

Annexes A & B are not for publication as they contain exempt information of the description in Paragraphs 14 and 21 of Schedule 12A of the Local Government Act 1972.

Appendix 1

Treasury Management Mid-Year Report 2017-18

› Cardiff Council



Introduction

- 1.1 Treasury management activities are the management of an organisation's 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 code developed for public services in 2011 by the Chartered Institute of Public Finance and Accountancy (CIPFA) as well as Council approved policies and clauses adopted by Council in February 2010.
- 1.3 In accordance with these policies, this report provides members with a mid-year update of Treasury Management activities as at 30 September 2017 and covers:-
 - the economic background to treasury activities
 - investments
 - borrowing
 - debt rescheduling
 - compliance with treasury limits and prudential indicators
 - strategy update for remainder of year.
- 1.4 Annexe D includes a glossary which defines key terms used in this report. During 2017/18, 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 2017 the Annual Report on the Outturn for Treasury Management for 2016/17.

Economic Background

- 2.1 Economic growth in the UK economy has been weak over the last two quarters, primarily as a result of increases in inflation. The devaluation of sterling following the referendum is feeding into the cost of imports into the UK, which then has an adverse impact on consumer spending power resulting in reduced expenditure.
- 2.2 Despite weak growth, the Bank of England Monetary Policy Committee meeting of September 2017 surprised financial markets by adopting a more aggressive tone and warning that Bank Rate will need to rise. This was primarily after consideration of higher inflation forecasts, low unemployment and weak productivity.
- 2.3 Market expectations immediately changed towards a bank rate increase in the early part of 2018 or sooner, reversing the emergency bank rate cut of 0.25% introduced in August 2016. However there still remains

much uncertainty such as growth forecasts, UK negotiations with the EU, and consumer confidence.

- 2.4 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, their forecast continues to show an increase in the second quarter of 2019, with a further review of the forecast to be undertaken in November.

| | Sep-17 | Mar-18 | Mar-19 | Mar-20 |
|----------------|--------|--------|--------|--------|
| Bank Rate | 0.25% | 0.25% | 0.25% | 0.75% |
| 5yr PWLB rate | 1.59% | 1.60% | 1.80% | 2.00% |
| 10yr PWLB rate | 2.18% | 2.30% | 2.50% | 2.70% |
| 25yr PWLB rate | 2.79% | 2.90% | 3.10% | 3.30% |
| 50yr PWLB rate | 2.52% | 2.70% | 2.90% | 3.10% |

- 2.5 It can be seen from the table that the cost of borrowing is significantly in excess of the rates that are available from investments. PWLB rates are based on gilt yields which have in recent years seen significant reductions due to economic uncertainty, a bond buying programme by the bank of England and demand for safe haven assets. Whilst geopolitical events can have short term impacts 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 investments. The Council also aims to achieve the optimum return on its investments appropriate to these priorities.
- 3.3 The Council invests with financial institutions in accordance with criteria approved in the 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 2017/18 Treasury Management Strategy.

- 3.4 As well as the historically low bank rate, the Government's Funding for Lending Scheme has also had the impact of reducing returns on investments.
- 3.5 At the 30 September 2017, investments stood at £72.6 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 A** shows with whom these investments were held as at 30 September 2017. All investments are deemed recoverable.
- 3.6 A selection of performance indicators and benchmarking charts, is included in **Annexe B** 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 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 2017/18 is £360,000. The return achieved since the start of the year is 0.41% compared to the benchmark 7 day London Interbank Bid Rate (LIBID) of 0.11% and 3 month LIBID 0.18%
- 3.8 The Council currently uses the Debt Management and Deposit Facility (DMADF) as a last resort if no alternative investment opportunities are available. The maximum rates available from the facility are 0.10%.

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.

- 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. This reduces the CFR. Calculation of the CFR is summarised in the following table.

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

- 4.3 The level of CFR is dependent on a range of factors including progress in implementing the Capital Programme during the year so estimates can change.
- 4.4 At 30 September 2017, the Council had £672.1 million of external borrowing predominantly made up of fixed interest rate borrowing from the PWLB payable on maturity.

| 31-Mar-17 | | | 30-Sep-17 | |
|--------------|-------------|--------------------------------|--------------|-------------|
| £m | Rate (%) | | £m | Rate (%) |
| 617.2 | | Public Works Loan Board (PWLB) | 613.8 | |
| 51.0 | | Market | 51.0 | |
| 3.0 | | Welsh Government | 4.5 | |
| 2.8 | | Other | 2.8 | |
| 674.0 | 4.74 | Total External Debt | 672.1 | 4.72 |

New borrowing undertaken during the year to date

- 4.5 Loans of £1.5 million from Welsh Government and £0.11 million from Salix have been received for project specific schemes and are at 0%. A further £2.6 million is committed from Salix for a scheme to implement LED lanterns on principal roads in the city.

