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| **REPORT REFERENCE NO.** | **RC/17/7** |
| **MEETING** | **RESOURCES COMMITTEE** |
| **DATE OF MEETING** | **1 SEPTEMBER 2017** |
| **SUBJECT OF REPORT** | **TREASURY MANAGEMENT PERFORMANCE 2017-2018: QUARTER 1** |
| **LEAD OFFICER** | **TREASURER** |
| **RECOMMENDATIONS** | ***That the performance in relation to the treasury management activities of the Authority for 2017-18 (to June 2017) be noted.*** |
| **EXECUTIVE SUMMARY** | The Chartered Institute of Public Finance and Accountancy (CIPFA) issued a Code of Practice for Treasury Management. The Code suggests that members should be informed of Treasury Management activities at least twice a year, but preferably quarterly. This report therefore ensures this Authority is embracing Best Practice in accordance with CIPFA's Code of Practice. |
| **RESOURCE IMPLICATIONS** | As indicated within the report. |
| **EQUALITY IMPACT ASSESSMENT** | An initial assessment has not identified any equality issues emanating from this report. |
| **APPENDICES** | A. Investments held as at 30 June 2017. |
| **LIST OF BACKGROUND PAPERS** | Treasury Management Strategy (including Prudential and Treasury Indicators) Report DSFRA/17/3 – as approved at the meeting of the DSFRA meeting held on the 17 February 2017 |

## 1. INTRODUCTION

1.1 The Treasury Management Strategy for Devon and Somerset FRA has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Treasury Management in Public Services Code of Practice (the Code) and the CIPFA Prudential Code. The Code recommends that members be updated on treasury management activities regularly (TMSS, annual and midyear reports). This report, therefore, ensures this Authority is implementing best practice in accordance with the Code and includes:

- The creation and maintenance of a Treasury Management Policy Statement, which sets out the policies and objectives of the Authority's treasury management activities;
- 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;
- The receipt by the full Authority of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year;
- The 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.

1.2 Treasury management in this context is defined as:

> "The management of the local authority's 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. "

1.3 The preparation of this report demonstrates that the Authority is implementing best practice in accordance with the code.

## 2. ECONOMIC BACKGROUND

2.1 The UK Gross Domestic Product annual growth rates in each calendar year 2013 – 2016 of 1.9%, 3.1%, 2.2% and 1.8%, have all been the top rate, or near top rate, of any of the G7 countries in every year. It is particularly notable that the UK performance was repeated in 2016, a year in which the Bank of England had forecast in August 2016 that growth would be near to zero in the second half of the year due to the economic shock it expected from the result of the Brexit referendum in June.

2.2 2.2 It has had to change its mind, however, and in its February and May 2017 Inflation Reports, the Bank upgraded its forecasts for growth (May Report - 2017 1.9%, 2018 and 2019 1.9%). Over these years,, it also expects inflation to accelerate towards nearly 3% as increases in costs as a result of the fall in the value of sterling since the referendum, gradually feeds through into the economy, though it should fall back to 2.2% in 2019. Provided those cost pressures do not feed through into significantly higher domestically generated inflation within the UK, the Monetary Policy Committee is expected to 'look though' this one off blip upwards in inflation.

2.3 Wage inflation, which is a key driver of domestically generated price pressures, is currently subdued. There is, though, a potential risk that the Monetary Policy Committee might muster a majority to reverse the emergency 0.25% rate cut before embarking on a progressive trend of increases in Bank Rate at a later time.

2.4 Gross Domestic Product growth in the US has been highly volatile in 2016 but overall mediocre, at an average of 1.6% for the year. Quarter 1 in 2017 has also been mediocre at 1.4% but current indications are that growth could rebound strongly in quarter 2. The disappointment so far has been the lack of decisive action from President Trump to make progress with his promised fiscal stimulus package. The Federal Reserve has, therefore, started on the upswing in rates now that the economy is at or around “full employment” and inflationary pressures have been building to exceed its 2% target. It has, therefore, raised rates four times, with the last three following quickly on one another in December 2016 and March and June 2017. One or two more increases are expected in 2017 and possibly four in 2018.

2.5 Growth in the European Union improved in 2016 to 1.7% after the European Central Bank cut rates into negative territory and embarked on massive quantitative easing during the year. The European Central Bank is now forecasting growth of 1.9% in 2017, 1.8% in 2018 and 1.7% in 2019. It has committed to continuing major monthly quantitative easing purchases of debt instruments, though in April 2017 it reduced the rate from €80bn per month to €60bn, to continue until the end of 2017, in order to stimulate growth and to get inflation up to its 2% target.

