Agenda Item No:12

TREASURY MANAGEMENT REPORT - QUARTER ONE 2018-19

To:	**General Purpose Committee**
Meeting Date:	**20th September 2018**
From:	**Chief Finance Officer**
Electoral division(s):	**All**
Forward Plan ref:	**Not applicable** *Key decision:* **No**
Purpose:	**To provide the first 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.**

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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, Q1 saw:

- Bank of England kept base rate unchanged due to concerns whether weak economic growth in 2017 & Q1 2018 was indicative of the start of a prolonged slow down or just a temporary blip, to which bad weather had been a contributor;
- The economy showed signs of regaining momentum, employment growth rose strongly but wage growth softened, and consumer price inflation eased further;
- Progress on Brexit negotiations stalled;
- At its June meeting, the European Central Bank announced it would begin halving its monthly quantitative easing purchases and then end all purchases after December;
- The Federal Reserve continues its upswing in rates, with seven increases since the first one in December 2015, the latest one being in June 2018.

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											
	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate View	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
5yr PWLB Rate	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
10yr PWLB Rate	2.40%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	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 benefit of the August interest rate rise will be 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 Q1 2018-19 (excluding third party loans):

Table 2 – Investment maturity profile at end of Q1 2018-19

		Maturity Period				
		0d	0-3m	3-6m	Total	
Product	Access Type	£m	£m	£m	£m	%
Money Market Funds	Same-Day	44.4			**44.4**	**35.4**
Bank Call Account	Instant Access	5.0			**5.0**	**4.0**
Local Authorities	Fixed Term	0.0	21.0	0.0	**21.0**	**16.7**
Certificate of Deposits	Fixed Term / Tradeable	0.0	25.0	30.0	**55.0**	**43.9**
	Total	**49.4**	**46.0**	**30.0**	**125.4**	**100.0**
	%	**39.4**	**36.7**	**23.9**	**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 Q1:

- This Land Ltd - £36.846m – loans advanced to Council's wholly owned property companies.
- Arthur Rank Hospice Charity - £3.680m – loan to local charitable organisation to enable the build of a 24 bedded hospice; and
- UK Municipal Bonds Agency (MBA) – £0.4m – share equity investment to establish the agency to raise bond finance as an alternative to PWLB & markets.

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 front-loaded nature of various government funding streams and timing of capital expenditure, the average level of funds available for investment purposes during this quarter was £92.8m. 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 underperformed against the most comparable weighted duration benchmark by 4 basis points (£10k less than benchmark return), as significant cash provision has been kept liquid to service capital expenditure demands (primarily related to This Land). Any impact upon latest budget projections for the financial year are reported through the Budget Monitoring process.

Table 3: Benchmark Performance – Q1 2018-19

Benchmark	Benchmark Return	Council Performance
3m LIBID	0.55%	0.51%

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 can't 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 by £44.9m during Q1. At 31st March 2018 the Council held £497.9m of borrowing, of which £135.0m was undertaken for less than 1 year. The balance of outstanding borrowing at the end of Q1 was £542.8m, of which £100m was for less than 1 year. New longer term loans of £80.0m were raised during Q1 for capital purposes for period of between 1.5 and 3 years from other Local Authorities. PWLB principal repayments of £0.5m were made on schedule. A £80k PWLB loan principal repayment was made on schedule.

5.3 Table 4 below sets out the maturity profile of the Council's borrowing portfolio at the end of Q1. 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 – Q1 2018-19

Term Remaining	Borrowing	
	£m	%
Under 12 months	117.603	21.7
1-2 years	35.160	6.5
2-5 years	100.091	18.4
5-10 years	68.761	12.7
10-20 years	68.990	12.7
20-30 years	46.675	8.6
30-40 years	20.000	3.7
40-50 years	35.000	6.4
Over 50 years	50.500	9.3
TOTAL	**542.780**	**100.0**

5.4 The presentation of the figures above differs from that in the Treasury Indicator for maturity structure of borrowing in Appendix C as the table below includes LOBO loans at their final maturity rather than their next call date. In the current low interest rate environment the likelihood of lenders exercising their option to increase the interest rates on these loans, 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. To date, the MBA has not issued any bonds.

