North Somerset Council

REPORT TO THE AUDIT COMMITTEE

DATE OF MEETING: 07 DECEMBER 2017

SUBJECT OF REPORT: TREASURY MANAGEMENT MID-YEAR REPORT 2017/18

TOWN OR PARISH: ALL

OFFICER/MEMBER PRESENTING: MALCOLM COE, HEAD OF FINANCE & PROPERTY

KEY DECISION: NO

RECOMMENDATIONS

The Audit Committee is asked to note the treasury management in-year monitoring report.

1. SUMMARY OF REPORT

This report informs the Committee of the council's;

- treasury management activities during the first six months of 2017/18 and confirms that the activities undertaken during the year have complied with both the requirements of the Accountability and Responsibility Framework and also the approved Treasury Management Strategy approved by Council in February 2017.

- prudential indicators for 2017/18, as required by CIPFA's Prudential Code for Capital Finance in Local Authorities.

2. POLICY

Part 1 (7) of the Financial Regulations, sets out the councils' policy framework with regards to treasury management activities.

Following the council's adoption of the 2011 edition of the CIPFA *Treasury Management in the Public Services: Code of Practice*, Members are required to approve an annual treasury management strategy before the start of each financial year and then to receive an in-year report and also an annual report after the end of each financial year. This in-year report covers the period 1 April to 30 September 2017.

In addition, the Communities and Local Government *Guidance on Local Government Investments* recommends that a local authority review and potentially amend its investment strategy in the light of changing internal or external circumstances. This report therefore meets the requirements of both sets of guidance.

3. DETAILS

3.1 External context provided by Arlingclose Ltd (treasury advisers)

Prime Minister Theresa May called an unscheduled General Election in June, to resolve uncertainty and in the hope of gaining an enhanced mandate to enter the forthcoming Brexit negotiations. The surprise result has led to a minority Conservative government in a confidence and supply arrangement with the Democratic Unionist Party. This political impasse clearly results in an enhanced level of political uncertainty, however the potential for a so-called hard Brexit is now diminished, reducing the associated economic headwinds for the UK economy from a ‘no deal’ or otherwise unfavourable trade agreement.

The reaction from the markets on the election’s outcome has been fairly muted, business confidence now hinges on the progress (or not) on Brexit negotiations, whether new trade treaties and arrangements are successfully concluded and whether or not the UK continues to remain part of the EU customs union post the country’s exit from the EU.

The UK Consumer Price Inflation (CPI) index has continued to rise throughout 2017, increasing from 2.3% in March to 2.6% in June and up again to 2.9% in August. The BOE has forecast that CPI will continue to rise and is expected to reach 3.0% by October. This is largely the result of depreciating Sterling and rising oil prices in quarter two being passed onto consumers.

Following the inflation report the Bank of England met in September and voted to maintain interest rates at 0.25% by a majority of 7 to 2 and to maintain the stock of bond purchases. However indications were given that action would be taken to bring inflation back within the 2% target if the economy follows a consistent path as that of the August inflation report. Albeit at a gradual pace and to a limited extent.

The comments from the Bank of England’s Monetary Policy Committee resulted in the financial markets building in an interest rate rise much earlier than originally forecast with PWLB rates increasing by 0.15% and fixed term deposits increasing by a similar margin. An interest rate rise followed in November raising rate back to 0.5%

Globally the economic outlook has improved and is reflected in rising equity prices. Despite this outlook investors have marked down the UK’s economic growth prospects since the EU referendum.

Credit background: UK bank credit default swaps have continued their downward trend, reaching three year lows by the end of June. Bank share prices have not moved in any particular pattern.

There were a few credit rating changes during the quarter. Moody’s downgraded Standard Chartered Bank’s long-term rating to A1 from Aa3 on the expectation that the bank’s profitability will be lower following management’s efforts to de-risk their balance sheet. Moody’s downgraded the major Canadian banks’ long-term ratings on the agency’s expectation of a more challenging operating environment for the banks for the remainder of 2017 and beyond that could lead to a deterioration in the banks' asset quality and increase their sensitivity to external shocks. Moody’s also downgraded the ratings of the large Australian banks to Aa3 from Aa2 reflecting the agency’s view of the rising risks from the banks’ exposure to the Australian housing market and the elevated proportion of lending to residential property investors.

