Gateshead Council

REPORT TO AUDIT AND STANDARDS COMMITTEE
03 OCTOBER 2016

TITLE OF REPORT: **Treasury Management – Performance to 30 September 2016**

REPORT OF: **Darren Collins – Strategic Director, Corporate Resources**

Purpose of the Report

1. The purpose of this report is to review Treasury Management performance for the six months to 30 September 2016, covering investments and borrowing. This is consistent with approved performance management arrangements.

Background

2. The mid-year performance of the Treasury Management Service is reported in line with CIPFA's Code of Practice on Treasury Management and the Council's Treasury Policy Statement and Treasury Strategy which was approved by Council on 26 March 2016.

3. The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

4. The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations.

5. Accordingly, treasury management is defined as:

   "The management of the Council'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."

6. The primary objective of the investment strategy is to safeguard the Council's assets with a secondary objective of obtaining an optimum rate of return on investments and minimising the costs of borrowing.

Investment Performance

7. The latest projection of gross investment income for 2016/17 based on interest earned to date and expected interest to March 2017 is £0.479m, compared to the original estimate of £0.509m.

8. This gross investment interest is adjusted to account for £0.137m interest payable to third parties and interest receivable of £1.249m from various third parties, the most significant of which is Newcastle International Airport. This gives a projected net interest to the General Fund 2016/17 of £1.591m compared to the budget of £1.599m.

9. The current variance to budget is a result of the Bank of England's decision to reduce Bank rate from 0.50% to 0.25%, the first rate cut since 2009. This has resulted in investment counterparties reducing their deposit rates by around 0.25% which has resulted in a lower amount of interest expected for this financial year. There is potential for a further shortfall of expected investment income if the Bank of England decides to cut this rate again later in the year.

Rate of Return

10. The average rate of return is monitored for each investment type that the Council enters into and these are used to calculate an average rate of return for the Council for the year to date. The current rate of return is 0.62%, which is greater than the original estimate of 0.59%.

11. As a means of benchmarking, the average rate of return for the month and year to date is compared to the equivalent 7 day London Inter-Bank Bid Rate (LIBID), which is the rate that banks are willing to borrow money from each other. The monthly return of 0.050% exceeds the LIBID 7 day rate equivalent of 0.01%. The Council's average rate of return of 0.62% is also well in excess of the equivalent LIBID 7 day rate of 0.31%.

12. The quarterly Capita Asset Services Investment Benchmarking report assesses both the rate of return and the risk of the counterparty to calculate a weighted average rate of return, which is used for comparison across other authorities. In the most recent report received, June 2016, the Council achieved a return of 0.64% on its investments which is in line with the risk adjusted expectations defined in the Benchmarking Report. The Council is between the lower (0.59%) and upper (0.68%) performance boundaries which compares over 200 Local Authorities against an expected rate of return based on the amount of risk applied.

13. This rate of return would be expected to decrease during the year as investment balances reduce and current deposits are replaced with shorter, lower yielding deposits due to the cut in bank rate.

14. It is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous years as rates are at an all time low and in line with the current 0.25% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment, investment returns are likely to remain low for the remainder of the year.

15. Details of Capita Asset Services, the Council's treasury adviser's latest interest rate forecast as of the 8th August can be seen in Appendix 1.

Heritable Bank

16. The Council had a deposit of £2.792m at risk in Heritable Bank, a wholly owned subsidiary of an Icelandic bank, Landsbanki, when it entered administration in October 2008. The full deposit in Heritable was due to mature by the end of 2008/09 with interest.

17. To date dividends totalling £2.736m (98.00p in the £) have been received. This is an overachievement against the estimated return of 90p in the £. This includes a recent dividend of £0.111m received in August 2015, leaving an outstanding balance of £0.056m

18. The most recent update from the administrators, Ernst and Young, in March 2016, provided detail of all dividends received to date and advised that no further dividend is expected at the current time until the current administration period closes on the 6 October 2016.

Borrowing

19. The total borrowing for the Council and HRA as at 30 September 2016 was £593.721m, which was within the operational borrowing limit of £725m. This borrowing is made up of £473.721m PWLB loans and £120m market loans.

