Report of:	Meeting	Date
Councillor Alan Vincent, Resources Portfolio Holder and Clare James, Head of Finance	Council	6 December 2018

Treasury Management Activity April 2018 to September 2018

1. Purpose of report

1.1 To report on the overall position and activities in respect of Treasury Management for the first half of the financial year 2018/19.

2. Outcomes

2.1 An informed Council who have an understanding of Treasury Management activity, in line with the approved Treasury Management Policy and Strategy Statements and Treasury Management Practices.

3. Recommendations

3.1 That the Annual Report on Treasury Management Activity for the first half of the 2018/19 financial year be approved.

3.2 That the Treasury Management Policy and Strategy Statements and Treasury Management Practices be updated to allow for investments to be made in two additional Money Market Fund structures, namely Low Volatility Net Asset Value and Variable Net Asset Value funds.

4. Background

4.1 Capital Strategy

4.1.1 In December 2017, the Chartered Institute of Public Finance and Accountancy (CIPFA), issued revised Prudential and Treasury Management Codes. As from 2019/20, all local authorities will be required to prepare a Capital Strategy which is intended to provide the following:-

- A high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services
- An overview of how the associated risk is managed
- The implication for the future financial stability

4.1.2 A report setting out our Capital Strategy will be taken to Cabinet, with responsibility retained by the full Council, before 31st March 2019.

4.2 **Treasury Management**

4.2.1 The council operates a balanced budget, which broadly means cash raised during the year will meet its expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment returns.

4.2.2 The second main function of the treasury management operation is the funding of the council's capital plans. The management of longer term cash may involve arranging long or short term loans, or using long term cash flow surpluses and on occasion any debt previously drawn may be restructured to meet council risk or cost objectives.

4.2.3 Accordingly, treasury management is defined as: "The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

4.2.4 This report has been written in accordance with the requirements of the CIPFA Code of Practice on Treasury Management (revised 2017).
The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the council will seek to achieve these policies and objectives.
3. Receipt by the full Council of an annual Treasury Management Strategy Statement – including the Annual Investment Strategy and Minimum Revenue Provision Policy – for the year ahead (April 2019), a Mid-year Review Report (November 2018) and an Annual Report (May 2019) covering activities during the previous year.
4. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
5. Delegation by the Council of the role of scrutiny of treasury management and policies to a specific named body. For this council the delegated body is the Overview and Scrutiny

Committee.

4.2.5 This mid-year report covers the following for the six months ending 30 September 2018:

a) An economic update for the first part of the 2018/19 year;
b) A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
c) The council's capital expenditure, as set out in the Capital Programme, and prudential indicators;
d) A review of the council's investment portfolio for 2018/19;
e) A review of the council's borrowing strategy for 2018/19;
f) A review of any debt rescheduling undertaken during 2018/19;
g) A review of compliance with Treasury and Prudential limits for 2018/19;

5. Key issues and proposals

5.1 Economics update

5.1.1 The Monetary Policy Committee (MPC) voted to increase the Bank Rate on 2 August from 0.5% to 0.75%. The UK's economic growth is expected to remain modest at 1.5% in 2018, although the Bank of England's August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019, albeit there were several caveats. These mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

5.1.2 Some MPC members have expressed concerns about a build-up of inflationary pressures, particularly with the pound falling in value against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation rose unexpectedly in August to 2.7%, but it is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in the Bank Rate. The MPC has indicated the Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in the Bank Rate for the second half of 2019.

5.1.3 Unemployment has continued at a 43 year low of 4% on the Independent Labour Organisation measure.

5.1.4 In the USA, President Trump's massive easing of fiscal policy is fuelling a (temporary) boost in consumption which has generated an upturn in the rate of growth which rose from 2.2% (annualised rate) in Quarter 1 to 4.2% in Quarter 2, but also an upturn in inflationary pressures.

5.1.5 In the Eurozone growth remained unchanged at 0.4% in Quarter 2, but has undershot early forecasts for a stronger economic performance in 2018. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of 2% for 2018, the horizon is less clear than it seemed a short while ago.

