

AUDIT COMMITTEE – 24 NOVEMBER 2017

Title of paper:	Treasury Management 2017/18 Half Yearly Update	
Director(s)/ Corporate Director(s):	Laura Pattman, Strategic Director of Finance	Wards affected: All
Report author(s) and contact details:	Glyn Daykin, Senior Accountant - Treasury Management Tel: 0115 8763724	
Other colleagues who have provided input:	Members of Treasury Management Panel: Laura Pattman, Strategic Director of Finance Theresa Channell, Head of Corporate Finance Susan Risdall, Technical Team Leader Jo Worster, Strategic Finance Team Leader	
Recommendation(s):		
1	To note the treasury management actions taken in 2017/18 to 30 September 2017.	

1 REASONS FOR RECOMMENDATIONS

- 1.1 To ensure that Councillors are kept informed of the actions taken by the Chief Finance Officer (CFO) under delegated authority. The currently adopted Treasury Management Code of Practice requires the CFO to submit at least three reports on treasury management each year; a policy and strategy statement for the ensuing financial year, a 6-monthly progress report and an outturn report after the end of the financial year.
- 1.2 The CIPFA Prudential Code requires local authorities to nominate a body within the organisation to be responsible for scrutiny of treasury management activity. It is considered that the City Council's Audit Committee is the most appropriate body for this function. In undertaking this function, the Audit Committee holds the responsibility to provide effective scrutiny of treasury management policies and practices.

2 BACKGROUND

- 2.1 Treasury management is the management of a local authority's cash flows, borrowings and investments, together with the management of the associated risks and the pursuit of the optimum performance or return consistent with those risks. Since 1 April 2004 councils have been required to have regard to the Prudential Code. The Code requires treasury management to be carried out in accordance with good professional practice. The City Council retains external advisors to assist with this activity.
- 2.2 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. This report covers treasury activity and the associated monitoring and control of risk.
- 2.3 The half yearly update report is scheduled to be considered by Executive Board on 19 December 2017.

3 TREASURY MANAGEMENT ACTIVITY TO 30 SEPTEMBER 2017

3.1 Summary. This report sets out the 2017/18 performance in the 6 months to 30 September 2017 in respect of the management of the Council's external debt and investments. The key points are:

3.1.1 the balance of external debt increased by £3.030m and the average rate of interest payable on the debt portfolio increased from 3.3% at 31 March 2017 to 3.4% at 30 September 2017 (see section 3.3.2);

3.1.2 the average rate of interest earned on short-term investments was 0.250%. This is benchmarked against the 7 day London Inter-bank (LIBID) rate provided by the Bank of England, which averaged 0.20% for the same period (see section 3.9.3);

3.1.3 the 2017/18 budget for General Fund Treasury Management was £46.837m (see section 3.15);

3.1.4 there were no breaches of the Prudential Indicators set for 2017/18 (see section 3.11).

3.2 The Economy and Interest rates during 2017/18

3.2.1 Growth and Inflation:

After the UK economy surprised with strong growth in 2016, growth in 2017 has been disappointingly weak with quarters 1 & 2 year on year growth of 1.7% & 1.5% respectively which was the slowest for the first half of any year since 2012. The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the referendum, feeding increases in the cost of imports into the economy. Inflation (CPI) is forecast to peak at 3% in 2017 before falling back to near to its target rate of 2% in two years time. Inflation actually came in at 2.9% in August.

3.2.2 UK Monetary Policy:

The Monetary Policy Committee (MPC) meeting of 14 September 2017 surprised markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise. The Bank of England Inflation Reports during 2017 have clearly flagged up that they expected CPI inflation to peak at just under 3% in 2017 so the focus was on an emerging view that with unemployment falling to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that the amount of spare capacity in the economy was significantly diminishing towards a point at which they now needed to take action.

3.2.3 At the MPC meeting on 2nd November 2017 the MPC increased Bank Rate from 0.25% to 0.50% and gave forward guidance that they expected to increase Bank Rate only twice more in the next three years to reach 1.0% by 2020. This forward guidance on Bank Rate is in line with previous statements that Bank Rate would only go up very gradually and to a limited extent.

