

# Treasury Management Mid-term Report 2018/19

## Introduction

In April 2002 the Authority 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 meeting on 1 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 are 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 but has yet to publish the local authority specific Guidance Notes to the latter. In England MHCLG (Ministry for Homes and Local Government) 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 will be producing its Capital Strategy later in 2018-19 for approval by full Council.

## External Context

**Economic background:** Oil prices rose by 23% over the six months to around \$82/barrel. UK Consumer Price Inflation (CPI) for August rose to 2.7% year/year, above the consensus forecast and that of the Bank of England's in its August *Inflation Report*, as the effects of sterling's large depreciation in 2016 began to fade. The most recent labour market data for July 2018 showed the unemployment rate at 4%, its lowest since 1975. The 3-month average annual growth rate for regular pay, i.e. excluding bonuses, was 2.9% providing some evidence that a shortage of workers is providing support to wages. However, real wages (i.e. adjusted for inflation) grew by 0.2%, a marginal increase unlikely to have had much effect on households.

The rebound in quarterly GDP growth in Q2 to 0.4% appeared to overturn the weakness in Q1 which was largely due to weather-related factors. However, the detail showed much of Q2 GDP growth was attributed to an increase in inventories. Year/year GDP growth at 1.2% also remains below trend. The Bank of England made no change to monetary policy at its meetings in May and June, however hawkish minutes and a 6-3 vote to maintain rates was followed by a unanimous decision for a rate rise of 0.25% in August, taking Bank Rate to 0.75%.

Having raised rates in March, the US Federal Reserve again increased its target range of official interest rates in each of June and September by 0.25% to the current 2%-2.25%. Markets now expect one further rise in 2018.

The escalating trade war between the US and China as tariffs announced by the Trump administration appeared to become an entrenched dispute, damaging not just to China but also other Asian economies in the supply chain. The fallout, combined with tighter monetary policy, risks contributing to a slowdown in global economic activity and growth in 2019.

The EU Withdrawal Bill, which repeals the European Communities Act 1972 that took the UK into the EU and enables EU law to be transferred into UK law, narrowly made it through Parliament. With just six months to go when Article 50 expires on 29<sup>th</sup> March 2019, neither the Withdrawal Agreement between the UK and the EU which will be legally binding on separation issues and the financial settlement, nor its annex which will outline the shape of their future relationship, have been finalised, extending the period of economic uncertainty.

**Financial markets:** Gilt yields displayed marked volatility during the period, particularly following Italy's political crisis in late May when government bond yields saw sharp moves akin to those at the height of the European financial crisis with falls in yield in safe-haven UK, German and US government bonds. Over the period, despite the volatility, the net change in gilt yields was small. The 5-year benchmark gilt only rose marginally from 1.13% to 1.16%. There was a larger increase in 10-year gilt yields from 1.37% to 1.57% and in the 20-year gilt yield from 1.74% to 1.89%. The increase in Bank Rate resulted in higher money markets rates. 1-month, 3-month and 12-month LIBID rates averaged 0.56%, 0.70% and 0.95% respectively over the period.

**Credit background:** Reflecting its perceived higher risk, the Credit Default Swap (CDS) spread for non-ringfenced bank NatWest Markets plc rose relatively sharply over the period to around 96bps. The CDS for the ringfenced entity, National Westminster Bank plc, has held steady below 40bps. Although the CDS of other UK banks rose marginally over the period, they continue to remain low compared to historic averages.

The ringfencing of the big four UK banks - Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc - is complete, the transfer of their business lines into retail (ringfenced) and investment banking (non-ringfenced) is progressing and will need to be completed by the end of 2018.

There were a few credit rating changes during the period. Moody's downgraded Barclays Bank plc's long-term rating to A2 from A1 and NatWest Markets plc to Baa2 from A3 on its view of the credit metrics of the entities post ringfencing. Upgrades to long-term ratings included those for Royal Bank of Scotland plc, NatWest Bank and Ulster Bank to A2 from A3 by Moody's and to A- from BBB+ by both Fitch and Standard & Poor's (S&P). Lloyds Bank plc and Bank of Scotland plc were upgraded to A+ from A by S&P and to Aa3 from A1 by Moody's.

