Appendix A

Treasury Management Update

Six Months Ended 30 September 2018

Introduction

In December 2017 the Council 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 Council to approve treasury management semi-annual and annual reports. The Council's treasury management strategy for 2018/19 was approved at a meeting of Full Council on 23 February 2018.

The Council has 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 Council'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 Council specific Guidance Notes to the latter. In England the Ministry of Housing Communities and Local Government (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 Council will be producing its Capital Strategy later in 2018-19 for approval by Shadow 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 on 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 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 on 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 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 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 31 March 2018, the Council's 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 the Table below.

Table 1: Balance Sheet Summary

	31.03.18 Actual £000
General Fund CFR	5,204
Less: Usable reserves	(8,115)
Less: Working capital	(13,007)
Net Investment Capacity	**(15,918)**

The Council'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 30 September 2018 and the change in the first six months of 2018/19 is shown in the table below.

Table 2: Treasury Management Summary

	31.03.18 Balance £000	Movement £000	30.09.18 Balance £000	30.09.18 Rate %
Long-term borrowing Short-term borrowing	0 0	0 0	0 0	N/A N/A
Total borrowing	**0**	**0**	**0**	
Long-term investments Short-term investments Cash and cash equivalents	0 12,938 3,462	0 1,269 1,399	0 14,207 4,861	N/A 0.46 0.51
Total investments	**16,400**	**2,668**	**19,068**	**0.48**
Net Investments	**16,400**	**2,668**	**19,068**	

Borrowing Strategy during the half year

At 30 September 2018 the Council held no external loans, this position remains unchanged from that reported at 31 March 2018 as part of the 2017/18 Treasury Management Outturn Report.

The Council's chief objective if it needs to borrow is 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 Council's long-term plans change being a secondary objective.

However, the Council does not expect to borrow externally for the remainder of 2018/19.

Table 3: Borrowing Position

	Opening CFR 31/03/2018 £000	MRP £000	Maturing Debt £000	New Borrowing £000	Closing CFR 30/09/2018 £000
CFR	5,204	(143)	0	0	5,061

Investment Activity

The Council holds invested funds on its own behalf with a separate fund in respect of the Section 106 Agreement it has with EDF relating to the building of Hinkley Point C Nuclear Power Station, representing income received in advance of expenditure plus balances and reserves held. During the six-month period, the Council's investment balance ranged between £12.9m and £22.5m due to timing differences between income and expenditure. The investment position is shown in the table below.

Table 4: Treasury Investment Position

	31.03.18 Balance £000	Movement £000	30.09.18 Balance £000	30.09.18 Average Rate %
Banks & Building Societies (unsecured)	112	500	612	0.37
Covered Bonds (secured)	500	(500)	0	0.00
Government (incl. local authorities)	12,438	1,769	14,207	0.46
Money Market Funds	3,350	899	4,249	0.52
Total Investments	**16,400**	**2,668**	**19,068**	

Both the CIPFA Code and government guidance require the Council 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 Council's main objective when investing money is the security of capital. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2018/19.

Credit Risk

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. This is an extract from Arlingclose's quarterly investment benchmarking.

Table 5: Investment Benchmarking – Treasury Investments Managed In-house

	Credit Score	Credit Rating	Bail-in Exposure	Rate of Return
31.03.2018 30.09.2018	3.38 3.39	AA AA	21% 19%	0.35% 0.57%
Similar LAs All LAs	4.28 4.38	AA- AA-	56% 60%	1.41% 1.25%

MHCLG have 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. The Council responded to the consultation which closed on 28 September supporting an unlimited statutory override across all asset types.

Following the consultation process the Government has put in place a statutory override for a five year period across all investment schemes. This will require the establishment of a new unusable reserve to hold the fair value movements on investments to promote transparency and ensure there is no effect on the General Fund balance.

Non-Treasury Investments

The definition of investments in CIPFA’s revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council 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.

Currently the Council has no existing non-treasury investments.

Treasury Performance

The average cash balances were £18.294m during the period. Investments in Money Market Funds generated an average rate of 0.52%, investments with the Debt Management Office (DMO) generated an average of 0.35%, investments with Banks and Building Societies generated an average of 0.37%, while investments with Local Councils generated an average of 0.69%.

The Council's budgeted investment income for the year is £0.028m with forecast returns predicted to be £0.064m. Investment income in respect of Hinkley S106 funds are ring-fenced and added to the S106 Account.

Compliance

The Assistant Director – Strategic Finance is pleased to report that all treasury management activities undertaken during the first half of 2018/19 complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table below.

Table 6: Investment Limits

	30.09.18 Actual	**2018/19 Limit**	**Complied**
Any single organisation, including Supernational and Sovereign Agencies, except the UK Government and UK Local Authorities	£1.5m	£2m	✓
UK Government	£14.21m	Unlimited	✓
Any group of organisations under the same ownership (Except UK Government)	£0.45m	£2m per Group	✓
Any group of pooled funds under the same management	£0m	£2m per Manager	✓
Negotiable instruments held in a broker's nominated account	£0m	£5m per Broker	✓
Foreign Banks (Excluding Supernational Organisations)	£0m	£2m per Country	✓
Registered providers	£0m	£5m in Total	✓
Loans to unrated corporates	£0m	£2m in Total	✓
Money Market Funds	£4.25m	£10m in Total	✓

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

Table 7: Debt Limits

	30.09.18 Actual £m	2018/19 Operational Boundary £m	2018/19 Authorised Limit £m	Complied
Borrowing	0	12	24	✓
Total Debt	**0**	**12**	**24**	✓

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. However, it can be confirmed that total debt did not breach the operational boundary during the six-month period to 30th September 2018.

Treasury Management Indicators

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

Security: The Council 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.

	30.09.18 Actual	2018/19 Target	Complied
Portfolio Average Credit Rating	AA	A-	✓

Liquidity: The Council 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 borrowing.

	30.09.18 Actual	2018/19 Target	Complied
Total cash available within 3 months	£10.2m	£15.0m	✓

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 was:

	30.09.18 Actual %	2018/19 Limit %	Complied
Upper limit on fixed interest rate exposure	31	100	✓
Upper limit on variable interest rate exposure	69	100	✓

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.

Principal Sums Invested for Periods Longer than 365 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 long-term principal sum invested to final maturities beyond the period end were:

	2018/19 £m	2019/20 £m	2020/21 £m
Actual principal invested beyond year end	4.0	0.0	0.0
Limit on principal invested beyond year end	10.0	6.0	6.0
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

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.

	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