MEETING:	**AUDIT AND GOVERNANCE COMMITTEE**
DATE:	**28 NOVEMBER 2019**
TITLE:	**TREASURY MANAGEMENT 2019/20 – 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 2019, the Council's borrowing and investments remained well within the limits originally set. There were no new defaults by banks in which the Council deposited money. Furthermore, it is estimated that the Council's actual investment income will exceed the expected income in the 2019/20 budget.

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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 2019/20 was approved by full Council on 8th March 2019. 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 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Council's Capital Strategy, complying with CIPFA's requirement, was also approved by full Council also on 8th March 2019.

2. EXTERNAL CONTEXT

Economic background: UK Consumer Price Inflation (CPI) fell to 1.7% year/year in August 2019 from 2.0% in July, weaker than the consensus forecast of 1.9% and below the Bank of England's target. The most recent labour market data for the three months to July 2019 showed the unemployment rate edged back down to 3.8% while the employment rate remained at 76.1%, the joint highest since records began in 1971. Nominal annual wage growth measured by the 3-month average excluding bonuses was 3.8% and 4.0% including bonuses. Adjusting for inflation, real wages were up 1.9% excluding bonuses and 2.1% including.

The Quarterly National Accounts for Q2 GDP confirmed the UK economy contracted by 0.2% following the 0.5% gain in Q1 which was distorted by stockpiling ahead of Brexit. Only the services sector registered an increase in growth, a very modest 0.1%, with both production and construction falling and the former registering its largest drop since Q4 2012. Business investment fell by 0.4% (revised from -0.5% in the first estimate) as Brexit uncertainties impacted on business planning and decision-making.

Politics, both home and abroad, continued to be a big driver of financial markets over the last quarter. Boris Johnson won the Conservative Party leadership contest and has committed to leaving the EU on 31st January 2020 regardless of whether a deal is reached with the EU. Mr Johnson prorogued Parliament which led some MPs to put forward a bill requiring him to seek a Brexit extension if no deal is in place by 19th October. The move was successful and, having been approved by the House of Lords, was passed into law. The Supreme Court subsequently ruled Mr Johnson's suspension of Parliament unlawful.

Tensions continued between the US and China with no trade agreement in sight and both countries imposing further tariffs on each other's goods. The US Federal Reserve cut its target Federal Funds rates by 0.25% in September to a range of 1.75% - 2%, a pre-emptive move to maintain economic growth amid escalating concerns over the trade war and a weaker economic environment leading to more pronounced global slowdown. The euro area Purchasing Manager Indices (PMIs) pointed to a deepening slowdown in the Eurozone. These elevated concerns have caused key government yield curves to invert, something seen by many commentators as a predictor of a global recession. Market expectations are for further interest rate cuts from the Fed and in September the European Central Bank reduced its deposit rate to -0.5% and announced the recommencement of quantitative easing from 1st November.

The Bank of England maintained Bank Rate at 0.75% and in its August Inflation Report noted the deterioration in global activity and sentiment and confirmed that monetary policy decisions related to Brexit could be in either direction depending on whether or not a deal is ultimately reached by 31st January 2020.

Financial markets: After rallying early in 2019, financial markets have been adopting a more risk-off approach in the following period as equities saw greater volatility and bonds rallied (prices up, yields down) in a flight to quality and anticipation of more monetary stimulus from central banks. The Dow Jones, FTSE 100 and FTSE 250 are broadly back at the same levels seen in March/April.

Gilt yields remained volatile over the period on the back of ongoing economic and political uncertainty. From a yield of 0.63% at the end of June, the 5-year benchmark gilt yield fell to 0.32% by the end of September. There were falls in the 10-year and 20-year gilts over the same period, with the former dropping from 0.83% to 0.55% and the latter falling from 1.35% to 0.88%. 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.65%, 0.75% and 1.00% respectively over the period.

Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth remains a global risk. The US yield curve remains inverted with 10-year Treasury yields lower than US 3-month bills. History has shown that a recession hasn't been far behind a yield curve inversion. Following the sale of 10-year Bunds at -0.24% in June, yields on German government securities continue to remain negative in the secondary market with 2 and 5-year securities currently both trading around -0.77%.

Credit background: Credit Default Swap (CDS) spreads rose and then fell again during the quarter, continuing to remain low in historical terms. After rising to almost 120bps in May, the spread on non-ringfenced bank NatWest Markets plc fell back to around 80bps by the end of September, while for the ringfenced entity, National Westminster Bank plc, the spread remained around 40bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 34 and 76bps at the end of the period.

There were minimal credit rating changes during the period. Moody's upgraded The Co-operative Bank's long-term rating to B3 and Fitch upgraded Clydesdale Bank and Virgin Money to A-.

3. LOCAL CONTEXT

On 30th September 2019, the Council had net borrowing of £56m 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 £176m, while usable reserves and working capital are the underlying resources available for investment. The Council had £106.7m of borrowing and £36.0m of investments.

These factors are summarised in the table below.

