Report to Audit Committee
Date of meeting 13 December 2017
By the Director of Corporate Resources
INFORMATION REPORT

Not exempt

Treasury Management and Prudential Indicators mid-year report 2017/18

Executive Summary

This report covers treasury activity and prudential indicators for the first half of 2017/18. During the period the Council complied with its legislative and regulatory requirements and the statutory borrowing limit, the Authorised Limit, was not breached.

At 30 September 2017, the Council's external debt was £9m (£4m at 31 March 2017) and its investments totalled £56.3m (£50.1m at 31 March 2017).

During the first half of 2017/18, the Council's cash balances were invested in accordance with the Council's treasury management strategy. Interest of £0.45m was earned on investments at an average return of 0.8% (1.2% full year 2016/17).

Recommendations

The Committee is recommended to:

i) Note the treasury management stewardship report at the mid-year 2017/18
ii) Note the mid-year prudential indicators for 2017/18

Reasons for Recommendations

i) This mid-year report is a requirement of the Council's reporting procedures
ii) This report meets the requirements of the relevant CIPFA Codes of Practice for Treasury Management and Prudential Indicators in Capital Finance.

Background Papers
"Treasury Management Strategy 2017-18" – Audit Committee 4 January 2017
"Budget 2017/18 and Medium Term Financial Strategy" – Cabinet 26 January 2017
"Medium Term Financial Strategy 2018/19 to 2021/22" – Cabinet 23 November 2017

Consultation: Arlingclose Limited. Council's Treasury management advisors

Wards affected: All
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Background Information

1 Introduction

The purpose of this report

1.1 This report covers treasury management activity and prudential indicators for the first half of 2017/18. It meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003. The Code recommends that Members are informed of Treasury Management activities at least twice a year.

Background

1.2 In line with the CIPFA Prudential Code for Capital Finance in Local Authorities the Council adopts prudential indicators for each financial year and reports on performance relative to those indicators. This requirement is designed to show that capital spending is prudent, affordable and sustainable and that treasury practices adequately manage risk. The original indicators for 2017/18 together with Treasury Management Strategy 2017/18 were approved by Council on 15 February 2017. The Treasury Management Strategy 2017/18 had been recommended for approval by this Committee on 4 January 2017.

1.3 The economic background to treasury management remains challenging with concerns over Brexit, inflation, indebtedness, productivity and growth weighing on the economy and financial system which has still not fully recovered from the financial crisis. Arlingclose Limited, the Council's treasury management advisors have provided a commentary on the year so far in Appendix A.

1.4 There are also a number of regulatory changes that affect the operation of treasury management under way and Arlingclose have provided a commentary in Appendix B. The Director of Corporate Resources will monitor the development of the regulations in order to mitigate any risks to the Council's treasury operations.

1.5 At the end of 2016/17 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £16.0m, while usable reserves and working capital which are the underlying resources available for investment were £62m. The Council had £4m of borrowing and £50m of investments reflecting its use of internal resources rather than borrowing.

2 Treasury management

Borrowing Activity

2.1 During the period in question £10m of short term loans were taken out towards the end of July 2017 at an average rate of 0.21%. This was necessary to fund the purchase of the Forum retail units at the end of July. £5m of the short term loans were repaid towards the end of September 2017 as the net inflow of tax collected and returning investments build up cash resources. On 30 September 2017 the Council's borrowing comprised its £4m long term PWLB loan at 3.38% and the remaining short term borrowing of £5m at average rate of 0.24%.

2.2 The remaining £5m of short term loans were repaid in October 2017. It is expected that there will be a significant net cash outflow in the rest of the financial year. This is caused by the usual tailing off of cash as the tax inflows are weighted towards the first ten months of the years and the spending on new waste collection vehicles and the Broadbridge Heath Leisure centre. As a consequence, the Council will need to constantly review its investment position in the rest of the year. This may well involve a combination of cashing in longer term money market funds and further short term borrowing. Short term rates have edged up since the rate change so it is expected that the Council would be paying in the range 0.4% to 0.5%. The yields from longer term money market funds are likely to be in a similar range so the Director of Corporate Resources will monitor the position closely.

Investment Activity

2.3 The treasury management position at 30 September 2017 is shown below. This is a snapshot rather than the cumulative returns. The cumulative returns are markedly lower at 0.8%. In general the Council holds more liquid balances in the first half of the year which force down yields. The cumulative yield would also have been reduced as the Council held the £15m meant for the Forum purchase in liquid form in the time running up to the final settlement which extended to about a month before final terms were agreed.

