

Report

Audit Committee

Part 1

Date: 22 November 2018

Item No: 6

Subject **Report on Treasury Management for the period to 30 September 2018**

Purpose This report is to inform the Audit Committee of treasury activities undertaken during the period to 30 September 2018 and confirms that all treasury and prudential indicators have been adhered to in the first half of the financial year.

Author Assistant Head of Finance

Ward General

Summary The Council continues to be both a short term investor of cash and borrower to manage day-to-day cash flows. Current forecasts indicate that in the future, temporary borrowing will continue to be required to fund normal day to day cash flow activities.

All borrowing and investments undertaken during the first half of the year was expected and within the Council's agreed limits.

Proposal **To note the report on treasury management activities for the period to 30 September 2018 and provide comments to Council.**

Action by Head of Finance

Timetable Immediate

This report was prepared after consultation with:

- Treasury Advisors
- Head of Finance

Please list here those officers and members you have consulted on this report.

Signed

BACKGROUND

1. The Council's Treasury Management Strategy and Prudential Indicators were approved by Council in February 2018 alongside the Medium Term Financial Plan and the 2018/19 Budget.
2. The Treasury Management Strategy for 2018/19 has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year. The Code also recommends that members are informed of Treasury Management activities at least twice a year. This report therefore ensures this authority is embracing best practice in accordance with CIPFA's recommendations.
3. 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.
4. 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. The Authority will be producing its Capital Strategy later in 2018/19 for approval by full Council.
5. The Welsh Government (WG) asked for comments on changes to its Guidance on Minimum Revenue Provision (MRP). These include clarification or changes to terminology and the calculation of MRP.
6. The report has been prepared in accordance with the CIPFA Treasury Management Code and the Prudential Code, and reviews and reports on:
 - Borrowing Strategy / Activity
 - Investment Strategy / Activity
 - Economic Background
 - Compliance with Prudential Indicators approved by Council

BORROWING STRATEGY / ACTIVITY

Short and Long Term Borrowing

7. Whilst the Council has significant long term borrowing requirements, the Council's current strategy of funding capital expenditure is through reducing investments ('internal borrowing') rather than undertaking new borrowing i.e. we defer taking out new long term borrowing and fund capital expenditure from day to day positive cash-flows for as long as we can.

By using this strategy the Council can also minimise cash holding at a time when counterparty risk remains high. The interest rates achievable on the Council's investments are also significantly lower than the current rates payable on long term borrowing and this remains the main reason for our current 'internally borrowed' strategy.

8. Whilst the strategy minimises investment counterparty risk, the risk of interest rate exposure is increased as the current low longer term borrowing rates may rise in the future. The market position is being constantly monitored in order to minimise this risk.
9. As shown in Appendix B, during the first half of the year the amount of borrowing has reduced by a small amount of £0.7m to £146.8m, this relates to loans which we have taken out on an interest and principal repayment basis.

10. No further long term loans have been taken out in the first half of the financial year. However, it is anticipated that the Council will need to undertake additional borrowing on a short term basis for the remainder of the year in order to cover normal day to day cash flow activity. With current estimates it is not expected that any additional long-term borrowing would be required in this financial year. However, the £40m stock issue is maturing on 10th April 2019, therefore is the possibility if it is deemed beneficial to do so with advice from our external advisors that we would take out borrowing early if the cost of carry is favourable.
11. Appendix B summarises the Council's debt position as at 30 September 2018. The changes in debt outstanding relate to the raising and repaying of temporary loans.
12. In regards to LOBOs, no loans were called during the period. All £30m outstanding is subject to potential change of interest rates by the lender (which would automatically trigger a right to the Council to repay these loans) prior to the end of this financial year. Should a change of interest rate be requested, then it will be considered in detail and a decision on how we proceed will be made in conjunction with our treasury advisors.

INVESTMENTS ACTIVITY / POSITION

13. The Council's strategies in this area of Treasury Management are (i) to be a short term and relatively low value investor and (ii) investment priorities should follow the priorities of security, liquidity and yield, in that order.

The Council's strategy of being a short-term investor has been maintained, though the repayment of the Friar's Walk loans has increased cash holdings temporarily. In line with our strategy, this will be allowed to reduce over the next year or so. As at 30 September 2018, there was a £22.6m balance of short-term investments.

