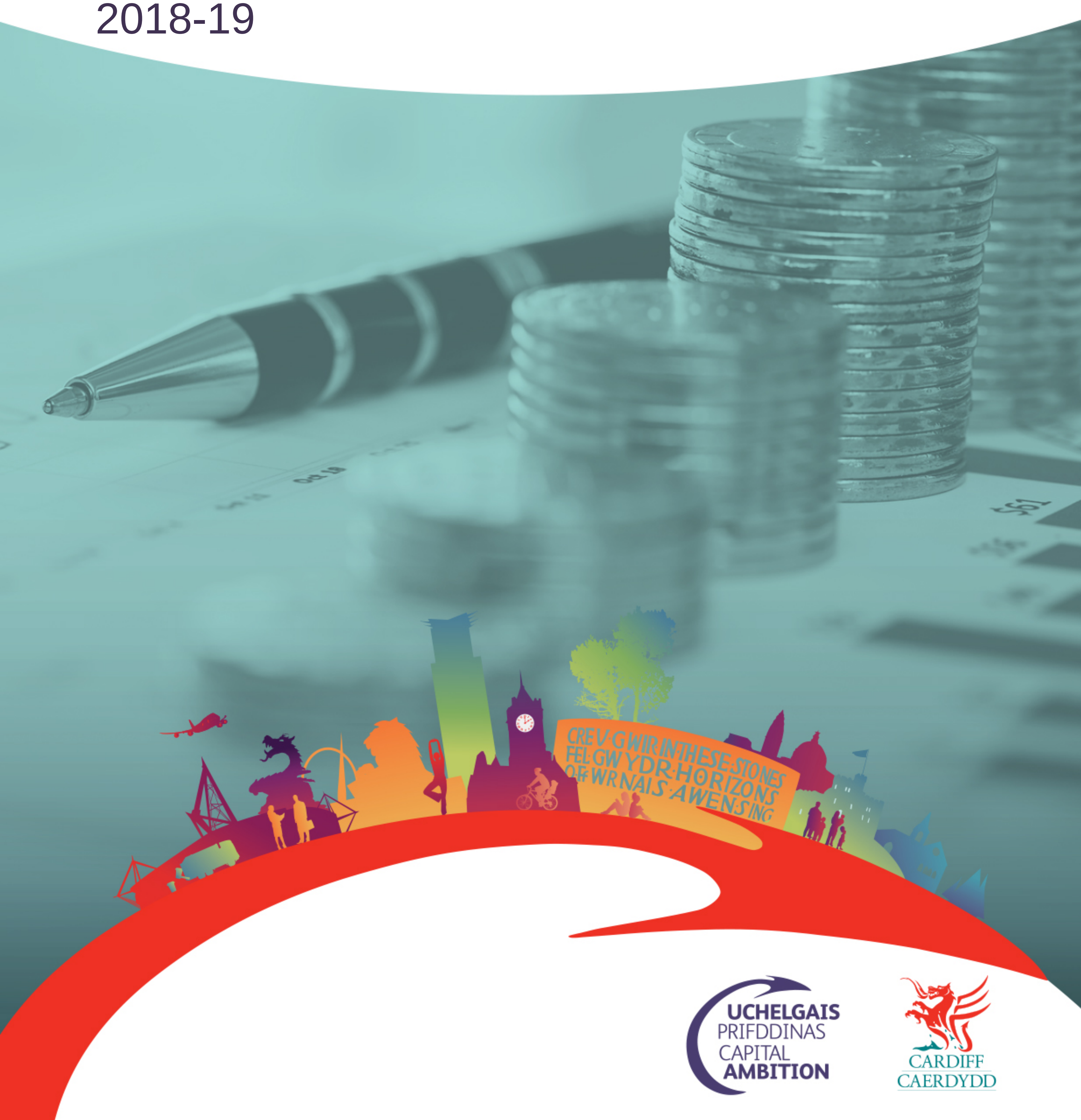
Appendix 1

Treasury Management Mid-Year Report

2018-19



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Introduction

1.1 Treasury management activities are the management of an organisation's borrowing, investments and 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 carries out its treasury management activities in accordance with a Treasury Management Code of Practice for public services, updated by CIPFA in 2017. This requires the Council to set out the policies and objectives of its treasury management activities and adopt four Clauses of Treasury Management (replicated in **Annexe A**). Changes recommended by the Code will be considered as part of the Treasury Strategy for 2019/20 and the requirements are considered later in this report.

