remains challenging given the low interest rate environment and creditworthiness concerns. Officers will continue to review the investment opportunities available to the Council.

The Prudential Indicators have been updated to reflect current capital expenditure and income projections and the extension of the General Services Capital Plan to 2021/22.

9 Recommendations

It is recommended that Council:-

a) Note the report and the treasury activity undertaken in the period to 07 October 2016, as outlined in Section 4;
b) Note the forecast activity during the second-half of the year as outlined in Section 5;
c) Approve the revisions to the Prudential Indicators in Section 6 of this report.

25 October 2016

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Appendices

Appendix 1: Economic Update for first part of 2016/17 financial year
Appendix 2: PWLB Borrowing Rates 1 April 2016 to 30 September 2016
Appendix 3: Capita Asset Services Interest Rate Forecasts
Appendix 4: Prudential Indicators Detail

Appendix 1: Economic Update for first part of 2016/17 financial year

UK

UK Gross Domestic Product (GDP) growth rates in 2013 of 2.2% and 2.9% in 2014 were strong but 2015 was disappointing at 1.8%, though it still remained one of the leading rates among the G7 countries. Growth improved in quarter 4 of 2015 from +0.4% to 0.7% but fell back to +0.4% (2.0% y/y) in quarter 1 of 2016 before bouncing back again to +0.7% (2.1% y/y) in quarter 2. During most of 2015, the economy had faced headwinds for exporters from the appreciation during the year of sterling against the Euro, and weak growth in the EU, China and emerging markets, plus the dampening effect of the Government's continuing austerity programme. The referendum vote for Brexit in June this year delivered an immediate shock fall in confidence indicators and business surveys, pointing to an impending sharp slowdown in the economy. However, subsequent surveys have shown a sharp recovery in confidence and business surveys, though it is generally expected that although the economy will now avoid flat lining, growth will be weak through the second half of 2016 and in 2017.

The Bank of England meeting on August 4th addressed this expected slowdown in growth by a package of measures including a cut in Bank Rate from 0.50% to 0.25%. The Inflation Report included an unchanged forecast for growth for 2016 of 2.0% but cut the forecast for 2017 from 2.3% to just 0.8%. The Governor of the Bank of England, Mark Carney, had warned that a vote for Brexit would be likely to cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the UK would have continuing full access, (i.e. without tariffs), to the EU single market. He also warned that the Bank could not do all the heavy lifting and suggested that the Government will need to help growth by increasing investment expenditure and possibly by using fiscal policy tools (taxation). The new Chancellor Phillip Hammond announced after the referendum result, that the target of achieving a budget surplus in 2020 will be eased in the Autumn Statement on November 23.

The Inflation Report also included a sharp rise in the forecast for inflation to around 2.4% in 2018 and 2019. CPI has started rising during 2016 as the falls in the price of oil and food twelve months ago fall out of the calculation during the year and, in addition, the post referendum 10% fall in the value of sterling on a trade weighted basis is likely to result in a 3% increase in CPI over a time period of 3-4 years. However, the MPC is expected to look thorough a one off upward blip from this devaluation of sterling in order to support economic growth, especially if pay increases continue to remain subdued and therefore pose little danger of stoking core inflationary price pressures within the UK economy.

US

The American economy had a patchy 2015 with sharp swings in the growth rate leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 disappointed at +0.8% on an annualised basis while quarter 2 improved, but only to a lacklustre +1.4%. However, forward indicators are pointing towards a pickup in growth in the rest of 2016. The Fed. embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene and then the Brexit vote, have caused a delay in the timing of the second increase which is now strongly expected in December this year.

Eurozone

In the Eurozone, the European Central Bank (ECB) commenced in March 2015 its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected Eurozone countries at a rate of €60bn per month; this was intended to run initially to September 2016 but was extended to March 2017 at its December 2015 meeting. At its December and March meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise from around zero towards the target of 2%. GDP growth rose by 0.6% in quarter 1 2016 (1.7% y/y) but slowed to +0.3% (+1.6% y/y) in quarter 2. This has added to comments from many forecasters that central banks around the world are running out of ammunition to stimulate economic growth and to boost inflation. They stress that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand in the their economies and economic growth.

