PLYMOUTH CITY COUNCIL

Subject:	Mid-Year Treasury Management Report 2018/19
Committee:	Audit Committee
Date:	10 December 2018
Cabinet Member:	Councillor Lowry
CMT Member:	Andrew Hardingham (Service Director for Finance)
Author:	Chris Flower (Finance Business Partner for Capital and Treasury Management)
Contact details	Tel: 01752 304212 email: chris.flower@plymouth.gov.uk
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 2018/19 was approved by full Council at its budget meeting on 16 February 2018.
This report provides an update on the progress and outcomes against the Treasury Management Strategy for the six month period ended 30 September 2018. 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.

Corporate Plan

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 Medium Term Financial Planning.

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 2018/19 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 2018/19 to Council on 16 February 2018.

Background papers:

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

Sign off:

Fin	pl.18.19.146	Leg	LT/31678/3011	Mon Off		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 2018/19

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 2018.

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 2018/19 was approved by full Council on 16 February 2018 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. Regulatory Updates

2.1 Following consultation in 2017, CIPFA published new versions of the Prudential Code for Capital Finance in Local Authorities (Prudential Code) and the Treasury Management Code of Practice but has yet to publish the local authority specific Guidance Notes to the latter. In England Ministry of Housing Communities and Local Government (MHCLG) published its revised Investment Guidance which came into effect from April 2018.

2.2 The updated Prudential Code includes a new requirement for local authorities to provide a Capital Strategy, which is to be a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, will be producing its Capital Strategy later in 2018 19 for approval by full Council.

2.3 Changes to the MHCLG Investment Guidance 2018 includes the requirement to report 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.

3. External Context as at 1st October 2018

3.1 **Economic background:** Oil prices rose by 23% over the six months to around \$82/barrel. UK Consumer Price Inflation (CPI) for August rose to 2.7% year on year, above the consensus forecast and that of the Bank of England's in its August Inflation Report, as the effects of sterling's large depreciation in 2016 began to fade. The most recent labour market data for July 2018 showed the unemployment rate at 4%, its lowest since 1975. The 3-month average annual growth rate for regular pay, i.e. excluding bonuses, was 2.9% providing some evidence that a shortage of workers is providing support to wages. However real wages (i.e. adjusted for inflation) grew only by 0.2%, a marginal increase unlikely to have had much effect on households.

3.2 The rebound in quarterly GDP growth in Q2 to 0.4% appeared to overturn the weakness in Q1 which was largely due to weather-related factors. However, the detail showed much of Q2 GDP growth was attributed to an increase in inventories. Year/year GDP growth at 1.2% also remains below trend. The Bank of England made no change to monetary policy at its meetings in May and June, however hawkish minutes and a 6-3 vote to maintain rates was followed by a unanimous decision for a rate rise of 0.25% in August, taking Bank Rate to 0.75%.

3.3 Having raised rates in March, the US Federal Reserve again increased its target range of official interest rates in each of June and September by 0.25% to the current 2%-2.25%. Markets now expect one further rise in 2018.

3.4 The escalating trade war between the US and China as tariffs announced by the Trump administration appeared to become an entrenched dispute, damaging not just to China but also other Asian economies in the supply chain. The fallout, combined with tighter monetary policy, risks contributing to a slowdown in global economic activity and growth in 2019.

3.5 The EU Withdrawal Bill, which repeals the European Communities Act 1972 that took the UK into the EU and enables EU law to be transferred into UK law, narrowly made it through Parliament. With just six months to go when Article 50 expires on 29th March 2019, neither the Withdrawal Agreement between the UK and the EU which will be legally binding on separation issues and the financial settlement, nor its annex which will outline the shape of their future relationship, have been finalised, extending the period of economic uncertainty.

4 **Financial markets:**

4.1 Gilt yields displayed marked volatility during the period, particularly following Italy's political crisis in late May when government bond yields saw sharp moves akin to those at the height of the European financial crisis with falls in yield in safe-haven UK, German and US government bonds. Over the period, despite the volatility, the bet change in gilt yields was small. The 5-year benchmark gilt only rose marginally from 1.13% to 1.16%. There was a larger increase in 10-year gilt yields from 1.37% to 1.57% and in the 20-year gilt yield from 1.74% to 1.89%. The increase in Bank Rate resulted in higher in money markets rates. 1-month, 3-month and 12-month LIBID rates averaged 0.56%, 0.70% and 0.95% respectively over the period.

5 Credit background:

5.1 Reflecting its perceived higher risk, the Credit Default Swap (CDS) spread for non-ring-fenced bank NatWest Markets plc rose relatively sharply over the period to around 96bps. The CDS for the ring-fenced entity, National Westminster Bank plc, has held steady below 40bps. Although the CDS of other UK banks rose marginally over the period, they continue to remain low compared to historic averages.

