Southend-on-Sea Borough Council

Agenda Item No.

Report of the Department of the Chief Executive
to
Cabinet
on
8 November 2016

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Mid-Year Treasury Management Report – 2016/17
Policy and Resources Scrutiny Committee
Executive Councillor: Councillor Moring
A Part 1 Public Agenda Item

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1. Purpose of Report

1.1 The Mid-Year Treasury Management Report covers the treasury management activity and compliance with the treasury management strategy for both quarter two and the period from April to September 2016.

2. Recommendations

That the following is approved:

2.1 The Mid-Year Treasury Management Report for 2016/17.

2.2 The revisions to the Treasury Management Policy for 2016/17 as set out in Section 13 and in Appendix 3.

That the following is noted:

2.3 Treasury management activities were carried out in accordance with the CIPFA (The Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management in the Public Sector during the period from April to September 2016.

2.4 The loan and investment portfolios were actively managed to minimise cost and maximise interest earned, whilst maintaining a low level of risk.

2.5 An average of £49.9m of investments were managed in-house. These earned £0.15m of interest during this six month period at an average rate of 0.62%. This is 0.34% over the average 7 day LIBID (London Interbank Bid Rate) and 0.20% over the average bank base rate.

2.6 An average of £19.7m of investments was managed by our former external fund manager. These earned £0.14m of interest during this six month period at an average rate of 1.37%. This is 1.09% over the average 7 day LIBID and 0.95% over the average bank base rate.

2.7 During September 2016 £22.7m was recalled from our former external fund manager and £15m was invested equally across two short dated bond funds and £5m was invested into an enhanced cash fund.

2.8 An average of £14.5m was managed by two property fund managers. This reduced in value by £79k during this six month period from a combination of a decrease in the value of the units partially offset by income distribution, giving a combined return of -1.09%.

2.9 The level of borrowing from the Public Works Loan Board (PWLB) (excluding debt relating to services transferred from Essex County Council on 1st April 1998) remained at the same level of £227.8m (Housing Revenue Account (HRA): £77.0m, General Fund: £150.8m) during the period from April to September 2016.

2.10 The level of financing for 'invest to save' schemes increased from £3.21m to £5.94m during the period from April to September 2016.

3. Background

3.1 This Council has adopted the 'CIPFA Code of Practice for Treasury Management in the Public Sector'and operates its treasury management service in compliance with this code.The code recommends that local authorities submit reports regularly as part of its Governance arrangements.

3.2 Current guidance is that authorities should report formally at least twice a year and preferably quarterly. The Treasury Management Policy Statement for 2016/17 set out that reports would be submitted to Cabinet quarterly on the activities of the treasury management operation. This is the second quarter report for the financial year 2016/17.

3.3 Appendix 1 shows the treasury management position at the end of quarter two of 2016/17.

3.4 Appendix 2 shows the treasury management performance specifically for quarter two of 2016/17.

4 National Context

4.1 After the initial shock of the 'Brexit' decision the evidence so far would seem to support the view that the UK economy may not suffer as greatly from the EU withdrawal decision as had been feared. The vote had little impact on households with consumer spending remaining strong, but those levels look unsustainable. Also there is a long time until the actual break from Europe is finalised, so market sentiment could change.

4.2 Headline CPI reached a two year high of 1.0% in September as the weaker Sterling has led to an increase in the price of imports which is starting to feed through to consumer prices. Over time the weakening of Sterling should help exporters although the uncertainty surrounding the UK trading partnerships may offer an on-going challenge.

4.3 Employment growth and a decline in unemployment in the three months to June indicate that the labour market largely overlooked the uncertainty surrounding the EU referendum. The employment rate reached a record high, but the unemployment rate was unchanged at 4.9%.

4.4 In August the Bank of England reduced the bank base rate to a new historic low of 0.25% and expanded their Quantitative Easing (QE) programme to £435bn, an increase of £60bn. The Bank has signalled that it has no intention of following other central banks' moves in setting negative interest rates, suggesting that future cuts will halt at around 0.1%, placing the emphasis on QE and Government fiscal policy.