Rest of World

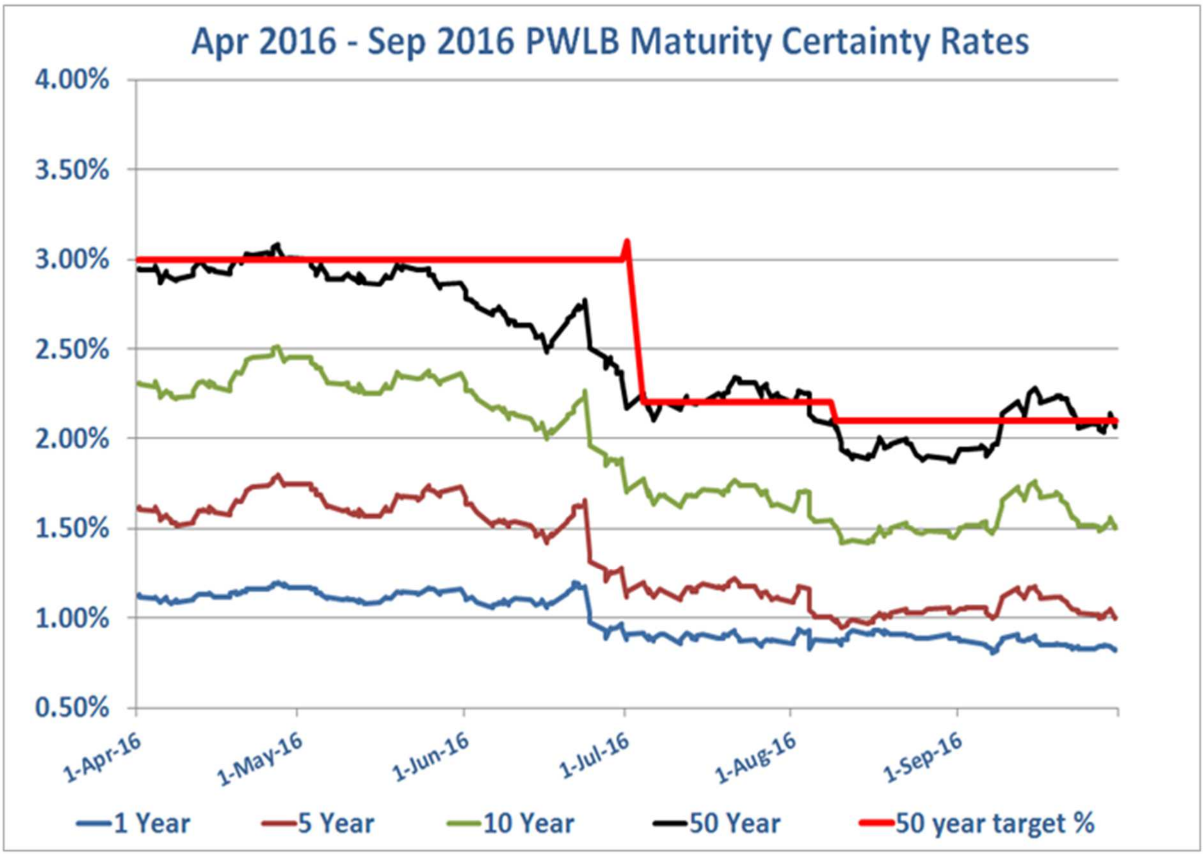
Japan is still bogged down in anaemic growth and making little progress on fundamental reform of the economy while Chinese economic growth has been weakening and medium term risks have been increasing.

Appendix 2: PWLB Borrowing Rates 1 April 2016 to 30 September 2016

The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date:

PWLB certainty rates 1 April 2016 to 30TH September 2016

	1 Year	5 Year	10 Year	25 Year	50 Year
1/4/16	1.13%	1.62%	2.31%	3.14%	2.95%
30/9/16	0.83%	1.01%	1.52%	2.27%	2.10%
Low	0.81%	0.95%	1.42%	2.08%	1.87%
Date	07/09/2016	10/08/2016	10/08/2016	12/08/2016	30/08/2016
High	1.20%	1.80%	2.51%	3.28%	3.08%
Date	27/04/2016	27/04/2016	27/04/2016	27/04/2016	27/04/2016
Average	0.99%	1.33%	1.92%	2.69%	2.46%



Appendix 3: Capita Asset Services Interest Rate Forecasts

The Council's treasury advisor, Capita Asset Services, has provided the following forecast:

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Bank rate	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.25%	0.25%	0.25%	0.25%	0.50%
5yr PWLB rate	1.00%	1.00%	1.10%	1.10%	1.10%	1.10%	1.20%	1.20%	1.20%	1.20%	1.30%
10yr PWLB rate	1.50%	1.50%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.70%	1.80%
25yr PWLB rate	2.30%	2.30%	2.40%	2.40%	2.40%	2.40%	2.50%	2.50%	2.50%	2.50%	2.60%
50yr PWLB rate	2.10%	2.10%	2.20%	2.20%	2.20%	2.20%	2.30%	2.30%	2.30%	2.30%	2.40%

