

# Mid-Year Treasury Management Report 2018/19

AC as at 26-10-18 - LT



## 1. Introduction and Background

The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering maximising investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

As a consequence treasury management is defined as:

“The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.”

The Council has adopted the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a **Mid-year Review Report** and an Annual Report (stewardship report) covering activities during the previous year.
4. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
5. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Scrutiny (Audit and Value for Money Council Services) Committee.

## 2. This Annual Treasury Report Covers

This mid-year report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- An economic update for 2018/19
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- A review of the Council's investment portfolio for 2018/19
- A review of the Council's borrowing strategy for 2018/19
- A review of any debt rescheduling undertaken during 2018/19
- A review of compliance with Treasury and Prudential Limits for 2018/19
- Other treasury matters

## 3. Economic Update

- 3.1 **UK.** The first half of 2018/19 has seen UK economic growth post a modest performance, but sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase Bank Rate on 2<sup>nd</sup> August from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, the Bank of England's August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019, albeit there were several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.
- 3.2 Some MPC members have expressed concerns about a build-up of inflationary pressures, particularly with the pound falling in value again against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation rose unexpectedly from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019.
- 3.3 As for the labour market, unemployment has continued at a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high in July, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 2.9%, (3 month average regular pay, excluding bonuses) and to a one month figure in July of 3.1%. This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 0.4%, near to the joint high of 0.5% since 2009. (The previous high point

was in July 2015.) Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC were right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy. However, the MPC will need to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit.

- 3.4 In the political arena, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, the central position is that Prime Minister May's government will endure, despite various setbacks, along the route to Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.
- 3.5 **USA.** President Trump's massive easing of fiscal policy is fuelling a (temporary) boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2, but also an upturn in inflationary pressures. With inflation moving towards 3%, the Fed increased rates another 0.25% in September to between 2.00% and 2.25%, this being four increases in 2018, and indicated they expected to increase rates four more times by the end of 2019. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019.
- 3.6 **EUROZONE.** Growth was unchanged at 0.4% in quarter 2, but has undershot early forecasts for a stronger economic performance in 2018. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of 2% for 2018, the horizon is less clear than it seemed just a short while ago.
- 3.7 **CHINA.** Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

3.8 **JAPAN** - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

### 3.8 **Interest rate forecasts**

The Council's treasury advisor, Link Asset Services, have provided the interest rate forecasts and commentary, which is attached at **Annex 3**.

## 4. **The Treasury Management Strategy and Annual Investment Strategy Update**

### 4.1 Background

The Treasury Management Strategy Statement (TMSS) for 2018/19 was approved by this Council on 26th February 2018. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as follows:

- Security of capital
- Liquidity

The Council will also aim to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity.

4.2 There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and latest forecasts.

### 4.3 Overview

The Council held £31m of investments as at 30 September 2018 (£30m at 30 September 2017) and the investment portfolio yield for the first six months of the year is 0.76% (0.43% 2017/18). A breakdown of the Council's investment portfolio is shown at **Annex 2** of this report.

The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2018/19.

It continues to be a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the current 0.75% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

The current investment counterparty criteria selection approved in the Treasury Management Strategy Statement is meeting the requirements of the treasury function.

