

AUDIT COMMITTEE - 30 NOVEMBER 2018

Title of paper:	Treasury Management 2018/19 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 2018/19 to date.	

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 Capital Strategy

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 implications for future financial sustainability

A report setting out our Capital Strategy will be taken to the full council, before 31st March 2019.

2.2 Treasury Management

The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash 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 return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

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."

- 2.3 This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).

The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- 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. Full council or delegated body (Executive Board) to receive a Mid-year Review Report and an Annual Report, covering activities during the previous year.
- 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.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Audit Committee.

- 2.4 This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of the 2018/19 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure, and prudential indicators;
- A review of the Council's investment portfolio for 2018/19;
- A review of the Council's borrowing strategy for 2018/19;
- A review of any debt rescheduling undertaken during 2018/19;
- A review of compliance with Treasury and Prudential Limits for 2018/19

- 2.5 The Treasury Management 2018/19 Half Yearly Update report is scheduled to be considered by Executive Board on 20 December 2018.

- 2.6 In respect of external investments, the Council is also required to ensure that the Ministry for Housing, Communities and Local Government (MHCLG) guidance is followed, with the priorities being, in order:
- security of the invested capital;
 - liquidity of the invested capital; and
 - commensurate with security and liquidity, an optimum return on those investments.
- 2.7 The successful identification, monitoring and control of risk are the prime criteria by which the effectiveness of the Council's treasury management activities is measured. Treasury management risks are identified in the Treasury Management Practices document. The main risks to the Council's treasury activities are:
- liquidity risk (inadequate cash resources);
 - market or interest rate risk (fluctuations in interest rate levels and, thereby, in the revenue impacts of loans and investments);
 - inflation risks (exposure to inflation);
 - credit and counterparty risk (security of investments);
 - refinancing risks (impact of debt maturing in future years);
 - legal and regulatory risk (i.e. non-compliance with statutory and regulatory requirements, risk of fraud).
- 2.8 The treasury management reports written during the financial year of 2018/19 will take account of the following updates to guidance: -
- CIPFA Code of Practice on Treasury Management 2017
 - CIPFA Prudential Code 2017
 - CIPFA Treasury Management in the Public Services Guidance Notes 2018
 - Statutory investment guidance where it has been updated in 2018 (MHCLG)
 - Statutory MRP guidance where it has been updated in 2018 (MHCLG)

The council is awaiting further guidance to be issued from CIPFA (expected by end of 2018) to clarify how the revised Prudential Code is to be applied alongside the updated investment guidance from MHCLG.

3 TREASURY MANAGEMENT ACTIVITY TO 30 SEPTEMBER 2018

- 3.1 Summary. This report sets out the 2018/19 performance in the 6 months to 30 September 2018 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 £46.9m and the average rate of interest payable on the debt portfolio decreased from 3.4% at 31 March 2018 to 3.3% at 30 September 2018 (see section 3.4.2);
- 3.1.2 the average rate of interest earned on short-term investments was 0.59%. This is benchmarked against the 7 day London Inter-bank (LIBID) rate provided by the Bank of England, which averaged 0.54% for the same period (see section 3.9.3);
- 3.1.3 the 2018/19 budget for General Fund Treasury Management was £51.747m (see section 3.12);
- 3.1.4 there were no breaches of the Prudential Indicators set for 2018/19 (see section 3.10).

3.2 The Economy and Interest rates during 2018/19

3.2.1 Growth and Inflation:

The first half of 2018/19 has seen UK economic growth post a modest performance, but sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase Bank Rate on 2nd August from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, 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 – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

Some MPC members have expressed concerns about a build-up of inflationary pressures, particularly with the pound falling in value again against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation rose unexpectedly from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate.

3.2.2 Forecast Interest rates:

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%

The flow of generally positive economic statistics after the end of the quarter ended 30 June lead to the decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, to 0.75%. However, the MPC emphasised again, that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary or 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.

3.2.3 Appendix B shows the money market interest rates, the PWLB borrowing rates for the half-year to 30 September 2018 and a forward view for PWLB rates.

