AUDIT COMMITTEE 25 SEPTEMBER 2015

TREASURY MANAGEMENT MID-YEAR MONITORING REPORT 2015/16

1. PURPOSE

1.1. The Treasury Management Strategy for 2015/16 is underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

1.2. The Code also recommends that members are informed of Treasury Management activities at least twice a year (a mid year and a year end report). This report therefore ensures that New Forest District Council (NFDC) are embracing best practice in accordance with CIPFA's recommendations.

1.3. Treasury management is defined as: "The management of investments and cash flows, 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. ECONOMIC BACKGROUND

2.1. The following Section outlines the key economic themes currently in the UK against which investment and borrowing decisions have been made in the year to date.

2.2. Growth – positive growth in the UK economy has continued with output growing at a preliminary estimate of 2.6% year-on-year in Q2 2015, which was in line with the market's expectations. The largest contribution to growth came from services – increasing by 0.7% and contributing 0.5% to overall growth.

2.3. The latest figures released by the Office for National Statistics for June 2015 show a broadly stable UK labour market, with marginal movements in the number of employed (down to 73.4% from 73.5%) and the number of unemployed (up to 5.8% from 5.7%). Wage growth was 2.8% excluding bonuses over the three months to June 2015 year-on-year.

2.4. The Consumer Prices Index (CPI) rose by 0.1% in the year to July 2015, up from 0.0% in June. This was slightly above market expectations, which had predicted inflation remaining at 0.0%. As set out in the Governor of the Bank of England's letter to the Chancellor, around three quarters of the weakness in headline inflation relative to the 2% target reflects unusually low contributions from energy, food and other imported goods prices. The remaining part of the undershoot is judged to reflect relatively weak domestic cost growth, given a continuing, but declining, drag from spare capacity in the labour market.

2.5. UK Monetary Policy: at its meeting ending on 9 September 2015, the Monetary Policy Committee (MPC) voted by a majority of 8-1 to maintain Bank Rate at 0.5%. Interestingly this is the second meeting running that the vote to hold rates at 0.5% has not been unanimous, perhaps indicating that the first rise in interest rates is approaching.

2.6. The MPC has previously emphasised that when the Bank Rate does begin to rise, it is expected to do so only gradually and to remain below average historical levels for some time to come. The treasury management advisers to NFDC, Arlingclose, now estimate the first rise in interest rates will be in the second quarter of 2016, which is still later than many economic commentators. Arlingclose's expectation is that the appropriate level for Bank Rate for the post-crisis UK economy will be lower than the previous norm, between 2.0 and 3.0%.

3. BORROWING STRATEGY

3.1. At 31/08/2015 NFDC held £144.5m of loans, (unchanged from 31/03/2015) including HRA and non-HRA. NFDC does not expect to borrow in 2015/16.

3.2. NFDC's chief objective when borrowing continues to be striking an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should NFDC's long-term plans change being a secondary objective,

3.3. Affordability and the "cost of carry" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained, and are likely to remain, lower than long-term rates, NFDC determined it was more cost effective in the short-term to use internal resources instead.

3.4. As at 31 August 2015 NFDC had a total of £144.5m of long term loans, made up of a number of Public Works Loan Board (PWLB) loans at a weighted average fixed interest rate of 3.12%, and average outstanding term remaining of 22.8 years. This average rate is below the rate currently being offered for a similar timescale and therefore when viewed against historic interest rates the debt portfolio represents good mitigation against the long-term risk of exposure to interest rate fluctuations, which could increase the cost of borrowing.

3.5. The premia that applies to the premature repayment of PWLB loans is still relatively expensive for the loans in NFDC's portfolio and therefore unattractive for debt rescheduling. As a consequence no rescheduling activity has taken place. However, consideration will continue to be given to any advantageous opportunity for NFDC to reduce or restructure its debt portfolio.

4. INVESTMENT ACTIVITY

4.1. NFDC hold invested funds representing income received in advance of expenditure plus balances and reserves held.

4.2. The Guidance on Local Government Investments in England gives priority to security and liquidity and NFDC's aim is to achieve a yield commensurate with these principles.

