APPENDIX A

Treasury Management Strategy Statement and Annual Investment Strategy

Mid-year Review Report 2016-17

1 Background

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.

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. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

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."

2 Introduction

The primary requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. Receipt by the full council 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.
4. Delegation by the Council 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 Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is Budget and Strategic Planning Working Group:

This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of the 2016/17 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure (prudential indicators);
- A review of the Council's investment portfolio for 2016/17;
- A review of the Council's borrowing strategy for 2016/17;
- A review of any debt rescheduling undertaken during 2016/17;
- A review of compliance with Treasury and Prudential Limits for 2016/17.

3 Economics and interest rates (as provided by the Council's Treasury Management advisors)

3.1 Economics update

UK 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 23 November.

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.

3.2 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. 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.

4 Treasury Management Strategy Statement and Annual Investment Strategy update

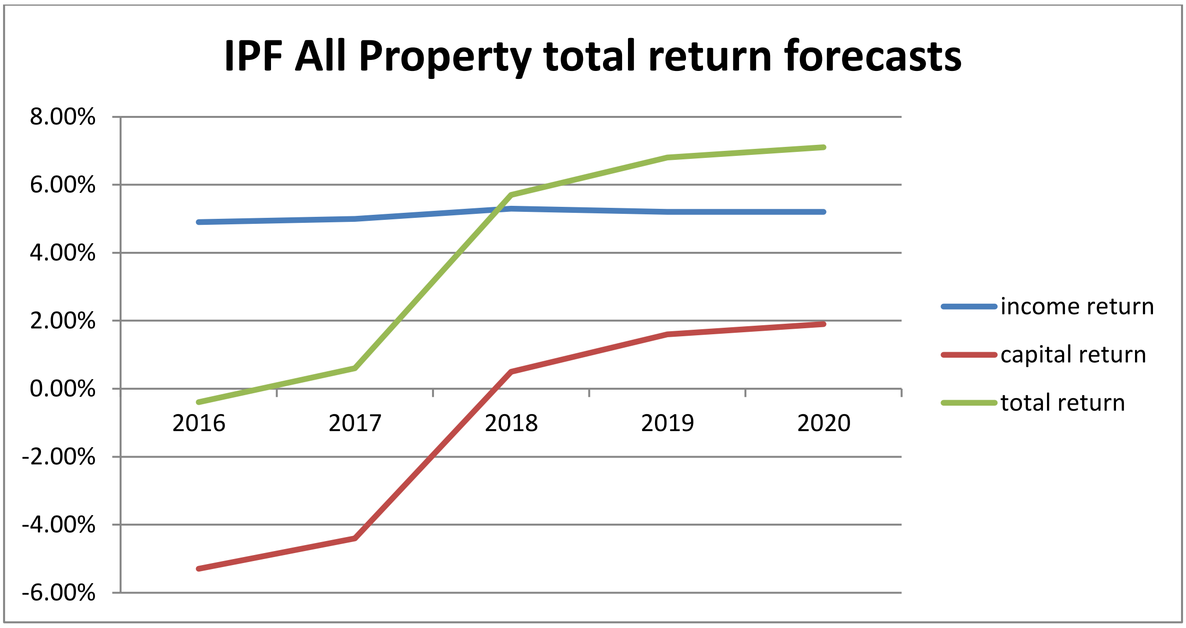
The Treasury Management Strategy Statement (TMSS) for 2016/17 was approved by this Council on 10th February 2016. The underlying TMSS approved previously requires revision in the light of economic and operational movements during the year. The proposed changes and supporting detail for the changes are set out below:

It is proposed to amend the TMSS to include Property Funds. This will provide a wider variety of investment instruments to use and diversify the investment portfolio from financial institutions. The credit, liquidity and interest rate and market risks associated with these funds will be reviewed and appropriate due diligence will also be undertaken before investment of this type is undertaken. The use of these instruments can be deemed capital expenditure, a careful selection process will be undertaken to ensure that any property funds invested in will be those considered to be revenue expenditure. Guidance will be sought on the status of any fund it may consider using. Property Funds are considered to be a long term investment and therefore a minimum maturity limit of 5 years is considered appropriate.