3.3 Local Context

3.3.1 The Treasury Management Strategy Statement, (TMSS), for 2018/19 was approved by Full Council on 5 March 2018.

There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

3.3.2 The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

3.3.3 At 31/03/2018 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £1,369.8m. The revised forecast CFR at 31/03/2019 is now £1,534.2m due to the inclusion of 'planned' capital schemes yet to be approved including further commercial property acquisitions and the proposed program of works on the southern entrance to the city. Recognising schemes under development allows the council to understand the financial position if the schemes are subsequently approved and to set appropriate prudential indicators including the limit for external debt.

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	2018/19 Original Estimate £m	2018/19 Revised Estimate £m
Total capital expenditure	172.287	332.741
Financed by:		
Capital Receipts	16.244	22.680
Capital Grants & Contributions	53.725	77.812
Internal Funds / Revenue (inc. Major Repairs Reserve)	39.740	36.497
Total financing	109.709	136.989
Borrowing requirement	62.578	195.752

3.3.4 The council is evaluating further 'proposed capital schemes' that would increase the council's borrowing requirement, but as the financial implications of these schemes are yet to be fully quantified they have not been included in the above estimates.

3.4 Borrowing strategy

3.4.1 To finance the CFR the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions.

3.4.2 At 30/9/2018 the Council has increased the balance of external loans by £46.9m on the 31/3/2018 balance, as part of its strategy for funding previous years' capital programmes. The Council expects to borrow up to a further £99.5m in 2018/19 based on the revised capital program and forecast cash flow requirements.

3.4.3 **Table 2** summarises the Council's outstanding external debt at 30 September 2018 showing the value of debt and the average interest rate payable on the debt:

TABLE 2: DEBT PORTFOLIO				
	01-Apr-18		30-Sep-18	
DEBT	£m	Average Interest %	£m	Average Interest %
PWLB borrowing	787.3	3.448	799.2	3.487
Market loans inc LOBO	49.0	4.348	49.0	4.348
Local bonds & Stock	0.6	3.001	0.6	3.001
Temporary borrowing	28.7	0.43	63.7	0.682
TOTAL LOANS DEBT	865.6	3.398	912.5	3.316
Other inc PFI	208.0		206.5	
TOTAL DEBT	1073.6		1119.0	

At 30/09/2018, the Council had £1,119.0m of external borrowing including £206.5m of Private Finance Initiative (PFI) and lease liabilities. 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. As at 31 March 2018 the Council had c.£296m of internal borrowing and expects to maintain this position as 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.

3.4.4 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.

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. To date short-term interest rates have remained, and are likely to remain for a significant period, lower than long-term rates. The Council determined it to be more cost effective in the short-term to maintain the use internal resources and borrow short-term loans for some of its borrowing requirement.

3.4.5 The expected path for the interest rates on new fixed rate long term loans is a gradual increase over the coming years, but within this time frame there will be some volatility and therefore opportunities to fix new loans at low rates in periods where the UK Gilt yields fall.

3.4.6 In 2018/19 the Council has borrowed £20m from the Public Works Loans Board (PWLB) at a fixed rate of 2.31%, 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.

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 a total of £224m of such loans were borrowed at an average rate of 0.542% and an average life of 41 days which includes the replacement of maturing loans.

3.5 Debt rescheduling

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 PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

3.6 PWLB Certainty Rate Update

The Council qualifies for borrowing at the 'Certainty Rate' (0.20% below the PWLB standard rate) for a 12 month period from 01/11/2017. The Council submitted its application to the MHCLG to access this reduced rate for a further 12 month period from 01/11/2018.

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 2018/19 is expected to be £12.593m at an average rate of 4.10%. This includes £37.161m of fixed rate internal borrowing maturing 01 October 2044.

3.9 Investments

3.9.1 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.

3.9.2 As shown by forecasts in section 3.1, 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 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.

- 3.9.3 The Council held £57.0m of investments as at 30 September 2018 (£31.3m at 31 March 2018) and the investment portfolio yield for the first 6 months of the year is 0.59% against a benchmark (Average 7-day LIBID) of 0.54%.
- 3.9.4 **Appendix A** provides details of the Council's external investments at 30 September 2018, 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. 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.

Table 3 below summarises investment activity in 2018/19.