4.3. The transposition of European Union directives into UK legislation now places the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors through potential bail-in of unsecured bank deposits.

4.4. Given the increasing risk and continued low returns from short-term unsecured bank investments, it is NFDC's aim to further diversify into more secure and/or higher yielding asset classes during 2015/16. The majority of NFDC's surplus cash was previously invested in the short-term unsecured bank deposits, certificates of deposit and money market funds. This diversification into securities with underlying collateral and investments with organisations which are not subject to bail-in represents a substantial change in strategy this year.

4.5. During 2014/15 NFDC invested £2.0m in a pooled property fund, and at the beginning of this financial year invested £1.05m in a second pooled property fund (which is considered to be a capital investment in accounting terms). These investments are aimed for the long-term and provide a regular dividend income, and so far, in the very short term, have proved to be a good investment for NFDC to make.

4.6. In order to access additional investments that can attract higher returns than cash and make use of NFDC's stable core balances, NFDC are considering further investments of up to a further £4m in long-term pooled funds, including pooled equity funds, which are also considered to be capital investments (bringing the total to £5m capital spend).

4.7. NFDC's investment holding was £65.0m at 31 August 2015, which is £10.4m higher than the same time last year, and was placed with the following counterparties:

Table 1: Investment Activity as at 31 August 2015

Duration to maturity	Overnight £m	< 1 year £m	> 1 year £m	Total £m
Subject to bail-in risk				
Bank call accounts	0.6			0.6
Bank fixed deposits		1.0		1.0
Bank certificates of deposit*		19.0		19.0
	0.6	20.0	0.0	20.6
Exempt from bail-in risk				
Covered floating rate notes		2.5	2.0	4.5
Floating rate notes			1.0	1.0
Covered bonds		1.0	4.0	5.0
Corporate bonds		9.9		9.9
Money market funds	11.0			11.0
Local authorities		4.0	6.0	10.0
Pooled property fund			3.1	3.1
	11.0	17.4	16.1	44.5
Total	**11.6**	**37.4**	**16.1**	**65.1**

*certificates of deposit have fixed terms but have greater liquidity as they can be sold on the secondary market.

4.8. Security of capital has remained NFDC's main investment objective. This has been maintained by following NFDC's counterparty policy as set out in its Treasury Management Strategy Statement for 2015/16.

4.9. Counterparty credit quality was assessed and monitored with reference to credit ratings (NFDC's minimum long-term counterparty rating for institutions defined as having 'high credit quality' is BBB+ across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

4.10. The average cash balances were £64.6m during the year to 31 August 2015. The average interest rate earned on NFDC's investments at 31 August 2015 was 0.97%, which should be considered within the context of an unchanged UK Base Rate of 0.5% since March 2009 and very low short-term money market rates.

4.11. The new treasury management strategy limits came into effect on 1 April 2015. In advance of this Hampshire County Council (HCC) were managing NFDC's investments to prepare for the implementation of the limits in the new strategy. Unfortunately there was one call account that was in breach of the new limits on 1 April 2015, which was identified on the day as part of HCC's normal controls but too late to be able to move the funds to comply with the strategy.

4.12. As this was a call account HCC was able to rectify the situation the following day but it does mean that there was a small non-compliance with the new strategy. There was no financial impact for NFDC as a result. HCC have reviewed this to identify what caused this issue and how HCC's controls can be improved to ensure that this does not happen again.

5. COMPLIANCE WITH PRUDENTIAL INDICATORS

5.1. NFDC confirms compliance with its Prudential Indicators for 2015/16, which were set in February 2015 as part of the Council's Medium Term Financial Plan 2014 to 2018, and Budget & Council Tax Report 2015-2016.

Authorised limit for external debt

5.2. CIPFA's Code of Practice require authorities to set an authorised limit for external debt, defined as the sum of external borrowing and other long-term liabilities. The annual strategy report agreed by Council on 19 February 2015 set an authorised limit for external debt of £178.4m.

5.3. This limit is based on the estimated CFR in order to enable it to be financed entirely from external borrowing should NFDC's internal reserves become depleted. This limit also includes an allowance for temporary borrowing to cover normal cash flow requirements and unexpected outflows or delays in receiving cash.