4.5 The economic situation together with the financial market conditions prevailing throughout the quarter continued to provide challenges for treasury management activities. There have not been substantial changes in the credit ratings of financial institutions so we continue to have a restricted list of counterparties (i.e. people we can invest with) that still meet our prudent investment criteria.

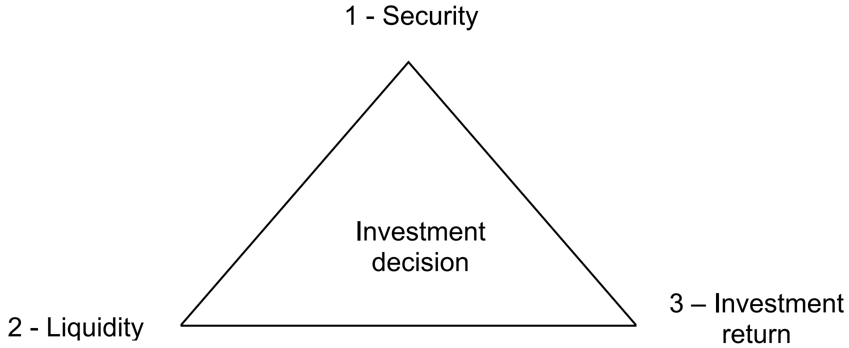
4.6 However, with a restricted list of counterparties and the increased focus on counterparty risk following the Icelandic Banks collapse, monies were mainly placed for short periods of time or in instant access accounts, which increased the liquidity of these funds.

4.7 Low interest rates prevailed throughout the quarter from April to June 2016 and this led to low investment income earnings from most investments. The lower bank base rate will lead to even lower prospects for investment income going forward.

5 Investments – quarter two (July to September)

5.1 A prime objective of our investment activities is the security of the principal sums invested. To ensure this security before a deposit is made an organisation is tested against a matrix of credit criteria. During the period from July to September 2016 investment deposits were limited to those who met the criteria in the Annual Investment Strategy when the deposit was placed.

5.2 Other investment objectives are to maintain liquidity (i.e. adequate cash resources to allow the council to operate) and to optimise the investment income generated by surplus cash in a way that is consistent with a prudent level of risk. Investment decisions are made with reference to these objectives, with security and liquidity being placed ahead of the investment return. This is shown in the diagram below:



Security:

5.3 To maintain the security of sums invested, we seek to lower counterparty risk by investing in financial institutions with good credit ratings, across a range of sectors and countries. The risk of loss of principal of monies is minimised through the Annual Investment Strategy.

5.4 Pie chart 1 of Appendix 1 shows that at the end of quarter two; 52% of our in-house investments were placed with financial institutions with a long term rating of AAA, and 48% with a long term rating of A-.

5.5 As shown in pie chart 2 of Appendix 1, these monies were with various counterparties, 48% being placed directly with banks and 52% placed with a range of counterparties via money market funds.

5.6 Pie chart 3 of Appendix 1 shows the countries where the parent company of the financial institution with which we have monies invested is registered. For money market funds there are various counterparties spread across many countries. The cumulative balance of funds held with any one institution was kept within agreed limits.

Liquidity:

5.7 Our in-house monies were mostly available on an instant access basis at the end of quarter two, except for £10m which has been placed in a 95 day notice account. The maturity profile of our investments is shown in pie chart 4 of Appendix 1.

Investment return:

5.8 Until early September the Council continued to use the fund manager Aberdeen Asset Management to manage monies on our behalf. An average of £16.7m was invested in this fund during the quarter earning an average rate of 2.40%.

5.9 The Council had an average of £47.2m of investments managed in-house over the period from July to September, and these earned an average interest rate of 0.57%. Of the in-house managed funds:

- an average of £10.0m was held in notice accounts that earned an average interest rate of 0.53%;
- use was also made of call accounts during the year, because they provide instant access to funds. An average of £8.4m was held in these accounts and earned an average return of 0.65% over the quarter;
- an average of £28.8m was held in money market funds earning an average of 0.56% over the quarter. These work in the same way as a deposit account but the money in the overall fund is invested in a number of counterparties, therefore spreading the counterparty risk.