	Principal £m	Average Interest Rate %
Call accounts	1.2	0.01
Money Market Funds	27.4	0.50
Short-term deposits	6.0	0.47
Long-term deposits	5.8	1.58
Pooled Funds	15.9	3.90
Total Investments	**56.3**	**1.56**
Long-term PWLB loans	4.0	3.38
Short term borrowing	5.0	0.24
Total Borrowing	**9.0**	**1.50**
Net Investments	**47.3**	**1.57**

2.4 Short term rates were extremely low in the period. They should pick up slightly in the second half of the year as the effect of the BoE increasing the base rate from 0.25% to 0.5% in November 2017 feeds through.

2.5 Investment income was £0.45m against the budget of £0.31m. The average return was 0.8% against a budget of 0.76% and the adopted yield benchmark 7 day LIBID of 0.11%. Cash balances ranged from £40m to £67m averaging £54m against a budgeted average balance of £41m. Part of the difference would be capital programme lagging behind the budget including the Bridge leisure centre which was budgeted to be further into construction by the middle of the financial year. It is estimated the full year income could be in the region of £0.77m compared to budget of £0.59m. The extra income reflects increased use of pooled funds approved in the annual strategy but not in the original budget which was calculated before the 2017/18 strategy was agreed.

2.6 Pooled funds comprising equity, bonds and property are a relatively new part of the strategy and they introduce a risk to the capital value of the investments falling as the underlying asset values can be volatile in the short term. At the end of the first half of the year the value of the investments was £40,000 below the initial investment. However, it should be remembered that these investments are longer term so the current small capital loss should not be overemphasised.

2.7 Security of capital has remained the Council's main investment objective. Key to this is the counterparty policy as set out in its treasury management strategy. Counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

2.8 **Security benchmark** – The Council set a security benchmark rating of A-, which is the average credit rating for the investment portfolio. The average rating was above the benchmark at either A+ or AA-.

2.9 **Liquidity benchmark** – The Council sets a benchmark to maintain a minimum of liquidity. The benchmark set was that £3m is available within a rolling three month period without additional borrowing. The Director of Corporate Resources can report that liquidity arrangements were well within benchmark during the year to date with overnight cash alone not falling below £4m.

2.10 **Counterparty Update –** Arlingclose Limited, the Council's treasury management advisors, monitor the quality of potential counterparties and have provided a commentary on the developments in the first part of the year in Appendix C.

Compliance with Prudential Indicators

2.11 The Council confirms compliance with its Prudential Indicators for 2017/18, which were set out in January 2017 as part of the Council's Treasury Management Strategy.

Treasury Management Indicators

2.12 **Interest rate exposures -** This indicator is set to control the Council's exposure to interest rate risk. The exposures to fixed and variable rate interest rates, expressed as an amount of net principal borrowed, were as the table below. Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate. As investments count as negative borrowing the variable rate figure was negative during the period.

	Limit	Actual	Met?
Upper limit on fixed rate exposures	£15m	£4m	✓
Upper limit on variable rate exposures	£0m	£-30m	✓

2.13 **Maturity Structures Of Borrowing** – These gross limits are set in order to reduce the Council's exposure to large fixed rate loans - those instruments which carry a fixed interest rate for the duration of the instrument - falling due for refinancing. As the Council only has one such debt it has freedom to refinance the debt. The table below shows the estimates and current position.

	Upper Limit	Lower Limit	Actual	Met?
Under 12 months	100%	0	0	✓
12 months and within 24 months	100%	0	100%	✓
24 months and within five years	100%	0	0	✓
Five years and within 10 years	100%	0	0	✓
10 years and above	100%	0	0	✓

2.14 **Principal sums invested for periods longer than 364 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 long-term investments. The total principal sums invested to final maturities beyond the period end were:

	Original Indicator	Maximum Position
Maximum principal sums invested > 364 days	£12m	£5.8m

3 Prudential Indicators 2017/18

3.1 The Local Government Act 2003 requires the Council to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much it can afford to borrow. The objectives of the Prudential Code are to ensure that capital investment plans are affordable, prudent and sustainable. To demonstrate that the Council meets these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

3.2 **The Council's Capital Expenditure and Financing 2017/18 -** This is one of the required prudential indicators and shows total capital expenditure for the year and how this is financed. The estimated indicator is shown below.