5.2 The ring-fencing of the big four UK banks - Barclays, Bank of Scotland/Lloyds, HSBC and RBS/NatWest Bank plc – is complete, the transfer of their business lines into retail (ring-fenced) and investment banking (non-ring-fenced) is progressing and will need to be completed by the end of 2018.

5.3 There were a few credit rating changes during the period. Moody's downgraded Barclays Bank plc's long-term rating to A2 from A1 and NatWest Markets plc to Baa2 from A3 on its view of the credit metrics of the entities post ring-fencing. Upgrades to long-term ratings included those for Royal Bank of Scotland plc, NatWest Bank and Ulster Bank to A2 from A3 by Moody's and to A- from BBB+ by both Fitch and Standard & Poor's (S&P). Lloyds Bank plc and Bank of Scotland plc were upgraded to A+ from A by S&P and to Aa3 from A1 by Moody's.

5.4 Our treasury advisor Arlingclose will henceforth provide ratings which are specific to wholesale deposits including certificates of deposit, rather than provide general issuer credit ratings. Non-preferred senior unsecured debt and senior bonds are at higher risk of bail-in than deposit products, either through contractual terms, national law, or resolution authorities' flexibility during bail-in. Arlingclose's creditworthiness advice will continue to include unsecured bank deposits and CDs

6. Local Context

6.1 At 31st March 2018 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £415m, while usable reserves £60m. The Council had £367m of borrowing and £80m of investments.

6.2 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 £380m over the forecast period.

7. Borrowing Strategy

7.1 At 30/9/2018 the Council held £416m of loans, (an increase of £49m from 31/3/2018), 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.

7.2 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.

7.3 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.

7.4 Temporary and short term loans borrowed from the markets, predominantly from other local authorities, has also remained affordable and attractive. The Council has £283m 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. However this strategy is kept under constant review.

8. Borrowing activity in during the half year

8.1 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.

8.2 At 30/9/2018 the Council held £416m of loans, (an increase of £49m on 31/3/2018), as part of its strategy for funding the capital programme.

The 30th September 2018 borrowing position is show in the table below.

	Balance at 01/04/2018 £m	Movement £m	Balance at 30/09/2018 £m
Short Term Borrowing	223	60	283
LOBO	82	(11)	71
Public Works Loans Board	44	-	44
Other long term loans	18	-	18
Total Borrowing	**367**	**49**	**416**
Long Term Investments	36	(7)	29
Short Term Investments	18	-	18
Cash and Cash Equivalents	26	(3)	23
Total Investments	**80**	**(10)**	**70**
Net Borrowing	287	59	346

8.3 The Council's chief objective when borrowing has been to strike 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 Authority's long-term plans change being a secondary objective.

8.4 In keeping with these objectives, this strategy enabled the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

8.5 With short-term interest rates remaining much lower than long-term rates, the Council considered it to be more cost effective in the near term to use short-term loans instead. The net movement in short term loans is shown in the table above.

8.6 As the Council has an increasing CFR due to the capital programme and an estimated borrowing requirement as determined by the Liability Benchmark which also takes into account usable reserves and working capital, the Council borrowed an additional £60m short term loans, to provide some longer-term certainty and stability to the debt portfolio.

8.7 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 01/11/2018. In April the Council submitted its application to the CLG along with the 2018/19 Capital Estimates Return to qualify for this reduced rate for a further 12 month.

8.8 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.

8.9 LOBO

The LOBOs (Lender's Option Borrower's Option) are 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 2019/19.

Since the 1st April 2018 the Council has refinanced a £11m LOBO and has reduced is holding of LOBO loans from £82m to £71m.

It is the Council's strategy to try and renegotiate the LOBO loans with the banks 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.

8.10 Other Debt Activity

Although not classed as borrowing, the Council also raise capital finance via Private Finance Initiative (PFI) and finance leases etc. As at 30th September 2018, the total debt was £121m including PFI £108m Finance leases £2m. The Council has raised no additional PFI borrowing during the period to 30th September 2018.

9 Investment Activity

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

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

Investment Activity

Investments	Balance on 01/04/2018 £m	Movement Movement £m	Balance on 30/09/2018 £m
Short Term Investments			
Other Investments	18	0	18
Money Market Funds	26	(3)	23
Long Term Investments			
Pooled Funds	25	0	25
Other Funds	11	(7)	4
TOTAL INVESTMENTS	**80**	**(10)**	**70**
Increase/ (Decrease) in Investments £m			(10)

9.3 Both the CIPFA Code and MHCLG guidance requires 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.

9.4 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 or Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

10 Budgeted Income and Outturn

10.1 At the start of the year the UK Bank Rate was 0.5% and on 2nd August 2018 it went up to 0.75%. Short-term money markets and the Debt Management Account Deposit Facility (DMADF) still offer very low rates of return.