2.6 There are major concerns about various stresses within the European Union; these could even have the potential to call into question the European Union project. The Dutch and French elections passed off without creating any waves for the European Union but we still have a national election in Germany on 22 October; this is not currently expected to cause any significant change. What could be more problematic is the general election in Austria on 15 October 2017where a major front runner is the Freedom Party which is strongly anti-immigration and anti-European Union. There is also a risk of a snap general election in Italy before the final end possible date of 20 May 2018. A continuing major stress point is dealing with the unsustainable level of national debt in Greece in the face of implacable opposition from Germany to any further bail out. High levels of unemployment in some European Union countries and the free movement of people within the European Union, together with the European Union’s fraught relationship with Turkey in controlling such people movements, are also major stress issues. On top of which the EU also now has to deal with Brexit negotiations with the UK.

2.7 China is expected to continue with reasonably strong growth, (by Chinese standards), of 6.5% in 2017. However, medium term risks are increasing. Japan has only achieved 1% growth in 2016 and is struggling to get inflation to move from around 0%, despite massive fiscal stimulus and monetary policy action by the Bank of Japan.

***Interest Rate Forecasts***

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

| | Sep-17 | Dec-17 | Mar-18 | Jun-18 | Sep-18 | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Bank rate | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.50% | 0.50% | 0.75% | 0.75% |
| 5yr PWLB rate | 1.40% | 1.50% | 1.60% | 1.70% | 1.70% | 1.80% | 1.80% | 1.90% | 1.90% | 2.00% | 2.00% |
| 10yr PWLB rate | 2.10% | 2.20% | 2.30% | 2.30% | 2.40% | 2.40% | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% |
| 25yr PWLB rate | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% | 3.30% | 3.30% |
| 50yr PWLB rate | 2.60% | 2.70% | 2.70% | 2.80% | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.10% | 3.10% |

2.9 The Monetary Policy Committee cut Bank Rate from 0.50% to 0.25% on 4 August 2016 in order to counteract what it forecast was going to be a sharp slowdown in growth in the second half of 2016. However, since then, growth has been robust until dipping in quarter 1 of 2017 to 0.2%. Also, Consumer Prices Index inflation has risen substantially as a result of the sharp fall in the value of sterling since the referendum. Consequently, Bank Rate has not been cut again, and market concern has switched to whether the Monetary Policy Committee could get together a majority to reverse the August emergency 0.25% rate cut before embarking on a progressive trend of increases in Bank Rate at a later time when the economic and political / Brexit situation is more robust to withstand such increases.

2.10 There is much uncertainty at this time over the slender majority the Conservative Government has, which is dependent on Democratic Unionist Party support, and also over what form of Brexit will transpire and how difficult the European Union could be in setting terms. There are therefore a multiplicity of ifs and buts at the current time and depending on how things transpire, then this will materially influence Monetary Policy Committee decision making as to when Bank Rate will rise.

2.11 Accordingly, a first increase to 0.50% is not tentatively pencilled in, as in the table above, until quarter 2 of 2019, after the Brexit negotiations have been concluded (though the period for negotiations could be extended). However, if strong domestically generated inflation, e.g. from wage increases within the UK, were to emerge, then the pace and timing of increases in Bank Rate could be brought forward.

## 3. TREASURY MANAGEMENT STRATEGY STATEMENT

***Annual Investment Strategy***

3.1 The Authority's Annual Investment Strategy, which is incorporated in the Treasury Management Strategy Statement (TMSS) was approved by the Authority on the 17 February 2017. It outlines the Authority's investment priorities as follows:

- Security of Capital
- Liquidity
- Yield

3.2 The Authority will also aim to achieve the optimum return on investments commensurate with the proper levels of security and liquidity. In the current economic, climate it is considered appropriate to keep a significant proportion of investments short term. This will not only cover short term cash flow needs but will also seek out value available in significantly higher rates in periods up to 12 months with highly credit rated financial institutions using the Capita suggested creditworthiness matrices, including Credit Default Swap (CDS) overlay information provided by Capita.

