Treasury Management Report Q1 2018/19

Introduction

In March 2012 the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports. This report provides an additional quarterly update.

The Authority's treasury management strategy for 2018/19 was approved at a meeting of the Authority on 7 March 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.

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.

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.

External Context

Economic background: Commodity prices fell during the quarter, although oil prices rose, peaking at $75 a barrel before falling slightly to just over $73. The primary factor in the oil price's recent fall was the OPEC's (Organisation of Petroleum Exporting Countries) announcement that a deal had been reached with non-OPEC nations to increase nominal production by 1 million barrels a day.

UK Consumer Price Inflation (CPI) index fell over the quarter and the data released for May showed CPI at 2.4%, a 12-month low. The most recent labour market data for April 2018 showed the unemployment rate at 4.2%, a low last seen in 1975. However real wages (i.e. adjusted for inflation) grew only by 0.4%, a marginal increase unlikely to have had much effect for households. Q1 GDP data released in April and revised in May showed economic activity slowing to 0.2%. 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 have raised expectations of a rate hike at the August meeting.

Having raised rates in March, the US Federal Reserve again increased its target range of official interest rates in June by 0.25% to between 1.75% and 2% and markets now expect two further rises in 2018.

Fears rose of a global trade war on the announcement of the Trump Administration implementing tariffs on $200bn of imports, notably steel, aluminium, food and chemicals. Canada, the EU and China contemplated announced retaliatory tariffs as did Mexico. Many of these have since been instituted in early July. The announcements sparked a sell-off in global equity markets, with the

major equity global indices falling.

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 a vote of 319 to 303, after the government gave assurances that Parliament would have a meaningful vote in the event of a no-deal Brexit. Very little progress was made in negotiating future trading arrangements, extending the period of uncertainty.

Financial markets: Gilt yields displayed marked volatility during the quarter, 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. The yield on the 5-year benchmark gilt fell from 1.13% to 1.04% during the quarter, the 10-year gilt fell from 1.36% to 1.28% and the yield on the 20-year gilt rose marginally from 1.71% to 1.72%. Money markets rates remained low: 1-month, 3-month and 12-month LIBID rates averaged 0.38%, 0.55% and 0.84% in the quarter respectively.

Credit background: UK bank credit default swaps rose marginally over the quarter, but the overall level was still low against historic averages.

There were a few credit rating changes during the quarter. Moody's downgraded Barclays Bank Plc's long-term rating to A2 from A1 after the banking group completed its restructure to be compliant with UK bank ring-fencing requirements which come into effect in 2019. The agency also downgraded Royal Bank of Scotland plc's (RBS plc) long-term ratings to Baa2 from A3 on its view that the credit metrics of RBS plc, which will become the non-ring-fenced NatWest Markets plc, will become weaker and less diversified and the main functions of the bank would be in higher risk activities. Moody's and Fitch upgraded the long-term ratings of NatWest Bank and Ulster Bank on the view that their credit profiles are expected to improve following ring-fencing.

Local Context

On 31st March 2018, the Authority had net borrowing of £39m 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 £000
General Fund CFR	42,923
HRA CFR	74,134
Total CFR	**117,057**
Less: Usable reserves	(66,899)
Less: Working capital	(11,034)
Net borrowing	**39,124**

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 June 2018 and the change in the quarter is show in Table 2 below.

Table 2: Treasury Management Summary

	31.3.18 Balance £000	Q1 2018 Movement £000	30.6.18 Balance £000	30.6.18 Rate %
Long-term borrowing	83,292		83,292	
Short-term borrowing	2,223		2,223	
Total borrowing	**85,515**	**0**	**85,515**	**3.40%**
Long-term investments	25,564	436	26,000	
Short-term investments	17,410	(5,000)	12,410	
Cash and cash equivalents	3,417	6,126	9,543	
Total investments	**46,391**	**1,562**	**47,953**	**1.24%**
Net borrowing	**(39,124)**		**(37,562)**	

Borrowing Strategy during the quarter

At 30th June 2018 the Authority held £85.5m of loans, a similar position to 31st March 2018, as part of its strategy for funding previous years' capital programmes. The quarter-end borrowing position is show in Table 3 below.

Table 3: Borrowing Position

	31.3.18 Balance £m	Q1 Movement £m	30.6.18 Balance £m	30.6.18 Weighted Average Rate %
Public Works Loan Board	82,515	0	82,515	3.35
Banks (LOBO)	3,000	0	3,000	4.75
Total borrowing	**85,515**		**85,515**	

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 borrowing was undertaken. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

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 borrowed rolling temporary / short-term loans instead.

As the Authority has an increasing CFR due to the capital programme and an estimated borrowing requirement as determined by the Liability Benchmark which also takes into account usable reserves and working capital.

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 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 quarter 1.

