PLYMOUTH CITY COUNCIL

Subject:	Mid-Year Treasury Management Report 2017/18
Committee:	Audit Committee
Date:	7 December 2017
Cabinet Member:	Councillor Darcy
CMT Member:	Andrew Hardingham (Interim Joint Strategic Director Transformation and Change)
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Ref:	FIN/CF
Key Decision:	No
Part:	I

Purpose of the report:

The Local Government Act 2003 requires the Council to set out its Treasury Strategy for borrowing and to prepare an Annual Investment Strategy. The Council's Strategy for 2017/18 was approved by full Council at its budget meeting on 17 February 2017. This report provides an update on the progress and outcomes against the Treasury Management Strategy for the six month period ended 30 September 2017. It is a requirement of the CIPFA Code of Practice on Treasury Management that a mid- year report, as a minimum, should be presented to Full Council.

The Council Corporate Plan 2016-19:

Effective financial management is fundamental to the delivery of corporate improvement priorities. Treasury Management activity has a significant impact on the Council's activity both in revenue budget terms and capital investment and is a key factor in facilitating the delivery against a number of corporate priorities.

Implications for Medium Term Financial Plan and Resource Implications: Including finance, human, IT and land

Treasury Management affects the Council's budget in terms of borrowing costs and investment returns and its implications have been fully incorporated into the Council's budgets.

Other Implications: e.g. Child Poverty, Community Safety, Health and Safety and Risk Management:
N/A

Equality and Diversity

Has an Equality Impact Assessment been undertaken? No

Recommendations and Reasons for recommended action:

1. The Mid-Year Treasury Management Report 2017/18 to be noted by the Audit Committee.

Alternative options considered and rejected:

It is statutory requirement under the Local Government Act 2003 and supporting regulations to set an annual treasury strategy for borrowing and prepare an Annual Investment Strategy. The Council has adopted the CIPFA Code of Practice for Treasury Management which requires a mid-year report to be submitted to the Audit Committee and full council.

Published work / information:

Treasury Management Strategy and Annual Investment Strategy 2017/18 to Council 17 February 2017.

Background papers:

Title	Part I	Part II	Exemption Paragraph Number						
			1	2	3	4	5	6	7
Not applicable									

Sign off:

Fin	pl1718.128	Leg	lt/29497/281117	Mon Off	lt/DVS/29497	HR		Assets		IT		Strat Proc	
Originating SMT Member – Andrew Hardingham													
Has the Cabinet Member(s) agreed the contents of the report? Yes													

Mid-Year Treasury Management Report 2016/17

1. Introduction

1.1 This report is to provide the Audit Committee and the Council with a mid-year review of the Council's treasury management activities for the first 6 months to 30 September 2017.

1.2 The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires that authorities report on the performance of the treasury management function at least twice yearly (mid-year and at year end).

1.3 The Council's Treasury Management Strategy for 2017/18 was approved by full Council on 17 February 2017 which is published on the Council's web site.

1.4 The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

2. External Context as at 23 October 2017

2.1 **Economic backdrop**: Commodity prices fluctuated over the period with oil falling below $45 a barrel before inching back up to $58 a barrel. UK Consumer Price Inflation (CPI) index rose with the data print for August showing CPI at 2.9%, its highest since June 2013 as the fall in the value of sterling following the June 2016 referendum result continued to feed through into higher import prices. The new inflation measure CPIH, which includes owner occupiers' housing costs, was at 2.7%.

2.2 The unemployment rate fell to 4.3%, its lowest since May 1975, but the squeeze on consumers intensified as average earnings grew at 2.5%, below the rate of inflation. Economic activity expanded at a much slower pace as evidenced by Q1 and Q2 GDP growth of 0.2% and 0.3% respectively. With the dominant services sector accounting for 79% of GDP, the strength of consumer spending remains vital to growth, but with household savings falling and real wage growth negative, there are concerns that these will be a constraint on economic activity in the second half of 2017.

