Treasury Management Report Q1 2017/18

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 2011 Edition* (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 2017/18 was approved at a meeting of the Authority on 1 March 2017. 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.

External Context

Commodity prices slid back during the quarter with oil falling below $50 a barrel. The primary factor in the oil price fall was oversupply and a lack of belief in OPEC's (Organisation of Petroleum Exporting Countries) ability to deliver on agreed production caps of members.

UK Consumer Price Inflation (CPI) index rose over the quarter and the data print for May showed CPI at 2.9%, its highest since June 2013. The effect of the fall in fuel prices was offset by rises in a number of other categories in the CPI 'basket' as the fall in the value of sterling following June 2016's referendum result continued to feed through into higher import prices. The most recent labour market data for April 2017 showed that the unemployment rate at 4.6% remained at its lowest since July 1975 but that the squeeze on real wages (i.e. after inflation) is intensifying and resulting in negative real wage growth. Q1 GDP data released in April and revised in May showed economic activity growing at a much slower pace of 0.2%. However recent surveys indicate that the slowdown in the first quarter is being viewed as an anomaly and that Q2 GDP could rebound. Understandably, the Bank of England made no change to monetary policy at its meeting on 15th June.

Having raised rates in March, the US Federal Reserve made no change to monetary policy at the conclusion of its meeting in May. The recent weakness witnessed in the first print of Q1 US GDP was noted in the accompanying statement but the Fed viewed this as a transitory issue and was of the view that the GDP path and household spending would recover during 2017. The US Federal Reserve then increased its target range of official interest rates in June for the second time in 2017 by 25bps (basis points) to between 1% and 1.25% and a further similar increase is expected during the second half of 2017.

Prime Minister Theresa May called an unscheduled General Election in June, to resolve uncertainty and in the hope of gaining an enhanced mandate to enter the forthcoming Brexit negotiations. The surprise result has led to a minority Conservative government in a confidence and supply arrangement with the Democratic Unionist Party. This political impasse clearly results in an enhanced level of political uncertainty, however the potential for a so-called hard Brexit is now diminished, reducing the associated economic headwinds for the UK economy from a 'no deal' or otherwise unfavourable trade agreement.

The reaction from the markets on the election's outcome has been fairly muted, business confidence now hinges on the progress (or not) on Brexit negotiations, whether new trade

treaties and arrangements are successfully concluded and whether or not the UK continues to remain part of the EU customs union post the country's exit from the EU.

In the face of this uncertainty, Arlingclose expects the Bank of England will look through periods of high inflation and maintain its low-for-longer stance on policy interest rates for an extended period.

Financial markets: Gilt yields displayed some volatility with a marked uptick in late June. This was largely due to the expectation of tapering of Quantitative Easing (QE) in the US and Europe, which also had an impact on gilts. The yield on the 5 year benchmark gilt rose from 0.56% to 0.69% during the quarter, that on the 10-year gilt rose from 1.06% to 1.26% and the yield on the 20-year gilt rose from 1.65% to 1.78%.

The FTSE 100 reached a record high of 7548 in May but dropped off slightly towards the end of the quarter. The FTSE-250 and FTSE All Share indices also rose, the All Share index closing at 4002 at the end of June. Money markets rates have remained low: 1-month, 3-month and 12-month LIBID rates have averaged 0.25%, 0.33% and 0.66% in the quarter respectively.

Credit background: UK bank credit default swaps have continued their downward trend, reaching three year lows by the end of June. Bank share prices have not moved in any particular pattern.

There were a few credit rating changes during the quarter. Moody's downgraded Standard Chartered Bank's long-term rating to A1 from Aa3 on the expectation that the bank's profitability will be lower following management's efforts to de-risk their balance sheet. The agency also affirmed Royal Bank of Scotland's and NatWest's long-term ratings at Baa1. Moody's downgraded the major Canadian banks' long-term ratings on the agency's expectation of a more challenging operating environment for the banks for the remainder of 2017 and beyond, that could lead to a deterioration in the banks' asset quality and increase their sensitivity to external shocks. Moody's downgraded the ratings of the large Australian banks to Aa3 from Aa2 reflecting the agency's view of the rising risks from the banks' exposure to the Australian housing market and the elevated proportion of lending to residential property investors.

