Treasury Management Semi-Annual Report 2018-19

Introduction

In December 2011 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 the Council on 21 February 2018. The Council 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 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, guidance notes have been published in relation to both Codes which the Council's Treasury Management Team are currently reviewing.

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 for 2019-2020 later in 2018-19 for approval by full Council in February 2019.

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 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 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 31st March 2018, the Council had £364.38m worth of borrowing and £13.94m worth of investments. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves 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	157.31
HRA CFR	253.43
Total CFR	**410.74**
Less: *Other debt liabilities	(27.68)
Borrowing CFR	**383.06**
Less: Usable reserves & working capital	(32.62)
Net borrowing	**350.44**

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

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 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
Long-term borrowing	297.34	12.22	309.56
Short-term borrowing	67.04	(35.51)	31.53
Total borrowing	**364.38**	**(23.29)**	**341.09**
Long-term investments	0.00	0.00	0.00
Short-term investments	0.00	0.00	0.00
Cash and cash equivalents	13.94	(11.65)	2.29
Total investments	**13.94**	**(11.65)**	**2.29**
Net borrowing	**350.44**		**338.80**

Borrowing Strategy during the quarter

At 30th September 2018 the Council held £341.09m of loans, (decrease of £23.29 on 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	Movement £m	30.9.18 Balance £m
Public Works Loan Board	273.59	12.05	285.64
Banks (LOBO)	15.30	0.00	15.30
Banks (fixed-term)	8.50	0.00	8.50
Local authorities (short-term)	65.00	(35.00)	30.00
Other*	1.99	(0.34)	1.65
Total borrowing	**364.38**	**(23.29)**	**341.09**

*Includes Salix, and Welsh Government Invest to Save loans.

The Council'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 Council's long-term plans change being a secondary objective.

With short-term interest rates remaining much lower than long-term rates, the Council considered it to be more cost effective in the near term to use internal resources or primarily to borrow short term, activity in this market can be seen in Table 2. The Council has taken two longer term PWLB loans out in this period, the second for £2.2m specifically to take advantage of the Infrastructure Rate (40 basis points below PWLB rates) made available to the Council via Welsh Government, Table 4 below provides details.

Table 4: New Long Term Borrowing

Long-dated Loans	**Amount £m**	**Rate %**	**Period Years**
PWLB EIP Loan-1	10	2.22	20
PWLB EIP Loan-2	2.22	1.98	20
Total new long-term borrowing	**12.22**		

LOBO loans: The Council continues to hold £15.3m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. The Council approached its LOBO lenders with a view to restructuring in this period, the terms offered at this time were not deemed beneficial and no further actions has been taken.

Treasury Investment Activity

The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the six month period, the Council's investment balance ranged between £0.1m and £25.04m due to timing differences between income and expenditure. The investment position during the six months is shown in table 5 below.

Table 5: Treasury Investment Position

	31.3.18 Balance £m	**Movement £m**	**30.9.18 Balance £m**
Banks/building societies (unsec)	13.94	(12.53)	1.41
Government (incl. local authorities)	0.00	0.00	0.00
Money Market Funds	0.00	0.88	0.88
Total investments	**13.94**	**(11.65)**	**2.29**

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 objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults.

In furtherance of these objectives, the Council has sought to invest with a heavy bias toward security and liquidity. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 6 below.

Table 6: Investment Benchmarking

	Credit Score	**Credit Rating**	**Bail-in Exposure**	**Rate of Return %**
31.03.2018	4.87	A+	100%	0.35
30.06.2018	4.96	A+	100%	0.45
30.09.2018	4.74	A+	100%	0.66
All Welsh LAs 30.09.2018	4.63	A+	62%	0.70

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.
The Council considers that whilst it has given a number of loans for service purposes to local organisations it considers that these are not for financial return, rather for supporting the local economy.

Compliance

The Head of Finance reports that all treasury management activities undertaken during the six month period complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

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

Compliance with specific investment limits is demonstrated in Table 8 below.

Table 7: Debt Limits

	Maximum in period £m	30.9.18 Actual £m	2018/19 Operational Boundary £m	2018/19 Authorised Limit £m	Complied? Yes/No
Borrowing	364.38	341.09	419.89	434.89	Yes
PFI and Finance Leases	26.66	26.66	27.74	27.74	Yes
Total debt	**391.04**	**367.75**	**447.63**	**462.63**	

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

	To date Maximum £m*	30.9.18 Actual £m	2018/19 Limit £m	Complied? Yes/No
Any single organisation, except the UK Government	4.823	1.385	5.0	Yes
Any group of organisations under the same ownership	0.0	0.0	5.0	Yes
Any group of pooled funds under the same management	0.0	0.0	5.0	Yes
Negotiable instruments held in a broker's nominee account	0.0	0.0	20.0	Yes
Limit per non-UK country	3.0	0.0	10.0	Yes
Registered providers	0.0	0.0	5.0	Yes
Unsecured investments with building societies	0.0	0.0	2.0	Yes
Loans to unrated corporates	0.0	0.0	0.0	Yes
Money Market Funds	13.778	0.875	20.0	Yes

*This is the maximum level of investment in the reporting period.

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.

	30.9.18 Actual	**2018/19 Target**	**Complied?**
Portfolio average credit rating	A+	A	Yes

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 amount of net principal borrowed / interest payable was:

	30.9.18 Actual £m	**2018/19 Limit £m**	**Complied?**
Upper limit on fixed interest rate exposure	311.09	407.60	Yes
Upper limit on variable interest rate exposure	30.00	70.00	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 Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

Maturity Structure of Fixed Rate Borrowing	Upper Limit %	Lower Limit %	Actual Fixed Rate Borrowing at 30/09/2018 £m	Fixed Rate Borrowing at 30/09/2018 %	Compliance with Set Limits?
under 12 months	30	0	48.95	14.35	Yes
12 months and within 24 months	20	0	2.77	0.81	Yes
24 months and within 5 years	20	0	8.20	2.40	Yes
5 years and within 10 years	80	0	26.70	7.83	Yes
10 years and within 20 years	80	0	173.27	50.80	Yes
20 years and within 30 years	80	0	22.17	6.50	Yes
30 years and within 40 years	80	0	59.03	17.31	Yes
40 years and within 50 years	80	0	0.00	0.00	Yes
50 years and above	90	0	0.00	0.00	Yes
Total			341.09	100.0	

Time periods start on the first day of each period immediately following stated date (i.e. 30th September 2018). 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 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	**2019/20**	**2019/21**
Actual principal invested beyond year end	-	-	-
Limit on principal invested beyond year end	£10m	£5m	£5m
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.