AUDIT AND ACCOUNTS COMMITTEE
28TH NOVEMBER 2018

TREASURY MANAGEMENT 2018-19 MID YEAR REPORT

1. Purpose of Report

1.1. This report provides an update on the Council's treasury activity and prudential indicators for the first half of 2018/19. As indicated in the report none of the Prudential Indicators have been breached and a prudent approach has been taken in relation to the investment activity, with priority being given to security and liquidity over yield.

2. Background Information

2.1. The Council's Treasury Management Strategy for 2018/19 was approved by Full Council on 8 March 2018 The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk is therefore central to the Council's Treasury Management Strategy.

2.2. Following consultation in 2017, CIPFA published new versions of the Prudential Code for Capital Finance in Local Authorities (Prudential Code) and the Treasury Management Code of Practice but has yet to publish the local authority specific Guidance Notes to the latter. In England MHCLG published its revised Investment Guidance which came into effect from April 2018.

2.3. The updated Prudential Code includes a new requirement for local authorities to provide a Capital Strategy, which is to be a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments.

2.4. The Code also recommends that members are informed of Treasury Management activities at least twice a year. This report therefore ensures that this Council is embracing best practice in accordance with CIPFA's recommendations.

2.5. 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".

3. Economic Background

3.1. **Appendix A** gives a report on the economic background from our Treasury Consultants, Arlingclose.

4. Regulatory Updates

4.1. *International Financial Reporting Standard (IFRS) 9 – Financial Instruments*: The new standard presents revised guidance on the classification and measurement of financial assets, including a new expected credit loss model for calculating impairment.

4.2. IFRS 9 replaces the 'incurred loss' model in IAS 39 with an 'expected credit loss' model, which means that a loss event will no longer need to occur before an impairment allowance is recognised.

4.3. The standard aims to address concerns about 'too little, too late' provisioning for loan losses, and will accelerate recognition of losses.

4.4. The accounting treatment of the expected credit loss model for the financial assets depends on the business model the initial investment was made on. There are three options with regard to the business model:

- Achieve objectives by collecting contractual cash flows;
- Achieve objectives by both collecting contractual cash flows and selling assets; and
- Achieve objectives by any other means that collecting cash flows.

4.5. Once the Business Model has been identified this then will identify the accounting treatment as either Amortised Cost, Fair Value through Other Comprehensive Income or Fair Value through Profit/Loss. Officers have prepared workings papers for all the current live investments that were held before IFRS9 was implemented, on the business model of 'achieve objectives by collecting contractual cash flows' and confirmed with our auditors, Mazars, that the impact would be immaterial. The table below shows a full instrument by instrument breakdown and the Business Model that has been proposed .

Counterparty	Balance at 31.3.18	Business Model
Bank Deposit/Notice Account		
Santander	£5,000,000	achieve objectives by collecting contractual cash flows
Handelsbanken	£5,000,000	achieve objectives by collecting contractual cash flows
Lloyds	£4,900,000	achieve objectives by collecting contractual cash flows
Money Market Fund		
Goldmans Sachs	£343,000	achieve objectives by collecting contractual cash flows
Deutsche Bank	£295,000	achieve objectives by collecting contractual cash flows
Invesco	£5,934,000	achieve objectives by collecting contractual cash flows
CCLA	£3,000,000	achieve objectives by collecting contractual cash flows
Other		
Trade Receivables	£4,666,417	achieve objectives by collecting contractual cash flows

4.6. Each new financial instrument that the Council enters into will now need to be assessed at the point of inception. Each instrument will be reviewed on an individual basis to find the correct business model, a framework will be included within the Investment Strategy and the

Treasury Management Strategy. This will then be reported back to this Committee.

4.7. MHCLG consulted on statutory overrides relating to the IFRS 9 Financial Instruments accounting standard from 2018/19. The consultation recognised that the requirement in IFRS 9 for certain investments to be accounted for as fair value through profit and loss may introduce “more income statement volatility” which may impact on budget calculations. The consultation proposed a time-limited statutory override and sought views whether it should be applied only to pooled property funds.

5. Treasury Management Strategy Statement and Annual Investment Strategy update

5.1. The Treasury Management Strategy Statement (TMSS) for 2018/19 was approved by Full Council on 8 March 2018. The indicator relating to Interest Rate Exposure was originally set based on cash flow forecasts of the total value of investments held on any given day. Due to the actual profiling of payments and receipts, officers feel that a percentage basis rather than a set value would allow this indicator to be managed more effectively. Below is the proposed change to the approved Prudential Indicator for the Interest Rate exposure which is contained within the TMSS 2018/19.

