Treasury Management Report Q3 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 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; the local authority specific Guidance Notes for the Codes were published in July 2018. 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 has produced its Capital Strategy for approval by full Council on 7 March 2019 as part of the 2019/20 budget-setting process.

External Context

Economic background: After rising to over $80/barrel around the middle of the year, oil prices fell back sharply by 25% to just over $60 in December. UK Consumer Price Inflation (CPI) for November was up 2.3% year/year, in line with the consensus forecast and broadly in line with the Bank of England's November *Inflation Report*. The most recent labour market data for the three months to October 2018 showed the unemployment rate remained at 4.1% while the employment rate of 75.7% was the joint-highest estimate since comparable estimates began in 1971. The 3-month average annual growth rate for pay excluding bonuses was 3.3% as wages continue to rise steadily and provide some pull on general inflation. Adjusted for inflation, real wages grew by 1.0%, a level likely to only have a modest impact on consumer spending.

The rise in quarterly GDP growth to 0.6% in the third calendar quarter from 0.4% in the second was due to weather-related factors boosting overall household consumption and construction activity over the summer. At 1.5%, annual GDP growth continues to remain below trend. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have been made since.

The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the 2.25%-2.50% range in November while lowering its forecast of rate rises in 2019 to two from the three previously projected.

A temporary truce in the ongoing trade war between the US and China was announced as the leaders of both countries agreed to halt new trade tariffs for 90 days to allow talks to continue. Tariffs already imposed will remain in place. The fallout continues to impact on economic growth

and stock market volatility.

With less than three months until Article 50 expires on 29th March 2019, the deal Theresa May secured from the EU, together with the controversial Northern Ireland 'backstop', was brought in front of MPs in December to debate and ultimately vote on. Due to the level of opposition to the deal, the vote was subsequently delayed so Mrs May could seek clarification from the EU on how the withdrawal agreement could be ratified. EU leaders have been clear, however, that the terms of the deal are not up for further negotiation. The ongoing uncertainty continues to weigh on sterling and UK markets.

Financial markets: Investors wrestled with a range of global concerns: an economic slowdown in China, rising trade tensions between the US and China, a sharply lower oil price, slowing Euro area output and, of course, the ongoing uncertainty surrounding Brexit. December was a month to forget in terms of performance of riskier asset classes, most notably equities. The FTSE 100 (a good indicator of global corporate sentiment) returned -8.8% assuming dividends were reinvested; in pure price terms it fell around 13%. But spreads on corporate bonds also widened reflecting concerns about tougher economic conditions ahead and the abilities of corporates to service their debt obligations.

Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. After rising to 1.30% in October, gilts regained their safe-haven status in December - the 5-year benchmark gilt yield fell as low as 0.82% and there were similar falls in the 10-year and 20-year gilts over the same period dropping from 1.59% to 1.06% and from 2.05% to 1.62%. The higher Bank Rate continued to push up money markets rates. 1-month, 3-month and 12-month LIBID rates averaged 0.58%, 0.76% and 1.03% respectively over the period.

Credit background: Credit Default Swap (CDS) spreads drifted up over the period, reflecting the ongoing uncertainty around Brexit but continuing to remain low in historical terms. The spread on non-ringfenced bank, NatWest Markets plc, rose sharply to around 129bps while for the ringfenced entity, National Westminster Bank plc, the CDS spread held relatively steady around 44bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 44 and 94 bps at the end of the period.

The ringfencing of the big four UK banks (Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc) is complete and the transfer of their business lines into retail (ringfenced) and investment banking (non-ringfenced) continues prior to starting trading as separate entities from 1st January 2019.

The Bank of England released its latest report on bank stress testing, illustrating that all entities tested were deemed to have passed the test once the levels of capital and potential mitigating actions presumed to be taken by management were factored in. The BoE did not require any bank to raise additional capital.

There were minimal credit rating changes during the period. Moody's revised the outlook on Nationwide Building Society to negative from stable as it believes Nationwide may become more reliant on retail deposit funding going forward, reducing the volume of wholesale deposits and senior debt available to a level where only a two-notch uplift is warranted rather than the current three notches.

Our treasury advisor Arlingclose will continue to 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.

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 31st December 2018 and the change during the period is show in Table 2 below.

Table 2: Treasury Management Summary

	31.3.18 Balance £000	**Movement £000**	**31.12.18 Balance £000**	**31.12.18 Rate %**
Long-term borrowing	83,292	(3,000)	80,292	
Short-term borrowing	2,223	3,897	6,120	
Total borrowing	**85,515**	**897**	**86,412**	**3.39%**
Long-term investments	25,564	14,436	40,000	
Short-term investments	17,410	(12,410)	5,000	
Cash and cash equivalents	3,417	2,940	6,357	
Total investments	**46,391**	**4,966**	**51,357**	**2.05%**
Net borrowing	**(39,124)**		**(35,055)**	

At the beginning of December the Council was able to repurchase its LOBO loan which has resulted in a £3m reduction in long term borrowing. A short term loan of £5m has been taken out with Hampshire County Council to offset the LOBO repurchase and for strategic cash management purposes.