5.2 Interest Rate Forecasts

5.2.1 The council's treasury advisor, Link Asset Services, has provided the following forecast:

Link Asset Services Interest Rate View	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate View	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
3 Month LIBID	0.75%	0.80%	0.80%	0.90%	1.10%	1.10%	1.20%	1.40%	1.50%	1.60%	1.60%
6 Month LIBID	0.85%	0.90%	0.90%	1.00%	1.20%	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%
12 Month LIBID	1.00%	1.00%	1.00%	1.10%	1.30%	1.30%	1.40%	1.60%	1.70%	1.80%	1.80%
5yr PWLB Rate	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
10yr PWLB Rate	2.40%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%

5.2.2 The MPC emphasised that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate (where monetary policy is neither expansionary of contractionary) than before the crash; indeed they gave a figure for this of around 2.5% in ten years' time but they declined to give a medium term forecast. Link Asset Services do not think that the MPC will increase the Bank Rate in February 2019, ahead of the deadline in March for Brexit. They also feel that the MPC is more likely to wait until August 2019, than May 2019, before the next increase, to be followed by further increases of 0.25% in May and November 2020 to reach 1.5%. However, the cautious pace of even these limited increases is dependent on a reasonably orderly Brexit.

The balance of risks to the UK

5.2.3

- The overall balance of risks to economic growth in the UK is probably neutral.
- The balance of risks to increases in the Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong Gross Domestic Product (GDP) growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

5.2.4

- Bank of England monetary policy takes action too quickly over the next three years to raise the Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.

- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, owing to its high level of government debt, low rate of economic growth and vulnerable banking system, and the election in March of an anti-austerity government. This is likely to lead to friction with the EU when setting the target for the fiscal deficit in the national budget. Unsurprisingly, investors have taken a dim view of this and so Italian bond yields have been rising.
- Austria, the Czech Republic and Hungary now form a strongly anti-immigration bloc within the EU while Italy, this year, has also elected a strongly anti-immigration government. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position as a result of the rise of the anti-immigration party. To compound this, the result of the Swedish general election in September 2018 has left an anti-immigration party potentially holding the balance of power in forming a coalition government. The challenges from these political developments could put considerable pressure on the cohesion of the EU and could spill over into impacting the euro, EU financial policy and financial markets.
- The imposition of trade tariffs by President Trump could negatively impact world growth. President Trump's specific actions against Turkey pose a particular risk to its economy which could, in turn, negatively impact Spanish and French banks which have significant exposures to loans to Turkey.
- Weak capitalisation of some European banks.
- Rising interest rates in the US could negatively impact emerging countries which have borrowed heavily in dollar denominated debt, so causing an investor flight to safe havens e.g. UK gilts.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates

5.2.5

- President Trump's fiscal plans to stimulate economic expansion causing a significant increase in inflation in the US and causing further sell offs of government bonds in major western countries.
- The Federal Reserve Board causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Federal Reserve. Funds Rate and in the pace and strength of reversal of Quantitive Easing (QE), which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.
- The Bank of England is too slow in the pace and strength of increases in the Bank Rate allowing inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in the Bank Rate faster than we currently expect.

- UK inflation, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

5.3 Treasury Management Strategy Statement and Annual Investment Strategy Update

5.3.1 The Treasury Management Strategy Statement (TMSS) for 2018/19 was approved by this Council on 12 April 2018. There are no policy changes to the TMSS and details in this report update the position in the light of the updated economic position and budgetary changes already approved.

5.4 Capital Position

5.4.1 This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

Capital Expenditure	2018/19 Original Estimate £m	Current Position as at 30/09/18 £m	2018/19 Revised Estimate £m
Total	10.158	4.203	9.078

5.5 Changes to the Financing of the Capital Programme

5.5.1 The table below shows how the capital expenditure (above) will be financed. Any shortfall of resources results in a need to borrow.

Capital Expenditure	2018/19 Original Estimate £m	2018/19 Revised Estimate £m
Total	10.158	9.078
Financed by:		
Capital Receipts	0.044	0.063
Capital Grants and Contributions	9.743	7.918
Revenue/Reserves	0.371	1.097
Total Financing	10.158	9.078
Borrowing Requirement	0	0

5.6 Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

5.6.1 The table below shows the Capital Financing Requirement (CFR), which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period, which is termed the Operational Boundary.

5.6.2 We are on target to achieve the original forecast CFR and the Operational Boundary for external debt will remain the same.

Operational boundary	2018/19 Original Estimate £m	2019/20 Revised Estimate £m
Prudential Indicator – Capital Financing Requirement:		
Total CFR	11,356	11,356
Prudential Indicator – Operational Boundary for external debt:		
Debt	13,548	13,548
Other long term liabilities	8	8
Total	13,556	13,556

5.7 Limits to Borrowing Activity

5.7.1 The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowing less investment) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total CFR in the preceding year plus the estimates of any additional CFR for 2018/19 and the next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

5.7.2 The Head of Finance reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

5.7.3 A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It was set at £20m at Council 12 April 2018. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

5.8 Investment Portfolio

5.8.1 In accordance with the Code, it is the council's priority to ensure security of capital and liquidity and to obtain an appropriate level of return which is consistent with the council's risk appetite. As shown by forecasts at 5.2, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the current 0.75% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

5.8.2 The council has continued to invest any surplus balances with the council's Bank, NatWest on call deposit facility, Money Market Funds (MMF) with Prime Rate Capital Management, the Bank of Scotland (Overnight/Call account), Handelsbanken Instant Access account, Santander (95 day corporate notice facility) and Qatar National Bank (1 month and 3 month fixed notice facilities). The council also made a fixed term loan to Eastleigh Borough Council via Tradition brokers.