2.3 The Bank of England made no change to monetary policy at its meetings in the first half of the financial year. The vote to keep Bank Rate at 0.25% narrowed to 5-3 in June highlighting that some MPC members were more concerned about rising inflation than the risks to growth. Although at September's meeting the Committee voted 7-2 in favour of keeping Bank Rate unchanged, the MPC changed their vote in November to raise the official interest rates to 0.5%. The Monetary Policy

Committee re-emphasised that any prospective increases in Bank Rate would be expected to be at a gradual pace and to a limited extent.

2.4 In contrast, near-term global growth prospects improved. The US Federal Reserve (The fed) increased its target range of official interest rates in June for the second time in 2017 by 25bps (basis points) to between 1% and 1.25% and, despite US inflation hitting a soft patch with core CPI at 1.7%, a further similar increase is expected in its December 2017 meeting. The Fed also announced confirmed that it would be starting a reversal of its vast Quantitative Easing programme and reduce the $4.2 trillion of bonds it acquired by initially cutting the amount it reinvests by $10bn a month.

2.5 Geopolitical tensions escalated in August as the US and North Korea exchanged escalating verbal threats over reports about enhancements in North Korea's missile programme. The provocation from both sides helped wipe off nearly $1 trillion from global equity markets but benefited safe-haven assets such as gold, the US dollar and the Japanese yen. Tensions remained high, with North Korea's threat to fire missiles towards the US naval base in Guam, its recent missile tests over Japan and a further testing of its latent nuclear capabilities.

2.6 Prime Minister Theresa May called an unscheduled General Election in June, to resolve uncertainty but the result has led to a minority Conservative government in coalition with the Democratic Unionist Party. This clearly results in an enhanced level of political uncertainty. Although the potential for a so-called hard Brexit is diminished, lack of clarity over future trading partnerships, in particular future customs agreements with the rest of the EU block, is denting business sentiment and investment. The reaction from the markets on the UK election's outcome was fairly muted, business confidence now hinges on the progress (or not) on Brexit negotiations, the ultimate 'divorce bill' for the exit and whether new trade treaties and customs arrangements are successfully concluded to the UK's benefit.

2.7 In the face of a struggling economy and Brexit-related uncertainty, The Council's TM advisors, Arlingclose, expects the Bank of England to take only a very measured approach to any monetary policy tightening, any increase will be gradual and limited as the interest rate backdrop will have to provide substantial support to the UK economy through the Brexit transition.

3. Market reaction:

3.1 **Financial markets:** Gilt yields displayed significant volatility over the six-month period with the appearing change in sentiment in the Bank of England's outlook for interest rates, the push-pull from expectations of tapering of Quantitative Easing (QE) in the US and Europe and from geopolitical tensions, which also had an impact. The yield on the 5-year gilts fell to 0.35% in mid-June, but then rose to 0.80% by the end of September. The 10-year gilts similarly rose from their lows of 0.93% to 1.38% at the end of the quarter, and those on 20-year gilts from 1.62% to 1.94%.

3.2 The FTSE 100 nevertheless powered away reaching a record high of 7548 in May but dropped back to 7377 at the end of September. Money markets rates have remained low: 1-month, 3-month and 12-month LIBID rates have averaged 0.25%, 0.30% and 0.65% over the period from January to 21st September.

3.3 The most noticeable fall in money market rates was for very short-dated periods (overnight to 1 month) where rates fell to between 0.1% and 0.2%.

4. Regulatory Updates

4.1 **MiFID II (European regulations):** Local authorities are currently treated by regulated financial services firms as professional clients who can "opt down" to be treated as retail clients instead. From 3rd January 2018, as a result of the second Markets in Financial Instruments Directive (MiFID II), local authorities will be treated as retail clients who can "opt up" to be professional clients, providing that they meet certain criteria.

Regulated financial services firms include banks, brokers, advisers, fund managers and custodians, but only where they are selling, arranging, advising or managing designated investments. In order to opt up to professional, the authority must have an investment balance of at least £10 million and the person authorised to make investment decisions on behalf of the authority must have at least one year's relevant professional experience. In addition, the firm must assess that that person has the expertise, experience and knowledge to make investment decisions and understand the risks involved.