5.10 In accordance with the Treasury Management Strategy the performance during the quarter is compared to the average 7 day LIBID (London Interbank Bid Rate). Overall, investment performance was higher than the average 7 day LIBID and higher than the average base rate for the quarter. The bank base rate was at 0.50% for the first part of the quarter and was reduced to 0.25% on 4 August 2016. The 7 day LIBID rate fluctuated between 0.12% and 0.37%. Performance is shown in Graph 1 of Appendix 2.

6 Investments – quarter two cumulative position

6.1 During the period from April to September 2016 the Council complied with all of the relevant statutory and regulatory requirements which limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of the Code of Practice for Treasury Management means its treasury practices demonstrate a low risk approach.

6.2 The Council is aware of the risks of passive management of the treasury portfolio and has proactively managed levels of debt and investments over the six month period with the support of its treasury management advisers.

6.3 The table below summarises the Council's investment position for the period from April to September 2016:

Table 1: Investment position

	At 31 March 2016	At 30 September 2016	April to September 2016	
	Actual Balance (£000s)	Actual Balance (£000s)	Average Balance (£000s)	Average Rate (%)
Notice accounts	10,000	10,000	10,000	0.61
Fixed term deposits	5,000	0	1,722	0.88
Call accounts	7,315	7,895	8,314	0.65
Money market funds	24,000	19,000	29,895	0.60
Total investments managed in-house	**46,315**	**36,895**	**49,931**	**0.62**
Enhanced Cash Funds	22,541	4,998	19,717	1.37*
Short Dated Bond Funds	0	15,022	780	#
Property funds	12,712	15,134	14,483	-1.09
Total investments managed externally	**35,253**	**35,154**	**34,980**	**0.32@**
Total investments	**81,568**	**72,049**	**84,911**	**0.50**

* This includes the investment in Payden & Rygel (paragraph 9.5) which was invested at the end of September. As there has not yet been any income distributions the combined return is not meaningful at this stage, so the rate quoted is for Aberdeen Asset Management only.

#These funds were invested in the second half of September. As there have not yet been any income distributions the combined return is not meaningful at this stage.

@This rate excludes Payden & Rygel and the two Short Dated Bond Funds for the reasons set out above.

6.4 The majority of the cash balances held by the Council are required to meet short term cash flow requirements and therefore throughout the six month period monies were placed 28 times for periods of one year or less. The table on the next page shows the most used counterparties overall and the countries in which they are based. All deals are in sterling despite the country the counterparties are based in.

Table 2: Counterparties used

Counterparty	Country	No. of Deals	Value of Deals (£m)
Goldman Sachs	Money Market Fund (Various Counterparties)	11	52
BlackRock	Money Market Fund (Various Counterparties)	7	38
Standard Life Investment	Money Market Fund (Various Counterparties)	5	34
Insight Investment Management Ltd	Money Market Fund (Various Counterparties)	5	18

6.5 In addition to the above, use was also made of call accounts during the year, because they provide instant access to funds. This meant that funds were available for unexpected cash flow events to avoid having to pay higher rates to borrow from the market. During the period from April to September 2016 an average of £8.3m was held in such accounts.

7. Property Funds – quarter two (July to September)

7.1 Throughout the quarter long term funds were invested in two property funds: Rockspring Property Investment Management Limited and Lothbury Investment Management Limited.

7.2 The monies are invested in units in the fund, the fund is then invested as a whole by the fund managers into properties. An income distribution is generated from the rental income streams from the properties in the fund. Income distributions are reinvested back into the fund. There are high entrance and exit fees and the price of the units can rise and fall, depending on the value of the properties in the fund, so these funds are invested over the long term with the aim of realising higher yields than other investments.

7.3 The interest equalisation reserve will be used to capture some of the income in the years when the property values are rising, and will then be available to offset any losses should property values fall. Members should be aware that this means that the investment returns in some quarters will look very good and in other quarters there may be losses reported, but these will not impact the revenue account as the interest equalisation reserve would be used to meet any temporary losses.

7.4 An average of £7.9m was managed by Rockspring Property Investment Management Limited. During quarter two, the value of the fund decreased by £0.225m due to the decrease in the unit value. There was also an income distribution relating to that period of £0.107m and this distribution will be confirmed and distributed in quarter three.