Our treasury advisor Arlingclose will henceforth 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 31<sup>st</sup> March 2018, the Authority had net borrowing of £157.9m arising from its revenue and capital income and expenditure. 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

|                       | <b>31.3.18<br/>Actual<br/>£m</b> |
|-----------------------|----------------------------------|
| General Fund CFR      | 52.7                             |
| HRA CFR               | 154.4                            |
| <b>Total CFR</b>      | <b>207.1</b>                     |
| Internal borrowing    | -21.6                            |
| <b>Borrowing CFR</b>  | <b>185.5</b>                     |
| Less: Usable reserves | -42.2                            |
| Less: Working capital | -0.1                             |
| <b>Net Worth</b>      | <b>143.2</b>                     |

\* finance leases, PFI liabilities and transferred debt that form part of the Authority's total debt

The treasury management position at 30<sup>th</sup> September 2018 and the change during the period is show in Table 2 below.

Table 2: Treasury Management Summary

|                           | <b>31.3.18<br/>Balance<br/>£m</b> | <b>Movement<br/>£m</b> | <b>30.9.18<br/>Balance<br/>£m</b> | <b>30.9.18<br/>Rate<br/>%</b> |
|---------------------------|-----------------------------------|------------------------|-----------------------------------|-------------------------------|
| Long-term borrowing       | 185.5                             | 0                      | 185.5                             | 3.02                          |
| <b>Total borrowing</b>    | <b>185.5</b>                      | <b>0</b>               | <b>185.5</b>                      |                               |
| Short-term investments    | 8.0                               | 1.0                    | 9.0                               | 0.82                          |
| Cash and cash equivalents | 18.7                              | -9.2                   | 9.3                               | 0.22                          |
| <b>Total investments</b>  | <b>26.7</b>                       | <b>-8.2</b>            | <b>18.3</b>                       |                               |
| <b>Net Borrowing</b>      | <b>158.8</b>                      | <b>-8.2</b>            | <b>167.2</b>                      |                               |

The figures in the tables above show the Net Borrowing figure from differing scenarios. Table 1 depicts the net borrowing if the General Fund would have entered the borrowing market to fund its capital programme, with the HRA "Bailing out" by using some of its reserves.

Table 2 shows the borrowing position from a cash aspect with the movements in year giving a revised total.

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.

### **Borrowing Strategy during the period**

At 30<sup>th</sup> September 2018 the Authority held 185.5m of loans, a similar position to 31<sup>st</sup> March 2018, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30<sup>th</sup> September are summarised in Table 3 below.

**Table 3: Borrowing Position**

|                               | <b>31.3.18<br/>Balance<br/>£m</b> | <b>Q1 Net<br/>Movement<br/>£m</b> | <b>30.9.18<br/>Balance<br/>£m</b> | <b>30.9.18<br/>Weighted<br/>Average<br/>Rate<br/>%</b> | <b>30.9.18<br/>Weighted<br/>Average<br/>Maturity<br/>(years)</b> |
|-------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|--------------------------------------------------------|------------------------------------------------------------------|
| <b>Total borrowing - PWLB</b> | <b>185.5</b>                      | <b>0</b>                          | <b>185.5</b>                      | <b>3.02</b>                                            | <b>18.46</b>                                                     |

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.

There has been no increase in borrowing during the period as investment balances have been maintained at around the same levels.

### **Treasury Investment Activity**

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the six-month period, the Authority's investment balance ranged between £23.7m and £19.5 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

**Table 4: Treasury Investment Position**

|                                        | <b>31.3.18<br/>Balance<br/>£m</b> | <b>Net<br/>Movement<br/>£m</b> | <b>30.9.18<br/>Balance<br/>£m</b> | <b>30.9.18<br/>Rate of<br/>Return<br/>%</b> | <b>30.9.18<br/>Weighted<br/>Average<br/>Maturity<br/>Days</b> |
|----------------------------------------|-----------------------------------|--------------------------------|-----------------------------------|---------------------------------------------|---------------------------------------------------------------|
| Banks & building societies (unsecured) | 7.0                               | 0.8                            | 7.8                               | 0.67                                        | 140                                                           |
| Government (incl. local authorities)   | 5.0                               | -2.0                           | 3.0                               | 0.80                                        | 142                                                           |
| Money Market Funds                     | 10.0                              | -2.5                           | 7.5                               | 0.69                                        | 1                                                             |
| Non-treasury items                     |                                   |                                |                                   |                                             |                                                               |
| Waste Management<br>Contractor         | 1.7                               | -0.5                           | 1.2                               | 4.90                                        | 488                                                           |
| <b>Total investments</b>               | <b>23.7</b>                       | <b>-4.2</b>                    | <b>19.5</b>                       |                                             |                                                               |

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.

