Agenda Item 5(i)

Executive Member	Councillor Lynne Brooks
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Date	22nd September 2016

Ward(s) affected	The annual report covers the whole District

Subject	Treasury Management – Annual Report and Prudential Indicators – 2015/2016

RECOMMENDATIONS

That Audit Committee is asked to recommend to Council;

1. That the Treasury Management Annual Outturn report for 2015/2016 be noted.
2. That the actual Prudential Indicators reported for 2015/2016, as detailed in Appendix A to this report, be approved.

EXECUTIVE SUMMARY

Treasury management is the control and management of all the Council's cash, regardless of its source. It covers management of the daily cash position and investments. The Council currently has no borrowings. Officers carry out this function within the parameters set by the Council each year in the Treasury Management Strategy Report.

This report reviews the performance of the Prudential Indicators and Treasury Management Strategy and Annual Plan 2015/16 as agreed by Council on 17th February 2015.

The report meets the requirements of both the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code). The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003. The primary requirements of the Codes are the:

- Creation and maintenance of a Treasury Management Policy Statement (TMPS) that sets out the policies and objectives of the Council's treasury management activities.

- Creation and maintenance of Treasury Management Practices (TMPs) that set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by Council of an annual strategy report for the year, a mid-year treasury update report and a subsequent annual review report (this report) after the end of the financial year.

Changes in recent years in the regulatory environment place a much greater onus on Members' for the review and scrutiny of treasury management policy and activity. This report is important in that respect, as it provides details of the outturn position for treasury management activities and highlights compliance with the Council's policies previously approved by Members.

Council have delegated the responsibilities for implementing and monitoring treasury management policies and practices to the Audit Committee and for the operation and administration of treasury management decisions to the Deputy Chief Executive (Section 151 Officer), who will act in accordance with the organisation's treasury management policy statement and TMP's, and CIPFA's Standard of Professional Practice on Treasury Management.

In summary, the Council's in-house team together with some externally managed funds achieved a rate of return on investments of 1.47%. The Council achieved an overall return of £481,475 in 2015/16 approximately £17,000 below budget. Investment balances at balance sheet dates decreased from £26.615m (31/03/15) to £21.247m (31/03/16). The 2015/16 financial year continued the challenging environment of previous years with low investment returns and continuing counterparty risk.

In conducting the treasury management activities of the Council there were no breaches of the agreed Strategy and the in-house team operated within the Prudential Indicators set by Council.

CORPORATE PRIORITY OUTCOMES

This report is an update on the Council's Prudential Indicators and treasury operations as contained in the Treasury Management Strategy for 2015/16.

1. BACKGROUND/INTRODUCTION

1.1 Treasury management is defined as:

"The management of the local authority'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 annual treasury management outturn report for 2015/16 covers:

- The economy and interest rates
- The Council's capital expenditure and financing
- Investment rates
- Borrowing strategy
- Borrowing outturn
- Compliance with Prudential and Treasury Management Indicators (and Appendix A)
- Investment strategy
- Investment outturn
- Debt rescheduling
- Other issues

2. **The economy and interest rates in 2015/16**

Market expectations for the first increase in Bank Rate moved considerably during 2015/16, starting at quarter 3 2015 but soon moving back to quarter 1 2016. However, by the end of the year, market expectations had moved back radically to quarter 2 2018 due to many fears including concerns around China's economic growth, the potential destabilisation of some emerging market countries and the continuation of the collapse in oil prices during 2015. These factors together with continuing Eurozone growth uncertainties all contributed towards these fears.

These concerns have caused sharp market volatility in equity prices during the year with corresponding impacts on bond prices and bond yields due to safe haven flows. Bank Rate, therefore, remained unchanged at 0.5% for the seventh successive year. Economic growth (Gross Domestic Product (GDP)) in 2015/16 has been disappointing with growth falling steadily from an annual rate of 2.9% in quarter 1 2015 to 2.1% in quarter 4.

The sharp volatility in equity markets during the year was reflected in sharp volatility in bond yields. However, the overall dominant trend in bond yields since July 2015 has been for yields to fall to historically low levels as forecasts for inflation have repeatedly been revised downwards and expectations of increases in central rates have been pushed back. In addition, a notable trend in the year was that several central banks introduced negative interest rates as a measure to stimulate the creation of credit and hence economic growth.

The European Central Bank (ECB) commenced a full blown quantitative easing (QE) programme of purchases of Eurozone government and other bonds starting in March 2015 at €60bn per month. This put downward pressure on Eurozone bond yields. There was a further increase in this programme of QE in December 2015.

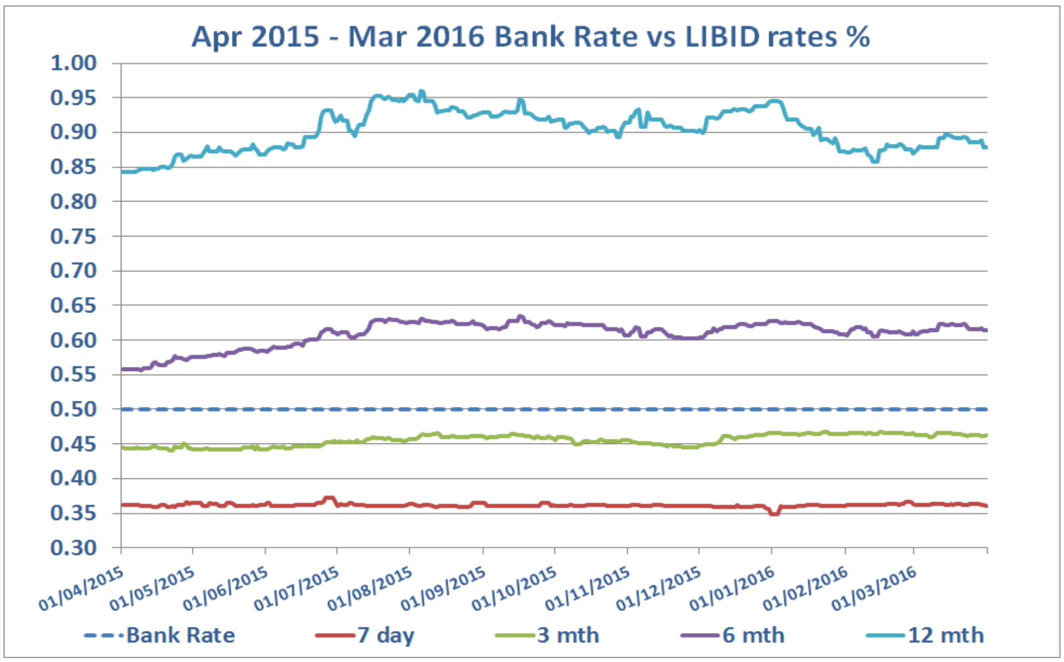
In America the economy has continued to grow healthily on the back of resilient consumer demand. The first increase in the central rate occurred in December 2015 since when there has been a return to caution as to the speed of further increases due to concerns around the risks to world growth.

The UK elected a majority Conservative Government in May 2015, removing one uncertainty but introducing another due to the promise of a referendum on the UK remaining part of the European Union. The government maintained its tight fiscal policy stance but the more recent downturn in expectations for economic growth has made it more difficult to return the public sector net borrowing to a balanced annual position within the period of this parliament.