Ring-fencing, which requires the larger UK banks to separate their core retail banking activity from the rest of their business, is expected to be implemented within the next year. In May, following Arlingclose's advice, the Authority reduced the maximum duration of its deposits at Bank of Scotland, HSBC Bank and Lloyds Bank from 13 months to 6 months as there is some uncertainty surrounding which banking entities the Authority will be dealing with once ring-fencing is implemented. Even where there has been a level of clarity provided regarding where local authority customers will sit within the proposed new legal structures of the banks, it is not yet known what the balance sheet structures of those banks will be.

S&P also revised Nordea Banks outlook to stable from negative, whilst affirming their long-term rating at AA-. The outlook revision reflects Nordea's geographic diversification and strong financials.

Local Context

On 31st March 2017, the Authority had net borrowing / investments of £25m 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

	31.3.17 Actual £000
General Fund CFR	11,685
HRA CFR	79,890
Total CFR	**91,575**
Less: Usable reserves	(60,833)
Less: Working capital	(5,430)
Net borrowing	**25,312**

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 30th June 2017 and the change in the quarter is show in table 2 below.

Table 2: Treasury Management Summary

	31.3.17 Balance £000	**Q1 Movement £000**	**30.6.17 Balance £000**	**30.6.17 Rate %**
Long-term borrowing	85,515		85,515	
Short-term borrowing *	6,153	(4,000)	2,153	
Total borrowing	**91,668**	**(4,000)**	**87,668**	**3.39%**
Short-term investments	55,704	4,880	50,824	
Cash and cash equivalents	10,652	(7,849)	18,501	
Total investments	**66,356**	**(2,969)**	**69,325**	**0.30%**
Net borrowing	**(25,312)**	**(6,919)**	**(18,343)**	

**Short-term temporary loan repaid in quarter 1.*

Borrowing Strategy during the quarter

At 30/6/2017 the Authority held £88m of loans, a decrease of £4m on 31/3/2017, as part of its strategy for funding previous years' capital programmes. The quarter-end borrowing position is shown in table 3 below.

Table 3: Borrowing Position

	31.3.17 Balance £000	**Q1 Movement £000**	**30.6.17 Balance £000**	**30.6.17 Rate %**
Public Works Loan Board	84,668	0	84,668	3.35
Banks (LOBO)	3,000	0	3,000	4.75
Local authorities (short-term)	4,000	(4,000)	0	n/a
Total borrowing	**91,668**	**(4,000)**	**87,668**	**3.39**

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.

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. Further details of borrowing can be found in Appendix 3.

Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During quarter 1, the Authority's investment balance ranged between £63.4 and £69.8 million due to timing differences between income and expenditure. The investment position during the quarter is shown in table 4 below. Further details of the position at 30/06/2017 can be found in Appendix 2.

Table 4: Investment Position

	31.3.17 Balance £000	Q1 Movement £000	30.6.17 Balance £000	30.6.17 Rate %
Banks & building societies (unsecured)	51,919	(17,504)	34,415	0.42
Government (incl. local authorities)	4,910	18,500	23,410	0.60
Money Market Funds	9,527	(1,027)	8,500	0.20
Other Pooled Funds	0	3,000	3,000	4.50
Total investments	**66,356**	**2,969**	**69,325**	

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.

Given the increasing risk and falling returns from short-term unsecured bank investments, the Authority has started to diversify into more secure and higher yielding asset classes. £3m that is available for longer-term investment was moved from bank and building society deposits into pooled property funds at the end of the quarter, and a further £3m at the end of July. 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

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
31.03.2017	4.30	AA-	60%	47	0.61%
30.06.2017	4.26	AA-	65%	72	0.37%
Similar LAs	**4.36**	**AA-**	**66%**	**118**	**1.64%**
All LAs	**4.32**	**AA-**	**65%**	**45**	**1.19%**

*Weighted average maturity

Performance Report

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

	Forecast for Year £000	Budget £000	Over/ (under)	YTD Return %	Benchmark %	Over/ (under)
Interest Received	370	305	65	0.45	0.18	0.27
Interest Payable	2,953	2,953	0	3.39	3.39	0.00

Actual interest and dividends income for the quarter is £77k, which is in line with the YTD budget of £76k, and has been achieved as a result of having a higher level of funds available for investment than budgeted, as interest rates continue to fall on bank deposits and money market funds. The higher level of funds available is only temporary, due to changes in the timing of approved capital expenditure payments. The higher forecast for the full year in the table (above) is partly due to better income expected in subsequent quarters, which arises from the £6m investment in the CCLA property fund (in £3m tranches on 30th June and 31st July) at a return of approximately 4.2% p.a. This investment is considered longer term (typically 5 – 10 years).