5.2. Current Indicator

	2018/19 £m	**2019/20 £m**	**2020/21 £m**
Fixed Rate			
Borrowing	124.2	124.2	124.2
Investments	-5	-5	-5
Net Upper limit on fixed rate exposure	**119.2**	**119.2**	**119.2**
Variable Rate			
Borrowing	31	31	31
Investments	-37.3	-37.3	-37.3
Net Upper Limit on variable rate exposure	**-6.3**	**-6.3**	**-6.3**

5.3. New Proposed Indicator

	2018/19	**2019/20**	**2020/21**
Fixed Rate			
Borrowing	100%	100%	100%
Investments	75%	75%	75%
Variable Rate			
Borrowing	20%	20%	20%
Investments	100%	100%	100%

6. Local Context

6.1. At 31/3/2018 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £125m, while usable reserves and working capital which are the underlying resources available for investment were £44.8m.

The table below shows the revised estimates for capital expenditure and the changes since the Capital Programme was agreed within the Capital Programme budget on 8 March 2018.

Capital Expenditure	2018/19 Capital Budget approved 8 March 2018 £m	Current Expenditure £m	2018/19 Revised Estimate £m
General Fund Expenditure	5.047	1.890	12.526
HRA Expenditure	17.614	5.585	19.878
Total Capital Expenditure	**22.661**	**7.475**	**32.404**

The financing of the Capital Programme will be determined by the S151 Officer at the year end based on best use of resources.

The increase from the Budget approved 8 March 2018 relates to approved capital carry forward requests and approved variations to the capital programme.

6.2. At 31/3/2018, the Council had £89m of borrowing and £24m of investments. The Council's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.

6.3. The Council has an increasing CFR over the next 2 years due to the Capital Programme and there may be a requirement to borrow up to £6.6m over the forecast period. However, if reserve levels permit, internal borrowing will be considered.

7. Borrowing Strategy

7.1. At 30/9/2018 the Council held £89m of loans, as part of its strategy for funding previous years' capital programmes.

7.2. **Borrowing Activity in 2018/19**

	Balance on 01/04/2018 £m	Balance on 30/09/2018 £m
Short Term Borrowing	7.815	7.562
Long Term Borrowing	81.580	81.580
TOTAL BORROWING	**89.395**	**89.142**
Other Long Term Liabilities	0.224	0.224
TOTAL EXTERNAL DEBT	**89.619**	**89.366**
CFR	124.681	124.681
Under / (over) borrowing	35.062	35.315

7.3. As the Council is in a significant under borrowed position, as per the table in 7.2, there may be a requirement during the remainder of the financial year where new borrowing is required. Any new borrowing will be within the approved Treasury Management Borrowing Strategy framework and will have been reviewed for cost effectiveness as whether to borrow shorter term or long term in relation to interest rate forecasts.

7.4. **PWLB Certainty Rate and Project Rate Update**: The PWLB introduced a 'Certainty Rate' for borrowing in 2013 which is 0.20% below the PWLB standard rate. The rate is made available for a 12 month period, in return for the Council providing advance information about its capital investment plans. During September 2018 the Council submitted its application to CLG via the new certainty rate form to access this reduced rate for a further 12 month period from 01/11/2018.

7.5. **LOBOs**: The Council holds £3.5m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. All of the £3.5m of LOBOS had options during the last 6 months, none of which were exercised by the lender. The Council acknowledges there is an element of refinancing risk even though in the current interest rate environment lenders are unlikely to exercise their options.

7.6. **Internal borrowing*:*** For the Council, the use of internal resources in lieu of borrowing has continued to be the most cost effective means of funding of capital expenditure that has not been funded from grants and other resources. This has lowered overall treasury risk by reducing both external debt and temporary investments. However this position will not be sustainable over the medium term as the Council needs to use reserves for the purpose they were set aside for, and external borrowing may need to be undertaken.

7.7. **Debt rescheduling*:*** The premium charge for early repayment of PWLB debt remains relatively expensive for the loans in the Council's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken or is proposed during the rest of the financial year as a consequence.

8. Investment Activity

8.1. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a return commensurate with these principles.

8.2. **Investment Activity in 2018/19**

Type of Investment	**Balance on 01/04/2018 £m**	**Balance on 30/09/2018 £m**	**Average Interest Rate**
Short term Investments:			
Fixed Term Deposits	9.900	9.900	0.68%
Money Market Funds	9.572	24.583	0.61%
Bank Call Account	5.000	0.050	0.20%
Total Short term Investments	**24.472**	**34.533**	

Long term Investments	0	0	
TOTAL INVESTMENTS	**24.472**	**34.533**	
Increase/ (Decrease) in Investments		10.061	

8.3. Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

9. Non-Treasury Investments

9.1. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return or regeneration purposes. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return or regeneration purposes.