2017/18	**Original Estimate £000**	**Current projection £000**
Total capital expenditure	26,310	30,524
Resourced by:		
Capital receipts and contributions	(8,603)	(7,695)
Capital grants	(513)	(750)
Revenue reserves	(2,953)	(6,773)
Unfinanced capital expenditure (additional need to borrow)	14,241	15,306

3.3 The estimated capital spend in 2017/18 is over the original budget. An underspend as compared to the original budget set in February for 2017/18 has been offset by the Forum Retail Unit purchase which was £12m over the original £3m budget. The revenue reserves financing has also been increased in line with the "Medium Term Financial Strategy 2018/19 to 2021/22" report to the Cabinet on 23 November. The final unfinanced expenditure is only slightly over the original estimate as the increase due to the Forum purchase is offset by the extra use of revenue reserves.

3.4 **The Council's overall borrowing need -** The Council's underlying need to borrow is termed the Capital Financing Requirement (CFR). It represents the accumulated net capital expenditure which has not been financed by revenue or other resources. Part of the Council's treasury activities is to address this borrowing need, either through borrowing from external bodies, or utilising temporary cash resources within the Council.

3.5 The Council is required to make an annual revenue charge, the Minimum Revenue Provision (MRP), to reduce the CFR – effectively a repayment of the borrowing need. The Council's 2017/18 MRP Policy was approved on 15 February 2017 within the 2017/18 Budget report.

3.6 The Council's CFR for the year is shown below, and represents a key prudential indicator. There is a small increase in the expected CFR mainly due to the unfinanced capital spend being more than expected as discussed above. No increase in long term borrowing is now projected in this financial year.

Capital Financing Requirement and External Debt Year end 2017/18	**Original estimate £000**	**Current projection £000**
CFR	29,276	30,371
External debt	4,000	4,000

3.7 External borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2017/18 and next two financial years. No difficulties are envisaged for the current or future years in complying with this Prudential Indicator.

3.8 **Borrowing limits** - The Council approved these Prudential Indicators as part of the 2017/18 Budget report.

3.9 **Operational boundary for external debt:** The operational boundary is based on the Authority's estimate of most likely, i.e. prudent, but not worst case scenario for external debt.

3.10 **Authorised limit for external debt:** The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

	Limit	Actual	Met?
Operational boundary – borrowing	£4m	£4m	✓
Operational boundary – other long-term liability	£0m	£0m	✓
Operational boundary – TOTAL	£4m	£4m	✓
Authorised limit – borrowing	£14m	£4m	✓
Authorised limit – other long-term liability	£1m	£0m	✓
Authorised limit – TOTAL	£15m	£4m	✓

3.11 **The ratio of financing costs to net revenue stream -** This indicator identifies the trend in the cost of capital (financing costs net of interest and investment income) against the net revenue stream. The indicator for the year was 2% and the current estimate is approximately 3% as the estimate of financing costs has shaded upwards.

4 Outcome of consultations

4.1 Arlingclose Limited, the Council Treasury management advisors, have made comments which have been incorporated into the report.

5 Staffing consequences

5.1 There are no direct staff resourcing consequences. However, the risks in the investment environment highlights the continuing need for staff training and staff will take advantage of courses run by its advisors Arlingclose Limited.

6 Financial consequences

6.1 Interest earned is expected to be above budget improving the current year's financial performance. The outturn is forecast to be £0.2m above budget as a result of having higher cash balances and the return from the pooled funds investment amounts that were not in the 2017/18 budget but subsequently approved in the strategy. Extra borrowing costs will be incurred but they will not be material against the £0.135m current budget

7 Other considerations

7.1 There are no consequences of any action proposed in respect of Risk; Crime & Disorder; Human Rights; Equality & Diversity and Sustainability.

Appendix A

Economic background to the midpoint of 2017/18

Economic backdrop: Commodity prices fluctuated over the period with oil falling below $45 a barrel before inching back up to $58 a barrel. UK Consumer Price Inflation (CPI) index rose with the data print for August showing CPI at 2.9%, its highest since June 2013 as the fall in the value of sterling following the June 2016 referendum result continued to feed through into higher import prices. The new inflation measure CPIH, which includes owner occupiers' housing costs, was at 2.7%.

