

Agenda Item No:	8	
Committee:	Council	
Date:	15 November 2018	
Report Title:	Treasury Management Strategy Statement and Annual Investment Strategy Mid-Year Review 2018/19	

## 1 Purpose / Summary

The purpose of this report is to review the Council's Treasury Management activity for the first six months of 2018/19 and to provide members with an update on matters pertinent to future updates to the Council's Treasury Management Strategy.

## 2 Key issues

- The Treasury Management Mid-Year Review 2018/19 as considered by Cabinet on 15 November 2018 is attached.
- Updates to the Treasury Management Code of Practice and the Prudential Code will impact on the Council's reporting and oversight arrangements from 2019/20. Proposals are being developed by officers to ensure adherence to the new requirements.
- The Council has operated within its Treasury Management Strategy Statement (TMSS), Annual Investment Strategy, treasury limits and prudential indicators set by Council for the first six months of 2018/19.
- The Monetary Policy Committee (MPC) voted to increase the Bank Rate on 2<sup>nd</sup> August 2018 from 0.50 to 0.75%. Further, the MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track.
- Prudential indicators for the Capital Financing Requirement (CFR) and the capital position have been revised.
- Due to the Council's long term debt portfolio (£7.8m at 31/03/18) currently attracting excessive premiums for early redemption of debt, as has been the case since 2007, it is not financially advantageous for the Council to comply with the Gross Borrowing and Capital Financing Prudential Indicator in 2018/19.
- Investment income received for the first six months of 2018/19 is £76k which is an improvement on the original estimate for this period reflecting the increase in the Bank rate. Consequently, the budgeted outturn for the year has been revised upwards from £140k to £155k. Nevertheless market rates remain low and are expected to continue to remain so based on current medium-term forecasts.
- Overall interest rate achieved from investments for the first six months of 2018/19 was 0.64% (7 day LIBID un compounded rate 0.44%).
- The Money Market Fund sector is now in the last stages of introducing new regulations. These will see existing non-government Constant Net Asset Value (CNAV) funds convert to Low Volatility Net Asset Value (LVNAV) pricing.

### 3 Recommendations

It is recommended that:-

- Members note the report.

It is recommended by Cabinet that the:-

- Treasury Management Strategy is updated to allow use of Constant Net Asset Value (CNAV), Low Volatility Net Asset Value (LVNAV) and Variable Net Asset Value (VNAV) Money Market Funds, as detailed in paragraph 3.1.

Wards Affected	All
Portfolio Holder(s)	Councillor Anne Hay, Portfolio Holder, Finance
Report Originator(s)	Kamal Mehta, Interim Corporate Director and Chief Finance Officer Mark Saunders, Chief Accountant
Contact Officer(s)	Kamal Mehta, Interim Corporate Director and Chief Finance Officer Mark Saunders, Chief Accountant
Background Paper (s)	Link Asset Services template Council Report - 22 February 2018 - General Fund Budget 2018/19 and Capital Programme 2018-21 Cabinet Report – 19 July 2018 - Capital Programme Update

## Report:

### **1 Context**

- 1.1 The Council's responsibilities in relation to Treasury Management are defined as part of the Local Government Act 2003 ('the Act'). The Act requires the Council to have regard to the Treasury Management Code published by the Chartered Institute of Public Finance and Accountancy, (CIPFA). CIPFA updated the Treasury Management Code in December 2017 and this report has been prepared with reference to the requirements set out in the updated Code.
- 1.2 Additionally, there is a statutory requirement for the Council to comply with the Prudential Code which is also published by CIPFA and was also updated in December 2017. There is a close interaction between the Treasury Management Code and the Prudential Code. The Prudential Code establishes a framework for the Council to self-regulate the affordability, prudence and sustainability of its capital expenditure and borrowing plans whilst the Treasury Management Code is concerned with how the Council uses its Treasury Management function to progress the future plans developed with reference to the Prudential Code.
- 1.3 Reductions in central government funding for local government and declining returns on deposits invested with financial institutions has led some local authorities to explore other avenues for generating investment returns, including in investment in non-financial assets. The recent updates to the Treasury Management Code and the Prudential Code reflect these trends and this has been further underlined by statutory guidance on Local Government Investments published by the Ministry of Housing and Local Government in February 2018. In particular, there is a recognition that all authorities need to ensure they can clearly identify the strategic considerations underpinning their investment strategies and effective governance frameworks are in place to protect and preserve each authority's long-term financial sustainability. Specifically, from 2019/20, all local authorities will be required to have an approved Capital Strategy which is intended to provide the following:
  - a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services;
  - an overview of how the associated risk is managed;
  - the implications for future financial sustainability.