7.5 The Rockspring fund decreased by £0.118m during this three month period from a combination of the decrease in the value of the units partially offset by the income distribution, giving a combined return of -5.91%. The fund started the quarter at £7.935m and decreased in value with the fund at the end of the quarter at £7.817m. This is set out in Table 1 of Appendix 2.

7.6 An average of £7.4m was managed by Lothbury Property Investment Management Limited. During quarter two, the value of the fund decreased by £0.274m due to the decrease in the unit value. There was also an income distribution relating to that period of £0.058m and this distribution will be confirmed and distributed in quarter three.

7.7 The Lothbury fund decreased by £0.216m during this three month period from a combination of the decrease in the value of the units partially offset by the income distribution, giving a combined return of -11.53%. The fund started the quarter at £7.533m and decreased in value with the fund at the end of the quarter at £7.317m. This is set out in Table 1 of Appendix 2.

7.8 The decrease in unit value in both funds in quarter two was symptomatic of a general slowdown in the property market that has been exacerbated by the 'Brexit' outcome of the EU referendum. However the scale of the decrease was limited by the active strategies of both fund managers in de-risking their portfolios. The largest property decreases have been seen in central London, in particular in the City of London. The Rockspring fund has no central London exposure and the Lothbury fund has some central London properties, but none in the City of London. Both property fund managers anticipate that the recent correction in property prices is mostly over and that values should stabilise in the forthcoming quarters.

8 Property Funds – quarter two cumulative position

8.1 An average of £7.9m was managed by Rockspring Property Investment Management Limited. During the period from April to September 2016, the value of the fund decreased by £0.209m due to the decrease in the unit value. There was also an income distribution relating to that period of £0.211m and the quarter two part of this distribution will be confirmed and distributed in quarter three.

8.2 The fund earned £0.002m during this six month period from a combination of the decrease in the value of the units offset by the income distribution, giving a combined return of 0.05%. The fund started the six month period at £7.815m and increased in value with the fund at the end of the period at £7.817m.

8.3 An average of £6.6m was managed by Lothbury Property Investment Management Limited. During the period from April to September 2016, the value of the fund decreased by £0.190m due to the decrease in the unit value. There was also an income distribution relating to that period of £0.109m and the quarter two part of this distribution will be confirmed and distributed in quarter three. The value of the fund also increased by £2.502m due to the value of the new units purchased after fees.

8.4 The fund decreased by £0.081m during this six month period from a combination of the decrease in the value of the units offset by the income distribution, giving a combined return of -2.45%. The fund started the six month period at £4.896m and increased in value with the fund at the end of the period at £7.317m.

9. Medium term cash management

9.1 Long term monies are invested in property funds as set out in the paragraphs above. During quarter two the Section 151 Officer, in consultation with the Council's treasury management advisers, undertook an exercise to select fund managers and their appropriate Short Dated Bond Funds for the investment of medium term funds.

9.2 The monies are invested in units in the fund, the fund is then invested as a whole by the fund managers into corporate bonds in the one to five year range. An income distribution will be generated from the coupon on the bond and the price of units can rise and fall, depending on the value of the corporate bonds in the fund. So these investments would be over the medium term with the aim of realising higher yields than short term investments.

9.3 The interest equalisation reserve will be used to capture some of the income in the years when the corporate bond values are rising, and will then be available to offset any losses should bond values fall. Members should be aware that this means that the investment returns in some quarters will look good and in other quarters there may be losses reported, but these will not impact the revenue account as the interest equalisation reserve would be used to meet any temporary losses.

9.4 The funds selected for investment were the Royal London Investment Grade Short Dated Credit Fund and the AXA Sterling Credit Short Duration Bond Fund. £7.5m was invested into each fund during September 2016.

9.5 In addition to these funds, Payden & Rygel's Sterling Reserve Fund was selected for investment of slightly shorter medium term funds. This fund has a AAAf credit rating from Standard & Poor's and has a focus on very high credit quality investments, including floating rate notes and fixed rate bonds. The current weighted average life of investments in the fund is 1.79 years. £5m was invested into this fund during September 2016.