3.3 A full list of investments held as at 30 June 2017 are shown in Appendix A.

3.4 The average level of funds available for investment purposes during the quarter was £35.430m. These funds were available on a temporary basis and the level of funds was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme.

| Benchmark | Benchmark Return | Authority Performance | Investment interest to Quarter 1 |
|---|---|---|---|
| 3 Month LIBID | 0.19% | 0.37% | £23,973. |

3.5 As illustrated, the Authority outperformed the 3 month LIBID benchmark by 0.1816bp. It is currently anticipated that the actual investment return for the whole of 2017-18 will exceed the Authority's budgeted investment target of £79k.

***Borrowing Strategy***

*Prudential Indicators:*

3.6 It is a statutory duty for the Authority to determine and keep under review the "Affordable Borrowing Limits". The Authority's' approved Prudential Indicators (affordability limits) are outlined in the approved TMSS.

3.7 A full list of the approved limits (as amended) are included in the Financial Performance Report 2017-2018, considered elsewhere on the agenda, which confirms that no breaches of the Prudential Indicators were made in the period to June 2017 and that there are no concerns that they will be breached during the financial year.

*Current external borrowing*

3.8 3.8 The Authority has not taken any external loans since June 2012 and has been using cash resources to meet any capital expenditure. The amount of outstanding external borrowing as at 30 June 2017 was £25.724m, forecast to reduce to £25.630m by the end of the financial year as a result of natural loan repayments. All of this debt is at fixed rate with the remaining principal having an average rate of 4.233% and average life of 27.86 years.

*Loan Rescheduling*

3.9 No debt rescheduling was undertaken during the quarter. The Authority will continue to work closely with our treasury advisors to explore any opportunities to repay existing loans, however current Public Works Loan Board early repayment rates mean there is no financial benefit in undertaking premature loan repayment at this time.

*New Borrowing*

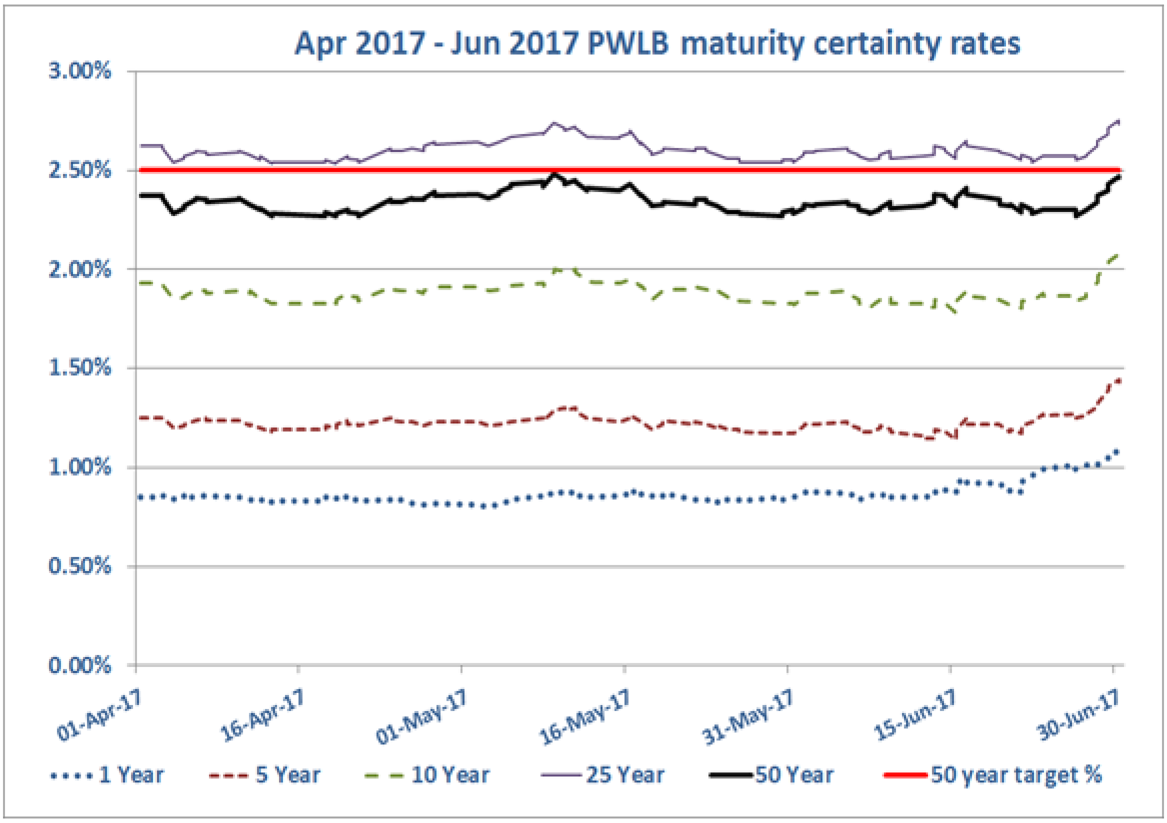
3.10 As depicted in the graph and table below, Public Works Loan Board rates varied little during the quarter until rising sharply in the last week of June. During the quarter, the 50 year Public Works Loan Board target (certainty) rate for new long term borrowing was 2.50%. It is noted that with the exception of 50 year loans, the high point for borrowing rates occurred on the same day 30th June 2017.

