North Somerset Council

REPORT TO THE AUDIT COMMITTEE

DATE OF MEETING: 29 NOVEMBER 2018

SUBJECT OF REPORT: TREASURY MANAGEMENT MID-YEAR REPORT 2018/19

TOWN OR PARISH: ALL

OFFICER/MEMBER PRESENTING: RICHARD PENSKA, INTERIM S151 OFFICER

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 Audit Committee of the council's;

- treasury management activities during the first six months of 2018/19 and confirms that the activities undertaken during the year have complied with both the requirements of the Accountability and Responsibility Framework and the approved Treasury Management Strategy approved by Council in February 2018.

- prudential indicators for 2018/19, 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 an annual report after the end of each financial year. This in-year report covers the period 1st April to 30th September 2018.

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 MHCLG published its revised Investment Guidance which came into effect from April 2018.

The MHCLG *Guidance on Local Government Investments* recommends that a council 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.

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 council will be producing its Capital Strategy later in 2018/19 for approval by full Council.

3. DETAILS

3.1 External context provided by Arlingclose Ltd (treasury advisers)

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%.

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.

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.

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.

The UK Consumer Price Inflation (CPI) for August rose to 2.7% year/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. This is largely due to Oil prices having risen by 23% over the six months to around $82/barrel.

Credit background: Although the credit default swaps of many UK banks rose marginally over the period, they continue to remain low compared to historic averages.

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 ringfencing. 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.

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 by the end of 2018. The ringfencing 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 (ringfenced) and investment banking (non-ringfenced) is progressing and will need to be completed by the end of 2018.

3.2 Investment activity

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 treasury investments before seeking the optimum 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.

During the six-month period, the council's investment balance ranged between £40 and £76 million due to timing differences between income and expenditure. The following table summarises the council's external investments at 30th September 2018 and compares to the balances held at 31st March 2018. This sum includes monies managed by the council's in-house team, as well as £10m, 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	71.0	0.0	10.0	**81.0**
> 1 Year	0.0	10.0	0.0	**10.0**
Total - 30th Sept 2018	**71.0**	**10.0**	**10.0**	**91.0**
Total - 31st March 2018	**42.0**	**10.0**	**14.0**	**66.0**

As can be seen above, the council is currently holding approximately £25.0m 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 been the council's main investment objective, and this is under-pinned by the council's choice of investment products and counter-party policies which were contained within the TM Strategy approved in February 2018. 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 Investment funds

The table below shows further analysis of the investments held at 31st March and 30th September 2018 which adhered to this Strategy.

Analysis of External Investments (principal sums)			
	30/09/2018 £m	31/03/2018 £m	Movement £m
UK banks	55.0	18.0	37.0
Overseas	4.0	14.0	-10.0
UK Building Societies	16.0	7.0	9.0
Money Market Funds	0.0	0.0	0.0
Debt management Office	0.0	0.0	0.0
Local Authorities	6.0	17.0	-11.0
Pooled Investment Funds	10.0	10.0	0.0
Total	**91.0**	**66.0**	**25.0**

The council's £10m of externally managed pooled multi-asset and property funds generated an average total return of 4.61% over the first 6 months, comprising a 4.33% income return which is used to support services in year, and 0.28% of capital growth (at 30 September). Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the council's investment objectives is regularly reviewed. Considering their performance and the council's latest cash flow forecasts, investment in these funds has been maintained.

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 (or potential capital gains) at that time. However accounting regulations mean that this this loss is revalued every year and held within an earmarked reserve until the investment is sold.

The council's treasury advisers, Arlingclose Ltd have been comfortable with these classes of investment and recommended the two additional funds at the beginning of the previous year. Whilst they recognise the potential 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 represents a way of diversifying the investment portfolio away from focusing entirely upon bank credit risk.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in the table below.

Investment Benchmarking – Treasury investments managed in-house					
	Credit Score	**Credit Rating**	**Bail-in Exposure**	**Weighted Average Maturity (days)**	**Rate of Return %**
31.03.2018	4.62	A+	60%	79	0.51
30.09.2018	5.14	A+	72%	74	0.79
Similar LAs	**4.53**	**A+**	**66%**	**52**	**0.75**

All LAs	**4.38**	**AA-**	**60%**	**37**	**0.76**

3.3 Investment interest budgets

Current projections of current and potential future investments indicate that the council will achieve £0.75m in interest compared to budgeted levels of £0.75m.

Summary of External Investments as at (principal sums)				
	In-House Deposits £m	In-House Pooled Funds £m	Tradition £m	**Total £m**
Projected Out-turn	0.33	0.35	0.06	**0.75**
Budget	0.33	0.35	0.06	**0.75**
Forecast Variance	**0.00**	**0.00**	**0.00**	**0.00**

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 0.50% from November 2017, with a rise to 0.75% in August 2018. However, the timing of the rate rise means the impact upon interest receivable within the current financial year is diluted with a significant proportion of the portfolio invested at the lower rate yet to mature to allow reinvestment at the higher rates currently available.

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 was 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. Despite this, the increase in the interest rate in the first half of the year will increase the likelihood of achieving returns in comparison with the previous year. It is anticipated that the additional pooled fund investments will continue to generate higher returns than the traditional fixed-term cash deposits and mitigate against the lower returns from traditional fixed term deposits.

Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority 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.

In addition to the investments referred to above, the Authority also holds £40m of such investments;

- directly owned property, i.e. commercial investments

This investment is expected to generate £0.4m of investment income for the Authority after taking account of direct costs.

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 was introduced to provide a single approach to the classification and measurement of financial instruments.

One of the key impacts of IFRS 9 is that, whilst many council 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. It is important to note that if there is no statutory override, under the IFRS 9 accounting regulations any unrealised capital gain or loss calculated at the end of March 2019 will impact on the council's revenue budget. **Based on share prices at 30th September 2018, it is estimated that a Fair Value adjustment ranging from a loss of £0.2m to a gain of £0.1m would be charged to the council's revenue budget.**

In November 2018 MHCLG confirmed that a statutory override would be introduced for 2018/19 time-limited for five years which would in effect continue the previous accounting treatment. If the statutory override were to be removed after that time, any fair value gains or losses would be charged to the council's general fund in accordance with IFRS 9.

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 timescales for those institutions which could have a negative out-look.

The Section 151 Officer had invested an additional £5m in pooled funds during the previous financial year, a decision supported by the council's external advisers. However, since that time the decision to adopt IFRS 9 has been confirmed which will impact upon these type of investments (i.e. 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 be considered as part a wider options appraisal as part of the 2019/20 investment strategy and will depend in part on the ultimate accounting treatment decided upon by CIPFA/ LASAAC and MHCLG (that is, the extent to which they allow a statutory override for fair value share price movements).

3.6 Long-term borrowing

Over recent years the PWLB has remained the most attractive source of borrowing for the council 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 £148.322m which is profiled for repayment between March 2019 and March 2058, with no more than £15m 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 one loan to mature in year with £0.1m maturing at the end of March 2019 via the Public Works Loan Board.

Long-term PWLB debt profile (principal only) as at 30th September 2018

	Debt £m	Average Rate %
Less than 1 year	0.10	2.11
Between 1 and 2 years	1.00	5.50
Between 2 and 5 years	12.84	3.14
Between 5 and 10 years	28.26	3.91
Over 10 years	106.12	4.07
	148.32	

In addition, the council also has long-term borrowing obligations of £13m 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 £161.32m.

At this time there has been no change to the overall debt total although as Members will recall a further borrowing requirement of £70.751m for 2018/19 was identified in the capital budget and capital investment strategy report considered by the Executive at the meeting in February, £50m of which related to the increase in the council's Commercial Investment Strategy report, from its previous level of £50m.

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 change during this period then the council will review borrowing decisions and gather further information in order to assess all options available and also forecast the potential 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 council 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)

3.7 Treasury management indicators

The council measures its exposures to treasury management risks using the indicators approved in February 2018 and shown at Appendix 1. This report confirms that the council has complied with its prudential indicators for 2018/19, and the Executive are asked to note the following indicators as at 30th September 2018.

3.8 Outlook for the remainder of 2018/19

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.

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.

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	Mar-21	Jun-21	Sep-21
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Ca:	0.75	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Downside risk	0.00	0.00	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75

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.

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 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 had resulted in a slight change of approach in the prior year with the additional investment into pooled funds which increases the risk of capital losses. Most of surplus cash remains held as short-term investments and in addition £10m 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 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 during times of financial hardship	Diversification into pooled funds	Amber
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 because 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**	*Limit losses to 10% or £500k, whichever is greater, before consulting on withdrawing the investment*	Red

	accounting practice (IFRS9)		

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 2018

TREASURY MANAGEMENT INDICATORS

The following Treasury Management prudential indicators were set for 2018/19 as part of the MTFP process. The limits are shown below together with the actual indicators for the first six months of 2018/19.

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		
	2018/19 Limit £m	**2018/19 Actual £m**
Long-term borrowing	298	148.3
Other long-term liabilities (Avon debt, leases, temporary borrowing etc)	55	14.4
Total Authorised Limit	**353**	**162.7**

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		
	2018/19 Limit £m	**2018/19 Actual £m**
Long-term borrowing	257	148.3
Other long-term liabilities (Avon debt, leases, temporary borrowing etc)	50	14.4
Total Operational Boundary	**307**	**162.7**

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 Exposures			
	2018/19 Limit £m	**2018/19 Actual £m**	**Complied?**
Upper limit on fixed rate exposures (net)	229	81.2	Yes
Upper limit on variable rate exposures (net)	38	(9.9) *	Yes

* 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 at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

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 %	Complied?
Under 12 months	50%	0%	0.9%	Yes
12 months and within 24 months	30%	0%	0%	Yes
24 months and within 5 years	40%	0%	8.8%	Yes
5 years and within 10 years	50%	0%	16.2%	Yes
10 years and above	100%	0%	74.1%	Yes

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.

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.

Principal sums invested for periods longer than 364 days			
	2018/19 £m	2019/20 £m	2020/21 £m
Upper limit of principal sums invested beyond one year	65	59	59
Actual principal sums invested beyond one year	10	10	10
Complied?	Yes	Yes	Yes