Subject: **2018/19 TREASURY MANAGEMENT MID YEAR REPORT**

Report to: **Policy and Resources Committee 27 November 2018**

Report by: Finance Director

SUBJECT MATTER

This report presents for the 2018/19 financial year the following:

- **the mid-year position for treasury management;**
- **the borrowing requirement and debt for the current financial year;**
- **the mid-year borrowing position;**

compared with the Treasury Management Strategy.

Recommendations:

Members are asked to approve the treasury management half yearly report for 2018/19.

1. INTRODUCTION AND BACKGROUND

1.1 The Authority adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2011 Edition (the CIPFA code) which requires the Authority to approve treasury management semi-annual and annual reports.

1.2 The Authority's treasury management strategy for 2018/19 was approved at the meeting of the Council in February 2018. The Authority 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 are therefore central to the Authority's treasury management strategy.

1.3 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. In England MHCLG published its revised Investment Guidance which came into effect from April 2018.

1.4 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 alongside the budget.

2. NATIONAL CONTEXT AND ECONOMIC COMMENTRY

2.1 Economic background: 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.

2.2 The Bank of England made no change to monetary policy at its meetings in May and June, however there was an unanimous decision for a rate rise of 0.25% in August, taking Bank Rate to 0.75%.

2.3 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. The ongoing relationship between the UK and the EU has not been finalised leading to uncertaintity in economic forecasts which we will continue to monitor.

2.4 Financial markets and credit background: There has been gilt yields volatility over the period. 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.

2.5 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.

2.6 There were a few credit rating changes during the period. Moody's downgraded Barclays Bank plc's long-term rating to A2 from A1 deposits held with Barclays are compliant with TMSS and meet Arlingclose recommendations of being less than 6 months.

2.7 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.

2.8 At the budget for 2018, it was announced that in order to help solve the 'housing crisis', the Government would scrap the borrowing cap limitations on how much councils can borrow against their HRA Assets. The budget stated that the HRA debt cap would be removed with immediate effect and the new determination came into force on 29th October 2018. There will be implications to the treasury management strategy and these will be reported separately and reflected in the 2019/20 strategy, including a review of the indicators to ensure that these are set appropriately. The current authorised limit for borrowing is £140 million and the Council is still under this, in the short term it is not envisaged that this would be exceeded however the limit will need to be reviewed and updated as applicable as work on the future HRA business plan is completed.

3. LOCAL CONTEXT

3.1 On 31st March 2018, the Authority had net borrowing of £93.7m arising from its revenue and capital income and expenditure. 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**	**30.09.18 £m**
General Fund CFR	£50.013	£52.125
HRA CFR	£81.542	£82.902
Total CFR	**£131.555**	**£135.027**
Less: *Other debt liabilities	(£1.010)	(£1.010)
Borrowing CFR	**£130.546**	**£134.017**
Less: Long term investments	(£2.000)	(£2.000)
Less: Usable reserves	(£26.139)	(£27.275)
Less: Working capital	(7.244)	(£11.032)
Net borrowing	**£95.163**	**£93.710**

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

3.2 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 at 30th September 2018 and the change over the period is shown 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 Short-term borrowing	£81.388 £28.504	£27.413 (£17.913)	£108.801 £10.591	1.25 - 4.95% 0.75 -11.00%
Total borrowing	**£109.892**	**£9,500**	**£119.392**	
Long-term investments Short-term investments Cash and cash equivalents	£2.000 0 £12.729	0 0 £10.944	£2.000 0 £23.682	4.69% **0.0 – 0.62%**
Total investments	**£14.729**	**£10.944**	**£25.682**	
Net borrowing	**£95.163**	**(£1.444)**	**£93.710**	

Note: the March figures in the table are from the balance sheet in the Authority's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments

3.3 The decrease in net borrowing in table 1 has translated into a rise in investment balances due to the Authority's internal borrowing policy. The £18m decrease in short term borrowing has arisen from refinancing low cost short term borrowing with low cost long term borrowing from the Local Authority lending market. The Authority repaid £18m of loans at 0.77% to 0.95% and borrowed £26m at 1.25% to 1.45% from other Local Authorities over two to three year terms. These loan rates compare favourable to similar term loans from Public Works Loan Board (PWLB) which accrue interest at 1.54% to 1.60%.

3.4 Short term borrowing includes a £0.5m loan at 11% interest which was taken out in December 1983 and is due to be repaid on 14 December 2018. Once this high cost loan is repaid the range of interest rates on short term borrowing will be 0.75% to 4.95%.

