Overview and Scrutiny Committee

15 January 2019

Title	Treasury Management Half Yearly Report 2018/19
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 2018/19 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’s *Treasury Management in the Public Services: Code of Practice* (the CIPFA 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 2018/19 was reviewed and approved by Cabinet on 24 January 2018, and approved by Council on 22 February 2018, 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 2018. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. This report covers treasury activity and the associated monitoring and control of risks.

1.5 Following consultation in 2017, CIPFA published new versions of the Prudential Code for Capital Finance in Local Authorities (Prudential Code) and the Treasury Management Code of Practice. In England, MHCLG published its revised Investment Guidance which came into effect from April 2018.

1.6 The updated Prudential Code includes a new requirement for local authorities to provide a Capital Strategy, which is to be a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. Councils are required to approve their Capital Strategy by end of 2018/19. The Council is producing its Capital Strategy for 2018/19 for approval by full Council.

External Context – Economic background

1.7 Oil prices rose by 23% over the six months to around $82/barrel. The UK Consumer Price Inflation (CPI) for September rose to 2.4% year on year as the effects of sterling's large depreciation in 2016 began to fade. The ONS labour market data for the quarter to August 2018 showed the unemployment rate at 4%, the 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.

1.8 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%.

1.9 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.

1.10 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.

1.11 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 at the time of writing this report, extending the period of economic uncertainty.

External Context – Financial markets

1.12 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.

External Context – Credit background

1.13 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.

1.14 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.

1.15 There were a few credit rating changes during the period. Moody's downgraded Barclays Bank plc's long-term rating to A2 from A1 and NatWest Markets plc to Baa2 from A3 on its view of the credit metrics of the entities post ringfencing. Upgrades to long-term ratings included those for Royal Bank of Scotland plc, NatWest Bank and Ulster Bank to A2 from A3 by Moody's and to A- from BBB+ by both Fitch and Standard & Poor's (S&P). Lloyds Bank plc and Bank of Scotland plc were upgraded to A+ from A by S&P and to Aa3 from A1 by Moody's. Our treasury advisor Arlingclose will henceforth provide ratings which are specific to wholesale deposits including certificates of deposit, rather than provide general issuer credit ratings. Non-preferred senior unsecured debt and senior bonds are at higher risk of bail-in than deposit products, either through contractual terms, national law, or resolution authorities' flexibility during bail-in. Arlingclose's creditworthiness advice will continue to include unsecured bank deposits and CDs but not senior unsecured bonds issued by commercial banks

Local Context

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

1.17 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.

1.18 On 31 March 2018, the Council had capital expenditure of £273m including £258m (94%) on investment properties. 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 next.

Table 1: Capital Expenditure Summary as at 31 March 2018

	2017/18 £'000
Opening Capital Financing Requirement	**416,250**
Capital expenditure	
Property, Plant and Equipment	13,520
Investment Properties	258,229
Intangible Assets	370
Revenue Spend Funded from Capital under Statute	1,241
Total Capital Expenditure	**273,360**
Sources of Finance	
Capital Receipts	(1,250)
Government Grants and Contributions	(1,021)
Revenue contributions	(838)
Repayment of debt	(4,517)
Total Sources of Finance	(7,626)
Closing Capital Financing Requirement	**681,984**

1.19 The financing of capital expenditure in 2017/18 is shown in Table 2.

Table 2: Financing of Capital Expenditure

	2017/18 £'000
Total Capital Expenditure	**273,360**
Financed by:	
Capital Receipts	(1,250)
Government Grants and Contributions	(1,021)
Revenue Resources	(838)
Borrowing	(270,251)
Total Capital Financing	**(273,360)**

1.20 The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 30 September 2018 and the change over the period is shown in Table 3 next.

Table 3: Treasury Management Summary

	31/03/2018 Balance £m	Movement £m	30/09/2018 Balance £m
Long-term borrowing	(651)	(374)	(1,025)
Short-term borrowing	(14)	6	(8)
Total borrowing	**(665)**	**(368)**	**(1,033)**
Long-term investments	21	-	21
Short-term investments	1	19	20
Cash and cash equivalents	5	36	41
Total investments	**27**	**55**	**82**
Net borrowing	**(638)**	**(313)**	**(951)**

1.21 Cash balances total £41m and short-term investments £20m, reflecting the increases in income generation. Managers are currently assessing the long-term availability of funds and investment opportunities so that more funds can be allocated to long-term investments.

1.22 The increase in borrowing and income highlights the need for review and strengthening of the Treasury Management function. The function is currently resourced as small proportions of existing posts, although the actual work required has increased significantly since the Council started acquiring and developing property. As well as internal assessment by Finance of staffing requirements, the Root and Branch team is currently reviewing the Treasury Management function. In addition, the Council is implementing a Treasury Management system, available through the existing Arlingclose service, which will help with cashflow projections and general Treasury Management administration,

2. Borrowing Strategy to 30 September 2018

2.1 At 30 September 2018, the Council held £1,033m of loans, an increase of £370m from 31 March 2018, including £1,008m long-term PWLB borrowing as part of its strategy for funding major acquisitions and developments. The 30 September 2018 borrowing position is show in Table 4 next.

Table 4: Borrowing Position

	31/03/2018 Balance £m	Movement £m	30/09/2018 Balance £m
Public Works Loan Board	648	360	1,008
Local authorities - long-term	3	14	17
Local authorities - short-term			8
	14	(6)	
Total Borrowing	**665**	**368**	**1,033**

2.2 At 30 September 2018, the Council also had short-term borrowing totalling £19m. This reflected the cashflow impact of some of the costs associated with acquisitions. These funds were borrowed from other local authorities because of 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 2018

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 2018, the Council's investment portfolio was a total of £68.8m, with £29.0m of this being short-term cashflow funds. A breakdown of the investments is given in **Appendix A**. It should be noted that one of the short-term loans to a local authority breached the £5m counterparty limit. This issue was identified soon after the trade, and procedures have been tightened to help prevent such a breach in future.

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 2018/19.

2.11 The Council seeks professional advice from Arlingclose and closely adheres to the advice set out in the Ministry of Housing, Communities and Local Government (MHCLG) guidance. Given Spelthorne's dependency on investment returns to balance the budget, the Council's investment strategy is also kept under constant review and quarterly review meetings are held with Arlingclose, the Council's treasury advisor.

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 2018/19

2.13 Having raised policy rates in August 2018 to 0.75%, the Bank of England's Monetary Policy Committee (MPC) has maintained expectations of a slow rise in interest rates over the forecast horizon.

2.14 The MPC has a definite bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. While policymakers are wary of domestic inflationary pressures over the next two years, it is believed that the MPC members consider both that (a) ultra-low interest rates result in other economic problems, and that (b) higher Bank Rate will be a more effective weapon should downside Brexit risks crystallise and cuts are required.

2.15 Arlingclose's central case is for Bank Rate to rise twice in 2019. The risks are weighted to the downside. The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in Q2 2018, but the annual growth rate of 1.2% remains well below the long-term average rate.

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 CIPFA's 2019 Treasury Management and Prudential Codes and in MHCLG's Guidance on Investments effective from April 2018.

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