9.6 Since these funds were invested the combined value has changed from £19.986m to £20.020m, an increase of £0.034m. As these funds are newly invested there have not yet been any income distributions, so the combined return is not meaningful at this stage.

9.7 The monies currently managed on our behalf by the fund manager Aberdeen Asset Management Plc were recalled to enable the investments set out above to be made.

10. Borrowing – quarter two

10.1 The Capital Financing Requirement (CFR) is the Council's theoretical need to borrow but the Section 151 Officer can manage the Council's actual borrowing position by either:

1 - borrowing to the CFR;
2 - choosing to use temporary cash flow funds instead of borrowing (internal borrowing) or;
3 - borrowing for future increases in the CFR (borrowing in advance of need)

10.2 The Council began quarter two in the second of the above scenarios, with actual borrowing below CFR.

10.3 This, together with the Council's cash flow, the prevailing Public Works Loans Board (PWLB) interest rates and the future requirements of the capital programme, were taken into account when deciding the amount and timing of any loans. No new PWLB loans were taken out and no loans matured during the quarter. No debt restructuring was carried out during the quarter.

10.4 The level of borrowing from the Public Works Loan Board (PWLB) (excluding debt relating to services transferred from Essex County Council on 1st April 1998) remained at £227.8m during the quarter. A profile of the repayment dates is shown in Graph 2 of Appendix 2.

10.5 The level of PWLB borrowing at £227.8m is in line with the financing requirements of the capital programme and the revenue costs of this borrowing are fully accounted for in the revenue budget. The current level of borrowing is also in line with the Council's prudential indicators and is prudent, affordable and sustainable.

10.6 Interest rates from the PWLB fluctuated throughout the quarter in response to economic events: 10 year PWLB rates between 1.46% and 1.83%; 25 year PWLB rates between 2.09% and 2.60% and 50 year PWLB rates between 1.87% and 2.34%. These rates are after the PWLB 'certainty rate' discount of 0.20%.

10.7 During quarter two, there was no short term borrowing activity undertaken for cash flow purposes. This is shown in Table 3 of Appendix 2.

11. Borrowing – quarter two cumulative position

11.1 The Council's borrowing limits for 2016/17 are shown in the table below:

	2016/17 (£m)
Authorised Limit	290
Operational Boundary	280

The Authorised Limit is the “Affordable Borrowing Limit” required by the Local Government Act 2003. This is the outer boundary of the Council’s borrowing based on a realistic assessment of the risks and allows sufficient headroom to take account of unusual cash movements.

The Operational Boundary is the expected total borrowing position of the Council during the year and reflects decisions on the amount of debt needed for the Capital Programme. Periods where the actual position is either below or over the Boundary are acceptable subject to the Authorised Limit not being breached.

11.2 The Council’soutstanding borrowing as at 30 September 2016 was:

- Southend-on-Sea Borough Council £227.8m
- ECC transferred debt £13.1m

Repayments in the first 6 months of 2016/2017 were:

- Southend-on-Sea Borough Council £0m
- ECC transferred debt £0m

11.3 Outstanding debt relating to services transferred from Essex County Council (ECC) on 1st April 1998, remains under the management of ECC. Southend Borough Council reimburses the debt costs incurred by the County. The debt is recognised as a deferred liability on our balance sheet.

11.4 The interest payments for PWLB and excluding transferred debt, during the period from April to September 2016 were £5.263m, compared to the original budget of £5.263m for the same period. These interest payments are the same as budgeted as, due to the reasons set out in paragraph 10.3, no new loans were taken out during the first two quarters of 2016/17.

11.5 The table below summarises the PWLB borrowing activities over the period from April to September 2016:

Quarter	**Borrowing at beginning of quarter (£m)**	**New borrowing (£m)**	**Re-financing (£m)**	**Borrowing repaid (£m)**	**Borrowing at end of quarter (£m)**
April to June 2016	227.8	0	0	(0)	227.8
July to September 2016	227.8	0	0	(0)	227.8
Of which:					
General Fund	150.8	0	0	(0)	150.8
HRA	77.0	0	0	(0)	77.0

All PWLB debt held is repayable on maturity.

