Report for:	Corporate Committee 21 September 2017
Item number:	**8**
Title:	Treasury Management Update Report
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Ward(s) affected:	N/A
Report for Key/ Non Key Decision:	Non Key decision

1. Describe the issue under consideration

1.1. This report updates the Committee on the Council's treasury management activities and performance in the three months to 30th June 2017 in accordance with the CIPFA Treasury Management Code of Practice.

2. Cabinet Member Introduction

2.1. Not applicable.

3. Recommendations

3.1. That members note the Treasury Management activity undertaken during the three months to 30th June 2017 and the performance achieved.

4. Reason for Decision

4.1. None.

5. Other options considered

5.1. None.

6. Background information

6.1. The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which requires local authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement. CIPFA has defined Treasury management as: "The management of the local authority's 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."

6.2. The Code recommends that members are informed of treasury management activities at least twice a year. Formulation of treasury policy, strategy and activity is delegated to the Corporate Committee and this Committee receives reports quarterly.

6.3. However, overall responsibility for treasury management remains with full Council and the Council approved the Treasury Management Strategy Statement and set the Prudential Indicators for 2017/18 on 27 February 2017. The Corporate Committee is responsible for monitoring treasury management activity and this is achieved through the receipt of quarterly reports. This report forms the 1st quarterly monitoring report for 2017/18.

6.4. Government guidance on local authority treasury management states that local authorities should consider the following factors in the order they are stated:

Security - Liquidity - Yield

The Treasury Management Strategy reflects these factors and is explicit that the priority for the Council is the security of its funds. However, no treasury activity is without risk and the effective identification and management of risk are integral to the Council's treasury management activities.

6.5. The quarterly reports during 2017/18 are structured to cover borrowing first and then investments according to these factors, so that members can see how they are being addressed operationally.

7. Contribution to Strategic Outcomes

7.1. None.

8. Statutory Officers comments (Chief Finance Officer (including procurement), Assistant Director of Corporate Governance, Equalities)

Finance and Procurement

8.1. Interest rates earned on investments remain low and significantly less than the cost of new borrowing and therefore the strategy of minimising cash balances is continuing in 2017/18. Borrowing will be taken when required for liquidity purposes with the preference being short term local authorities' loans at very low rates. However longer term interest rates with the Public Works and Loans Board continue to be carefully monitored. The ability to take advantage of low interest rates in this way has resulted in anticipated savings on the treasury management budget.

Legal

8.2. The contents and recommendation of this report are in accordance the Treasury Management Strategy Statement and consistent with legislation governing the financial affairs of the Council. In considering the report Members must take into account the expert financial advice available to it and any further oral advice given at the meeting of the Committee.

Equalities

8.3. There are no equalities issues arising from this report.

9. Use of Appendices

Appendix 1 – Prudential and Treasury Indicators

10. Local Government (Access to Information) Act 1985

10.1. Not applicable.

11. External Context: Economic Commentary and Outlook

11.1. Commodity prices slid back during the quarter with oil falling below $50 a barrel. The primary factor in the oil price fall was oversupply and a lack of belief in OPEC's (Organisation of Petroleum Exporting Countries) ability to deliver on agreed production caps of members.

11.2. UK Consumer Price Inflation (CPI) index rose over the quarter and the data print for May showed CPI at 2.9%, its highest since June 2013. The effect of the fall in fuel prices was offset by rises in a number of other categories in the CPI 'basket' as the fall in the value of sterling following June 2016's referendum result continued to feed through into higher import prices. The most recent labour market data for April 2017 showed that the unemployment rate at 4.6% remained at its lowest since July 1975 but that the squeeze on real wages (i.e. after inflation) is intensifying and resulting in negative real wage growth. Q1 GDP data released in April and revised in May showed economic activity growing at a much slower pace of 0.2%. However recent surveys indicate that the slowdown in the first quarter is being viewed as an anomaly and that Q2 GDP could rebound. Understandably, the Bank of England made no change to monetary policy at its meeting on 15th June.

11.3. Having raised rates in March, the US Federal Reserve made no change to monetary policy at the conclusion of its meeting in May. The recent weakness witnessed in the first print of Q1 US GDP was noted in the accompanying statement but the Fed viewed this as a transitory issue and was of the view that the GDP path and household spending would recover during 2017. The US Federal Reserve then increased its target range of official interest rates in June for the second time in 2017 by 25bps (basis points) to between 1% and 1.25% and a further similar increase is expected during the second half of 2017.