The comments above relate to the financial year 2015/16 and were prior to the result of the Referendum on the UK membership of the European Union in June 2016.

Bank Rate remained at its historic low of 0.5% throughout the year, unchanged for seven years (since 5th March 2009). *The Base Rate has subsequently been reduced by 0.25% to 0.25% on 4th August 2016 (outside of this reporting period).* Deposit rates remained depressed during the whole of the year, primarily due to the effects of the Funding for Lending Scheme and due to the continuing weak expectations as to when the Bank Rate would start rising.

Bank Rate v London Interbank BID (LIBID) investment rates



3. **Capital Expenditure and Financing 2015/16**

3.1 The Council finances capital expenditure resulting in an increase in long-term assets. These may either be;

- Financed immediately through the application of capital receipts, capital grants or contributions from revenue expenditure, or
- If insufficient financing is available the expenditure will give rise to a borrowing need

3.2 The Council finances capital expenditure out of capital reserves and did not borrow during 2015/16.

3.3 The table below shows how capital expenditure was financed over the past two years. The decrease in actual expenditure over the estimate and subsequent financing was mainly as a result of slippage on minor works projects, Hope Springs Eternal, Leatherhead Youth Football Club, Pippbrook offices refurbishment and the Meadowbank Wellbeing Centre, Dorking. Members approved carry forward to 2016/17 of £582,000 capital minor works scheme provision at the Executive meeting on 19th July.

	2014/15 Actual £000	**2015/16 Estimate £000**	**2015/16 Actual £000**
Total capital expenditure	**3,764**	**9,594**	**6,502**
Resourced by :			
Capital receipts	2,462	4,290	4,164
Capital grants	370	1,911	2,183
Capital reserves	932	117	155
Repairs & Renewals Fund	0	3,276	0
Total Resources Applied	**3,764**	**9,594**	**6,502**

4. Investment Rates in 2015/16

4.1 The market interest rates at the start and end of the year are shown below. As can be seen rates have stabilised albeit at historically low levels. The reduction in interest rates, including the effect of the introduction of the Funding for Lending Scheme by the Government, has had a significant bearing on the interest earnings of the Authority on internal investments and will do so moving forward.

Market Rates:

Notice	31/03/14	31/03/15	31/03/16
	%	%	%
Overnight	0.45	0.45	0.45
1 Week	0.48	0.48	0.48
1 Month	0.46	0.50	0.50
3 Months	0.55	0.60	0.60
6 Months	0.65	0.75	0.75
364 Day	0.90	1.10	1.10

5. Borrowing Strategy for 2015/16

5.1 The major objectives to be followed in 2015/16 if there had been an underlying borrowing requirement were:

- To forecast average future interest rates and movements in future interest rates
- To ensure that, where possible, the Council’s debt free status is retained
- To manage the Council’s short-term debt, if any so arises, ensuring prompt payment of interest and principal on the due dates

- To secure the cheapest cost for financing capital schemes commensurate with future risk

6. Borrowing Outturn for 2015/16

6.1 The Council did not raise any funds through the money market or through the Public Works Loans Board (PWLB), either in the short or long term, during 2015/16. This has been the case since 1997. The Council's last external loan was repaid in February 1997 and Mole Valley became debt free on 1st April 1997.

6.2 Whilst there was no need to borrow in 2015/16 the increased size of the capital programme in 2015/16 and 2016/17 means that the Council will be drawing heavily on its reserves. The planned level of capital expenditure in 2016/17 is expected to make borrowing a necessity. The position will be closely monitored.

7. Compliance with Prudential and Treasury Management Indicators

7.1 During the financial year the Council operated within the Prudential and Treasury Management Indicators 2015/16 – 2017/18 and Treasury Management Strategy and Plan 2015-16 as agreed by Council on 17th February 2015. The outturn for the Prudential and Treasury Management Indicators is detailed in Appendix A of this report.

8. Investment Strategy for 2015/16

8.1 The Investment Strategy's primary objectives are safeguarding the re-payment of the principal and interest of its investments on a timely basis first and ensuring adequate liquidity second, with the investment return being the third objective.

8.2 Members will recall that in recent Treasury Management Strategy Reports agreement was given to increased licence in terms of the scope and range of its investments. The change was required as work on the Medium Term Financial Strategy had demonstrated an imbalance between reducing funding sources and increased costs.

8.3 The focus of the revised Strategy remained primarily on safeguarding sufficient of the Council's balances in secure and liquid investments to ensure overall stability. However, it was recommended that between £8m and £12m could be diverted in the interests of securing a higher return and providing a more substantial income stream for the Council's revenue account. This was dependent on the options that became available. These options would include extending the investment portfolio (eg through longer term investments or property funds) and/or diverting part of the investment portfolio into property purchases.

8.4 The Council predominantly manages its investments in-house and invests with the institutions listed in the Council's approved lending list. The Council primarily invests for a range of periods less than one year dependent on the Council's cash flows, its interest rate view and the rates of interest on offer. The Base Rate remained at 0.50% for the duration of the financial year.

8.5 The expectation for interest rates within the Strategy for 2015/16 anticipated the Bank Rate remaining unchanged at 0.50%. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

8.6 No institutions in which investments were made during 2015/16 had any difficulty in repaying principal and interest in full during the year.

9. Investment Outturn for 2015/16

9.1 The Council's Investment Policy is governed by Communities and Local Government (CLG) guidance, which has been implemented in the annual investment strategy approved by the Council on 17th February 2015. This Policy sets out the approach for selecting investment counterparties, and is based on credit ratings provided by the three main credit rating agencies supplemented by additional market data, such as rating outlooks, credit default swaps, bank share prices etc. Counterparties are selected and limits applied using rating criteria. The application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria. This is in compliance with the CIPFA Treasury Management Code of Practice. Credit rating information is supplied by our treasury management advisor (Capita Asset Services).

9.2 Detailed below is the result of the investment strategy undertaken by the Council.

Internally Managed Funds

9.3 The Council maintained its investment activities during the year, as agreed by Council on 17th February 2015.

9.4 During the year all investments were made in full compliance with the Council's treasury management policies and practices and the Council had no liquidity difficulties.

9.5 The limit to be placed, with each counterparty, remained at £7.5 million. The Council also operated a 'group limit', whereby the collective investment exposure to individual banks within the same banking group was restricted to a group total set also at £7.5 million.

9.6 The analysis below shows the activity undertaken on internally managed funds during 2015/16.

	£
Balance outstanding 01/04/15	26,615,000
Investments made during the year	145,611,000
Upward revaluation of CCLA Property Fund investment (at 31/03/16)	341,000
	172,567,000
Less: Investments maturing during the year	151,320,000

Balance outstanding 31/03/16	21,247,000

9.7 These investments generated interest of approximately £481,000 in the year (£507,000 in 2014/15), gross of all associated charges against a budget of £498,000. As referred to in paragraph 8.3 agreement was given to increased licence in terms of the scope and range of Council investments. During 2015/16 funds were moved from short-term investments where interest rates were performing at historically low levels. These funds were re-invested in, better performing, property purchases that generated a rental income but meant that there was less to invest in financial instruments. This would help to explain the variation in actual outturn and estimate for investment interest earnings. The majority of income is received from short-term investments (investments that mature in, or are held for, 12 months or less) but the increase over the budget has been achieved by investing some funds longer-term (investments that are placed for a period longer than 12 months). In particular attractive yields were still being achieved on a 'cap and collar' investment (arrangements where limits are placed on the minimum and maximum coupon rates receivable against a benchmark). This investment matured on 29th September 2015. Also good returns are still being achieved on the investment of £5m that was made in the CCLA Property Fund on 30th June 2013 (refer to paragraph 9.10). During the reporting period there was no movement in the Base Rate.