The unemployment rate fell to 4.3%, its lowest since May 1975, but the squeeze on consumers intensified as average earnings grew at 2.5%, below the rate of inflation. Economic activity expanded at a much slower pace as evidenced by Q1 and Q2 GDP growth of 0.2% and 0.3% respectively. With the dominant services sector accounting for 79% of GDP, the strength of consumer spending remains vital to growth, but with household savings falling and real wage growth negative, there are concerns that these will be a constraint on economic activity in the second half of calendar 2017.

The Bank of England made no change to monetary policy at its meetings in the first half of the financial year. The vote to keep Bank Rate at 0.25% narrowed to 5-3 in June highlighting that some MPC members were more concerned about rising inflation than the risks to growth. Although at September's meeting the Committee voted 7-2 in favour of keeping Bank Rate unchanged, the MPC changed their rhetoric, implying a rise in Bank Rate in "the coming months". The Council's treasury advisor Arlingclose was not convinced the UK's economic outlook yet justified a rise, but the Bank's interpretation of the data seemed to have shifted and in the second half of the year the Bank did move.

In contrast to the UK, near-term global growth prospects improved. The US Federal Reserve increased its target range of official interest rates in June for the second time in 2017 by 25bps (basis points) to between 1% and 1.25% and, despite US inflation hitting a soft patch with core CPI at 1.7%, a further similar increase is expected in its December 2017 meeting. The Fed also announced confirmed that it would be starting a reversal of its vast Quantitative Easing programme and reduce the $4.2 trillion of bonds it acquired by initially cutting the amount it reinvests by $10bn a month.

Geopolitical tensions escalated in August as the US and North Korea exchanged escalating verbal threats over reports about enhancements in North Korea's missile programme. The provocation from both sides helped wipe off nearly $1 trillion from global equity markets but benefited safe-haven assets such as gold, the US dollar and the Japanese yen. Tensions remained high, with North Korea's threat to fire missiles towards the US naval base in Guam, its recent missile tests over Japan and a further testing of its latent nuclear capabilities.

Prime Minister Theresa May called an unscheduled General Election in June, to resolve uncertainty but the surprise result has led to a minority Conservative government in coalition with the Democratic Unionist Party. This clearly results in an enhanced level of political uncertainty. Although the potential for a so-called hard Brexit is diminished, lack of clarity over future trading partnerships, in particular future customs agreements with the rest of the EU block, is denting business sentiment and investment. The reaction from the markets on the UK election's outcome was fairly muted, business confidence now hinges on the progress (or not) on Brexit negotiations, the ultimate 'divorce bill' for the exit and whether new trade treaties and customs arrangements are successfully concluded to the UK's benefit.

In the face of a struggling economy and Brexit-related uncertainty, Arlingclose expects the Bank of England to take only a very measured approach to any monetary policy tightening; any increase will be gradual and limited as the interest rate backdrop will have to provide substantial support to the UK economy through the Brexit transition

Financial markets: Gilt yields displayed significant volatility over the six-month period with the appearing change in sentiment in the Bank of England's outlook for interest rates, the push-pull from expectations of tapering of Quantitative Easing (QE) in the US and Europe and from geopolitical tensions, which also had an impact. The yield on the 5-year gilts fell to 0.35% in mid-June, but then rose to 0.80% by the end of September. The 10-year gilts similarly rose from their lows of 0.93% to 1.38% at the end of the quarter, and those on 20-year gilts from 1.62% to 1.94%.

The FTSE 100 nevertheless powered away reaching a record high of 7548 in May but dropped back to 7377 at the end of September. Money markets rates have remained low: 1-month, 3-month and 12-month LIBID rates have averaged 0.25%, 0.30% and 0.65% over the period from January to 21st September 2017.

Appendix B

Regulatory Updates

MiFID II: Local authorities are currently treated by regulated financial services firms as professional clients who can "opt down" to be treated as retail clients instead. But from 3rd January 2018, as a result of the second Markets in Financial Instruments Directive (MiFID II), local authorities will be treated as retail clients who can "opt up" to be professional clients, providing that they meet certain criteria. Regulated financial services firms include banks; brokers, advisers, fund managers and custodians, but only where they are selling, arranging, advising or managing designated investments. In order to opt up to professional, the authority must have an investment balance of at least £10 million and the person authorised to make investment decisions on behalf of the authority must have at least one year's relevant professional experience. In addition, the firm must assess that that person has the expertise, experience and knowledge to make investment decisions and understand the risks involved.