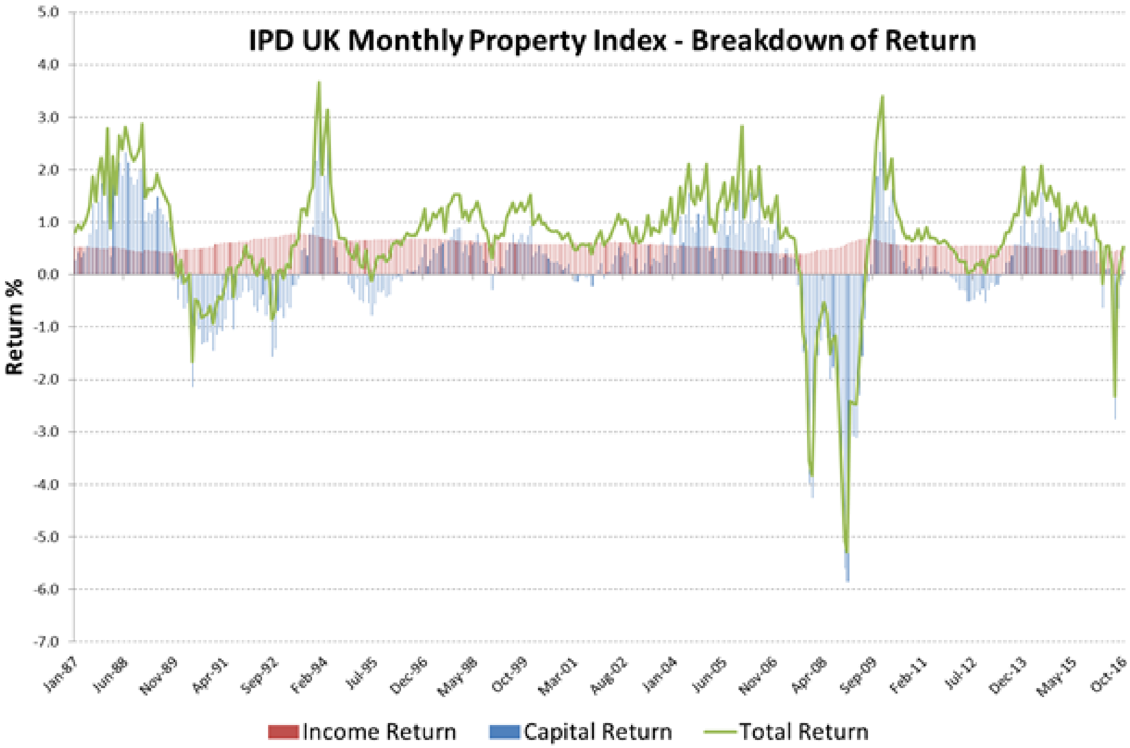
Property Funds are more volatile than other asset classes. Following Brexit there was a fall in property markets, considered to be fuelled by the uncertainty of the impact of Brexit. However in recent months there has been a stabilisation of the market and GDP increased by 0.5% from July to September 2016, compared to 0.7% from April to June 2016. There is a positive correlation between economic growth and property prices.

Returns from property funds consist of capital returns and rental income returns. The Investment Property Forum summary report post Brexit (August 2016) is a consensus forecast from fund managers and fund specialists.

The forecast shows returns are predicted to be negative (-0.4%) during 2016, but from 2017 positive growth will return, as shown by the graph below. Income returns will be the primary contributor during this period.



The graph below from the Investment Property Databank (IPD) shows over the last 20 years capital returns have been negative during the recessions and following Brexit, income returns have remained positive throughout this period.



5 The Council's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

5.1 Prudential Indicator for Capital Expenditure

This table 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	2016/17 Revised Estimate £'000
Non HRA	4,622	6,196
HRA	3,915	3,415
Total capital expenditure	**8,537**	**9,611**

The increase from the original estimate of £4.622m to £6.188m is as a result of carry forwards (£1.135m including larger projects such as Housing Foyer, DFGs, Cattle Market (improvements to access) and the Pavilion); re-profiling of the Cattle Market Re-Development budget (£981k) and an increase to the Leisure Vision budget (£65k). These movements have partially been offset by expected underspends in 2016/17 (of which £367k will be moved into 2017/18); £44k of savings, and £210k for the Pavilion which assumes the project will not progress at least in 2016/17.

In terms of the HRA the movement from the original estimate of £3.915m to the revised estimate of £3.415m is as a result of carry forwards from 2015-16 being included into the 2016-17 capital programme, balanced against a forecast underspend and resulting carry forwards into the 2017-18 programme.

5.2 Changes to the Financing of the Capital Programme

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.