4. BORROWING ACTIVITY – MID YEAR

4.1 At 30th September 2018 the Authority held £119.392m of loans, an increase of £9.500m, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30th September are summarised in Table 3 below.

Table 3: Borrowing Position	31.3.18 Balance £m	Movement £m	30.9.18 Balance £m	30.9.18 Rate %	30.9.18 Maturity years
Public Works Loan Board	£71.388	£0.000	£71.388	3.15% - 4.40%	10 - 40 years
Banks (LOBO)	£3.000	£0.000	£3.000	4.95%	1 - 2 years
Banks (fixed-term)	£7.500	£0.000	£7.500	3.35% - 11.00%	<1 to 60 years
Local authorities (long-term)	£0.000	£26.000	£26.000	1.25% - 1.45%	1 - 3 years
Local authorities (long-term capital repayment)	£0.000	£1.418	£1.418	4.44%	1 - 14 years
Local authorities (short-term capital repayment)	£0.000	£0.082	£0.082	4.44%	<1 year
Local authorities (short-term)	£28.004	(£18.000)	£10.004	0.75%	<1 year
Total borrowing	**£109.892**	**£9.500**	**£119.392**		

4.2 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.

4.3 In furtherance of keeping with these objectives, new loans totalling £27.500m were borrowed from Local Authorities and £18.000m was repaid. The long term maturity loans of £26.000m are due within 1 – 3 years. The Authority also borrowed £1.500m on a capital repayment basis as part funding for a commercial unit at Beacon Park. This capital repayment loan is split between long-term repayment schedule (1-14 years) and short-term repayment schedule (less than one year). This strategy enabled the Authority to reduce net borrowing costs and reduce overall treasury risk.

4.4 With short-term interest rates remaining much lower than long-term rates, the Authority considered it to be more cost effective in the near term to use internal resources or forward borrowed on a short-term basis (within year only). The net movement in loans is shown in table 3 above.

4.5 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 has been undertaken.

4.6 LOBO loans: The Authority continues to hold £3m 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 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 period.

5. INVESTMENT ACTIVITY

5.1 The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held and any money borrowed in advance of need. During the first half of 2018/19 the Authority’s investment balance ranged between £11.945 million and £36.445 million, due to timing differences between income and expenditure. The investment position during the first six months of the year is shown in table 4 below.

Table 4: Treasury Investment Position	**31.3.18 Balance £m**	**Movement £m**	**30.9.18 Balance £m**	**Average Rate %**
Banks & building societies (unsecured)	£5.244	(£4.716)	£0.528	0.0%
Money Market Funds	£8.945	£1.140	£10.085	0.46%
DMO	£0	£12.940	£12.940	0.50/0.51%
Total investments	**£14.189**	**£9.364**	**£23.553**	

5.2 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 treasury investments before seeking the optimum 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. Due to the general low level of investment balances and for the purpose of liquidity during the first half of 2018/19, the investments were primarily in Money Market Funds and DMO.

Table 5: Investment Benchmarking	Balance £m	Short term / Money Market Fund			
		Fitch	Moody's	S&P	Arlingclose Limit £000
Barclays Bank Plc*	£1.220	F1	P-1 *-	A-1	
Goldman Sachs International Bank	£1.085	AAAmmf	Aaa-mf	AAAm	£51.300
Standard Life (Ignis)	£3.000	AAAmmf	-	AAAm	£61.000
Aberdeen Asset Management PLC	£3.000	AAAmmf	Aaa-mf	AAAm	£72.000
Insight/Northern Trust	£3.000	AAAmmf	-	AAAm	£120.400
DMO	£12.940	F1+	Aa2	A-1+u	
Total	**£24.245**				
* Includes operational cash					

*The 2018/19 TMSS set the limit per pooled fund at £3m with which the authority complied

5.3 Non-Treasury Investments

5.4 The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. 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.

5.5 The Authority also holds £44m of such investments in*:*

- directly owned investment property £44m
- shareholding in subsidiaries £0.5m
- loans to subsidiaries £1.5m
- other totalling £3.3m (including £2.9m of which are home improvement loans)

5.6 These investments are expected to generate £1.8m of investment income for the Authority after taking account of direct costs. This income is over a number of properties which provide varying rates of return.

6. FINANCIAL IMPLICATIONS – COMPLIANCE REPORT

6.1 The following sections reports the compliance of the treasury management activities undertaken during the first half of 2018/19 compared to the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 6 below.

