



| <u>Committee and Date</u> |
|------------------------------------|
| Cabinet 28 November 2018 |
| Audit Committee 6 December 2018 |
| Council 13 December 2018 |

TREASURY STRATEGY 2018/19 – MID YEAR REVIEW

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1. Summary

1.1 This mid year Treasury Strategy report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management 2017 and covers the following:-

- An economic update for the first six months of 2018/19
- A review of the Treasury Strategy 2018/19 and Annual Investment Strategy
- A review of the Council's investment portfolio for 2018/19
- A review of the Council's borrowing strategy for 2018/19
- A review of any debt rescheduling undertaken
- A review of compliance with Treasury and Prudential limits for 2018/19

1.2 The key points to note are:-

- The internal treasury team achieved a return of 0.72% on the Council's cash balances outperforming the benchmark by 0.28%. This amounts to additional income of £161,320 for the first six months of the year which is included within the Council's projected outturn position.
- In the first six months all treasury management activities have been in accordance with the approved limits and prudential indicators set out in the Council's Treasury Strategy.

2. Recommendations

2.1 Members are asked to accept the position as set out in the report.

2.2 Members note that any changes required to the Treasury Strategy including the Annual Investment Strategy or prudential and treasury indicators as a result of decisions made by the Capital Investment Board will be reported to Council for approval.

2.3 Members are asked to approve the updated MRP policy at appendix D.

REPORT

3. Risk Assessment and Opportunities Appraisal

- 3.1 The recommendations contained in this report are compatible with the provisions of the Human Rights Act 1998.
- 3.2 There are no direct environmental, equalities or climate change consequences arising from this report.
- 3.3 Compliance with the CIPFA Code of Practice on Treasury Management, the Council's Treasury Policy Statement and Treasury Management Practices and the Prudential Code for Capital Finance together with the rigorous internal controls will enable the Council to manage the risk associated with Treasury Management activities and the potential for financial loss.

4. Financial Implications

- 4.1 The Council makes assumptions about the levels of borrowing and investment income over the financial year. Reduced borrowing as a result of capital receipt generation or delays in delivery of the capital programme will both have a positive impact of the council's cash position. Similarly, higher than benchmarked returns on available cash will also help the Council's financial position. For monitoring purposes, assumptions are made early in the year about borrowing and returns based on the strategies agreed by Council in the preceding February. Performance outside of these assumptions results in increased or reduced income for the Council.
- 4.2 The six monthly performance is above benchmark and has delivered additional income of £161,320 which will be reflected in the Period 6 Revenue Monitor.
- 4.3 The Council currently has £118m held in investments as detailed in Appendix A and borrowing of £312m at fixed interest rates.

5. Background

- 5.1 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the Treasury Management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.
- 5.2 The second main function of the Treasury Management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.
- 5.3 The Council defines its treasury management activities as "the management of the authority's borrowing, investments and cash flows, its banking, money market and capital market transactions, the effective control of the risks associated with the activities, and the pursuit of optimum performance consistent with those risks". The report informs Members of the treasury activities of the Council for the first six months of the financial year.
- 5.4 In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued revised Prudential and Treasury Management Codes. As from

2019/20, all local authorities will be required to prepare a 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 our Capital Strategy will be taken to the full Council before 31st March 2019

- 5.5 This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2017.

6. Economic update

- 6.1 **Global Economy** – President Trump's easing of fiscal policy is fuelling a temporary boost in consumption which has generated an upturn in the rate of strong annualised growth which rose from 2.2% in quarter 1 to 4.2% in quarter 2. There was also an upturn in inflationary pressures, with inflation moving towards 3%. On the back of this, the Federal Reserve (Fed) increased rates by 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.

- 6.2 Chinese economic growth 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.

- 6.3 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.

- 6.4 **UK Economy** – 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 vote 9-0 to increase Bank Rate on 2nd 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. However, there were several caveats mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

- 6.5 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.

- 6.6 Unemployment has continued at a 43 year low of 4%. 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% 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. 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. 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.
- 6.7 There is a risk that the current government may be unable to secure a majority in the Commons over Brexit. However, Link's central position is that the 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.

7 Economic Forecast

- 7.1 The Council receives its treasury advice from Link Asset Services. Their latest interest rate forecasts 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% |

- 7.2. The flow of generally positive economic statistics after the end of the June quarter 2018 meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, to 0.75%. However, 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. Link do not think that the MPC will increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. Link also feel that the MPC is more likely to wait until August 2019, than May 2019, before the next increase, to be

followed by further increases of 0.25% in May and November 2020 to reach 1.5%. However, the cautious pace of even these limited increases is dependent on a reasonably orderly Brexit.

- 7.3. The overall balance of risks to economic growth in the UK is probably neutral. The balance of risks to increases in Bank Rate and shorter term PWLB rates are probably also even and are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.
- 7.4. Long term PWLB rates are expected to rise to 2.9% in June 2019 before steadily increasing over time to reach 3.3% by December 2020.

8. Treasury Strategy update

- 8.1 The Treasury Management Strategy (TMS) for 2018/19 was approved by Full Council on 22 February 2018. This Treasury Strategy does not require updating as there are no policy changes or any changes required to the prudential and treasury indicators previously approved. The details in this report update the position in the light of the updated economic position.