11.4. Prime Minister Theresa May called an unscheduled General Election in June, to resolve uncertainty and in the hope of gaining an enhanced mandate to enter the forthcoming Brexit negotiations. The surprise result has led to a minority Conservative government in a confidence and supply arrangement with the Democratic Unionist Party. This political impasse clearly results in an enhanced level of political uncertainty, however the potential for a so-called hard Brexit is now diminished, reducing the associated economic headwinds for the UK economy from a 'no deal' or otherwise unfavourable trade agreement.

11.5. The reaction from the markets on the election's outcome has been fairly muted, business confidence now hinges on the progress (or not) on Brexit negotiations, whether new trade treaties and arrangements are successfully concluded and whether or not the UK continues to remain part of the EU customs union post the country's exit from the EU.

11.6. In the face of this uncertainty, Arlingclose expects the Bank of England will look through periods of high inflation and maintain its low-for-longer stance on policy interest rates for an extended period.

Financial markets:

11.7. Gilt yields displayed some volatility with a marked uptick in late June. This was largely due to the expectation of tapering of Quantitative Easing (QE) in the US and Europe, which also had an impact on gilts. The yield on the 5 year benchmark gilt rose from 0.56% to 0.69% during the quarter, that on the 10-year gilt rose from 1.06% to 1.26% and the yield on the 20-year gilt rose from 1.65% to 1.78%.

11.8. The FTSE 100 reached a record high of 7548 in May but dropped off slightly towards the end of the quarter. The FTSE-250 and FTSE All Share indices also rose, the All Share index closing at 4002 at the end of June. Money markets rates have remained low: 1-month, 3-month and 12-month LIBID rates have averaged 0.25%, 0.33% and 0.66% in the quarter respectively.

Credit background:

11.9. UK bank credit default swaps have continued their downward trend, reaching three year lows by the end of June. Bank share prices have not moved in any particular pattern.

11.10. There were a few credit rating changes during the quarter. Moody's downgraded Standard Chartered Bank's long-term rating to A1 from Aa3 on the expectation that the bank's profitability will be lower following management's efforts to de-risk their balance sheet. The agency also affirmed Royal Bank of Scotland's and NatWest's long-term ratings at Baa1. Moody's downgraded the major Canadian banks' long-term ratings on the agency's expectation of a more challenging operating environment for the banks for the remainder of 2017 and beyond, that could lead to a deterioration in the banks' asset quality and increase their sensitivity to external shocks. Moody's downgraded the ratings of the large Australian banks to Aa3 from Aa2 reflecting the agency's view of the rising risks from the banks' exposure to the Australian housing market and the elevated proportion of lending to residential property investors.

11.11. Ring-fencing, which requires the larger UK banks to separate their core retail banking activity from the rest of their business, is expected to be implemented within the next year. In May, following Arlingclose's advice, the Authority reduced the maximum duration of its deposits at Bank of Scotland, HSBC Bank and Lloyds Bank from 13 months to 6 months as there is some uncertainty surrounding which banking entities the Authority will be dealing with once ring-fencing is implemented. Even where there has been a level of clarity provided regarding where local authority customers will sit within the proposed new legal structures of the banks, it is not yet known what the balance sheet structures of those banks will be.

11.12. S&P also revised Nordea Banks outlook to stable from negative, whilst affirming their long-term rating at AA-. The outlook revision reflects Nordea's geographic diversification and strong financials.

12. Local Context

12.1. At 31/3/2017 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £575.2m. The Council had £347.0m of borrowing and £18.6m of investments.

12.2. The Council's current strategy is to maintain borrowing and below the Capital Financing Requirement (CFR), this is referred to as internal borrowing.

12.3. The Council has an increasing CFR over the next 3 years due to the capital programme, but minimal investments which can be used to fund capital plan cashflows. The Council will therefore need to take out additional borrowing over the forecast 3 year period.

13. Borrowing Strategy During the Quarter

13.1. At 30/06/2017 the Council held £268.0m of long term loans, (a decrease of £2.6m on 31/3/2017), as part of its strategy for funding previous years' capital programmes. The Council expects to take out additional long term borrowing in 2017/18, as the Council's underlying need to borrow is growing. Interest rates are carefully monitored and advice is taken from the Council's treasury adviser Arlingclose in relation to this.

13.2. The Council's 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 Council's long-term plans change being a secondary objective.

