Public

To:
All members of the
Overview and Scrutiny Committee

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Date: 11 January 2018

Supplementary Agenda

Overview and Scrutiny Committee - Tuesday, 16 January 2018

Dear Councillor

I enclose the following item which was marked 'to follow' on the agenda for the Overview and Scrutiny Committee meeting to be held on Tuesday, 16 January 2018:

Yours sincerely

Gillian Hobbs
Corporate Governance

To the members of the Overview and Scrutiny Committee

Councillors:

S.C. Mooney (Vice-Chair, in the Chair)
R.O. Barratt
J.R. Boughtflower
S. Capes
T.J.M. Evans
K. Flurry
A.E. Friday
A.L. Griffiths
N. Islam
J.G. Kavanagh
D. Patel
D. Saliagopoulos
J.R. Sexton
R.A. Smith-Ainsley
B.B. Spoor

Overview and Scrutiny Committee

16 January 2018

SPELTHORNE MEANS BUSINESS

Title	Treasury Management Half Yearly Report 2017/18		
Purpose of the report	To note		
Report Author	Anna Russell, Deputy Chief Accountant		
Cabinet Member	Councillor Howard Williams	**Confidential**	No
Corporate Priority	Financial Sustainability		
Recommendations	**Overview and Scrutiny Committee is asked to note the treasury position achieved during the first six months of 2017/18 and the financial environment in global markets.**		
Reason for Recommendation	**Not applicable**		

1. Introduction and Context

1.1 Treasury Management is "the management of the Council's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks".

1.2 The Council has adopted the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management Code which requires the Council to report on performance of the treasury management function at least twice yearly (mid-year and at year end).

1.3 The Council's Treasury Management Strategy for 2017/18 was reviewed and approved by Cabinet in January 2018, and approved by Council in February 2017, and has been consistently applied since the beginning of the financial year.

1.4 This report is an interim statement of treasury activities for the first six months of the financial year, to the end of September 2017. The Council has invested and borrowed 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. This report covers treasury activity and the associated monitoring and control of risks.

External Context – Economic commentary and outlook

1.5 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%.

1.6 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 year 2017.

1.7 The Bank of England made no change to monetary policy at its meetings in the first half of the financial year, although it subsequently edged it up to 0.5% in November.. 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" which indeed proved to be the case.

1.8 In contrast, near-term global growth prospects improved. The US Federal Reserve ("the Fed") 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.

1.9 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.

1.10 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 increased 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) of 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.

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

External Context – Financial markets

1.12 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%.

1.13 The FTSE 100 nevertheless powered away reaching a record high of 7548 in May, dropping back to 7377 by September end. 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 21 September.

External Context – Credit background

1.14 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.

1.15 There were a few credit rating changes during the quarter. 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.

1.16 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+.

1.17 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 Council 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.

1.18 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 21 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.

Regulatory Updates - MiFID II

1.19 Until 2 January 2018, local authorities are 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.

1.20 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, as either retail or professional clients, are not protected by the Financial Services Compensation Scheme nor are they eligible to complain to the Financial Ombudsman Service. 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. In the past, the Council declined to opt down to retail client status as costs were considered to outweigh the benefits.

1.21 The Council meets the conditions to opt up to professional status and intends to do so in order to maintain its current MiFID status.

Regulatory Updates - CIPFA Consultation on Prudential and Treasury Management Codes

1.22 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 30 September 2017. The Council has responded to the consultation.

1.23 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 and for group accounts. Other proposed changes include applying the principles of the Code to subsidiaries.

1.24 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.

1.25 CIPFA intends to publish the two revised Codes at end 2017/ start 2018 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, although it is increasingly looking likely that this timescale is optimistic and the changes may not take effect until 2019/20. The Department of Communities and Local Government (DCLG) and CIPFA wish to have a more rigorous framework in place for the treatment of commercial investments as soon as is practical. DCLG in November issued a consultation on revising its Investment Guidance and its Minimum Revenue Provision guidance for local authorities in England.

Local Context

1.26 With the purchase of properties starting with the BP internation campus site in Sunbury during 2016/17, the Council now has significant levels of long term borrowing, secured to fund the property acquisitions.

1.27 The Council's current strategy when making strategic asset acquisitions is to take advantage of the cheap borrowing rates available, whilst maintaining and supplementing when possible the investment portfolio that has been built up.

1.28 On 31 March 2017, the Council had net investments of £422m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. This is summarised in Table 1 below.

Table 1: Balance Sheet Summary as at 31 March 2017

CAPITAL FINANCING REQUIREMENT	**2016/17 £000**
Opening Capital Financing Requirement	**-**
Capital investment	
Property, Plant and Equipment	1,140
Investment Properties	417,500
Intangible Assets	238
Revenue Spend Funded from Capital under Statute	3,536
Total Capital Investment	**422,414**
Sources of Finance	
Capital Receipts	(2,718)
Government Grants and Contributions	(625)
Sums set aside from Revenue	(2,986)
Borrowing	(413,264)
Reserves	(2,821)
Total Sources of Finance	**(422,414)**
Closing Capital Financing Requirement	**-**

1.29 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. This has also been undertaken to allow time for the Council to successful undertake an alternative funding exercise to access an element of finance from alternative funders at rates cheaper than the PWLB. The treasury management position as at 30th September 2017 and the change over the period is show in Table 2 below.