## 5. Investment Portfolio

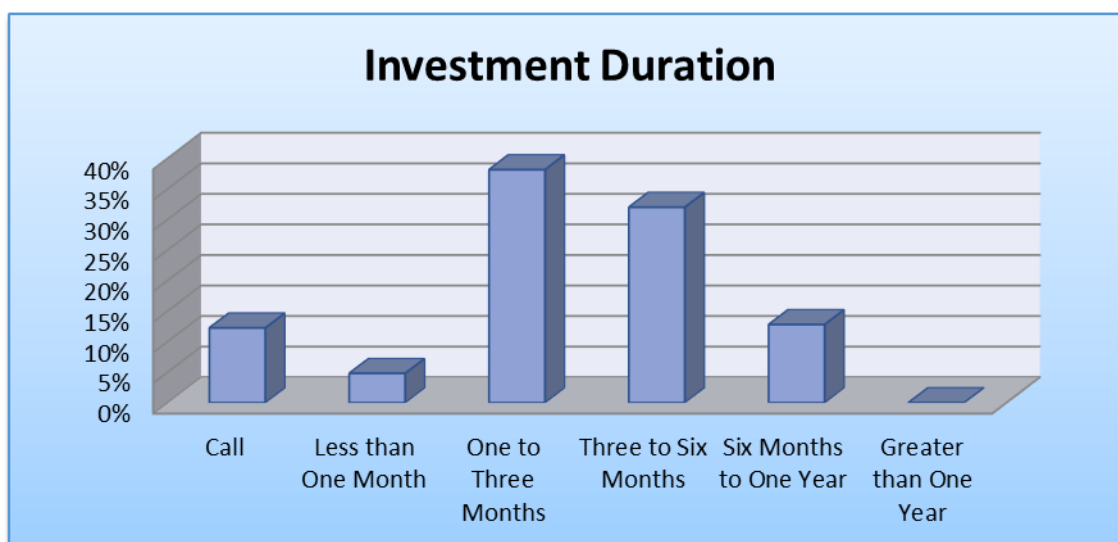
5.1 In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite.

5.2 The investment portfolio yield for the first six months of the year is 0.76%.

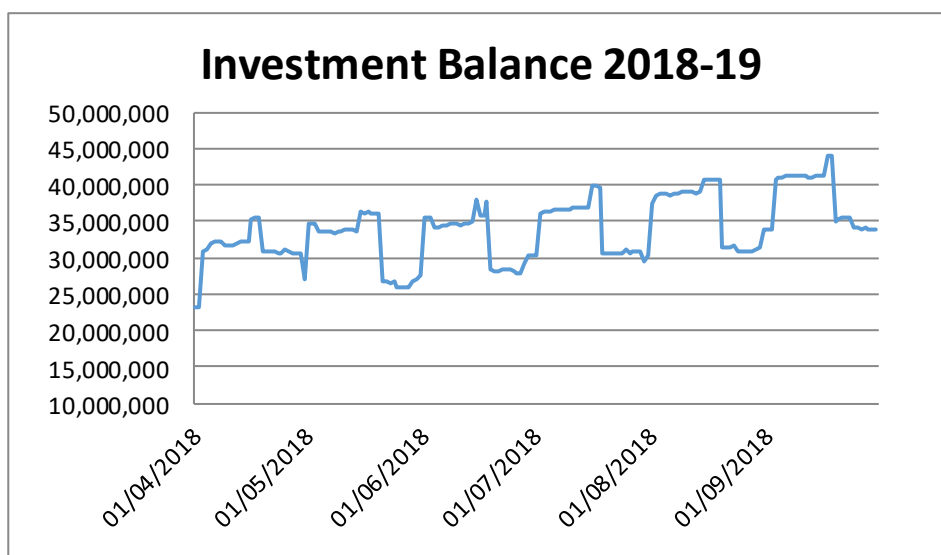
	<i>Average Rate Year to 30/09/18</i>
ESBC	0.76%
LIBID – 6 month	0.76%
Base Rate	0.58%

The bank rate is now at a nine year high, although future changes are likely to be slow but gradual increases over the coming years. Although, historically the rate remains very low. Despite this, the above table demonstrates that the authority has outperformed the average base rate and is in line with the average 6 month LIBID benchmark. The Council's budgeted investment return for 2018/19 is 0.5%, performance is therefore currently forecast to exceed the budget.

5.3 A full list of investments held as at 30th September 2018, totalling £31m is shown in **Annex 2**. The graph below demonstrates the maturity profile of investments. The investment listing includes certificates of deposit held with a number of international banks, as well as UK Government Treasury Bills. These instruments offer significant counterparty strength as well as diversification of the portfolio.



5.4 Average cash balances in the first six months of 2018/19 were £34m. The graph below demonstrates how these balances have fluctuated so far this year.