13.3. 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. Based on professional advice received from the Council's Treasury Management advisor Arlingclose, short-term interest rates are likely to remain low for a significant period.

Borrowing Activity

Borrowing	Balance at 1 Apr 2017 £'000	Borrowing Raised £'000	Maturities £'000	Balance at 30 June £'000	Avg Rate %
Short term Borrowing					
- UK Local Authorities	76,400	98,000	131,400	43,000	0.30
Long Term Borrowing					
- PWLB	145,646	0	2,614	143,032	5.49
- LOBO	125,000	0	0	125,000	4.72
TOTAL BORROWING	347,046	98,000	134,014	311,032	4.46

13.4. **LOBOs:** The Council holds £125m of LOBO (Lender's Option Borrower's Option) 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. £50m of these LOBOS had options during the quarter, none of which were 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.

Debt Rescheduling

13.5. The premium charge for early repayment of PWLB debt remains relatively expensive for the loans in the Council's portfolio and therefore unattractive for debt rescheduling activity.

14. Investment Activities

14.1. The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. Cashflow forecasts indicated that during 2017/18 the Council's investment balances would range between £0 and £50 million.

14.2. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles

14.3. The Council has sought to minimise its security risk by setting limits on each institution on the lending list. The Council has complied with all these limits during the financial year to date.

14.4. The economic environment remains uncertain, and given this background, the Council has kept cash investments to a minimum and short term. Money Market Funds continue to be used extensively as the portfolios are spread across a range of underlying investments to diversify risk. They also provide instant access enabling officers to take action quickly if there are any concerns about creditworthiness. The remainder of the Council's investments are held with the DMO (government agency).

Investment Activity

Investments	Balance at 1 Apr 2017 £'000	Investments Made £'000	Maturities £'000	Balance at 30 June £'000	Avg Rate /Yield %
Short term Investments (call accounts, depos					
- Banks & Building Societies	0	0	0	0	0
UK Government:					
- Deposits at Debt Management Office	10,000	93,600	103,600	0	0.10
- UK Local Authorities	0	0	0	0	0.00
Money Market Funds	8,575	92,910	86,035	15,450	0.20
TOTAL INVESTMENTS	18,575	186,510	189,635	15,450	0.17

Credit Risk

14.5. The table below shows counterparty credit quality as measured by credit ratings and the percentage of the in-house investment portfolio exposed to bail-in risk.

Date	Value Weighted Average - Credit Risk Score	Value Weighted Average - Credit Rating	Time Weighted Average - Credit Risk Score	Time Weighted Average - Credit Rating	Investments exposed to bail-in risk %
31/03/2017	3.49	AA	3.06	AA	46
30/06/2017	4.54	A+	4.54	A+	100

Scoring:
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-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

14.6. The UK Bank Rate had been maintained at 0.25% since August 2016. Short-term money market rates have remained at relatively low levels. Following the reduction in Bank Rate, rates for very short-dated periods (overnight – 1 month) fell to between 0.1% and 0.2%. Debt Management Account Deposit Facility (DMADF) rates are currently 0.10%.

14.7. Investments in Money Market Funds generated an average rate of 0.20%. The Council's forecast investment income for the year is estimated at £30k.

14.8. The Bank Rate is may be cut further towards zero in the coming months, which would in turn lower the rates short-dated money market investments with banks and building societies. As the Council's surplus cash continues to be invested in short-dated money market instruments, this scenario would most likely result in a fall in investment income over the year.

15. Compliance with Prudential Indicators

15.1. The Council confirms compliance with its Prudential Indicators for 2017/18, which was set in February 2017 as part of the Council's Treasury Management Strategy Statement.

Treasury Management Indicator

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

15.3. **Interest Rate Exposures**: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net [principal borrowed will be:

	2017/18 Q1	**2017/18 Full Year**	**2018/19**
Upper limit on fixed interest rate exposure	100%	100%	100%
Actual	80%		
Upper limit on variable interest rate exposure	60%	60%	60%
Actual	20%		

15.4. Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate, including short term borrowings.

15.5. **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:

Maturity structure of borrowing (U: upper, L: lower)	L	U	30-Jun-17
under 12 months	0%	60%	20.4%
12 months & within 2 years	0%	40%	0.0%
2 years & within 5 years	0%	40%	9.7%
5 years & within 10 years	0%	40%	6.1%
10 yrs & within 20 yrs	0%	40%	3.9%
20 yrs & within 30 yrs	0%	40%	3.2%
30 yrs & within 40 yrs	0%	50%	29.5%
40 yrs & within 50 yrs	0%	50%	27.2%
50 yrs & above	0%	40%	0.0%

15.6. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

15.7. **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. Given the policy of spending down cash balances and use of internal borrowing the Council does not expect to invest beyond 364 days in the medium term.

