APPENDIX A

South Holland District Council

Treasury Management Strategy Statement and Annual Investment Strategy

Mid Year Review Report 2015/16

1.0 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 operations ensure 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 obligations. 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 Accordingly, treasury management is defined as:

"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

1.4 The Treasury Management function is administered by Compass Point Business Services on behalf of the Council.

1.5 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011 was adopted by this Council on 8 March 2012.

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 activities;
- 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 the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a **Mid-Year Review Report** and an Annual Report (stewardship report) covering activities during the previous year;
- 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 Governance and Audit Committee.

2.0 SUMMARY

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

- An economic update for the 2015/16 financial year to 30th September 2015;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure (prudential indicators);
- A review of the Council's investment portfolio for 2015/16;
- A review of the Council's borrowing strategy for 2015/16;
- A review of any debt rescheduling undertaken during 2015/16;
- A review of compliance with Treasury and Prudential Limits for 2015/16.

2.2 There are no key changes to the Treasury or Capital Strategy.

3.0 ECONOMIC UPDATE

3.1 Economic performance to date and outlook.

U.K.

UK Gross Domestic Product (GDP) growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again, possibly being equal to that of the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a rebound in quarter 2 to +0.7% (+2.4% y/y). Growth is expected to weaken to about +0.5% in quarter 3 as the economy faces headwinds for exporters from the appreciation 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, although the pace of reductions was eased in the May Budget. Despite these headwinds, the Bank of England August Inflation Report had included a forecast for growth to remain around 2.4 – 2.8% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that Consumer Price Index (CPI) inflation has fallen to, or near to, zero over the last quarter. Investment expenditure is also expected to support growth. However, since the report was issued, the Purchasing Manager's Index, (PMI), for services on 5 October would indicate a further decline in the growth rate to only +0.3% in Q4, which would be the lowest rate since the end of 2012. In addition, worldwide economic statistics and UK consumer and business confidence have distinctly weakened so it would therefore not be a surprise if the next Inflation Report in November were to cut those forecasts in August.

The August Bank of England Inflation Report forecast was notably subdued in respect of inflation which was forecast to barely get back up to the 2% target within the 2-3 year time horizon. However, with the price of oil taking a fresh downward direction and Iran expected to soon re-join the world oil market after the impending lifting of sanctions, there could be several more months of low inflation still to come, especially as world commodity prices have generally been depressed by the Chinese economic downturn.

There are therefore considerable risks around whether inflation will rise in the near future as strongly as had previously been expected; this will make it more difficult for the central banks of both the US and the UK to raise rates as soon as was being forecast until recently, especially given the recent major concerns around the slowdown in Chinese growth, the knock on impact on the earnings of emerging countries from falling oil and commodity prices, and the volatility we have seen in equity and bond markets in 2015 so far, which could potentially spill over to impact the real economies rather than just financial markets.

U.S.A

The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015. While there had been confident expectations during the summer that the Federal Reserve (Fed.) could start increasing rates at its meeting on 17 September, or if not by the end of 2015, the recent downbeat news about Chinese and Japanese growth and the knock on impact on emerging countries that are major suppliers of commodities, was cited as the main reason for the Fed's decision to pull back from making that start. The nonfarm payrolls figures for September and revised August, issued on 2 October, were disappointingly weak and confirmed concerns that US growth is likely to weaken. This has pushed back expectations of a first rate increase from 2015 into 2016.

Eurozone

In the Eurozone, the European Central Bank (ECB) fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing (QE) to buy up high credit quality government and other debt of selected Eurozone (EZ) countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This already appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to a significant improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and looks as if it may maintain this pace in quarter 3. However, the recent downbeat Chinese and Japanese news has raised questions as to whether the ECB will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

3.2 Interest rate forecast.

The Council's treasury advisor, Capita Asset Services, has provided the following forecast:

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%
5yr PWLB rate	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%
10yr PWLB rate	3.00%	3.20%	3.30%	3.40%	3.50%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%
50yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%

Capita Asset Services undertook its last review of interest rate forecasts on 11 August shortly after the quarterly Bank of England Inflation Report. Later in August, fears around the slowdown in China and Japan caused major volatility in equities and bonds and sparked a flight from equities into safe havens like gilts and so caused Public Works Loans Board (PWLB) rates to fall below the above forecasts for quarter 4 2015. However, there is much volatility in rates as news ebbs and flows in negative or positive ways and news in September in respect of Volkswagen, and other corporates, has compounded downward pressure on equity prices. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2016.