14. All investments are placed on a temporary basis and are placed in high security institutions, in line with our other strategy in this area, dealing with our investing priorities of (i) security (ii) liquidity and (iii) yield, in that order. At the 30 September 2018 £21.0m was placed with various local authorities and £1.6m with Santander Call Account with the maximum maturity date of 14 June 2019.
15. January 2018 saw the implementation in the UK of the second Markets in Financial Instruments Directive (MiFID II), where firms will be obliged to treat all local authorities as retail clients unless they opt up to professional client status and meet certain criteria. These criteria include holding a minimum of £10m investment balance and employing knowledgeable and experienced staff to carry out investment transactions. It is anticipated that our investment balances will remain well above the minimum £10m, until the start of 2019/20, when the stock issue of £40m will be due, at this point the Council will need re-finance and undertake new long-term borrowing.
16. The Council does not hold any long-term (more than 364 days) investments as at 30 September 2018.

OTHER MID YEAR TREASURY MATTERS

Economic background and Counter Party Update

17. Appendix A outlines the underlying economic environment during the first half of the financial year, as provided by the Council's Treasury Management Advisors Arlingclose.
18. As discussed previously in this report the Council does not have any long-term investments, and the investments that it currently undertakes is mainly with other local authorities which are deemed very secure, therefore the risk is currently limited. There were no significant changes in credit ratings advised in the first half of the financial year that had implications for the approved lending list. The long term rating of Santander UK, the Council's bankers, remains at A above the Council's minimum

level of A-.

Compliance with Prudential Indicators approved by Council

19. The Authority measures and manages its exposures to treasury management risks using various indicators which can be found in Appendix B. The Authority has complied with the Prudential Indicators for 2018/19, set in March 2018 as part of the Treasury Management Strategy. Details of treasury-related Prudential Indicators can be found in Appendix B.

Risks

Risk	Impact of Risk if it occurs* (H/M/L)	Probability of risk occurring (H/M/L)	What is the Council doing or what has it done to avoid the risk or reduce its effect	Who is responsible for dealing with the risk?
Investment counterparty not repaying investments	High but depending on investment value	Low	The Council only invests with Institutions with very high credit scores. It employs advisors to monitor money market movements and changes to credit scores and acts immediately should things change adversely. The lower levels of funds available for investment will also alleviate the risk.	Members, Head of Finance, Treasury staff, based on advice from treasury advisors
Interest Rates moving adversely against expectations	Low	Low	Despite recent increase in the bank rate to 0.75%, future expectations for higher short term rates are subdued. The Treasury strategy approved allows for the use of short term borrowing once investment funds are exhausted to take advantage of these low rates.	Head of Finance, Treasury staff, treasury advisors

* Taking account of proposed mitigation measures

Links to Council Policies and Priorities

It is the Council's policy to ensure that the security of the capital sums invested is fully recognised and has absolute priority. The Council follows the advice of the Welsh Governments that any investment decisions take account of security, liquidity and yield in that order.

Options Available

The Prudential Code and statute requires that, during and at the end of each financial year, reports on these matters are presented to Council for approval. Thus the only option available is consider the report and provide comments to the Council.

Preferred Option and Why

Note the contents of the report and provide comments to the Council.

Comments of Chief Financial Officer

Decisions made on treasury matters will be made with a view the Treasury Management Strategy, Treasury Advisors and Prudential Indicators.

Comments of Monitoring Officer

There are no legal implications. The in-year and annual treasury management report is consistent with relevant Chartered Institute of Public Finance and Accountancy Guidance, Treasury Management principles and the Council's investment strategy.

Staffing Implications: Comments of Head of People and Business Change

There are no staffing implications arising from this report.

Comments of Cabinet Member

N/A.

Background Papers

Treasury Management Strategy report to Audit Committee January 2018.

Report to Council February 2018: 2018/19 Budget and Medium Term Financial Plan

Dated: 04 November 2018

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%, which it has remained at since.

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 net 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 money market 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

The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in table 1 below.

Table 1: Balance Sheet Summary

	31.3.18 Actual £m
General Fund CFR	282.2
Less: Other debt liabilities *	-45.1
Borrowing CFR	237.1
Less: Usable reserves	-102.9
Less: Working capital	4.0
Net borrowing	130.2

* finance leases, PFI liabilities and transferred debt that form part of the Authority's total debt

The Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

The treasury management position as at 30 September 2018 and the change over the period is show in table 2 below.