16. <u>Outlook for the remainder of 2017/18</u>

16.1. Just over a year after the UK voted to leave the EU there is still a great deal of uncertainty on Brexit negotiations, even after Article 50 was triggered in April. To add to this, the Conservative party lost their overall majority after they called a snap election in June meaning that negotiations may be even harder going forward.

16.2. UK GDP growth is forecast to be around 1.6% for 2017 and 1.4% in 2018. Subdued consumer spending will be the main driver behind this period of weaker growth, along with muted business investment due to Brexit-related uncertainty. Arlingclose, the Council's treasury adviser's central case for the path of Bank Rate over the next three years remains at 0.25%. Arlingclose believes that the high inflation reflects the impact of sterling's weakness on imports, and in the face of weaker growth prospects, will be looked through by Bank of England policymakers. The likely path for Bank Rate is for it to remain flat at 0.25%. However, there is downside risk for rates to be cut to 0.00% in the short-term and medium-term, and scope for rates to be increased from 2019 onwards, albeit modestly to 0.50%.

16.3. In addition, Arlingclose believes that the Government and the Bank of England have both the tools and the willingness to use them to prevent any immediate market-wide problems leading to bank insolvencies. The cautious approach to credit advice means that the banks currently on the Authority's counterparty list have sufficient equity buffers to deal with any localised problems in the short term.

Appendix 1: Prudential Indicators

No.	Prudential Indicator	2017/18 Original Indicator*	2017/18 Forecast Position 30 June
CAPITAL INDICATORS			
1	Capital Expenditure	£'000	£'000
	General Fund	133,941	133,941
	HRA	68,901	68,901
	TOTAL	202,842	202,842
2	Ratio of financing costs to net revenue stream	%	%
	General Fund	2.18	2.18
	HRA	9.87	9.87
3	Capital Financing Requirement	£'000	£'000
	General Fund	373,224	373,224
	HRA	271,096	271,096
	TOTAL	644,320	644,320
4	Incremental impact of capital investment decisions	£	£
	Band D Council Tax	13.75	13.75
	Weekly Housing rents	0.20	0.20
5	Borrowing Limits	£'000	£'000
	Authorised Limit / actual debt	536,063	311,032
	Operational Boundary/actual debt	481,105	311,032

*adjusted for slippage from 2016/17

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No.	Prudential Indicator	2017/18 Original Indicator		2017/18 Forecast Position 30 June
6	HRA Debt Cap	£'000		£'000
	Headroom	56,442		56,442
7	Gross debt compared to CFR	£'000		£'000
	Gross debt	347,046		311,032
	CFR	644,320		644,320
8	Upper limit – fixed rate exposure	100%		79.6%
	Upper limit – variable rate	60%		20.4%
9	Maturity structure of borrowing (U: upper, L: lower)	**L**	**U**	**30-Jun-17**
	under 12 months	0%	60%	20.4%
	12 months & within 2 years	0%	40%	0.0%
	2 years & within 5 years	0%	40%	9.7%
	5 years & within 10 years	0%	40%	6.1%
	10 yrs & within 20 yrs	0%	40%	3.9%
	20 yrs & within 30 yrs	0%	40%	3.2%
	30 yrs & within 40 yrs	0%	50%	29.5%
	40 yrs & within 50 yrs	0%	50%	27.2%
	50 yrs & above	0%	40%	0.0%
10	Sums invested for > 364 days	£0		£0
11	Adoption of CIPFA Treasury Management Code of Practice	√		√
12	**LOBO Adjusted** Maturity structure of borrowing (U: upper, L: lower)	L	U	**30-Jun-17**
	under 12 months	0%	60%	44.5%
	12 months & within 2 years	0%	40%	16.1%
	2 years & within 5 years	0%	40%	9.7%
	5 years & within 10 years	0%	40%	6.1%
	10 yrs & within 20 yrs	0%	40%	3.9%
	20 yrs & within 30 yrs	0%	40%	0.0%
	30 yrs & within 40 yrs	0%	50%	16.7%
	40 yrs & within 50 yrs	0%	50%	3.1%
	50 yrs & above	0%	40%	0.0%

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