**Agenda Item No:8**

## TREASURY MANAGEMENT REPORT – QUARTER THREE UPDATE 2018-19

| | |
|---|---|
| *To:* | **General Purpose Committee** |
| *Meeting Date:* | **26th March 2019** |
| *From:* | **Chief Finance Officer** |
| *Electoral division(s):* | **All** |
| *Forward Plan ref:* | **Not applicable** *Key decision:* **No** |
| *Purpose:* | **To provide the third quarterly update on the Treasury Management Strategy 2018-19, approved by Council in February 2018.** |
| *Recommendation:* | **The General Purposes Committee is recommended to note the Treasury Management Report.** |



| | ***Officer contact:*** | | ***Member contacts:*** |
|---|---|---|---|
| Name: | Carl Oliver / Tom Kelly | Names: | Councillors Count & Hickford |
| Post: | Group Accountant / Head of Finance | Post: | Chair/Vice-Chair |
| Email: | Carl.oliver@milton-keynes.gov.uk / Tom.Kelly@cambrdigeshire.gov.uk | Email: | Steve.Count@cambridgeshire.gov.uk / Roger.Hickford@cambridgeshire.gov.uk |
| Tel: | 01908 252414 / 01223 703599 | Tel: | 01223 706398 |

## 1. BACKGROUND

1.1 The Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice for Treasury Management recommends that members be updated on treasury management activities regularly (annual, mid-year or quarterly reports). This report, therefore, ensures this Council is implementing best practice in accordance with the Code.

## 2. ECONOMIC CLIMATE

2.1 A detailed commentary from the Council's treasury advisors of the current economic climate is provided at **Appendix A** to this report. In brief summary, Q3 saw:

- The economy lost some momentum after a strong quarter (ended 30th September);
- There was a further acceleration in wage growth;
- Early signs that lower oil prices will soon depress inflation;
- The Chancellor delivered what was seen as a giveaway in the autumn Budget;
- The Monetary Policy Committee inertia on interest rates
- Parliament was deadlocked over Brexit;
- Equity markets worldwide were hit hard by global growth fears.

## 3. INTEREST RATE FORECAST

3.1 The latest forecast for UK Bank Rate along with PWLB borrowing rates (certainty rate) from the Council's treasury advisors is set out below:

**Table 1: Interest Rate Forecast**

| Link Asset Services Interest Rate View | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 |
| Bank Rate View | 0.75% | 1.00% | 1.00% | 1.00% | 1.25% | 1.25% | 1.25% | 1.50% | 1.50% | 1.75% | 1.75% |
| 5yr PWLB Rate | 2.10% | 2.20% | 2.20% | 2.30% | 2.30% | 2.40% | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% |
| 10yr PWLB Rate | 2.50% | 2.60% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.10% | 3.10% | 3.20% |
| 25yr PWLB Rate | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% | 3.50% | 3.50% |
| 50yr PWLB Rate | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% | 3.30% | 3.30% |

3.2 There are many risks to the forecast set out above, principally around the timing and pace of further rate rises, and a listing of underlying assumptions is attached at **Appendix B**. Budget estimates prudently include sensitivity analysis of the impact that a slower than forecast economic recovery would have upon the Council, and any impact of changes to interest rates is reported through the Budget Monitoring process.

## 4. INVESTMENTS

4.1 The Treasury Management Strategy Statement (TMSS) for 2018-19, which includes the

Annual Investment Strategy, was approved by the Council on 6th February 2018. It sets out the Council's investment priorities as being:

1. Security of Capital;
2. Liquidity; and then
3. Yield

4.2 The Council will aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity.

4.3 The table below summarises the maturity profile of the Council's investment portfolio at the end of Q3 2018-19 (excluding third party loans):