TABLE 3 - Investment Activity in 2018/19	Balance on 01/04/2018 £m	Balance on 30/09/2018 £m	Avg Rate/Yield (%) Avg days to maturity
Short term Investments (call accounts, deposits)			
- Banks and Building Societies with ratings of A- or higher	0	10.0	0.95% / 95
- Local Authorities	10.0	15.0	0.75% / 9
Long term Investments	0.0	0.0	N/A
Money Market Funds	21.3	32.2	0.70% / 1
TOTAL INVESTMENTS	31.3	57.0	0.75% / 20
- Increase/ (Decrease) in Investments £m		25.7	

- 3.9.6 The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy have not been breached during the first 6 months of 2018/19.
- 3.9.7 The Council's budgeted investment return for 2018/19 is £0.120m, and performance for the year to date is £0.074m above budget for treasury investment income. This variance has been offset against the increases in variable/short term borrowing costs.
- 3.9.8 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 Compliance with Prudential Indicators
The Council confirms compliance with its Prudential Indicators for 2018/19 set on 5 March 2018 as part of the Council's Treasury Management Strategy Statement.
- 3.10.1 The Council measures and manages its exposures to treasury management risks using the following additional indicators.

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

	2018/19 £m	2019/20 £m	2020/21 £m
Upper limit on variable interest rate exposure	300	300	300
Actual	141		

3.10.3 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%	10%
12 months and within 24 months	0%	25%	3%
24 months and within 5 years	0%	25%	10%
5 years and within 10 years	0%	25%	14%
10 years and within 25 years	0%	50%	18%
25 years and within 40 years	0%	50%	19%
40 years and above	0%	50%	26%

3.10.4 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:

	2018/19 £m	2019/20 £m	2020/21 £m
Limit on principal invested beyond year end	100	50	20
Actual	0		

3.10.5 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.

The table below shows the expected debt position during 2018/19.

	2018/19 Original Estimate £m	Current Position £m	2018/19 Revised Estimate £m
Borrowing	952.8	912.5	1,012.6
Other long term liabilities*	201.0	206.5	201.0
Total debt (year end position)	1,153.8	1,119.0	1,213.6
Operational Boundary for external debt	1,313.8	1,313.8	1,313.8
Authorised limit for external debt	1,353.8	1,353.8	1,353.8

* On balance sheet PFI schemes and finance leases etc.

The increase in estimated borrowing in 2018/19 since the original estimate is due to the inclusion of 'planned' schemes within the capital program. No revision to this indicator is necessary as provision for planned schemes was included in the original approved limit. The additional capital expenditure will be subject to an affordability assessment as part of the business case approval from the Section 151 Officer.

3.11 Other

3.11.1 **UK banks – ring fencing**

The largest UK banks, (those with more than £25bn of deposits), are required, by UK law, to separate core retail banking services from their investment and international banking activities by 1st 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.

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.

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 others and those with sufficiently high ratings, (and any other metrics considered), will be considered for investment purposes.

3.11.2 **IFRS 9 accounting standard**

This accounting standard came into effect from 1st April 2018. It means that the category of investments valued under the available for sale category 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 more specialist types of investments, (e.g. pooled funds and third party loans), are likely to be impacted.

The Ministry of Housing, Communities and Local Government (MHCLG), are currently conducting a consultation for a temporary override to allow English local authorities

time to adjust their portfolio of investments. Councilors will be updated when the result of this consultation is known.

3.12 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 £51.747m for 2018/19.

An estimated outturn for 2018/19 is included in the Quarter 2 Budget Monitoring report on the 18 December 2018 Executive Board agenda. The budget for 2019/20 will be submitted with the 2019/20 Treasury Management Strategy in February 2019.

3.13 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.

The treasury management risk register's overall risk rating at 30 September 2018 was Likelihood = unlikely, Impact = minor. However there are a number of risks which are above target for which the Treasury Management working group continue to manage 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 Money Market and PWLB loan rates
- 5.2 Treasury Management in the Public Services Code of Practice 2017–CIPFA
- 5.3 Prudential Code 2017-CIPFA
- 5.4 Treasury Management in the Public Services Guidance Notes 2018 - CIPFA
- 5.5 Statutory guidance on local government investments 3rd Edition 2018
- 5.6 Statutory guidance on Minimum Revenue Provision (MRP) 2018