The main additional protection for retail clients is a duty on the firm to ensure that the investment is "suitable" for the client. However, local authorities are not protected by the Financial Services Compensation Scheme nor are they eligible to complain to the Financial Ombudsman Service whether they are retail or professional clients. It is also likely that retail clients will face an increased cost and potentially restricted access to certain products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice. The Authority has declined to opt down to retail client status in the past as the costs were thought to outweigh the benefits.

The Authority meets the conditions to opt up to professional status and intends to do so in order to maintain their current MiFID status.

CIPFA Consultation on Prudential and Treasury Management Codes: In February 2017 CIPFA canvassed views on the relevance, adoption and practical application of the Treasury Management and Prudential Codes and after reviewing responses launched a further consultation on changes to the codes in August with a deadline for responses of 30th September 2017. The Council responded to the consultation after taking advice from Arlingclose.

The proposed changes to the Prudential Code include the production of a new high-level Capital Strategy report to full council which will cover the basics of the capital programme and treasury management. The prudential indicators for capital expenditure and the authorised borrowing limit would be included in this report but other indicators may be delegated to another committee. There are plans to drop certain prudential indicators, however local indicators are recommended for ring fenced funds (including the HRA) and for group accounts. Other proposed changes include applying the principles of the Code to subsidiaries.

Proposed changes to the Treasury Management Code include the potential for non-treasury investments such as commercial investments in properties in the definition of "investments" as well as loans made or shares brought for service purposes. Another proposed change is the inclusion of financial guarantees as instruments requiring risk management and addressed within the Treasury Management Strategy. Approval of the technical detail of the Treasury Management Strategy may be delegated to a committee rather than needing approval of full Council. There are also plans to drop or alter some of the current treasury management indicators.

CIPFA intends to publish the two revised Codes towards the end of 2017 for implementation in 2018/19, although CIPFA plans to put transitional arrangements in place for reports that are required to be approved before the start of the 2018/19 financial year.

The Department of Communities and Local Government (DCLG) has at various forums stated a wish to have a more rigorous framework in place for the treatment of commercial investments as soon as is practical. The DCLG has issued a revision to its Investment and MRP Guidance for local authorities in England. It is open for consultation until 22nd December 2017 with final version expected at the end of January 2018.

Appendix C

Counterparty issues

Credit background: UK bank credit default swaps continued their downward trend, reaching three-year lows by the end of June. Bank share prices have not moved in any particular pattern.

There were a few credit rating changes during the half year. The significant change was the downgrade by Moody's to the UK sovereign rating in September from Aa1 to Aa2 which resulted in subsequent downgrades to sub-sovereign entities including local authorities. Moody's downgraded Standard Chartered Bank's long-term rating to A1 from Aa3 on the expectation that the bank's profitability will be lower following management's efforts to de-risk their balance sheet. The agency also affirmed Royal Bank of Scotland's and NatWest's long-term ratings at Baa1, placed Lloyds Bank's A1 rating on review for upgrade, revised the outlook of Santander UK plc, and Nationwide and Coventry building societies from negative to stable but downgraded the long-term rating of Leeds BS from A2 to A3. The agency downgraded long-term ratings of the major Canadian banks on the expectation of a more challenging operating environment and the ratings of the large Australian banks on its view of the rising risks from their exposure to the Australian housing market and the elevated proportion of lending to residential property investors.

S&P also revised Nordea Bank's outlook to stable from negative, whilst affirming their long-term rating at AA-. The agency also upgraded the long-term rating of ING Bank from A to A+.

Ring-fencing, which requires the larger UK banks to separate their core retail banking activity from the rest of their business, is expected to be implemented within the next year. In May, following Arlingclose's advice, the Authority reduced the maximum duration of unsecured investments with Bank of Scotland, HSBC Bank and Lloyds Bank from 13 months to 6 months as until banks' new structures are finally determined and published, the different credit risks of the 'retail' and 'investment' banks cannot be known for certain.

The new EU regulations for Money Market Funds were finally approved and published in July and existing funds will have to be compliant by no later than 21st January 2019. The key features include Low Volatility NAV (LVNAV) Money Market Funds which will be permitted to maintain a constant dealing NAV, providing they meet strict new criteria and minimum liquidity requirements. MMFs will not be prohibited from having an external fund rating (as had been suggested in draft regulations). Arlingclose expects most of the short-term MMFs it recommends to convert to the LVNAV structure and awaits confirmation from each fund.