REPORT REFERENCE NO.	**RC/17/8**
MEETING	**RESOURCES COMMITTEE**
DATE OF MEETING	**15 NOVEMBER 2017**
SUBJECT OF REPORT	**TREASURY MANAGEMENT PERFORMANCE 2017-2018: QUARTER 2**
LEAD OFFICER	**DIRECTOR OF FINANCE (TREASURER)**
RECOMMENDATIONS	***That the performance in relation to the treasury management activities of the Authority for 2017-18 (to September 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	Appendix A – Investments held as at 30 September 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 Fire & Rescue Authority 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 (treasury management strategy, 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 **UK.** After the UK economy surprised on the upside with strong growth in 2016, growth in 2017 has been disappointingly weak; quarter 1 came in at only +0.3% (+1.7% y/y) and quarter 2 was +0.3% (+1.5% y/y) which meant that growth in the first half of 2017 was the slowest for the first half of any year since 2012. The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 75% of Growth Domestic Product has seen weak growth as consumers cut back on their expenditure.

2.2 However, more recently there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year. However, this sector only accounts for around 11% of Growth Domestic Product so expansion in this sector will have a much more muted effect on the average total Growth Domestic Product growth figure for the UK economy as a whole.

2.3 The Monetary Policy Committee (MPC) meeting of 14 September 2017 surprised markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise. The Bank of England Inflation Reports during 2017 clearly flagged up that they expected Consumer Price Index inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years' time. Inflation actually came in at 2.9% in August, (this data was released on 12 September), and so the Bank revised its forecast for the peak to over 3% at the 14 September Monetary Policy Committee meeting.

2.4 This marginal revision can hardly justify why the Monetary Policy Committee became so aggressive with its wording.The focus was on an emerging view that with unemployment falling to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that the amount of spare capacity in the economy was significantly diminishing towards a point at which they now needed to take action. In addition, the Monetary Policy Committee took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of increasing globalisation. This effectively means that the UK labour force faces competition from overseas labour e.g. in outsourcing work to developing economies, and this therefore depresses the negotiating power of UK labour. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a decrease in such globalisation pressures in the UK, and so would be inflationary over the next few years.

2.5 It therefore looks very likely that the Monetary Policy Committee will increase Bank Rate to 0.5% in November 2017 or, if not, in February 2018. The big question after that will be whether this will be a one off increase or the start of a slow, but regular, increase in Bank Rate. As at the start of October 2017, short sterling rates are indicating that financial markets do not expect a second increase until May 2018 with a third increase in November 2019. However, some forecasters are flagging up that they expect growth to improve significantly in 2017 and into 2018, as the fall in inflation will bring to an end the negative impact on consumer spending power while a strong export performance will compensate for weak services sector growth. If this scenario were to materialise, then the Monetary Policy Committee would have added reason to embark on a series of slow but gradual increases in Bank Rate during 2018. While there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two years will pan out.

2.6 **EU.** Economic growth in the EU, (the UK's biggest trading partner), has been lack lustre for several years after the financial crisis despite the European Central Bank eventually cutting its main rate to -0.4% and embarking on a massive programme of Quantitative Easing (QE). However, growth picked up in 2016 and now looks to have gathered ongoing substantial strength and momentum thanks to this stimulus. Gross Domestic Product growth was 0.5% in quarter 1 (2.0% y/y) and 0.6% in quarter (2.3% y/y). However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in August inflation was 1.5%. It is therefore unlikely to start on an upswing in rates until possibly 2019.

2.7 **USA.** Growth in the American economy has been volatile in 2015 and 2016. 2017 is following that path again with quarter 1 coming in at only 1.2% but quarter 2 rebounding to 3.1%, resulting in an overall annualised figure of 2.1% for the first half year. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.4%, while wage inflation pressures, and inflationary pressures in general, have been building. The Federal Reserve (Fed) has started on a gradual upswing in rates with three increases since December 2016; and there could be one more rate rise in 2017 which would then lift the central rate to 1.25 – 1.50%. There could then be another four more increases in 2018. At its June meeting, the Fed strongly hinted that it would soon begin to unwind its $4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

2.8 **Chinese economic growth** has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

2.9 **Japan** is struggling to stimulate consistent significant growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

<u>Interest Rate Forecasts</u>

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

	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%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.50%	1.60%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%
50yr PWLB rate	2.70%	2.70%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%

2.11 Capita Asset Services undertook its last review of interest rate forecasts on 9 August after the quarterly Bank of England Inflation Report. There was no change in Monetary Policy Committee policy at that meeting. However, the Monetary Policy Committee meeting of 14 September revealed a sharp change in sentiment whereby a majority of Monetary Policy Committee members said they would be voting for an increase in Bank Rate "over the coming months". It is therefore possible that there will be an increase to 0.5% at the November MPC meeting. If that happens, the question will then be as to whether the Monetary Policy Committee will stop at just withdrawing the emergency Bank Rate cut of 0.25% in August 2016, after the result of the EU withdrawal referendum, or whether they will embark on a series of further increases in Bank Rate during 2018.

2.12 The overall balance of risks to economic recovery in the UK is currently to the downside but huge variables over the coming few years include just what final form Brexit will take, when finally agreed with the EU, and when.

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 September 2017 are shown in Appendix A.