	Original Estimate 2015/16 £	**Actual Outturn 2015/16 £**	**Variance 2015/16 £**
Internally Managed Funds	498,000	481,475	16,525

9.8 Mole Valley achieved a rate of return of 1.47% on its internally managed funds during the year, this was based on an average fund value of approximately £32,673,000. The formal method used to compare performance is to contrast the rate of return against the average uncompounded 7-day LIBID (London Interbank BID) rate (0.361% for 2015/16). The long-term 'cap and collar' investments previously alluded to have in part enhanced the return on internally managed funds when compared to the benchmark. This investment matured during the reporting period (29/09/15).

9.9 Detailed below is the result of the investment strategy undertaken by the Council.

Funds	**Average Fund Value**	**Rate of Return**	**Benchmark Return ***
Internally / Externally Managed	£32,673,000	1.47%	0.361%

* 7-day LIBID uncompounded 0.361%

The uncompounded rates are for internally managed funds and exclude the roll-up of principal and interest. Upon maturity of the investment, interest is paid over with the original principal sum.

Externally Managed Funds – Churches, Charities and Local Authorities (CCLA)

9.10 On 30th June 2013 the Council invested £5m in the Charities, Churches and Local Authorities (CCLA) Property Fund. To realise the full potential of this investment it should be considered as a medium to long term placement. Income is received quarterly and in the current economic climate good yields are still being achieved.

9.11 The Fund offers all of the advantages of a professionally managed property portfolio, with broadly diversified exposure to high quality properties in the strongest areas of the market. The Fund is a high quality, well diversified commercial and industrial property portfolio. There is a focus on delivering attractive income returns and the Fund is actively managed to add value.

9.12 CCLA has been appointed by the Local Authorities' Mutual Investment Trust (LAMIT) to manage and administer the Local Authorities' Property Fund. LAMIT was established approximately 30 years ago to provide investment services for local authorities in the UK. It is controlled by Members and Officers appointed by the Associations of Local Authorities in the United Kingdom and by Trust Members representing the Funds' unit holders.

9.13 Excellent returns of 5.57% were achieved from this Fund during the year. With the property market remaining buoyant it is anticipated that these returns will continue during 2016/17.

10. Debt rescheduling

10.1 The Council did not raise any funds through the money market or through the Public Works Loans Board (PWLB) during the year. The last external loan was repaid in February 1997 and Mole Valley became debt free on 1st April 1997. Therefore, debt rescheduling was not an issue.

11. Other issues

11.1 The Treasury Management Strategy Report for 2017/18 to 2019/20 will be presented to the November Audit Committee.

12. **Financial Implications** – are covered in the body of this report.

13. **Legal Implications** - The Council's treasury management activities are regulated by a variety of professional codes, statutes and guidance:

- The Local Government Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity.

- The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (no restrictions were made in 2015/16).
- The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act.
- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities. The Prudential Code required indicators to be set, some of which are limits, for a minimum of three forthcoming years.
- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services.
- Under the Act the DCLG has issued Investment Guidance to structure and regulate the Council's investment activities. Updated guidance became available on 1st April 2010. The emphasis of the Guidance is on the security and liquidity of investments.

The Council has complied with all of the above relevant statutory and regulatory requirements that limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means both that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

14. CORPORATE IMPLICATIONS

Monitoring Officer commentary – The Monitoring Officer confirms that all relevant legal implications have been taken into account.

S151 Officer commentary - The S151 Officer confirms that all financial implications have been taken into account.

Risk Implications - The Council considers security, liquidity and yield, in that order, when making investment decisions:

Security – counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swaps, gross domestic product (GDP) of the country in which the institution operates, the country's net debt as a percentage of GDP, any potential support mechanisms and share price. The minimum long-term counterparty credit rating determined for 2015/16 was A/A3/A (Fitch/Moody's/Standard and Poors).

Liquidity – the Council maintained a sufficient, though not excessive, level of liquidity during the year using various call accounts and short-term, fixed-rate, deposits.

Yield – the Council sought to optimise returns commensurate with its objectives of security and liquidity. Short-term money market rates remained at very low levels throughout the year which had a significant impact on investment income.

A high reliance on investment income can place the Council at significant risk of budget variation as interest rates rise and fall, which has an impact upon future

Council Tax levels. The Council's Medium Term Financial Strategy addresses this risk and seeks to reduce this reliance over time.

Locking significant investments into long-term fixed-rate deals means the Council has a potential disadvantage in a rising interest market, especially if the interest rate rises above the assumption made when the long-term deal was placed.

To mitigate this, the Council's in-house team predominantly invest up to periods of three months only, hence advantage can be taken of prevailing interest rates upon the investments maturity. This minimises the disadvantage whilst maintaining certainty over the level of future return and stability in planned future Council Tax levels. With interest rates remaining at historically low levels the Authority has made some longer term investments that are higher yielding, although less liquid. This has proved to be a good decision as interest rates have remained at low levels throughout the year.

The Council will continue to look to diversify its investment portfolio and the 2016/17 Treasury Management Strategy provides for alternative investment funds should the opportunity arise.

Equalities Implications – There are no equalities implications arising as a direct consequence of this report.

Employment Issues - None within the report.

Sustainability Issues - None within the report.

Consultation – A number of meetings were convened during the year involving Capita Asset Services, Members and Officers.

15. BACKGROUND PAPERS

CIPFA Treasury Management in the Public Services – Code of Practice and Cross-Sectoral Guidance Notes (2011 edition).

CIPFA Treasury Management in the Public Services – Guidance Notes for Local Authorities including Police Authorities and Fire Authorities (2011 edition).

CIPFA the Prudential Code for Capital Finance in Local Authorities (2013 edition).

Treasury Management Annual Strategy Report 2015-16 and Prudential Indicators 2015-16 to 2017-18.

Performance management information from Capita Asset Services.

2015/16 final accounts working papers.

APPENDIX A

1. **PRUDENTIAL AND TREASURY MANAGEMENT INDICATORS AND COMPLIANCE ISSUES**

1.1 The treasury management service is an important part of the overall financial management of the Council's affairs. Whilst the Prudential Indicators consider the affordability and impact of capital expenditure decisions, the treasury management service covers the effective funding of these decisions.

1.2 The 2003 Prudential Code for Capital Finance in Local Authorities required that actual prudential indicators be reported after the year-end. The table below summarises the key prudential indicator performance for 2015/16.