Balance Sheet Summary

	31.3.19 Actual £m	Movement £m	30.9.19 Actual £m
General Fund CFR	178	(2)	176
Less: *Other debt liabilities	(3)	0	(3)
Borrowing CFR	**175**	**(2)**	**173**
External borrowing	(118)	0	(118)
Internal borrowing	**57**	**(2)**	**55**
Less: Usable reserves	(74)	12	(62)
Less: Working capital	(27)	(22)	(49)
Net borrowing	**(44)**	**(12)**	**(56)**

* 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 2019 and the change during the period is shown in the table below.

Treasury Management Summary

	31.3.19 Balance £m	6 month Movement £m	30.9.19 Balance £m	30.9.19 Rate %
Long-term borrowing	106.4	(1.7)	104.7	5.6
Short-term borrowing	0	2.0	2.0	0.7
Total borrowing	**106.4**	**0.3**	**106.7**	**5.6**
Long-term investments	10.0	0	10.0	5.7
Short-term investments	10.0	9.0	19.0	0.9
Cash and cash equivalents	14.6	(7.6)	7.0	0.8
Total investments	**34.6**	**1.4**	**36.0**	**1.7**

4. BORROWING STRATEGY

At 30th September 2019 the Council held £104.7m of loans as part of its strategy for funding previous years' capital programmes and £2.0m of loans for cash flow purposes. Outstanding loans on 30th September are summarised in the table below.

Borrowing Position

	31.3.19 Balance £m	6 months Movement £m	30.9.19 Balance £m	30.9.19 Rate %
Public Works Loan Board	90.2	(1.7)	88.5	5.9
Bank (long term)	16.2	0	16.2	4.2
Local Authority	0	2.0	2.0	0.7
Total borrowing	**106.4**	**0.3**	**106.7**	**5.6**

The Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

With short term interest rates remaining much lower than long term rates, the Council considered it to be more cost effective in the near term to use internal resources and borrow short term loans instead. This strategy enabled the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

PWLB Certainty Rate and Project Rate Update

On the 9th October 2019 the standard PWLB interest rate rose by 1%, the Council does not foresee any PWLB borrowing requirement at present.

The Council qualified for borrowing at the 'Certainty Rate' (0.20% below the PWLB standard rate) for a 12 month period from 1 November 2018. In October 2019 the Council submitted its application to the Treasury to access this reduced rate for a further 12 month period from 1 November 2019.

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. During the 6 months, the Council's investment balance ranged between £71.2 and £33.0 million due to timing differences between income and expenditure. The investment position during the period is shown in the table below.

Treasury Investment Position

	31.3.19 Balance £m	6 month Movement £m	30.9.19 Balance £m	30.9.19 Income Returns %
Banks & building societies (unsecured)	15.2	(4.9)	10.3	0.9
Local authorities	0.0	9.0	9.0	0.9
Money Market Funds	9.4	(2.7)	6.7	0.8
Pooled Funds (intial investment)	10.0	0.0	10.0	5.7
Total investments	**34.6**	**1.4**	**36.0**	**1.7**

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. Interest of £ 287k was received in the period 1st April to 30th September 2019.

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 2019/20.

£10m of the Authority's investments are held in externally managed strategic pooled property and equity funds where short- term security and liquidity are lesser consideration, and the objectives instead are regular revenue income and long- term price stability. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued stability in meeting the Authority's investment objective are regularly reviewed.

The performance of our pooled property and equity funds at 30 September 2019 can be seen below:

FUND NAME	ASSET CLASS	No of Units Held in Period	Current Value £	Capital Growth £	Dividends Earned £	Holding Period (yrs)	Capital Return	Income Return	Total Return	Volatility
CCLA - LAMIT PROPERTY FUND	PROPERTY	1,524,344	4,559,770	-440,231	111,699	0.6	-8.80%	2.23%	-6.57%	7.5%
INVESTEC DIVERSIFIED INCOME FUND	MULTI ASSET	1,209,599	1,224,814	-25,186	38,652	0.6	-2.01%	3.09%	1.08%	2.2%
KAMES DIVERSIFIED MONTHLY INCOME FUND	MULTI ASSET	1,158,480	1,281,164	31,164	44,299	0.6	2.49%	3.54%	6.04%	3.9%
SCHRODER INCOME MAXIMISER FUND	EQUITY - UK	4,783,773	2,261,290	-238,710	165,007	0.6	-9.55%	6.60%	-2.95%	9.5%
GRAND TOTAL			9,327,038	-672,963	359,657	0.6	-6.73%	3.60%	-3.13%	4.9%
			Capital gains and losses under one year are not annualised		Annualised Returns:		-6.73%	6.10%	-0.63%	

It is evident that the combined capital value of £9.3m is less than the initial investment at 30 September 2019 of £10m. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters, and even years; but with the confidence that over a three to five year period total returns will exceed cash interest rates. Investment in these funds will be maintained in the medium term.