Maturing Loans in year to date

- 4.6 Annexe C shows the maturity profile of the Council's borrowing as at 30 September 2017. Loans of £3.5 million have been repaid in the first half of this year, with a further £2.6 million due to be repaid by 31 March 2018. 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.

- 4.7 (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.
- 4.8 The Council has 6 such loan 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.
- 4.9 Interest rates on the Council's 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 | 21/11/2017 | 6 months | 21/11/2041 |
| 6 | 21/11/2017 | 6 months | 21/11/2041 |
| 6 | 21/11/2017 | 6 months | 23/05/2067 |
| 6 | 01/09/2017 | 6 months | 23/05/2067 |
| 5 | 15/01/2018 | 5 years | 17/01/2078 |
| 22 | 21/11/2020 | 5 years | 23/11/2065 |

- 4.10 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 LOBO's form a relatively low proportion of the Council's overall borrowing at 7.6%.

Borrowing Strategy

- 4.11 The borrowing strategy outlined in the February 2017 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

The forecast level of internal borrowing at 31 March 2018 in relation to the CFR is deemed manageable. However, based on the current forecasts of future capital expenditure plans and high level analysis of the sustainability of internal borrowing from the Council's balance sheet position for future years, external borrowing will be required to be undertaken in the medium term.

- 4.12 As shown in the interest rate forecasts above, long term borrowing rates are significantly 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.
- 4.13 If no further PWLB or Market borrowing is undertaken, the value of external loans at 31 March 2018 will be £672 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 £756 million (General Fund £484 million and HRA £273 million). Without any further borrowing this financial year internal borrowing would be £85 million. In order to ensure this is manageable, it is currently anticipated that borrowing of £20 million will be undertaken in the last quarter of 2017/18.
- 4.14 The estimated total interest payable on borrowing for 2017/18 is £31.9 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 2017/18. 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 £614 million, £403 million are eligible for early repayment. However this would incur a premium of £348 million as at 30 September 2017. 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 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 2017.
- 6.2 Following Housing Finance Reform the Council complies with an indebtedness cap in the Housing Revenue Account of £316.5 million. This will need to be monitored closely as part of the Treasury Strategy and HRA Business Planning process.

Strategy update for the remainder of 2017/18

- 7.1 The Markets in Financial Instruments Directive (MiFID) is EU legislation that regulates firms who provide financial instrument services to clients. MiFID was applied in the UK from November 2007, but is now being revised with changes to take effect from 3 January 2018, with the new legislation being known as MiFID II.
- 7.2 The aim is to ensure financial institutions undertake more extensive checks on their client's suitability for investment products. Organisations undertaking investments will be either classified as 'retail' or 'professional'.
- 7.3 MiFID II requires all Local Authorities to be initially treated as "retail clients" unless they "opt up" to a "professional client". The assumption being that retail clients require a greater level of due diligence and support for investment decision making. Financial institutions will owe a greater duty of care to retail clients, however, they will have no greater financial protection than professional clients.
- 7.4 In order to continue using Money Market Funds or to have access to Certificates of Deposit or other products which are included in the Treasury Management Strategy the Council will request to be classified as a professional client.
- 7.5 In addition to the above changes, the Chartered Institute of Public Finance and Accountancy, (CIPFA), is currently conducting an exercise to consult local authorities on revising the Treasury Management Code, and the Prudential Code. A particular focus of this exercise is how to deal with local authority investments which are not treasury type investments e.g. investments in property, loans to subsidiaries etc. Potential changes, timing of their implementation and the likely impact on the Council will be monitored and reported as part of the 2018/19 budget report and Treasury Management Strategy.

Annexes

Annexe A – Investments at 30 September 2017

Annexe B – Investment Charts at 30 September 2017

Annexe C – Maturity Analysis of Borrowing as at 30 September 2017

Annexe D – Glossary of Treasury Management terms