3.4 The average level of funds available for investment purposes during the quarter was £40.497m (£35.430m in Quarter 1). 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 2
3 Month LIBID	0.17%	0.32%	£0.050m.

3.5 As illustrated, the Authority outperformed the 3 month LIBID benchmark by 0.15bp. 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 September 2017 and that there are no concerns that they will be breached during the financial year.

Current external borrowing

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 September 2017 was £25.677m, 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

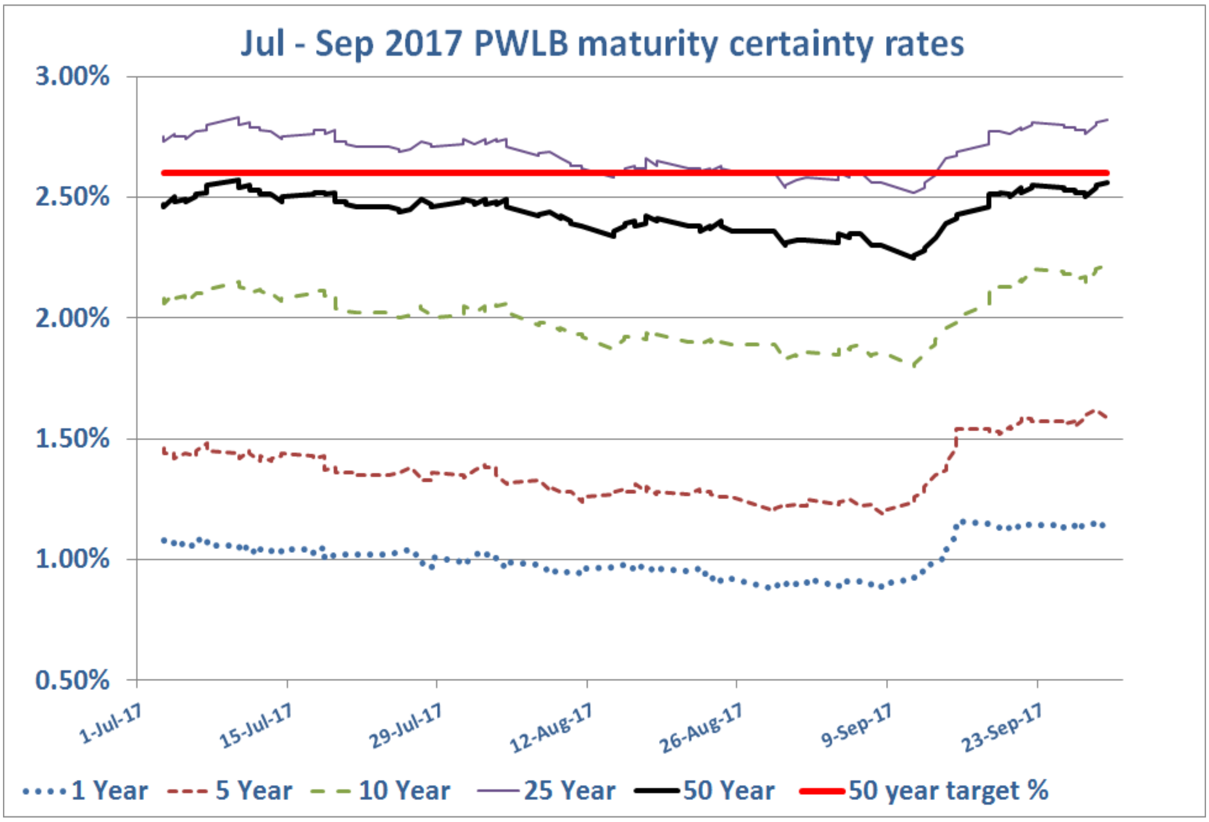
3.10 As depicted in the graph(s) below, there has been significant volatility in PWLB rates during the final weeks of quarter 2 following the September MPC meeting and the suggestion that Bank Rate will need to increase sooner than markets initially anticipated, partly because of inflation concerns and also because of the tightening labour market.

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 September 2017

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.88%	1.19%	1.80%	2.52%	2.25%
Date	29/08/2017	08/09/2017	11/09/2017	11/09/2017	11/09/2017
High	1.16%	1.62%	2.22%	2.83%	2.57%
Date	15/09/2017	28/09/2017	29/09/2017	10/07/2017	10/07/2017
Average	1.01%	1.37%	2.00%	2.69%	2.44%

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 September 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.

AMY WEBB
Director of Finance & Treasurer

APPENDIX A TO REPORT RC/17/8

Investments as at 30 September 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
		1.000	T	6 Months	0.34
Qatar National Bank	5.000	3.000	T	1 Year	0.82
		1.000	T	1 Year	0.82
Bank of Scotland	5.000	2.100	T	6 Months	0.36
		1.500	T	6 Months	0.55
		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	0.31
Lloyds Bank	2.000	2.000	T	6 Months	0.55
Nationwide	2.000	2.000	T	6 Months	0.30
Barclays FIBCA	2.000	0.001	C	Instant Access	Variable
Barclays	8.000	3.000	T	1 Year	0.55
		2.000	T	6 Months	0.30
Standard Life Money Market Fund	6.000	5.980	C	Instant Access	Variable
BlackRock Money Market Fund	5.000	2.003	C	Instant Access	Variable
Federated Liquidity Fund	5.000	0.330	C	Instant Access	Variable
Total invested as at 30 September 2017		**£42.514M**			