CABINET – 15TH NOVEMBER 2018

Report of the Head of Finance and Property Services

Lead Member: Councillor Tom Barkley

Part A

ITEM 9 TREASURY MANAGEMENT UPDATE – MID-YEAR REVIEW FOR THE 6 MONTHS ENDED 30TH SEPTEMBER 2018

Purpose of Report

This report reviews the Treasury Management Strategy and the Annual Investment Strategy, plus the various Prudential Borrowing and Treasury Indicators for the first six months of 2018/19.

Recommendations

That it be recommended to Council to note this mid-year review of the Treasury Management Strategy Statement, Prudential Borrowing and Treasury Indicators plus the Annual Investment Strategy, as shown in Part B.

Reasons

To ensure that the Council's governance and management procedures for Treasury Management reflect best practice and comply with the Revised CIPFA Treasury Management in the Public Services Code of Practice, Guidance Notes and Treasury Management Policy Statement, that funding of capital expenditure is taken within the totality of the Council's financial position and that borrowing and investment is only carried out with proper regard to the Prudential Code for Capital Finance in Local Authorities.

Policy Justification and Previous Decisions

The Treasury Management Strategy Statement, Prudential & Treasury Indicators and Annual Investment Strategy must be approved by Council each year and reviewed half yearly. This review is set out in the attached report as Part B. The Strategy for the year was approved by Council on 26th February 2018 (minute ref: 80.3).

Implementation Timetable including Future Decisions and Scrutiny

This report will be available for Overview Scrutiny Group on 12th November 2018, should they wish to consider it, and for the Audit Committee on 27th November 2018.

Report Implications

The following implications have been identified for this report.

Financial Implications

There are no direct financial implications arising from this report.

Risk Management

There are no direct risks arising from the recommendation in this report. Risks associated with the Treasury Policy etc in general are included in Part B.

Key Decision:	No
Background Papers:	None
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Part B

Treasury Management Update – Half Year Ended 30th September 2018

Background

1. In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued revised Prudential and Treasury Management Codes. As from 2019/20, all local authorities will be required to prepare a Capital Strategy which is intended to provide the following: a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services; an overview of how the associated risk is managed; and the implications for future financial sustainability. A report setting out our Capital Strategy will be taken to the full Council, (or Cabinet, with responsibility retained by the full Council), in February 2019.

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

3. 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.

4. Accordingly, treasury management is defined as:

   "The management of the local authority's borrowing, 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."

5. This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).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.
- 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 Audit Committee.

6. This 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 first part of the 2018/19 financial year;
   - 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 2018/19;
   - A review of the Council's borrowing strategy for 2018/19;
   - A review of any debt rescheduling undertaken during 2018/19;
   - A review of compliance with Treasury and Prudential Limits for 2018/19.

7. This is a mid-year report therefore there are no proposed changes to the Treasury and Capital Strategies at this point.

<u>Economic Background</u>

<u>UK</u>

8. The first half of 2018/19 has seen UK economic growth post a modest performance, but sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase Bank Rate on 2nd August from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, the Bank of England's August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019, albeit there were several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

9. Some MPC members have expressed concerns about a build-up of inflationary pressures, particularly with the pound falling in value again against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation rose unexpectedly from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019.

10. As for the labour market, unemployment has continued at a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high in July, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 2.9%, (3 month average regular pay, excluding bonuses) and to a one month figure in July of 3.1%. This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 0.4%, near to the joint high of 0.5% since 2009. (The previous high point was in July 2015.) Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC were right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy. However, the MPC will need to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit.

11. In the political arena, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along the route to Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

USA

12. President Trump's massive easing of fiscal policy is fuelling a (temporary) boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2, but also an upturn in inflationary pressures. With inflation moving towards 3%, the Fed increased rates another 0.25% in September to between 2.00% and 2.25%, this being four increases in 2018, and indicated they expected to increase rates four more times by the end of 2019. The dilemma, however, is what to do when the

temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019.

EUROZONE

13. Growth was unchanged at 0.4% in quarter 2, but has undershot early forecasts for a stronger economic performance in 2018. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of 2% for 2018, the horizon is less clear than it seemed just a short while ago.

CHINA

14. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

JAPAN

15. Japan has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

Interest Rate Forecast

16. The Council's treasury advisor, Link Asset Services, has provided the following forecast:

Link Asset Services Interest Rate View	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate View	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
3 Month LIBID	0.75%	0.80%	0.80%	0.90%	1.10%	1.10%	1.20%	1.40%	1.50%	1.60%	1.60%
6 Month LIBID	0.85%	0.90%	0.90%	1.00%	1.20%	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%
12 Month LIBID	1.00%	1.00%	1.00%	1.10%	1.30%	1.30%	1.40%	1.60%	1.70%	1.80%	1.80%
5yr PWLB Rate	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
10yr PWLB Rate	2.40%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%

17. The flow of generally positive economic statistics after the end of the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, to 0.75%. However, the MPC emphasised again, that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary nor contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years' time but they declined to give a medium term forecast. We do not think that the MPC will increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. We also feel that the MPC is more likely to wait until August 2019, than May 2019, before the next increase, to be followed by further increases of 0.25% in May and November 2020 to reach 1.5%. However, the cautious pace of even these limited increases is dependent on a reasonably orderly Brexit.