Capital Expenditure	2016/17 Original Estimate £'000	2016/17 Revised Estimate £'000
Total capital expenditure	**8,537**	**9,611**
Financed by:		
Capital receipts	1,602	2,637
Third party contribution	2,750	3,269
Renewals and Repairs Fund	132	118
Capital grants	100	162
Reserves	3,953	3,425
Total financing	**8,537**	**9,611**
Borrowing requirement	**0**	**0**

Due to the changes outlined in para 5.1 there has been associated changes in the financing requirements and sources of funding which are outlined above. The capital receipts financing has increased due to the schemes being carried forward from 2015-16. The third party contributions have increased to reflect reprofiling of the Cattle Market project into later years. The reserve financing has decreased to reflect reprofiling of HRA schemes, namely Beckmill Court Refurbishment.

5.3 Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period, which is termed the Operational Boundary.

Prudential Indicator – Capital Financing Requirement

We are on target to achieve the original forecast Capital Financing Requirement.

Prudential Indicator – the Operational Boundary for external debt

	2016/17 Original Estimate £'000	**2016/17 Revised Estimate £'000**
CFR – non housing	126	126
CFR – housing	31,484	31,484
Total CFR	**31,610**	**31,610**
Net movement in CFR	**0**	**0**
Borrowing	36,413	36,413
Other long term liabilities*	126	126
Total debt (year end position)	**36,539**	**36,539**

** On balance sheet PFI schemes and finance leases etc.*

5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2016/17 and next two financial years. This allows some flexibility for limited early borrowing for future years

	2016/17 Original Estimate £'000	**2016/17 Revised Estimate £'000**
Borrowing	31,413	31,413
Other long term liabilities*	126	126
Total debt	31,539	31,539
CFR* (year end position)	31,610	31,610

The Head of Central Services reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Authorised limit for external debt	**2016/17 Original Indicator £'000**	**2016/17 Revised Indicator £'000**
Borrowing	45,870	45,870
Other long term liabilities*	130	130
Total	46,000	46,000

6 Investment Portfolio

In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As set out in Section 3, 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. 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.

The Council held £22.1m of investments as at 30 September 2016 (£17.65m at 31 March 2016) and the investment portfolio yield for the first six months of the year is 0.72% against the seven day money market rate of 0.28%.

The Head of Central Services confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2016/17.

The Council's budgeted investment return for 2016/17 is £102,450, and performance for the year is in line with the budget.

Investment Counterparty criteria

The current investment counterparty criteria selection approved in the TMSS requires the following operational changes to be incorporated:

<u>Maturity Limits</u>
The creditworthiness service provided by Capita Asset Services is currently used. This modelling approach combines credit ratings, credit Watches and credit Outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are currently used by the Council to determine the suggested duration for investments.

- Yellow 5 years
- Purple 2 years
- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 100 days
- No colour not to be used

The main rating agencies have, through much of the financial crisis period from 2008 – 2015, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. Commencing in 2015, in response to the evolving regulatory regime, all three agencies began removing these "uplifts" with the timing of the process determined by regulatory progress at the national level. The process has been part of a wider reassessment of methodologies by each of the rating agencies. In addition to the removal of implied support, new methodologies are now taking into account additional factors, such as regulatory capital levels. In some cases, these factors have "netted" each other off, to leave underlying ratings either unchanged or little changed. A consequence of these new methodologies is that they also lowered the importance of the (Fitch) Support and Viability ratings and have seen the (Moody's) Financial Strength rating withdrawn by the agency.

In keeping with the agencies' new methodologies, the rating element of the Capita Asset Services methodology now focuses solely on the Short and Long Term ratings of an institution. (However, the other key elements to our process, namely the assessment of Rating Watch and Outlook information as well as the Credit Default Swap (CDS) overlay have not been changed.)

The evolving regulatory environment, in tandem with the rating agencies' new methodologies, also meant that sovereign ratings became of lesser importance in the assessment process. It is important to stress that these rating agency changes do not reflect any changes in the underlying status or credit quality of the institution. They are merely reflective of a reassessment of rating agency methodologies in the light of changes to the regulatory environment in which financial institutions operate. While some banks have received lower credit ratings as a result of these changes, this does not mean that they are suddenly less credit worthy than they were formerly. Rather, in the majority of cases, this mainly reflects the fact that implied sovereign government support has effectively been withdrawn from banks. They are now expected to have sufficiently strong balance sheets to be able to withstand foreseeable adverse financial circumstances without government support. In fact, in many cases, the balance sheets of banks are now much more robust than they were before the financial crisis when they had higher ratings than now.