4.2 The main additional protection for retail clients is a duty on the firm to ensure that the investment is "suitable" for the client. However, local authorities are not protected by the Financial Services Compensation Scheme nor are they eligible to complain to the Financial Ombudsman Service whether they are retail or professional clients. It is also likely that retail clients will face an increased cost and potentially restricted access to certain products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice. The Council has declined to opt down to retail client status in the past as the costs were thought to outweigh the benefits.

The Council meets the conditions to opt up to professional status and intends to do so in December 2017 in order to maintain their current MiFID status.

4.3 **CIPFA Consultation on Prudential and Treasury Management Codes:** In February 2017 CIPFA canvassed views on the relevance, adoption and practical application of the Treasury Management and Prudential Codes and after reviewing responses launched a further consultation on changes to the codes in August with a deadline for responses of 30th September 2017.

4.4 The proposed changes to the Prudential Code include the production of a new high-level Capital Strategy report to full council which will cover the basics of the capital programme and treasury management. The prudential indicators for capital expenditure and the authorised borrowing limit would be included in this report but other indicators may be delegated to another committee. There are plans to drop certain prudential indicators, however local indicators are recommended for ring fenced funds and for group accounts. Other proposed changes include applying the principles of the Code to subsidiaries.

4.5 Proposed changes to the Treasury Management Code include the potential for non-treasury investments such as commercial investments in properties in the definition of "investments" as well as loans made or shares brought for service purposes. Another proposed change is the inclusion of financial guarantees as instruments requiring risk management and addressed within the Treasury Management Strategy. Approval of the technical detail of the Treasury Management Strategy may be delegated to a committee rather than needing approval of full Council. There are also plans to drop or alter some of the current treasury management indicators.

4.6 CIPFA intends to publish the two revised Codes towards the end of 2017 for implementation in 2018/19, although CIPFA plans to put transitional arrangements in place for reports that are required to be approved before the start of the 2018/19 financial year.

4.7 **The Department of Communities and Local Government (DCLG) consultation:** the DCLG wish to have a more rigorous framework in place for the treatment of commercial investments as soon as is practical. It is understood that DCLG will be revising its Investment Guidance (and its MRP guidance) for local authorities in England.

The changes could have revenue implications for the Council because they have suggested that MRP calculations could be restricted to 40 years for properties. This could increase the cost of MRP by about £200k per year.

5. Local Context

5.1 At 31st March 2017 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £354m, while usable reserves and working capital was £55m. The Council had £290m of borrowing and £68m of investments.

5.2 The Council has an increasing CFR over the next 5 years due to the capital programme, but will maintain their investments and will therefore require borrowing of up to £624m over the forecast period.

6. Borrowing Strategy

6.1 At 30/9/2017 the Council held £311m of loans, (an increase of £23m from 31/3/2017), as part of its strategy in funding the capital programme.

The Council's chief objective when borrowing continues to be striking an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

In furtherance of these objectives, new short term borrowing was taken on to invest in the capital programme. The new borrowing has been taken at historically low interest rates so that the cost to the council tax payer is kept to a minimum.

6.2 Affordability and the "cost of carry" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained, and are likely to remain at least over the forthcoming two years, lower than long-term rates, the Council determined it was more cost effective in the short-term to use internal resources and borrow short-term loans.

6.3 The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assists the Council with this 'cost of carry' and breakeven analysis.

6.4 Temporary and short term loans borrowed from the markets, predominantly from other local authorities, has also remained affordable and attractive. The Council has £167m of such loans that were borrowed at an average life of 3 months. Arlingclose supports the Council's borrowing strategy to maintain the short term borrowing.

7. Borrowing activity in during the half year

7.1 The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

7.2 At 30/9/2017 the Council held £311m of loans, (an increase of £23m on 31/3/2017), as part of its strategy for funding the capital programme. The 30th September 2017 borrowing position is show in the table below.