9.2. As per section 4.5, these Non-Treasury Investments have also been reviewed for the impact of IFRS9, see breakdown below, and will need approval on the business model the investments are held under;

Counterparty	Balance at 31.3.18	Business Model
Growth Investment Fund	£597,267	achieve objectives by collecting contractual cash flows
Loans to Housing Associations	£22,994	achieve objectives by collecting contractual cash flows
Loans to Parish Councils	£18,570	achieve objectives by collecting contractual cash flows

These investments generated £0.023m of investment income for the Council after taking account of direct costs, representing a rate of return of 4.06%.

10. Prudential Indicators

10.1. The Council can confirm that it has complied with its Prudential Indicators for 2018/19, which was set on 8 March 2018 as part of the Council's Treasury Management Strategy Statement.

10.2. **Upper Limits for Fixed and Variable Interest Rate Exposure.** These indicators allow the Council to manage the extent to which it is exposed to changes in external interest rates.

£m	Approved 2018/19 £m	Actual to 30/09/2018 £m
Fixed		
Upper Limit for Exposure on Debt	124.2	86.1
Upper Limit for Exposure on Investments	-5	0
Net Fixed Exposure	**119.2**	**86.1**
Variable		
Upper Limit for Exposure on Debt	31	3.1
Upper Limit for Exposure on Investments	-37.3	-34.5
Net Variable Rate Exposure	**-6.3**	**-31.4**

10.3. **Maturity Structure of Fixed Rate Borrowing.** This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

	Upper Limit %	Actual at 30/09/18 £	Actual at 30/09/18 %	Compliance
Under 12 months	15%	£4.5m	5.2%	Yes
12-24 months	15%	£2.0m	2.3%	Yes
2-5 years	30%	£13.6m	15.8%	Yes
5-10 years	100%	£22.7m	26.4%	Yes
Over 10 years	100%	£43.3m	50.3%	Yes

10.4. **Principal Sums Invested for over 364 Days.** All investments were made on a short-term basis and there were no investments for more than 364 days.

10.5. **Authorised Limit and Operational Boundary for External Debt.** The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of their indebted status. This is a statutory limit which should not be breached. The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit. The s151 Officer confirms that there were no breaches to the Authorised Limit and the Operational Boundary during 2018/19.

	Approved Operational Boundary 2018/19 £m	Authorised Limit 2018/19 £m	Actual External Debt 30/09/18 £m
Borrowing	128.3	128.4	89.1
Other Long Term Liabilities	0.4	0.6	0.2
Total	**128.7**	**129.0**	**89.3**

11. Outlook for the remainder of 2018/19

11.1. **Appendix B** gives a summarised outlook for the rest of the current financial year from our Treasury Consultants, Arlingclose.

12. Banking Arrangements

12.1. Lloyds bank plc, the Councils current banking service providers, has reviewed its contractual arrangement with its local authority customers, the review concluded that each local authority is to enter into an agreement where a set off or transfer of credit balances in accounts held with the bank, in or towards the satisfaction of any liabilities can be carried out.

12.2. The Council has been successfully operating this process since transferring over to Lloyds in 2017 and the agreement allows the Council to continue to have credit and debit balances across all of its Lloyds bank accounts.

13. RECOMMENDATIONS that:-

(a) that members approve the new Prudential Indicator for Interest Rate Exposure contained within the Treasury Management Strategy as per section 5 and recommend to full Council on 11 December;

(b) the treasury activity be noted; and

(c) the Prudential Indicators detailed in Section 10 of the report be noted.

(d) the business model applied to all current investment re IFRS9, section 4.5 and section 9.2, is to 'achieve objectives by collecting contractual cash flows'.

(e) the Lloyds Set Off agreement as detailed at 12.1 and 12.2 is noted and approved.

Background Papers
Nil.

For further information please contact Andrew Snape, Assistant Business Manager – Financial Services on extension 5523.

N Wilson
Business Manager Financial Services

APPENDIX A

External Context

Economic background: Oil prices rose by 23% over the six months to around $82/barrel. UK Consumer Price Inflation (CPI) for August rose to 2.7% year/year, above the consensus forecast and that of the Bank of England's in its August *Inflation Report*, as the effects of sterling's large depreciation in 2016 began to fade. The most recent labour market data for July 2018 showed the unemployment rate at 4%, its lowest since 1975. The 3-month average annual growth rate for regular pay, i.e. excluding bonuses, was 2.9% providing some evidence that a shortage of workers is providing support to wages. However real wages (i.e. adjusted for inflation) grew only by 0.2%, a marginal increase unlikely to have had much effect on households.

