Report to Audit Committee
18 December 2019
By the Director of Corporate Resources
INFORMATION REPORT

Not exempt

Treasury Management and Prudential Indicators mid-year report 2019/20

Executive Summary

This report covers treasury activity and prudential indicators for the first half of 2019/20. 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 2019, the Council had no external debt (£4m at 31 March 2019) and its investments totalled £42.9m (£44.6m at 30 September 2018).

During the first half of 2019/20, the Council's cash balances were invested in accordance with the Council's treasury management strategy. Interest of £0.44m was earned on investments at an average return of 2.3% (2.1% full year 2018/19).

Recommendations

The Committee is recommended to:

i) Note the treasury management stewardship report at the mid-year 2019/20
ii) Note the mid-year prudential indicators for 2019/20

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 2019-20" – Audit Committee 12 December 2018
"Budget 2019/20 and Medium Term Financial Strategy to 2022/23" – Cabinet 24 January 2019

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 2019/20. 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 2019/20 together with Capital Strategy were approved by Council on 13 February 2019. The Capital Strategy including the Treasury Management Strategy 2019/20 had been recommended for approval by this Committee on 12 December 2018.

1.3 The economic background to treasury management remains challenging with concerns over Brexit, indebtedness, productivity and growth weighing on the economy and financial system which has still not fully recovered from the 2008 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 2018/19 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £33.2m, while usable reserves and working capital which are the underlying resources available for investment were £65m. The Council had £4m of borrowing and £36.1m 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 2019 and the change during the period is show in table below

	31.3.19 Balance £m	Movement £m	30.9.19 Balance £m	30.9.19 Rate %
Long-term borrowing	0	0	0	
Short-term borrowing	4	-4	0	
Total borrowing	**4**	**-4**	**4**	
Long-term investments	16.8	2.8	19.6	3.8
Short-term investments	13.4	-2.0	11.4	1.3
Cash and cash equivalents	5.9	6.0	11.9	0.7
Total investments	**36.1**	**6.8**	**42.9**	**2.3**

2 Treasury management

Borrowing Activity

2.1 There is now no borrowing as the single £4m PWLB loan at 3.38% was repaid on 1st April 2019.

Investment Activity

2.2 The treasury management position at 30 September 2019 is shown below. This is the month end position but the daily position can vary as a large portion of income comes in at the beginning of month to be distributed to precepting authorities a few days later.

	31.3.19 Balance £m	**Movement £m**	**30.9.19 Balance £m**	**30.9.19 Rate %**
Call accounts	1.9	-1.5	0.4	0.4
Money Market Funds – call	4.0	7.5	11.5	0.7
Money Market Funds – cash plus or short bonds	9.4	0.0	9.4	1.2
Short-term deposits	4.0	-2.0	2.0	1.7
Pooled Funds - Property	5.0	-0.1	4.9	4.2
Pooled Funds – Multi-Asset	5.0	0.0	5.0	4.3
Pooled Funds – Equity	3.5	0.3	3.8	3.5
Pooled Funds – Bonds	3.3	2.6	5.9	2.9
Total Investments	**36.1**	**6.8**	**42.9**	**2.3**

2.3 Both the CIPFA Code and government guidance require the Authority 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 Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

2.4 Investment income in the period was £0.44m which just exceeded the budget of £0.43m. The average return was 2.25% well over the adopted yield benchmark 7 day LIBID of 0.53% but slightly under budgeted figure of 2.35%. Average cash balances were more than those in the budget which compensates for the slightly lower yield meaning that the current forecast for the full year is that it will be at or slightly above the budget of £0.89m.

2.5 Given the risk and low returns from short-term unsecured bank investments, the council has diversified into more secure and/or higher yielding asset classes. Pooled funds comprising equity, bonds and property are a key part of the strategy and as can be seen from the table above are a significant contributor to overall income.

2.6 However, the pooled funds asset values can be volatile in the short term. At the end of the first half of the year the value of these investments was £200,000 above the initial investment. However, it should be remembered that these investments are longer term so any snapshot of capital gain or loss should not be overemphasised.

