Cabinet	
21 December 2016	

Title	Treasury Management Half Yearly Report 2016/17		
Purpose of the report	To note		
Report Author	Ryan Maslen		
Cabinet Member	Councillor Howard Williams	**Confidential**	No
Corporate Priority	Financial Sustainability		
Recommendations	**Cabinet is asked to note the treasury position achieved during the first six months of 2016/17 and the financial environment in global markets.**		

1. Introduction and Context

1.1 Treasury Management is "the management of the Council'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".

1.2 The Council has adopted the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management Code which requires the Council to report on performance of the treasury management function at least twice yearly (mid-year and at year end).

1.3 The Council's Treasury Management Strategy for 2016/17 was reviewed and approved by Cabinet in January 2016 and has been consistently applied since the beginning of the financial year.

1.4 This report is an interim statement of treasury activities for the first six months of the financial year, to the end of September 2016. The Council has invested and borrowed substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. This report covers treasury activity and the associated monitoring and control of risks.

External Context – Economic commentary and outlook

1.5 The UK economic outlook changed significantly on 23rd June 2016. The surprise result of the referendum on EU membership prompted forecasters to rip up previous projections and dust off worst-case scenarios. Growth forecasts had already been downgraded as 2016 progressed, as the very existence of the referendum dampened business investment, but the crystallisation of the risks and the subsequent political turmoil prompted a sharp decline in household, business and investor sentiment.

1.6 The repercussions of this plunge in sentiment on economic growth were judged by the Bank of England to be severe, prompting the Monetary Policy Committee to initiate substantial monetary policy easing at its August meeting to mitigate the worst of the downside risks. This included a cut in Bank Rate to 0.25%, further gilt and corporate bond purchases (QE) and cheap funding for banks (Term Funding Scheme) to maintain the supply of credit to the economy.

1.7 In response to the Bank of England's policy announcement, money market rates and bond yields declined to new record lows. Since the onset of the financial crisis over eight years ago, Arlingclose's rate outlook has progressed from 'lower for longer' to 'even lower for even longer' to, now, 'even lower for the indeterminable future'.

1.8 Whilst the economic growth consequences of Brexit remain speculative, there is uniformity in expectations that uncertainty over the UK's future trade relations with the EU and the rest of the world will weigh on economic activity and business investment, dampen investment intentions and tighten credit availability, prompting lower activity levels and potentially a rise in unemployment. These effects will dampen economic growth through the second half of 2016 and in 2017.

1.9 Meanwhile, inflation is expected to pick up due to a rise in import prices, dampening real wage growth and real investment returns. The rise in inflation is highly unlikely to prompt monetary tightening by the Bank of England, with policymakers looking through import-led CPI spikes, concentrating instead on the negative effects of Brexit on economic activity and, ultimately, inflation.

Local Context

1.10 The financial position of the Council has changed beyond recognition in recent months, with significant levels of long term borrowing being secured to fund the purchase of the BP site in Sunbury.

1.11 The Council's current strategy is to take advantage of the cheap borrowing rates available when making strategic asset acquisitions, whilst maintaining and supplementing when possible the investment portfolio that has been built up over recent years which has performed so well.

2. Options analysis and proposal

Borrowing Activity to 30th September 2016

2.1 At 30th September 2016, the Council had long term borrowing of £377.5m, which funded the Sunbury site purchase on an annuity basis over a fifty year period at an average rate of interest of 1.27%. These funds were borrowed from the Public Works Loan Board (PWLB), an executive agency of HM Treasury. The PWLB was the Authority's preferred source of borrowing given the transparency and control that its facilities continue to provide.

2.2 At 30th September 2016, the Council also had short term borrowing totalling £89m. This reflected the cashflow impact of some of the temporary costs incurred in relation to VAT for the purchase. These funds were borrowed from other local authorities, due to the short term nature of the requirement and the affordable rates on offer.

2.3 The Council will also need to borrow additional funds on both a long and short term basis for any further strategic acquisition purchases that occur in the future. Work is ongoing with Arlingclose and the portfolio holder to ensure that the cheapest and most appropriate duration and source are secured.