Table 2: Treasury Management Summary

	31.3.18 Balance £m	Movement £m	30.9.18 Balance £m	30.9.18 Rate %
Long-term borrowing	145.5	(40.7)	104.8	4.44
Short-term borrowing	2.0	40.0	42.0	8.48
Total borrowing	147.5	(0.7)	146.8	5.60
Long-term investments	-	-	-	-
Short-term investments	(21.0)	-	(21.0)	0.75
Cash and cash equivalents	(3.2)	1.6	(1.6)	0.65
Total investments	(24.2)	1.6	(22.6)	0.74
Net borrowing	123.3	0.9	124.2	N/A

Borrowing Strategy during the half year

At 30th September 2018 the Authority held £146.8m of loans, (a decrease of £0.7m on 31st March 2018), as part of its strategy for funding previous years' capital programmes. The 30th September 2018 borrowing position is show in table 3 below.

Table 3: Borrowing Position

	31.3.18 Balance £m	Movement £m	30.9.18 Balance £m	30.9.18 Weighted average rate %	30.9.18 Weighted average maturity years
Public Works Loan Board	70.5	(0.7)	68.8	4.50	15.8
Banks (LOBO)	30.0	0	30.0	4.43	35.7
Banks (fixed-term)	5.0	0	5.0	3.77	59.4
Stock Issue	40.0	0	40.0	8.875	0.5
Local authorities (long-term)	0	0	0	-	-
Local authorities (short-term)	2.0	0	2.0	0.62	0
Total borrowing	147.5	(0.7)	146.8	5.60%	17.0

The Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective.

In keeping with these objectives, no new long term borrowing was undertaken while £0.7m of existing loans were allowed to mature without replacement. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

The "cost of carry" analysis performed by the Authority's treasury management advisor Arlingclose did not indicate any value in borrowing in advance for future years' planned expenditure and therefore none was taken.

The Authority continues to hold £30m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the first half of 2018/19.

Investment Activity

The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the first half of 2018/19 the Authority's investment balance ranged between £20m and £46m due to timing differences between income and expenditure. The investment position during the half year is shown in table 4 below.

Table 4: Investment Position

	31.3.18 Balance £m	Movement £m	30.9.18 Balance £m	30.9.18 Weighted average rate %	30.9.18 Weighted average maturity Years
Banks & building societies (unsecured)	1.0	0.6	1.6	0.65	0
Government (incl. local authorities)	20.0	1.0	21.0	0.75	0.28
Total investments	21.0	1.6	22.6	0.74	0.28

Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The

Authority'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.

Compliance Report

The Head of Finance is pleased to report that all treasury management activities undertaken during the first half of 2018/19 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 5 below.

Table 5: Investment Limits

	30.9.18 Actual (£m)	2018/19 Limit (£m)	Complied
Any single organisation, except UK Central Government	1.6	£10m	✓
UK Central Government	21.0	Unlimited	✓
Any group of organisations under the same ownership	0	£10m per group	✓
Registered Providers	0	£5m	✓
Loans to unrated corporates	0	£5m	
Unsecured investments with Building Societies	0	£5m	✓

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 6 below.

Table 6: Debt Limits

	H1 Maximum (£m)	30.9.18 Actual (£m)	2018/19 Operational Boundary (£m)	2018/19 Authorised Limit (£m)	Complied
Borrowing	150	147	197	217	✓
PFI & finance leases	45	45	46	46	✓
Total debt	195	192	243	263	✓

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Treasury Management Indicators

The Authority measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures: This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed was:

	30.9.18 Actual	2018/19 Limit	Complied
Upper limit on fixed interest rate exposure	100%	100%	✓
Upper limit on variable interest rate exposure	0	50%	✓

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

Maturity Structure of Borrowing: This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing were:

	30.9.18 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	22%	70%	0%	✓
12 months and within 24 months	27%	60%	0%	✓
24 months and within 5 years	6%	60%	0%	✓
5 years and within 10 years	23%	50%	0%	✓
10 years and within 20 years	7%	30%	0%	✓
20 years and within 30 years	0%	20%	0%	✓
30 years and within 40 years	10%	20%	0%	✓
40 years and within 50 years	2%	20%	0%	✓
50 years and above	3%	20%	0%	✓

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than 364 days: The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2018/19	2019/20	2020/21
Actual principal invested beyond year end	0	0	0
Limit on principal invested beyond year end	40	10	10
Complied	✓	✓	✓

Outlook for the remainder of 2018/19

Having raised policy 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.