Compliance

2.7 The Director of Corporate Resources reports that all treasury management activities undertaken during the first half of 2019/20 complied with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

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 £1m and a further £9m available within a week's notice.

Compliance with Prudential Indicators

2.12 The Council can confirm compliance with its Prudential Indicators for 2019/20, which were set out in December 2018 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 variable rate interest rates is quantified by the one-year revenue impact of a 1% rise or fall in interest rates. The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates.

Interest rate risk indicator - Upper limit	Limit	Actual	Complied
One-year revenue impact of a 1% rise	£0.2m	£0.14m	✓
One-year revenue impact of a 1% fall	£0.2m	£0.14m	✓

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. There was no investments for more than 364 days so the Council was well within the indicator set:

	Original Indicator	Maximum Position
Maximum principal sums invested > 364 days	£12m	£0m

3 **Prudential Indicators 2019/20**

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 2019/20 -** 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.

2019/20	**Original Estimate £m**	**Current projection £000**
Total capital expenditure	19.2	13.4
Resourced by:		
External Resources	4.7	3.7
Internal Resources	10.8	6.7
Debt	3.7	3.0
Total financing	19.2	13.4

3.3 The estimated capital spend in 2019/20 is projected as under the original budget with financing similarly lower than expected.

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 2019/20 MRP Policy was approved on 13 February 2019 within the 2019/20 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 less than expected. No increase in long-term borrowing is projected in this financial year.

Capital Financing Requirement and External Debt Year end 2019/20	**Original estimate £m**	**Current projection £m**
CFR	36.4	35.3
External debt	0	0

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 2019/20 and next two financial years. No difficulties are envisaged for the current or future years in complying with this Prudential Indicator as no long-term borrowing is currently planned.

3.8 **Borrowing limits** - The Council approved these Prudential Indicators as part of the 2019/20 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	£0m	£0m	✓
Operational boundary – other long-term liability	£0m	£0m	✓
Operational boundary – TOTAL	£0m	£0m	✓
Authorised limit – borrowing	£15m	£0m	✓
Authorised limit – other long-term liability	£1m	£0m	✓
Authorised limit – TOTAL	£16m	£0m	✓

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 0% as investment income was almost exactly matching the financing costs. Based on current estimates the ratio is -0.4% as investments slightly exceed financing costs so the net financing costs are within the benchmark.

4 Non-Treasury Investments

4.1 The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

4.2 The Council has a significant directly owned property portfolio valued at £50.9m at the end of 2018/19. No new properties have been added to the portfolio in the first half of the year. The original investment strategy set £3.5m as the income figure from the property portfolio and the present forecast is £3.6m. There are a number of other indicators that were set for the year that cannot be definitively calculated until the end of the year when the accounts are closed and all relevant income and expenditure is accrued and central expenses are apportioned across all the Council's services. Some indicators can estimated as a snap shot from property records and the table below shows the original estimated indicators and the latest projections.

Indicator	Estimate	Latest
Average Vacancy levels	2%	0.3%
Tenant over 5%	5	5
Weighted Average Unexpired Lease Term (WAULT)	11yr	10yr
Bad debts written off	£10,000	£3,000

4.3 A number of indicators for the investment properties require the end of year value of the property. The value of the properties remains as it was at the end of 2018/19 as a revaluation only occurs at the end of the financial year. There has been evidence of a decrease in some property sector values in the past few months but there is no clear way to extrapolate to the Council's portfolio.

4.4 The Council has one small loan (£0.3m) to a community run leisure centre and this is performing as expected so the income should meet the estimate and no increase in the expectation of any credit loss is envisaged.

4.5 The July meeting of this Committee recommended a limit on investment in its subsidiaries for 2019/20 of £0.5m to allow the Council to invest in its housing company. It is expected that a £0.5m investment will be made in the second half of the year.

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 in 2019/20 is expected to be £18,000 above budget. MRP will be £37,000 under the budget. Minimal interest for short term cash flow purposes of £1,000 is expected to be paid out in the 2019/20 year.

