MEETING:	**AUDIT AND GOVERNANCE COMMITTEE**
DATE:	**29 NOVEMBER 2018**
TITLE:	**TREASURY MANAGEMENT 2018/19 – MID YEAR REVIEW**
PURPOSE:	**CIPFA's Code of Practice recommends that a report on the Council's actual Treasury Management during the current financial year is produced.**
RECOMMENDATION:	**RECEIVE THE REPORT FOR INFORMATION**
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EXECUTIVE SUMMARY

During the six month period between 1 April and 30 September 2018, the Council's borrowing remained well within the limits originally set. There were no new defaults by banks in which the Council deposited money.

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1. INTRODUCTION

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). This report provides a mid-year update.

The Council's Treasury Management Strategy for 2018/19 was approved by full Council on 8 March 2018 which can be accessed on
https://democratiaeth.cyngor.gwynedd.gov.uk/documents/s16298/Rheolaeth%20Trysorlys.pdf?LLL=1

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.

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. This report covers treasury activity and the associated monitoring and control of risk. The Council will be producing its Capital Strategy later in 2018-19 for approval by full Council.

The Welsh Government (WG) asked for comments on changes to its Guidance on Minimum Revenue Provision (MRP). These include clarification or changes to terminology and the calculation of MRP.

2. EXTERNAL CONTEXT

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/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.

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%.

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.

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.

Financial markets: 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.

Credit background: Reflecting its perceived higher risk, the Credit Default Swap (CDS) spread for non-ringfenced bank NatWest Markets plc rose relatively sharply over the period to around 96bps. The CDS for the ringfenced 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.

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.

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.

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 but not senior unsecured bonds issued by commercial banks.

3. LOCAL CONTEXT

On 31st March 2018, the Council had net borrowing of £47m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £177m, while usable reserves and working capital are the underlying resources available for investment. The Council had £118m of borrowing and £47m of investments.

These factors are summarised in the table below.

	31.3.18 Actual £m
General Fund CFR	177
Less: *Other debt liabilities	(2)
Borrowing CFR	**175**
External borrowing	(118)
Internal borrowing	**57**
Less: Usable reserves	(56)
Less: Working capital	(48)
Net borrowing	**(47)**

* finance leases, PFI liabilities

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.

The treasury management position at 30th September 2018 and the change during the period is shown in Table 2 below.

	31.3.18 Balance £m	6 month Movement £m	30.9.18 Balance £m	30.9.18 Rate %
Long-term borrowing	108	0	108	5.8
Short-term borrowing	10	0	10	0.8
Total borrowing	**118**	**0**	**118**	**5.3**
Long-term investments	1	0	1	0.9
Short-term investments	34	7	41	0.4
Cash and cash equivalents	12	3	15	0.3
Total investments	**47**	**10**	**57**	**0.5**

4. BORROWING STRATEGY

At 30/9/2018 the Council held £108m of loans as part of its strategy for funding previous years' capital programmes and £10m of loans for cash flow purposes.

Over the last ten years borrowing the Council monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise the benefits of internal. Arlingclose assists the Council with this 'cost of carry' and breakeven analysis which did not indicate any value in borrowing in advance for future years' planned expenditure.

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.

The Council expects to borrow in the next six months and will assess whether this will continue to be using short term loans or to take out long term loans.

Borrowing Position at 30.09.18

	31.3.18 Balance £m	6 months Movement £m	30.9.18 Balance £m	30.9.18 Rate %
Public Works Loan Board	95	(2)	93	5.8
Bank (fixed-term)	16	0	16	4.2
Bank (short-term)	0	10	10	0.8
Total borrowing	**111**	**8**	**119**	**5.5**

PWLB Certainty Rate and Project Rate Update

The Council qualified for borrowing at the 'Certainty Rate' (0.20% below the PWLB standard rate) for a 12 month period from 1 November 2017. In September 2018 the Council submitted its application to the Treasury to access this reduced rate for a further 12 month period from 1 November 2018.

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.

Changes in the debt portfolio over the period have achieved a reduction in the level of borrowing as well as a reduction in credit risk by repaying loans from investment balances.