3.2.4 Forecast Interest rates

The Council's treasury advisor, Capita Asset Services, has provided the following forecast as at 7 November 2017:

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank rate	0.50%	0.50%	0.50%	0.50%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%
5yr PWLB rate	1.50%	1.60%	1.60%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.10%
10yr PWLB rate	2.10%	2.20%	2.30%	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%
25yr PWLB rate	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%
50yr PWLB rate	2.50%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%

3.2.5 Appendix B shows the money market interest rates and the PWLB borrowing rates for the half-year to 30 September 2017.

3.3 Local Context

At 31/03/2017 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £1,280.5m. The forecast CFR at 31/03/2018 is now expected to be £1,371.8m. The increase in CFR is mainly due to additional capital schemes being approved within the capital programme since the original estimate.

3.3.1 Table 1 below shows the original and expected financing arrangements of the capital programme. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

TABLE 1: CAPITAL EXPENDITURE	2017/18	2017/18
	Original	Revised
	Estimate	Estimate
	£m	£m
Total capital expenditure	209.091	279.538
Financed by:		
Capital receipts	42.783	25.906
Capital grants & Contributions	51.708	63.416
Internal Funds / Revenue (inc. Major Repairs Reserve)	34.619	57.405
Total financing	129.11	146.727
Borrowing requirement	79.981	132.811

- 3.3.2 Table 2 summarises the Council's outstanding external debt at 30 September 2017 showing the value of debt and the average interest rate payable on the debt:

TABLE 2: DEBT PORTFOLIO				
	01-Apr-17		30-Sep-17	
DEBT	£m	%	£m	%
PWLB borrowing	623.6	3.7	656.1	3.7
Market loans	49.0	4.3	49.0	4.3
Local bonds & Stock	0.6	3.0	0.6	3.0
Temporary borrowing	115.7	0.3	86.2	0.4
TOTAL DEBT	788.9	3.3	791.9	3.4

- 3.3.3 At 30/09/2017, the Council had £1,014.6m of external borrowing including £222.7m of Private Finance Initiative (PFI) Debt and £28.8m of investments. The Council has continued to maintain borrowing and investments below their underlying levels, referred to as internal borrowing, subject to holding a minimum investment balance of around £30m. The difference between the CFR and the total external borrowings was £265.6m at 1 April 2017 which is utilised cash flow funds in lieu of borrowing (internal borrowing). This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.
- 3.4 Borrowing strategy
At 30/9/2017 the Council has increased the balance of external loans by £3.030m on the 31/3/2017 balance, as part of its strategy for funding previous years' capital programmes. The Council expects to borrow a further £60m in 2017/18.
- 3.4.1 The chief objective when borrowing continues to be striking 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 long-term plans change being a secondary objective.
- 3.4.2 Affordability and the "cost of carry" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained, and are likely to remain for a significant period, lower than long-term rates, the Council determined it was more cost effective in the short-term to maintain the use of internal resources / borrow short-term loans for some of its borrowing requirement this year. This approach is prudent and cost effective in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.
- 3.4.3 The expected path for the interest rates on new fixed rate long term loans is a very gradual increase over the coming years, but with this time frame there will be some volatility and therefore opportunities to fix new loans at low rates when in periods where the UK Gilt yields fall.
- 3.4.4 The Council borrowed two tranches of £20m from the Public Works Loans Board (PWLB) on fixed rates of 2.30% & 2.32% respectively, both on a 50 year maturity loan basis to fund capital expenditure and maturing loans. The PWLB was the Authority's

preferred source of long term borrowing given the transparency and control that its facilities continue to provide.

3.4.5 Temporary and short-dated loans borrowed from the markets, predominantly from other local authorities, has also remained affordable and attractive. In the 6 months to 30 September £231m of such loans were borrowed at an average rate of 0.390% and an average life of 3 months which includes the replacement of maturing loans. The balance at 30 September 2017 is £86.2m.

3.4.6 Overall the debt portfolio has seen an increase in fixed rate debt and reduction in the balance of short term loans in 2017/18 meaning the average rate on the debt portfolio has risen slightly, but has reduced the exposure to variable interest rates and has continued to minimising the exposure to credit risk by holding a liquidity balance only of unsecured investments.