The rebound in quarterly GDP growth in Q2 to 0.4% appeared to overturn the weakness in Q1 which was largely due to weather-related factors. However, the detail showed much of Q2 GDP growth was attributed to an increase in inventories. Year/year GDP growth at 1.2% also remains below trend. The Bank of England made no change to monetary policy at its meetings in May and June, however hawkish minutes and a 6-3 vote to maintain rates was followed by a unanimous decision for a rate rise of 0.25% in August, taking Bank Rate to 0.75%.

Having raised rates in March, the US Federal Reserve again increased its target range of official interest rates in each of June and September by 0.25% to the current 2%-2.25%. Markets now expect one further rise in 2018.

The escalating trade war between the US and China as tariffs announced by the Trump administration appeared to become an entrenched dispute, damaging not just to China but also other Asian economies in the supply chain. The fallout, combined with tighter monetary policy, risks contributing to a slowdown in global economic activity and growth in 2019.

The EU Withdrawal Bill, which repeals the European Communities Act 1972 that took the UK into the EU and enables EU law to be transferred into UK law, narrowly made it through Parliament. With just six months to go when Article 50 expires on 29th March 2019, neither the Withdrawal Agreement between the UK and the EU, which will be legally binding on separation issues and the financial settlement, nor its annex which will outline the shape of their future relationship, have been finalised, extending the period of economic uncertainty.

Financial markets: Gilt yields displayed marked volatility during the period, particularly following Italy's political crisis in late May when government bond yields saw sharp moves akin to those at the height of the European financial crisis with falls in yield in safe-haven UK, German and US government bonds. Over the period, despite the volatility, the bet change in gilt yields was small. The 5-year benchmark gilt only rose marginally from 1.13% to 1.16%. There was a larger increase in 10-year gilt yields from 1.37% to 1.57% and in the 20-year gilt yield from 1.74% to 1.89%. The increase in Bank Rate resulted in higher in money markets rates. 1-month, 3-month and 12-month LIBID rates averaged 0.56%, 0.70% and 0.95% respectively over the period.

Credit background: Reflecting its perceived higher risk, the Credit Default Swap (CDS) spread for non-ringfenced bank NatWest Markets plc rose relatively sharply over the period to around 96bps. The CDS for the ringfenced entity, National Westminster Bank plc, has held steady below 40bps. Although the CDS of other UK banks rose marginally over the period, they continue to remain low compared to historic averages.

The ringfencing of the big four UK banks - Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc – is complete, the transfer of their business lines into retail (ringfenced) and investment banking (non-ringfenced) is progressing and will need to be completed by the end of 2018.

There were a few credit rating changes during the period. Moody's downgraded Barclays Bank plc's long-term rating to A2 from A1 and NatWest Markets plc to Baa2 from A3 on its view of the credit metrics of the entities post ringfencing. Upgrades to long-term ratings included those for Royal Bank of Scotland plc, NatWest Bank and Ulster Bank to A2 from A3 by Moody's and to A- from BBB+ by both Fitch and Standard & Poor's (S&P). Lloyds Bank plc and Bank of Scotland plc were upgraded to A+ from A by S&P and to Aa3 from A1 by Moody's.

Our treasury advisor Arlingclose will henceforth provide ratings which are specific to wholesale deposits including certificates of deposit, rather than provide general issuer credit ratings. Non-preferred senior unsecured debt and senior bonds are at higher risk of bail-in than deposit products, either through contractual terms, national law, or resolution authorities' flexibility during bail-in. Arlingclose's creditworthiness advice will continue to include unsecured bank deposits and CDs but not senior unsecured bonds issued by commercial banks.

APPENDIX B

Outlook for the remainder of 2018/19

Having raised interest rates in August 2018 to 0.75%, the Bank of England's Monetary Policy Committee (MPC) has maintained expectations of a slow rise in interest rates over the forecast horizon.

The MPC has a definite bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. While policymakers are wary of domestic inflationary pressures over the next two years, it is believed that the MPC members consider both that (a) ultra-low interest rates result in other economic problems, and that (b) higher Bank Rate will be a more effective weapon should downside Brexit risks crystallise and cuts are required.

Arlingclose's central case is for Bank Rate to rise twice in 2019. The risks are weighted to the downside. The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in Q2 2018, but the annual growth rate of 1.2% remains well below the long term average.

	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Ca	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**	**1.25**
Downside risk	0.00	0.00	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75

The view is that the UK economy still faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Central bank actions and geopolitical risks, such as prospective trade wars, have and will continue to produce significant volatility in financial markets, including bond markets.