10.2 The Council's budgeted investment income for the year is estimated at £1.730m. The Council is currently anticipating delivering this by the year end.

11 Non-Treasury Investments

11.1 The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return.
This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

11.2 The Council also holds £135.227m of investments in directly owned property as part of the Asset Investment Fund as at 30th September 2018. This represents an increase in the first six months of the year of £38.316m.

11.3 The non-treasury investments in the Asset Investment Fund are forecast to generate £2.903 (budget £1.600m) of investment income for the Council after taking account of direct costs and service borrowing, representing a rate of return of 2.1%.

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.

12.2 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.

Investment Limits

	30.9.18 Actual	2018/19 Limit	Complied
Any group of funds under the same management	£20m	£25m	✓
Investments held in a broker's nominee account	£0	£25m	✓
Foreign countries	0	£10m	✓
Registered Providers	£0	£25m	✓
Unsecured investments with Building Societies	£5m	£10m	✓

Loans to unrated corporates	£10m	£25m	✓
Money Market Funds (maximum held)	£46m	£60m	✓

13 Debt Limits

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

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

Operational Boundary	30.09.18 Actual £m	2018/19 Target £m	Complied
Borrowing	416	540	✓
Other long-term liabilities	121	140	✓
Total Debt	537	680	✓

The Council confirms that during 2018/19 the Operational Boundary has not been breached.

13.2 The Authorised Limit for external debt 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	**30/09/18 Actual £m**	**2018/19 Target £m**	**Complied**
Borrowing	416	670	✓
Other long-term liabilities	121	160	✓
Total Debt	537	835	✓

Total debt as at 30/9/2018 was £537m. The Council confirms that during 2018/19 the Authorised Limit was not breached at any time.

14 Treasury Management Indicators

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

14.1 **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.

	30.09.18 Actual	2018/19 Target	Complied
Portfolio average credit rating	A	A	✓

14.2 **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.

14.3 **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 was:

	30.09.18 Actual	2018/19 Target	Complied
Upper limit on fixed interest rate exposure	100%	100%	✓
Upper limit on variable interest rate exposure	0%	25%	✓

14.4 **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 were:

	30.09.18 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	56%	90%	0%	✓
12 months and within 24 months	13%	40%	0%	✓
24 months and within 5 years	0%	40%	0%	✓
5 years and within 10 years	1%	25%	0%	✓
10 years and above	33%	95%	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.

14.5 **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:

	30.09.18 Actual	Target	Complied
Limit on principal invested beyond year end	£0m	£45m	✓

The Council does, however, have £20m invested in the CCLA Pooled Property Fund and £5m in the CCLA Diversified Income Fund which the Council is holding the investment for the long term. However, these investments are classified as a short term investment because it can be called upon at any point.

154 Investment Training

15.1 During the period to 30th September 2018 officers have attended the following Treasury Management training:

Arlingclose Meetings – Treasury Management Board Meeting
CIPFA – Treasury Management Workshop
Arlingclose - Investment workshop
Arlingclose – Strategy Workshop for Investments, Capital and Treasury Management

16 Outlook for the remainder of 2018/19

16.1 Having raised policy rates in August 2018 to 0.75%, the Bank of England's Monetary Policy Committee (MPC) has maintained expectations of a slow rise in interest rates over the forecast horizon.

16.2 The MPC has a definite bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. While policymakers are wary of domestic inflationary pressures over the next two years, it is believed that the MPC members consider both that (a) ultra-low interest rates result in other economic problems, and that (b) higher Bank Rate will be a more effective weapon should downside Brexit risks crystallise and cuts are required.

16.3 Arlingclose's central case is for Bank Rate to rise twice in 2019. The risks are weighted to the downside. The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in Q2 2018, but the annual growth rate of 1.2% remains well below the long term average

	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Official Bank Rate										
Upside risk	0.00	0.00	0.00	0.50	0.50	0.50	0.25	0.25	0.25	0.25
Arlingclose Central Case	0.75	0.75	1.00	1.00	1.25	0.25	0.25	0.25	0.25	0.25
Downside Risk	0.00	0.00	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75

16.4 The view is that the UK economy still faces a challenging outlook as the minority government continues to negotiate the country's exit from the European Union. Central bank actions and geopolitical risks, such as prospective trade wars, have and will continue to produce significant volatility in financial markets, including bond markets.