5.8.3 The approved £6m maximum limits within the Annual Investment Strategy were breached on two occasions during the first 6 months of 2018/19 in April and September. The first occasion was due to the failure to action a bank transfer to place an authorised deposit. This left a balance of £8,326,888.41 in the NatWest liquidity account. The second occasion was due to an incorrect figure being input into the cash flow spread sheet resulting in a larger than expected automatic roll up into the NatWest Liquidity account making the balance £6,120,194.88, this was picked up the following day and the transfer made. There were no costs incurred as a result of either action.

5.8.4 Within the council's current Annual Investment Strategy, the Investment Policy criteria are based on Link Asset Services creditworthiness service and it is meeting the requirement of the treasury management function. The council, to date, has adopted a very cautious approach and regularly monitors organisations with which investments are held to ensure they meet the Investment Policy criteria.

Investment Counterparty criteria

5.8.5 The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

5.8.6 Interest receivable on investments for the first half of the financial year is £46,608 (or £46,701 including miscellaneous items) compared to an annual budget of £47,390. The rate of interest received is expected to reduce through the second part of the year due to the funds available for investment diminishing as a result of increased capital expenditure and reduced levels of Council Tax income in the last quarter of the year.

5.8.7 The equated investments for the first half of 2018/19 are detailed in the following table indicating that investments earned an average return of 0.55% against a benchmark LIBID (London Interbank Bid Rate) 7-day average of 0.43%.

	Equated Investment Principal	Interest Due	Rate of Return	Benchmark Return
	£	£		
NatWest Liquidity Account	1,098,397	1,566	0.14%	0.43%
Money Market Funds	2,632,412	15,052	0.57%	0.43%
Bank of Scotland Call Account	1,817,056	8,661	0.48%	0.43%
Qatar 1 month fixed	1,323,288	6,616	0.50%	0.43%
Qatar 3 month fixed	1,460,273	13,493	0.92%	0.43%
Handelsbanken IA Account	492,327	1,685	0.34%	0.43%
Eastleigh Borough Council Fixed	361,644	2,893	0.80%	0.43%
Santander (95 Day Notice)	698,630	4,192	0.60%	0.43%
Total	9,884,027	54,158	0.55%	0.43%

5.9 Borrowing

5.9.1 The council's capital financing requirement (CFR) for 2018/19 as approved by Council on 14 February 2018 is £11.4m. The CFR denotes the council's underlying need to borrow for capital purposes. This borrowing can be external from the Public Works Loan Board (PWLB) or the market or internal (from balances on a temporary basis).
The 2018/19 budget assumed no additional long-term borrowing and capital schemes were to be funded by grants and contributions, capital receipts and Reserves.

5.9.2 There were no short-term borrowing transactions (i.e. less than 365 days) during the first six months of 2018/19.

5.9.3 Interest payments in respect of short-term and long-term borrowing for the first half of the financial year are on target and total £34,415 compared to a budgeted figure of £68,830 for the full year. Including miscellaneous payments in 2018/19 the actual at 30 September is £34,566 compared to a full year budget of £69,850. The budget includes £1,000 for interest in the latter part of the financial year owing to potential temporary borrowing requirements as income from Council Tax reduces during February and March.

5.9.4 The council incurs charges at 4% over the current base rate for net overdrawn balances with no annual arrangement fee. The Council's net bank account position was not overdrawn during the period April to September 2018.

5.10 Debt Rescheduling

5.10.1 Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates and following the increase in the margin added to gilt yields which has impacted on PWLB new borrowing rates since 2010. No debt rescheduling has therefore been undertaken during the 6 months to 30 September 2018.