9. Annual Investment Strategy

- 9.1 The Council's Annual Investment Strategy, which is incorporated in the TMS, outlines the Council's investment priorities as the security and liquidity of its capital. As shown by forecasts in section 7.1, 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 and in line with the current 0.75% bank rate.
- 9.2 The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.
- 9.3 The Council aims to achieve the optimum return on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term (up to 1 year), and only invest with highly credit rated financial institutions using Link's suggested creditworthiness approach, including sovereign credit rating and Credit Default Swap (CDS) overlay information provided by Link. The Treasury Team continue to take a prudent approach keeping investments short term and with the most highly credit rated organisations.
- 9.3 In the first six months of 2018/19 the internal treasury team outperformed its benchmark by 0.28%. The investment return was 0.72% compared to the benchmark of 0.44%. This amounts to additional income of £161,320 during the first six months which is included within the Council's projected outturn position.
- 9.4 A full list of investments held as at 30 September 2018, compared to Link's counterparty list, and changes to Fitch, Moody's and Standard & Poor's credit ratings are shown in **Appendix A**. None of the approved limits within the Annual Investment Strategy were breached during the first six months of 2018/19 and have not been previously breached. Officers continue to monitor the credit ratings of institutions on a daily basis. Delegated authority has been put in place to make any amendments to the approved lending list.

- 9.5 As illustrated in the economic background section above, investment rates available in the market have increased slightly due to the bank rate increase to 0.75% in August 2018. The average level of funds available for investment purposes in the first six months of 2018/19 was £118 million.
- 9.6 The Council's interest receivable/payable budgets are currently projecting a surplus of £3.35 million as reported in the monthly revenue monitoring reports due to no long term borrowing being undertaken, changes to the Minimum Revenue Provision (MRP) calculation previously approved by Council and investment returns achieved being higher than anticipated.

10. Borrowing

- 10.1 It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits". Council's approved Prudential Indicators (affordability limits) are outlined in the TMS. A list of the approved limits is shown in **Appendix B**. The schedule at **Appendix C** details the Prudential Borrowing approved and utilised to date.
- 10.2 Officers can confirm that the Prudential Indicators were not breached during the first six months of 2018/19 and have not been previously breached.
- 10.3 No new external borrowing has currently been undertaken to date in 2018/19, although discussions are currently being held at the Capital Investment Board where outline business cases are being considered. The schemes being considered are already within the current authorised borrowing limits in place. In the event the authorised borrowing limits need to be amended, this will be reported to Council for approval. The table below illustrates the low and high points across different maturity bands for borrowing rates for the first six months of the financial year.

| | 1 Year | 5 Year | 10 Year | 25 Year | 50 Year |
|---------|------------|------------|------------|------------|------------|
| 3.4.18 | 1.48% | 1.84% | 2.22% | 2.55% | 2.27% |
| 30.9.18 | 1.55% | 1.93% | 2.33% | 2.74% | 2.56% |
| Low | 1.28% | 1.67% | 2.09% | 2.50% | 2.25% |
| Date | 01/06/2018 | 29/05/2018 | 20/07/2018 | 20/07/2018 | 29/05/2018 |
| High | 1.57% | 1.99% | 2.43% | 2.83% | 2.64% |
| Date | 17/04/2018 | 25/09/2018 | 25/04/2018 | 25/09/2018 | 25/09/2018 |
| Average | 1.46% | 1.84% | 2.25% | 2.64% | 2.41% |

11. Debt Rescheduling

- 11.1 Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. During the first six months of the year no debt rescheduling was undertaken.

12 MRP Policy

- 12.1 Members will be aware that a revised minimum revenue provision statement 2018/19 was approved by Council on 20th September 2018. This approval was to support the recommendation to amend the supported borrowing MRP calculation to an option 3b method based on an annuity calculation. There are further changes detailing a switch from straight line to annuity payment method for certain new unsupported borrowing approvals from 2018/19. This will provide a consistent approach to calculations on both supported and unsupported borrowing approvals going forward that will link both to the expected asset life. These changes have now been incorporated into the revised MRP statement, attached at appendix D which members are asked to approve.

13 UK Banks – Ring Fencing

- 13.1 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. Several banks are very close to the threshold already and so may come into scope in the future regardless.
- 13.2 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 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.
- 13.3 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 with other institutions and selecting only those with sufficiently high ratings for investment purposes.
- 13.4 As outlined in appendix A, the Council currently has investments with HSBC, Barclays & Lloyds. HSBC and Lloyds are classified as ring fenced banks and Barclays as non ring fenced. All these institutions appear on Link Asset Services approved lending list and meet the council’s creditworthiness criteria.

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| List of Background Papers (This MUST be completed for all reports, but does not include items containing exempt or confidential information) |
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| Council, 22 February 2018, Treasury Strategy 2018/19 |
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| Council, 20 September 2018, Revised Minimum Revenue Provision Statement 2018/19 |
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| Cabinet Member: |
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| David Minnery, Portfolio Holder for Finance |
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| Local Member |
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| Appendices |
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| A. Investment Report as at 30th September 2018 |
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| B. Prudential Limits |
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| C. Prudential Borrowing Schedule |
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| D. MRP Policy |
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