A report setting out the Council's Capital Strategy will be prepared for consideration and approval by Full Council before 31st March 2019 as part of the annual budget-setting timetable.

- 1.4 The updated Treasury Management Code states that, providing the Council's Capital Strategy provides key information relating to treasury management, full Council is no longer required to approve a separate Treasury Management Strategy. However, where such an approach is adopted the Chief Finance Officer is required to put in place arrangements for separate approval and review of the Council's treasury management strategy and treasury management activities and full Council retains overall responsibility for Treasury Management. Details of the Council's proposals for future oversight of treasury management will be considered at a future meeting of this committee.

## **Treasury Management**

- 1.4 Treasury management is defined as “The management of the local authority’s borrowing, 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.”
- 1.5 The Council complies with the requirements of CIPFA’s Code of Practice on Treasury Management (revised 2017).
- 1.6 The primary requirements of the Code applicable to the 2018/19 financial year are as follows:
  - Creation and maintenance of a Treasury Management Policy Statement, which sets out the policies and objectives of the Council’s treasury management activities.
  - Creation and maintenance of Treasury Management Practices, which set out the manner in which the Council will seek to achieve those policies and objectives.
  - Receipt by full Council of an annual Treasury Management Strategy Statement, including the Annual Investment Strategy and Minimum Revenue Provision Policy for the year ahead, a Mid-year Review Report and an Annual Report covering activities during the previous year.
  - Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
  - Delegation by the Council of the role of scrutiny of treasury management strategy and policies (including Mid-year Review Report) to a specific named body. For this Council the delegated body is Corporate Governance Committee.
- 1.7 This mid-year report has been prepared in compliance with CIPFA’s Code of Practice on Treasury Management and covers the following:
  - an economic update for the first six months of 2018/19 taking account of expert analysis provided by the Council’s Treasury Management Advisors, Link Asset Services;
  - a review of the Treasury Management Strategy Statement and Annual Investment Strategy;
  - the Council’s capital plans;
  - a review of the Council’s investment portfolio for 2018/19;
  - a report of the Council’s borrowing strategy for 2018/19;
  - a report of debt rescheduling during 2018/19;
  - a review of compliance with Treasury and Prudential Limits for 2018/19.

## **2 Economic Update**

- 2.1 The first half of 2018/19 has seen UK economic growth post a modest performance, but sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase Bank Rate on 2<sup>nd</sup> August from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, the Bank of England’s August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019, albeit there were several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.
- 2.2 Some MPC members have expressed concerns about a build-up of inflationary pressures, particularly with the pound falling in value again against both the US dollar

and the Euro. The Consumer Price Index (CPI) measure of inflation rose unexpectedly from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019. The MPC emphasised again, that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary or contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years' time but they declined to give a medium term forecast