2.4 The Authority'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 the Authority's long-term plans change being a secondary objective.

2.5 Affordability and the "cost of carry" remained important influences on the Authority'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.

Investment Activity to 30th September 2016

2.6 The Guidance on Local Government Investments in England gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles. However, the ability to maximise interest returns within these guidelines is paramount to generating sufficient funds to support the Councils revenue budget.

2.7 As at 30th September 2016, the Council's investment portfolio was a total of £43.29m, with £19.5m of this being short term cashflow funds. A breakdown of the investments is attached as **Appendix A**.

2.8 Given the increasing risk and continued low returns from short-term unsecured bank investments, it is the Council's aim to further diversify into more secure or higher yielding asset classes. The availability of funds for investment is dependent upon the timing of precept payments, receipt of grants and progress on the capital programme.

2.9 New pooled fund investments totalling £8m were made in the first half of 2016/17, taking advantage of the timing issues identified above. These new investment decisions were taken in consultation with the portfolio holder and Arlingclose, with the aim of maintaining a balanced portfolio and generating a return of at least 4% per annum.

2.10 The pooled fund investments form a key part of the portfolio and a full list of these and their current performance is detailed in **Appendix B**.

Investment Performance Monitoring

2.11 Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2016/17.

2.12 The Council seeks professional advice from Arlingclose and closely adheres to the advice set out in the Department for Communities and Local Government (DCLG) guidance. Given Spelthorne's dependency on investment returns to balance the budget, the Council's investment strategy is also kept under constant review and regular quarterly review meetings are held with Arlingclose, the Council's treasury advisors. All investment and borrowing decisions are made in consultation with our advisors.

2.13 Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating for institutions defined as having "high credit quality" is A- 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.

2.14 Moody's affirmed the ratings of nine UK banks and building societies but revised the outlook to negative for those that it perceived to be exposed to a more challenging operating environment arising from the EU referendum 'leave' outcome.

2.15 There was no immediate change to Arlingclose's credit advice on UK banks and building societies as a result of the referendum result. Our advisor believes there is a risk that the uncertainty over the UK's future trading prospects will bring forward the timing of the next UK recession.

2.16 All investment performance is monitored on a monthly basis. The original estimate for net investment income to be credited to the General Fund in 2016/17 was £1.15m, a significant increase from 2015/16 (£635,300). This reflected the significant capital receipts that were anticipated by the Council in relation to Bridge Street which were to be received and immediately re-invested.

2.17 The Council has been able to utilise cashflow timing gains at the beginning of the financial year to make some of the planned pooled fund investments. This has gone some way to meeting the budget target. However, the delayed receipt and then recent developments regarding Bridge Street may mean the additional investments planned will now not be able to proceed. Therefore, current estimates predict an outturn position of £967k, £183k short of the budgeted position.

2.18 Over recent years the Council has built up and maintained an interest equalisation reserve to protect the Council against future changes in interest rates and other unplanned movements in the investment income received. This fund currently contains £493k. It is proposed that this fund will be utilised at year end to fund the deficit.

2.19 The Council has also incurred costs of £83k in relation to the short term borrowing for the BP purchase referred to in point 2.2 above. Whilst we are able to capitalise arrangement fees for such deals, interest costs have to be treated as revenue expenditure and are totally reliant on the opportunities that become available and whether there are any short term associated costs applicable.

2.20 The UK Bank Rate had been maintained at 0.5% since March 2009 until August 2016, when it was cut to 0.25%. It is now forecast to remain at this level for the foreseeable future. These figures illustrate the importance of the pooled fund investments we hold, and their performance as shown in **Appendix A** is fundamental to achieving the investment income target. This also justifies the approach to maintain these balances and fund asset acquisitions via borrowing at the historically low levels available.

2.21 The Council confirms compliance with its Prudential Indicators for 2016/17, which were amended as part of the Council meeting in July 2016.

Conclusions and Outlook for the remainder of 2016/17

2.22 The economic outlook for the UK has immeasurably altered following the popular vote to leave the EU. The long-term position of the UK economy will be largely dependent on the agreements the government is able to secure with the EU, particularly with regard to Single Market access.