Despite market turbulence since late August causing a sharp downturn in PWLB rates, the overall trend in the longer term will be for gilt yields and PWLB rates to rise when economic recovery is firmly established accompanied by rising inflation and consequent increases in Bank Rate, and the eventual unwinding of QE. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

The disappointing US nonfarm payrolls figures and UK PMI services figures at the beginning of October have served to reinforce a trend of increasing concerns that growth is likely to be significantly weaker than had previously been expected. This, therefore, has markedly increased concerns, both in the US and UK, that growth is only being achieved by monetary policy being highly aggressive with central rates at near zero and huge QE in place. In turn, this is also causing an increasing debate as to how realistic it will be for central banks to start on reversing such aggressive monetary policy until such time as strong growth rates are more firmly established and confidence increases that inflation is going to get back to around 2% within a 2-3 year time horizon. Market expectations in October for the first Bank Rate increase have therefore shifted back sharply into the second half of 2016.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth turns significantly weaker than we currently anticipate.
- Weak growth or recession in the UK’s main trading partners - the EU, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or the start of Fed. rate increases, causing a flight to safe havens.

The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include:

- Uncertainty around the risk of a UK exit from the EU.
- The ECB severely disappointing financial markets with a programme of asset purchases which proves insufficient to significantly stimulate growth in the EZ.
- The commencement by the US Federal Reserve of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

4.0 TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY

4.1 The Treasury Management Strategy Statement (TMSS) for 2015/16 was approved by Council on 25th February 2015.

There are no policy changes to the TMSS, the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

5.0 THE COUNCIL'S CAPITAL POSITION (PRUDENTIAL INDICATORS)

This part of the report is structured to update:

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

5.1 Prudential Indicator for Capital Expenditure.

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

Capital Expenditure	**2015-16 Original Programme £'000**	**Position As At 30-09-15 £'000**	**2015-16 Latest Approved £'000**
General Fund	2,156	160	2,228
Housing Revenue Account (HRA)	7,256	1,731	7,500
Total	**9,412**	**1,891**	**9,728**

5.2 Changes to the Financing of the Capital Programme.

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements. The programme is fully funded without the need for external borrowing which means there are no future repayment implications (Minimum Revenue Provision).

The HRA capital programme is currently being examined and the estimate shown below for 2015-16 is likely to change when revised policies are agreed and authorised by council.

Capital Expenditure	**2015-16 Original Programme £'000**	**Position As At 30-09-15 £'000**	**2015-16 Latest Approved £'000**
General Fund	2,156	160	2,228
HRA	7,256	1,731	7,500
Total spend	**9,412**	**1,891**	**9,728**
Financed by:			
Capital receipts	550	122	697
Capital grants and Contributions	1,031	147	990
Direct Revenue Funding/Use of Reserves	7,831	1,622	8,041
Total financing	**9,412**	**1,891**	**9,728**
Borrowing need	**0**	**0**	**0**

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

The following table shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. Actions are in progress, which are likely to change / reduce the CFR position by the end of the financial year for Housing and non housing activities.

It also shows the expected debt position over the period. This is termed the Operational Boundary.

	2015-16 Original Estimate For Year End £'000	Position As At 30/09/15 £'000
CFR – non housing	1,983	1,907
CFR – housing	69,165	69,555
Total CFR	**71,148**	**71,462**
Net movement in CFR	**(500)**	**(355)**
Borrowing	86,456	67,456
Other long term liabilities	1,000	1,000
Total debt 31 March	**87,456**	**68,456**

5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2015/16 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2015-16 Original Estimate For Year End £'000	Position As At 30/09/15 £'000	2015-16 Revised Estimate For Year End £'000
Gross borrowing	67,469	67,456	67,456
Less investments	(16,673)	(31,342)	(23,137)
Net borrowing	**50,796**	**36,114**	**44,319**
CFR (year end position)	**71,148**	**71,462**	**TBA**

The Executive Director Commercialisation (Section 151 Officer) reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

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

Authorised limit for external debt	2015-16 Original Estimate £'000	Position As At 30/09/15 £'000	2015-16 Revised Estimate £'000
Borrowing	89,456	89,456	89,456
Other long term liabilities	1,000	1,000	1,000
Total	**90,456**	**90,456**	**90,456**

6.0 INVESTMENT PORTFOLIO 2015/16

6.1 In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk policy. As set out in Section 3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment, investment returns are likely to remain low.

The Council held £31.342m of investments as at 30 September 2015 (£23.477m as at 31 March 2015) and the investment portfolio yield for the first six months of the year is 0.685% against a benchmark of 0.43% (average 3 month LIBID).