Based on this it is now considered appropriate where an institution has a colour coding (minimum Green 100 days) investments can be made up to 1 year. Financial institutions with 'no colour' will continue not be used.
The following institutions could be used:

	Current TMSS Limits	**Updated TMSS Limits**
Lloyds	6 months at 0.65%	12 months at 1.00%
Barclays	6 months at 0.46%	12 months at 0.76%
Standard Chartered Bank	3 months at 0.43%	12 months at 0.87%

<u>Specified Investments</u>

The TMSS currently shows the following:

	£ limit per institution	**Max. maturity limit**
Money Market Funds AAA rated	£3m per fund	Liquid

The description is to be updated to refer to Pooled Investment Vehicles, this will include Money Market Funds and Enhanced Cash Funds, the required rating remains at AAA and the limit per fund remains at £3m.

7 Borrowing

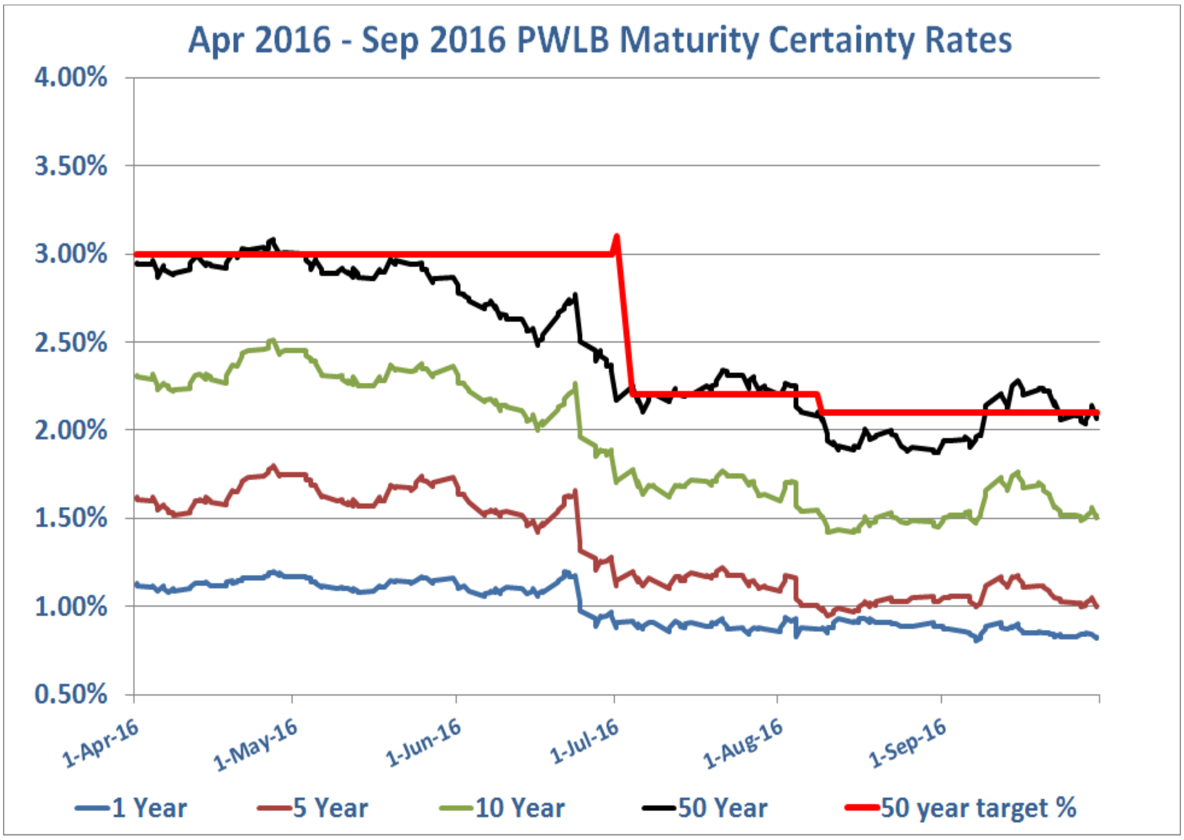
The Council's capital financing requirement (CFR) for 2016/17 is £31.610m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Table 5.4 shows the Council has borrowings of £31.413m. This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

No new external borrowing will be undertaken during this financial year.

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

PWLB certainty rates 1 April 2016 to 30 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%



8 Debt Rescheduling

Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.