1.3 Council received a report in February 2018 on the Council's Treasury Management Strategy for 2018/19. During 2018/19, Audit Committee has received periodic updates on the position and performance of Treasury Management and the issues included in the report below. In addition Council received in September 2018 the Annual Report on the Outturn for Treasury Management for 2017/18.

1.4 In accordance with Council policy, this report provides members with a mid-year update as at 30 September 2018 and covers:-

- the economic background to treasury activities
- investments
- borrowing
- debt rescheduling
- compliance with treasury limits and prudential indicators
- Treasury strategy, accounting and Treasury Management Code update for remainder of year.

1.5 Annexe E includes a glossary which defines key terms used in this report.

Economic Background

2.1 Whilst UK growth in the first half of the year has been modest, this coupled with concern about the build up of inflationary pressures as a result of reduction in the value of sterling was sufficient for the Bank of England to raise the bank base rate to 0.75% in August 2018. Whilst financial markets are assuming the next increase in 2019 there are a number of local and international factors that will influence the approach and timing. These include:-

- risks to wage and price inflation in the UK, with indications that employers are finding difficulties in filling job vacancies with suitable staff

- strong economic growth, reversal of the stimulus measures of quantitative easing previously introduced and increasing interest rates in the United States of America
- international trade risks impacting on growth and levels of debt
- uncertainty around the terms and implications of the UK's exit from the European Union.

2.2 With this in mind, the table below shows the Council's treasury management advisors August forecast for bank rate and Public Works Loan Board (PWLB) borrowing rates. Until more definitive data highlighting an increase is available, the forecast continues to show an increase in the second quarter of 2019, with a further review of the forecast to be undertaken in November.

	30/09/2018	March 2019	March 2020	March 2021
Bank Rate	0.75%	0.75%	1.00%	1.50%
5yr PWLB rate	1.93%	2.10%	2.30%	2.60%
10yr PWLB rate	2.33%	2.50%	2.80%	3.10%
25yr PWLB rate	2.74%	3.00%	3.30%	3.50%
50yr PWLB rate	2.56%	2.80%	3.10%	3.30%

2.3 PWLB rates are based on gilt yields and are thus subject to volatility caused by the uncertainties highlighted above along with geopolitical events. It can be seen from the table that the cost of borrowing remains significantly in excess of the rates that are available from investments. Borrowing rates have reduced in recent years as part of a bond buying programme by the Bank of England (Quantitative Easing). However central banks also need to consider the timing and strength of reversing the quantitative easing which was undertaken to inject liquidity into economies after 2008. There are concerns that economic growth has been too reliant on this stimulus resulting in a search for returns on riskier financial assets. Accordingly, whilst there are short term influences on rates, the overall long term forecast is for PWLB rates to rise. Increases in borrowing rates will impact on the costs of new borrowing to be undertaken. There will be no impact on existing borrowing as this is at fixed rates of interest.

Investment

3.1 The management of the Council's cash flows may involve temporary lending of surplus funds to low risk counterparties or temporary borrowing pending receipt of income.

3.2 The Council's investment priorities remain the security and then liquidity of its Treasury investments. The Council also aims to achieve the optimum return appropriate to these priorities.

3.3 The Council invests with financial institutions in accordance with criteria approved in its Treasury Strategy. The categories, names, periods and size limits on this list can be extended, varied or restricted at any time by the Corporate Director Resources under delegated powers. Based primarily on Fitch credit criteria and a number of other factors which the Council takes into account, lending to these institutions is subject to time and size limits and credit worthiness continues to be carefully monitored. There have been no changes made to the list of eligible counterparties included as part of the 2018/19 Treasury Management Strategy approved by Council.

3.4 Following the introduction of The Markets in Financial Instruments Directive (MiFID) in January 2018, the Council has opted to be classified as a professional client rather than a retail client by financial institutions.

The Government's Funding for Lending Scheme has had the impact of reducing returns on investments. Returns are likely to remain low during 2018 and gently rise over the next few years. The approach of deferring external borrowing by using temporary cash balances has served well over the last few years. However, caution should be adopted to avoid incurring higher borrowing costs in the future when new borrowing is unavoidable.

3.5 At the 30 September 2018, investments stood at £65.2 million. These temporary funds fluctuate daily and arise for a number of reasons, including the timing differences between the receipt of grant and other income and the utilisation of these funds on salaries and other operating costs. It includes the level of reserves, provisions, and other balances. It is also affected by the timing of borrowing and capital expenditure transactions. **Annexe B** shows with whom these investments were held as at 30 September 2018. All investments are deemed recoverable.