2.23 The short to medium-term outlook has been more downbeat due to the uncertainty generated by the result and the forthcoming negotiations. Economic and political uncertainty will likely dampen or delay investment intentions, prompting lower activity levels and potentially a rise in unemployment. The downward trend in growth apparent on the run up to the referendum may continue through the second half of 2016, although some economic data has held up better than was initially expected, perhaps suggesting a less severe slowdown than feared.

2.24 Arlingclose has changed its central case for the path of Bank Rate over the next three years. Arlingclose believes any currency-driven inflationary pressure will be looked through by Bank of England policymakers. Arlingclose's central case is for Bank Rate to remain at 0.25%, but there is a 25% possibility of a drop to close to zero, with a very small chance of a reduction below zero.

2.25 Global interest rate expectations have been pared back considerably. The result of the US presidential election is also likely to delay rate increases by the Federal Reserve, which had previously been expected in December 2016.

2.26 The investment strategy is kept under constant review so that the Council can adapt quickly to the constantly changing environment. The Council continues to be proactive in seeking ways of maintaining and improving current levels of return against a very challenging global investment environment.

2.27 The full list of approved investment instruments is attached in **Appendix C** and **D**; this reflects the application of the creditworthiness criteria recommended by the Council's advisors, Arlingclose.

Proposals

2.28 The use of pooled investment funds within the portfolio has been fundamental to the continued positive performance and should help maintain overall investment returns into the future. These investments will also enable the Council to diversify the assets and underlying risk in the investment portfolio and should provide the potential for enhanced returns.

2.29 Further diversification and growth of the investment portfolio is planned, and opportunities to broaden the portfolio are being pursued with Arlingclose wherever possible.

3. Financial implications

3.1 The financial implications are as set out in this report. The ability to maximise interest returns is paramount to generate sufficient funds to support the General Fund and even a small decline in interest rates can mean a significant reduction in cash returns. Therefore, it is our aim to continue to maintain flexibility commensurate with the high level of security and liquidity and minimal risk when making investment decisions.

4. Other considerations

4.1 The Council fully complies with best practice as set out in the Chartered Institute of Public Finance and Accountancy (CIPFA) Prudential Code for Capital Finance in Local Authorities, the Department for Communities and Local Government (DCLG) Guidance on Investments issued in March 2004 and the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management in the Public Sector 2009 and Cross Sectional Guidance Notes.

4.2 Nothing in the Council's current strategy is intended to preclude or inhibit capital investment in local projects deemed beneficial to the local community and which have been approved by the Council.

5. Timetable for implementation

5.1 Treasury management is an ongoing activity and normally there is no specific timetable for implementation.

Background papers: There are none

Appendices: Appendices A – D are attached

Appendix A

Details of Investments Held as at 30th September 2016

Investment Type	Initial Inv. Amount £m	Yield %	Start Date	Maturity Date
Pooled Investment Funds (see Appendix B for details)				
Charteris Elite Equity Income	0.8	5.02*	11 May 2012	N/A
Schroders UK Corporate Bond	1.5	5.13*	11 May 2012	N/A
M&G Optimal Income Sterling	1.69	2.95*	13 Apr 2015	N/A
M&G Global Dividend	1.0	4.32*	27 Jun 2012	N/A
M&G Extra Income Fund	2.0	4.00*	15 Aug 2016	N/A
Schroders Income Maximiser	1.0	9.00*	06 Jul 2012	N/A
Schroders Income Maximiser	1.0	9.00*	24 Jul 2015	N/A
Schroders Income Maximiser	1.0	9.00*	26 Aug 2016	N/A
CCLA Property Fund (LAMIT)	1.5	5.82*	31 Mar 2013	N/A
CCLA Property Fund (LAMIT)	1.0	5.82*	30 Apr 2014	N/A
Investec Diversified Income	3.0	4.00*	25 Aug 2016	N/A
Threadneedle UK Equity Fund	2.0	4.00*	08 Sept 2016	N/A
Total	**17.49**	**5.18***		
Fixed Rate Deposits				
Marsden Building Society	1.0	0.75	22 Apr 2016	24 Oct 2016
Lloyds Bank	3.0	0.92	12 Apr 2016	13 Mar 2017
Network Housing Group	2.0	3.60	28 Apr 2016	27 Apr 2021
Total	**6.00**	**1.79**		
Total - Core Inv. Portfolio	**23.49**	**4.31**	**Average**	
Cash Flow Investments				
Standard Life Investments	5.0	0.37		Instant Access
Legal & General	4.5	0.33		Instant Access
BNP Paribas	5.0	0.40		Instant Access
Santander	5.0	1.05		120 Day Notice
Total	**19.5**	**0.54**		
Funding Circle				
Loans to small businesses	0.3	5.00	16 Apr 2015	
Total Investments at 30.9.16	**43.29**	**2.11**	**Overall Average**	