The Balance of Risks to the UK

18. The overall balance of risks to economic growth in the UK is probably neutral. The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

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

- Bank of England monetary policy takes action too quickly over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March of a government which has made a lot of anti-austerity noise. This is likely to lead to friction with the EU when setting the target for the fiscal deficit in the national budget. Unsurprisingly, investors have taken a dim view of this and so Italian bond yields have been rising.
- Austria, the Czech Republic and Hungary now form a strongly anti-immigration bloc within the EU while Italy, this year, has also elected a strongly anti-immigration government. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position as a result of the rise of the anti-immigration AfD party. To compound this, the result of the Swedish general election in September 2018 has left an anti-immigration party potentially holding the balance of power in forming a coalition government. The challenges from these political developments could put considerable pressure on the cohesion of

the EU and could spill over into impacting the euro, EU financial policy and financial markets.

- The imposition of trade tariffs by President Trump could negatively impact world growth. President Trump's specific actions against Turkey pose a particular risk to its economy which could, in turn, negatively impact Spanish and French banks which have significant exposures to loans to Turkey.
- Weak capitalisation of some European banks.
- Rising interest rates in the US could negatively impact emerging countries which have borrowed heavily in dollar denominated debt, so causing an investor flight to safe havens e.g. UK gilts.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

20. Upside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- President Trump's fiscal plans to stimulate economic expansion causing a significant increase in inflation in the US and causing further sell offs of government bonds in major western countries.
- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.
- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- UK inflation, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

<u>Treasury Management Strategy Statement and Annual Investment Strategy update</u>

21. The Treasury Management Strategy Statement (TMSS) for 2018/19, which includes the Annual Investment Strategy, was approved by Council on 26th February 2018 (Council Minute 80.3 2017/18). 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 appetite.

22. 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.

23. As shown by forecasts in paragraph 16, 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 current 0.75% 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 and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

24. In the current economic climate it is considered not only appropriate to keep some investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with highly credit rated financial institutions, using the Council's creditworthiness approach including sovereign credit rating and Credit Default Swap (CDS) overlay information. In addition, the Annual Investment Strategy allows the Council to invest in property funds and provide loans to other Local Authorities for a maximum of 2 years.

25. The approved limits within the Annual Investment Strategy were not breached during the six months ended 30th September 2018.

26. The average level of funds available for investment purposes during the half year was £51.52m. The majority of these funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme.

27. During the six months to 30th September 2018, the Council's interest rate earned on investments excluding property funds was 0.67% against a benchmark of 3 month London Interbank Bid Rate (LIBID) of 0.61%. This measure is used as a comparator because it allows comparisons with the Council's benchmarking group and matches the weighted average time period of the Council's current investments. Although the return rate is low, our performance can still be considered to be good as we exceeded the target rate.

28. The interest rate earned by the Council's property funds for Q1 was 1.8% This is a reasonable rate in comparison to the benchmark Q1 rate for property fund investments of 1.6% supplied by Link Asset Management.

29. The actual interest received to 30th September 2018 was £174k, against an annual budget of £300k so the Council performed above target in both percentage and actual returns for the six months. It is proposed to review the investment income budget as part of 2019/20 budget setting in light of the higher than budgeted returns being achieved.

New Borrowing

30. No new borrowing was undertaken during the half year and neither has the Council borrowed in advance of need during the six months ended 30th September 2018. Similarly, no debt rescheduling was undertaken during the half year.

Compliance with Treasury and Prudential Limits

31. It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. The Council's approved Treasury and Prudential Indicators (affordability limits) are included in the approved TMSS.

32. During the financial year to date, the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices. The prudential and treasury Indicators are shown in Appendix 1.

Additional Information

33. New regulations are coming into force with regards to the operation and regulatory structure of Money Market Funds, as part of wider reforms aimed at strengthening the resilience of the financial markets. This involves funds being re-categorised as Variable Net Asset Value (VNAV) or Low-volatility Net Asset Value (LVNAV) funds. This should not present any issues in terms of the funds that the Council invests in as the important consideration is that the funds remain AAA money market fund rated.

34. **UK Banks ring-fencing** The largest UK banks, (those with more than £25bn of retail / Small and Medium-sized Enterprise (SME) deposits), are required, by UK law, to separate core retail banking services from their investment and international banking activities by 1st January 2019. This is known as "ring-fencing". Whilst smaller banks with less than £25bn in deposits are exempt, they can choose to opt up. Several banks are very close to the threshold already and so may come into scope in the future regardless.

35. Ring-fencing is a regulatory initiative created in response to the global financial crisis. It mandates the separation of retail and SME deposits from investment banking, in order to improve the resilience and resolvability of banks by changing their structure. In general, simpler, activities offered from within a ring-fenced bank, (RFB), will be focused on lower risk, day-to-day core transactions, whilst more complex and "riskier" activities are required to be housed in a separate entity, a non-ring-fenced bank, (NRFB). This is intended to ensure that an entity's core activities are not adversely affected by the acts or omissions of other members of its group.