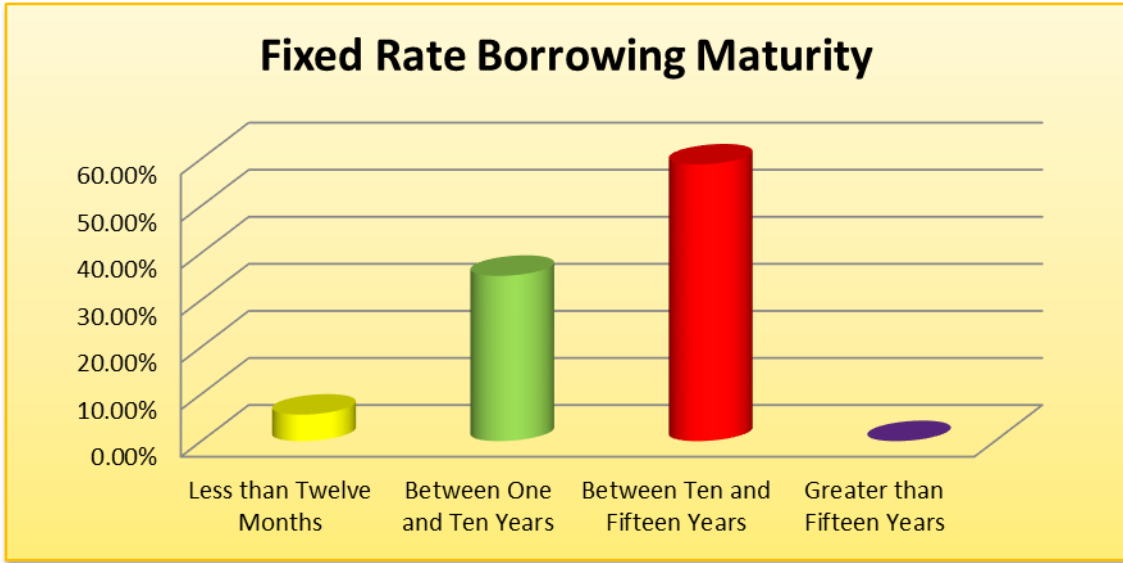
## 6. External Borrowing

The Council's capital financing requirement (CFR) as at 31<sup>st</sup> March 2019 is estimated to be £16m (£16.9m as at 31<sup>st</sup> March 2018). Excluding finance leases, the CFR is estimated to be £15.1m as at 31<sup>st</sup> March 2018 (£15.6m at 31<sup>st</sup> March 2018). The forecast CFR is now higher than when the budget and treasury management strategy was set, this reflects the latest information in relation to the timing of capital receipts that are planned to be partially utilised to repay internal debt, which in turn will deliver savings to the revenue budget. As set out within the quarterly finance reports, this can be mitigated in 2018/19 by a combination of increased investment income and the debt repayment reserve. However, there remains the risk that this could impact on the MTFs in 2019/20 and beyond.

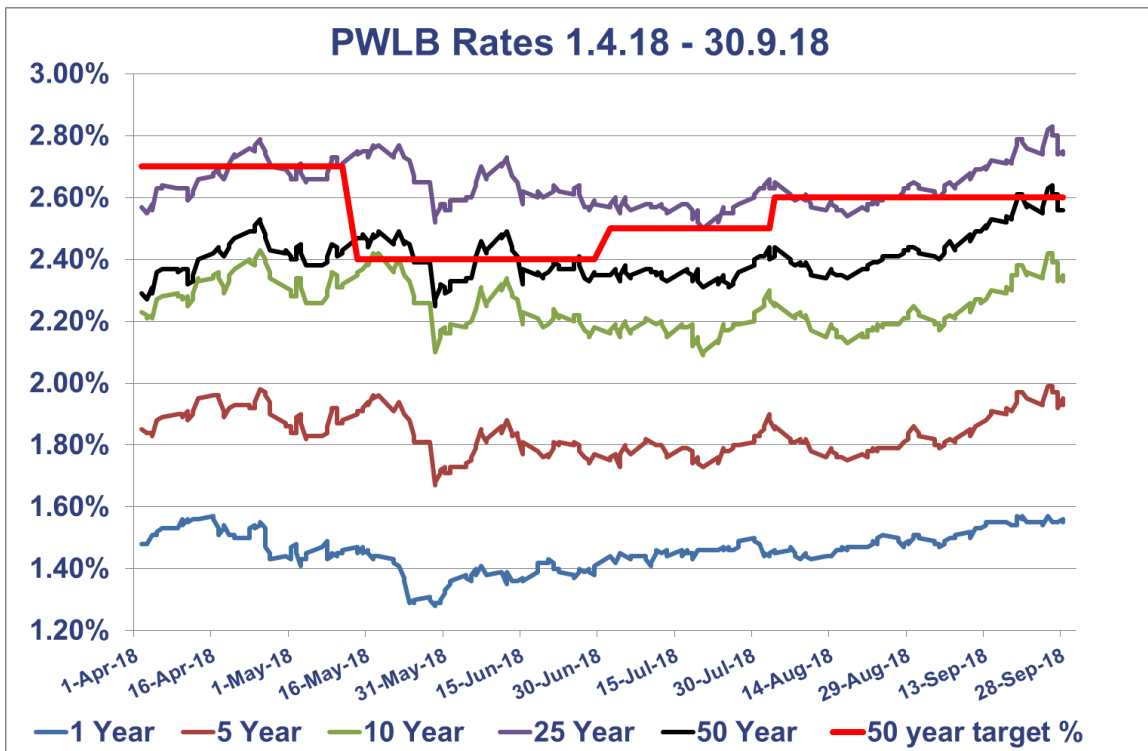
The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions.