- 2.3 As for the labour market, unemployment has continued at a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high in July, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 2.9%, (3 month average regular pay, excluding bonuses) and to a one month figure in July of 3.1%. This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 0.4%, near to the joint high of 0.5% since 2009. (The previous high point was in July 2015.) Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. Link Asset Services suggest that this tends to confirm that the MPC were right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy. However, the MPC will need to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit.
- 2.4 In the political arena, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, Link Asset Services continue to anticipate that Prime Minister May's government will endure, despite various setbacks, along the route to Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.
- 2.5 In the USA, President Trump's massive easing of fiscal policy is fuelling a (temporary) boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2% (annualised rate) in quarter 1 to 4.2% in quarter 2, but also an upturn in inflationary pressures. With inflation moving towards 3%, the Fed increased rates another 0.25% in September to between 2.00% and 2.25%, this being four increases in 2018, and indicated they expected to increase rates four more times by the end of 2019. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019.
- 2.6 Growth in the Eurozone was unchanged at 0.4% in quarter 2, but has undershot early forecasts for a stronger economic performance in 2018. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of 2% for 2018, the horizon is less clear than it seemed just a short while ago.
- 2.7 Economic growth in China has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of

unsold property, and to address the level of non-performing loans in the banking and credit systems.

2.8 Prospects for interest rates and borrowings over the medium term are shown below.

Link Asset Services Interest Rate View											
	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate View	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
3 Month LIBID	0.75%	0.80%	0.80%	0.90%	1.10%	1.10%	1.20%	1.40%	1.50%	1.60%	1.60%
6 Month LIBID	0.85%	0.90%	0.90%	1.00%	1.20%	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%
12 Month LIBID	1.00%	1.00%	1.00%	1.10%	1.30%	1.30%	1.40%	1.60%	1.70%	1.80%	1.80%
5yr PWLB Rate	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
10yr PWLB Rate	2.40%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%

### 3 Treasury Management Strategy Statement and Annual Investment Strategy Update

- 3.1 The Treasury Management Strategy Statement (TMSS) for 2018/19 was approved by Council on 22 February 2018. Due to expected changes in Money Market regulations which are due to come into effect in the very early stages of 2019, it is recommended that the Council updates its Annual Investment Strategy immediately to ensure the Council is able to use money market funds which are classified as either Constant Net Asset Value (CNAV), Low Volatility Net Asset Value (LNAV) or Variable Net Asset Value (VNAV) should it wish to do so. The existing Annual Investment Strategy does not specify which money market funds the Council can invest in so this change will provide for additional clarity and it reflects guidance the Council has received from its Treasury Management Advisors.
- 3.2 Prudential indicators for the Capital Financing Requirement (CFR) and the capital position have been revised.

### 4 The Council's Capital Position

- 4.1 This part of the report is structured to update:
- the Council's capital expenditure plans;
  - how these plans are being financed;
  - the impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and compliance with limits in place for borrowing activity.
- 4.2 At its meeting on 19 July 2018 the Cabinet approved revised estimates for the 2018/19 capital programme and the financing of that programme. The table below compares the revised estimates with the original capital programme which was incorporated into the 2018/19 Treasury Management Strategy Statement (TMSS).

<b>Capital Programme</b>	<b>2018/19 Original Estimate £000</b>	<b>2018/19 Revised Estimate £000</b>
<b>Forecast Capital Expenditure</b>	<b>3,145</b>	<b>3,852</b>
Financed by :		
Capital Grants	980	1,106
Section 106's	0	96
Capital Receipts	413	317
Capital Reserves	580	994
Finance Leases	0	336
<b>Total Financing</b>	<b>1,973</b>	<b>2,849</b>
<b>Borrowing Requirement</b>	<b>1,172</b>	<b>1,003</b>

- 4.3 The main changes to the programme since February 2018 is an acceleration of the vehicle replacement programme with spending budgeted for 2019/20 due to happen in this financial year. Re-profiling adjustments consistent with the variations reported to Council and Cabinet as part of the outturn report on 17 May 2018 have also been reflected.
- 4.4 The anticipated expenditure funded from disabled facilities grants has increased to take account of the confirmed allocation from government and a brought-forward underspend from the prior year. A scheme to develop the Skate Park at Wisbech using section 106 monies has also been added to the capital programme for the 2018/19 financial year.
- 4.5 The table below shows the anticipated CFR at 31 March 2019, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period; this is termed the Operational Boundary.