In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the Authority has kept investment balances short term in line with the cash flow so as to enable funds to be available when required by operational and capital requirements. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

**Table 5: Investment Benchmarking - Treasury investments managed in-house**

|                | <b>Credit Score</b> | <b>Credit Rating</b> | <b>Bail-in Exposure</b> | <b>Weighted Average Maturity (days)</b> | <b>Rate of Return %</b> |
|----------------|---------------------|----------------------|-------------------------|-----------------------------------------|-------------------------|
| 31.03.2018     | 4.03                | AA-                  | 55%                     | 35                                      | 1.05%                   |
| 30.09.2018     | 4.29                | AA-                  | 65%                     | 18                                      | 0.70%                   |
| <b>All Las</b> | <b>4.12</b>         | <b>AA-</b>           | <b>61%</b>              | <b>98</b>                               | <b>1.37%</b>            |

The limit of Bail-in for the Council is higher than that of other Local Authorities due to our reliance on keeping funds in banks for "on-call" demand due to liquidity issues of the capital programme.

On 1 January 2018 the Movements in Financial Instruments Directive II (MiFID2) came into force and Councils were allowed to elect to be classed in one of two areas: (i) Professional Clients or (ii) Agency Clients, with this Council opting for Professional Status on the grounds of cost and accessibility to better products.

As part of this we are now required to keep £10m of investments at all times and make a number of transactions per annum. Investigations are now being made into the use of "Pooled Funds" so that funds are gathered from a number of areas, pooled together to make an investment with the aim of gaining better returns.

MHCLG consulted on statutory overrides relating to the IFRS 9 Financial Instruments accounting standard from 2018/19. The consultation recognised that the requirement in IFRS 9 for certain investments to be accounted for as fair value through profit and loss may introduce "more income statement volatility" which may impact on budget calculations. The consultation proposed a time-limited statutory override and sought views whether it should be applied only to pooled property funds.

### **Non-Treasury Investments**

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

The Authority also holds £1.2m of such investments in loans to the current Waste Collection Contractor which is repayable over the next 16 months.

This investment will generate returns of £56,000 of investment income for the Authority, representing a rate of return of 4.9%. This deal was brokered at the commencement of the current contract to enable the contractor to purchase vehicles for use on the contract at favourable rates to both parties.

### Treasury Performance

The Authority measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in table 6 below.

Table 6: Performance

|                                       | Actual<br>£m  | Budget<br>£m  | Over/<br>under | Actual<br>% | Benchmark<br>% | Over/<br>-under |
|---------------------------------------|---------------|---------------|----------------|-------------|----------------|-----------------|
| <b>Total borrowing</b>                | <b>-185.5</b> | <b>-212.0</b> | <b>26.5</b>    | <b>3.02</b> | <b>2.97</b>    | <b>-0.05</b>    |
| <b>Total treasury<br/>investments</b> | <b>18.5</b>   | <b>10.0</b>   | <b>9.5</b>     | <b>0.70</b> | <b>0.29</b>    | <b>0.41</b>     |
|                                       | <b>167.0</b>  | <b>-202.0</b> | <b>36.0</b>    | n/a         | n/a            | n/a             |

### Compliance

The S151 Officer reports that all treasury management activities undertaken complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy with the exception of a few minor breaches to allow cash to be held in the Councils bank account for up to 4 days prior to the monthly precept payments to Essex authorities. Compliance with specific investment limits is demonstrated in table 8 below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below.