Consistent with the strategy, no new borrowing has been undertaken during the first half of 2018/19. The current borrowing levels and maturity profile are set out in the table and graph below.

Debt Type	Principal Outstanding (£)	Average Rate
<b>Total Fixed Debt</b>		
PWLB Maturity	5,700,000	4.646%
PWLB Annuity	605,962	8.330%
<b>Total Variable Debt</b>		
Market	4,500,000	5.914%
GBSLEP Loan	375,000	
<b>Total External Debt</b>	<b>11,180,962</b>	<b>5.381%</b>



The table below shows the movement in PWLB certainty rates for the first six months of the year to date:



As set out in the Treasury Management Strategy Statement for 2018/19, the Council is operating a under-borrowed position, which is favourable in the current market conditions. It is not currently anticipated that any external borrowing will be undertaken in the remainder of the year. Nevertheless, the Financial Management Unit will continue to monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances and any decisions will be reported to the appropriate decision making body at the next available opportunity.



## 7. Debt Re-Scheduling

Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. As a consequence there has not been any re-scheduling undertaken.

## 8. Compliance with Treasury and Prudential Limits

It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits". Council's approved Treasury and Prudential Indicators (affordability limits) are outlined in the approved TMSS.

During the financial year to date the Council has operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators are shown in **Annex 1**.

## 9. Other Treasury Matters

### Icelandic Deposit/Administration

This authority currently has £0.285m investments frozen in the Icelandic bank (KSF). We anticipate further dividend repayments from the administration process and Members will be informed in the normal manner.

### UK Banks – Ring fencing

The largest UK banks, (those with more than £25bn of retail / Small and Medium-sized Enterprise (SME) deposits), are required, by UK law, to separate core retail banking services from their investment and international banking activities by 1st January 2019. This is known as "ring-fencing". Whilst smaller banks with less than £25bn in deposits are exempt, they can choose to opt up. Several banks are very close to the threshold already and so may come into scope in the future regardless.

Ring-fencing is a regulatory initiative created in response to the global financial crisis. It mandates the separation of retail and SME deposits from investment banking, in order to improve the resilience and resolvability of banks by changing their structure. In general, simpler, activities offered from within a ring-fenced bank, (RFB), will be focused on lower risk, day-to-day core transactions, whilst more complex and "riskier" activities are required to be housed in a separate entity, a non-ring-fenced bank, (NRFB). This is intended to ensure that an entity's core activities are not adversely affected by the acts or omissions of other members of its group.

While the structure of the banks included within this process may have changed, the fundamentals of credit assessment have not. The Council will continue to assess the new-formed entities in the same way that it does others and those with sufficiently high ratings, (and any other metrics considered), will be considered for investment purposes.

### IFRS9 accounting standard

This accounting standard came into effect from 1<sup>st</sup> April 2018. It means that the category of investments valued under the available for sale category will be removed and any potential fluctuations in market valuations may impact onto the Surplus or Deficit on the Provision of Services, rather than being held on the balance sheet. This change is unlikely to materially affect the types of treasury management investments currently utilised by ESBC, but more specialist types of investments, (e.g.property funds, commercial investments), are likely to be impacted.