<b>Prudential Indicators</b>	<b>2018/19 Original Estimate £000</b>	<b>2018/19 Revised Estimate £000</b>
<b>Capital Financing Requirement as at 31 March 2019</b>	<b>1,786</b>	<b>1,859</b>
<b>External Debt / Operational Boundary</b>		
Borrowing	10,000	10,000
Other Long Term Liabilities Finance Leases	2,000	2,000
<b>Total Debt 31 March</b>	<b>12,000</b>	<b>12,000</b>

- 4.6 The Council's revised estimate for CFR is £73k higher than the original estimate. This results principally from the acceleration of the vehicle replacement programme and the re-profiling of capital expenditure between years.
- 4.7 The Council has made provision to repay all 'borrowing' liabilities through increased Minimum Revenue Provision (MRP) in the General Fund revenue budget.
- 4.8 Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within defined limits. One of these is that the Council needs to ensure that its gross debt, does not, except in the short term, exceed the total CFR in the preceding year plus the estimates of any additional CFR for 2018/19 and the next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

<b>Limits to Borrowing Activity</b>	<b>2018/19 Original Estimate £000</b>	<b>2018/19 Revised Estimate £000</b>
Gross Borrowing	7,800	7,800
Plus Other Long Term Liabilities Finance Leases	563	845
<b>Anticipated Gross Borrowing as at 31 March 2019</b>	<b>8,363</b>	<b>8,645</b>
<b>Anticipated Capital Financing Requirement as at 31 March 2019</b>	<b>1,786</b>	<b>1,859</b>

- 4.9 As a result of the Council's long term Public Works Loan Board (PWLB) debt portfolio of £4.5m (31/03/2018) currently attracting excessive premiums (£2.883m at the time of writing this report) if it were prematurely repaid, it is not financially advantageous for the Council to fully comply with this prudential indicator. A similar issue applies to the fixed rate loan of £3.3m which the Council has with Barclays. This has been the case since the housing stock transfer in 2007 and has been acknowledged and approved by Council since then. In addition, the Council's external auditors have also acknowledged this situation and have not raised any issues with our strategy.
- 4.10 A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit, which represents the limit beyond which borrowing is prohibited and needs to be set and revised by Members. It reflects the level for borrowing which, while not desired could be afforded in the short term but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.



<b>Authorised Limit For External Debt</b>	<b>2018/19 Original Estimate £000</b>	<b>2018/19 Revised Estimate £000</b>
Borrowing	15,000	15,000
Plus Other Long Term Liabilities Finance Leases	2,000	2,000
<b>Total Borrowing</b>	<b>17,000</b>	<b>17,000</b>

- 4.11 The interim Corporate Director & Chief Finance Officer reports that no difficulties are envisaged for the current year in complying with the above prudential indicators.

## **5 Investment Portfolio**

- 5.1 In accordance with the Treasury Management Code, it is the Council's priority to ensure security of capital and liquidity and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As set out in section 2, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis and its impact on banks indicates that the Council should continue to pursue a low risk and short term strategy. This reflects the fact that credit ratings for European and British Banks continue to result in the Council's Treasury Management advisors tending to recommend that amounts should not be deposited with these financial institutions for terms in excess of 12 months. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual, investment returns are likely to remain low.
- 5.2 The Council held investments of £24.54m as at 30<sup>th</sup> September 2018 (£19.5m at 31<sup>st</sup> March 2018) as detailed at Appendix A. The investment portfolio yield for the first 6 months of the year is 0.64% (7 day LIBID un-compounded rate 0.44%).
- 5.3 The interim Corporate Director and Chief Finance Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2018/19. The Council has achieved investment income of £76k to 30<sup>th</sup> September 2018. The 2017/18 projected outturn of £140k has been revised upwards to £155k.
- 5.4 The Money Market Fund sector is now in the last stages of introducing new regulations. These will see existing non-government Constant Net Asset Value (CNAV) funds convert to Low Volatility Net Asset Value (LVNAV) pricing, whilst Variable Net Asset Value funds remain unchanged.
- 5.5 The Council has not currently made use of Money Market funds, though their use is permitted within the current TMSS approved in February 2018.
- 5.6 As explained at paragraph 3.1 above, the change in Money Market regulations are expected to change in the very early stages of 2019. It is recommended to Council that the use of CNAV, LVNAV and VNAV Money Market Funds be approved.