Table 6: Investment Limits	**2018/19 Maximum £m**	**30.9.18 Actual £m**	**2018/19 Limit £m**	**Complied? Yes/No**
Any single organisation, except the UK Government	£2.000	£1.220	£2.000	✓
Any group of organisations under the same ownership	£2.000	£1.220	£2.000 per group	✓
UK Central Government	Unlimited	£12.940	Unlimited	✓
Money Market Funds	£10.000	£10.085	£3.000 per fund £10.000 in total	No

6.2 The Authority exceeded the investment limits in table 6 above during the first 6 months of 2018/19. The Money Market Funds maximum limit of £10.000m and the Authority had invested at the highest £15.000m and at the lowest £10.085m during this period, this was due to the Authority having higher retained cash balances than anticipated, and considered our strategic goals of security, liquidity and return and chose the Money Market Funds as the most appropriate to achieve the strategic goals.

6.3 Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below.

Table 7: Debt Limits	**2018/19 Maximum* £m**	**30.9.18 Actual £m**	**2018/19 Authorised Limit £m**	**2018/19 Operationa l Boundary Limit £m**	**Complied? Yes/No**
Borrowing	£125.392	£119,392	£140.000	£135.000	✓
Long term liabilities, PFI and finance leases	£2,000	£1,010	£2.000	£2.000	✓
Total debt	**£127.392**	**£120.402**	**£142.000**	**£137.000**	✓

'Maximum' is the highest actual outstanding borrowing at any point during the first six months of 2018/19.

6.4 The authorised limit for external debt represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit is set by Council as part of the annual treasury management strategy. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the long term. The operational boundary is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be similar to the CFR, but may be lower or higher depending on the levels of actual debt.

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

6.6 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 all borrowing were:

Maturity Structure of Borrowing	30.09.18 Actual £000	Upper Limit	Lower Limit	Complied
Under 12 months	9%	20%	0%	
12 months and within 24 months	12%	40%	0%	✓
24 months and within 5 years	12%	60%	0%	✓
5 years and within 10 years	0%	80%	0%	✓
10 years and above	66%	100%	0%	✓

6.7 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. The Authority utilised the low cost Local Authority lending market to increase its liquidity resilience and reduce costs by taking out low rate, short term loans.

6.8 This led to the Authority exceeding the short term borrowing limit of its approved Treasury Management Strategy between 1 December 2017 and 18 May 2018. On 16 May 2018 the Authority reduced its short term borrowing by taking out longer term loans at below PWLB rates and repaid short term borrowing of £12.000m.

6.9 The longer term loans were for £11.500m for 2 years at 1.3% and £1.500m for 3 years at 1.4%. Following the refinancing of debt in May 2018 the amount due in less than 12 months was £16.5000m or 14.9% of the total debt. Therefore subsequently our maturity of borrowing has remained compliant.

6.10 Principal Sums Invested for Periods Longer than 365 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:

Principal Sums Invested for Periods Longer than 365 days	2018/19 £m	2019/20 £m	2019/21 £m
Actual principal invested beyond year end	Nil	Nil	Nil
Limit on principal invested beyond year end	£12.000	£12.000	£12.000
Complied?	✓	✓	✓

7. OUTLOOK FOR THE REMAINDER OF 2018/19.

7.1 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.

7.2 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 current downside risks crystallise and cuts are required.

7.3 Arlingclose anticipates two rate rises of 0.25% each in 2019/20 with a year end base rate of 1.25%. There is a degree of uncertaintity in the economic forecast that we will continue to monitor.

8. FINANCIAL AND RISK IMPLICATIONS

8.1 The financial implications and risks are outlined in the report, and are largely related to the impact of interest rate changes. An element of the financial risk implications can be mitigated by the fact that the Council maintains a general reserve balance which includes an allowance for changes in interest rate that can be used in the short term.

9. RECOMMENDATIONS

9.1 Members are asked to approve the treasury management half yearly report for 2018/19.

10. BACKGROUND PAPERS

10.1 Treasury Management Strategy 2018/19
Treasury Management Outturn report 2017/18
Arlingclose updates and reports

Appendix A

TREASURY MANAGEMENT INDICATORS

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

Security: The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Security	**30.9.18 Actual**	**2018/19 Target**	**Complied**
Portfolio average credit rating	**AA-**	**A**	✓

Liquidity: The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount [of cash available to meet unexpected payments within a rolling three-month period, and the amount it can borrow each period without giving prior notice.

Liquidity	**30.9.18 Actual £m**	**2018/19 Target £m**	**Complied**
Total cash available without notice	£11.305	£10.000	✓
Bank Overdraft	£0	£0.250	✓
Total sum borrowed in past 3 months without prior notice	£27.500	not set	

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 a proportion of net principal borrowed was:

Interest Rate Exposures	**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%	100%	✓

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.