**Table 2 – Investment maturity profile at end of Q3 2018-19**

| | | Maturity Period | | | |
|---|---|---|---|---|---|
| | | **0d** | **0-3m** | **Total** | |
| **Product** | **Access Type** | **£m** | **£m** | **£m** | **%** |
| | | | | | |
| Money Market Funds | Same-Day | 39.5 | | **39.5** | ***51.0*** |
| Bank Call Account | Instant Access | 7.9 | | **7.9** | ***10.2*** |
| Local Authorities | Fixed Term | 0.0 | 20.0 | **20.0** | ***25.8*** |
| Certificate of Deposits | Fixed Term / Tradeable | 0.0 | 10.0 | **10.0** | ***13.0*** |
| | | | | | |
| | **Total** | **47.4** | **30.0** | **77.4** | ***100.0*** |
| | ***%*** | ***61.2*** | ***38.8*** | ***100.0*** | |

4.4 Set out below are details of the amounts outstanding on loans and share equity investments classed as capital expenditure advanced to third party organisations at the end of Q3:

- This Land Ltd - £46.486m; loans advanced to Council's wholly owned property company. In addition the Council held £1.792m equity in the company;
- Arthur Rank Hospice Charity - £3.680m; loan to local charitable organisation for development of a new hospice facility. Secured against property assets;
- UK Municipal Bonds Agency (MBA) – £0.400m; to establish the agency to raise bond finance as an alternative to Public Works Loan Board (PWLB) & markets;
- Estover Playing Field 2015 CIC - £0.350m; loan to an arm's length community interest company (CIC) for expenditure on acquisition and development of the Estover Playing Field to provide local economic development. Guaranteed by March Town Council;
- LGSS Law - £0.325m; loan to jointly owned public sector shared services venture to aid the cashflow of the company; and
- Wisbech Town Council - £0.150m; loan towards the acquisition and restoration of Wisbech Castle.

4.5 Financial markets trade on confidence and certainty, and although the Bank of England forward guidance is aimed at providing this, markets remain sceptical. Investment rates have increased from historical lows following the base rate rises, but remain relatively low in short to medium-term durations, with limited pickup in value for longer durations.

4.6 At 31st March 2018 investment balances totalled £26.8m, held in Money Market Funds and Call/Notice accounts. This figure excludes third party loans and share capital which are set out above. Due to the nature of various government funding streams and timing of capital expenditure, the average level of funds available for investment purposes during quarter three was £65.1m. Short-term loans will be repaid as they mature but in the meantime, short-term investments have been placed in accordance with the Council's approved investment strategy.

4.7 Investment balances are forecast to reduce by the financial year end as internal resources from temporary positive cashflow surpluses are applied to fund expenditure demands in lieu of fully funding the borrowing requirement (internal borrowing) on a net basis. This process effectively reduces the cost of carrying additional borrowing at a higher cost than the income that could be generated through short term investment of those balances, as well as reducing investment counterparty credit risk.

4.8 The Council's investments outperformed against the most comparable weighted duration benchmark by 9 basis points (equivalent to £17k more than benchmark return). Any impact upon latest budget projections for the financial year are reported through the Budget Monitoring process.

**Table 3: Benchmark Performance – Q3 2018-19**

| Benchmark | Benchmark Return | Council Performance |
|---|---|---|
| **1m LIBID** | 0.61% | 0.70% |

4.9 Leaving market conditions aside, the Council's return on investments is influenced by a number of factors, the largest contributors being the duration of investments and the credit quality of the institution or instrument:

- Credit risk is the consideration of the likelihood of default and is controlled through the creditworthiness policy approved by Council.
- The duration of an investment introduces liquidity risk; the risk that funds cannot be accessed when required.
- Interest rate risk; the risk that arises from fluctuating market interest rates.

4.10 These factors and associated risks are actively managed by the LGSS Integrated Finance Treasury team.

## 5. BORROWING

5.1 The Council can raise cash through borrowing in order to fund expenditure on its capital programme for the benefit of Cambridgeshire. The amount of new borrowing needed each year is determined by capital expenditure plans and projections of the Capital Financing Requirement, underlying borrowing requirement, forecast cash-backed reserves and both current and forecast economic conditions.