Ring-fencing, which requires the larger UK banks to separate their core retail banking activity from the rest of their business, is expected to be implemented within the next year. In May, following Arlingclose's advice, the Authority reduced the maximum duration of its deposits at Bank of Scotland, HSBC Bank and Lloyds Bank from 13 months to 6 months as there is some uncertainty surrounding which banking entities the Authority will be dealing with once ring-fencing is implemented. Even where there has been a level of clarity provided regarding where local authority customers will sit within the proposed new legal structures of the banks, it is not yet known what the balance sheet structures of those banks will be.

3.2 Investment activity

The Guidance on Local Government Investments in England gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles. The following table summarises the council's external investments at 30 September 2017, and compares to the balances held at 31 March 2017. This sum includes monies managed by the council's in-house team, as well as £20m, which is currently managed by the council's external fund manager.

Summary of External Investments as at (principal sums)				
	In-House Cash Deposits £m	In-House Pooled Funds £m	Tradition £m	**Total £m**
< 1 Year	69.3	0.0	20.0	**89.3**
> 1 Year	0.00	10.0	0.0	**10.0**
Total - 30th Sept 2017	**69.3**	**10.0**	**20.0**	**99.3**
Total - 31st March 2017	**55.5**	**5.0**	**20.0**	**80.5**

As can be seen above, the council is currently holding approximately £18.8m more cash in September than it did at the end of March. However it should be noted that this profile is very similar to recent years and the increase in balances is not reflective of additional resources, but merely represents a timing issue at this point in the financial year whereby income is received in advance of associated expenditure. It is projected that these balances will reduce in the coming months as the council's expenditure commitments relating to both revenue and capital budgets are fulfilled and cash receipts become less.

The security of capital has previously been the authority's main investment objective and this is under-pinned by the authority's choice of investment products and counter-party policies which were contained within the TM Strategy approved in February 2017. Members will be aware that the February Strategy allows investments to be placed in the following types of investment:

- Other Local Authorities;
- AAA-rated Money Market Funds;
- Call Accounts;
- Term Deposits with approved financial institutions;
- DMADF (Government Debt Management Office);
- Gilts and Treasury Bills; Bonds issued by Multilateral Development Banks, such as the European Investment Bank; Certificates of Deposit (CD's)
- Pooled funds

The table below shows further analysis of the investments held at 31 March and 30 September 2017 which adhered to this Strategy.

Analysis of External Investments (principal sums)			
	30/09/2017 £m	31/03/2017 £m	Movement £m
UK banks	36.8	23.0	13.8
Overseas	22.0	27.5	(5.5)
UK Building Societies	13.0	15.0	(2.0)
Money Market Funds	0.0	0.0	0.0
Debt management Office	0.0	0.0	0.0
Local Authorities	17.5	10.0	7.5
Pooled Funds	10.0	5.0	5.0
Total	**99.30**	**80.5**	**18.8**

In April 2017 the Section 151 Officer approved an additional £5m investment into pooled funds, more specifically in two multi asset funds where investments are made into a broad range of asset classes. The decision provided additional diversity to the portfolio, protection from bail-in risk and also above inflation returns.

Members will note that such funds are pooled investment products and are accessed on a traded share basis rather than a fixed cash deposit sum. This does mean that such investments are classified as ‘available for sale’ assets rather than a ‘receivable investment’ and will therefore require a revaluation at the end of each financial year, meaning that these classes of investment will expose the council to the risk of capital losses at that time.

It is important to note that under the current accounting regulations the capital loss calculated at the end of March 2018 will not impact on the council’s revenue budget, but will instead be transferred into the Financial Instruments Adjustment Account on the balance sheet, where it will be reflected until such time as the investment is sold and the loss crystallised.

The council’s treasury advisers, Arlingclose Ltd have been comfortable with these class of investments, and recommended the two additional funds at the beginning of the year. Whilst they recognise the capital loss issue, they suggest that this investment should be viewed as a long-term term investment on a 5-year rolling horizon and recommend that Members focus upon the potential income return and not be distracted by the capital fluctuations in the share values. The advisers have also confirmed that such an investment in the multi-asset funds would offer some accounting advantages compared with other property investments, because it represents a way of diversifying the investment portfolio away from focusing entirely upon bank credit risk.

3.3 Investment interest budgets

Current projections of current and potential future investments indicate that the council will have a surplus of £0.76m in interest compared to budgeted levels of £0.74m.