1.3 The Council at its meeting on 17th February 2015 adopted the prudential indicators for 2015/16.

PRUDENTIAL INDICATORS

2014/15 Actual	PRUDENTIAL INDICATOR	2015/16 Estimate	2015/16 Actual
	CAPITAL EXPENDITURE / AFFORDABILITY		
	Capital Expenditure Plans– Prudential Indicator 1		
£000's	**Capital Expenditure**	**£000's**	**£000's**
3,764	General Fund	7,402	6,502
3,764	**Total**	**7,402**	**6,502**
	Capital Financing Requirement (CFR) – Prudential Indicator 2		
£000's	**Capital Financing Requirement**	**£000's**	**£000's**
2,791	General Fund	2,585	2,676
2,791	**Total**	**2,585**	**2,676**
	Ratio of Financing Costs to Net Revenue Stream – Prudential Indicator 3		
%	**Ratio of Financing Costs to Net Revenue Stream**	**%**	**%**
5.04	General Fund	5.0	4.79
5.04	**Total**	**5.0**	**4.79**
	Incremental Impact of Capital Investment Decisions on the Band D Council Tax – Prudential Indicator 4		
£p	**Increase in Council Tax (Band D) per annum**	**£p**	**£p**
0.05		0.88	0.35
	TREASURY MANAGEMENT		
	Borrowing and the Capital Financing Requirement (CFR) – Prudential Indicator 5		
£000's	**External Debt**	**£000's**	**£000's**
0	General Fund	0	0

Capital Financing Requirement (CFR)

1.4 The CFR is derived from the Authority's balance sheet and measures its underlying need to borrow for a capital purpose. This Authority fully finances its capital expenditure (including the value of assets acquired under finance leases) without borrowing. Where capital expenditure is to be financed in future years by charges to revenue as assets are used by the Authority, the expenditure results in an increase in the Capital Financing Requirement, a measure of the capital expenditure incurred historically by the Authority that has yet to be finalised.

1.5 In accordance with best practice this Authority does not associate borrowing with particular items or types of expenditure, in day-to-day cash management no distinction can be made between capital cash and revenue cash. Any external borrowing would arise as a consequence on all financial transactions whereas this measure reflects the Authority's underlying need to borrow for a capital purpose only.

Net Borrowing and the CFR

1.6 In order to ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2015/16 plus the expected changes to the CFR over 2016/17 and 2017/18. The Council has complied with this prudential indicator.

TREASURY MANAGEMENT INDICATORS

The Operational Boundary – Prudential Indicator 6

1.7 The Operational Boundary is the expected borrowing position of the Council during the year, and periods where the actual position is either below or over the Operational Boundary is acceptable subject to the Authorised Limit not being exceeded. The Operational Boundary does not allow for additional headroom as is the case with the Authorised Limit. A limit of £4m was used for the Operational Boundary. The actual outturn was £2.8m (£3.0m in 2014/15) for finance lease liabilities. There was no borrowing during 2015/16.

The Authorised Limit – Prudential Indicator 7

1.8 The Authorised Limit is the 'Affordable Borrowing Limit' required by S3 of the Local Government Act 2003 irrespective of the Authority's indebted status. The limit is the maximum amount of external debt that can be outstanding at any one time during the financial year. The Authorised Limit also provides some headroom for unexpected cash movements. The introduction of International Financial Reporting Standards (IFRS) required finance leases to be included under other long-term liabilities on the balance sheet. A limit of £5.5m was used for the Authorised Limit. The actual outturn was £2.8m (£3.0m in 2014/15) for finance lease liabilities. There was no borrowing during 2015/16.

Actual financing costs as a proportion of net revenue stream

1.9 This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream. Since the Council is a debt free Authority this indicator is not relevant.

1.10 A 'debt free' Authority does not incur financing costs because it does not have any long-term debt. Instead, this indicator measures the investment income earned by the Council as a percentage of the Council Tax budget requirement, so as to show the level by which investment income is being used to underpin the Council's operational budget. See table at paragraph 1.3 (Appendix A).

Investment Activity

1.11 The purpose of the following indicators is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates.

1.12 **Maximum principal sums invested > 364 days – <u>Prudential Indicator 8</u>**

Maximum principal sums invested > 364 days			
	2014/15 Actual	**2015/16 Estimate**	**2015/16 Actual**
Principal sums invested > 364 days	£5.7m	£12m	£6.0m

1.13 **Interest rate exposure – <u>Prudential Indicator 9</u>**

Interest rate exposures	**2014/15 Actual**	**2015/16 Estimate**	**2015/16 Actual**
	Upper	**Upper**	**Upper**
Limits on fixed interest rates: (investments only)	62.25%	100%	66.89%
Limits on variable interest rates: (investments only)	37.75%	35%	33.11%

1.14 **Maturity structure of fixed interest rate borrowing 2015/16 – <u>Prudential Indicator 10</u>**

Maturity structure of fixed interest rate borrowing 2015/16		
	Lower	**Upper**
Under 12 months	0%	0%
12 months to 2 years	0%	0%
2 years to 5 years	0%	0%
5 years to 10 years	0%	0%
10 years and above	0%	0%

1.15 The Council has been debt free since 1st April 1997. These indicators have therefore not moved from 0% in the estimate or the actual outturn.

Adoption of the CIPFA Treasury Management Code

1.16 This indicator demonstrates that the Council has adopted the principles of best practice.

1.17 The Council approved the adoption of the CIPFA Treasury Management Code at its full Council meeting on 20th January 2004.

1.18 The Council has incorporated the changes from the revised CIPFA Treasury Management Code of Practice into its treasury policies, procedures and practices. Council approved the revised Treasury Management Policy on 17th February 2015.

Mole Valley District Council

Agenda Item 5(ii)

Executive Member	Councillor Lynne Brooks
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Date	24th November 2016

Ward(s) affected	The Treasury Management Mid Year Monitoring Report covers the whole District.

Subject	Treasury Management – Mid Year Monitoring Report – 2016/17.

RECOMMENDATIONS

The Committee is asked to:

1) Receive and note the Treasury Management Mid Year Monitoring Report for the period ended 30th September 2016.
2) Commend the report to Council, including the amendment to Prudential Indicator 9 (interest rate exposure on investments) as explained in paragraph 5.28, making any relevant recommendations and observations as Members see fit.

EXECUTIVE SUMMARY

This report outlines the performance of the Treasury Management function of the Council for the six months ending 30th September 2016. It provides an update on the current economic conditions affecting Treasury Management decision making and looks ahead to future reporting requirements.

The key points to note are:

- All treasury related transactions were undertaken by authorised officers and within the limits approved by the Council.
- All investments were to counterparties on the approved lending list.
- The Council operated within the Prudential Indicators for Treasury Management.

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

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management function.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

- Receipt by 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 covering activities during the previous year.
- 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.
- 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 the Audit Committee.

This report meets that requirement. It also incorporates the needs of the Prudential Code to ensure adequate monitoring of the capital expenditure plans and the Council's prudential indicators (PIs). The Treasury Management Strategy and PIs were previously reported to Council on 23rd February 2016 and Audit Committee on 17th March 2016.