Table 2: Treasury Management Summary

	31/03/2017 Balance £m	Movement £m	30/09/2017 Balance £m
Long-term borrowing	(406)	(44)	(450)
Short-term borrowing	(8)	(34)	(42)
Total borrowing	**(414)**	**(78)**	**(492)**
Long-term investments	22	(4)	18
Short-term investments	-	-	-
Cash and cash equivalents	7	28	36
Total investments	**29**	**24**	**53**
Net borrowing	**(385)**	**(54)**	**(439)**

2. Borrowing Strategy to 30 September 2017

2.1 At 30 September 2017, the Council held £492m of loans, an increase of £78m from 31 March 2017, including £450m long-term PWLB borrowing as part of its strategy for funding major acquisitions and developments. The 30 September 2017 borrowing position is show in Table 3 below.

Table 3: Borrowing Position

	31/03/2017 Balance £m	Movement £m	30/09/2017 Balance £m
Public Works Loan Board (PWLB)	406	44	450
Local authorities	8	34	42
Total Borrowing	**414**	**78**	**492**

2.2 At 30 September 2017, the Council also had short term borrowing totalling £42m. This reflected the cashflow impact of some of the costs associated with acquisitions such as VAT. These funds were borrowed from other local authorities, due to the short term nature of the requirement and the affordable rates on offer.

2.3 The Council will also need to borrow additional funds on both a long and short term basis for any further strategic acquisition purchases that occur in the future. Work is ongoing with Arlingclose and the portfolio holder to ensure that the cheapest and most appropriate duration and source are secured.

2.4 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.

2.5 Affordability and the "cost of carry" remained important influences on the Authority's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing.

Investment Activity to 30 September 2017

2.6 The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles. However, the ability to maximise interest returns within these guidelines is paramount to generating sufficient funds to support the Council's revenue budget.

2.7 As at 30 September 2017, the Council's investment portfolio was a total of £43.29m, with £19.5m of this being short-term cashflow funds. A breakdown of the investments is given in **Appendix A**.

2.8 Given the increasing risk and continued low returns from short-term unsecured bank investments, it is the Council's aim to further diversify into more secure or higher yielding asset classes. The availability of funds for investment is dependent upon the timing of precept payments, receipt of grants and progress on the capital programme.

2.9 The pooled fund investments form a key part of the portfolio and a full list of these and their current performance is detailed in **Appendix B**.

Investment Performance Monitoring

2.10 Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2017/18.

2.11 The Council seeks professional advice from Arlingclose and closely adheres to the advice set out in the Department for Communities and Local Government (DCLG) guidance. Given Spelthorne's dependency on investment returns to balance the budget, the Council's investment strategy is also kept under constant review and regular quarterly review meetings are held with Arlingclose, the Council's treasury advisors. All investment and borrowing decisions are made in consultation with our advisors.

2.12 Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating for institutions defined as having "high credit quality" is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

Conclusions and Outlook for the remainder of 2017/18

2.13 The UK economy faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Both consumer and business confidence remain subdued. Household consumption growth, the driver of UK GDP growth, has softened following a contraction in real wages. Savings rates remain low and real earnings growth (i.e after inflation) struggles in the face of higher inflation.

2.14 The Bank of England's Monetary Policy Committee has changed its rhetoric, implying a rise in Bank Rate in "the coming months". Arlingclose is not convinced the UK's economic outlook justifies such a move at this stage, but the Bank's interpretation of the data seems to have shifted.

2.15 This decision is still very data dependant and Arlingclose is, for now, maintaining its central case for Bank Rate at 0.25% whilst introducing near-term upside risks to the forecast as shown below. Arlingclose's central case is for gilt yields to remain broadly stable in the across the medium term, but there may be near term volatility due to shifts in interest rate expectations.

3. Financial implications

3.1 The financial implications are as set out in this report. The ability to maximise interest returns is paramount to generate sufficient funds to support the General Fund and even a small decline in interest rates can mean a significant reduction in cash returns. Therefore, it is our aim to continue to maintain flexibility commensurate with the high level of security and liquidity and minimal risk when making investment decisions.

4. Other considerations

4.1 The Council fully complies with best practice as set out in the Chartered Institute of Public Finance and Accountancy (CIPFA) Prudential Code for Capital Finance in Local Authorities, the Department for Communities and Local Government (DCLG) Guidance on Investments issued in March 2004 and the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management in the Public Sector 2009 and Cross Sectional Guidance Notes.

4.2 Nothing in the Council's current strategy is intended to preclude or inhibit capital investment in local projects deemed beneficial to the local community and which have been approved by the Council.