5.4. During the period to 31 August 2015 remained well within the authorised limit of £178.4m and no new long term borrowing has been taken out. There has been no temporary borrowing, other than cash overdraft of £1.0m, so the maximum total external debt in the period has remained at £146.5m.

Operational boundary for external debt

5.5. NFDC has set an operational boundary for external debt reflecting the more likely scenario and consistent with NFDC's capital plans and Treasury Management Strategy. Temporary breaches of the 2015/16 operational boundary can take place for cash flow reasons, but any sustained breach will lead to further investigation. The Council approved an operational boundary for 2015/16 of £163.4m.

5.6. As outlined above NFDC's maximum total external debt of £145.5m in the period from April to August 2015 was within the operational boundary.

6. TREASURY MANAGEMENT INDICATORS

6.1. NFDC measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

6.2. NFDC has to set an upper limit on its fixed and variable interest rate exposure for both total investments and total external debt. The Council has approved the following limits, none of which have been exceeded as follows:

Table 2: Interest Rate Exposures	Approved Limits for 2015/16	Maximum during April – August 2015/16	Compliance with Limits:
Upper limit on fixed interest rate investment exposure	£20.0m	£8.0m	Yes
Upper limit on variable interest rate investment exposure	£80.0m	£69.9m	Yes
Upper limit on fixed interest rate borrowing exposure	£163.4m	£145.5m	Yes
Upper limit on variable interest rate borrowing exposure	£163.4m	£1.0m	Yes

6.3. The limit for borrowing rate exposure has been set to enable maximum policy flexibility for the potential for refinancing e.g. from variable to fixed rate borrowing. NFDC's long-term debt portfolio is currently made up of fixed interest loans.

6.4. The upper limit for exposure for investments rates is based on an extreme case for the total investment balances, and to allow for all of this to be held at variable rate (investments with a maturity of less than one year) if necessary.

Maturity Structure of Borrowing

6.5. The Code also requires NFDC to set upper and lower percentage limits on the maturity structure of its long-term fixed rate borrowing during 2015/16. The following table shows the limits approved by the Council. These have been set in order to allow maximum flexibility in managing the debt portfolio and are consistent with the existing portfolio.

Table 3: Maturity Structure of Borrowing	Upper	Lower	Actual
Under 12 months	25%	0%	0%
12 months and within 24 months	25%	0%	0%
24 months and within 5 years	25%	0%	9%
5 years and within 10 years	25%	0%	15%
10 years and above	100%	0%	76%

Principal Sums Invested for Periods Longer than 364 days

6.6. For 2015/16 NFDC restricted investments for periods of over a year to a maximum of £20.0m. At 31 August 2015 NFDC had £16.0m of investments with over 364 days to their maturity.

7. CHANGES TO THE 2015/16 TREASURY MANAGEMENT STRATEGY

7.1. Over the 18 months that Hampshire County Council has managed NFDC's Treasury Management function, NFDC's investment balances have risen significantly from £46m to over £75m at its highest point this financial year, and the diversification of those balances has been managed between initially eight counterparties which has now grown to 36 counterparties.

7.2. Investment balances are higher than predicted when the current Treasury Management Strategy was approved. Current forecasts show that investment balances could peak at £89m. In order to create greater diversification and provide more flexibility it would be helpful to make some changes to the 2015/16 Treasury Management Strategy.

Investment Limits

7.3. Increasing the investment and counterparty limits will increase the flexibility, which is required to a greater extent now that cash balances are greater.

7.4. As approved in the 2015/16 Treasury Management Strategy, a group of banks under the same ownership will be treated as a single organisation for limit purposes. Maximum limits will also be placed on fund managers and industry sectors as below:

Table 4: Investment Limits	**Cash Limit** **Current**	 **Revised**
Any single organisation, except the UK Central Government	£5m each	£8m each
UK Central Government	Unlimited	Unlimited
Any group of organisations under the same ownership	£5m per group	£8m per group
Any group of pooled funds under the same management	£5m per manager	£8m per manager
Registered Providers	£6m in total	£6m in total
Money Market Funds	50% in total	50% in total

7.5. NFDC may invest its surplus funds with any of the counterparty types in Table 5, subject to the cash limits (per counterparty) and the time limits shown.