5. INVESTMENT ACTIVITY

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

The Welsh Government's Investment Guidance gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the 6 months, the Council's investment balance ranged between £79.4 and £31.4 million due to timing differences between income and expenditure. The investment position during the period is shown in the table below.

	31.3.18 Balance £m	**6 month Movement £m**	**30.9.18 Balance £m**
Banks & building societies (unsecured)	11.1	3.8	14.9
Covered bonds (secured)	2.1	(1.0)	1.1
Government (incl. local authorities)	25.0	(7.0)	18.0
Money Market Funds	9.3	(0.4)	8.9
Total investments	**47.5**	**(4.6)**	**42.9**

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 Authority'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.

Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2018/19.

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

Performance Report

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

	Credit Score	**Credit Rating**	**Bail-in Exposure**	**Weighted Average Maturity (days)**	**Rate of Return %**
31.03.2018	3.96	AA-	43%	48	0.55
30.06.2018	3.85	AA-	42%	52	0.69
30.09.2018					
Similar LAs	**5.78**	**A**	**58%**	**248**	**0.75**
All LAs	**4.21**	**AA-**	**62%**	**42**	**0.65**

Investments were made with banks and building societies and included call accounts, fixed-rate term deposits and certificates of deposit, Money Market Funds and covered bonds.

The average cash balances were £48.7m during the six months. Following a UK Bank Rate of 0.25% since August 2016 the rate was increased to 0.5% in October 2017 and then increased again in July 2018 to 0.75%.

The Council's budgeted investment income for the year is estimated at £0.17m. based on an investment outturn of 0.5% for the whole year.

Compliance Report

I can confirm compliance with its Prudential Indicators for 2018/19, which were set in March 2018 as part of the Council's Treasury Management Strategy Statement.

Debt Limits

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

	6 month Maximum	30.9.18 Actual	2018/19 Operational Boundary	2018/19 Authorised Limit	Complied
Borrowing	106.5m	106.5m	180m	190m	✓
PFI & finance leases	4.0m	4.0m	**0**	**0**	✓
Total debt	**110.5m**	**110.5m**	**180m**	**190m**	✓

Investment Limits

	H1 Maximum	30.9.18 Actual	2018/19 Limit	Complied
Any single organisation, except the UK Government	£6m	£43m	£6m each	✓
Any group of organisations under the same ownership	0	0	£6m per group	✓
Any group of pooled funds under the same management	0	0	£15m per manager	✓
Negotiable instruments held in a broker's nominee account	0	0	£30m per broker	✓
Limit per non-UK country	£3m	£4m	£6m per country	✓
Registered providers	0	0	£15m in total	✓
Unsecured investments with building societies	£3m	2.1m	£6m in total	✓
Loans to unrated corporates	0	0	£6m in total	✓
Money Market Funds	£32m	£8.9m	£30m in total	x

The maximum monetary amounts in table above are based on a maximum total of investments at £60 million. In April each year the Council receives two payments of government grant at the beginning of the month. This took the total investments over £60million for 14 days and therefore the money market investments were above the £30million threshold but always under 50% of the total investments.

Treasury Management Indicators

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

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating or credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment.

	Target	Actual
Portfolio average credit score	6.0	3.85

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.

	30.9.18 Actual	2018/19 Target	Complied
Total cash available within 3 months	14.8m	£10m	✓

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

	2017/18	2018/19	2019/20
Upper limit on fixed interest rate exposure	100%	100%	100%
Actual	100%		
Upper limit on variable interest rate exposure	50%	50%	50%
Actual	0%		

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

	Upper	Lower	Actual
Under 12 months	25%	0%	0%
12 months and within 24 months	25%	0%	0.3%
24 months and within 5 years	50%	0%	4.9%
5 years and within 10 years	75%	0%	16.3%
10 years and within 20 years	100%	0%	25.5%
20 years and within 30 years	100%	0%	12.7%
30 years and within 40 years	100%	0%	16.6%
40 years and within 50 years	100%	0%	8.7%

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 limits on the total principal sum invested to final maturities beyond the period end will be:

	2017/18	2018/19	2019/20
Limit on principal invested beyond year end	£40m	£20m	£10m
Actual	£2.18m	£0	£0

7. Investment Training

During the period, officers have attended investment training with Arlingclose and CIPFA relevant to their roles.

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.

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