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 2019/20

Economic background: UK Consumer Price Inflation (CPIH) fell to 1.7% year/year in August 2019 from 2.0% in July, weaker than the consensus forecast of 1.9% and below the Bank of England's target. The most recent labour market data for the three months to July 2019 showed the unemployment rate edged back down to 3.8% while the employment rate remained at 76.1%, the joint highest since records began in 1971. Nominal annual wage growth measured by the 3-month average excluding bonuses was 3.8% and 4.0% including bonuses. Adjusting for inflation, real wages were up 1.9% excluding bonuses and 2.1% including.

The Quarterly National Accounts for Q2 GDP confirmed the UK economy contracted by 0.2% following the 0.5% gain in Q1 which was distorted by stockpiling ahead of an expected Brexit. Only the services sector registered an increase in growth, a very modest 0.1%, with both production and construction falling and the former registering its largest drop since Q4 2012. Business investment fell by 0.4% (revised from -0.5% in the first estimate) as Brexit uncertainties impacted on business planning and decision-making.

Politics, both home and abroad, continued to be a big driver of financial markets over the last quarter.

In the UK Boris Johnson won the Conservative Party leadership contest and was committed to leaving the EU on 31st October regardless of whether a deal was reached with the EU. However, Parliament passed a bill requiring him to seek a Brexit extension whcich extended Brexit uncertainty into the second half of the fiananveila year.

Globvally tensions continued between the US and China with no trade agreement in sight and both countries imposing further tariffs on each other's goods. The US Federal Reserve cut its target Federal Funds rates by 0.25% in September to a range of 1.75% - 2%, a pre-emptive move to maintain economic growth amid escalating concerns over the trade war and a weaker economic environment leading to more pronounced global slowdown. The euro area Purchasing Manager Indices (PMIs) pointed to a deepening slowdown in the Eurozone. These elevated concerns have caused key government yield curves to invert, something seen by many commentators as a predictor of a global recession. Market expectations are for further interest rate cuts from the Fed and in September the European Central Bank reduced its deposit rate to -0.5% and announced the recommencement of quantitative easing from 1st November.

The Bank of England maintained Bank Rate at 0.75% and in its August Inflation Report noted the deterioration in global activity and sentiment and confirmed that monetary policy decisions related to Brexit could be in either direction.

Financial markets: After rallying early in 2019, financial markets have been adopting a more risk-off approach in the following period as equities saw greater volatility and bonds rallied (prices up, yields down) in a flight to quality and anticipation of more monetary stimulus from central banks. The Dow Jones, FTSE 100 and FTSE 250 are broadly back at the same levels seen in March/April.

Gilt yields remained volatile over the period on the back of ongoing economic and political uncertainty. From a yield of 0.63% at the end of June, the 5-year benchmark gilt yield fell to 0.32% by the end of September. There were falls in the 10-year and 20-year gilts over the same period, with the former dropping from 0.83% to 0.55% and the latter falling from 1.35% to 0.88%. 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.65%, 0.75% and 1.00% respectively over the period.

Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth remains a global risk. The US yield curve remains inverted with 10-year Treasury yields lower than US 3-month bills. History has shown that a recession hasn't been far behind a yield curve inversion. Following the sale of 10-year Bunds at -0.24% in June, yields on German government securities continue to remain negative in the secondary market with 2 and 5-year securities currently both trading around -0.77%.

Credit background: Credit Default Swap (CDS) spreads rose and then fell again during the quarter, continuing to remain low in historical terms. After rising to almost 120bps in May, the spread on non-ringfenced bank NatWest Markets plc fell back to around 80bps by the end of September, while for the ringfenced entity, National Westminster Bank plc, the spread remained around 40bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 34 and 76bps at the end of the period.

There were minimal credit rating changes during the period. Moody's upgraded The Co-operative Bank's long-term rating to B3 and Fitch upgraded Clydesdale Bank and Virgin Money to A-.