12 Funding for Invest to Save Schemes

12.1 During 2014/15 a capital project was completed on draught proofing and insulation in the Civic Centre which will generate on-going energy savings. This is an invest-to-save project and the predicted revenue streams cover the financing costs of the project.

12.2 To finance this project the Council took out an interest free loan of £0.14m with Salix Finance Ltd which is an independent, not for profit company, funded by the Department for Energy and Climate Change that delivers interest-free capital to the public sector to improve their energy efficiency and reduce their carbon emissions. The loan is for a period of four years with equal instalments to be repaid every six months. There are no revenue budget implications of this funding as there are no interest payments to be made and the revenue savings generated are expected to exceed the amount needed for the repayments. £0.018m of this loan was repaid during 2015/16 with a further £0.018m repaid during the period from April to September 2016.

12.3 At the meeting of Cabinet on 23 June 2015 the LED Street Lighting and Illuminated Street Furniture Replacement Project was approved which was to be partly funded by 25 year reducing balance 'invest to save' finance from the Green Investment Bank (GIB). The balance outstanding at the end of quarter two was £5.83m. There were no repayments during the period from April to September 2016.

12.4 Funding of these invest to save schemes is shown in Table 4 of Appendix 2.

13 Revised Treasury Management Policy

13.1 As a result of the amendments to the Council's senior management structure approved at the Cabinet meeting of 20 September 2016 it has been necessary to amend the Treasury Management Policy Statement and Treasury Management Strategy for 2016/17. These changes are:

- references to the Head of Finance and Resources have been replaced with Director of Finance and Resources;
- in the current approved policy the approval of short/long term investments is delegated to the Chief Finance Officer and in their absence is delegated to the Deputy Section 151 Officer or the Director of Corporate Services. In the revised Annex 1 to the policy the reference to the Director of Corporate Services has been replaced by the Group Manager (Financial Planning & Control).

13.2 These revisions to the Treasury Management Policy for 2016/17 are set out in Appendix 3.

14 Compliance with Treasury Management Strategy – quarter two

14.1 The Council’s investment policy is governed by the CIPFA Code of Practice for Treasury Management in the Public Sector (revised in November 2009), which has been implemented in the Annual Investment Strategy approved by the Council on 25 February 2016. The investment activity during the quarter conformed to the approved strategy and the cash flow was successfully managed to maintain liquidity. This is shown in Table 5 of Appendix 2.

15 Other Options

15.1 There are many options available for the operation of the Treasury Management function, with varying degrees of risk associated with them. The Treasury Management Policy aims to effectively control risk to within a prudent level, whilst providing optimum performance consistent with that level of risk.

16 Reasons for Recommendations

16.1 The CIPFA Code of Practice on Treasury Management recommends that Local Authorities should submit reports regularly. The Treasury Management Policy Statement for 2016/17 set out that reports would be submitted to Cabinet quarterly on the activities of the treasury management operation.

17 Corporate Implications

17.1 Contribution to Council’s Vision & Critical Priorities

Treasury Management practices in accordance with statutory requirements, together with compliance with the prudential indicators acknowledge how effective treasury management provides support towards the achievement of the Council’s Vision and Critical Priorities.

17.2 Financial Implications

The financial implications of Treasury Management are dealt with throughout this report.

17.3 Legal Implications

This Council has adopted the ‘CIPFA Code of Practice for Treasury Management in the Public Sector’ and operates its treasury management service in compliance with this code.

17.4 People Implications

None.

17.5 Property Implications

None.

17.6 Consultation

The key Treasury Management decisions are taken in consultation with our Treasury Management advisers.

17.7 Equalities and Diversity Implications

None.

17.8 Risk Assessment

The Treasury Management Policy acknowledges that the successful identification, monitoring and management of risk are fundamental to the effectiveness of its activities.

17.9 Value for Money

Treasury Management activities include the pursuit of optimum performance consistent with effective control of the risks associated with those activities.

17.10 Community Safety Implications

None.

17.11 Environmental Impact

None.

18 Background Papers

None.

19 Appendices

Appendix 1 – Treasury Management Position as at 30th September 2016

Appendix 2 – Treasury Management Performance for Quarter Two – 2016/17

Appendix 3 – Revisions to the Treasury Management Policy for 2016/17