Appendix A

Treasury Management Mid Year Review 2018/19

Introduction

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 22nd 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 but has yet to publish the local authority specific Guidance Notes to the latter. 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 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%, the 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 only 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 29th 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 bet 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 in 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 31st March 2018, the Authority had net borrowing of £10m 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

	31.3.18 Actual £m
General Fund CFR	55
HRA CFR	86
Total CFR	**141**
Less: PFI Liabilities	-5
Borrowing CFR	**136**
External borrowing	-97
Internal borrowing	39
Less: Usable reserves	-25
Less: Working capital	-4
Net borrowing	**10**

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 30th September 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**	**30.9.18 Balance £m**	**30.9.18 Av Rate %**
Long-term borrowing	97	0	97	2.94
Short-term borrowing	23.5	-9.5	14	0.70
Total borrowing	**120.5**	**-9.5**	**111**	
Short-term investments	11.5	1.5	13	0.58
Cash and cash equivalents	2	0	2	0.55
Total investments	**13.5**	**1.5**	**15**	**-**
Net borrowing	**107**	**-8**	**96**	**-**

Borrowing Strategy during the period

At 30th September 2018 the Authority held £14m of loans, a decrease of £9.5m from 31st March 2018, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30th September are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.18 Balance £m	**H1 Net Movement £m**	**30.9.18 Balance £m**	**30.9.18 Weighted Average Rate %**	**30.9.18 Weighted Average Maturity (years)**
Public Works Loan Board	87	0	87	3.03	14.06
Phoenix Life Ltd	10	0	10	2.86	39.00
Local authorities (short-term)	23.5	-9.5	14	0.72	0.56
Total borrowing	**120.5**	**-9.5**	**111**	**-**	**-**

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.

In keeping with these objectives, no new borrowing was undertaken, while £9.5m of existing loans were allowed to mature without replacement. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

Other Debt Activity

After £0.06m repayment of prior years' Private Finance Initiative liabilities, total debt other than borrowing stood at £4.7m on 30th September 2018, taking total debt to £116m.

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 £6.5 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

	31.3.18 Balance £m	Net Movement £m	30.9.18 Balance £m	30.9.18 Av Rate of Return %
Banks & building societies (unsecured)	3	-1	2	0.55
Government (incl. local authorities)	9.5	2.5	12	0.57
Money Market Funds	1	0	1	0.63
	0	0	0	0
Total investments	**13.5**	**1.5**	**15**	

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.

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	3.92	AA-	17%	22	0.43
30.09.2018	3.89	AA-	17%	43	0.57
Similar LAs	**4.28**	**AA-**	**56%**	**88**	**1.41**
All LAs	**4.38**	**AA-**	**60%**	**37**	**1.25**

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 £47.5m of such investments in loans to its subsidiary Aspire (CRP) Ltd.

This investment is expected to generate £1.9m of investment income in 2018/19 for the Authority after taking account of direct costs, representing a rate of return of 4%. This is higher than the return earned on treasury investments, but reflects the additional risks to the Authority of holding such investments.

Compliance

The Director of Finance and Corporate Services reports that all treasury management activities undertaken during the first half of the year complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy with the exception of the Councils current account which exceeded the £2m limit for one working day due to a large payment being received after the deadline to invest, this was outside of the councils control. Compliance with specific investment limits is demonstrated in table 7 below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 8 below and for your information the Prudential Indicators are attached in appendix A.

Table 6: Debt Limits

	H1 Maximum £m	**30.9.18 Actual £m**	**2018/19 Operational Boundary £m**	**2018/19 Authorised Limit £m**	**Complied?**
Borrowing	124	111	116	244	✓
PFI and Finance Leases	5	5	6	6	✓
Total debt	**129**	**116**	**122**	**250**	

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. Total debt was above the operational boundary for 48 days during the six-month period.

Table 7: Investment Limits

	H1 Maximum £m	**30.9.18 Actual £m**	**2018/19 Limit £m**	**Complied?**
Banks and other organisations whose lowest published long-term credit rating from the credit rating agencies is BBB+ or higher, per bank	**1**	**1**	**1**	✓
Councils General Bank Account excluding deposit accounts	**4**	**1.2**	**2**	X
UK Central Government	**9.5**	**0**	**Unlimited**	✓
UK Local Authorities including Police and Fire (irrespective of credit rating) per authority	**6**	**3.5**	**6**	✓
UK Building societies without credit ratings	**0**	**0**	**1**	✓
Saffron Building Society	**0**	**0**	**0.5**	✓

Money Market Funds, per fund	**1**	**1**	**1**	✓

Treasury Management Indicators

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

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 amount of net interest payable was:

	30.9.18 Actual	**2018/19 Limit**	**Complied?**
Upper limit on fixed interest rate exposure	1,460	2,856	✓
Upper limit on variable interest rate exposure	55	80	✓

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:

	30.9.18 Actual	**Upper Limit**	**Complied?**
Under 12 months	14%	20%	✓
12 months and within 24 months	2%	20%	✓
24 months and within 5 years	6%	60%	✓
5 years and within 10 years	14%	100%	✓
10 years and above	64%	100%	✓

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	£10m	£10m	£10m
Complied?	✓	✓	✓

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 that (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.