CORPORATE PRIORITY OUTCOMES

Strong governance arrangements mean that resources are directed in accordance with the agreed strategies and according to prudential indicators and limits as set out in the 2016/17 Treasury Management Strategy that there is sound and inclusive decision making and that there is clear accountability for the use of those resources in order to achieve desired outcomes for communities and service users in accord with the Council's investment priorities of security (first), liquidity (second) and finally yield.

The Committee has the authority to determine the Recommendations.

1. Background

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

1.2 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.

1.3 As a consequence treasury management is defined as:

'The management of the local authority'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'.

1.4 The report updates members on 2016/17 treasury management activities as at 30th September 2016 and covers:

- The general economic performance to date and outlook.
- Treasury Management Strategy Statement update
- Compliance with regulatory requirements (treasury and prudential limits), approved policies and practices for 2016/17.

2. **Key Changes to the Treasury and Capital Strategies**

2.1 At its meeting on 11th October 2016 Council gave its approval for an Asset Investment Strategy aimed at increasing income for the Council.

2.2 Members were advised that the Asset Investment Strategy proposed in the report would see the creation of a £48.5m fund that would be used to purchase property investments that would deliver a good rate of return for the Council.

2.3 The £48.5m fund has been added to the capital programme, see Prudential Indicator 1 (Capital Expenditure Plans) at paragraph 5.3.

2.4 It is envisaged that the increased capital programme for 2016/17 will not have a detrimental effect on the capital expenditure Prudential Indicators and limits considered within this report. The Prudential Indicators and limits were considered as part of the 2016/17 Treasury Management Strategy agreed by Council on 23rd February 2016.

2.5 Should property investment purchase opportunities arise that mean the agreed 2016/17 capital expenditure prudential indicators are breached then the following action, as agreed by Council on 21st February 2012, would be taken;

'That if any urgent and immediate changes to the Treasury Management (TM) Strategy are required they will be delegated to the Deputy Chief Executive (Section 151 Officer) in consultation with the Portfolio Holder for Finance and Investments and Chairman of Audit Committee. If all are in agreement the TM Strategy and Treasury Management Practices (TMP's) will be modified to reflect this change. Ultimately any change will be ratified at the next available Council meeting after having been considered at the first available meeting of the Audit Committee'.

2.6 Future implications of the Asset Investment Strategy on the capital expenditure prudential indicators and limits will be factored into the 2017/18 – 2019/20 Treasury Management Strategy Report that will be considered by Audit Committee in March 2017

3. **Economic Update**

3.1 **Economic performance to date and outlook**

3.2 Commentary from Capita Asset Services (Capita Asset Services is a trading name of Capita Treasury Solutions Limited and are the Council's treasury management advisors) is set out in Appendix A.

4. **Treasury Management Strategy Statement update**

4.1 The report is structured to highlight any key changes to the Council's capital activity (the prudential indicators (PIs)), the economic outlook and the actual and proposed treasury management activity (borrowing and investment).

4.2 The Treasury Management Strategy for 2016/17 was approved by the Council on 23rd February 2016 there have been no changes to the Strategy in the half year to 30th September 2016.

5. **Compliance with Regulatory Requirements (Treasury and Prudential Limits), Approved Policies and Practices for 2016/17.**

Key Prudential Indicators

5.1 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 (PIs) and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

Borrowing

5.2 Prudential Indicators for 2016/17 were set in accordance with the Prudential Code and the Treasury Management Code of Practice and were approved by Council on 23rd February 2016. These Prudential Indicators and the actual performance against them are set out below:

Prudential Indicators for Capital Expenditure and the Financing of the Capital Programme

Prudential Indicator 1 – Capital Expenditure Plans and Financing

5.3 The table below draws together the main strategy elements of the capital expenditure plans, including the recently agreed Asset Investment Strategy and the existing capital programme, and the expected financing arrangements of this capital expenditure.

Capital Expenditure	2016/17 Original £m	2016/17 Revised (incl. c/f) £m	2017/18 Estimate £m	2018/19 Estimate £m	2019/20 Estimate £m
Capital Expenditure	11.672	28.020	20.776	19.831	16.346

Financed by:					
Capital reserves	1.200	5.154	0.900	0.900	0.900
Government grants	0.270	0.606	0.270	0.270	0.270
Other grants and conts.	1.568	3.226	2.056	0.750	0.750
Revenue	2.069	0.320	0.320	0.720	0.520
Net financing need for the year	**6.565**	**18.714**	**17.230**	**17.191**	**13.906**

Prudential Indicator 2 - Capital Financing Requirement (CFR)

5.4 The CFR reflects the underlying need to finance capital expenditure by borrowing or other long-term liability arrangements. Other long-term liabilities include credit arrangements associated with finance leases. The CFR will increase whenever capital expenditure is incurred. If this expenditure is resourced immediately then there is a zero net increase in the CFR. If this expenditure is not immediately resourced then the CFR of the Authority will increase. A positive CFR indicates a borrowing requirement which will incur a Minimum Revenue Provision (MRP) or statutory repayment of principal and interest from the general fund.

5.5 The latest CFR projections are:

	2016/17 Original £m	2016/17 Revised £m	2017/18 Estimate £m	2018/19 Estimate £m	2019/20 Estimate £m
Capital Financing Requirement (CFR)	9.380	21.380	37.670	53.920	66.260

Affordability Prudential Indicators

5.6 The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

5.7 **Ratio of financing costs to net revenue stream** – This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

Prudential Indicator 3 – Ratio of financing costs to net revenue stream

	2016/17 Estimate £m	2016/17 Estimate (as at 30/09/16) £m	2017/18 Estimate £m	2018/19 Estimate £m	2019/20 Estimate £m
Net Financing Cost (revenue)	(0.448)	(0.212)	0.997	1.863	2.935
Revenue Budget	9.971	9.971	9.781	9.466	8.905
Ratio %	**(4.49)**	**(3.98)**	**10.19**	**19.68**	**32.95**

5.8 **Incremental impact of capital investment decisions on the Council Tax** – This indicator identifies the revenue costs associated with changes to the three year capital programme recommended in the budget report compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates.

Prudential Indicator 4 - Incremental impact of capital investment decisions on the Band D Council Tax

	2016/17 Estimate £m	2016/17 Estimate (as at 30/09/16) £m	2017/18 Estimate £m	2018/19 Estimate £m	2019/20 Estimate £m
2015/16 MTFS	6.7	6.7	-	-	-
2016/17 MTFS	11.7	28.0	20.8	19.8	16.3
Increase / (Decrease) in Capital Programme	5.0	21.3	20.8	19.8	16.3
Interest rate assumption (Investments)	0.75%	0.25%	0.25%	0.25%	0.25%
Interest rate assumption (Borrowing)	0.00%	2.90%	2.90%	3.05%	3.25%
Net Revenue (Income)/ Expenditure Arising	(0.038)	(0.251)	(0.426)	(0.796)	(0.516)

From Capital Investment Decisions					
Council Tax Base	39,884	39,884	39,984	40,084	40,184
Increase / (Decrease) in Band D Council Tax	£0.95	-£6.30	-£10.68	-£19.96	-£12.94

Borrowing

5.9 There has been no requirement for any short-term borrowing, for the purposes of cash flow management, during the first half of 2016/17. The Council's last external loan was repaid in February 1997 and Mole Valley became debt free on 1st April 1997.