	Balance at 01/04/2017 £m	Movement £m	Balance at 30/09/2017 £m
Short Term Borrowing	144	23	167
Long Term Borrowing			
LOBO	82	-	82
Public Works Loans Board	44	-	44
Other long term loans	18	-	18
Total Borrowing	**288**	**23**	**311**
Long Term Investments	33	5	38
Short Term Investments	17	(1)	16
Cash and Cash Equivalents	18	(3)	15
Total Investments	**68**	**1**	**69**
Net Borrowing	220	22	242

7.3 PWLB Certainty Rate

The Council qualifies for borrowing from the PWLB at the 'Certainty Rate' (0.20% below the PWLB standard rate) for a 12 month period from 01/11/2017. In April the Council submitted its application to the CLG along with the 2017/18 Capital Estimates Return to qualify for this reduced rate for a further 12 month.

7.4 Debt Rescheduling:

The premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Council's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence.

7.5 LOBO

The Council continues to hold £82m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the first half of 2017/18.

It is the Council's strategy to try and renegotiate the LOBO loans with the banks and to refinance the debt without additional cost to the Council. The aim is to remove the options and remove the uncertainty of possible future interest rate rises.

7.6 Other Debt Activity

Although not classed as borrowing, the Council also raise capital finance via Private Finance Initiative / finance leases / etc. As at 30th September 2017, the total debt was £122m including PFI £111m Finance leases £2m. The Council has raised no additional PFI borrowing during the period to 30th September 2017.

8. Investment Activity

8.1 The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held.

8.2 The investment position during the half year is shown in the table below.

Investment Activity

Investments	Balance on 01/04/2017 £m	Movement £m	Balance on 30/09/2017 £m
Short Term Investments			
Other Investments	17	(1)	16
Money Market Funds	18	(3)	15
Long Term Investments			
Pooled Funds	22	5	27
Other Funds	11	0	11
TOTAL INVESTMENTS	**68**	**1**	**69**
Increase/ (Decrease) in Investments £m			1

8.3 Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

8.4 In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the Council has further diversified into more secure and higher yielding asset classes. £5m has been invested in the new CCLA pooled fund called the Diversified Income Fund which should give a return of about 3.5%.

8.5 Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

9 Other Investment Activity

9.1 Although not currently classed as treasury management activities and therefore not covered by the CIPFA Code, the Council also holds £61.328m of investments in directly owned property as at 30th September 2017. This represents an increase in the first six months of the year of £30.097m.

9.2 These non-treasury investments generated £1.591m of investment income for the Council in the first six months after taking account of direct costs and MRP, representing a rate of return of 2.6%. This is higher than the return earned on treasury investments, but reflects the additional risks to the Council of holding such investments.

9.3 If CIPFA's proposed amendments to the Treasury Management Code are adopted in the revised Code from 2018/19, these will henceforth be included in the expanded definition of "investments".

10 Budgeted Income and Outturn

10.1 The average cash balances held during the period were £18.527m. The UK Bank Rate was 0.5% from March 2009 to August 2016, when it was cut to 0.25%. On 2nd November 2017 the Bank of England raised the Bake Rate to 0.5%. Short-term money markets and the Debt Management Account Deposit Facility (DMADF) still very low rates of return.

The Council's budgeted investment income for the year is estimated at £1.3m. The Council is currently anticipating delivering this by the year end.

11 Update on Investments with Icelandic Banks

11.1 In March 2017 the Icelandic Government lifted restriction on the movement of cash out of Iceland. In June 2017 the Council received the balance of its investments (£1.3m) in the Iceland banks plus interest earned since the banking crisis in Iceland in 2008.

The original amount invested in 2008 was £13.000m and the Council has received £13,392m made up of the original principal outstanding interest.

12 Compliance with Prudential Indicators

12.1 Prudential Indicators 2017/18

The Local Government Act 2003 requires the Council to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice.