**** Yields on pooled funds are estimates based on in year performance or estimated performance when the fund was recently opened.***

Appendix B

Pooled Funds as at 30th September 2016

Fund	Date of Purchase	Initial Investment	Dividends Received to 30/9/16	Annualised Dividend Yield	Capital Gain at 30/9/16	Total Return at 30/9/16	Total Return
		£	£	£	£	£	%
Charteris Elite Income Fund	11/05/12	800,000	20,095	5.02%	5,023	25,118	3.14%
Schroders UK Corporate Bond Fund	11/05/12	1,500,000	38,488	5.13%	198,592	237,079	15.81%
Schroders Income Maximizer Fund	06/07/12	1,000,000	24,860	4.97%	177,215	202,075	20.21%
Schroders Income Maximizer Fund	24/07/15	1,000,000	20,209	4.04%	- 42,999	- 22,789	-2.28%
Schroders Income Maximizer Fund	26/08/16	1,000,000	-	0.00%	16,790	16,790	1.68%
M&G Optimal Income Sterling	13/04/15	1,690,636	4,882	0.58%	- 113	4,769	0.28%
M&G Global Dividend Fund	27/06/16	1,000,000	25,238	5.05%	502,909	528,147	52.81%
M&G Extra Income Fund	15/08/16	2,000,000	-	0.00%	- 18,209	- 18,209	-0.91%
CCLA Property Fund	31/03/13	1,500,000	23,186	3.09%	365,603	388,789	25.92%
CCLA Property Fund	30/04/14	1,000,000	13,239	2.65%	65,229	78,468	7.85%
Investec Diversified Income	25/08/16	3,000,000	-	0.00%	- 29,835	- 29,835	-0.99%
Threadneedle UK Equity Fund	08/09/16	2,000,000	-	0.00%	24,904	24,904	1.25%
Value 30/9/2016		**17,490,636**	**170,196**	**1.95%**	**1,265,109**	**1,435,305**	**8.21%**

Pooled Fund Performance to 30th September 2016

The Capital appreciation of these investments as at 30/9/16 equates to 7.23%. However, capital gains and losses may fluctuate throughout the period the investments are held. Any gains would only be realised when the funds are sold. Dividends are received at various times during the year, some are paid quarterly and others half yearly. For the four recent investment made dividends are yet to be received. The income yield as at 30/9/16 is 0.97% and the estimated annualised income yield on these funds is expected to be in the region of 5.18%.

Appendix C

Approved Counterparties

The Council may invest its surplus funds with any of the counterparty types in the table below, subject to the cash limits (per counterparty) and the time limits shown.

The cash limits shown reflect the capital receipt that the Council may receive during 2016/17. This approach has been agreed in conjunction with our treasury advisors, to enable the Council to have sufficient flexibility within the strategy being set to manage the funds appropriately if they are received. If and when this is realised the Council will manage the funds appropriately, looking to diversify investments as much as possible and keep exposure to approximately 5% per counterparty wherever possible.