5. Timetable for implementation

5.1 Treasury management is an ongoing activity and normally there is no specific timetable for implementation.

Background papers: There are none

Appendices: Appendices A – B are attached

Appendix A

Details of Investments Held as at 30 September 2017

Investment Type	Initial Inv. Amount £m	Yield %	Start Date	Maturity Date
<u>Pooled Investment Funds</u>				
<u>(see Appendix B for details)</u>				
Charteris Elite Equity Income	0.8	3.65*	11 May 2012	N/A
Schroders UK Corporate Bond	1.5	5.12*	11 May 2012	N/A
M&G Optimal Income Sterling	1.69	2.07*	13 Apr 2015	N/A
M&G Global Dividend	1.0	4.19*	27 Jun 2012	N/A
M&G Extra Income Fund	2.0	2.33*	15 Aug 2016	N/A
Schroders Income Maximiser	1.0	6.68*	06 Jul 2012	N/A
Schroders Income Maximiser	1.0	6.68*	24 Jul 2015	N/A
Schroders Income Maximiser	1.0	6.68*	26 Aug 2016	N/A
CCLA Property Fund (LAMIT)	1.5	5.72*	31 Mar 2013	N/A
CCLA Property Fund (LAMIT)	1.0	5.72*	30 Apr 2014	N/A
Investec Diversified Income	3.0	3.00*	25 Aug 2016	N/A
Threadneedle UK Equity Fund	2.0	1.65*	08 Sept 2016	N/A
Total	**17.49**	**3.98***		
<u>Fixed Rate Deposits</u>				
Network Housing Group	2.0	3.60	28 Apr 2016	27 Apr 2021
Total	**2.00**	**3.60**		
Total - Core Inv. Portfolio	**19.49**	**3.94**	**Average**	
<u>Cash Flow Investments</u>				
Insight	5.0	0.17		Instant Access
Standard Life Investments	5.0	0.20		Instant Access
BNP Paribas	5.0	0.24		Instant Access
Federated	5.0	0.21		Instant Access
GSMMF	0.4	0.13		Instant Access
LGIM	5.0	0.17		Instant Access
CCLA	5.0	0.18		Instant Access
Invesco	5.0	0.20		Instant Access
Total	**35.4**	**0.19**		
<u>Funding Circle</u>				
Loans to small businesses	0.3	4.81	16 Apr 2015	31 Mar 2019
Total Investments at 30/9/17	**43.29**	**1.49**	**Overall average**	

* *Yields on pooled funds are estimates based on in-year performance or estimated performance when the fund was recently opened.*

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Appendix B

Pooled Funds as at 30 September 2017

Fund	Date of Purchase	Initial Investment	Dividends Received to 30/9/17	Annualised Dividend Yield	Capital Gain at 30/9/17	Total Return at 30/9/17	Total Return
		£	£	%	£	£	%
Charteris Elite Income Fund	11/05/12	800,120	19,851	3.65%	58,827	78,678	9.83%
Schroders UK Corporate Bond	11/05/12	1,500,000	36,749	5.12%	208,451	245,200	16.35%
Schroders Income Maximiser Fund	06/07/12	1,000,000	29,012	6.68%	206,374	235,386	23.54%
Schroders Income Maximiser Fund	24/07/15	1,000,000	23,585	6.68%	- 19,294	4,291	0.43%
Schroders Income Maximiser Fund	26/08/16	1,000,000	25,059	6.68%	41,976	67,035	6.70%
M&G Global Dividend Fund	27/06/12	1,000,000	26,835	4.19%	609,561	636,396	63.64%
M&G Optimal Income Sterling	13/04/15	1,690,636	-	2.07%	85,114	85,114	5.03%
M&G UK Income Distribution Sterling	15/08/16	2,000,000	41,986	2.33%	18,162	60,148	3.01%
Investec Diversified Income	25/08/16	3,000,000	55,120	3.00%	- 71,661	- 16,541	-0.55%
Threadneedle Inv Services - UK Equity	08/09/16	2,000,000	27,969	1.65%	121,045	149,014	7.45%
CCLA - The LAs Property Fund	31/03/13	1,500,000	22,436	5.72%	477,358	499,794	33.32%
CCLA - The LAs Property Fund	30/04/14	1,000,000	12,810	5.72%	129,040	141,850	14.19%
Value at 30/9/2017		**17,490,756**	**321,412**	**3.98%**	**1,864,953**	**2,186,365**	**12.50%**

Pooled Fund Performance to 30 September 2017

The Capital appreciation of these investments as at 30/9/17 equates to 10.66%. However, capital gains and losses may fluctuate throughout the period the investments are held. Any gains would only be realised when the funds are sold. Dividends are received at various times during the year, with some paid quarterly and others half yearly. The income yield for 2017/18 as at 30/9/17 is 1.84% and the estimated annualised income yield on these funds is expected to be in the region of 3.98%.

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