6. BORROWING RESTRUCTURING

6.1 No borrowing rescheduling was undertaken during the Q1. 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. COMPLIANCE WITH 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. TECHNICAL BREACH OF COUNTERPARTY EXPOSURE LIMIT

8.1 The Council, through approving its TMSS, sets limits to manage financial exposure to its treasury counterparties. During Q1 2018-19, a technical breach of the Council's strategy occurred with the details below:

Counterparty involved: Barclays Bank (the Council's bankers)
Number of occasions counterparty exposure limit breached: 1
Total number of days in breach of limit: 23 days (23rd April 2018 to 15th May 2018)
Maximum exposure amount during period: £63.8m
Counterparty limit: £20.0m

Reason for breach: The breach occurred because of the way in which the counterparty policy was interpreted at that time, with it only being considered that amounts deposited in investment products with counterparties constituted an exposure against counterparty limits. The technical breach occurred when excess cash balances were allowed to remain in the Council's main bank current account over the period in question in addition to amounts already placed on deposit up to the limit (provision exists to allow for unexpected receipts after dealing activity has taken place where redressed at the next available opportunity). The risk of default with Barclays Bank is considered very low and at no point in time were the Council's funds under immediate threat. Procedures have been strengthened to prevent reoccurrences and no technical breaches have occurred since.

9. ALIGNMENT WITH CORPORATE PRIORITIES

9.1 Developing the local economy for the benefit of all

There are no significant implications for this priority.

9.2 Helping people live healthy and independent lives

There are no significant implications for this priority.

9.3 Supporting and protecting vulnerable people

There are no significant implications for this priority.

10. SIGNIFICANT IMPLICATIONS

10.1 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.

10.2 Procurement/Contractual/Council Contract Procedure Rules Implications

There are no significant implications for this category.

10.3 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**.

10.4 Equality and Diversity Implications

There are no significant implications for this category.

10.5 Engagement and Communications Implications

There are no significant implications for this category.

10.6 Localism and Local Member Involvement

There are no significant implications for this category.

10.7 Public Health Implications

There are no significant implications for this category.

Implications	**Officer Clearance**
Have the resource implications been cleared by Finance?	Yes 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

- UK Growth in 2017 was disappointingly weak in the first half of the year but picked up to 0.5% in quarter 3 and 0.4% in quarter 4. Growth in quarter 1 of 2018 was again disappointing, although on the first revision the rate improved from 0.1 to 0.2% to allay fears that the economy may have started a prolonged period of very weak growth. Initial indications in quarter 2 are that growth may have picked up speed to around 0.4%. The main reason for weak growth during 2017 and 2018 has been that inflation has been exceeding pay growth until recently, meaning that there has been negative growth in consumer disposable income when consumer expenditure is the biggest driver of the services sector which accounts for about 75% of GDP.

- The manufacturing sector was the bright spot in the economy in 2017 in terms of strong growth but quarter 1 was the weakest quarter for one and a half years and forward indicators do not suggest a return to strong growth is likely.

- During January and February financial markets were viewing a Bank Rate increase at the May Monetary Policy Committee (MPC) meeting as likely to be a near certainty after strong growth in the second half of 2017. However, the ensuing weeks before the meeting saw opinion turn right around and the MPC did not disappoint by leaving rates unchanged due to concerns as to whether the weak growth in quarter 1 was indicative of the start of a prolonged slow down or just a temporary blip, to which bad weather had been just one contributor. As it transpired the rate rise was agreed in August.

- However, there remains much uncertainty around the Brexit negotiations, consumer spending levels and business investment, so it is still far too early to be confident about how strong growth and inflationary pressures will be over the next two years, and therefore the pace of any rate increases.

EU

- A recovery to strong growth in 2016 and 2017 looks as if it will weaken somewhat going forward. Despite providing massive monetary stimulus, the ECB has been struggling to get inflation up to its 2% target. However, in April the headline Eurozone rate jumped up from 1.4% to 1.9% although the core inflation rate was still subdued in rising from 0.7% to 1.1%. At its June meeting, the ECB announced it would halve its monthly quantitative easing purchases from €30bn to €15bn, and then end all purchases after December. It is unlikely to make a start on increasing interest rates until late in 2019.