The Ministry of Housing, Communities and Local Government (MHCLG), are currently conducting a consultation for a temporary override to allow English local authorities time to adjust their portfolio of investments.

## Annex 1: Prudential and Treasury Indicators

PRUDENTIAL INDICATOR	2017/18	2018/19	2018/19
	Outturn	Estimate	Probable
	£'000	£'000	£'000
<b>Capital Expenditure</b>	1,832	2,479#	<b>913</b>
<b>Ratio of financing costs to net revenue stream</b>	14.07%	11.59%	<b>12.09%</b>
<b>Capital Financing Requirement</b> (excluding finance leases)	15,518	11,455	<b>15,107</b>
<b>Capital Financing Requirement as at 31 March</b> (including finance leases)*	16,896	12,303	<b>15,974</b>
<b>External Debt*</b> (including finance leases)	12,779	12,125	<b>12,210</b>

*\*this includes finance leases and estimate accrued interest at year end (as per accounting requirements)*

*#excludes approved debt repayment from capital receipts of £3.8m.*

<b>Maturity structure of new fixed rate borrowing during 2018/19</b>	upper limit	lower limit
under 12 months	85%	0%
12 months and within 24 months	85%	0%
24 months and within 5 years	85%	0%
5 years and within 10 years	90%	0%
10 years and above	90%	0%

## Annex 1: Prudential and Treasury Indicators

PRUDENTIAL INDICATOR	2017/18	2018/19	2018/19	2019/20	2020/21
(2). TREASURY MANAGEMENT PRUDENTIAL INDICATORS	Outturn	Estimate	Probable	Estimate	Estimate
<b>Authorised Limit for external debt</b>					
borrowing	18,500	16,500	16,500	15,500	14,500
other long term liabilities	23,000	3,000	3,000	3,000	3,000
<b>TOTAL</b>	<b>21,500</b>	<b>19,500</b>	<b>19,500</b>	<b>18,500</b>	<b>17,500</b>
<b>Operational Boundary for external debt -</b>					
borrowing	16,500	15,500	15,500	14,500	12,500
other long term liabilities	2,000	2,000	2,000	2,000	3,000
<b>TOTAL</b>	<b>18,500</b>	<b>17,500</b>	<b>17,500</b>	<b>16,500</b>	<b>15,500</b>
<b>Upper limit on fixed interest rate exposure</b>	9,000	9,000	<b>9,000</b>	<b>9,000</b>	<b>9,000</b>
<b>Upper limit for variable rate exposure</b>	4,000	4,000	<b>4,000</b>	<b>4,000</b>	<b>4,000</b>
<b>Upper limit for total principal sums invested for over 1 year</b>	5,000	5,000	<b>5,000</b>	<b>5,000</b>	<b>5,000</b>

## Annex 2: Investments as at 30<sup>th</sup> September 2018

Borrower	Principal (£)	Interest Rate	Start Date	Maturity Date
<b>Call Accounts and Money Market Funds</b>				
RBS SIBA	76,152	0.01%		Call
Federated Money Market Fund	3,750,000	0.70%		Call
Lloyds	2,500,000	0.80%		95 day notice
Santander	3,500,000	0.85%		95 day notice
Barclays 95 Day Notice Account	3,424,111	0.70%		95 day notice
Barclays Holding Account	15	0.00%		
<b>Fixed Deposits / T Bills / Certificates of Deposit</b>				
Bank of Scotland	1,500,000	1.05%	28/09/2018	27/09/2019
Bank of Scotland	500,000	1.00%	06/07/2018	08/07/2019
Bank of Scotland	500,000	0.65%	08/05/2018	08/11/2018
Lloyds	1,000,000	1.00%	01/06/2018	03/06/2019
Nationwide CD	1,500,000	0.68%	13/07/2018	11/01/2019
Nordea CD	1,500,000	0.77%	27/07/2018	28/01/2019
Toronto Dominion CD	1,500,000	0.73%	24/04/2018	24/10/2018
UK Treasury Bill	1,000,000	0.54%	18/06/2018	17/12/2018
UK Treasury Bill	1,000,000	0.70%	13/08/2018	12/11/2018
UK Treasury Bill	1,000,000	0.70%	20/08/2018	18/02/2019
UK Treasury Bill	1,000,000	0.70%	28/08/2018	25/02/2019
UK Treasury Bill	1,000,000	0.70%	03/09/2018	04/03/2019
UK Treasury Bill	1,000,000	0.71%	03/09/2018	04/03/2019
UK Treasury Bill	1,000,000	0.71%	24/09/2018	25/03/2019
National Westminster Bank CD	1,000,000	0.90%	13/08/2018	13/02/2019
National Westminster Bank CD	1,000,000	0.90%	03/09/2018	04/03/2019
National Westminster Bank CD	1,000,000	1.04%	17/09/2018	16/09/2019