20. The Treasury Strategy estimates for this financial year were based on a borrowing requirement of £81m. To date this year the Council has taken long term borrowing from the PWLB of £5m. The timing of further borrowing will depend on a combination of cash flow requirements to support the capital programme and achieving preferential borrowing rates at the time.

21. The current forecast for interest payable on borrowing is allocated to the General Fund and the Housing Revenue Account (HRA) as shown in the following table:

	General Fund	**HRA**
Interest Payable	£11.234m	£15.366
Average rate of interest	3.87%	4.57%

This represents a gross saving of £1.124m on the original estimate, of which £0.628m is a saving for the General Fund and £0.497m is for the HRA.

Summary of Mid-year Performance

22. The projected net impact of investments and borrowing activity on the revenue budget in 2016/17 is an underspend of £1.117m, comprising £0.620m General Fund and £0.497m HRA.

23.

General Fund	Estimate £m	Projected Outturn £m	Variance £m
Investments	(1.599)	(1.591)	0.008
Borrowing	11.862	11.234	(0.628)
Net Position	**10.263**	**9.643**	**(0.620)**

24. Investment returns are likely to remain relatively low during 2016/17 and beyond and interest rates are expected to be below long term borrowing rates therefore value for money considerations indicate that best value can be obtained by delaying new external borrowing and by using internal cash balances to finance new capital expenditure in the short term (this is referred to as internal borrowing).

25. The current approach of borrowing internally provides benefits in terms of reduced credit risk, as the Council has less cash invested than if it had gone to the markets and borrowed externally. This means that cash balances are lower than projected and investment returns are lower than budgeted, but this loss of income is significantly outweighed by the savings from reduced borrowing costs and reduced credit risk.

26. Internal borrowing does have an element of interest rate risk on the overall treasury management positions, if interest rates were suddenly to rise but this is being taken into account when discussing potential borrowing options with our treasury management advisers, CAPITA

27. **Treasury Management Policy and Strategy Update**

28. The Treasury Management Policy and Strategy Statement approved by Cabinet on the 15 March 2016 required revision in the light of economic developments following the BREXIT vote and the requirement to remove the UK from the sovereign criteria. The report to make this amendment was presented to Audit and Standards committee and recommended by Cabinet on the 13 September 2016 and approved by Council on the 22nd September 2016.

Recommendation

29. The Committee is asked to note the Treasury Management Performance to 30 September 2016.

Capita Interest Rate Forecast **Appendix 1**

	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Bank rate	0.25%	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%	1.00%	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%	1.50%	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%	2.30%	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%	2.10%	2.20%	2.20%	2.20%	2.20%	2.30%	2.30%	2.30%	2.30%	2.40%

Capita Asset Services undertook its last review of interest rate forecasts on 8 August shortly after the quarterly Bank of England Inflation Report and the MPC cutting Bank Rate from 0.50% to 0.25% and launching various quantitative easing measures. This action was prompted by concerns that the UK economy would slow down sharply as a result of the Brexit vote. It is possible that the MPC could cut Bank Rate further to nearly zero, probably at the November quarterly inflation report meeting. Since the Brexit vote on 23 June, gilt yields and PWLB rates have fallen sharply. Investment rates also fell after the cut in Bank Rate.

The above forecast includes a very tentative first increase in Bank Rate in June 2018. 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.

There are also concerns that weak growth in the UK, EZ, China and Japan is only being achieved by monetary policy being highly aggressive. While such policies undoubtedly help to stimulate growth, there is substantial doubt that without additional aggressive fiscal action by national governments to stimulate growth and inflation, (and also fundamental economic and political reforms in some countries), then many countries are likely to have a prolonged struggle to return to both strong growth, and inflation rising to around 2%, within the next few years.

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

- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or Fed. rate increases, causing a further flight to safe havens (bonds).
- Geopolitical risks in Europe, the Middle East and Asia, increasing safe haven flows.
- 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.
- A resurgence of the Eurozone sovereign debt crisis.
- Weak capitalisation of some European banks.

- Monetary policy action failing to stimulate sustainable growth and combat the threat of deflation in western economies, especially the Eurozone and Japan.

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.