Appendix 1 - Treasury Management Report Q3 2018/19

Introduction

The Authority has 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 full Council meeting on 26 February 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 is 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's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 25 February 2019.

External Context (provided by the Council's treasury management advisor, Arlingclose)

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 has 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 borrowing of £365.4m, and £45.9m of investments. 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 £m
General Fund CFR	343.3
HRA CFR	248.7
Total CFR	**591.9**
Less: *Other debt liabilities	-34.0
Borrowing CFR - comprised of:	**557.9**
- External borrowing	365.4
- Internal borrowing	192.6

* finance leases and PFI liabilities form part of the Authority's total debt

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 £m	**Movement £m**	**31.12.18 Balance £m**	**31.12.18 Rate %**
Long-term borrowing	307.4	58.9	366.2	4.14
Short-term borrowing	58.0	-40.0	18.0	0.93
Total borrowing	**365.4**	**18.9**	**384.2**	**3.99**
Long-term investments	0.0	0.0	0.0	0.00
Short-term investments	10.0	30.0	40.0	0.79
Cash and cash equivalents	35.9	-19.1	16.9	0.71
Total investments	**45.9**	**10.9**	**56.9**	**0.77**
Net borrowing	**319.4**		**327.4**	

Borrowing Strategy during the period

At 31st December 2018 the Authority held £384.2m of loans, an increase of £18.9m from 31st March 2018, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 31st December are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.18 Balance £m	Net Movement £m	31.12.18 Balance £m	31.12.18 Weighted Average Rate %	31.12.18 Weighted Average Maturity (years)
Public Works Loan Board	182.4	58.9	241.2	3.83	27.59
Banks (LOBO)	125.0	0.0	125.0	4.72	41.44
Banks (fixed-term)	0.0	0.0	0.0	0	0
Local authorities (long-term)	0.0	0.0	0.0	0	0
Local authorities (short-term)	58.0	-40.0	18.0	0.93	0.37
Total borrowing	**365.4**	**18.9**	**384.2**	**3.99**	**30.82**

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.

As the Authority has an increasing CFR due to the capital programme and an estimated borrowing requirement, the Authority expected to carry out additional long term borrowing in 2018/19, and raised £70m of long term fixed rate loans from the PWLB in the first three quarters of the year, at an average rate of 2.57% which will provide longer-term certainty and stability to the debt portfolio. This borrowing was taken to fund the Council's growing underlying need to borrow from the capital programme, in conjunction with considerations around interest rates.

The Council has a significant capital programme, and a large proportion of this will be financed by borrowing, which the Council will have to undertake in coming years. The Council's treasury advisor, Arlingclose undertakes weekly 'cost of carry' analysis to inform the Council about whether it is financially beneficial to undertake borrowing now or to delay this for set time periods: given PWLB interest rate forecasts. Any borrowing which is taken to prior to capital expenditure taking place, and reducing internal borrowing, would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing, creating an immediate cost for revenue budgets.

The Council does not, at the time of writing, anticipate that any additional long term borrowing will be raised in 2018/19 due to the aforementioned borrowing transactions. However, the timing of new borrowing is somewhat dependent on the wider economic position of the UK. A significant 'known unknown' in future forecasting is the impact of Brexit, which may impact adversely on gilts, and therefore PWLB rates. The Council will therefore consider undertaking borrowing in the current year to reduce the extent of the Council's internal borrowing, and meet the cost of carry until future years' capital expenditure takes place, if this is affordable, prudent, and if there is intelligence that PWLB borrowing rates may to rise significantly. This is a matter that is under continual review by officers, and the Council's appointed treasury management advisor, Arlingclose.

LOBO loans: The Authority continues to hold £125m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the period.

Treasury Investment Activity

The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the three quarters period, the Authority's investment balance ranged between £11.2 and £87.9 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 £m	Net Movement £m	31.12.18 Balance £m	31.12.18 Rate of Return %	31.12.18 Weighted Average Maturity days
Banks & building societies (unsecured)	0.0	0.0	0.0	0.00	0.0
Money Market Funds	0.0	16.9	16.9	0.71	1.0
UK Government:					
- Local Authorities	10.0	30.0	40.0	0.79	41.1
- Debt Management Office	35.9	-35.9	0.0	0.00	0.0
Total investments	**45.9**	**10.9**	**56.9**	**0.77**	**29.2**

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.

The table below shows counterparty credit quality as measured by credit ratings on the final day of each quarter during the year. The table also shows the percentage of the in-house investment portfolio exposed to bail-in risk. Bail-in is the response to the government bail-outs in the global financial crisis, when a number of banks failed and received government bail-outs in 2008. Under bail-in, unsecured deposits made with certain financial institutions would be at risk, should the institution fail, and investors would lose a portion of their invested funds. The below table shows a snapshot at a point in time, and movements in the figures do not reflect changes in policy or strategy, but are indicative of the Council's cashflows on that particular date.

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	3.14	AA	0%	70	0.36
31.12.2018	3.92	AA-	30%	29	0.77
Similar LAs	4.28	AA-	54%	102	0.87
All LAs	4.24	AA-	58%	34	0.81

Scoring:
-AAA = highest credit quality = 1
- D = lowest credit quality = 26
-Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

Budgeted Income and Outturn

Treasury Investments generated an average rate of return of 0.63% in the first three quarters of the year. The Council's forecast investment income for the year is estimated at £298k against a budget of £136.5k.

Borrowing costs for 2018/19 are forecast at £15.0m (£10.3m HRA, £4.7m General Fund) against a budget of £15.7m (£10.0m HRA, £5.7m General Fund). The underspend forecast is due to a number of factors, including: the current lower interest rate environment reducing interest costs for the Council, and delays in the capital programme's delivery. Slippage in the Council's capital programme will reduce the borrowing requirement, and reduce this forecast.

Compliance

The Director of Finance (S151 Officer) reports that all treasury management activities undertaken during complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy Statement.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 6 below.

Table 6: Debt Limits

	Q3 Maximum	31.12.18 Actual	2018/19 Operational Boundary	2018/19 Authorised Limit	Complied?
Borrowing	384.2	384.2	568.4	618.4	Yes
PFI and Finance Leases	34.0	34.0	39.9	43.3	Yes
Total debt	**418.2**	**418.2**	**608.3**	**661.6**	**Yes**

Treasury Management Indicators

The Authority measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Risk:
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	93.1%	100%	Yes
Upper limit on variable interest rate exposure	6.9%	60%	Yes

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	26.4%	60.0%	0.0%	Yes
12 months and within 24 months	1.9%	40.0%	0.0%	Yes
24 months and within 5 years	16.4%	40.0%	0.0%	Yes
5 years and within 10 years	4.9%	40.0%	0.0%	Yes
10 years and within 20 years	8.4%	40.0%	0.0%	Yes
20 years and within 30 years	10.4%	40.0%	0.0%	Yes
30 years and within 40 years	16.1%	50.0%	0.0%	Yes
40 years and within 50 years	15.5%	50.0%	0.0%	Yes
50 years and above	0.0%	40.0%	0.0%	Yes

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	-	-	-
Limit on principal invested beyond year end	£10m	£10m	£10m
Complied?	Yes	Yes	Yes

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.