Summary of External Investments as at (principal sums)				
	In-House Deposits £m	In-House Pooled Funds £m	Tradition £m	**Total £m**
Projected Out-turn	0.32	0.36	0.08	**0.76**
Budget	0.34	0.31	0.09	**0.74**
Forecast Variance	**(0.02)**	**0.05**	**(0.01)**	**0.02**

There are a significant number of factors which influence the council's ability to generate investment returns on its balances, some of which being:- the official Bank Rate, money market activity, counter-party limits, credit ratings, levels and timing of surplus cash balances available as well as economic and political factors, with the majority of these being external and beyond the council's control.

The UK Bank Rate had been maintained at 0.25% from August 2016 until November 2017, with a rise to 0.5% on the 2nd of the month. However the timing of the rate rise is unlikely to have any major impact upon interest receivable within the current financial year with cash balances forecast to fall from December and a significant proportion of the portfolio maturing in the next 12 months.

As well as being influenced by the official Bank rate, the money markets are also affected by the quantities of surplus cash available at any given time. The markets have not changed significantly from previous years with short-term periods remaining highly liquid which has resulted in a reduction in rates and numbers of investors which the council can place funds inhibited following advice from its advisors.

In summary, average maturity durations of the portfolio have reduced following advice from Arlingclose. This is mainly a result of the uncertainty surrounding the ring fencing requirements placed upon the banking sector by the FCA and the possible increase in exposure to bail-in risk from the changes. This coupled together with a lower interest rate in the first half of the year will reduce the likelihood of achieving returns in comparison with the previous year. It is anticipated that the additional pooled fund investment will generate higher returns than the traditional fixed-term cash deposits and mitigate against the falling returns from traditional fixed term deposits.

3.4 Adoption of IFRS 9

At their meeting on 8 November 2017 CIPFA / LASAAC approved the adoption of IFRS 9, Financial Instruments into the Local Authority Accounting Code of Practice (the Code), with an effective date of April 2018. The new accounting standard will be introduced to provide a single approach to the classification and measurement of financial instruments.

One of the key impacts of IFRS 9 will be that, whilst many local authority loans and investments will continue to be held at amortised cost, **all gains and losses arising from changes in the fair value of some categories of investments will have to be recognised in authorities' revenue accounts.** This means that from 2018/19 any changes in the value of certain investments will have a consequent **impact on the general fund**.

Previously any changes in the fair value of these investments were only recognised in the general fund when the asset was sold and the gain or loss was crystallised. CIPFA are aware that the recognition of unrealised gains and losses may provide a particular challenge to local authority CFOs since no statutory over-ride has been included within the standard as they will now need to account for such losses after the end of each financial year bringing fluctuation and risk to the ongoing budget monitoring forecasts and out-turn positions.

It is suggested that in future CFO's may have to consider whether unrealised gains should be held back in order to provide for potential future losses and note that this may have an impact on the level of local authority reserves being held to manage risk.

The CIPFA/LASAAC Board considered the categories of investments that could be caught by the fair value measurement provisions of IFRS 9. Particular attention was paid to the various collective investment vehicles that form part of many local authorities' investment portfolios. For North Somerset this relates to the £5m investment held in the CCLA property fund, and also the £5m held in the multi-asset funds. **At this time it is estimated that a loss ranging from £0.5m-£0.9m will be charged to the council's revenue budget after the change.**

There was some sympathy for the view that some form of statutory override might be appropriate, particularly relating to the treatment of existing unrealised gains or losses on transition at 1 April 2018. Representatives from central and devolved governments in attendance at the meeting confirmed that they would be willing to consider representations from local authorities in this area informed by evidence. That being said, even if implemented this would be a one-off measure and will not continue beyond the transition period and so it will be necessary to factor this legislative change into the council's future treasury management strategy.

3.5 Review of the investment strategy

Since the current Investment Strategy was approved in February, the outlook for credit (or counter-party) risk for the council in the current year has largely remained unchanged although the council is aware that credit ratings for institutions are relative, rather than absolute measures of credit risk. The council continues to monitor risks in this area, and would look to review and amend both its lending criteria and also timescales for those institutions which could have a negative out-look. Any such changes would represent additional process issues and would not affect the overall flexibility of the Strategy itself.

As mentioned above, the Section 151 Officer has invested an additional £5m in pooled funds during the financial year, a decision supported by the council's external advisers. However since that time the decision to approve IFRS 9 has been confirmed which will impact upon investments classified as available for sale in the future.

At this time it is not proposed that any further changes be made to the current Strategy as there remains sufficient flexibility within current approvals. Additional investments into pooled funds will not be made in order to mitigate future capital losses and their associated impact into the revenue budget. Such pooled investments will be considered as part a wider options appraisal as part of the 2018/19 investment strategy.