5.10 It is estimated that the Council will have to externally borrow £19m to fund the 2016/17 capital programme during the second half of the financial year. It is forecast that a further £48.3m will have to be borrowed externally over the next three years to finance the capital programme.

Prudential Indicators for Borrowing:

Borrowing Limits

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

Prudential Indicator 5 – Gross Borrowing and Long-term Liabilities and the Capital Financing Requirement (CFR).

	2016/17 Original Estimate	**2016/17 Revised Estimate**	**2017/18 Original Estimate**	**2018/19 Original Estimate**	**2019/20 Original Estimate**
External debt	**£m**	**£m**	**£m**	**£m**	**£m**
Debt at 1st April	0	0	21.5	39.9	57.4
Expected change in debt	7.0	19.0	16.2	15.6	12.0
Other long-term liabilities (OLTL)	2.8	2.8	2.5	2.2	1.9
Expected change in OLTL	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)
Actual gross debt at 31st March	**9.5**	**21.5**	**39.9**	**57.4**	**71.0**
Capital	**9.4**	**21.4**	**37.3**	**52.9**	**64.6**

Financing Requirement					
Under/(over) borrowing	**(0.1)**	**(0.1)**	**(2.6)**	**(4.5)**	**(6.4)**

5.12 The Strategic Director (Section 151 Officer) reports that no difficulties are envisaged for the current year in complying with this prudential indicator.

<u>Prudential Indicator 6 – Operational Boundary</u>

5.13 The **Operational Boundary** is the expected external borrowing position of the Council during the year and periods where the actual position is either below or over the Operational Boundary is acceptable subject to the Authorised Limit not being exceeded without approval from Council. Refer to the table at paragraph 5.3 (Prudential Indicator 1 – Capital Expenditure Plans). The Treasury Management Strategy agreed by Council on 23rd February 2016 included for an Operational Boundary of £30m. The cost of finance leases included within the Operational Boundary in 2016/17 amounted to £2.8m.

<u>Prudential Indicator 7 – Authorised Limit</u>

5.14 A further prudential indicator controls the overall level of external borrowing. This is the **Authorised Limit** which represents the limit beyond which borrowing is prohibited without approval from Council. It reflects the level of external 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 external borrowing need with some headroom for unexpected movements. See paragraph 5.3 (Prudential Indicator 1 – Capital Expenditure Plans). The Authorised Limit is the 'Affordable Borrowing Limit' required by Section 3 of the Local Government Act 2003 irrespective of its indebted status. The introduction of International Financial Reporting Standards (IFRS) required finance leases to be included under other long-term liabilities on the balance sheet. The Treasury Management Strategy agreed by Council on 23rd February 2016 included for an Authorised Limit of £35m. The cost of finance leases included within the Authorised Limit in 2016/17 amounted to £2.8m.

<u>Investment Strategy</u>

5.15 The objectives of the Council's investment strategy are safeguarding the repayment of the principal and interest of its investments on time, the liquidity of those sums, with the investment return being the final objective. As set out in paragraph 3 and Appendix A (Economic Background) 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 0.25% Bank Rate. Indeed, the introduction of the Funding for Lending Scheme has reduced market investment rates even further. 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 and short term strategy. Given this risk environment, investment returns are likely to remain low.

5.16 The Council's in-house investment team manages an investment portfolio of between £15 million and £30 million. Fluctuations will occur during the year as for example council tax and non-domestic rate direct debits are collected in ten months out of twelve and this has a significant effect on the balances that are held at year end. The opening and closing balances on the Council's investment portfolio for the first half of 2016/17 are as follows:

	Investments at 01/04/2016 £m	Investments at 30/09/2016 £m
Temporary investments	15.224	13.197
CCLA Property Fund investment	6.023	5.806
Total investments outstanding	21.247	19.003

5.17 The constituent parts of the investment position as at 30th September 2016 are:

Sector	Country	Up to 1 year £m	1 - 2 years £m	2 – 3 years £m	3 - 5 years £m
Banks	UK	11.697	0	0	0
Building Societies	UK	1.500	0	0	0
Property Fund investment	UK	5.806	0	0	0
Total		**19.003**	**0**	**0**	**0**

5.18 On 30th June 2013 the Council invested £5m in the Charities, Churches and Local Authorities (CCLA) Property Fund. This is a high quality, well diversified property fund. To realise the full potential of this investment it should be considered as a medium to long term placement. Income is received quarterly and in the current economic climate yields remain good.

5.19 The Fund offers all of the advantages of a professionally managed property portfolio, with broadly diversified exposure to high quality properties in the strongest areas of the market. The Fund is a high quality, well diversified commercial and industrial property portfolio. There is a focus on delivering attractive income returns and the fund is actively managed to add value.

5.20 CCLA has been appointed by the Local Authorities' Mutual Investment Trust (LAMIT) to manage and administer the Local Authorities' Property Fund. LAMIT was established around 30 years ago to provide investment services for local authorities in the UK. It is controlled by Members and Officers appointed by the Associations of

Local Authorities in the United Kingdom and by Trust Members representing the Funds' unit holders.

5.21 Good dividend returns continue to be received on this Fund. At 31st March 2016 the valuation of the Fund, based on the units held x the bid (selling) price amounted to £6.023m. The valuation as at 30th September 2016 was £5.806m a decrease in the Fund valuation of £217,000 (3.6%). Over this period values in the property sector were affected by the uncertainty which followed the referendum result. Overseas investors have been important supporters of the sector and there were doubts too about the demand for London properties in a 'hard Brexit' world. Since then values have eased slightly each month but with transactional evidence very thin, this appears to reflect more the caution of valuers than any selling pressure from investors. The downtrend seems to have lost momentum in September but realistically it will be a few months before conditions are truly back to normal.

5.22 CCLA interest (dividend) earnings to 30th September amounted to £151,000. It is anticipated that the annual interest earnings from the CCLA Property Fund investment will amount to £300,000 out of a total projected interest forecast of £350,000 (original estimate £448,000). Some funds have been moved from short-term investments where interest rates were performing at historically low levels. These funds were re-invested in, better performing, property purchases that generated a rental income. This, together with the decision to make an early repayment of £4m towards the pension fund deficit in September, has meant that there was less to invest in financial instruments. This would help to explain the variation in the projected forecast and the original budget for investment interest earnings.

5.23 Banks and building societies have availed themselves of cheaper funds through the Bank of England's Funding for Lending Scheme (FLS), first introduced in August 2012. The Scheme has subsequently been extended and currently runs until January 2018. Unfortunately this has had a detrimental effect on the Council's investment interest earnings.