Capita Asset Services undertook a quarterly review of its interest rate forecasts after the MPC meeting of 4th August cut Bank Rate to 0.25% and gave forward guidance that it expected to cut Bank Rate again to near zero before the year end. The above forecast therefore includes a further cut to 0.10% in November this year and a first increase in May 2018, to 0.25%, but no further increase to 0.50% until a year later. Mark Carney has repeatedly stated that increases in Bank Rate will be slow and gradual after they do start. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when the growth in average disposable income is still weak and could well turn negative when inflation rises during the next two years to exceed average pay increases.

The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. An eventual world economic recovery may also see investors switching from the safe haven of bonds to equities. However, we have been experiencing exceptional levels of volatility in financial markets which have caused significant swings in PWLB rates. Our PWLB rate forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

The overall balance of risks to economic recovery in the UK remains to the downside. Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Monetary policy action reaching its limit of effectiveness and failing to stimulate significant sustainable growth, combat the threat of deflation and reduce high levels of debt in some major developed economies, combined with a lack of adequate action from national governments to promote growth through structural reforms, fiscal policy and investment expenditure;
- Weak capitalisation of some European banks;
- A resurgence of the Eurozone sovereign debt crisis;
- Geopolitical risks in Europe, the Middle East and Asia, increasing safe haven flows;
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or Fed. rate increases, causing a further flight to safe havens (bonds);
- UK economic growth and increases in inflation are weaker than we currently anticipate;

- Weak growth or recession in the UK's main trading partners - the EU and US.

The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- The pace and timing of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities;
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Appendix 4 Prudential Indicators Detail

Prudential Indicator for Capital Expenditure

The table below shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the budget:-

Capital Expenditure by Service	2016/17 Original Estimate £000's	Current Position £000's	2016/17 Revised Estimate £000's
Resources	6,178	1,364	12,661
Education, Community & Economy	22,342	10,104	23,273
Health & Social Care	105	26	407
Council Transformation	87	(14)	328
Unallocated	976	0	0
HRA	42,813	6,665	22,449
Total	**72,501**	**18,145**	**59,118**

Forecast levels of capital expenditure on:-

- Resources has increased compared to budget, with the inclusion of approved budgets for the following projects: Stobhill Depot Replacement, SWAN programme, Digital Services Requirements for the new GoreGlen & Bilston Primaries, Straiton Bing Site Investigation and Mayfield Park Amenities; together with a £4.556 million rephasing of budgets from 2015/16 / 2017/18 to/from 2016/17;
- Education, Community & Economy has increased by £0.931 million with the inclusion of approved budgets for the following projects: Inspiring Learning Spaces and the Borders Rail Economic Development Projects, and an acceleration in the forecast level of spend for the Paradykes & Roslin Primary School projects;
- Health & Social Care has increased by £0.302 million to reflect the approval of the Homecare budget and the rephasing of spend for the Assistive Technology project;
- Council Transformation has increased by £0.241 million to reflect rephasing of project spend from 2015/16 to 2016/17;
- HRA has decreased by £20.364 million to reflect the rephasing of the Phase II and III programmes.

Prudential Indicator for the Financing of the Capital Programme & Borrowing

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (principal repayments). This direct borrowing need is also supplemented by maturing debt and other treasury requirements.

Capital Financing	2016/17 Original Estimate £000's	Current Position £000's	2016/17 Revised Estimate £000's
Total Capital Expenditure	**72,501**	**18,145**	**59,118**
Capital Grants	8,222	3,793	8,428
Capital Receipts	1,148	1,962	2,155
Capital Reserves	0	0	0
Developer Contributions	3,265	497	5,012
Other Contributions	526	(167)	2,809
Total Financing	**13,160**	**6,085**	**18,403**
Borrowing Required	**59,341**	**12,060**	**40,714**

Total expected financing has increased from £13.160 million to £18.403 million, reflecting:-

- An increase in the forecast level of capital receipts applied to the HRA capital plan;
- an increase in the forecast level of developer contributions that can be applied to finance the capital plan;
- an increase in the level of "other contributions", reflecting the application of the insurance receipt for Hopefield, the funding from NHS Lothian for the Paradykes project and the funding from Scottish Futures Trust for the Inspiring Learning Spaces project.