Treasury Management Report Q3 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.

The treasury management strategy for 2017/18 was approved at a meeting of the Authority on 1st 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

Economic backdrop: The significant economic event was the increase in the Bank Rate in November by 0.25% to 0.50%, making it the first increase by the Bank of England's MPC to rates since July 2007. The vote to increase Bank Rate was 7-2, reflecting the MPC's growing concern that rising inflation had finally outweighed the risks to growth and largely to meet expectations the Bank itself created. The Bank has reiterated that it expects any future increases in Bank Rate to be at a gradual pace and limited in extent.

Commodity prices rose over the period with oil increasing to around $67 a barrel from a low of $42 in June. UK Consumer Price Inflation (CPI) index continued to rise with the data print for November showing CPI at 3.1%, its highest since March 2012 as the fall in the value of sterling following the June 2016 referendum result continued to feed through into higher import prices. The new inflation measure CPIH, which includes owner occupiers' housing costs, was at 2.8%.

The number of unemployed in the economy continued to decrease, although the unemployment rate remained at 4.3%. Consumers' wages continued to shrink, in real terms, given average earnings growth remained subdued at 2.5%, a good deal below the rate of inflation. Economic activity expanded at a much slower pace as evidenced by Q2 and Q3 GDP growth of 0.3% and 0.4% respectively. With the dominant services sector accounting for 79% of GDP, the strength of consumer spending remains vital to growth, but with household savings remaining relatively low and real wage growth negative, there are concerns that these will be a constraint on future economic activity.

In contrast, near-term global growth prospects improved. The US economy grew steadily and inflation increased to 2.2%. As was expected, the Federal Reserve increased its target range of official interest rates in December for the third time in 2017 by 25 basis points to between 1.25% and 1.50%. The Fed is expected to deliver three more increases in 2018 and a further two in 2019. The central bank's growth forecasts were revised up based on the newly-passed personal and corporate tax rate cuts proposed by Donald Trump.

In the face of a struggling economy and Brexit-related uncertainty, Arlingclose expects the Bank of England to take a very measured approach to any monetary policy tightening. Any increases will be gradual and limited as the interest rate backdrop will have to provide substantial support to the UK economy through the Brexit transition.

Financial markets: Gilt yields were broadly stable over the quarter as much of the uncertainty which plagued the first half of the year dissipated. The yield on the 5-year gilts fell slightly to 0.72% at the end of the quarter, down from 0.80% in September. The 10-year gilts similarly fell from 1.38% to 1.19% at the end of the quarter and the 20-year gilts from 1.94% to 1.73%.

The FTSE 100 continued to climb, reaching yet another record high of 7688 at the end of calendar year. Money markets rates, unsurprisingly, have increased over the quarter: 1-month, 3-month and 12-month LIBID rates have averaged 0.43%, 0.47% and 0.76% over the period October-December.

Credit background: UK bank credit default swaps have remained broadly stable throughout the quarter. Bank share prices have not moved in any pattern.

Much of the activity by credit rating agencies during the quarter has related to the upcoming UK bank ringfencing which will take effect in 2018. Ringfencing requires the larger UK banks to separate their core retail banking activity from the rest of their business, resulting in two separate banks. In general, the agencies expect to give the ringfenced "retail" bank a higher credit rating than the non-ringfenced "investment" bank. In practice, this will only affect Barclays, HSBC, Lloyds and RBS as other UK banks and building societies either only conduct retail banking activities or have less than £25 billion of deposits covered by the Financial Services Compensation Scheme.

Barclays Bank plc was upgraded to A from A- by Standard & Poor's (S&P), after the bank announced its plans for its ringfenced bank, Barclays Bank UK plc, and the non-ringfenced bank, Barclays Bank plc. S&P also assigned preliminary ratings of 'A/A-1' to Barclays Bank UK plc.

In November S&P revised upwards the outlook of various UK banks and building societies to positive or stable and simultaneously affirmed their long and short-term ratings. These reflect the agency's view that the institutions now show increased resilience, have made substantial progress in meeting regulatory capital requirements and are now better positioned to deal with uncertainties and potential turbulence in the run-up to the UK's exit from the EU in March 2019.