3.5 Debt rescheduling

The penalties (premia) for the early repayment of Public Works Loan Board (PWLB) debt, which constitutes over 90% of the Council's existing long-term borrowing, have remained prohibitively high. Therefore, no opportunities for debt rescheduling arose in the first half of 2017/18

3.6 PWLB Certainty Rate and Project Rate Update

The Council qualifies for borrowing at the 'Certainty Rate' (0.20% below the PWLB standard rate) for a 12 month period from 01/11/2016. In April the Council submitted its application to the DCLG along with the 2017/18 Capital Estimates Return to access this reduced rate for a further 12 month period from 01/11/2017.

3.7 Lender's Option Borrower's Options (LOBO) Loans

The Council holds £34.000m of LOBO loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. £14.000m of these LOBO loans have options during the year, none have been exercised by the lender. The Council acknowledges there is an element of refinancing risk even though in the current interest rate environment lenders are unlikely to exercise their options.

3.8 Housing Revenue Account (HRA) Treasury Management Strategy

From 1 April 2002, the Council's HRA was allocated a separate debt portfolio based on the appropriate proportion of the Councils existing debt at that time. As a result of existing debt maturing, and not being replaced, the HRA accumulates an internal borrowing position. The interest payable in 2017/18 is expected to be £12.137m at an average rate of 4.33%. This includes £37.161m of fixed rate internal borrowing maturing 01 October 2044.

3.9 Investments

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.

3.9.1 As shown by the Money Market rates data in Appendix B, 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 have been in line with the 0.25% Bank Rate.

- 3.9.2 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.
- 3.9.3 The Council held £28.8m of investments as at 30 September 2017 (£27.0m at 31 March 2017) and the investment portfolio yield for the first 6 months of the year is 0.25% against a benchmark (Average 7-day LIBID) of 0.20%.
- 3.9.4 Appendix A provides details of the Council's external investments at 30 September 2017, analysed between investment type and individual counterparties showing the current Fitch long-term credit rating.
- 3.9.5 As the Council has maintained a reduced level of investments it remains insulated from the low interest rates on short-dated money market instruments.
- 3.9.6 The relatively low investment balance is a reflection of the overall strategy to reduce credit risk exposure by reducing investment balances to fund the capital programme and the repaying of maturing debt.
- 3.9.7 Table 3 below summarises investment activity in 2017/18.

TABLE 3 - Investment Activity in 2017/18

Investments	Balance on 01/04/2017 £m	Balance on 30/09/2017 £m	Avg Rate/Yield (%) Avg days to maturity
Short term Investments (call accounts, deposits)			
- Banks and Building Societies with ratings of A- or higher	5.0	10.0	0.32% / 32
- Local Authorities	10.0	10.0	0.22% / 2
Long term Investments	0.0	0.0	N/A
Money Market Funds	12.0	8.8	0.21% / 1
TOTAL INVESTMENTS *	27.0	28.8	0.25% / 12
- Increase/ (Decrease) in Investments £m		1.8	

Note: * excludes remaining balance held in Icelandic ISK Escrow account

- 3.9.8 The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first 6 months of 2017/18.
- 3.9.9 The Council's budgeted investment return for 2017/18 is £0.120m, and performance for the year to date is £0.013m below budget.
- 3.9.10 Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

3.10 Icelandic Bank deposits – update

The administrators for the recovery of Glitnir Bank deposits (£11m) have made repayment to all priority creditors, including the City Council, in full settlement of the accepted claims. However, approximately 21% (£2.3m) of this sum had been paid in ISK and due to currency restrictions in Iceland, this sum had been retained in an interest-bearing account with the Central Bank of Iceland. On 27 June 2017 the Council received £3.2m as proceeds from the sale of the restricted ISK balance including accrued interest as the Central Bank of Iceland starts to remove the currency controls and normalise their economy.

3.10.1 The council has now received 100% of the principal balance deposited with Glitnir Bank.

3.11 Compliance with Prudential Indicators

The Council confirms compliance with its Prudential Indicators for 2017/18 set on 6 March 2017 as part of the Council's Treasury Management Strategy Statement.

3.11.1 The Council measures and manages its exposures to treasury management risks using the following additional indicators.

