Treasury Management Report Q2 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.

The Authority's treasury management strategy for 2018/19 was approved at a meeting 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 is 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: Oil prices rose by 23% over the six months to around $82/barrel. UK Consumer Price Inflation (CPI) for August rose to 2.7% year/year, above the consensus forecast and that of the Bank of England's in its August *Inflation Report*, as the effects of sterling's large depreciation in 2016 began to fade. The most recent labour market data for July 2018 showed the unemployment rate at 4%, its lowest since 1975. The 3-month average annual growth rate for regular pay, i.e. excluding bonuses, was 2.9% providing some evidence that a shortage of workers is providing support to wages. However, real wages (i.e. adjusted for inflation) grew only by 0.2%, a marginal increase unlikely to have had much effect on households.

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

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

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

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

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

Credit background: Reflecting its perceived higher risk, the Credit Default Swap (CDS) spread for non-ringfenced bank NatWest Markets plc, rose relatively sharply over the period to around 96bps. The CDS for the ringfenced entity, National Westminster Bank plc, has held steady below 40bps. Although the CDS of other UK banks rose marginally over the period, they continue to remain low compared to historic averages.
The ringfencing of the big four UK banks - Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc – is complete, the transfer of their business lines into retail (ringfenced) and investment banking (non-ringfenced) is progressing and will need to be completed by the end of 2018.

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

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

<u>Local Context</u>

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.

<u>Table 1: Balance Sheet Summary</u>

	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 September 2018 and the change during the period is show in Table 2 below.

<u>Table 2: Treasury Management Summary</u>

	31.3.18 Balance £000	**Movement £000**	**30.9.18 Balance £000**	**30.9.18 Rate %**
Long-term borrowing	83,292		83,292	
Short-term borrowing	2,223	1,897	4,120	
Total borrowing	**85,515**	**1,897**	**87,412**	**3.40%**
Long-term investments	25,564	12,436	38,000	
Short-term investments	17,410	(7,410)	10,000	
Cash and cash equivalents	3,417	(1,118)	2,299	
Total investments	**46,391**	**3,908**	**50,299**	**2.02%**
Net borrowing	**(39,124)**		**(37,113)**	

After carrying out a review of the Council's long term financial position it was decided to invest an additional £12m into long-term investments during in the quarter, comprising a further £4m in the Investec Diversified Income fund and £8m in the CCLA Diversified Income Fund.

Borrowing Strategy during the period

At 30th September 2018 the Authority held £87.4m of loans, as part of its strategy for funding previous years' capital programmes. This is an increase of £1.9m since 31st March 2018, consisting of a £3m temporary loan for cashflow purposes, less a £1.1m repayment on the 'HRA' PWLB loan. Outstanding loans at 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 Weighted Average Rate %**
Public Works Loan Board	82,515	(1,103)	81,412	3.35
Banks (LOBO)	3,000	0	3,000	4.75
Local authorities (short-term)	0	3,000	3,000	0.80
Total borrowing	**85,515**	**1,897**	**87,412**	

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 for capital financing purposes was undertaken. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. A short term loan was taken out on the 28th September for one month to cover cash flow fluctuations.

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 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 the period.

Treasury Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the six-month period, the Authority's investment balance ranged between £45.9 and £50.3 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.18 Balance £000	Net Movement £000	30.9.18 Balance £000	30.9.18 Rate of Return %
Banks & building societies (unsecured)	383	366	749	0.13
Government (incl. local authorities)	17,410	(7,410)	10,000	0.75
Money Market Funds	3,034	(1,484)	1,550	0.66
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	4.36
- Multi asset income funds	5,920	12,080	18,000	4.07
Total investments	**46,391**	**3,908**	**50,299**	

The balance of the other pooled funds at 31.3.18 includes accounting adjustments of £436k 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 30.9.18, as the pooled funds are longer term investments and no loss is expected by the time of sale. Therefore the Q2 movement on other pooled funds represents the removal of the unrealised losses to restate the funds at book value, as well as an increased investment in the respective funds of £12m.

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. During the quarter a further £12m was invested in longer term investments. 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
30.09.2018	4.49	AA-	59%	74	2.15
Similar LAs	**4.28**	**AA-**	**56%**	**88**	**1.41**
All LAs	**4.38**	**AA-**	**60%**	**37**	**1.25**

*Weighted average maturity

The Authority's £38m of externally managed pooled funds generated an average total return of 1.13%, comprising a 3.89% income return which is used to support services in year, offset by a 2.75% 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 increased. A further £12m has been placed in multi-asset funds during the quarter. The Investment with the Investec Diversified Income has been increased to £10m (from £6m) and a new multi-asset fund was opened with the CCLA and £8m was deposited on the 20th September.

MHCLG consulted on statutory overrides relating to the IFRS 9 Financial Instruments accounting standard from 2018/19. The consultation recognised that the requirement in IFRS 9 for certain investments to be accounted for as fair value through profit and loss may introduce "more income statement volatility" which may impact on budget calculations. The consultation proposed a time-limited statutory override and sought views whether it should be applied only to pooled property funds. The Authority responded to the consultation which closed on 28th September.

Non-Treasury Investments

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 March 2017 Cabinet approved the transfer of garages, shops and land from the HRA to the General Fund, the transfer was forecast to deliver circa £286k net income for the General Fund. For the financial year 2017/18 a net income of £295k was achieved, this level is forecast to be exceeded in 2018/19 once the letting of the Aylesham shops is completed.

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%.

In April 2018 the purchase of the freehold of the former Co-op building, Castle Street, Dover was completed. At that time the site was proposed to be demolished and converted into car parking for the area. In July 2018 Cabinet approved a proposal to bring into temporary use the former Co-op building as a Mean-While space to provide an area to support community activities and to enable entrepreneurs and new businesses to market test their products/services. Options for the long term future of the site continue to be developed by officers for future consideration by Members.

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	1,173	999	174	2.02	0.74	1.28
Interest Payable	2,886	2,884	2	3.40	3.40	0

Compliance

The Chief Finance Officer reports that all treasury management activities undertaken during the quarter 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.

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

Table 7: Debt Limits

	H1 Maximum £m	30.9.18 Actual £m	2018/19 Operational Boundary £m	2018/19 Authorised Limit £m	Complied?
Borrowing	87.4	87.4	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.

Table 8: Investment Limits

	30.9.18 Actual	2018/19 Limit	Complied?
Any single organisation, except the UK Government	£10m	£8m per bank	✓
Any group of organisations under the same ownership	0	£16m per group	✓
Negotiable instruments held in a broker's nominee account	0	£15m	✓
UK Government	0	Unlimited	✓
Unsecured investments with building societies	0	£8m	✓
Pooled Investment Funds	£38m	£10m per fund	✓
Operating bank	£0.7m	£20m	✓
Money Market Funds	£1.5m	£10m per fund	✓

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.

	30.9.18 Actual	2018/19 Target	Complied?
Portfolio average credit rating	4.46	6	✓

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.

	30.9.18 Actual	2018/19 Target	Complied?
Total cash available within 3 months	£2.3m	£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:

	30.9.18 Actual	2018/19 Limit	Complied?
Upper limit on fixed interest rate exposure	£87.4m	£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:

	30.9.18 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	£4m	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?	✓	✓	✓

<u>Outlook for the remainder of 2018/19</u>

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.