As short term investments have matured the funds have been invested in longer term pooled investment funds.

Borrowing Strategy during the period

At 31st December 2018 the Authority held £86.4m of loans, as part of its strategy for funding previous years' capital programmes. This is an increase of £0.9m since 31st March 2018, consisting of a £5m temporary loan to finance the repayment of the LOBO and strategic cash management purposes, less a £1.1m repayment on the 'HRA' PWLB loan. Outstanding loans at 31st December 2018 are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.18 Balance £000	**Net Movement £000**	**31.12.18 Balance £000**	**31.12.18 Weighted Average Rate %**
Public Works Loan Board	82,515	(1,103)	81,412	3.44
Banks (LOBO)	3,000	(3,000)	0	0
Local authorities (short-term)	0	5,000	5,000	1.10
Total borrowing	**85,515**		**86,412**	

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.

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.

During the period the Council repurchased its £3m LOBO held with KA Finanz and took a temporary loan with Hampshire County Council for twelve months.

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.

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 £48 and £51 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investments Position

	31.3.18 Balance £000	Net Movement £000	31.12.18 Balance £000	31.12.18 Rate of Return %
Banks & building societies (unsecured)	383	7,851	8,234	0.2
Government (incl. local authorities)	17,410	(17,410)	0	
Money Market Funds	3,034	89	3,123	0.72
Other Pooled Funds:				
- Short-dated bond funds	8,000	0	8,000	0.93
- Strategic bond funds	5,900	2,100	8,000	3.06
- Property funds	5,744	256	6,000	4.14
- Multi asset income funds	5,920	12,080	18,000	4.79
Total investments	**46,391**	**4,966**	**51,357**	

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 31.12.18, as the pooled funds are longer term investments and no loss is expected by the time of sale. Therefore the Q3 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 £14m.

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/or higher yielding asset classes. During the quarter a further £2m 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
31.12.2018	5.07	A+	100%	8	1.19
Similar LAs	4.22	AA-	59%	77	0.94
All LAs	4.24	AA-	58%	34	0.97

The Authority's £40m of externally managed pooled funds generated an average total return of 1.66%, comprising a 3.60% income return which is used to support services in year, and offset by a 2.23% capital loss. 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 £2m has been placed in the Columbia Threadneedle Strategic Bond fund during the quarter.

Following consultation, MHCLG will implement a statutory override relating to the introduction of the IFRS 9 Financial Instruments accounting standard from 2018/19. While requiring IFRS 9 to be adopted in full, the statutory override will require fair value movements in pooled investment funds to be taken to a separate unusable reserve instead of the General Fund. The override will be in place for at least five years until 31st March 2023.

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 for financial return.

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, and £290k income is forecast for 2018/19.

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 £224k per annum, a net return of 1.3%.

In December 2017 a second site, Whitfield Court, was purchased. The site is located in the White Cliffs Business Park and the Council wants 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 £107k per annum, a net return of 2.4%.

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	1,254	999	255	2.05	0.65	1.40
Interest Payable	2,813	2,884	71	3.44	3.40	0.04

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

	Q3 Maximum £m	31.12.18 Actual £m	2018/19 Operational Boundary £m	2018/19 Authorised Limit £m	Complied?
Borrowing	86.4	86.4	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

	31.12.18 Actual	2018/19 Limit	Complied?
Any single organisation, except the UK Government	£5m	£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	£40m	£10m per fund	✓
Operating bank	£3.2m	£20m	✓
Money Market Funds	£3.1m	£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.

	31.12.18 Actual	2018/19 Target	Complied?
Portfolio average credit rating	5.07	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.

	31.12.18 Actual	2018/19 Target	Complied?
Total cash available within 3 months	£14.4m	£8m	✓

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:

	31.12.18 Actual	2018/19 Limit	Complied?
Upper limit on fixed interest rate exposure	£86.4m	£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:

	31.12.18 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	£6.1m	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	£54.3m	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 1 year: 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

Having raised rates by 0.25% in November 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 bias towards tighter monetary policy as its members consider that tight labour markets will prompt inflationary pressure in the future, ultra-low interest rates result in other economic problems, and higher Bank Rate will be a more effective policy weapon if downside risks to growth crystallise.

Arlingclose's central case is for Bank Rate to rise twice in 2019, after the UK exits the EU. However, recent events around Brexit have dampened interest rate expectations and the risks are weighted to the downside. The potential for severe economic outcomes has increased following the poor reception of the Withdrawal Agreement by MPs. The Bank of England will hold at or reduce interest rates from current levels if serious Brexit risks materialise.

	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Average
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	**0.17**
Arlingclose Central Case	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	1.13
Downside risk	0.00	-0.50	-0.75	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	**-0.85**

Gilt yields have remained at low levels. Arlingclose expects some upward movement from current level but a projected weak economic outlook and volatility arising from both economic and political events will continue to offer borrowing opportunities.