Credit Rating	Banks Unsecured	Banks Secured	Government	Corporates	Registered Providers
UK Govt	n/a	n/a	£ Unlimited 50 years	n/a	n/a
AAA	£5m 5 years	£5m 20 years	£5m 50 years	£5m 20 years	£5m 20 years
AA+	£5m 5 years	£5m 10 years	£5m 25 years	£5m 10 years	£5m 10 years
AA	£5m 4 years	£5m 5 years	£5m 15 years	£5m 5 years	£5m 10 years
AA-	£5m 3 years	£5m 4 years	£5m 10 years	£5m 4 years	£5m 10 years
A+	£5m 2 years	£5m 3 years	£5m 5 years	£5m 3 years	£5m 5 years
A	£5m 13 months	£5m 2 years	£5m 5 years	£5m 2 years	£5m 5 years
A-	£5m 6 months	£5m 13 months	£5m 5 years	£5m 13 months	£5m 5 years
BBB+	£5m 100 days	£5m 6 months	£5m 2 years	£5m 6 months	£5m 2 years
BBB	£5m next day only	£5m 100 days	n/a	n/a	n/a
None	£2m 6 months	n/a	£5m 25 years	£1m 5 years	£1m 5 years
Pooled funds	£5m per fund at point of investment				

This table must be read in conjunction with the notes below

Banks Unsecured: Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. Unsecured investment with banks rated BBB are restricted to overnight deposits at the Authority’s current account bank, Lloyds Bank plc.

Banks Secured: Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the highest of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

Government: Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is an insignificant risk of insolvency. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

Corporates: Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made as part of a diversified pool in order to spread the risk widely.

Registered Providers: Loans and bonds issued by, guaranteed by or secured on the assets of Registered Providers of Social Housing, formerly known as Housing Associations. These bodies are tightly regulated by the Homes and Communities Agency and, as providers of public services, they retain a high likelihood of receiving government support if needed.

Pooled Funds: Shares in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Authority to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives will be monitored regularly.

Appendix D

Specified Investments

The DCLG Guidance defines specified investments as those:

- denominated in pound sterling,
- due to be repaid within 12 months of arrangement,
- not defined as capital expenditure by legislation, and
- invested with one of:
  - the UK Government,
  - a UK local authority, parish council or community council, or
  - a body or investment scheme of “high credit quality”.

The Council defines “high credit quality” organisations and securities as those having a credit rating of [A-] or higher that are domiciled in the UK or a foreign country with a sovereign rating of [AA+] or higher. For money market funds and other pooled funds “high credit quality” is defined as those having a credit rating of [A-] or higher.

Non-Specified Investments

Any investment not meeting the definition of a specified investment is classed as non-specified. The Council does not intend to make any investments denominated in foreign currencies, nor any that are defined as capital expenditure by legislation, such as company shares. Non-specified investments will therefore be limited to long-term investments, i.e. those that are due to mature 12 months or longer from the date of arrangement, and investments with bodies and schemes not meeting the definition on high credit quality.

Investment Limits

The maximum that will be lent to any one organisation (other than the UK Government) will be £5 million, to mitigate the risk in the case of a single default. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on fund managers, investments in brokers’ nominee accounts, foreign countries and industry sectors as shown below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries. As detailed in Appendix C, the cash limits shown reflect the capital receipt that the Council may receive during 2016/17 and have been agreed in conjunction with our treasury advisors to provide the Council with an element of flexibility to be able to invest the funds in the most appropriate manner at the time.

	Cash limit
Any single organisation, except the UK Central Government	£5m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£5m per group
Any group of pooled funds under the same management	£5m per manager at point of investment
Negotiable instruments held in a broker’s nominee	£30m per broker

account	
Foreign countries	£5m per country
Registered Providers	£10m in total
Unsecured investments with Building Societies	£20m in total
Loans to unrated corporates	£2m in total
Money Market Funds	£20m in total

Investment of Money Borrowed in Advance of Need

The Authority may, from time to time, borrow in advance of need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Authority is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Authority's overall management of its treasury risks.

The total amount borrowed will not exceed the authorised borrowing limit of £550 million. The maximum period between borrowing and expenditure is expected to be two years, although the Authority is not required to link particular loans with particular items of expenditure.

Policy on Use of Financial Derivatives

Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

The Authority will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Authority is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.