Agenda Item No:9

TREASURY MANAGEMENT REPORT – QUARTER TWO AND MID-YEAR UPDATE 2018-19

To:	**General Purpose Committee**		
Meeting Date:	**27th November 2018**		
From:	**Chief Finance Officer**		
Electoral division(s):	**All**		
Forward Plan ref:	**Not applicable**	*Key decision:*	**No**
Purpose:	**To provide the second quarterly and mid-year update on the Treasury Management Strategy 2018-19, approved by Council in February 2018.**		
Recommendation:	**The General Purposes Committee is recommended to:**		

a) Note the Treasury Management Report.

b) Approve the addition of LNAV money market funds to the list of approved investments.

c) Forward to Full Council for approval.

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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, Q2 saw:

- The UK economy gathered some momentum; a tight labour market put upward pressure on wage growth and consumer price inflation rose unexpectedly;
- The Bank of England increased interest rates from 0.50% to 0.75%; however, they emphasised again that future increases would be gradual and would rise at a slow pace.
- Brexit negotiations remained at an impasse; UK equities market underperformed given the uncertainty.

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 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 Q2 2018-19 (excluding third party loans):

Table 2 – Investment maturity profile at end of Q2 2018-19

		Maturity Period			
		0d	**0-3m**	**Total**	
Product	**Access Type**	**£m**	**£m**	**£m**	**%**
Money Market Funds	Same-Day	14.5		**14.5**	**29.3**
Bank Call Account	Instant Access	5.0		**5.0**	**10.1**
Certificate of Deposits	Fixed Term / Tradeable	0.0	30.0	**30.0**	**60.6**
	Total	**19.5**	**30.0**	**49.5**	**100.0**
	%	**39.4**	**60.6**	**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 Q2:

- 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 quarter two was £76.3m. 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 10 basis points (equivalent to £19k more than benchmark return). Any impact on latest budget projections for the financial year are reported through the Budget Monitoring process.

Table 3: Benchmark Performance – Q2 2018-19

Benchmark	Benchmark Return	Council Performance
1m LIBID	0.47%	0.57%

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 by £20.0m during Q2. At Q1, the Council held £542.8m of borrowing, of which £100.0m matured in less than 1 year. At the end of Q2, the Council held £562.8m of borrowing, of which £137.5m matures in less than 1 year. The additional borrowing was taken short-term for durations up to one year from other Local Authorities.

5.3 Table 4 below sets out the maturity profile of the Council's borrowing portfolio at the end of Q2. The majority of loans are Public Works Loan Board (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	137.603	24.4
1-2 years	35.160	6.2
2-5 years	106.286	18.9
5-10 years	62.566	11.1
10-20 years	68.990	12.3
20-30 years	46.675	8.3
30-40 years	20.000	3.6
40-50 years	35.000	6.2
Over 50 years	50.500	9.0
TOTAL	**562.780**	**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. To date, the MBA has not issued any bonds.

6. BORROWING RESTRUCTURING

6.1 No borrowing rescheduling was undertaken during the Q2. 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. REGULATORY UPDATE

IFRS9 Accounting Standard

8.1 IFRS9 accounting standard came into effect from 1st April 2018. Under previous accounting standards, annual year-end book value movements in the market value of investments were held unrealised on the Balance Sheet. This approach recognised that there is a high likelihood that gains or losses will be reversed in time and so would only become a real cost or benefit to the authority at the point of redemption. However under IFRS9, any annual gains or losses would be charged directly to the General Fund. This change would have a minor impact on commonly used short-term treasury management investments. For longer term strategic investments like pooled property funds, third party loans and commercial investments, the impact could be significant on budget setting and Council Tax.

8.2 In September 2018, The Ministry of Housing, Communities and Local Government (MHCLG) consulted on a temporary statutory override to allow English local authorities to continue to mitigate the impact of valuation gains or losses. This temporary measure was intended to allow authorities time to adjust their portfolio of investments before full implementation of IFRS9 standard.

8.3 The LGSS Treasury team responded to the consultation to voice concern that this accounting standard may force local authorities to increase council tax or cut local public services based on a snapshot of financial markets at a point in time measurement each year. The circumstances meaning a temporary statutory override is appropriate now will still apply in April 2021 and beyond. A permanent override, as for longer term strategic pension fund investments, was put forward as a recommended solution.