3.6 Long-term borrowing

Over recent years the PWLB has remained the most attractive source of borrowing for the authority as it has offered greater flexibility and control than the external funding markets where resource levels are often lower during times of weakened economic activity and rates offered are usually higher than those from the PWLB.

At the start of the year the council held long-term borrowing of £124.405m which is profiled for repayment between September 2017 and March 2052, with no more than £7.3m repayable in any one financial year. This is in accordance with the council's current borrowing policy and is structured in a way to reduce exposure to significant cash-flow movements and adverse interest rates at the time each loan matures. The council has no remaining loans to mature in year with £5m having matured at the end of September via the Public Works Loan Board.

Long-term PWLB debt profile (principle only) as at 30th September 2017		
	Debt £m	Average Rate %
Less than 1 year	0.0	2.6
Between 1 and 2 years	1.1	3.8
Between 2 and 5 years	4.34	4.9
Between 5 and 10 years	26.76	4.1
Over 10 years	86.12	4.4
	118.32	

In addition the council also has long-term borrowing obligations of £14.4m in respect of the former Avon County Council, although these loans are currently administered by Bristol City Council meaning that the council's overall long-term debt stands at £132.72m.

At this time there has been no change to the overall debt total although as Members will recall a further borrowing requirement of £12.0m for 2017/17 was identified in the capital budget and capital investment strategy report considered by the Executive at the meeting in February. And an additional £18.74m for the proposals included within the Commercial Investment Strategy report to Council in July.

Given both the anticipated increase in capital expenditure and the reducing cash balances during the remainder of the year, it is anticipated that the council may begin to consider taking some of its borrowing requirement before the year-end although the timing of any such decisions will be reviewed to ensure that interest rates are at optimum levels and within the budget provision and that there are no opportunities available to re-finance existing debt structures.

Should rates rise during this period then the council will seek to defer borrowing decisions until the next financial year whilst advising of the associated impacts this would have on the councils' revenue budget.

Members will be aware that the PWLB offers various interest rate options for local authorities;

- Standard interest rates – both fixed and variable rates
- Certainty rate – which represents a discount of 0.2% from the standard rate should the authority provide information as required on their plans for long-term borrowing and associated capital spending
- Project rate – which represents a discount of 0.2% from the certainty rate (or 0.4% from the standard rate) for lending in respect of an infrastructure project nominated by a Local Enterprise Partnership (LEP)

The council was awarded access to the certainty rate for its 2017/18 borrowing requirement, and it is intended that proposed borrowing to be undertaken for the City-Region Deal investment projects will attract the project rate, with the North-South Link road (£7.2m) qualifying for the project rate in 2017/18. It is essential that the council ensures all borrowing decisions are based upon sound and viable business cases and interest rates on loans taken are at optimum levels in order to reduce the impact on the council's revenue budget.

3.7 Treasury management indicators

The council measures its exposures to treasury management risks using the indicators approved in February 2017, and shown at Appendix 1. This report confirms that the council has complied with its prudential indicators for 2016/17, and the Executive are asked to note the following indicators as at 30 September 2017.

4. CONSULTATION

None

5. FINANCIAL IMPLICATIONS

Financial implications are contained throughout the report.

6. RISK MANAGEMENT

The council does face significant types and degrees of risk in this area, from both internal and external sources. However the council has implemented, and adheres to, strict policies and internal controls in order to mitigate such risks wherever possible.

The council's primary objectives for the management of its investments have always been to give priority to the security and liquidity of its funds before seeking the best rate of return although the need to increase returns on a proportion of cash balances has resulted in a slight change of approach in the current year with the additional investment into pooled funds which increases the risk of capital losses. The majority of surplus cash remains held as short-term investments and in addition £20m is invested on behalf of the council by a professional fund manager, all of which helps the council to diversify its portfolio and reduce risk where possible.

The council's primary objective for the management of its debt is to ensure its long-term affordability. All of the council's current loans have been borrowed from the Public Works Loan Board at long-term fixed rates of interest thereby reducing the exposure of future interest rate rises which could potentially occur should variable or option loans be taken.

However it is noted that the continued combination of short duration investments and long duration debt could expose the council to the risk of falling investment income during periods of low interest rates. This risk is partially mitigated by the inclusion of some longer-term investments and retaining the option to prematurely repay some long-term loans should the financial assessment prove viable and offer best value to the tax paters.