Compliance Report

The Director of Finance can report that all treasury management activities undertaken during quarter 1 complied fully with the CIPFA Code of Practice. However, due to a number of investments maturing at the same time, our total investment with the Bank of Scotland briefly exceeded £8m from 19th – 29th June 2017 (by £463k approx. and for 11 days only), which is outside our Treasury Management Guidelines, but the money was held an instant access call account during that time. Compliance with specific investment limits is demonstrated in table 7 below.

Table 7: Investment Limits

	During Qtr to 30.6.17 Actual	2017/18 Limit	Complied
Any single organisation, except UK Government	£8.46m	£8m per bank	X
Any group of funds under the same management	£13.44m	£16m per group	✓
Investments held in a broker's nominee account	0	£15m	✓
UK Central Government	£1.9m	Unlimited	✓
Pooled investment funds	£3m	£10m per fund	✓
Unsecured investments with Building Societies	£7m	£8m	✓
Operating Bank	£1.3m	£20m	✓
Money Market Funds	£8m	£10m per fund	✓

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

Table 8: Debt Limits

	30.6.17 Actual	2017/18 Operational Boundary	2017/18 Authorised Limit	Complied
Borrowing	£87.7m	£333m	£338.5m	✓

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.

	30.6.17 Actual	2017/18 Target	Complied
Portfolio average credit score	4.26	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. The figure below includes a significant number of deposits maturing by 30th September, as well as a 90-day notice account, and is therefore higher than the usual level maintained, exceeding our normal short-term requirements. The actual liquidity measure figure is expected to reduce with capital outlay and the possible use of other investment instruments from October 2017, subject to approval, which is why higher levels of short-term cash are currently being maintained.

	30.6.17 Actual	2017/18 Target	Complied
Total cash available within 3 months	£49m	£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 borrowed was:

	30.6.17 Actual	2017/18 Limit	Complied
Upper limit on fixed interest rate exposure	£87.7m	£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 fixed rate borrowing were:

	30.6.17 Actual	**Upper Limit**	**Lower Limit**	**Complied**
Under 12 months	£2.2m	25%	0%	✓
12 months and within 24 months	£3.4m	50%	0%	✓
24 months and within 5 years	£7.2m	50%	0%	✓
5 years and within 10 years	£13.7m	100%	0%	✓
10 years and above	£61.2m	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 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:

	2017/18	**2018/19**	**2019/20**
Actual principal invested beyond year end	1.9m	1.9m	0
Limit on principal invested beyond year end	30m	30m	30m
Complied	✓	✓	✓

<u>Outlook for the remainder of 2017/18</u>

Just over a year after the UK voted to leave the EU there is still a great deal of uncertainty on Brexit negotiations, even after Article 50 was triggered in April. To add to this, the Conservative party lost their overall majority after they called a snap election in June meaning that negotiations may be even harder going forward.

UK GDP growth is forecast to be around 1.6% for 2017 and 1.4% in 2018. Subdued consumer spending will be the main driver behind this period of weaker growth, along with muted business investment due to Brexit-related uncertainty. Arlingclose's central case for the path of Bank Rate over the next three years remains at 0.25%. Arlingclose believes that the high inflation reflects the impact of sterling's weakness on imports, and in the face of weaker growth prospects, will be looked through by Bank of England policymakers. The likely path for Bank Rate is for it to remain flat at 0.25%. However, there is downside risk for rates to be cut to 0.00% in the short-term and medium-term, and scope for rates to be increased from 2019 onwards, albeit modestly to 0.50%.

See Interest Rate Forecast Table below.

	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Case	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
Downside risk	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25

In addition, Arlingclose believes that the Government and the Bank of England have both the tools and the willingness to use them to prevent any immediate market-wide problems leading to bank insolvencies. The cautious approach to credit advice means that the banks currently on the Authority's counterparty list have sufficient equity buffers to deal with any localised problems in the short term.