5.2 Overall borrowing outstanding increased during Q3 when compared to Q2 by £22.9m. At Q2, the Council held £562.8m of borrowing, of which £137.5m matured in less than 1 year. At the end of Q3, the Council held £585.7m of borrowing, of which £165.6m matures in less than 1 year. The net additional borrowing was primarily taken short-term for durations up to one year, with one loan of two years, all from other Local Authorities.

5.3 Table 4 below sets out the maturity profile of the Council's borrowing portfolio at the end of Q3. The majority of loans are PWLB loans and have a fixed interest rate and are long term in nature which limits the Council's exposure to interest rate fluctuations.

**Table 4: Borrowing Maturity Profile – Q2 2018-19**

| **Term Remaining** | **Borrowing** | |
|---|---|---|
| | **£m** | **%** |
| Under 12 months | 165.603 | 28.2 |
| 1-2 years | 60.160 | 10.3 |
| 2-5 years | 86.286 | 14.7 |
| 5-10 years | 62.566 | 10.7 |
| 10-20 years | 58.990 | 10.1 |
| 20-30 years | 46.595 | 8.0 |
| 30-40 years | 20.000 | 3.4 |
| 40-50 years | 35.000 | 6.0 |
| Over 50 years | 50.500 | 8.6 |
| **TOTAL** | **585.700** | **100.0** |

5.4 Market Lender Option Borrower Option (LOBO) loans are included at their final maturity rather than their next potential call date. In the current low interest rate environment the likelihood of lenders exercising their option to increase the interest rates on these loans - and so triggering the Council's option to repayment at par - is considered to be low.

5.5 The Council is in an internally borrowed cash position and balances will need to be replenished at some point in the future (subject to expenditure demands). Officers continue to assess cashflow forecasts against projected movements in borrowing rates. Sharp or sustained movements in borrowing rates will increase the likelihood of additional borrowing.

5.6 The Council has entered into a Framework Agreement and Joint and Several Guarantee arrangement with the UK Municipal Bonds Agency (MBA). This included the advance of seed capital shares of £0.4m as reported in paragraph 4.4 above. It is hoped this will allow for the Council to potentially raise loan finance through MBA as an alternative to PWLB and market loans. Feedback from the MBA suggests a bond issue is not currently imminent alongside current economic and market uncertainty. There is strong support to the MBA from the Local Government Association.

## 6. BORROWING RESTRUCTURING

6.1 No borrowing rescheduling was undertaken during the Q3. Rescheduling opportunities are limited in the current economic climate. For PWLB loans, due to the spread between the carrying rate of existing borrowing and early redemption rates, substantial exit (premium) costs would be incurred. For market borrowing, the lender uses the certainty of the loans cashflow profile to hedge against forecast interest rate movements and so would pass the cost of unwinding these instruments onto the Council as an exit (premium) cost.

6.2 Officers continue to monitor the position regularly, and are in ongoing dialogue with the market loan lenders who may be open to negotiating on exit costs in return for early repayment of principal. Further updates on this position will be reported should they materialise.

## 7. TREASURY AND PRUDENTIAL INDICATORS

7.1 The Council's approved Treasury and Prudential Indicators (affordability limits) were approved alongside the TMSS. It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits.

7.2 During the financial year to date the Council has operated within the Treasury and Prudential Indicators set out in the Council's TMSS, shown in **Appendix C**.

## 8. ALIGNMENT WITH CORPORATE PRIORITIES

### 8.1 A good quality of life for everyone

There are no significant implications for this priority.

### 8.2 Thriving places for people to live

There are no significant implications for this priority.

### 8.3 The best start for Cambridgeshire's children

There are no significant implications for this priority.