3.11.2 **Interest Rate Exposures:** This indicator is set to control the Council's exposure to interest rate risk. The limits on net fixed and variable rate interest rate exposures are:

	2017/18 £m	2018/19 £m	2019/20 £m
Upper limit on fixed interest rate exposure	900	900	900
Actual	622		
Upper limit on variable interest rate exposure	300	300	300
Actual	142		

3.11.3 **Maturity Structure of Borrowing:** This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	Lower	Upper	Actual
Under 12 months	0%	25%	12%
12 months and within 24 months	0%	25%	4%
24 months and within 5 years	0%	25%	12%
5 years and within 10 years	0%	50%	16%
10 years and within 25 years	0%	50%	23%
25 years and within 40 years	0%	25%	21%
40 years and above	0%	75%	11%

3.11.4 **Principal Sums Invested for Periods Longer than 364 days:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking

early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

	2017/18 £m	2018/19 £m	2019/20 £m
Limit on principal invested beyond year end	20	20	20
Actual	0		

3.11.5 **Operational Boundary and Authorised Limit for External Debt:** The operational boundary is based on the Council's estimate of most likely, i.e. prudent, but not worst case scenario for external debt. The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

3.11.6 The table below shows the expected debt position during 2017/18.

	2017/18		2017/18
	Original	Current	Revised
	Estimate	Position	Estimate
	£m	£m	£m
Borrowing	831.5	791.9	851.9
Other long term liabilities*	215.8	222.7	215.8
Total debt (year end position)	1047.3	1014.6	1067.7
Operational Boundary for external debt	1107.2	1107.2	1107.2
Authorised limit for external debt	1147.2	1147.2	1147.2

* On balance sheet PFI schemes and finance leases etc.

3.11.7 The Director of Finance reports that no difficulties are envisaged in the current year in complying with this indicator. Any revision to these limits requires Full Council approval as part of an amendment to the 2017/18 Treasury Strategy.

3.12 Adoption of the CIPFA Treasury Management Code

The Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* in March 2012.

3.13 Revised CIPFA Codes

The Chartered Institute of Public Finance and Accountancy, (CIPFA), is currently conducting an exercise to consult local authorities on revising the Treasury Management Code and Cross Sectoral Guidance Notes, and the Prudential Code. CIPFA is aiming to issue the revised codes during November.

3.13.1 A particular focus of this exercise is how to deal with local authority investments which are not treasury type investments e.g. by investing in purchasing property in order to generate income for the authority at a much higher level than can be attained by treasury investments. One recommendation is that local authorities should produce a new report to members to give a high level summary of the overall capital strategy and to enable members to see how the cash resources of the authority have been apportioned between treasury and non-treasury investments.

Officers are monitoring developments and will report to members when the new codes have been agreed and issued and on the likely impact on this authority.

3.14 MIFID II

The EU has now set a deadline of 3 January 2018 for the introduction of regulations under MIFID II. These regulations will govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. This will have little effect on this authority apart from having to fill in forms sent by each institution dealing with this authority and for each type of investment instrument we use apart from for cash deposits with banks and building societies.

3.15 General Fund Revenue Implications

Treasury management payments comprise interest charges and receipts and provision for repayment of debt. A proportion of the City Council's debt relates to capital expenditure on council housing and this is charged to the HRA. The remaining costs are included within the treasury management section of the General Fund budget. The General Fund Treasury Management budget is £46.837m for 2017/18.

3.15.1 An estimated outturn for 2017/18 is included in the Quarter 2 Budget Monitoring report on the 19 December 2017 Executive Board agenda. The budget for 2018/19 will be submitted with the 2018/19 treasury management strategy in February 2018.

3.16 Risk management

Risk management plays a fundamental role in treasury activities, due to the value and nature of transactions involved. The management of specific treasury management risks is set out in the Manual of Treasury Management Practices and Procedures and a risk register is prepared for the treasury function.

3.16.1 The treasury management risk register's overall risk rating at 30 September 2017 was Likelihood = unlikely, Impact = moderate which represents the same risk assessment as at 31 March 2017. The Treasury Management working group continue to manage this risk and take appropriate actions as required.

4 BACKGROUND PAPERS OTHER THAN PUBLISHED WORKS OR THOSE DISCLOSING EXEMPT OR CONFIDENTIAL INFORMATION

4.1 None.

5 PUBLISHED DOCUMENTS REFERRED TO IN COMPILING THIS REPORT

5.1 Treasury Management in the Public Services, Code of Practice 2011 – CIPFA

5.2 CIPFA statistics, Bloomberg sourced Money Market rates and PWLB loan rates 2017/18.