3.6 A selection of performance indicators and benchmarking charts, is included in **Annexe C** as follows:-

- **Counterparty exposure** displays actual investment against the maximum permitted directly with an organisation. This demonstrates that we are not exceeding any exposure limits.
- **Remaining maturity profile of investments**. This shows the duration of investments is spread and that the Council is taking advantage of slightly higher rates for longer term investment where reasonable to do so.
- **Investments by institution.** This expresses the investments held with different institutions as a percentage of the total and shows diversification is sought where possible.
- **Geographic spread of investments** as determined by the country of origin of relevant organisations. All countries are rated AA and above as per our approved criteria and are licensed to take UK deposits. Investments are in Sterling only.
- **Investments by Financial Sector.** The majority of investments continue to be with banks.

3.7 Whilst a difficult figure to forecast due to the uncertainty of the markets, cash flows and the number of variables that impact on the figure, the forecast level of interest receivable from treasury investments for 2018/19 is £485,000. The return achieved since the start of the year is 0.68% compared to the benchmark 7 day London Interbank Bid Rate (LIBID) of 0.44% and 3 month LIBID 0.61%

Borrowing

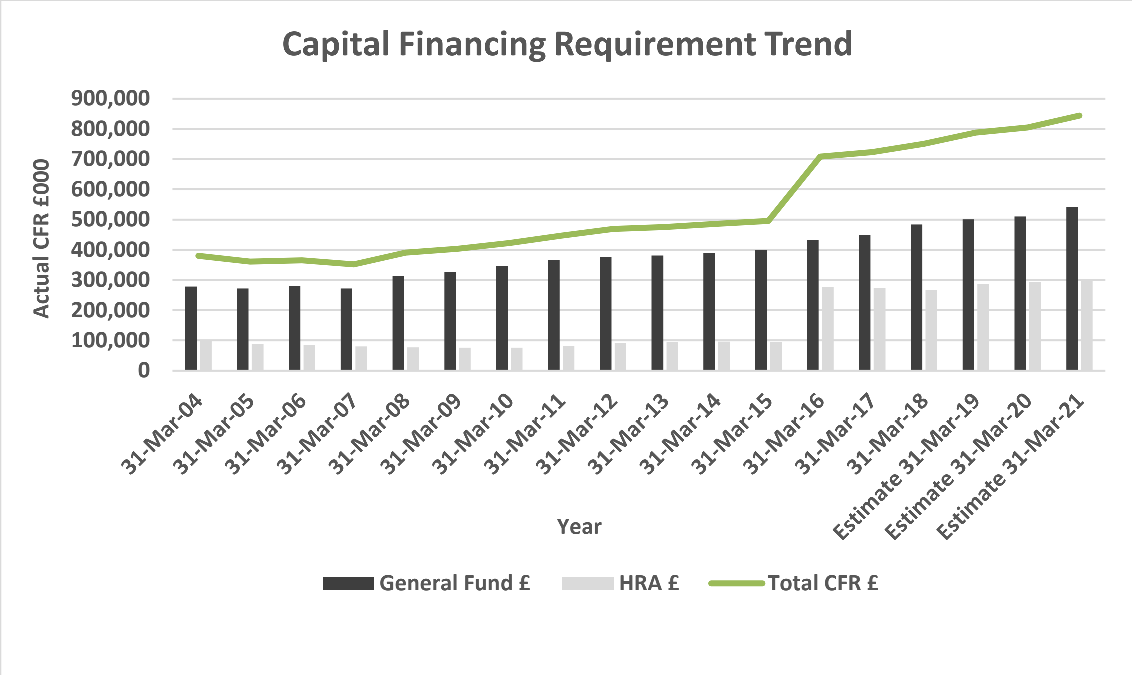
4.1 Long term borrowing is undertaken to finance the Council's Capital Programme and the main sources of borrowing currently are the PWLB and the Money Markets. The Council does not separate General Fund and Housing Revenue Account borrowing as all borrowing is the liability of the Council i.e borrowing is 'pooled'.

4.2 Where capital expenditure has been incurred without a resource to pay for it immediately e.g. via capital receipts, grants or other contributions, this will increase what is termed the Council's Capital Financing Requirement (CFR) or its need to undertake borrowing. The Council is required to make an annual prudent provision for the repayment of historic capital expenditure from its revenue budget and set this at a level that considers previous and future borrowing commitments as well as the period over which the benefits of capital expenditure are expected. This reduces the CFR. Calculation of the CFR is summarised in the following table and results in the need to borrow money.