Investment Benchmarking

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 %
31.03.2019	3.96	AA-	43%	48	0.55
30.06.2019	3.85	AA-	42%	52	0.69
30.09.2019	4.97	A+	58%	43	0.86
Similar LAs	**4.22**	**AA-**	**52%**	**96**	**0.78**
All LAs	**4.19**	**AA-**	**62%**	**28**	**0.83**

Treasury Management Performance

The Council measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates.

The average cash balances were £58.4m during the six months and the UK Bank base Rate has been set at 0.75% since July 2018.

The Council's budgeted investment income for the year is £0.18m, however the actual expected investment income for the year 2019/20 is estimated at £0.4m. This is based on an investment return of 1.7% for the whole year. There has been a significant increase due to the Council now investing in pooled property funds, which was not forecasted in the budget.

6. COMPLIANCE

I can confirm that all treasury management activities undertaken during the period complied fully with CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

Debt Limits

	Maximum during period	**30.9.19 Actual**	**2019/20 Operational Boundary**	**2019/20 Authorised Limit**	**Complied**
Borrowing	£106.7m	£106.7m	£180m	£190m	✓
PFI & finance leases	£4.0m	£4.0m	£0	£0	✓
Total debt	**£110.7m**	**£110.7m**	**£180m**	**£190m**	✓

Investment Limits

	Maximum during period	**30.9.19 Actual**	**2019/20 Limit**	**Complied**
Any single organisation, except the UK Government	£6m	£5m	£8m each	✓
Any group of organisations under the same ownership	£0	£0	£8m per group	✓
Any group of pooled funds under the same management	£11m	£5m	£20m per manager	✓
Negotiable instruments held in a broker's nominee account	£0	£0	£40m per broker	✓
Limit per non-UK country	£3m	£2m	£8m per country	✓
Registered providers	£0	£0	£20m in total	✓
Unsecured investments with building societies	£4m	£4m	£8m in total	✓
Loans to unrated corporates	£0	£0	£8m in total	✓
Money Market Funds	£31.5m	£6.7m	£40m in total	✓
Real Estate Investment Trusts	£0	£0	£20m in total	✓

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**	**Complied**
Portfolio average credit score	6.0	4.97	✓

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.

	30.9.19 Actual	**2019/20 Target**	**Complied**
Total cash available within 3 months	£22.0m	£10m	✓

Interest Rate Exposures: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one year revenue impact of a 1% rise or fall in interest was:

Interest rate risk indicator	**2019/20 Limit**	**2019/20 Target**	**Complied**
Upper limit on one-year revenue impact of a 1% rise in interest rates	£761,000	£547,000	✔
Upper limit on one-year revenue impact of a 1% fall in interest rates	£0	£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:

	2019/20	2020/21	2021/22
Actual principal invested beyond year end	£2.2m	£0	£0
Limit on principal invested beyond year end	£20m	£20m	£20m
Complied	✓	✓	✓

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 2019/20 AND BEYOND

Remainder of 2019/20

The global economy is entering a period of slower growth in response to political issues, primarily the trade policy stance of the US. The UK economy has displayed a marked slowdown in growth due to both Brexit uncertainty and the downturn in global activity. In response, global and UK interest rate expectations have eased dramatically.

There appears no near-term resolution to the trade dispute between China and the US, a dispute that the US appears comfortable exacerbating further. With the 2020 presidential election a year away, Donald Trump is unlikely to change his stance.

Central bank actions and geopolitical risks will continue to produce significant volatility in financial markets, including bond markets.

Our treasury advisor Arlingclose expects Bank Rate to remain at 0.75% for the foreseeable future but there remain substantial risks to this forecast, dependant on Brexit outcomes and the evolution of the global economy. Arlingclose also expects gilt yields to remain at low levels for the foreseeable future and judge the risks to be weighted to the downside and that volatility will continue to offer longer-term borrowing opportunities.

	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Cas	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Downside risk	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75

Readiness for Brexit

The next scheduled leave date for the UK to leave the EU is now 31st January 2020 and there remains little political clarity as to whether a deal will be agreed by this date and there is the possibility that the exit date is pushed back yet again. As 31st January approaches the Authority will ensure there are enough accounts open at UK-domiciled banks and Money Market Funds to hold sufficient liquidity required in the near term and that its account with the Debt Management Account Deposit Facility (DMADF) remains available for use in an emergency.

Proposed changes

The Welsh Government is consulting on proposed changes to its Statutory Guidance on Local Government Investments to be effective from the 2020/21 financial year. This involves a complete re-write along the lines of the guidance issued last year by the Ministry of Housing, Communities and Local Government (MHCLG) for local authorities in England.

The definition of investments is widened to include “all of the financial and non-financial assets a local authority has invested money into primarily or partially for the purpose of generating a surplus including investment property” providing it has been made using the power to invest contained in the Local Government Act 2003. In addition, loans to wholly-owned companies or associates, to a joint venture, or to a third party count as investments, irrespective of the purpose or legal power used.