The council measures its exposure to credit risk by monitoring the individual credit ratings of each investor within its portfolio on at least a monthly basis.

Top 5 current risks	Detail	Proposed mitigation measure	Mitigated RAG rating
1. Credit Risk	Risk of insolvency resulting in an inability to repay capital investment	More diverse portfolio of investments	Amber
2. EU Bail-in	Counterparties no longer supported by national governments	Diversification into pooled funds	Amber

	during times of financial hardship		
3. Liquidity	Lack of access to funds to pay bills	Mixture of maturity durations matched to cash-flow needs and access to temporary borrowing and longer term PWLB	Amber
4. Interest Rates	Reduction in interest receivable from investments as a result of base rate changes	Additional investments in pooled funds will limit exposure to interest rate movements.	Amber
5. Capital Losses	Risk of capital losses not being recovered **or becoming a revenue expense following changes to accounting practice (IFRS9)**	*Limit losses to 10% or £500k, whichever is greater, before consulting on withdrawing the investment*	Red

It is possible that changes to the current investment strategy or risk management mitigations will be required following the adoption of IFRS 9.

7. LEGAL POWERS AND IMPLICATIONS

The Code of Practice on Local Authority Accounting in the United Kingdom issued by the CIPFA/LASAAC Local Authority Accounting Code Board and updated on an annual basis.

Guidance on Local Government Investments issued by the Department of Communities and Local Government and the Welsh Government

8. EQUALITY IMPLICATIONS

NA

9. CORPORATE IMPLICATIONS

None apart from the financial implications on the corporate budget as discussed above.

10. OPTIONS CONSIDERED

Various options relating to both borrowing and investment choices have been considered throughout the report.

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BACKGROUND PAPERS

Capital & Treasury Management Strategy report – Executive, February 2017

TREASURY MANAGEMENT INDICATORS

The following Treasury Management prudential indicators were set for 2017/18 as part of the MTFP process. The limits are shown below together with the actual indicators for the first six months of 2017/18.

Authorised Limit for External Debt

In respect of its external debt, the council approved the following authorised limit for its total external debt. This limit separately identifies borrowing from other long-term liabilities such as finance leases. The actual level of external debt is shown, and is well within the limits set at the start of the year.

Authorised Limit for External Debt		
	2017/18 Limit £m	**2017/18 Actual £m**
Borrowing – NSC	218	118.3
Borrowing – Former Avon CC	16	14.4
Other LT liabilities	39	2.7
Authority Total	**273**	**135.4**

Operational Boundary

The council also approved the following operational boundary for external debt for the same period, which was based on the same estimates as the authorised limit, but reflected estimates of the most likely, prudent, but not worst case scenario, without the additional headroom included within the authorised limit to allow for unusual cash movements. As can be seen below, the actual level of external debt is well within the operational boundary set at the start of the year.

Operational Boundary for External Debt		
	2017/18 Limit £m	**2017/18 Actual £m**
Borrowing – NSC	207	118.3
Borrowing – Former Avon CC	16	14.4
Other LT liabilities	35	2.7
Authority Total	**258**	**135.4**

Interest Rate Exposure

This indicator is set to control the council's exposure to interest rate risk, including both exposures to fixed and variable rate interest rates, expressed as an amount of net principal borrowed.

Interest Rate Limits		
	2017/18 Limit £m	**2017/18 Actual £m**
Upper limit on fixed rate exposures **(net)**	202	48.9
Upper limit on variable rate exposures (net)	34	(12.80)*

* This includes £10m of pooled fund investments with a variable return. However the funds have both fixed and variable rate instruments within their portfolios.

Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year.

Maturity Structure of Borrowing

This indicator is set to control the council's exposure to refinancing risk. The maturity structure of fixed rate borrowing is shown below.

Maturity Structure of Borrowing			
	Upper Limit %	Lower Limit %	Actual %
Under 12 months	50%	0%	1%
12 months and within 24 months	30%	0%	2.4%
24 months and within 5 years	40%	0%	5.2%
5 years and within 10 years	50%	0%	21.6%
10 years and above	100%	0%	69.8%

Principal sums invested for periods longer than 364 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 total principal sums invested to final maturities beyond the period end are shown below.

Maturity Structure of Borrowing			
	2016/17 %	2017/18 %	2018/19 %
Upper limit of principal sums invested beyond one year	85	65	59
Actual principal sums invested beyond one year	5	15	10