Report to Audit Committee
Date of meeting 12 December 2018
By the Director of Corporate Resources
INFORMATION REPORT

Not exempt

Horsham District Council

Treasury Management and Prudential Indicators mid-year report 2018/19

Executive Summary

This report covers treasury activity and prudential indicators for the first half of 2018/19. 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 2018, the Council's external debt was £4m (£4m at 31 March 2018) and its investments totalled £44.6m (£56.3m at 30 September 2017).

During the first half of 2018/19, the Council's cash balances were invested in accordance with the Council's treasury management strategy although in one instance the exposure in the Council's own bank exceeded the level that strategy would allow as an investment in that bank. Interest of £0.4m was earned on investments at an average return of 1.0% (0.8% full year 2017/18).

Recommendations

The Committee is recommended to:

i) Note the treasury management stewardship report at the mid-year 2018/19
ii) Note the mid-year prudential indicators for 2018/19

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 2018-19" – Audit Committee 13 December 2017
"Budget 2018/19 and Medium Term Financial Strategy to 2021/22" – Cabinet 25 January 2018

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 2018/19. 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 2018/19 together with Treasury Management Strategy 2018/19 were approved by Council on 21 February 2018. The Treasury Management Strategy 2018/19 had been recommended for approval by this Committee on 13 December 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.

Local Context

1.4 At the end of 2017/18 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £30.4m, while usable reserves and working capital which are the underlying resources available for investment were £63m. The Council had £4m of borrowing and £37m of investments reflecting its use of internal resources rather than borrowing in order to reduce risk and keep interest costs low.

1.5 The treasury management position at 30 September 2018 and the change during the period is show in table below.

	31.3.18 Balance £m	**Movement £m**	**30.9.18 Balance £m**	**30.9.18 Rate %**
Long-term borrowing	0	0	0	
Short-term borrowing	4	0	4	3.4
Total borrowing	**4**	**0**	**4**	**3.4**
Long-term investments	17.6	-0.7	16.9	3.4
Short-term investments	14.2	5.7	19.9	0.8
Cash and cash equivalents	5.7	2.1	7.8	0.6
Total investments	**37.6**	**7.1**	**44.6**	**1.8**

2 Treasury management

Borrowing Activity

2.1 During the period in question there was no change in borrowing with only the single £4m PWLB loan at 3.38% which is now classed as short term as it matures on 31 March 2019.

Investment Activity

2.2 The treasury management position at 30 September 2018 is shown below. This is a snapshot rather than the cumulative returns. The cumulative returns are markedly lower at 1%. In general the Council holds more liquid balances in the first half of the year which force down yields so the final average yield for the year is expected to be closer to the present value.

	31.3.18 Balance £m	Movement £m	30.9.18 Balance £m	30.9.18 Rate %
Call accounts	0.7	0.1	0.8	0.1
Money Market Funds – call	5.0	2.0	7.0	0.7
Money Market Funds – longer term	9.4	0.0	9.4	0.6
Short-term deposits	4.8	5.7	10.5	1.1
Long-term deposits	2.0	-2.0	0.0	-
Pooled Funds	15.7	1.3	16.9	3.4
Total Investments	**37.6**	**7.1**	**44.6**	**1.8**

2.3 Short term rates picked up a little after the bank rate rise in August 2018 but they remain comparatively low when compared to historic levels. The prediction of rates is a slow increase in the medium term, although current events around Brexit make any prediction uncertain.

2.4 Investment income in the period was £0.43m against the budget of £0.29m. The average return was 1.0% against a budget of 1.1% and the adopted yield benchmark 7 day LIBID of 0.43%. Cash balances ranged from £33m to £49m averaging £42m against a budgeted average balance of £27m. The major part of the difference is the fact that the capital programme is lagging behind the budget. The current forecast of the full year income is in the region of £0.82m compared to budget of £0.71m reflecting cash balances exceeding the budget.

2.5 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 above the initial investment. However, it should be remembered that these investments are longer term so any capital gain or loss should not be overemphasised. The returns from pooled funds continue to be significantly higher than any other investment type.

Compliance

2.6 The Director of Corporate Resources reports that all treasury management activities undertaken during the first half of 2018/19 complied with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy apart from one instance where exposure to the Council's own bank exceeded the £2.5m that was set as an investment limit. Although this is not an investment as envisaged in the strategy it creates a credit exposure so it is reported here.

2.7 On 29 June 2018 the Council's bank balance had climbed to £2.4m during the day. As this was within the £2.5m limit there was no transfer of cash to other counterparties. However, at 16.30 in the afternoon the Council was credited with an unexpectedly high amount of £150,000 of rents. The usual credits are in the £1,000s or low £10,000s. The rent amount was received after the deadline for investing in other counterparties. As a result the total in the bank went £70,000 over the £2.5m that we would invest with our bank as an investment counterparty. Although this is not an investment as envisaged in the strategy it creates a credit exposure so it is reported here. In retrospect the bank balance should have been reduced to leave headroom for any unexpected credits, although this only happens infrequently.

2.8 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.

Treasury Management Indicators

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

2.10 **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 at above the benchmark at either A+ or AA- during the first half of the year.

2.11 **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 £2m and a further £9m available within a week's notice.

Compliance with Prudential Indicators

2.12 The Council confirms compliance with its Prudential Indicators for 2018/19, which were set out in December 2017 as part of the Council's Treasury Management Strategy.

Treasury Management Indicators

2.13 **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	£-31m	✓

2.14 **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	100%	✓
12 months and within 24 months	100%	0	0	✓
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	✓

2.15 **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	£2m

3 **Prudential Indicators 2018/19**

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 2018/19 -** 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.

2018/19	**Original Estimate £000**	**Current projection £000**
Total capital expenditure	24,296	18,229
Resourced by:		
Capital receipts and contributions	(6,496)	(4,028)
Capital grants	(713)	(1,250)
Revenue reserves incl New Homes	(7,201)	(6,564)
Unfinanced capital expenditure (additional need to borrow)	9,886	6,387

3.3 The estimated capital spend in 2018/19 is under the original budget with financing similarly lower than expected and less unfinanced spend than originally planned.

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 2018/19 MRP Policy was approved on 21 February 2018 within the 2018/19 Budget report.

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

Capital Financing Requirement and External Debt Year end 2018/19	**Original estimate £000**	**Current projection £000**
CFR	39,877	35,970
External debt	9,000	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 2018/19 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 2018/19 Budget report.

3.9 **Operational boundary for external debt:** The operational boundary is based on the Council'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	£9m	£4m	✓
Operational boundary – other long-term liability	£0m	£0m	✓
Operational boundary – TOTAL	£9m	£4m	✓
Authorised limit – borrowing	£17m	£4m	✓
Authorised limit – other long-term liability	£1m	£0m	✓
Authorised limit – TOTAL	£18m	£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 3% and the current estimate is approximately 2% as the interest paid is lower than budgeted and the interested received is over the budget.

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 £110,000 above 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 2018/19

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 bet 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.