Borrower - Icelandic Exposure	Principal (£)	Interest Rate	Start Date	Maturity Date
Singer	285,000	5.41%		08/10/2008

Investments rate of interest as at 30 <sup>th</sup> September 2018	Principal (£)	Interest Rate
<b>Total Investments</b>	<b>31,535,278</b>	
<b>Total Investments - Excluding Icelandic Exposure</b>	<b>31,250,278</b>	<b>0.80%</b>
<b>Total Investments - Icelandic Exposure Only</b>	<b>285,000</b>	<b>5.41%</b>

Average rate of interest for the year to date	Principal (£)	Interest Rate
<b>Total Investments</b>	<b>31,915,846</b>	
<b>Total Investments - Excluding Icelandic Exposure</b>	<b>31,630,846</b>	<b>0.76%</b>
<b>Total Investments - Icelandic Exposure Only</b>	<b>285,000</b>	<b>5.41%</b>

## Annex 3: Interest Rate Forecasts

The Council's treasury advisor, Link Asset Services, has provided the following forecast:

Link Asset Services Interest Rate View											
	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate View	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
3 Month LIBID	0.75%	0.80%	0.80%	0.90%	1.10%	1.10%	1.20%	1.40%	1.50%	1.60%	1.60%
6 Month LIBID	0.85%	0.90%	0.90%	1.00%	1.20%	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%
12 Month LIBID	1.00%	1.00%	1.00%	1.10%	1.30%	1.30%	1.40%	1.60%	1.70%	1.80%	1.80%
5yr PWLB Rate	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
10yr PWLB Rate	2.40%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%

The flow of generally positive economic statistics after the end of the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, to 0.75%. However, the MPC emphasised again, that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary or contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years' time but they declined to give a medium term forecast. We do not think that the MPC will increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. We also feel that the MPC is more likely to wait until August 2019, than May 2019, before the next increase, to be followed by further increases of 0.25% in May and November 2020 to reach 1.5%. However, the cautious pace of even these limited increases is dependent on a reasonably orderly Brexit.

### The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably neutral.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

### Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Bank of England monetary policy takes action too quickly over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March of a government which has made a lot of anti-austerity noise. This is likely to lead to friction with the EU when setting the

target for the fiscal deficit in the national budget. Unsurprisingly, investors have taken a dim view of this and so Italian bond yields have been rising.

- Austria, the Czech Republic and Hungary now form a strongly anti-immigration bloc within the EU while Italy, this year, has also elected a strongly anti-immigration government. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position as a result of the rise of the anti-immigration AfD party. To compound this, the result of the Swedish general election in September 2018 has left an anti-immigration party potentially holding the balance of power in forming a coalition government. The challenges from these political developments could put considerable pressure on the cohesion of the EU and could spill over into impacting the euro, EU financial policy and financial markets.
- The imposition of trade tariffs by President Trump could negatively impact world growth. President Trump's specific actions against Turkey pose a particular risk to its economy which could, in turn, negatively impact Spanish and French banks which have significant exposures to loans to Turkey.
- Weak capitalisation of some European banks.
- Rising interest rates in the US could negatively impact emerging countries which have borrowed heavily in dollar denominated debt, so causing an investor flight to safe havens e.g. UK gilts.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

#### **Upside risks to current forecasts for UK gilt yields and PWLB rates**

- President Trump's fiscal plans to stimulate economic expansion causing a significant increase in inflation in the US and causing further sell offs of government bonds in major western countries.
- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.
- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- UK inflation, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.