3.11 No new borrowing was undertaken during the quarter and none is planned during 2017-18 as a result of the Authority's adopted financial strategy to utilise revenue funds (revenue budget and reserves) to finance capital investment needs for the medium term.

**PWLB rates quarter ended 30 June 2017**

| | 1 Year | 5 Year | 10 Year | 25 Year | 50 Year |
|---|---|---|---|---|---|
| Low | 0.80% | 1.14% | 1.78% | 2.53% | 2.27% |
| Date | 03/05/2017 | 15/06/2017 | 15/06/2017 | 13/04/2017 | 13/04/2017 |
| High | 1.08% | 1.44% | 2.08% | 2.75% | 2.48% |
| Date | 30/06/2017 | 30/06/2017 | 30/06/2017 | 30/06/2017 | 09/05/2017 |
| Average | 0.87% | 1.23% | 1.89% | 2.60% | 2.34% |

3.12 Borrowing rates for this quarter are shown below.



*Borrowing in Advance of Need*

3.13 The Authority has not borrowed in advance of need during this quarter.

## 4. SUMMARY AND RECOMMENDATION

4.1 In compliance with the requirements of the Chartered Institute of Public Finance and Accountancy Code of Practice of Treasury Management, this report provides the Committee with the first quarter report on treasury management activities for 2017-2018 to June 2017. As is indicated in this report, none of the Prudential Indicators have been breached, and a prudent approach has been taken in relation to investment decisions taken so far, with priority being given to liquidity and security over yield. Whilst investment returns are still low as a consequence of the fall in interest rates, the Authority is still anticipating that investment returns will meet the budgeted target.

**KEVIN WOODWARD**
**Treasurer**

**APPENDIX A TO REPORT RC/17/7**

| Investments as at 30 June 2017 | | | | | |
|---|---|---|---|---|---|
| **Counterparty** | **Maximum to be invested** | **Total amount invested** | **Call or Term** | **Period invested** | **Interest rate(s)** |
| | **£m** | **£m** | | | |
| Santander | 5.000 | 2.000 | T | 6 Months | 0.42 |
| | | 1.000 | T | 6 Months | 0.39 |
| | | 1.000 | T | 6 Months | 0.38 |
| Qatar National Bank | 5.000 | 1.000 | T | 1 Year | 0.75 |
| | | 3.000 | T | 1 Year | 0.82 |
| | | 1.000 | T | 1 Year | 0.82 |
| Bank of Scotland | 6.400 | 1.500 | T | 6 Months | 0.65 |
| | | 1.500 | T | 6 Months | 0.55 |
| | | 2.100 | T | 6 Months | 0.60 |
| | | 1.400 | T | 3 Months | 0.45 |
| | | 1.400 | T | 6 Months | 0.55 |
| Goldman Sachs | 5.000 | 5.000 | T | 6 Months | 0.58 |
| Standard Chartered | 5.000 | 1.000 | T | 6 Months | 0.44 |
| | | 2.000 | T | 6 Months | 0.44 |
| Sumitomo Mitsui | 5.000 | 3.200 | T | 6 Months | 0.43 |
| Lloyds Bank | 2.000 | 2.000 | T | 6 Months | 0.55 |
| Nationwide | 2.000 | 2.000 | T | 6 Months | 0.37 |
| Standard Life Money Market Fund | 6.000 | 1.907 | C | Instant Access | Variable |
| BlackRock Money Market Fund | 5.000 | 0.532 | C | Instant Access | Variable |
| Federated Liquidity Fund | 5.000 | 0.330 | C | Instant Access | Variable |
| **Total invested as at 30 June 2017** | | **£33.370M** | | | |