8.4 In November 2018, MHCLG published the Government's response to the consultation. In summary the Government intends to:

- Require local authorities <u>to account for fair value movements in financial instruments</u> in accordance with proper practices as set out in the Code on Local Authority Accounting published by CIPFA.

- Introduce a mandatory statutory override requiring local authorities to reverse out all unrealised fair value movements resulting from pooled investment funds. This will be effective from financial year commencing 1 April 2018.
- Extend the proposed period for which the statutory override applies to five years. The Government will keep use of the override under review.
- Require Local Authorities to disclose the net impact of the unrealised fair value movements in a separate unusable reserve throughout the duration of the override.

8.5 Government did not see a case for issuing an initial statutory override without a time limit, which would have resulting in a permanent deviation from normal accounting practices. Any statutory override introduced would mean that local authority accounts will differ from accounts prepared by other entities, reducing transparency and comparability.

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)

<u>UK</u>

- The first half of 2018/19 has seen UK economic growth post a modest performance, but sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase Bank Rate on 2nd August from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, the Bank of England's August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019, albeit there were several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

- Some MPC members have expressed concerns about a build-up of inflationary pressures, particularly with the pound falling in value again against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation rose unexpectedly from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019.

- As for the labour market, unemployment has continued at a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high in July, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 2.9%, (3 month average regular pay, excluding bonuses) and to a one month figure in July of 3.1%. This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 0.4%, and near to the joint high of 0.5% since 2009 (The previous high point was in July 2015). 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. This tends to confirm that the MPC were right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy. However, the MPC will need to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit.

<u>EU</u>

- Growth was unchanged at 0.4% in quarter 2, but has undershot early forecasts for a stronger economic performance in 2018. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of 2% for 2018, the horizon is less clear than it seemed just a short while ago.

Appendix A continued.

US

- The US easing of fiscal policy is fuelling a (temporary) boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2, but also an upturn in inflationary pressures. With inflation moving towards 3%, the Fed increased rates another 0.25% in September to between 2.00% and 2.25%, this being four increases in 2018, and indicated they expected to increase rates four more times by the end of 2019. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019.

Asia

- 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:

The flow of generally positive economic statistics after the end of the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, to 0.75%. However, the MPC emphasised again, that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary of contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years' time but they declined to give a medium term forecast. We do not think that the MPC will increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. We also feel that the MPC is more likely to wait until August 2019, than May 2019, before the next increase, to be followed by further increases of 0.25% in May and November 2020 to reach 1.5%. However, the cautious pace of even these limited increases is dependent on a reasonably orderly Brexit.

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:

- Bank of England monetary policy takes action too quickly 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 the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March of a government which has made a lot of anti-austerity noise. This is likely to lead to friction with the EU when setting the target for the fiscal deficit in the national budget. Unsurprisingly, investors have taken a dim view of this and so Italian bond yields have been rising.
- The imposition of trade tariffs in the US could negatively impact world growth. Specific actions against Turkey pose a particular risk to its economy which could, in turn, negatively impact Spanish and French banks which have significant exposures to loans to Turkey.
- Weak capitalisation of some European banks.
- Rising interest rates in the US could negatively impact emerging countries which have borrowed heavily in dollar denominated debt, so causing an investor flight to safe havens e.g. UK gilts.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

Appendix B continued.

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

- US fiscal plans to stimulate economic expansion causing a significant increase in inflation in the US and causing further sell offs of government bonds in major western countries.
- The 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 Q2**
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	£894.6
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%	101%
Upper limit of variable interest rates based on net debt	65%	-1%
Principal sums invested > 364 days (exc' third party loans)	£0m	£0m
Maturity structure of borrowing limits:-		
Under 12 months	Max. 80% Min. 0%	27.2%
12 months to 2 years	Max. 50% Min. 0%	6.2%
2 years to 5 years	Max. 50% Min. 0%	18.9%
5 years to 10 years	Max. 50% Min. 0%	11.1%
10 years and above	Max. 100% Min. 0%	36.6%

- 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.