<u>Prudential Indictors for Investments</u>

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

<u>Prudential Indicator 8 – Funds invested for greater than 364 days</u>

5.25 Maximum principal sum limits for investments for periods longer than 364 days maturing in:

2016/17	£12,000,000
2017/18	£12,000,000
2018/19	£12,000,000

5.26 <u>Projection (as at 30/09/16)</u>

Matured or maturing within 2016/17	£0
Maturing in 12 to 24 months (2017/18)	£0
Maturing in 24 to 36 months (2018/19)	£0
Maturing in 36 to 48 months (2019/20)	£0

Prudential Indicator 9 – Interest Rate Exposure (Investment & Debt)

5.27 Interest Rate Exposure on **Investments**

Upper limit for fixed interest rate exposure	100%
Upper limit for variable interest rate exposure	20%

5.28 Projection (as at 30/09/16)

Upper Limit for fixed interest rate exposure	60%
Upper limit for variable interest rate exposure	40%

During the first six months of 2016/17 funds have been moved from short-term investments where interest rates were performing at historically low levels. These funds were re-invested in, better performing, property purchases that generated a rental income. This trend will continue in the second half of 2016/17 (refer to paragraph 2) leaving only a sufficient level of funds to meet day to day cash flow requirements. This will mean that the projection shown at Prudential Indicator 9 (interest rate exposure on investments) will need amending from the original estimate as a higher percentage of investments in financial instruments will now be held in variable interest rate investments (eg CCLA see paragraphs 5.19 to 5.23) than in fixed term deposits.

5.29 The Deputy Chief Executive (Section 151 Officer) confirms that all of the Council's investments were placed with organisations approved in the Annual Treasury Management Strategy for 2016/17.

5.30 Interest Rate Exposure on **Debt**

Upper limit for fixed interest rate exposure	100%
Upper limit for variable interest rate exposure	20%

5.31 Projection (as at 30/09/16)

Upper Limit for fixed interest rate exposure	100%
Upper limit for variable interest rate exposure	20%

Prudential Indicator 10 – Maturity Structure of Borrowing

5.32 Maturity structure of fixed interest rate borrowing in 2016/17:

	Lower	Upper
Under 12 months	0%	25%
12 months to 2 years	0%	25%
2 years to 5 years	0%	25%
5 years to 10 years	0%	50%
10 years and above	0%	100%

5.33 Projection (as at 30/09/16)

	Lower	Upper
Under 12 months	0%	25%
12 months to 2 years	0%	25%
2 years to 5 years	0%	25%
5 years to 10 years	0%	50%
10 years and above	0%	100%

5.34 Risk Benchmarking

A regulatory development is the consideration and approval of security and liquidity benchmarks. Yield benchmarks are currently widely used to assess investment performance. Discrete security and liquidity benchmarks are fairly new requirements to Member reporting, although the application of these is more subjective in nature. These were first set in the Treasury Strategy Report 26th January 2010 (Scrutiny and Audit Committee). The following reports the current position against the benchmarks originally approved.

5.35 Security

The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, was set as follows:

0.07% historic risk of default when compared to the whole portfolio.

The Deputy Chief Executive (Section 151 Officer) can report that the investment portfolio was maintained within this overall benchmark during this year to date.

Based on the Authority's minimum long-term credit rating of A/A3/A (Fitch/Moody's/Standard and Poor's credit rating agencies) the security benchmarks for each individual year were set as:

Benchmarks	1 year	2 years	3 years	4 years	5 years
Maximum (01/04/16)	0.06%	0.20%	0.37%	0.58%	0.81%
Maximum (30/09/16)	0.07%	0.19%	0.36%	0.55%	0.77%

Since the benchmarks were first included in the Strategy our advisors have received more up to date default information, which reflects increased counterparty defaults during the banking crisis. The table shows how the Council is benchmarking risk.

The Deputy Chief Executive (Section 151 Officer) can report that these benchmarks were not breached during the year to date.

Note: The benchmarks are an average risk of default measure, and would not constitute an expectation of loss against a particular investment. Where a counterparty is not credit rated a proxy rating will be applied.

5.36 <u>Liquidity</u>

In respect of this area the Council set liquidity facilities/benchmarks to maintain:

- Bank overdraft - £100,000
- Liquid short term deposits of at least £2,000,000 available immediately.

The Deputy Chief Executive (Section 151 Officer) can report that liquidity arrangements were satisfactory during the year to date.

5.37 <u>Yield</u>

Local measures of yield benchmarks are:

- Investments – Internal returns above the 7 day LIBID (London Interbank BID) rate.

6. **Financial Implications** – are covered in the body of this report.

7. **Legal Implications**

The Council's treasury management activities are regulated by a variety of professional codes, statutes and guidance:

- The Local Government Act 2003 (the 2003 Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity.
- The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (no restrictions were made in the first six months of 2015/16).
- Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act.
- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA *Prudential Code for Capital Finance in Local Authorities.*
- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services.
- Under the Act the DCLG has issued *Guidance on Local Government Investments* to structure and regulate the Council's investment activities. Updated guidance became available on 1st April 2010.

The Council has complied with all of the above relevant statutory and regulatory requirements that limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

8. **CORPORATE IMPLICATIONS**

Monitoring Officer commentary – The Monitoring Officer confirms that all relevant legal implications have been taken into account.

S151 Officer commentary – The S151 Officer confirms that all financial implications have been taken into account.

Risk Implications – The Council considers security, liquidity and yield, in that order, when making investment decisions:

Security – counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swaps, gross domestic product (GDP) of the country in which the institution operates, the country's net debt as a percentage of GDP, any potential support mechanisms and share price. The minimum long-term counterparty credit rating determined for 2016/17 was A/A3/A (Fitch/Moody's/Standard and Poors).

Liquidity – the Council maintained a sufficient, though not excessive, level of liquidity during the half-year using various call accounts and short-term, fixed-rate, deposits.

Yield – the Council sought to optimise returns commensurate with its objectives of security and liquidity. Short-term money market rates remained at very low levels throughout the half-year which had a significant impact on investment income. This was exacerbated by the reduction in Base Rate from 0.50% to 0.25% on 4th August 2016.

A high reliance on investment income can place the Council at significant risk of budget variation as interest rates rise and fall, which has an impact upon future Council Tax levels. The Council's Medium Term Financial Strategy addresses this risk and seeks to reduce this reliance over time.

Locking significant investments into long-term fixed-rate transactions means the Council has a potential disadvantage in a rising interest market, especially if the interest rate rises above the assumption made when the long-term deal was placed.

To mitigate this, the Council's in-house team predominantly invest up to periods of three months only, hence advantage can be taken of prevailing interest rates upon the investments maturity. This minimises the disadvantage whilst maintaining certainty over the level of future return and stability in planned future Council Tax levels.

Security of capital is cited in the Financial Services Risk Register (FIN 06) and this is mitigated by use of counterparty credit security ratings. The lowering of these ratings increases risk. It is felt that a credit rating of A is acceptable for the Council's risk profile (being 'top six' out of a possible 28 ratings) and represents upper quartile performance (Appendix B refers). Officers will also use supplementary credit information to monitor investment counterparties.

Equalities Implications – There are no equalities implications arising as a direct consequence of this report.

Employment Issues - None within the report.

Sustainability Issues - None within the report.

Consultation - The Council is in regular contact with Capita Asset Services, the Council's appointed Treasury Management advisor. Conversations have been held during the first half-year involving Capita Asset Services and officers.