## **6 Borrowing Strategy**

- 6.1 The Council's estimated CFR for 2018/19 is £1.859m (including finance lease borrowing facilities). The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market

(external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions.

- 6.2 During 2018/19 the council has approved the use of £1.003m of borrowing and the use of lease facilities totalling £0.336m to support capital investment. The decision whether to undertake internal or external borrowing to meet the Council's financing requirements will be undertaken as and when the financing is required based on an assessment of market conditions and the Council's overall financial position at that time.
- 6.3 It is not anticipated there will be any further borrowing undertaken during this financial year.

## **7 Debt Rescheduling**

- 7.1 Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling was undertaken during the first six months of 2018/19.

## **8 Other**

### **UK Banks – ring fencing**

- 8.1 The largest UK banks, (those with more than £25bn of retail / Small and Medium-sized Enterprise (SME) deposits), are required, by UK law, to separate core retail banking services from their investment and international banking activities by 1st January 2019. This is known as 'ring-fencing'. Whilst smaller banks with less than £25bn in deposits are exempt, they can choose to 'opt up' and adopt 'ring-fencing'. Several banks are very close to the threshold already and so may come into scope in the future regardless.
- 8.2 Ring-fencing is a regulatory initiative created in response to the global financial crisis. It mandates the separation of retail and SME deposits from investment banking, in order to improve the resilience and resolvability of banks by changing their structure. In general, simpler activities offered from within a ring-fenced bank, (RFB), will be focused on lower risk, day-to-day core transactions, whilst more complex and 'riskier' activities are required to be housed in a separate entity, a non-ring-fenced bank, (NRFB). This is intended to ensure that an entity's core activities are not adversely affected by the acts or omissions of other members of its group.
- 8.3 While the structure of the banks included within this process may have changed, the fundamentals of credit assessment have not. The Council will continue to assess the new-formed entities in the same way that it does others and those with sufficiently high ratings, (and any other metrics considered), will be considered for investment purposes.

APPENDIX A

TEMPORARY INVESTMENTS AS AT 30/09/2018

BORROWER	AMOUNT £000	START DATE	MATURITY DATE	PERIOD IN DAYS	CURRENT INTEREST RATE %
Barclays Bank*	3,540	16/06/14		Flexible Interest	0.60
Santander UK	5,000	15/12/15		180 Day Notice A/C	1.00
Bank of Scotland	1,000	16/05/18	11/10/18	148	0.71
Bank of Scotland	1,000	13/06/18	12/06/19	364	1.00
Lloyds Bank	3,500	15/06/18	11/10/18	118	0.67
Bank of Scotland	3,000	04/07/18	20/12/18	169	0.75
Coventry Building Society	1,000	11/07/18	19/11/18	131	0.60
Nationwide Building Society	2,000	16/07/18	19/12/18	156	0.67
Yorkshire Building Society	1,000	21/08/18	26/11/18	97	0.71
Lloyds Bank	1,500	21/08/18	19/03/19	210	0.88
Eastleigh Borough Council	2,000	03/09/18	28/02/19	178	0.75
<b>Total Investments at 30/09/2018</b>	<b>24,540</b>				

\* Barclays Bank Call Account is operated on the basis of meeting more immediate/very short term needs of the Council eg. payment of salaries, suppliers, benefits etc. Therefore a level of balance is maintained dependent on the immediate and very short-term requirements of the Council.