Table 5: Approved Investment Counterparties and Limits					
Credit Rating	**Banks Unsecured**	**Banks Secured**	**Government**	**Corporates**	**Registered Providers**
UK Govt	n/a	n/a	£ Unlimited 4 years	n/a	n/a
AAA	£4m 4 years	£8m 4 years	£8m 4 years	£4m 4 years	£4m 4 years
AA+	£4m 4 years	£8m 4 years	£8m 4 years	£4m 4 years	£4m 4 years
AA	£4m 4 years	£8m 4 years	£8m 4 years	£4m 4 years	£4m 4 years
AA-	£4m 3 years	£8m 4 years	£8m 4 years	£4m 4 years	£4m 4 years
A+	£4m 2 years	£8m 3 years	£4m 4 years	£4m 3 years	£4m 4 years
A	£4m 13 months	£8m 2 years	£4m 4 years	£4m 2 years	£4m 4 years
A-	£4m 6 months	£8m 13 months	£4m 4 years	£4m 13 months	£4m 4 years
BBB+	£2m 100 days	£4m 6 months	£2m 2 years	£2m 6 months	£2m 2 years
BBB or BBB-	£2m next day only	£4m 100 days	n/a	n/a	n/a
None	£1m 6 months	n/a	£4m 4 years	n/a	£4m 4 years
Pooled funds	£8m per fund				

Principle Sums Invested for Periods longer than 364 days

7.6. As a result of the cash balances held by NFDC being greater than expected, principal sums invested for periods longer than 364 days is now close to the limit set within the new strategy.

7.7. For 2015/16 NFDC restricted investments for periods of over a year to a maximum of £20.0m. At 31 August 2015 NFDC had £16.0m of investments with over 364 days to their maturity.

7.8. Therefore it would be prudent to increase this limit to £25.0m for 2015/16 to allow for further excess funds to be invested over a longer period so as to provide greater flexibility and to also take advantage of greater interest rates than those that are available in the over-night cash options.

Table 6	**2015/16**	**2016/17**	**2017/18**
Limit on principal invested beyond 364 days	£25m	£25m	£25m

7.9. Increasing the principle sum invested for periods longer than 364 days requires other limits to also be increased so as to comply with the new limit. These new limits are shown in the tables below.

Table 7: Non-Specified Investment Limits	Cash Limit
Total long-term investments	£25m
Total investments without credit ratings or rated below A- (excluding investments with other local authorities)	£10m
Total non-Sterling investments	£0m
Total investments in foreign countries rated below AA+	£0m
Total non-specified investments	£45m

Table 8: Interest Rate Exposures	2015/16	2016/17	2017/18
Upper limit on fixed interest rate investment exposure	£25.0m	£25.0m	£25.0m
Upper limit on variable interest rate investment exposure	£80.0m	£80.0m	£80.0m
Upper limit on fixed interest rate borrowing exposure	£163.4m	£163.7m	£159.8m
Upper limit on variable interest rate borrowing exposure	£163.4m	£163.7m	£159.8m

8. CRIME AND DISORDER AND ENVIRONMENTAL IMPLICATIONS

8.1. None arising directly from this report.

9. RECOMMENDATIONS

Members are recommended to:

9.1. consider the performance of the treasury function detailed in this report.

9.2. note the plan to add up to a further £4m of long-term pooled investments to New Forest District Council's investment portfolio.

9.3. note paragraphs 4.11 and 4.12 of this report which detail the one instance of investment limits being breached.

9.4. approve the changes to the 2015/16 Treasury Management Strategy as detailed in section 7.

Further information	Background papers
Please contact Andrew Boutflower (HCC), or Bob Jackson (Executive Director)	The Prudential Code, CIPFA Guidance Notes and ODPM Investment Guidance
	Local Government Act 2003
email: andrew.boutflower@hants.gov.uk	SI 2003/3146 Local Authorities (Capital Finance and Accounting) (England)

bob.jackson@nfdc.gov.uk	Regulations 2003
	Council 23 January 2015 – Audit Committee - Treasury Management Strategy Report 2015/16
	Published Papers