There have been no changes to Arlingclose's investment advice regarding banks and building societies during the quarter.

Regulatory Updates

MiFID II: As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3rd January 2018 local authorities will be treated as retail clients but can "opt up" to professional client status, providing that they meet certain criteria which includes having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority have at least a year's relevant professional experience. In addition, the regulated financial services firms to whom this directive applies must assess that that person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

The Authority has met the conditions to opt up to professional status and has done so in order to maintain its erstwhile MiFID II status prior to January 2018. The Authority will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

CIPFA Codes: CIPFA published revised editions of the Treasury Management and Prudential Codes in December 2017. The Authority is currently considering the changes from the 2011 Code for incorporation into future Treasury Management Strategies and monitoring reports.

The 2017 Prudential Code introduces the requirement for a Capital Strategy which sets out the long-term context of capital expenditure and investment decisions and their associated risks and rewards along with an overview of how risk is managed for future financial sustainability. Where this strategy is produced, it must be approved by full Council, and the determination of the Treasury Management Strategy can then be delegated to a committee.

In the 2017 Treasury Management Code the definition of 'investments' has been widened to include financial assets as well as non-financial assets held primarily for financial returns such as investment property. These, along with other investments made for non-treasury management purposes such as loans supporting service outcomes and investments in subsidiaries, must be discussed in the Capital Strategy or Investment Strategy.

DCLG Consultations on Investment Guidance and Minimum Revenue Provision (MRP): In November the DCLG consulted on proposed changes to its Guidance on Local Government Investments and Statutory Guidance on Minimum Revenue Provision (MRP) with a deadline for responses of 22nd December.

Proposed changes to the Investment Guidance include a wider definition of investments to include non-financial assets held primarily for generating income return and a new category called "loans" (e.g. temporary transfer of cash to a third party, joint venture, subsidiary or associate). The draft Guidance introduces the concept of proportionality, proposes additional disclosure for borrowing solely to invest and also specifies additional indicators. Investment strategies should detail the extent to which core expenditure is reliant on investment income and a contingency plan should yields on investments fall.

There is a proposed change to the basis of prudent MRP to "cover the gap between the Capital Financing Requirement (CFR) and grant income/capital receipts"; it cannot be a negative charge and can only be zero if the CFR is nil or negative. Guidance on asset lives has been updated, applying to any calculation using asset lives. Any change in MRP policy cannot create an overpayment; the new policy must be applied to the outstanding CFR going forward only.

The Authority is however aware of the Ministry of Housing, Communities and Local Government's (MHCLG) proposed changes to the Investment Guidance for English authorities.

Local Context

On 31st March 2017, the Authority had net borrowing 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	15,266
HRA CFR	76,309
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 31st December 2017 and the change over the period is show in table 2 below.

Table 2: Treasury Management Summary

	31.3.17 Balance £000	**Movement £000**	**31.12.17 Balance £000**	**31.12.17 Rate %**
Long-term borrowing	85,515	0	85,515	
Short-term borrowing	6,153	(5,068)	1,085	
Total borrowing	**91,668**	**(5,068)**	**86,600**	**3.39%**
Long-term investments	0	18,000	18,000	
Short-term investments	55,704	(30,856)	24,848	
Cash and cash equivalents	10,652	2,386	13,038	
Total investments	**66,356**	**(10,470)**	**55,886**	**0.65**
Net borrowing	**(25,312)**	**(5,402)**	**(30,714)**	

Borrowing Strategy during the first three quarters

At 31/12/2017 the Authority held £86.6m of loans, (a decrease of £5m on 31/3/2017), as part of its strategy for funding previous years' capital programmes. The 31st December 2017 borrowing position is show in table 3 below.

Table 3: Borrowing Position

	31.3.17 Balance £000	**Movement £000**	**31.12.17 Balance £000**	**31.12.17 rate %**
Public Works Loan Board	84,668	(1,068)	83,600	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**	**(5,068)**	**86,600**	**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 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 first three quarters of 2017/18.

Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the first three quarters of 2017/18 the Authority's investment balance ranged between £63.4 and £72.4 million due to timing differences between income and expenditure. The investment position during the first three quarters of 2017/18 is shown in table 4 below.

Table 4: Investment Position

	31.3.17 Balance £000	**Movement £000**	**31.12.17 Balance £000**	**31.12.17 rate %**
Banks & Building Societies	51,919	(30,443)	21,476	0.16
Government (incl. local authorities)	4,910	4,500	9,410	0.84
Money Market Funds	9,527	(2,527)	7,000	0.31
Other Pooled Funds	0	18,000	18,000	4.5
Total investments	**66,356**	**(10,470)**	**55,886**	

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 further diversified into more secure and higher yielding asset classes. £18m that is available for longer-term investment has now moved from bank and building society deposits into pooled investment funds. 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%
30.09.2017	4.61	A+	63%	71	0.15%
31.12.2017	4.73	A+	75%	55	0.87%
Similar LAs	**4.47**	**AA-**	**63%**	**92**	**1.37%**
All LAs	**4.51**	**A+**	**61%**	**41**	**1.14%**

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	Forecast %	Benchmark* %	Over/ under
Interest Received	552	305	247	0.65	0.40	0.25
Interest Payable	2,953	2,953	0	3.39	3.39	0

*3 month LIBID rate as at 31.12.17

Actual interest and dividends income for the nine-month period to December is £316k, which is better than the YTD budget of £229k, and has been achieved as a result of having a higher level of funds available for investment than budgeted, despite lower rates of return due to pressure on interest rates, as well as the two quarterly dividends from the £6m investment in the CCLA property fund (made in £3m tranches on 30th June and 31st July) at a return of approximately 4.57% p.a. (£125k received). This investment is considered longer term (typically 5 – 10 years) and largely accounts for the improved forecast position for the full year. The further investments in December 2017 of £6 million in the Colombia Threadneedle strategic bond fund and £6 million in the Investec diversified income fund are forecast to generate an annual return exceeding 4% (£23k est. receipt for December 2017 only). These longer term investments will significantly improve the overall return for the Council.

Compliance Report

The Director of Finance is pleased to report that all treasury management activities undertaken during quarter three of 2017/18 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

	Qtr to 31.12.17 Actual	2017/18 Limit	Complied
Any single organisation, except UK Government	£7.8m	£8m per bank	✓
Any group of funds under the same management	0	£16m per group	✓
Investments held in a broker's nominee account	0	£15m	✓
UK Central Government	£1.9m	Unlimited	✓
Pooled Investment funds	£6m per fund	£10m per fund	✓
Unsecured investments with Building Societies	0	£8m	✓
Operating Bank	£18m	£20m	✓
Money Market Funds	£6.5m	£10m per fund	✓

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

Table 8: Debt Limits

	31.12.17 Actual	2017/18 Operational Boundary	2017/18 Authorised Limit	Complied
Borrowing	£86.6m	£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.

	31.12.17 Actual	2017/18 Target	Complied
Portfolio average credit score	4.73	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.

	31.12.17 Actual	2017/18 Target	Complied
Total cash available within 3 months	£13m	£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:

	31.12.17 Actual	2017/18 Limit	Complied
Upper limit on fixed interest rate exposure	£86.6m	£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:

	31.12.17 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	£1.1m	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	✓	✓	✓

Outlook for the remainder of 2017/18

The UK economy faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Both consumer and business confidence remain subdued. Household consumption growth, the driver of UK GDP growth, has softened following a contraction in real wages. Savings rates are relatively low and real earnings growth (i.e. after inflation) struggles in the face of higher inflation.

The Bank of England's Monetary Policy Committee's decision to raise bank rate is likely to reduce inflation, all other things remaining equal, but is likely to have negative effect on what was already a weak growth outlook.

Arlingclose's central case is for Bank Rate to remain at 0.50% over the forecast period, whilst introducing upside risks from September 2018, as shown below, and downside risks from March 2019. Arlingclose's central case is for gilt yields to remain broadly stable across the medium term.

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