Treasury Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the quarter, the Authority's investment balance ranged between £45.8 and £47.9 million due to timing differences between income and expenditure. The investment position during the quarter is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.18 Balance £000	**Q1 2018 Movement £000**	**30.6.18 Balance £000**	**30.6.18 Rate of Return %**
Banks & building societies (unsecured)	383	(286)	97	0.08
Government (incl. local authorities)	17,410	(5,000)	12,410	0.94
Money Market Funds	3,034	6,412	9,446	0.50
Other Pooled Funds :				
- *Short-dated bond funds*	8,000	0	8,000	0.85
- *Strategic bond funds*	5,900	100	6,000	4.42
- *Property funds*	5,744	256	6,000	4.58
- *Multi asset income funds*	5,921	79	6,000	4.57
Total investments	**46,391**	**1,562**	**47,953**	

The balance of the other pooled funds at 31.3.18 includes accounting adjustments of £435k for unrealised losses, which were included at year-end for statutory reporting purposes (and separately reversed out through a non-useable reserve, as permitted). These have been excluded from the balance at 30.6.18, as the pooled funds are longer term investments and no loss is expected by the time of sale. Therefore the Q1 movement on other pooled funds represents the removal of the unrealised losses to restate the funds at book value, and not any increased investment in the respective funds.

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.

In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the Authority has diversified into more secure and higher yielding asset classes. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2018	3.63	AA-	15%	34	-0.23
30.06.2018	4.03	AA-	43%	18	0.78
Similar LAs	**4.37**	**AA-**	**61%**	**98**	**1.51**
All LAs	**4.46**	**AA-**	**62%**	**42**	**1.28**

*Weighted average maturity

The Authority's £26m of externally managed pooled investment funds generated an average total return of 1.14%, comprising a 3.89% income return which is used to support services in year, offset by 2.75% of capital loss (which is unrealised and does not affect the Council's budget at this time). Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives is regularly reviewed. In light of their performance and the Authority's latest cash flow forecasts, investment in these funds has been maintained.

Other Investment Activity

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 to generate a profit.

On 30 November 2016 Council approved the Property Investment Strategy. This approved investing up to £200m in commercial and residential property, either directly or through a property company, primarily in order to increase economic regeneration and also to generate returns.

In September 2017 the purchase of the freehold of the B&Q retail warehouse at White Cliffs Business Park, Dover was completed as the first acquisition under this initiative. After allowing for annual costs including borrowing (based on PWLB over 40 years) and management the resulting retained income is forecast to be £268k per annum, a net return of 1.6%.

In December 2017 a second site, Whitfield Court, was purchased. The site is located in the White Cliffs Business Park and the Council want to ensure the long term stability of the area. The site is a multi-let business park comprising 14 office and light industrial units totalling 45,636 sq. ft. After allowing for annual costs including borrowing (based on PWLB over 40 years) and management the resulting retained income is forecast to be £120k per annum, a net return of 2.65%.

Treasury Performance

The Authority measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in table 6 below.

Table 6: Performance

	Actual £000	Budget £000	Over/ under	Actual %	Benchmark %	Over/ under
Interest received	1,013	999	14	1.96	0.55	1.41
Interest payable	2,884	2,884	0	3.40	3.40	0

Compliance

The Director of Finance is pleased to report that all treasury management activities undertaken during quarter 1 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 7 below.

Table 7: Investment Limits

	30.6.18 Actual	2018/19 Limit	Complied?
Any single organisation, except the UK Government	£10.5m	£8m per bank	✓
Any group of pooled funds under the same management	0	£16m per group	✓
Negotiable instruments held in a broker's nominee account	0	£15m	✓
UK Government	£1.9m	Unlimited	✓
Unsecured investments with building societies	0	£8m	✓
Pooled Investment Funds	£26m	£10m per fund	✓
Operating bank	0.05m	£20m	✓
Money Market Funds	£9.4m	£10m per fund	✓

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 8 below.

Table 8: Debt Limits

	Q1 Maximum £m	30.6.18 Actual £m	2018/19 Operational Boundary £m	2018/19 Authorised Limit £m	Complied?
Borrowing	85.5	85.5	333	338.5	✓

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.

Security: The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score 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.

	30.6.18 Actual	2018/19 Target	Complied?
Portfolio average credit score	3.58	6.0	✓

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, without additional borrowing excluding deposits due back < 3 months.

	30.6.18 Actual	2018/19 Target	Complied?
Total cash available within 3 months	£9.5m	£8m	✓

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 amount of net principal was:

	30.6.18 Actual	2018/19 Limit	Complied?
Upper limit on fixed interest rate exposure	£85.5m	£300m	✓
Upper limit on variable interest rate exposure	0	£90m	✓

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 all borrowing were:

	30.6.18 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	£2.2m	25%	0%	✓
12 months and within 24 months	£3.5m	50%	0%	✓
24 months and within 5 years	£7.5m	50%	0%	✓
5 years and within 10 years	£15m	100%	0%	✓
10 years and above	£57.3m	100%	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 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:

	2018/19	2019/20	2019/21
Actual principal invested beyond year end	0	0	0
Limit on principal invested beyond year end	£30m	£30m	£30m
Complied?	✓	✓	✓

Outlook for the remainder of 2018/19

The MPC has maintained expectations of a rise in interest rates this year. Arlingclose's central case is for Bank Rate is to rise once in 2018 and twice more in 2019. The MPC has a definite bias towards tighter monetary policy. While policymakers are wary of domestic inflationary pressures over the next two years, it is believed that the MPC members consider both that: 1) ultra-low interest rates result in other economic problems, and that 2) higher Bank Rate will be a more effective weapon should downside Brexit risks crystallise.

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

Arlingclose's 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.