	Opening Capital Financing Requirement (CFR)
+	Capital expenditure incurred in year
-	Grants, contributions, reserves and receipts used for capital expenditure
-	Prudent Minimum Revenue Provision & Voluntary Repayment
=	*Closing Capital Financing Requirement (CFR)*

4.3 The CFR forecast is subject to the timing of capital expenditure, capital receipts and new schemes that may be considered for approval in future years. It can be seen that the Council's underlying need to borrow is increasing and will need to be repaid from future revenue budgets either from savings, revenue income or Council Tax and Housing Rents.

4.4 The historic trend in the CFR is shown with the increase in 2015/16 reflecting the Housing Revenue Account subsidy buyout as reported previously.



4.5 At 30 September 2018, the Council had £689.6 million of external borrowing predominantly made up of fixed interest rate borrowing from the PWLB payable on maturity.

31-Mar-18			30-Sep-18	
£m	**Rate (%)**		**£m**	**Rate (%)**
631.8		Public Works Loan Board	628.5	
51.0		Market (Lender Option Borrower Option)	51.0	
4.6		Welsh Government	4.6	
5.9		Other	5.5	
693.3	**4.64**	**Total External Debt**	**689.6**	**4.63**

New borrowing undertaken during the year to date

4.6 Interest free loans of £0.11 million from Salix have been received for project specific energy schemes.

Maturing Loans in year to date

4.7 **Annexe D** shows the maturity profile of the Council's borrowing as at 30 September 2018. Loans of £3.7 million have been repaid in the first half of this year, a further £0.81 million is due to be repaid by 31 March 2019. Unless the Council's Lender Option Borrower Option loans (LOBO's) are required to be repaid early, very little debt matures within the next 10 years.

4.8 (LOBO) products are loans to the Council where the lender can request a change in the rate of interest payable by the Council on pre-determined dates. The Council at this point has the option to repay the loan.

4.9 The Council has 6 such loans totalling £51 million. Apart from the option to increase rates, these loans are comparable to PWLB and have no other complications such as variation in interest rates or complex terms.

4.10 Interest rates on these loans range between 3.81% and 4.35% which are not unreasonable and are below the Council's average rate of interest payable. Details of the loans are shown in the table below.

£m	**Potential Repayment Date**	**Option Frequency**	**Full Term Maturity**
6	21/11/2018	6 months	21/11/2041
6	21/11/2018	6 months	21/11/2041
6	21/11/2018	6 months	23/05/2067
6	01/03/2019	6 months	23/05/2067
22	23/11/2020	5 years	23/11/2065
5	16/01/2023	5 years	17/01/2078

4.11 LOBO's to the value of £24 million are subject to the lender potentially requesting a change in the rate of interest payable every six months, which could trigger early repayment. This is deemed unlikely and any risk is a manageable refinancing risk as LOBOs in total, form a relatively low proportion of the Council's overall borrowing at 7.4%.

Borrowing Strategy

4.12 The borrowing strategy outlined in the February 2018 budget report indicated that:-

> *Whilst investment rates remain lower than long term borrowing rates internal borrowing will be used to minimise short-term costs where possible*
>
> *In order to mitigate against the risk of borrowing rates rising faster than currently anticipated, external borrowing (short medium and long term) for an element of the Council's borrowing requirement will be taken as has been done in previous years. This will aim to keep internal borrowing to approximately 10% or less of the forecast Capital Financing Requirement for 2018/19.*
>
> *Any external borrowing will consider the balance between fixed rates and variable rates to meet the long term borrowing policy aims identified in this report previously. Fixed rates would be taken if the borrowing need is high and rates are likely to increase, and conversely variable rates, if any borrowing need is temporary and rates are likely to fall.*

4.13 As shown in the interest rate forecasts set out in paragraph 2.2, long term borrowing rates are higher than investment rates which means that the cost of undertaking new borrowing would have a negative impact on the revenue budget. External borrowing may be deferred in order to minimise short term costs by using temporary cash balances to pay for capital expenditure rather than placing in an investment. This is termed 'internal borrowing'. However deferring borrowing is only a short term measure and could expose the Council to higher borrowing rates and costs in the future. The Council has taken an approach of undertaking external borrowing for an element of any borrowing requirement to mitigate any such risk.

4.14 If no further PWLB or Market borrowing is undertaken, the value of external loans at 31 March 2019 will be £689 million. At the same point, the Council's need to borrow for capital expenditure purposes, its Capital Financing Requirement (CFR), is currently forecast to be circa £785 million (General Fund £500 million and HRA £285 million). Without any further borrowing this financial year internal borrowing would be £96 million. In order to ensure this is manageable, it is currently anticipated that borrowing of circa £20 million will be undertaken during the second half of 2018/19.