To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

	30.9.17 Actual	2017/18 Limit	Complied
Any group of funds under the same management	20m	25m	✓
Investments held in a broker's nominee account	0	40m	✓
Foreign countries	0	12m	✓
Registered Providers	0	12m	✓
Unsecured investments with Building Societies	0	10m	✓
Loans to unrated corporates	0	5m	✓
Money Market Funds (maximum held)	15m	55m	✓

Compliance with the authorised limit and operational boundary for external debt is demonstrated in the table below.

Operational Boundary for External Debt: The Operational Boundary is based on the Council's estimate of most likely, i.e. prudent, but not worst case scenario for external debt.

Operational Boundary	30/09/17 Actual £m	2017/18 Target £m	Complied
Borrowing	311	400	✓
Other long-term liabilities	125	140	✓
Total Debt	436	540	✓

The Council confirms that during 2017/18, the Operational Boundary was not breached.

Authorised Limit for External Debt: The Authorised Limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	30/09/17 Actual £m	2017/18 Target £m	Complied
Borrowing	311	450	✓
Other long-term liabilities	125	160	✓
Total Debt	436	610	✓

Total debt at 30/9/2017 was £436m. The Council confirms that during 2017/18 the Authorised Limit was not breached at any time.

13 Treasury Management Indicators

The Council measures and manages its exposures to treasury management risks using the following indicators.

13.1 **Security**:

The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio.

	30.09.17 Actual	2017/18 Target	Complied
Portfolio average credit rating	A	A	✓

13.2 **Liquidity**

The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

In 2018/19 the Council will remove this liquidity measure from its Treasury Management Strategy because it has the ability to raise cash on a same day basis from other authorities thereby mitigating this risk.

13.3 Interest Rate Exposures:

This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed will be:

	30.09.17 Actual	2017/18 Target	Complied
Upper limit on fixed interest rate exposure	100%	100%	✓
Upper limit on variable interest rate exposure	0%	25%	✓

13.4 **Maturity Structure of Borrowing:** This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	30.09.17 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	54%	60%	0%	✓
12 months and within 24 months	20%	25%	0%	✓
24 months and within 5 years	19%	25%	0%	✓
5 years and within 10 years	15%	25%	0%	✓
10 years and above	11%	75%	0%	✓

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

13.5 **Principal Sums Invested for Periods Longer than 365 days:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

	30.09.17 Actual	Target	Complied
Limit on principal invested beyond year end	£0m	£20m	✓

The Council does, however, have £20m invested in the CCLA Pooled Property Fund which although the Council is holding the investment for the long term it is classified as a short term investment because it can be call upon at any point. This is currently providing a return in excess of 3.5%.

14 Investment Training

14.1 During the period to 30th September 2017 officers have attended the following Treasury Management training:

Arlingclose Workshops - Principles of Treasury Management
Arlingclose Meeting - Treasury Management Decision Making
CIPFA – Public sector Treasury Management

15 Outlook for the remainder of 2017/18

15.1 The UK economy faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Both consumer and business confidence remain subdued. Household consumption growth, the driver of UK GDP growth, has softened following a contraction in real wages. Savings rates are at an all-time low and real earnings growth (i.e. after inflation) struggles in the face of higher inflation.

15.2 The Authority's treasury adviser Arlingclose's central case is for UK Bank Rate to remain at 0.50% during 2018/19, following the rise from the historic low of 0.25%. The Monetary Policy Committee re-emphasised that any prospective increases in Bank Rate would be expected to be at a gradual pace and to a limited extent.

15.3 Future expectations for higher short term interest rates are subdued and on-going decisions remain data dependant and negotiations on exiting the EU cast a shadow over monetary policy decisions. The risks to Arlingclose's forecast are broadly balanced on both sides. The Arlingclose central case is for gilt yields to remain broadly stable across the medium term. Upward movement will be limited, although the UK government's seemingly deteriorating fiscal stance is an upside risk.

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Official Bank Rate										
Upside risk	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Downside Risk	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25