36. While the structure of the banks included within this process may have changed, the fundamentals of credit assessment have not. The Council will continue to assess the new-formed entities in the same way that it does others and those with sufficiently high ratings, (and any other metrics considered), will be considered for investment purposes.

37. **IFRS9 Accounting Standard** This accounting standard came into effect from 1st April 2018. It means that the category of investments valued under the available for sale category will be removed and any potential fluctuations in market valuations may impact onto the Surplus or Deficit on the Provision of Services, rather than being held on the balance sheet. This change is unlikely to materially affect the commonly used types of treasury management investments but more specialist types of investments, (e.g. pooled funds, third party loans, commercial investments), are likely to be impacted. The impact on the Council is likely to be minimal as the Council's exposure is limited to the property fund investments and these are kept under constant review in terms of their value and relative performance.

38. The Ministry of Housing, Communities and Local Government (MHCLG), are currently conducting a consultation for a temporary override to allow English local authorities time to adjust their portfolio of investments. Members will be updated when the result of this consultation is known.

39. **Changes in risk appetite** The 2018 CIPFA Codes and guidance notes have placed enhanced importance on risk management. Where an authority changes its risk appetite e.g. for moving surplus cash into or out of certain types of investment funds or other types of investment instruments, this change in risk appetite and policy should be brought to members' attention in treasury management update reports.

<u>Appendices</u>

Appendix 1: Prudential and Treasury Indicators as at 30th September 2018

Appendix 2: Investment Portfolio – Investments held as at 30th September 2018

Appendix 3: Glossary of Terms

APPENDIX 1:

Prudential and Treasury Indicators as at 30th September 2018

Treasury Indicators	2018-19 Budget £'000	30/09/18 Actual £'000
Authorised limit for external debt	96,000	81,190
Operational boundary for external debt	81,190	81,190
Gross external debt	81,190	81,190
Investments	32,603	51,630
Net borrowing	48,587	29,560

Prudential Indicators	2018/19 Budget £'000	30/09/18 Actual £'000
Capital expenditure – General Fund	**5,213**	**940**
Capital expenditure – HRA	**7,566**	**681**
Capital Financing Requirement (CFR) – GF	**-248**	**-248**
Capital Financing Requirement (CFR) – HRA	**81,820**	**81,820**
Annual change in CFR	**0**	**0**

In year external borrowing requirement	**0**	**0**
Ratio of financing costs to net revenue stream - GF	**-0.37%**	**-0.37%**
Ratio of financing costs to net revenue stream - HRA	**12.45%**	**12.45%**
<u>Incremental impact of capital investment decisions</u>:-		
Increase in council tax (band change) per annum.	**0%**	**0%**
Increase in average housing rent per week	**0%**	**0%**

For convenience a Glossary of Terms is provided at Appendix 3.

APPENDIX 2:

Investment Portfolio

Investments held as at 30th September 2018

Institution	**Maturity Date**	**Interest Rate** %	**Principal** £'000
Loans to other local authorities			
Liverpool City Council	25/01/2019	0.70	2,000
Bournemouth Borough Council	27/09/2019	0.72	2,000
Bank deposits and Money Market funds			
Close Brothers	26/10/2018	0.80	2,000
Nationwide Building Society	12/11/2018	0.64	2,000
Sumitomo Mitsui Banking Corporation Europe	17/12/2018	0.78	2,000
Standard Chartered Bank	35 Day Notice	0.78	8,000
Bank of Scotland	95 Day Notice	0.80	8,000
Goldman Sachs International Bank	180 Day Notice	0.75	5,000
Santander	180 Day Notice	0.95	8,000
Federated MMF	1 Day Notice	0.70	7,000
Insight MMF	1 Day Notice	0.62	630
Property funds			
Lothbury Property Fund	N/A		2,500
Hermes Property Fund	N/A		2,500
Total			**51,630**

APPENDIX 3:

Glossary of Terms

Capital Financing Requirement

CFR is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period, which is termed the Operational Boundary.

The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's indebtedness and so it's underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the indebtedness in line with each assets life, and so charges the economic consumption of capital assets as they are used.

Operational Boundary

The operational boundary is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt and the ability to fund under-borrowing by other cash resources.

Authorised Limit for External Debt

A further key prudential indicator represents a control on the maximum 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.

Gross External Debt

This is the total amount borrowed by the Council at a point in time. At 30th September 2018 the figure of £81,190 equates to £79,190k HRA and £2,000k market loan (General Fund).

Investments

The budgeted figure is the estimated average funds available for investment during the year. The actual figure is the total amount invested as at 30th September 2018.

Net Borrowing

Net borrowing is gross external debt less investments.

Ratio of financing costs to net revenue stream

This ratio looks at net interest payable as a proportion of revenue (broadly council tax and government grants in respect of the General Fund, rental income in respect of the HRA). Essentially, this is an indicator of the Council's ability to service its loans.

In this mid-year (and previously) interest receivable has exceeded interest payable for the General Fund producing a negative number for net interest payable and a somewhat odd looking negative ratio; this can be construed as indicating that the Council has no issues servicing General Fund loans at this time.