## 9. SIGNIFICANT IMPLICATIONS

### 9.1 Resource Implications

This report provides information on performance against the Treasury Management Strategy. Decisions on treasury management, which are driven by the capital programme and the Council's overall financial position, will impact the Debt Charges Budget and are reported through the Budget Monitoring process.

9.2 **Procurement/Contractual/Council Contract Procedure Rules Implications**

There are no significant implications for this category.

9.3 **Statutory, Legal and Risk Implications**

The Council continues to operate within the statutory requirements for borrowing and investments. Further details can be found within the Prudential Indicators in **Appendix C**.

9.4 **Equality and Diversity Implications**

There are no significant implications for this category.

9.5 **Engagement and Communications Implications**

There are no significant implications for this category.

9.6 **Localism and Local Member Involvement**

There are no significant implications for this category.

9.7 **Public Health Implications**

There are no significant implications for this category.

| Implications | Officer Clearance |
|---|---|
| | |
| **Have the resource implications been cleared by Finance?** | Yes<br>Name of Financial Officer: Tom Kelly |
| | |
| **Have the procurement/contractual/ Council Contract Procedure Rules implications been cleared by the LGSS Head of Procurement?** | Not applicable |
| | |
| **Has the impact on statutory, legal and risk implications been cleared by LGSS Law?** | Not applicable |
| | |
| **Have the equality and diversity implications been cleared by your Service Contact?** | Not applicable |
| | |
| **Have any engagement and communication implications been cleared by Communications?** | Not applicable |
| | |
| **Have any localism and Local Member involvement issues been cleared by your Service Contact?** | Not applicable |
| | |
| **Have any Public Health implications been cleared by Public Health** | Not applicable |

| Source Documents | Location |
|---|---|
| None | Not applicable |

**Appendix A**
**Economic Commentary; Extract from Treasury Advisors (Link Asset Services)**

## UK

- After weak economic growth of only 0.1% in quarter one, growth picked up to 0.4% in quarter 2 and to 0.6% in quarter 3. However, uncertainties over Brexit look likely to cause growth to have weakened again in quarter four. After the Monetary Policy Committee raised Bank Rate from 0.5% to 0.75% in August, it is little surprise that they have abstained from any further increases since then. We are unlikely to see any further action from the MPC until the uncertainties over Brexit clear. In the event of a 'disorderly exit', the MPC have said that rates could go up or down, though it is probably much more likely to be down so as to support growth. Nevertheless, the MPC does have concerns over the trend in wage inflation which peaked at a new post financial crisis high of 3.3%, (excluding bonuses), in the three months to October. The main issue causing this is a lack of suitably skilled people due to the continuing increase in total employment and unemployment being near to 43 year lows. Correspondingly, the total level of vacancies has risen to new highs.

- As for CPI inflation itself, this has been on a falling trend, reaching 2.3% in November. However, in the November Bank of England Inflation Report, the latest forecast for inflation over the two year time horizon was raised to being marginally above the MPC's target of 2%, indicating a slight build up in inflationary pressures.

- The rise in wage inflation and fall in CPI inflation is good news for consumers as their spending power is improving in this scenario as the difference between to two figures in now around 1%, i.e. a real terms increase. Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months.

## EU

- Growth fell in quarter 3 to 0.2% from 0.4% in quarter 2 but this is likely to be a one off blip caused primarily by a one off fall in car production. The ECB forecast growth in 2018 to be 1.9% falling to 1.7% in 2020. The ECB ended its programme of quantitative easing purchases of debt in December, which now means that the central banks in the US, UK and EU have all now ended the phase of post financial crisis expansion of liquidity supporting world financial markets.

## US

- The massive easing of fiscal policy in 2018 fuelled a (temporary) boost in consumption in 2018 which generated an upturn in the strong rate of growth; this rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2 and 3.5% in quarter 3. The strong growth in employment numbers has fed through to an upturn in wage inflation which hit 3.1% in November, however, CPI inflation overall fell to 2.2% and looks to be on a falling trend to drop below the Fed's target of 2% during 2019.