4.15 The estimated total interest payable on borrowing for 2018/19 is £32.2 million which includes interest payable by the Housing Revenue Account.

Debt Rescheduling

5.1 No debt rescheduling or early repayment of debt has been undertaken to date in 2018/19. The main obstacle remains the level of premium (penalty) that would be chargeable on early repayment by the PWLB. Of the existing PWLB loans of £628 million, £419 million are eligible for early repayment. However this would incur a premium of £311 million as at 30 September 2018. This premium is payable primarily because:-

- Interest rates on loans of equivalent maturities compared to those held are currently lower
- A penalty rate or lower early repayment rate was introduced by HM Treasury in November 2007, which increased the cost of premiums and reduced the flexibility of Local Authorities to make savings. This remains an obstacle in the ability of local authorities to manage debt more effectively.

5.2 Whilst the cost of Premiums can be spread over future years, options for restructuring that have been considered result in an adverse Net Present Value (NPV). Whilst there may have been short terms savings, these were outweighed by potentially longer term costs and not deemed cost effective.

Compliance with treasury limits and prudential indicators

6.1 During the financial year to date, the Council has operated within the treasury limits and prudential indicators set out in the annual Treasury Management Strategy in February 2018. The treasury and capital prudential indicators will be updated as part of the 2019/20 capital and treasury strategies in the Budget Report to Council in February 2019.

6.2 Following Housing Finance Reform the Council complies with an indebtedness cap in the Housing Revenue Account of £316.5 million. This and the affordability of additional investment will need to be monitored closely as part of the Treasury Strategy and HRA Business Planning process. Following the recent announcement about abolition of the Cap in England, the Welsh Government are waiting further details from HM Treasury to understand how this affects Local Housing Authorities in Wales and the timescales.

Treasury strategy, accounting and Treasury Management Code update for the remainder of 2018/19

7.1 The Treasury Strategy approved in February 2018 remains valid. The use of temporary cash balances instead of borrowing to pay for capital expenditure continues to result in short term savings. However, given uncertainty in interest rates, the Council will take an element of its external borrowing requirement over the second half of the year.

7.2 CIPFA have made changes to the Treasury Management Code in 2017. The main change relates to clarifying that the definition of 'Investments' includes both:

- Treasury Management investments (as historically included in this Strategy, as well as
- Investments made for policy reasons and managed outside of normal treasury management activity.

7.3 The changes are primarily in response to increasing commercialisation activities undertaken by a number of Local authorities. Examples of investments made for policy reasons and managed outside of normal treasury management activity include:-

- 'service investments' held in the course of provision and for the purposes of operational services
- 'commercial investments' which are taken mainly for financial reasons. These may be shares and loans in business structures e.g. subsidiaries; investments explicitly taken with the aim of making a financial surplus for the Council; non financial assets such as investment properties held primarily for financial benefit.

7.4 The Code requires that these investments should be proportional to the level of resources available to the organisation and the organisation should ensure that robust procedures for the consideration of risk and return are applied to these decisions. The Code requires that all investments have an appropriate investment management and risk management framework. This includes making it explicit in any decision making:-

- the powers under which investment is made
- the governance process including arrangements in place to ensure appropriate due diligence to support decision making
- the extent to which capital invested is placed at risk
- the impact of potential losses on financial sustainability
- the methodology and criteria for assessing performance and monitoring process
- how knowledge and skills in managing such investments is arranged and that these are monitored, reported and highlighted explicitly in the decision making process and due diligence.

7.5 It is also prudent that treasury management is carried out in accordance with good professional practice. These changes in the Code will be implemented as part of development of the Treasury Management Strategy, Investment Property Strategy and Treasury Management Practices for 2019/20. The Council will be requested to adopt the revised CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes 2017.

7.6 In parallel with the above changes, The Council will need to consider the impact of revised accounting standards, introduced primarily to address complex financial instruments and their valuation and presentation in financial accounts of organisation. The investments currently held by the Council are not deemed complex. Accordingly the changes are not expected to have a material impact on the Council’s Statement of Accounts or financial position for 2018/19.

Annexes

Annexe A – Treasury Management Policy and Four Clauses of Treasury Management
Annexe B – Investments at 30 September 2018
Annexe C – Investment Charts at 30 September 2018
Annexe D – Maturity Analysis of Borrowing as at 30 September 2018
Annexe E – Glossary of Treasury Management terms