5.10.2 The table below illustrates the council's debt and investment position at the beginning of the 2018/19 financial year and as at 30 September 2018:

	1 April 2018	30 September 2018
	£	£
Loans - Temporary	0	0
- Cash Overdrawn	178,441	156,148
Total Short-Term Debt	**178,441**	**156,148**
Loans - Long-Term Borrowing	1,552,000	1,552,000
Total Long-Term Debt	**1,552,000**	**1,552,000**
Investments - Temporary	14,425,250	22,308,249
Total Short-Term Investments	**14,425,250**	**22,308,249**
Cash in Bank	0	0
Cash held by the Authority	2,669	2,888
Total Cash and Cash Equivalents	**2,669**	**2,888**

6 Latest News

6.1 The following paragraphs provide an update on current Treasury Management matters.

Local Authority Resilience Measure

6.2 CIPFA has recently consulted on its plans to launch a Resilience Index which will be a measure of Local Authority Resilience, this could prove useful when we invest in Local Authorities for a fixed term though our brokers. However our Treasury Management Consultants have advised that all local authorities have the same credit rating in essence owing to central government backing.

UK Banks ring-fencing

6.3 The largest UK banks (those with more than £25bn of retail/Small and Medium Enterprise (SME) deposits) are required by law, to separate core retail banking services from their investment and international banking activities by 1 January 2019. This is known as 'ring-fencing'. Whilst smaller banks with less than £25bn in deposits are exempt, they can choose to opt up. Several banks are very close to the threshold already and so may come into scope in the future regardless.

6.4 Ring-fencing is a regulatory initiative created in response to the global financial crisis. It mandates the separation of retail and SME deposits from investment banking, in order to improve the resilience and resolvability of banks by changing their structure. In general, simpler, activities offered from within a ring-fenced bank (RFB) will be focused on lower risk, day-to-day core transactions, whilst more complex and "riskier" activities are required to be housed in a separate entity, a non-ring-fenced bank (NRFB). This is intended to ensure that an entity's core activities are not adversely affected by the acts or omissions of other members of its group.

6.5 While the structure of the banks included within this process may have changed, the fundamentals of credit assessment have not. The council will continue to assess the new-formed entities in the same way that it does all entities. Those with sufficiently high ratings that and meet our other lending criteria, will be considered for investment purposes.

IFRS9 accounting standard

6.6 This accounting standard came into effect from 1 April 2018. Councils have been granted a five year statutory override. It means that the category of investments valued as 'available for sale' will be removed and any potential fluctuations in market valuations may impact onto the Surplus or Deficit on the Provision of Services, rather than being held on the balance sheet. This change is unlikely to materially affect the commonly used types of treasury management investments but it would affect more specialist types of investments (e.g. pooled funds, third party loans, commercial investments). However, the impact on this authority is likely to be nil.

Money Market Fund Reform

6.7 New Money Market Fund (MMF) European regulation comes into force on 21 July 2018 and existing funds will have to be compliant by 21 January 2019. There will be three structural options of MMFs, CNAV (Public Debt Constant Net Asset Value), LVNAV (Low Volatility Net Asset Value) and VNAV (Variable Net Asset Value). The Council's current MMFs have not yet defined their structure but current Treasury Management Practices allow investment in CNAV MMFs. It is therefore intended that this report be used to update the current policy to allow for investment in LVNAV and VNAV funds in addition to CNAV MMFs. This will allow for any CNAV MMFs that convert to either of the other two structures and allow increased flexibility following the changes to regulation.

New Commercial Investment Guidance

6.8 CIPFA are expected to issue fresh guidance on borrowing before the end of the year in response to concerns that English councils could be putting public funds at “unnecessary or unquantified risk” when investing in commercial property. A joint statement by the Treasury and CIPFA warned that the “prime policy objective of a local authority’s treasury management investment activities was the security of funds, and that a local authority should avoid exposing public funds to unnecessary or unquantified risks”. Current guidance is very clear that “local authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed.” All relevant policies will be reviewed on receipt of the new guidance. As there are no plans to increase borrowing at this time it is unlikely that there will be an immediate significant impact. However, it is likely to have a significant bearing on future investment decisions and will need to be considered as part of the decision-making process.

Financial and legal implications	
Finance	Considered in detail in the report above.
Legal	The approval of the recommendations will ensure compliance with the CIPFA Code of Practice.

Other risks/implications: checklist

If there are significant implications arising from this report on any issues marked with a ✓ below, the report author will have consulted with the appropriate specialist officers on those implications and addressed them in the body of the report. There are no significant implications arising directly from this report, for those issues marked with an x.

risks/implications	**✓ / x**
community safety	**x**
equality and diversity	**x**
sustainability	**x**
health and safety	**x**

risks/implications	**✓ / x**
asset management	**x**
climate change	**x**
ICT	**x**

Processing Personal Data

If the decision(s) recommended in this report will result in personal data being processed, a privacy impact assessment (PIA) will have been completed and signed off by the council’s Data Protection Officer before the decision is taken (as required by the General Data Protection Regulations 2018).

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List of background papers:		
name of document	date	where available for inspection
None		

List of appendices

None

dem/cou/cr/18/0612jw2