- The Fed increased rates another 0.25% in December to between 2.25% and 2.50%, this being the fifth increase in 2018 and the ninth in this cycle. However, they did also reduce

**Appendix A Continued.**

their forecast for further increases from three to two. This latest increase compounded investor fears that the Fed is over doing the rate and level of increases in rates and that it is going to cause a US recession as a result.

- There is also much evidence in previous monetary policy cycles of the Fed's series of increases doing exactly that. Consequently, we have seen stock markets around the world plunging under the weight of fears around the Fed's actions, the trade war between the US and China, an expectation that world growth will slow, Brexit etc.

**<u>Asia</u>**

- In China, economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

- Japan has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

**Appendix B**
**Interest Rate Forecast Commentary; Extract from Treasury Advisors (Link Asset Services)**

Underlying assumptions to the interest rate forecast are:

After the August increase in Bank Rate to 0.75%, the first above 0.5% since the financial crash, the MPC has since then put any further action on hold, probably until such time as the fog of Brexit clears and there is some degree of certainty of what the UK will be heading into. It is particularly unlikely that the MPC would increase Bank Rate in February 2019 ahead of the deadline in March for Brexit, if no agreement on Brexit has been reached by then. The Interest Rate Forecast is based on a central assumption that there is an agreement on a reasonable form of Brexit. In that case, then we think that the MPC could return to increasing Bank Rate in May 2019 but then hold fire again until February 2020. However, this is obviously based on making huge assumptions which could be confounded. In the event of a 'disorderly Brexit', then cuts in Bank Rate could well be the next move.

The balance of risk to the UK is:

- The overall balance of risks to economic growth in the UK is probably neutral.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Brexit – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- Bank of England monetary policy takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of Eurozone sovereign debt crisis.
- Weak capitalisation of some European banks.
- Minority governments in Germany, Spain, Portugal, Netherlands, Ireland and Belgium.
- Further increases in interest rates in the US could spark a sudden flight of investment funds from more risky assets e.g. shares, into bonds yielding a much improved yield.
- There are concerns around the level of US corporate debt which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates are:

- Brexit – if both sides were to agree a compromise that removed all threats of economic and political disruption.
- The US Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed Funds Rate and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks

of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.

- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- UK inflation, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

**Appendix C**
**Treasury and Prudential Indicators**

| **Prudential Indicator** | **2018/19 Indicator** | **2018/19 Q3** |
|---|---|---|
| | | |
| Authorised limit for external debt<br>(Inc' loans raised to on-lend to Housing & Investment Company) | ----- £1,014.6m ----- | |
| Operational boundary for external debt<br>(Inc' loans raised to on-lend to Housing & Investment Company) | ----- £984.6m ----- | |
| Capital Financing Requirement (CFR) | £954.6m | £765.9m |
| Ratio of financing costs to net revenue streams | 8.1% | 7.6% |
| Incremental impact of capital investment decisions:- | | |
| a) Increase in council tax (band D) per annum. | £16.02p | £15.42p |
| Upper limit of fixed interest rates based on net debt | 150% | 109% |
| Upper limit of variable interest rates based on net debt | 65% | -9% |
| Principal sums invested > 364 days<br>(exc' third party loans) | £0m | £0m |
| Maturity structure of borrowing limits:- | | |
| Under 12 months | Max. 80%<br>Min. 0% | 30.9% |
| 12 months to 2 years | Max. 50%<br>Min. 0% | 10.3% |
| 2 years to 5 years | Max. 50%<br>Min. 0% | 14.7% |
| 5 years to 10 years | Max. 50%<br>Min. 0% | 10.7% |
| 10 years and above | Max. 100%<br>Min. 0% | 33.4% |
| | | |

- The Treasury Management Code of Practice guidance notes requires that maturity is determined by the earliest date on which the lender can trigger repayment, which in the case of LOBO loans is the next break/call point.