9. BACKGROUND PAPERS

Performance management information from Capita Asset Services.
CIPFA Treasury Management in the Public Services – Code of Practice and Cross-Sectoral Guidance Notes (2011 edition).
CIPFA Treasury Management in the Public Services – Guidance Notes for Local Authorities including Police Authorities and Fire Authorities (2011 edition).
CIPFA Prudential Code for Capital Finance in Local Authorities (2011 edition).
Treasury Management Annual Strategy Report 2016-17 and Prudential Indicators 2016-17 to 2018-19.

APPENDIX A

1. **Economic Update**

1.1 **Economic performance to date and outlook**

1.2 Commentary from Capita Asset Services.

1.3 **United Kingdom**

1.4 UK Gross Domestic Product (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 experienced difficult times for exporters from the appreciation during the year of sterling against the Euro, and weak growth in the European Union (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.

1.5 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 November 23rd.

1.6 The Inflation Report also included a sharp rise in the forecast for inflation to around 2.4% in 2018 and 2019. Consumer Price Index (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. 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 Monetary Policy Committee (MPC) is expected to look through 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.

1.7 **United States**

1.8 The American economy had a patchy 2015 with sharp swings in the growth rate leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 disappointed at +0.8% on an annualised basis while quarter 2 improved, but only to a lacklustre +1.4%. However, forward indicators are pointing towards a pickup in growth in the rest of 2016. The Federal Reserve embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene and then the Brexit vote, have caused a delay in the timing of the second increase which is now strongly expected in December this year.

1.9 **Eurozone**

1.10 In the Eurozone (EZ), the European Central Bank (ECB) commenced in March 2015 its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month. This was intended to run initially to September 2016 but was extended to March 2017 at its December 2015 meeting. At its December and March meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise from around zero towards the target of 2%. GDP growth rose by 0.6% in quarter 1 2016 (1.7% y/y) but slowed to +0.3% (+1.6% y/y) in quarter 2. This has added to comments from many forecasters that central banks around the world are running out of the means to stimulate economic growth and to boost inflation. They stress that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand in the their economies and economic growth.

1.11 **Japan and China**

1.12 Japan is still bogged down in weak growth and making little progress on fundamental reform of the economy while Chinese economic growth has been weakening and medium term risks have been increasing.

1.13 **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%

1.14 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 (Governor of the Bank of England), 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.

1.15 The overall longer run trend is for gilt yields and Public Works Loans Board (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. Capita's PWLB rate forecasts are based on the Certainty Rate (minus 20 basis points) which has been accessible to most authorities since 1st November 2012.

1.16 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 Federal Reserve rate increases, causing a further flight to safe havens (bonds).
- UK economic growth and increases in inflation are weaker than Capita currently anticipate.
- Weak growth or recession in the UK's main trading partners - the European Union and United States.

1.17 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 Federal Reserve 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 European Union and United States, causing an increase in the inflation premium inherent to gilt yields.

Appendix B – Hierarchy of Counterparty Security Ratings

Short Term		
Fitch	**Moody's**	**S&P**
F1+	P-1	A-1+
F1		A-1
F2	P-2	A-2
F3	P-3	A-3
B		B
C		C
D		D

Long Term			Description
Fitch	**Moody's**	**S&P**	(AAA = highest, D = lowest)
AAA	Aaa	AAA	Highest security
AA+	Aa1	AA+	
AA	Aa2	AA	
AA-	Aa3	AA-	
A+	A1	A+	
A	A2	A	
A-	A3	A-	
BBB+	Baa1	BBB+	
BBB	Baa2	BBB	
BBB-	Baa3	BBB-	
BB+	Ba1	BB+	
BB	Ba2	BB	
BB-	Ba3	BB-	
B+	B1	B+	
B	B2	B	
B-	B3	B-	
CCC+	Caa1	CCC+	
CCC	Caa2	CCC	
CCC-	Caa3	CCC-	
CC+	Ca	CC+	
CC	Ca	CC	
CC-	Ca	CC-	
C+	C	C+	
C	C	C	
C-	C	C-	
DDD	D	DDD	
DD	D	DD	
D	D	D	Lowest Security

Mole Valley District Council

Agenda Item 5(iii)

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Date	24 November 2016
Subject	Appointment of External Auditor

RECOMMENDATION

1.1 That the Committee recommends to Council that MVDC should opt in to the authorised national scheme for local auditor appointments, provided by Public Sector Audit Appointments, from 2018/19 onwards.

SUMMARY

2.1 All authorities need to decide how their Auditors will be appointed when the current, transitional arrangements finish in 2017/18. They may make the appointments themselves or subscribe to a national collective scheme which will take full responsibility for local auditor appointments, offering a high quality professional service and value for money.

Background

3.1 Following the demise of the Audit Commission, transitional arrangements were put in place for the appointment of local authority auditors. These arrangements expire after 2017/18.

3.2 A national scheme for appointing auditors to local authorities has been put together by Public Sector Audit Appointments (PSAA), supported by the LGA. The DCLG has approved and appointed PSAA to deliver and manage the scheme.

Public Sector Audit Appointments (PSAA)

4.1 PSAA is an independent, not-for-profit company established by the LGA and owned by the LGA's Improvement and Development Agency (IDeA). It already carries out a number of functions in relation to auditor appointment and therefore has significant experience in appointing auditors, managing contracts with audit firms and setting and determining audit fees.

4.2 In July 2016. PSAA was specified by the Secretary of State as an "appointing person" under regulation 3 of the Local Audit (Appointing Person) Regulations 2015.

4.3 The advantages of subscribing to the PSAA scheme are that it will:-

- Assure timely Auditor appointments
- Secure highly competitive prices
- Save on MVDC's procurement costs
- Save MVDC time and effort on creating auditor panels to carry out the appointment
- Focus on audit quality

- Operate on a not-for-profit basis, distributing any surplus funds to scheme members

4.4 Consultation with other authorities has indicated a high level of support for this approach. This will improve PSAA's bulk buying power and is likely to have a favorable impact on Audit prices for subscribing authorities.

Financial Implications

5.1 There will not be a fee to join the sector-led arrangement. The audit fees charged will cover the PSAA costs of appointing and managing.

Recommendation

6.1 Regulation 19 of the Local Audit (Appointing Persons) Regulations 2015 requires a decision to opt in to the national scheme must be made by Council. It is recommended that the Audit Committee recommend to Council, at its 6th December meeting, that MVDC subscribe to the national scheme.

Alternative option

7.1 The alternative is for MVDC to conduct its own procurement and establish an audit panel. This will be a far more resource intensive process and, without the bulk buying power of the sector led procurement, is likely to result in a more costly service.

What happens next?

8.1 The PSAA envisage the following timetable:-

- January 2017 – achieve sign-up of scheme members
- March 2017 – invite tenders from audit firms
- June 2017 – award contracts
- December 2017 – consult on and make final auditor appointments
- March 2018 – consult on, propose and publish fees

CORPORATE IMPLICATIONS

Legal Implications – Whilst the Council has a statutory duty to appoint external auditors, there are no legal implications arising as a direct result of this report.

Financial Implications – None at this stage, then as set out in the report.

Risk Implications – use of the PSAA minimizes the risk inherent in undertaking an individual procurement.

Equalities Implications – None contained within the report.

Employment Issues – None contained within the report.

Sustainability Issues – None contained within the report.

Consultation – contact with other authorities indicates a high degree of support for the sector led approach.