Deposits held as at 30th September 2015 were as follows:

Institution	As at 31-03-15 £'000	As at 30-09-15 £'000
Lloyds Bank PLC (Current Account)	388	240
NatWest Bank (Instant Access)	2	2
Svenska Handelsbanken Bank (Instant Access)	4,987	4,950
CCLA Money Market Fund (Instant Access)	4,100	1,450
Nationwide BS	5,000	3,000
Lloyds Bank PLC	4,500	4,500
Royal Bank of Scotland	4,500	4,500
Barclays Bank	0	4,200
Standard Chartered Bank	0	5,000
Goldman Sachs International	0	3,500
TOTAL	**23,477**	**31,342**

The Section 151 Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2015/16.

The Council's budgeted investment return for 2015/16 is £154,800, and performance for the year to date is £106,320.

The Council monitors risk of its investment portfolio against the Capita Asset Services counterparty risk matrix. This matrix gives recommended maximum investment durations for each financial institution based on the ratings allocated by the major credit rating agency's and also takes into account credit default swap prices.

6.2 Investment Counterparty criteria

The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

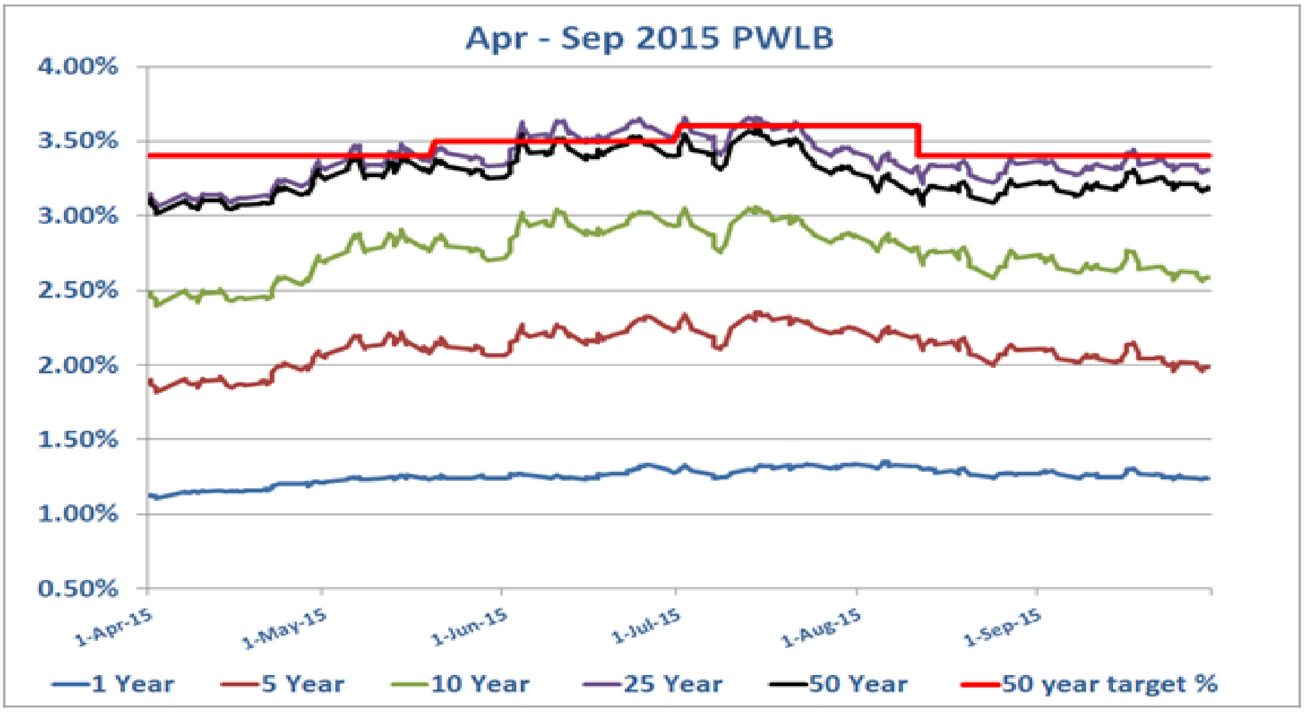
7.0 BORROWING

7.1 The Council's capital financing requirement (CFR) for 2015/16 is £71.462m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. The table at paragraph 5.4 shows the Council has borrowings of £67.456m in respect of the Housing Revenue Account self-financing settlement with no further requirements forecast at present.

As outlined below, the general trend has been an increase in interest rates during the first quarter but then a fall during the second quarter.

It is anticipated that further borrowing will not be undertaken during this financial year.

The graph below shows the movement in PWLB rates for the first six months of the year to 30th September 2015:



8.0 DEBT RESCHEDULING

8.1 The majority of the Councils debt was taken out in March 2012 as part of the HRA Financing Reforms. No major debt rescheduling opportunities have arisen in the year and none are planned to be available during the period of the latest Medium Term Financial Plan 2016/17 to 2019/20.