US

- Growth in the American economy was volatile in 2015, 2016 and 2017 during each year, with quarter 1 being particularly weak. The annual rate of GDP growth for 2017 was 2.3%. Quarter 1 in 2018 came in at 2.0%, down from 2.9% in the previous quarter. The $1.5 trillion income tax cut package coming into effect in January 2018, is likely to boost growth to the administration's 3% target. However, it is also likely to boost inflation at a time when spare capacity in the economy is minimal and unemployment, in particular, has fallen to the lowest level for 17 years, reaching 3.8% in May. The Fed has started on an upswing in rates with seven increases since the first one in December 2015, the latest one being in June 2018 to lift the central rate to 1.75 – 2.00%. There could be a further two or more increases in 2018.

<u>Asia</u>

- Chinese economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus and medium term risks are increasing.
- In Japan, the best economic run (of positive growth for eight quarters) since the 1980's came to an end in quarter 1 with a contraction of -0.6%, blamed on weak exports.

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

Underlying assumptions to the interest rate forecast are:

The interest rate forecast has been revised to reflect the first increase in Bank Rate in August (advanced from November). Link Asset Services (Link) do not think that the MPC will increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. Link also feel that the MPC is more likely to wait until August 2019, than May 2019, before the next increase, to be followed by the next increases in May and November 2020 to reach 1.5%. There is, therefore, no change in Bank Rate forecasts apart from the inclusion of the recent rate increase.

- Financial markets are now expecting the next increase in Bank Rate to be in February 2019 and then only one more in February 2020, therefore ending March 2021 at only 1.25%. The MPC commented that the markets were too cautious with their view of the pace of increases.

- However, the forecasts by the MPC and ourselves are predicated on an assumption that sufficient progress is made, in respect of negotiations, to produce a reasonable agreement for Brexit that benefits both the EU and the UK in a sensible manner. If no agreement is reached at all, then forecasts for increases in Bank rate and PWLB rates will be subject to greater change.

- Forecasts for average investment earnings beyond the three year time horizon will be heavily dependent on economic and political developments.

- As for forecasts of PWLB rates, there is little change apart from some minor advances of the pace of increase. The general situation is for volatility in bond yields to endure as investor fears and confidence ebb and flow between favouring relatively more “risky” assets i.e. equities, or the “safe haven” of government bonds. The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently, although there are likely to also be periods of sharp volatility from time to time.

- Link have pointed out consistently that the Federal Rate is likely to go up more quickly and more strongly than Bank Rate in the UK. While there is normally a high degree of correlation between the bond yields of both countries, Link would expect to see an eventual growing decoupling of yields between the two i.e. expect US yields to go up faster than UK yields. Over the period since the start of 2017, there has been a strong correlation between increases in treasury, gilt and bund yields for periods longer than 5 years, although the rate of increase in the UK and Germany has been somewhat lower than in the US. This area will be monitored for any resulting effect on PWLB rates.

Appendix C
Treasury and Prudential Indicators

Prudential Indicator	**2018/19 Indicator**	**2018/19 Q1**
Authorised limit for external debt (Inc' loans raised to on-lend to Housing & Investment Company)	----- £1,014.6m -----	
Operational boundary for external debt (Inc' loans raised to on-lend to Housing & Investment Company)	----- £984.6m -----	
Capital Financing Requirement (CFR)	£954.6m	£954.6m
Ratio of financing costs to net revenue streams	8.1%	8.1%
Incremental impact of capital investment decisions:-		
a) Increase in council tax (band D) per annum.	£16.02p	£16.02p
Upper limit of fixed interest rates based on net debt	150%	108%
Upper limit of variable interest rates based on net debt	65%	-8%
Principal sums invested > 364 days (exc' third party loans)	£0m	£0m
Maturity structure of borrowing limits:-		
Under 12 months	Max. 80% Min. 0%	24.5%
12 months to 2 years	Max. 50% Min. 0%	6.5%
2 years to 5 years	Max. 50% Min. 0%	18.4%
5 years to 10 years	Max. 50% Min. 0%	12.7%
10 years and above	Max. 100% Min. 0%	37.9%

- 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.