Table 7: Debt Limits

|                   | H1<br>Maximum | 30.9.18<br>Actual | 2018/19<br>Operational<br>Boundary | 2018/19<br>Authorised<br>Limit | Complied? |
|-------------------|---------------|-------------------|------------------------------------|--------------------------------|-----------|
| <b>Total debt</b> | <b>212.0</b>  | <b>185.5</b>      | <b>240.0</b>                       | <b>250.0</b>                   | Yes       |

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

**Table 8: Investment Limits**

|                                                           | H1<br>Maximum | 30.9.18<br>Actual | 2018/19<br>Limit | Complied? |
|-----------------------------------------------------------|---------------|-------------------|------------------|-----------|
| Any single organisation, except the UK Government         | £3m           | £3m               | £3m each         | Yes       |
| UK Central Government                                     | 0             | 0                 | Unlimited        | Yes       |
| Local Authorities                                         | £5m           | £3m               | £25m in total    | Yes       |
| Any group of organisations under the same ownership       | £3m           | £3m               | £3m per group    | Yes       |
| Any group of pooled funds under the same management       | 0             | 0                 | £5m per manager  | Yes       |
| Negotiable instruments held in a broker's nominee account | 0             | 0                 | £7m per broker   | Yes       |
| Limit per non-UK country                                  | 0             | 0                 | £3m per country  | Yes       |
| Registered providers                                      | 0             | 0                 | £5m in total     | Yes       |
| Unsecured investments with building societies             | 0             | 0                 | £5m in total     | Yes       |
| Money Market Funds                                        | £15m in total | £7.5m             | £15m in total    | Yes       |

### **Treasury Management Indicators**

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

**Security:** The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

|                                 | 30.9.18<br>Actual | 2018/19<br>Target | Complied? |
|---------------------------------|-------------------|-------------------|-----------|
| Portfolio average credit rating | AA-               | A-                | Yes       |

**Liquidity:** The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing. Due to capital cash being ahead of cash flow expectations the value was under by £0.7m, but income from Council Tax Direct Debits the following working day brought this back into line.

|                                      | 30.9.18<br>Actual | 2018/19<br>Target | Complied? |
|--------------------------------------|-------------------|-------------------|-----------|
| Total cash available within 3 months | £9.3m             | £10m              | No        |

**Interest Rate Exposures:** 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 proportion of net principal borrowed was:

|                                                | 30.9.18<br>Actual | 2018/19<br>Limit | Complied? |
|------------------------------------------------|-------------------|------------------|-----------|
| Upper limit on fixed interest rate exposure    | 82.8%             | 100%             | Yes       |
| Upper limit on variable interest rate exposure | 17.2%             | 75%              | 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 fixed rate borrowing were:

|                                | 30.9.18<br>Actual | Upper<br>Limit | Lower<br>Limit | Complied? |
|--------------------------------|-------------------|----------------|----------------|-----------|
| Under 12 months                | 0                 | 100%           | 0%             | Yes       |
| 12 months and within 24 months | 0                 | 100%           | 0%             | Yes       |
| 24 months and within 5 years   | 0                 | 100%           | 0%             | Yes       |
| 5 years and within 10 years    | 0                 | 100%           | 0%             | Yes       |
| 10 years and above             | 83%               | 100%           | 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 365 days:** 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   | 0       | 0       | 0       |
| Limit on principal invested beyond year end | £5m     | £3m     | £3m     |
| Complied?                                   | Yes     | Yes     | Yes     |

### Outlook for the remainder of 2018/19

Having raised policy rates in August 2018 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 definite bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. While policymakers are wary of domestic inflationary pressures over the next two years, it is believed that the MPC members consider both (a) ultra-low interest rates result in other economic problems, and that (b) higher Bank Rate will be a more effective weapon should downside Brexit risks crystallise and cuts are required.

Arlingclose's central case is for Bank Rate to rise twice in 2019. The risks are weighted to the downside. The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in Q2 2018, but the annual growth rate of 1.2% remains well below the long term average

|                         | Sep-18 | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 |
|-------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Official Bank Rate      |        |        |        |        |        |        |        |        |        |        |        |        |        |
| Upside risk             | 0.00   | 0.00   | 0.00   | 0.00   | 0.00   | 0.00   | 0.25   | 0.25   | 0.25   | 0.25   | 0.25   | 0.25   | 0.25   |
| Arlingclose Central Ca: | 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   |
| Downside risk           | 0.00   | 0.00   | 0.50   | 0.50   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   |

The view is that the UK economy still faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Central bank actions and geopolitical risks, such as prospective trade wars, have and will continue to produce significant volatility in financial markets, including bond markets.